TAX FOUNDATION

TAX FEATURES©

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Could Dole Economic Plan Work? Foundation Analysis Says It's Plausible

In an analysis of the newly unveiled Dole economic plan, which would cut the average taxpayer's federal tax bill by roughly $750 (see Chart 1), a Tax Foundation study concludes that the program's projected deficit reduction — a point of great debate in the economic community — is indeed plausible.

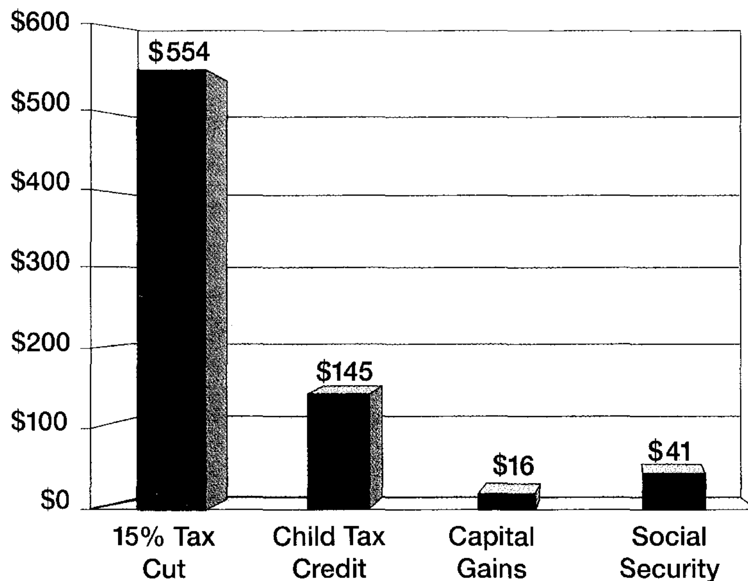

Chart 1: Average Tax Reduction Per Major Element of Dole Tax Plan, 1999

Source: Tax Foundation.

According to Dr. J.D. Foster, the Tax Foundation's Executive Director and Chief Economist, while the public debate hinges on whether lower tax rates can stimulate enough economic growth to increase federal receipts, the plan actually projects only modest output gains from the tax cuts. The balance of the deficit reduction stems from projected restraint in the growth of federal spending. The key questions here, observes Dr. Foster, are, first, whether the assumptions regarding accelerated economic growth are reasonable; and second, whether the proposed spending cuts would be sufficient to prevent the deficit from increasing, let alone to eliminate the deficit.

The centerpiece of the Dole plan is a set of tax cuts that, if enacted, are projected to reduce federal receipts by $548 billion over six years. (Chart 2 offers the main elements of the Dole tax cut package.) At the same time, Senator Dole calls for a balanced budget in that time frame, which some analysts have challenged as implausible.

In his analysis, however, Dr. Foster notes that the tax rate cuts are not the only source of economic growth in the plan. In all, there are four main sources of additional near-term economic growth contained in the Dole plan:

- Individual income tax rate cuts to reduce

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FRONT & CENTER

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Rep. Eleanor Holmes Norton (D-D.C.)

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Could Dole Economic Plan Work? It's Plausible

Chart 2: Provisions of Dole Tax Bill

Major Elements

- A reduction of personal income tax rates by 15% over 3 years.
- A reduction of the top capital gains tax rate to 14% from 28%. The capital gains rate for taxpayers in the 15% income tax bracket would be set at 7.5%.
- A $500 credit for every child 18 years of age and younger for low- and middle-income families.
- A $500 per child Education Investment Account. Accumulated earnings in these accounts would be tax free if the funds are left in the accounts for at least five years. Funds withdrawn from the accounts to pay for college education-related expenses would be tax-free.
- An expansion of Individual Retirement Accounts.
- Tax incentives for job training.
- To allow low- and middle-income parents and students to deduct interest paid on student loans for post-secondary education.
- To repeal the 1993 tax hike on Social Security benefits.

Minor Elements

- Prospective capital gains indexing.
- Estate tax relief.
- A tax credit for charitable contributions.
- A $1,000 deduction for custodial care of certain elderly dependents.
- Foreign sales corporation treatment for software.
- Reform of the independent contractor rules.
- Tax relief associated with State-sponsored college savings plans.
- Making permanent the exclusion for employer-provided educational assistance.
- Penalty-free withdrawals from IRAs and pension plans for education and training.
- Increasing deductibility of health insurance.
- Premiums to 100 percent for self employed workers.
- Clarifying the definition of principal place of business.
- Reducing the depreciation life of semiconductor manufacturing equipment from five to three years.

Dole Economics

Continued from page 1

the tax system's disincentives to work, save, and invest.

- A capital gains tax rate cut to spur capital formation and saving by reducing the cost of capital.
- Restraints in federal spending (see Chart 3) to increase the resources available to the private sector.
- The reduction in the budget deficit (see Chart 4) to reduce the borrowing requirements of the federal government. Some analysts observe that a declining budget deficit allows inflation-adjusted interest rates to fall, thereby encouraging additional investment.

In effect, observes Dr. Foster, the subsequent income growth effect predicted by the Dole campaign represents the increase in revenues assumed to follow from the enactment of the overall program, not just the tax relief elements.

The Dole program lists $217 billion in proposed spending restraint over six years relative to current law, as shown in Chart 3. Of this amount, the $34 billion from auctioning radio spectrum is actually not a reduction in spending but is similar to an asset sale, so the spending restraint would only reduce outlays by $183 billion. To put this figure into perspective, it represents 1.8% of the total $10.4 trillion the federal government would otherwise expect to spend over the next six years if current law is maintained. Judged in this light, the spending restraint is plausible, even minor, says Dr. Foster, if the Congress and the President could agree on where to restrain.

The report goes on to examine the Dole program's assumptions in terms of economic growth. According to the revenue estimates associated with the income growth effect from tax rate cuts, the Dole plan appears to assume the pattern of economic growth as seen in Chart 5.

Senator Dole's plan assumes the economy will be 3 percent bigger in 2002 than it would be without the program. Also, after a minor initial surge, the economy is projected to settle down to about a 2.6 percent annual growth rate, or about 0.3 of a percentage point higher than would otherwise be the case. Such a projected increase for such a modest tax reduction proposal might be questioned. But Dr. Foster believes that, based on an overall program including tax reform, a balanced budget, and regulatory and tort reform, the accelerated growth assumed in this plan appears entirely reasonable.

In particular, the surge in growth projected to occur in 1999 coincides with the completion of the 15% rate reduction. Projecting a temporary surge is reasonable because part of the benefit of the lower marginal tax rates arises as the lower rate induces individuals to move out of activities and investments made artificially favorable by the former, higher tax rates.

A common analysis of tax programs is the presentation of the distribution of the tax changes over various income groups. On average, taxpayers with incomes below $25,000 would see their income tax burden eliminated. It is important to realize, however, that some of this tax relief derives from the $500 child credit. Thus, families with

Dole Economics *continued on page 6*

Chart 3: Proposed Spending Reductions

Proposed Reduction	6-Year Savings
10% Cut in Non-Defense Administrative Costs	$90 billion
FCC Spectrum Auction	$34 billion
Non-Defense Program Reductions:	
Energy Department	$32 billion
Commerce Department	$15 billion
1% Reduction in Other Spending Programs	$46 billion
Total Savings	$217 billion

Source: Dole for President.

Four Tax Bills, Viewed Altogether, Loom Large

When viewed in their entirety, the four bills that Congress passed prior to closing for the August recess — including health care reform, providing taxpayers with more effective protections against IRS actions, welfare reform, and a combination minimum wage increase, small business tax relief, and miscellaneous provisions bill — make 170 changes either directly affecting taxes owed or tax administration, according to an analysis by the Tax Foundation.

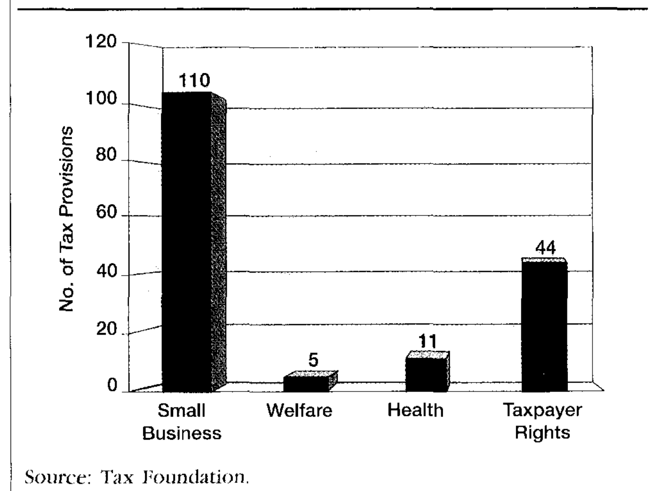
In his latest Special Report, "Analysis of the Four New Tax Laws," Tax Foundation Executive Director and Chief Economist J.D. Foster provides a summary of the fiscal impact of this summer's tax policy changes. In purely dollar terms, he calculates, the small business tax relief bill is the largest of the four bills, involving over $25 billion in tax increasing provisions and $21 billion in tax reducing provisions over the 1996 to 2006 time period. Together, the four bills include $52.9 billion in tax increases, $41.5 billion in tax reductions, and represents a net reduction in the budget deficit of $11.4 billion over the period. (See Chart 2 for largest tax increases and decreases.)

According to Dr. Foster, the four bills illustrate that there remains a strong tendency among policy makers to use the tax code as a tool of social or economic engineering.

These bills also demonstrate the many ways in which the income tax is an "ideal tool" for augmenting other policies. For example, the Earned Income Tax Credit is a basic element of the federal income maintenance system. And the repeal of the Section 936 Possessions Tax Credit eliminates a fundamental component of the fiscal relationship between the federal government and U.S. possessions such as Puerto Rico.

"Like any complex and heavily used piece of machinery, the federal income tax code requires occasional fine tuning and adjustment," says Dr. Foster. Without such changes, the fundamental complexities of an income tax and the evolution of the economy create unintended tax relief or mis-allocations of national resources. Also, says Dr. Foster, "While the Internal Revenue Code and the IRS are asked to do more, often with insufficient resources and an overabundance of congressional meddling, some taxpayers will inevitably be caught in the works." Recognizing this danger, he says, and recognizing the political advantages of standing up to the IRS, the Congress has now made finding new ways to protect the taxpayer part of its regular legislative program.

Chart 1: Number of Tax Provision in the Four New Tax Bills



Source: Tax Foundation.

Welfare Reform Legislation

The welfare reform bill represents a major shift in the federal government's approach to assisting those in need, while reducing the federal budget deficit by over $6.9 billion over the next six years. Only the bill's provisions relating to the Earned Income Tax Credit (EITC) affect tax policy.

The EITC is a refundable credit of up to $3,560 annually for a family with two or more children (lesser amounts for single workers and families with one child). A family with two children qualifies for the EITC by having wage income of no more than $28,524. The changes to the EITC, which yield $3.2 billion in savings over six years, include stablishing that the credit could only be claimed by individuals with valid taxpayer identification numbers, thereby excluding illegal aliens from the benefits; and requiring taxpayers to include previously excluded elements of capital income such as net capital gains.

Health Care Reform Legislation

The health care reform bill will induce important changes in the nation's health care system, particularly if the bill's most contentious provision, the medical savings accounts (MSAs), works as advertised in instilling greater market discipline in the health care system. The health care reform bill raises $20.4 billion in new revenues while providing about the same amount of tax relief, for a net of $12 million in deficit reduction over the next six years.

The MSA program is experimental and temporary. The bill directs the Treasury to monitor the development and use of MSAs. Under the bill, after December 31, 2000, no new MSA policies may be written, though individuals with MSA policies may continue to make tax deferred contributions. The expectation is that the Congress and the President will re-evaluate the program in the year 2000 to determine whether the program should be continued and, if so, whether changes are in order.

Minimum Wage and Small Business Tax Relief Legislation

This bill could more accurately be called the Minor Omnibus Tax and Minimum Wage Act of 1996 as it includes tax provisions relating to small businesses, pensions, reforms of the Subchapter S rules, international tax provisions, previously expired provisions, miscellaneous issues, and to revenue raising, all in addition to the minimum wage increase. On balance, the bill offers $21 billion in tax relief over 10 years, offset by $25 billion in tax increases, for a net of $4 billion in deficit reduction.

The minimum wage increases from $4.25 an hour to $4.75 effective October 1, 1996, and to $5.15 an hour effective September 1, 1997. The bill

New Tax Laws *continued on page 7*

A Flat Tax to Stabilize the District of Columbia

By Rep. Eleanor Holmes Norton (D-D.C.)

On behalf of the taxpayers who pay the highest combined state and federal taxes in the United States, I have introduced the District of Columbia Economic Recovery Act (DCERA). This bill is the missing part of the strategy needed to revive the economy of the District of Columbia. By providing tax discounts that are progressive according to income, the DCERA empowers residents to use their own money to help revive their own city. The money referred to in the bill does not come from any government and will not go to any government. These funds belong to D.C. taxpayers. The best and most natural way to support the city economy is the old-fashioned way — keeping and attracting middle income residents.

The days of the District as a stand alone, self-sufficient orphan are over. The District's extraordinary self-sufficiency lasted so long only because taxpayers remained so long. These local D.C. taxpayers tolerated the steep local taxes that were necessary to pay state, county, and municipal costs without help from a state. Now, those days are over. Fleeing the beautiful city many still love, they take with them the city's only reliable means of support.

> ***Between 1990 and 1995, 46,000 Washingtonians left, compared with 33,432 for the entire 1980s. This is probably the last chance to do anything about it. There is no precedent for rebuilding a tax base once it has been completely depleted.rity taxes as a business expense.***

Most Americans, including most members of Congress and other officials, are unaware of exactly what is different about the District, except for its status as the nation's capital. They see Washington, D.C., as another big city, like those in their own states. Even the best and brightest among them are genuinely surprised to learn of the unique features that set the District apart and are taking the District down. Even the most unfortunate of cities share none of the district's built-in disabilities: no state to recycle income from wealthier areas or from fleeing taxpayers; no exception granted from state responsibilities and costs; no commuter tax allowed by mandate of the Congress; no full self-government or representation in the Congress of the United States.

The only wonder is that the capital of the United States lasted in its present form with these disabilities for so long. It will not last much longer. The sine qua non of the city's economy, a tax base, is disappearing fast. Between 1990 and 1995, 46,000 Washingtonians left, compared with 33,432 for the entire 1980s. This is probably the last chance to do anything about it. There is no precedent for rebuilding a tax base once it has been completely depleted. There is plenty of experience that shows it can't be done.

But what if the Congress forgave a portion of federal income taxes to encourage residents to remain and revive the city the old-fashioned way — by living in the District, paying local taxes and spending their disposable income in the city? The tax code is replete with tax breaks, most to individuals and entities far better off than the District.

I did not develop the District of Columbia Economic Recovery Act until I was left without any other alternative. As a genuine plea for help, I have challenged any and all to suggest other ideas that would do the job. I have heard only the sound of silence.

This bill will not fund the District government. The District will benefit in the way governments should benefit — from the disposable income and taxes its residents pay in due course, not from the losing exercise of increasing taxes the residents and businesses that remain, and not from the dwindling hope that a Congress making the largest cuts in history will suddenly supply our every need.

The DCERA has already had an extraordinary confidence restoring effect in the city. It has united blacks, whites, and Hispanics, and struggling and well-to-do people. Anyone who goes into the District's neighborhoods

will tell you, from Ward 1 to Ward 8, the enthusiasm and the chorus is the same: do it and we'll stay.

The DCERA will reduce federal income taxes in three ways.

First, the standard deduction and personal exemption, instead of amounting to $6,400, will be more than twice as large — $15,000 for single filers, $25,000 for single heads of households, and $30,000 for married joint filers. This means that residents in those categories with incomes below $15,000, $25,000, and $30,000 will pay no federal income tax.

Second, a uniform rate of 15% will be applied progressively up the income scale to reduce present tax liability — from a 79% reduction for those with the most modest incomes ($15,000 to $30,000) to a 34% reduction for those with the highest incomes ($20,000 and above). The uniform rate rescues residents from bracket creep, the mechanism that taxes away a portion of an individual's income as it increases from one bracket to the next.

Third, the mortgage interest and charitable deductions remain. The home mortgage deduction is especially vital because homeowners make a sizeable investment in the city and make the commitment to remain here and pay vital property taxes. Often they are families with children and can help improve city schools.

The bill also seeks to spur business and economic development in the city in two ways.

First, the DCERA exempts capital gains so long as they derive from District investments by District residents.

Second, investment income will qualify for the low 15% rate, so long as these are investments in activity within the District by District residents. Social Security income and income from traditional IRS-qualified pension plans also qualify for the low DCERA rate.

The bill goes to great lengths to prevent unnatural consequences, such as gentrification, unnatural rises in property values, or tax shelter effects. The most important safeguards are the limitation of the bill's benefits to D.C.'s sourced income alone and to bona fide D.C. residents alone — defined as those whose "place of abode" is in the District, who are physically present in that place of abode for at least 183 days, and who pay D.C. income taxes. Naturally, District residents who choose to live in the District, although they work in the "consolidated metropolitan statistical area," will also receive the tax reduction. The further safeguard against gentrification, the D.C. City Council, in response to my introduction of the DCERA, has already enacted a bill which freezes property taxes, as well as income and sales taxes, for five years.

> ***My bill also contains the seeds for a new tax-based urban policy. However, it must be modeled somewhere first, and there is no better place to begin than in the nation's capital. Urban policy based on federal funding has been dead for almost 20 years.***

My bill also contains the seeds for a new tax-based urban policy. However, it must be modeled somewhere first, and there is no better place to begin than in the nation's capital. Urban policy based on federal funding has been dead for almost 20 years. Elements of the DCERA should be carefully studied when operative to identify features that might be used elsewhere. I would also encourage states to offer a break in state taxes to encourage residents to remain in cities.

The effects of the DCERA, of course, will not be immediately felt, although the tax break would become effective immediately. The inevitable time lag makes it important to consider the bill now. With no viable revenue stream in sight, the District must seek a practical and reliable way to achieve one now, and begin to work to produce the possibility of new revenue. It will be too late to start looking four years from now, when the city is mandated to have a permanently balanced budget.

The DCERA will not cure all that ails the District, but is is the most promising approach available to us. Tax cuts of one kind or another have been embraced by Democrats, Republicans, and the Administration; tax increases have been spurned by all. Nor will the absence of full democracy in the District, the inexcusable and indelible stain on the American polity, be eliminated by the DCERA. If the DCERA is enacted, D.C. residents will continue to pay federal income taxes without full federal representation, and D.C. citizens still do not have full democracy, home rule, or independence. Hopefully, however, if the DCERA is enacted, we at least will no longer be second in per capita income taxes paid to the federal government.

The Tax Foundation invites a national leader to provide a "Front and Center" column each month in Tax Features. *The views expressed in these columns are not necessarily those of the Tax Foundation.*

Could Dole Economic Plan Work? It's Plausible

Dole Economics

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children in this income range are almost certain to pay no income tax, while tax filers without eligible dependents may still owe some income tax. Filers in the next highest income group ($25,000 to $50,000) would experience a 24 percent drop in their income tax liability, on average, while the corresponding figures for the other income ranges are: a 19 percent drop for $50,000 to $75,000; a 16 percent drop for $75,000 to $100,000; an 11 percent drop for $100,000 to $200,000; and a 10 percent drop for income over $200,000.

Dr. Foster concludes that Senator Dole's proposed spending restraints, like the amount of assumed additional economic growth, appear modest, and so it is not unreasonable to expect that a Congress and President working together could achieve these goals. "The remaining question that only President Clinton and Senator Dole can argue, and that only the electorate can decide," says Dr. Foster, "is whether the reductions in spending would be wise and whether the promised tax relief is a fair trade for this amount of spending restraint."

Chart 4: Six-Year Budgetary Consequences of Dole Tax Proposal, 1997–2002 (Billions$)

	1997	1998	1999	2000	2001	2002	Total
Baseline Revenues (CBO Adjusted)	$1,498	$1,564	$1,635	$1,710	$1,790	$1,875	$1,0072
Tax Reductions	-12	-58	-99	-123	-127	-129	-548
Income Growth Effect	2	12	25	34	36	38	147
Projected Revenues	1,488	1,518	1,561	1,621	1,699	1,784	9,671
Budget Resolution Outlays	1,622	1,769	1,718	1,765	1,797	1,842	10,423
Proposed Spending Restraint	13	27	35	38	45	59	217
Deficit	121	134	122	106	53	-1	

Source: Dole in '96 campaign.

Chart 5: Six-Year Economic Growth Projection for Dole Tax Proposal, 1997–2002

	1997	1998	1999	2000	2001	2002	Total
Current Law	2.3%	2.3%	2.3%	2.3%	2.3%	2.3%	13.8%
New Growth	0.1	0.6	0.8	0.7	0.4	0.3	3.0
Total Projected Growth	2.4	2.9	3.1	3.0	2.7	2.6	16.9

Note: Totals may not correspond due to rounding.
Source: Dole in '96 campaign.

Mark Your Calendar

59th National Conference

"Does Social Security Have a Future?"

and Annual Dinner

November 21, 1996

The Waldorf=Astoria, New York City, N.Y.

New Tax Laws

Continued from page 3

increases the limit on expensing for small businesses to $25,000, phased in over eight years. Also, the bill allows owners to use the 15-year depreciation schedule for convenience stores, fast-food stores, and other structures installed at gasoline stations. And the bill extends the credit retroactively to off-premises employees.

The bill also includes important

Chart 2: Largest Tax Increases, Decreases in New Laws

Provision	Amount of Increase
Disallow interest deduction for corporate-owned life insurance	$16.0
Repeal the Possessions Tax Credit	$10.6
Modify the Earned Income Tax Credit	$ 6.7
Repeal the 50% interest income exclusion for loans to Employee Stock Ownership Plans	$ 2.3
Apply math error rules for dependency exemptions	$ 2.2
Reinstate the Airport and Airway Trust Fund excises	$ 1.6

Provision	Amount of Decrease
Provide tax relief related to long-term care insurance	$ 7.8
Increase the self-employed health insurance deduction	$ 6.4
Increase the expensing limitation for small businesses	$ 4.7
Ease the tax treatment of accelerated death benefits	$ 3.0
Allow Medical Savings Accounts for some taxpayers	$ 3.0
Allow a $5,000 adoption tax credit	$ 2.2
Modify treatment of foreign trusts	$ 2.1
Increase the availability of spousal Individual Retirement Accounts	$ 2.1
Repeal the bad debt reserve deduction for thrift institutions	$ 1.9
Extend the Research and Experimentation tax credit	$ 1.8
Extend the employer-provided education assistance exclusion	$ 1.1

Source: Tax Foundation.

New Tax Laws *continued on page 8*

FOUNDATION MESSAGE

J.D. Foster
Executive Director & Chief Economist

The Minimum Wage Message

Imagine you own a small business employing 20 people, about half of whom are paid the minimum wage. Some of your minimum wage workers are teenagers, others are people who drift from job to job, still others are trying to raise a family. All of them are hard working because you can't afford to get less than a full day's work out of anyone. After all, you're trying to run a business.

You started your business a few years back with money you'd saved and borrowed from your family. You also had to borrow against your house. And in the first couple years the times were lean. You almost lost the house. You rarely saw your family. But through hard work, taking risks, and a little luck, you've made it. The business is sound, customers are happy, taxes get paid, government regulations are met, and you're finally able to provide for your family off the company's profits.

Now along comes President Clinton happily signing a bill passed by a mostly Republican Congress saying you have to pay your minimum wage workers 90 cents more an hour. It doesn't seem like much, but it means your annual labor costs just went up over $20,000, not counting overtime. Where's the money to come from? From you, of course. These higher costs come right out of your bottom line. After taking the risks, putting in the hours, and making it all work, the government has decided you should take a portion of what you earn and give it to some of your workers.

The minimum wage represents a classic case of using government power to transfer income from one group to another.

The minimum wage represents a classic case of using government power, in this case the labor laws, to transfer income from one group to another. It transfers income from the owners of small businesses to their employees. It's an implicit tax on small businesses used to supplement the welfare system for low-wage workers. One difference between the minimum wage and other programs like the Earned Income Tax Credit is that the cost of the EITC is shared among all taxpayers. A select few bear the costs of the minimum wage.

Another difference, is that the costs of the minimum wage program don't show up in the federal budget. They only appear on the ledgers of the small businesses who pay those costs.

Of course, sometimes businesses will raise their prices, but they will still lose out as sales drop. And when prices increase, consumers get to pay the cost of the minimum wage hike, just as they would an increase in the sales tax. Lower- and middle-income taxpayers consume a greater share of their current income than upper-income taxpayers. So a price increase following a minimum wage hike is essentially a tax increase paid mostly by low- and middle-income consumers to finance additional income to low-income workers.

Too often, the minimum wage debate devolves into running battles among economists about how many jobs would be lost. Job creation (and destruction) is important, but this focus is far too narrow. The real message of the minimum wage hike is that the politics of tax and transfer are alive and well. Some pay, mostly small businessmen out of their income, so that others may benefit. Kind of reminds you of: From each according to his means, to each according to his needs, doesn't it. And you thought socialism was dead.

Four Tax Laws Add Up to Big Changes

New Tax Laws

Continued from page 7

changes to the rules relating to Subchapter S corporations. For tax purposes, the income of an S corporation is subject to a single level of tax at the ownership level, in contrast to the double level of tax associated with a C corporation. The S corporation reforms generally relax some of the strictures on ownership and activities that previously applied.

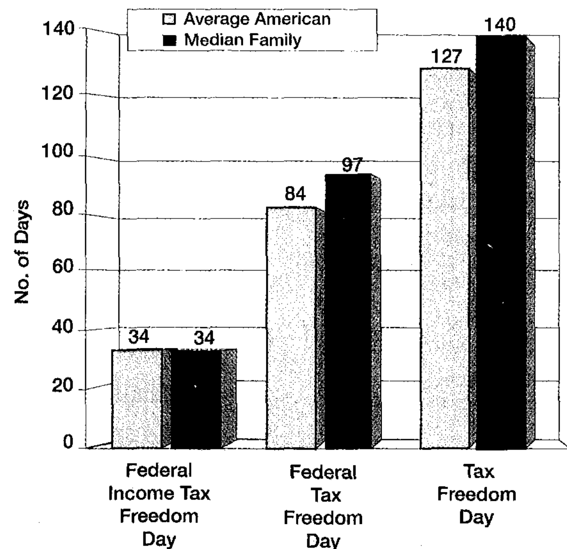
Taxpayer Bill of Rights 2 (H.R. 2337)

The first Taxpayer Bill of Rights was enacted in 1988 and was championed by Senator David Pryor (D-AR). T2, as the 1996 version is called, also originated through Senator Pryor's efforts. The total cost of the taxpayer provisions is $138 million over the fiscal years 1996 to 2000.

Most important, the bill replaces the taxpayer ombudsman with a newly created "taxpayer advocate." The taxpayer advocate will be at the same level in the sense of rank as the IRS chief counsel and will be appointed by the Commissioner. The taxpayer advocate will, among other things, assist taxpayers in resolving problems with the IRS and write reports to the congressional taxwriting committees proposing administrative and legislative changes to address these problems.

TAX BITE

Federal Income Tax Freedom Day, Federal Tax Freedom Day, and Tax Freedom Day, 1996



Source: Tax Foundation.

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