TAX FOUNDATION

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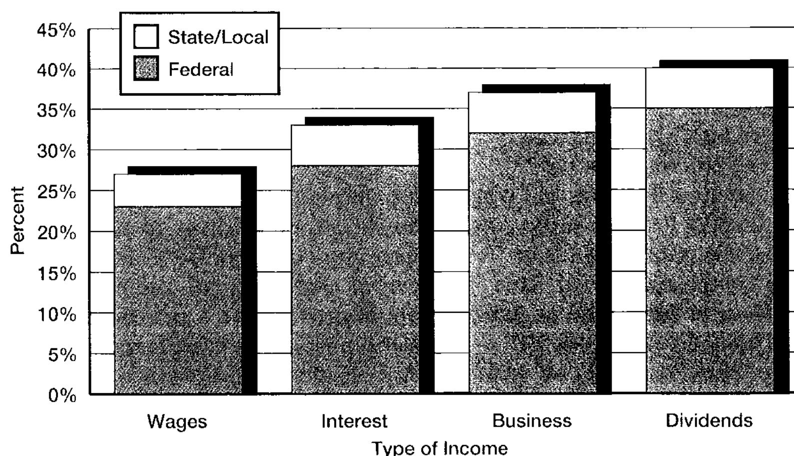
Effective Marginal Tax Rates Punish Investments

New Study Examines Effective Rates by Income, State

According to a newly released *Special Report* by the Tax Foundation, substantial differences between the marginal tax rates on wages and on savings and investment have created a strong disincentive to save, contributing to the current low level of saving in the United States.

In his study on "Individual Effective Tax Rates in the United States," Senior Economist Arthur Hall has determined the effective marginal tax rates for various types of income, and the effective average tax rates by income group and by state. Effective average tax rates represent the actual tax burden on taxpayers, after such things as deductions and exemptions are taken into account. Effective marginal tax rates, however, provide a more relevant measure of economic disincentives caused by taxation, says Dr. Hall—"because it's at the 'margin' that people decide whether it is worthwhile to work more or less, or to save more or less."



Source: Tax Foundation.

According to Dr. Hall's analysis, effective marginal tax rates for income from savings and investment are far higher than for income from wages. For example, in 1993 the total effective marginal tax rate was 39.9 percent for dividend income, 36.9 percent for proprietary business income, and 32.8 percent for interest income, compared to 27.4 percent for income from wages (*see Chart 1*). "These substantial differences in marginal rates create a strong disincentive to save, and contribute to the low level of private saving in the U.S.," states Dr. Hall.

These differences reflect not only a heavier tax burden for entrepreneurs and upper-income individuals, but also for senior citizens. As individuals reach retirement age, the proportion of their wage income generally falls

Effective Tax Burden continued on page 3

FRONT & CENTER

House Leaders Shouldn't Block "A to Z" Bid to Trim Federal Spending

Rep. William H. Zeliff, Jr. (R-N.H.)

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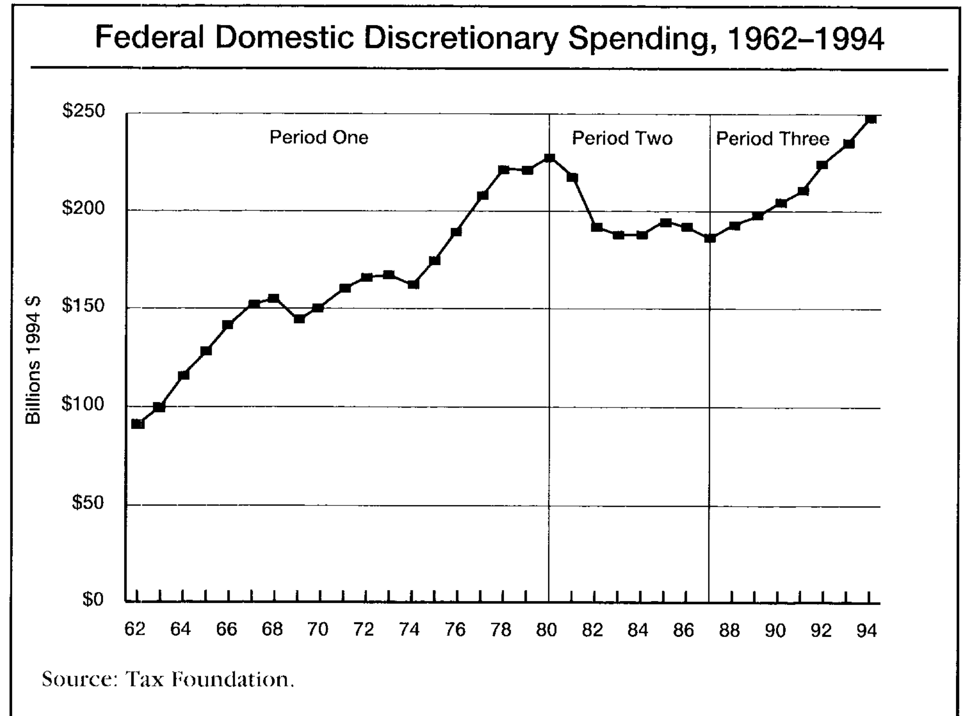
"A–Z" Spending Cuts Plan Has Potential to Do What Others Have Not, Foundation Study Says

A congressional proposal to cut federal spending, the "A - Z Spending Cuts Plan," has the potential to succeed where other spending-cut measures failed because it includes a one-time alteration of procedures, says a new study by the Tax Foundation. The A-Z plan was authored by Reps. Rob Andrews (D-N.J.) and Bill Zeliff (R.-N.H.).

"Cutting Federal Spending May Be as Easy as A to Z," by Foundation Economist Patrick Fleenor, provides an overview of recent attempts to curtail federal domestic outlays and reduce the budget deficit. As Mr. Fleenor observes, none of the proposals, going back to 1980, has achieved the level of success initially expected from legislators.

The study shows that, in terms of domestic discretionary spending, the past three decades can be divided into three distinct periods: 1962 to 1980, in which domestic discretionary spending soared; 1981 to 1987, when substantial cuts were made in this type of spending; and 1988 to the present, when domestic discretionary spending began growing again.



Source: Tax Foundation.

Between 1962 and 1980, domestic discretionary spending at the federal level grew over twice as fast as the overall economy. Some domestic categories—such as education, training, employment, and social services; income security; and Medicare—increased between eight and 12 times as fast as the U.S. economy.

However, starting with the Fiscal Year 1981 budget, domestic discretionary spending started falling. Two major pieces of legislation, the Omnibus Budget Reconcilation Act of 1981 (OBRA'81) and the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings), helped reduce and control this federal spending during most of the 1980s. By 1987, domestic discretionary spending had dropped 18.5 percent from its peak of $228.1 billion (1994$) in 1980.

Since 1987, though, this spending has risen rapidly, again outpacing the growth of the overall economy by a ratio of over nearly two to one.

"This rapid rise occurred during the same period that two significant pieces of budget legislation, ostensively aimed at controlling federal spending and reducing the deficit, were passed," observed Mr. Fleenor. The first bill was the Omnibus Budget Reconcilation Act of 1990 (OBRA'90), more popularly known as the 1990 Budget Deal. This included the Budget Enforcement Act (BEA), which placed ceilings for FY 1991-1993 on domestic, defense, and international spending.

The Omnibus Budget Reconciliation Act of 1993 (OBRA'93), like its predecessor, included limits on the growth of discretionary spending for later years, while extending the BEA enforcement mechanism until FY 1998.

Yet domestic discretionary spending in 1994 is expected to be $247.7 billion, or 38.2 percent greater than it was in 1987—compared to a rise in GDP of 13.3 percent in the same period. Domestic discretionary spending grew more rapidly between FY 1991 and FY 1995 than at anytime since the late 1970s.

The record of the various proposals aimed at controlling federal spending and reducing the deficit since 1980 is mixed, says Mr. Fleenor. Will the "A-Z Spending Cuts Plan" work?

Unlike past attempts, A-Z does not simply limit federal spending, nor does it offer a package of specific spending cuts, like the Penny-Kasich plan of 1993. Instead, the measure would provide for a one-time alteration of the process by which spending cuts are considered. Currently, any proposal to cut spending must work its way through the congressional committee system, which according to Mr. Fleenor tends to confer a disproportionate amount of power over the spending decisions on committee chairmen and other members of the leadership.

The Andrews-Zeliff proposal attempts to change the politics of the federal spending process by creating a special House session, during which proposals to cut spending would be considered by all members. Reps. Andrews and Zeliff hope that such a session will produce long overdue cuts in federal spending which have been stymied by the committee system. •

Effective Tax Rate

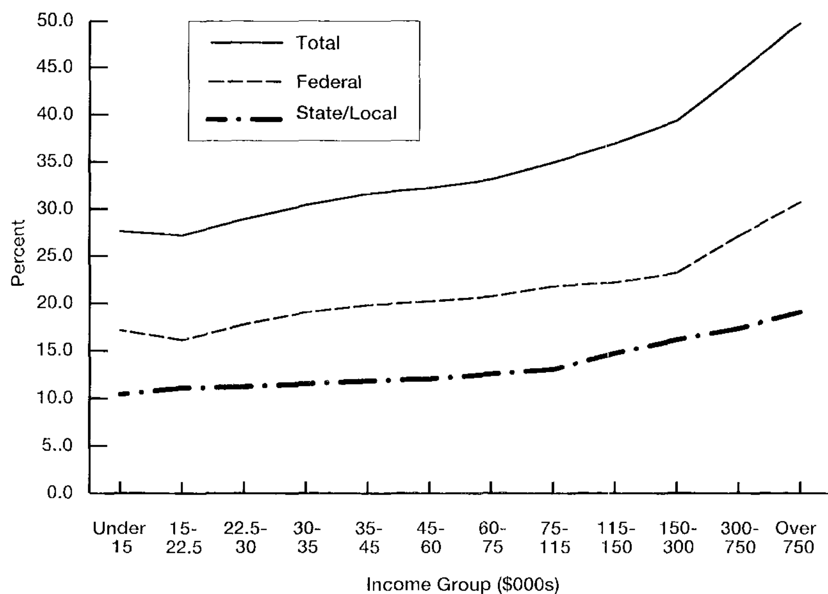
Continued from page 1

Chart 2: 1993 Effective Average Tax Rates by Income Group (Percent)

Income Group	Total	Federal	State/Local
under $15,000	27.6%	17.1%	10.4%
$15,000 under $22,500	27.2	16.1	11.1
$22,500 under $30,000	28.9	17.7	11.2
$30,000 under $35,000	30.4	19.0	11.5
$35,000 under $45,000	31.6	19.8	11.8
$45,000 under $60,000	32.2	20.2	12.0
$60,000 under $75,000	33.1	20.7	12.5
$75.000 under $115,000	34.9	21.8	13.0
$115,000 under $150,000	36.9	22.2	14.7
$150,000 under $300,000	39.3	23.2	16.1
$300,000 under $750,000	44.4	27.1	17.3
$750,000 or more	49.7	30.7	19.0
Total	34.6%	21.3%	13.2%

Source: Tax Foundation

Chart 3: 1993 Effective Average Tax Rates by Income Group



Source: Tax Foundation

and the proportion of their income from investments rises—investments that, as Dr. Hall has noted, are taxed at a much higher effective marginal rate. This tax burden was made even heavier by the 1993 tax bill, which increased marginal tax rates most substantially on income from saving and investment. Effective marginal tax rates for interest income rose 1.8 percentage points, for business income rates rose 3.3 percentage points, and for dividend income rates rose 3.4 percentage points. On the other hand, the rate increase on labor income amounted to 0.7 percentage points.

In his study, Dr. Hall also examined the effective average tax rates for the typical taxpayer in various income groups. Except for a dip at the low end of the income spectrum caused by the regressivity of federal payroll taxes, Charts 2 and 3 show the progressiveness of the total tax burden in the U.S. The average tax burden for the lowest income group (under $15,000) is 27.5 percent, compared to an average tax burden of 32.2 percent for middle-class Americans ($45,000-$60,000) and an average rate of 49.7 percent for the nation's wealthiest citizens ($750,000 and over). The effective average tax rate for the nation as a whole is 34.6 percent.

Connecticut, New York, New Jersey, Ohio, and Massachusetts comprise the states with the highest total effective average tax rates in the country—that is, residents of these states on average have the highest tax burden. In Connecticut, the effective average tax rate is 40.8 percent (26.5 percent for federal taxes and 14.3 percent for state and local taxes).

On the other hand, South Dakota, Arkansas, Idaho, Louisiana, and New Mexico have the lowest effective average tax rates. South Dakota's effective average tax rate is 28.3 percent (17.9 percent for federal taxes and 10.4 percent for state and local taxes).

However, Hawaii, New York, Minnesota, California, and Delaware have the highest total effective *marginal* income tax rates. (If Washington, D.C. were a state, it would rank second.) This means that, on average, residents of these states pay the nation's highest rates on each additional dollar they earn during the year.

South Dakota, Tennessee, Wyoming, Washington, and Florida have the lowest total effective marginal income tax rates. Not surprisingly, these low-ranked states, with the exception of Tennessee, impose no state (or local) income taxes. •

House Leaders Shouldn't Block "A to Z" Bid to Trim Federal Spending

Rep. William H. Zeliff, Jr. (R-N.H.)

The A to Z spending cut legislation is an innovative approach to cutting government spending. The plan, with its 230 cosponsors (175 Republicans, 56 Democrats), allows individual members of Congress to propose specific spending cuts. Each of these proposals will be debated and each will be voted on in an up-or-down, recorded vote.

And that is what is alarming the House leadership.

There have been many weak excuses over the years as to why Congress cannot balance the budget and live within its income, like ordinary folks and American businesses routinely do. In May, the House Democratic leadership set a new standard for blatant hypocrisy in an all-out attack on the A to Z spending cuts plan.

There have been many weak excuses over the years as to why Congress cannot balance the budget and live within its income, like ordinary folks and American businesses routinely do. In May, the House Democratic leadership set a new standard for blatant hypocrisy.

Speaker Tom Foley was quoted as saying, "The A to Z spending cuts plan was the most poorly thought-out proposal for the consideration of public policy that I have seen in years, because it does not allow members of Congress time to study the details of the proposals before voting."

Mr. Foley went on to say: "It denies the opportunity to members to have thoughtful consideration and review of legislation prior to votes. Just having a free-for-all out there of voting on bills that members haven't had an opportunity necessarily to read."

This concern for members' ability to study legislation before voting came from the very same mouths of the House leadership that, in November 1991, pushed through by voice vote a $30 billion bail out of the Federal Deposit Insurance Corporation while congressional staff were still sequestered putting together the legislative language. That's right—the House leadership that is now so concerned about the members' rights to study spending cuts legislation passed that $30 billion bailout before the bill was even drafted. Of course, members did not have copies to study—because they did not yet exist.

That same night, the House leadership, now so concerned about how public policy procedures are considered, jammed through another $25 billion expenditure. The leaders voted to bail out the Resolution Trust Corporation on a standing vote, so that the public—which they now want to protect—would not know who voted for the $25 billion. Again, this huge legislative proposal was crafted by two senior members with no other committee involvement.

Last year, the Rules Committee slipped into the reconciliation bill an entire rewrite of the congressional budget process (that they are now fighting so fiercely to defend) as part of a self-executing rule. The House leadership that is now so piously trying to protect the public policy consideration process reported this rule out in the middle of the night. The text of this power grab was not available until after debate started on the floor. The House leadership was so concerned about public policy considerations that no hearings were held, and no report was filed. Copies were not available for individual members. Fortunately, this power grab was killed by the Senate.

One reason the House leadership is fighting so fiercely against the A to Z spending cuts proposal is that it will allow members to vote to cut individual appropriations, authorizations, and entitlement programs without the approval of the House leadership.

The House leadership that is now so concerned with public policy considerations has avoided votes on raising America's debt limit since 1979 by use of the so-called "Gephardt rule." This automatically sends to the Senate an increase in the debt limit whenever the budget is adopted.

With most entitlements on automatic pilot and not subject to votes, the only way to cut spending is by amending the 13 appropriations bills. Members suggested 50 amendments to legislative branch appropriations, but the House leadership only allowed six spending cut amendments to come to the floor for a vote. On foreign aid, they allowed 5 of 33 spending cuts proposals to be voted on. One reason the House leadership is fighting so fiercely against the A to Z spending cuts proposal is that it will allow members to vote to cut individual appropriations, authorizations, and entitlement programs without the approval of the House leadership.

Another of the House leadership's "wonderful ways" for public policy consideration is its "King of the Hill" procedure. This rule provides that only the last amendment adopted is the one that passes. So they let members vote for popular amendments that win by wide margins, and then kill the popular proposals without have to vote them by passing a cover amendment last.

Last August, in another of the House leadership's "wonderful ways" to consider public policy, it passed the several-thousand-page Omnibus Budget Reconciliation Act by waiving all of the leadership's "wonderful rules," including the right to read this several-thousand-page document.

In fact, in the last session of Congress, the House leadership was so enamored with its "wonderful ways" for public policy consideration that it waived all rules pertaining to passing legislation an unbelievable 45 times. The House leadership was so deeply concerned about its "wonderful ways" that their vaunted lobbying reform legislation was not reported by committee and passed under suspension of the rules.

The recently adopted crime bill also bypassed the committee system.

Vice President Al Gore's Reinventing Government proposal was so hastily conceived that the pages had to be patched together with the equivalent of chewing gum.

The House leadership is so concerned with public policy considerations that it refuses to hold public hearings on issues like term limits or Whitewater, although it is clear the public would like these issues on the table. The House leadership is fiercely opposing the A to Z spending cuts proposal because it takes away the leadership's right to use the "Gag Rule."

By now you get the point that these vaunted public policy considerations are used to thwart the will of the majority of your elected representatives. The A to Z spending cuts plan is a threat to the House leadership because it would let the voices of the peoples' representatives be heard. It's as simple as A to Z. Members are allowed to propose individual programs for spending cuts. An hour of debate follows. Then a roll call vote. What are our leaders afraid of?

There may be reason to oppose the A to Z spending cuts legislation. But it is crystal clear that the House leadership's loyalty to the "wonderful" current public policy process is blatant hypocrisy. I urge the people of American to let their voices be heard. Let the House leadership know what you think about their "Profiles in Hypocrisy." Remove the leadership's "Gag Rule." No more business as usual. The A to Z spending cuts proposal brings about change!

The views expressed in Front & Center are not necessarily those of the Tax Foundation.

Foundation Study Determines that Estate Laws Generate Anti-Growth Effects in Market

A new Tax Foundation *Background Paper*, which attempts to gauge one of the economic impacts of federal transfer taxes, shows that federal estate tax laws can have roughly the same disincentive effects to entrepreneurial activity as a doubling of income tax rates.

The study, by Patrick Fleenor, Foundation Economist, and J.D. Foster, Foundation Executive Director and Chief Economist, is the second in a series examining federal transfer taxation. Titled "An Analysis of the Disincentive Effects of the Estate Tax on Entrepreneurship," the paper features a model of the wealth accumulation process developed by the Tax Foundation to compare wealth accumulation under various tax scenarios. Entrepreneurs were selected as subjects because they represent first-generation producers of wealth and are traditionally viewed by policy makers as key to American productivity and job growth.

The study offers two tax scenarios. In the first, an entrepreneur's life experience of work, saving, wealth creation, and business expansion is considered in the context of the current individual, corporate, and estate tax laws. (The tax rate on estates as small as $5 million is currently 44 percent, while estates over $20.04 million face a rate of 55 percent.)

In the second scenario, the estate tax is eliminated and the individual and corporate income tax rates are raised until the individual is left with the same bequest level as in the first scenario.

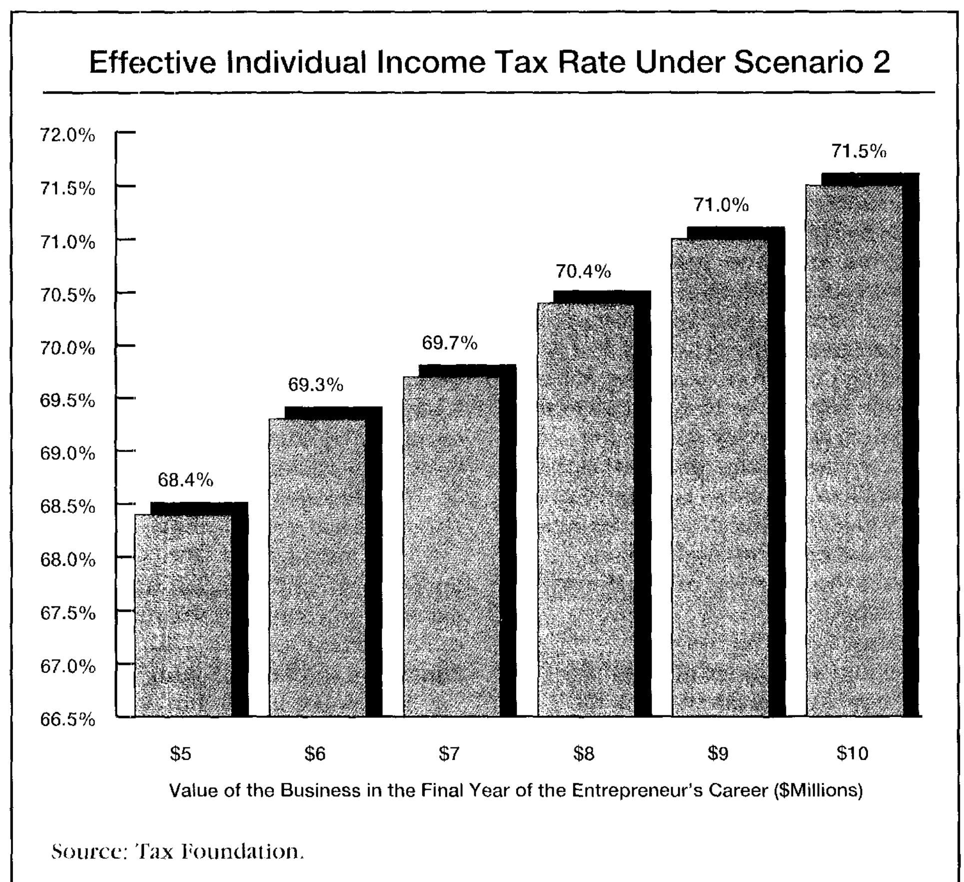
The simulations generated using the new model showed that the estate tax has roughly the same effect on entrepreneurial incentives as a doubling of income tax rates. Moreover, the necessary increase in income tax rates increases with the size of the estate because estate tax rates are themselves progressive. Thus, the estate tax creates a powerful disincentive for entrepreneurs to continue to develop their businesses and create jobs.

The chart below illustrates how strong this disincentive effect can be. It graphs the results of a series of simulations involving various size businesses. Each simulation examines the case of an entrepreneur who starts a business at age 21, owning and operating it as a noncorporate enterprise for the next 40 years. The chart shows the individual income tax rates which would be necessary to produce the same disincentive effect in the scenario in which no estate tax exists.

For example, in order to produce the same disincentive effect as exists under the current estate tax law, the proprietor of a business that is worth $5 million in the final year of his career would have to face an effective individual income tax rate of 68.4 percent throughout his life. Because of the progressive nature of the estate tax, the proprietor of a business worth $10 million would have to face an individual income tax rate of 71.5 percent.

The high effective income tax rates calculated using the Tax Foundation's model illustrate the disincentive effects of the current law. Such high income tax rates would lower income, discourage labor force participation, and result in lower saving rates. The current high effective estate tax rates have similar effects.

The authors point out that "the estate tax is a heavy burden to place on some of the nation's most productive citizens, especially in light of the fact that the estate tax raises only about 1 percent of federal revenue annually." •



Source: Tax Foundation.

U.S. International Tax Laws Place American Firms at Disadvantage

The U.S. policy of taxing the income earned by U.S. companies abroad significantly reduces their ability to compete with foreign companies, according to a new study produced by the Tax Foundation.

In "Taxation and the Competitiveness of U.S. Firms in World Markets," Professor Joosung Jun of Yale University—an Arthur Andersen Visiting Professor with the Tax Foundation—estimates the degree to which international tax rules affect the cost of capital, with particular attention paid to U.S. firms competing with businesses from other countries in major markets.

"U.S. tax rules affect the ability of U.S. foreign subsidiaries to compete in foreign markets with local companies and the subsidiaries of companies based in other countries," concludes Dr. Jun. For example, U.S. firms investing in Japan face a 10.6 percent cost of capital on their investments compared to a 9 percent cost of capital for Japanese companies. U.S. businesses investing in Australia were at an even greater disadvantage, facing a 11.5 percent cost of capital compared to a 9 percent cost for Australian firms.

(The cost of capital, a measure of the disincentive effects of taxation on investment, is the primary channel through which taxes influence U.S. business competitiveness overseas. A higher cost of capital means the company must earn a higher pre-tax return for the investment to be profitable, thereby restricting the number of investments the company can make.)

Dr. Jun says that U.S. companies in Japan appear to be at a serious disadvantage when compared to companies from other countries against whom they are competing. For example, firms operating in Japan from Canada, France, Germany, and the United Kingdom, among others, have an average cost of capital of 5.4 percent, almost half the average cost of capital facing U.S. firms. •

FOUNDATION MESSAGE

The Tax to Beat All Taxes?

The health care debate continues to sputter along, with some secondary committees completing their work, but the big three—Senate Finance, Ways and Means, and Energy and Commerce—each continue to slog their way through the three big questions: who should pay, how should they pay, and how to disguise the price controls. With all this going on, it would be easy to miss the administration's new proposals in the area of managing private pensions.

The administration is trying to make good on one of President Clinton's campaign promises by "encouraging" a vast increase in investments by private pensions into projects it deems socially desirable, like public-housing projects. According to the administration, pension fund managers will now be able to consider "collateral benefits" of investments in public housing, start-up companies, and so forth.

But there is a very good reason pension managers have in the past been reluctant to put Americans' retirement savings into social projects: they are probably bad investments. The risk-return profiles simply do not withstand financial scrutiny, so making these investments would be a violation of the manager's fiduciary responsibility.

J.D. Foster
Executive Director and Chief Economist

Restrained by spending caps, the administration has been unable to pursue the social agenda for which it probably believes it was elected. Mandates on state and local governments are starting to get a really bad reputation, and so this avenue may be blocked. That leaves pensions. Some $4.6 trillion just waiting to be directed by the government to help solve the problems that tax dollars and mandates cannot reach.

The problem, of course, is that these investments are not prudent. If they were, pension managers would have been all over themselves getting into the market. As *The Washington Post* wrote, private pension managers have generally avoided these kinds of investments "for fear of violating federal laws designed to protect retirees".

Most people who look at retirement saving policy in the U.S. are nervous. Social Security, while in good shape today and tomorrow, will be in big trouble by the time most baby-boomers start collecting their first checks. At the same time, Americans are not saving enough on their own for retirement. A large share of what saving has occured is in the pensions the adminsitration now wants to direct into their pet programs. Apparently, it has no qualms about sidestepping federal rules protecting retirees as long as it serves the adminstration's view of the greater good.

The worthiness of these social projects is not at issue. What is at issue is how they are to be funded. If they are socially worthwhile, then they should be defended as such, funds should be appropriated through the regular democratic processes, and taxes should be raised or other programs cut accordingly. Threatening the security or the returns of private citizens' pensions should be subject to the gravest scrutiny.

It is, of course, possible, that the administration is right, that private analysts and advisers have overstated the risks or understated the returns associated with these kinds of social projects. Perhaps the administration has better information or analysis than the folks who make their livings managing hundreds of billions of dollars in pensions.

Yeah, right.

Gibbs Addresses Policy Council

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Updating the Internal Revenue Service's computer system is the most important challenge the agency faces today, Lawrence B. Gibbs, partner at Miller & Chevalier, told the Tax Foundation's Program Committee in New York on June 9.

Mr. Gibbs, a former commissioner at the IRS, noted that the existing computer system is inefficient, error prone, and costly to use and maintain. The agency's latest attempt to replace its computer system centers on a replacement called "Tax Systems Modernization," or TSM. The thrust of TSM is to convert paper into electronic information, making the IRS more efficient in identifying and collecting its accounts receivable, maintaining its compliance programs, and communicating with taxpayers about their accounts and obligations. The principle mechanism used in TSM will be the IRS's Electronic Filing Program.

"Unless TSM is successful," Mr. Gibbs predicted, "the public's confidence in our tax administration system—and therefore the tax system itself—will be placed at risk."

He noted that some analysts have suggested that a net savings from a fully implemented TSM could be tens of billions of dollars annually, and "could be used to reduce the impetus for periodic complex legislation largely aimed at the business sector."

Mr. Gibbs noted that the Electronic Filing Program has come under fire recently, from the media and Congress, because of an alleged lack of safeguards to prevent and detect fraud. Many of the criticisms are legitimate and important, stated the guest speaker. Yet, "because of the importance of TSM to our tax administration system,...it is equally important that time and care be taken to identify the real causes of any such problems."•

In Memoriam

Robert Claybourne Brown
1926–1994

Robert Claybourne Brown, President of the Tax Foundation from 1974 to 1989, died on May 28 in Auburn, Calif., at the age of 68.

Mr. Brown, a native of Ukiah, Calif., was Executive Director of the California Taxpayers Association before joining the Tax Foundation in 1974.

As President, Mr. Brown organized the Foundation's move from New York City to Washington, D.C., in 1978.

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