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Finance Committee's Proposed 20¢ Cigarette Excise Hike Threatens Lower Income Earners' Pocketbooks

The Senate Finance Committee's proposed 20¢ per pack addition to the current 24¢ federal cigarette excise, announced June 20, could play havoc with lower-income Americans' pocketbooks, according to a new analysis by the Tax Foundation.

Chart 1: New Collections by Income Group Based on Finance Committee's 20¢ Cigarette Excise Hike

Adjusted Gross Income	5-Year Total ($Mils.)	Share of Tax Burden
under $15,000	$5,098.2	34.0%
$15,000 under $30,000	3,819.9	25.5
$30,000 under $45,000	2,315.2	15.4
$45,000 under $60,000	1,318.8	8.8
$60,000 under $75,000	911.6	6.1
$75,000 under $115,000	982.5	6.6
$115,000 under $300,000	474.2	3.2
$300,000 and over	80.0	0.5
Total	$15,000.00	100.00%

Source: Tax Foundation estimates based on data from IRS, Bureau of the Census, and Centers for Disease Control.

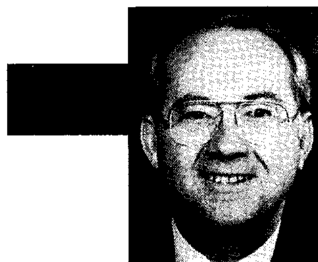
Tax Foundation Economist Patrick Fleenor says that, judging by historic cigarette consumptions patterns, over a third of the $15 billion that the Finance Committee hopes to bring in over five years will be paid by those earning less than $15,000 a year (see Chart 1). Another 25 percent of the total revenues will be paid by Americans earning between $15,000 and $30,000. In all, those earning $30,000 or less would foot about $8.9 billion over five years, or 60 percent of the total bill for the new tax.

Juxtaposed to this, those earning $115,000 or more will account for less than four percent of the additional tax revenues.

"Whether the Finance Committee recognizes it or not, the proposed tax will really make a dent in the budgets of America's lower-income housedholds," Mr. Fleenor stated.

(Recent economic studies, such as one completed in 1994 by Dr. W. Kip Viscusi, conclude that cigarette consumption is a decreas-

Cigarette Tax *continued on page 6*



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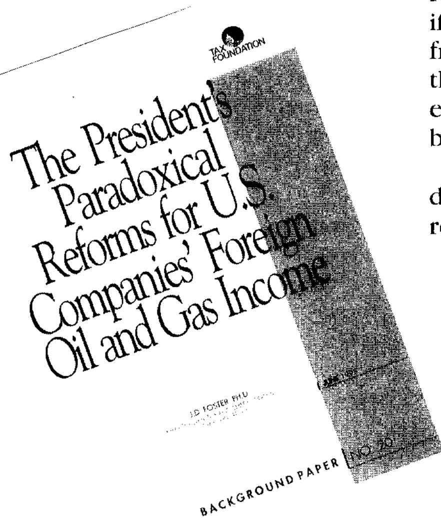
New Foundation Paper Challenges Changes to International Tax Provisions of Tax Code

Three changes to the international tax provisions of the Internal Revenue Code included in the President's fiscal 1998 budget would impede the ability of U.S. oil and gas companies to compete abroad, according to a new study by the Tax Foundation. In the latest Tax Foundation *Background Paper*, "The President's Paradoxical Reforms for U.S. Companies' Foreign Oil and Gas Income," J.D. Foster — Executive Director and Chief Economist at the Foundation — relates that, while expanding international trade remains generally popular, opening foreign markets is an empty concept without competitive U.S. companies able to take advantage of foreign market opportunities. Unfortunately, federal policies



in general, and U.S. international tax policies in particular, often pose an impediment to achieving the goals of U.S. trade policy. These policies often raise costs above those of American companies' competitors. It limits their ability to organize operations most efficiently on a global basis, and limits their flexibility to respond to new market challenges and opportunities.

In his analysis, Dr. Foster points to the oil and gas industry in the U.S. as typical in many ways of American companies competing overseas. Aggressive and successful, these companies must integrate their U.S. and foreign operations to maximize their efficiency and competitiveness. A high degree of integration also means that thousands of jobs in the U.S. depend critically on their employer's success overseas.

The international tax proposals in the fiscal 1998 budget would (1) end deferral for petroleum companies' active income by expanding the definition of Subpart F to include oil and gas income generated abroad; (2) create a new foreign tax credit limitation for oil and gas income, thereby segregating this income from all other income in the general foreign tax credit limitation; and (3) deny a foreign tax credit for taxes paid to a foreign government if the company receives "benefits" from the foreign government unless the foreign government imposes a generally applicable income tax on all businesses, domestic and foreign.

Dr. Foster concludes there are six distinct problems with the proposals relating to foreign oil and gas income:

1) *Damages U.S. companies' international competitiveness.* The President's proposals would further increase the U.S. tax liability on U.S. foreign oil and gas income. The increase in the U.S. tax burden would be significant in many cases. The proposals, therefore, would drive these companies from certain markets and force them to reduce operations in others, thereby ceding valuable opportunities to the foreign competition.

2) *Differential taxation of foreign oil and gas income.* The President's proposals clearly target U.S. subsidiaries' foreign oil and gas income for special treatment under the tax law. U.S. tax law already puts U.S. petroleum companies at a competitive disadvantage vis-a-vis foreign-based companies. The effect of this special treatment is to put these companies at a further competitive disadvantage. In addition, this treatment also exacerbates the differential tax burden between U.S.-owned oil and gas companies operating abroad and many other U.S.-owned foreign companies.

3) *Lack of justification.* As yet the Treasury has not made a serious argument for why or in what circumstances current policies fail. Presumably, the Administration believes the current policy is inadequate to prevent abuse in certain circumstances, but it has not yet described these circumstances or the abuse.

4) *Purposeless complexity.* The proposal to include foreign oil and gas income in a separate foreign tax credit limitation basket would further complicate the international tax provisions for no apparent purpose other than to levy additional tax on U.S. oil companies' foreign operations.

5) *Policy-less attack on deferral.* The proposal to expand the definition of Subpart F to include foreign oil and gas income represents an unwarranted and dubious erosion of the policy of deferring U.S. tax on active income earned abroad by U.S.-owned subsidiaries.

6) *Overly broad and restrictive application.* The "generally applicable" test in the Administration's proposal remains unspecified. Moreover, any specification is likely to result in a test that is overly restrictive. Further, even if the foreign income tax is not generally applicable by whatever metric is applied, the income tax can only be operating as a surrogate for a royalty to the extent the royalty has been waived or reduced from what would normally be charged. The U.S. taxpayer should be allowed to demonstrate that a reasonable royalty payment has been made, in which case the income tax cannot be a surrogate for a royalty.

In summary, says Dr. Foster, the President's proposals relating to foreign oil and gas income of U.S. multinational firms run counter to the Administration's goals of expanding free trade; they violate tax neutrality both in general and as between U.S. companies in differing industries; and they would seriously impede the competitiveness of one of the country's more successful industries. •

House Tax Plan Favors States With More Children

A Tax Foundation analysis of the major provisions of the House Ways & Means tax proposal shows that, considering the family-friendly emphasis of the bill, states that have larger populations of children will see a proportionately greater portion of federal tax relief. In addition, less affluent states are favored over more affluent states due to ceilings in certain tax provisions.

Foundation Economist Patrick Fleenor examined four key provisions of the tax bill:

- A $400-per-child tax credit for children under 17 in 1998 and $500 credit starting in 1999. Scale-backs begin for families with incomes over $110,000 and for unmarried parents with incomes over $75,000.
- A capital gains tax rate reduction to 10% for filers in the 15% income tax bracket and 20% for those in higher brackets; and an exemption on the initial home-sale gain of $250,000 for single homeowners and $500,000 for joint filers. Gains would be indexed for inflation after the year 2000.
- A scholarship program matching 50 percent of higher-education expenses up to $3,000 with a tax credit for families earning less than $80,000 a year. Smaller credits would be available to families earning as much as $100,000 a year.
- An extension of IRAs that would allow tax-free withdrawals after retirement — or before retirement, if used for a first-time home purchase. Contributions would be from taxable income.

California and New York, with the greatest number of eligible children within their borders, gain the greatest benefit from the child tax credit and the education tax credit. Californians are projected to receive about $12.4 billion tax relief for the child and tuition tax credits, according to the Foundation's analysis. New Yorkers will receive over $7.7 billion in child- and tuition-tax-credit relief.

On the other hand, states with large affluent and elderly populations will pay greater capital gains in the first five years of the proposed program. ●

Distribution of Selected Tax Provisions by State 1997-2002 Estimate (Millions of Dollars)

	Number of Kids Eligible for for Child Credit (Thousands)	Child Credit	Capital Gains	Education	IRAs
Alabama	587	-$1,027.96	$20.85	-$558.01	-$0.46
Alaska	89	-194.21	2.22	-45.24	-0.07
Arizona	570	-982.03	36.92	-437.99	-0.44
Arkansas	332	-583.00	13.60	-238.12	-0.25
California	4,907	-8,544.77	492.09	-3,851.95	-4.05
Colorado	564	-970.71	32.11	-444.54	-0.43
Connecticut	657	-1,129.62	64.61	-388.50	-0.59
Delaware	122	-208.44	6.99	-86.98	-0.10
Dist. of Col.	129	-216.02	13.73	-58.70	-0.11
Florida	2,140	-3,713.33	197.01	-1,026.80	-1.74
Georgia	1,020	-1,771.80	59.09	-860.46	-0.81
Hawaii	199	-341.05	18.49	-156.15	-0.15
Idaho	146	-248.96	6.72	-147.92	-0.10
Illinois	1,974	-3,395.86	124.01	-1,817.49	-1.62
Indiana	925	-1,576.06	30.43	-643.87	-0.71
Iowa	457	-781.76	15.41	-475.74	-0.33
Kansas	411	-698.96	21.66	-344.61	-0.31
Kentucky	528	-921.62	20.64	-411.95	-0.40
Louisiana	565	-1,013.51	14.60	-441.01	-0.43
Maine	216	-362.17	13.19	-140.54	-0.16
Maryland	891	-1,526.12	61.78	-537.04	-0.74
Massachusetts	1,175	-1,981.59	90.02	-843.59	-0.97
Michigan	1,521	-2,644.33	55.49	-1,277.89	-1.22
Minnesota	751	-1,276.29	42.05	-576.75	-0.58
Mississippi	326	-593.53	9.18	-371.11	-0.25
Missouri	830	-1,430.07	34.39	-539.89	-0.64
Montana	120	-211.73	5.42	-109.29	-0.08
Nebraska	263	-451.24	10.23	-249.78	-0.19
Nevada	217	-388.00	20.60	-96.96	-0.17
New Hampshire	221	-368.47	17.82	-140.42	-0.18
New Jersey	1,563	-2,689.08	131.80	-961.80	-1.37
New Mexico	217	-388.00	9.29	-229.67	-0.16
New York	3,114	-5,334.95	316.65	-2,376.75	-2.68
North Carolina	1,088	-1,878.54	61.08	-645.83	-0.85
North Dakota	102	-175.50	2.75	-106.71	-0.07
Ohio	1,883	-3,180.64	71.16	-1,314.27	-1.45
Oklahoma	464	-803.01	14.82	-435.98	-0.34
Oregon	466	-798.40	25.77	-332.95	-0.35
Pennsylvania	2,068	-3,512.89	95.69	-1,386.32	-1.62
Rhode Island	184	-310.53	13.36	-120.48	-0.15
South Carolina	537	-930.35	21.89	-403.11	-0.41
South Dakota	106	-185.73	3.80	-91.41	-0.07
Tennessee	767	-1,333.31	35.36	-476.89	-0.60
Texas	2,497	-4,449.89	119.09	-1,889.04	-1.94
Utah	241	-407.31	8.56	-293.67	-0.18
Vermont	101	-170.22	7.96	-69.89	-0.08
Virginia	1,072	-1,837.49	68.41	-624.26	-0.87
Washington	831	-1,397.80	40.77	-991.73	-0.64
West Virginia	252	-430.44	6.93	-209.20	-0.19
Wisconsin	824	-1,398.53	48.30	-686.42	-0.63
Wyoming	74	-127.20	3.19	-70.34	-0.05
United States	41,300	-71,293.00	2,658.00	-31,036.00	-33.00

Note: Negative numbers indicate tax relief, positive numbers indicate higher tax payments.
Source: Tax Foundation.

Deceptive Budget Deal

By Senator Phil Gramm (R-Texas)

After two years of partisan confrontation on the budget, the president and Congress have reached a bipartisan deal that appears to be all things to all people. The president gets more social spending, Republicans get a tax cut, and the American people get a balanced budget. If it all seems too good to be true, that's because it is.

Because the budgeting arms of both the administration and Congress assumed — before the budget debate even started — that the strong economy we now enjoy would produce sustained growth beyond the year 2002, the amount of the deficit reduction required to achieve a balanced budget immediately declined from $642 billion over the next five years to $339 billion. The it got even better. At the very moment of impasse in the budget negotiations, the Congressional Budget Office discovered that even its previous estimates of an improving economy understated the revenue windfall expected in the next five years and predicted that windfall alone would lower the deficit another $225 billion. Negotiators then rolled up their sleeves and assumed $15 billion of additional savings from lower consumer prices and $77 billion in additional savings from the even stronger economic growth that would be generated by balancing the budget.

> ***The most distinctive feature of the budget compromise is the size of domestic discretionary spending increases. While it is fashionable for Republicans to claims that this budget deal achieves the goals of the Contract With America, in reality it spends $212 billion more on domestic discretionary programs than the contract contained.***

The net result is that before a single chance in public policy became part of the budget compromise, deficits of $330 billion — 97 percent of the total deficit — had simply been assumed away. Only $9 billion, or 3 percent of deficit reduction in the budget compromise, comes from actually changing policy.

The most distinctive feature of the budget compromise is the size of domestic discretionary spending increases. While it is fashionable for Republicans to claims that this budget deal achieves the goals of the Contract With America, in reality it spends $212 billion more on domestic discretionary programs than the contract contained. The compromise increases domestic discretionary spending by $189 billion above the 1997 budget resolution and by $76 billion above President Clinton's actual budget request for 1997. In fact, if you look at the president's 1988 budget as scored by the Congressional Budget Office, the budget deal actually gives the president $1 billion more in discretionary spending than his own budget would have provided.

The most permanent feature of the bipartisan budget compromise is an increase in domestic spending on social programs, which the president has rightly compared to the explosion of social spending that occurred in the 1960s.

In addition to these increases in discretionary spending, the budget compromise contains new entitlement benefits in Medicare, Medicaid, food stamps, and SSI, and it overturns part of the one major reform of the 104th Congress: It re-establishes welfare benefits for legal aliens.

The budget compromise proudly trumpets $115 billion of savings in Medicare, but by committing to accept the president's plan to simply cut reimbursement for doctors and hospitals, Congress buys into a policy that has been implemented over and over again in the past 30 years without achieving substantial savings. Like other forms of price controls, reducing reimbursement for physicians and hospitals has historically been circumvented as the recipients have invented ways to work around the limitations. In addition, the compromise requires that the fastest growing part of Medicare, home health care, be taken out of the Medicare trust fund and financed from general revenues.

Perhaps the most perverse aspect of the compromise is that this budget will trample an emerging bipartisan commitment to real Medicare reform. This budget agreement virtually guar-

(B)y claiming to have solved the Medicare problem for 10 years, we will take the pressure off the president and Congress to reform Medicare even though the trust fund is careening toward bankruptcy, and Medicare will produce a $1.2 trillion drain (after $400 million in "cuts") on the federal Treasury over the next 10 years.

antees that five years from now Medicare will be in much worse shape than it is today. Moreover, virtually every penny of the $115 billion claimed from Medicare savings will be spent on increases in social programs and new entitlement benefits.

That brings us to my party's favorite part of the deal, the much-discussed $85 billion tax cut. The cut is largely funded by odds-and-ends measures, the largest of which is at least $26 billion of revenues assumed to be derived from auctioning off broadcast and non-broadcast spectrum — the right to use public airways for everything from broadcasting the 6 o'clock news to setting up a cellular phone system.

Last year, Congress assumed a limited spectrum auction of $2.9 billion as an offset to new spending. When actually auctioned, the spectrum brought in just $13.6 million, or roughly $1 for every $200 that Congress had assumed would be raised. Given our experience of last year, it is highly unlikely that anything like $26 billion will be raised from spectrum auction unless television stations are forced to buy spectrum to broadcast their new digital signals, something the Federal Communications Commission, the White House, and Congress have opposed.

The budget agreement claims a net reduction in taxes of $85 billion. Some $5 billion of that tax cut will be lost to the public because the assumed reductions in the consumer price index will raise income taxes by $5 billion. Of the remaining $80 billion, the Clinton administration's education tax credit will absorb roughly $35 billion, leaving Republicans some $45 billion in net tax cuts to fund their tax-cut priorities.

Unfortunately, the full Republican tax package costs $188 billion. Republicans on the House and Senate tax-writing committees now will be forced to try to stretch a net tax cut of $45 billion to cover a $500-per-child tax credit that costs $105 billion, capital gains relief that costs $32 billion, estate and death tax relief that cost $18 billion and individual retirement account expansion that costs $32 billion.

Even if $50 billion of offsetting tax increases can be found, it is a certainty that the individual tax credit will be dramatically curtailed, probably by ensuring that many middle- and upper-middle-income working families don't get any child tax credit. Capital gains and estate tax relief will be similarly truncated. In the end, despite all the talk of achieving a major tax cut, it is hard to see a substantial impact in a $7 trillion economy being created by a $45 billion tax cut.

Obviously, in a budget deal such as this, the logical question is: "Is it better than nothing?" And, as is usually the case, beauty is in the eye of the beholder. But in the final analysis, two factors ultimately make this budget agreement worse than no agreement. The first is the false perception it creates that the deficit problem has been fixed. This notion already has given rise to the largest increase in social spending since the '60s in this budget agreement and is likely to further open the floodgates as Congress convinces itself and the American public that the deficit is behind us. Second, by claiming to have solved the Medicare problem for 10 years, we will take the pressure off the president and Congress to reform Medicare even though the trust fund is careening toward bankruptcy, and Medicare will produce a $1.2 trillion drain (after $400 million in "cuts") on the federal Treasury over the next 10 years.

Historically, American has looked to its two great political parties to contest over principles and new ideas so that the highest principles and best ideas so that the highest principles and best ideas could become the governing consensus for the country. But divided government often produces massive pressure for bipartisanship, and the current budget deal is an example of how bipartisanship sometimes can manifest itself not in compromise policy but in a decision to join together to mislead the public. The opposite of gridlock is not necessarily efficiency, it is sometimes deception. •

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.*

Bottom Line on Finance Committee's Proposed Cigarette Excise Hike: Bottom Income Earners Would Pick Up Most of the Tab

Cigarette Tax

Continued from page 1

ing function of income. This means that, not only is the effective tax rate higher on lower-income taxpayers than on upper-income taxpayers, but the total amount of cigarette taxes paid by lower-income groups was greater than that paid by upper income groups. Cigarette taxes are consequently regressive in absolute terms, not simply in relation to income.)

In a state by state comparison, Mr. Fleenor determined that California will bear the single largest burden if the new tax is enacted, paying $1.16 billion to the U.S. Treasury over five years (see Chart 2). The 10 states with the highest projected tax payments will pay 50 percent of the overall tax increase, according to Mr. Fleenor's calculations (see Chart 3).

"What's ironic about this tax," noted Tax Foundation Executive Director J.D. Foster, "is that, with over half of it earmarked for healthcare costs for poor children, it amounts to a case of the poor paying for new programs for the poor."

In recent years, Congress has increasingly turned to federal excises as a means of bridging the gap between outlays and revenues. While the federal government imposes a wide range of excises, about 70 percent of these revenues come from the taxes on alcohol, tobacco, and gasoline and diesel fuel. Federal excises on tobacco raised about $5.9 billion in 1995, while the excise on distilled spirits, beer, and wine raised about $7.2 billion, and gasoline and diesel fuel taxes raised over $22.6 billion.

If the Senate Finance Committee's proposal is enacted, the federal excise on cigarettes will jump to 44¢ per pack. The tax was last raised on January 1, 1993, to its current 24¢ level, from a rate of 20¢. Since the start of World War II, the cigarette excise has been raised five times, from 7¢ in 1942 to 8¢ in 1951, to 16¢ in 1983, and to 20¢ in 1991. ●

Chart 2: New Collections by State Based on Finance Committee's 20¢ Cigarette Excise Hike ($Millions)

	Share of Tax Burden		Share of Tax Burden
Alabama	$278.1	Nebraska	92.1
Alaska	35.0	Nevada	92.1
Arizona	200.0	New Hampshire	115.6
Arkansas	177.7	New Jersey	413.1
California	1,155.5	New Mexico	70.2
Colorado	199.2	New York	829.5
Connecticut	167.5	North Carolina	563.5
Delaware	57.7	North Dakota	33.0
Florida	852.0	Ohio	801.8
Georgia	452.2	Oklahoma	229.0
Hawaii	34.9	Oregon	186.8
Idaho	56.3	Pennsylvania	743.4
Illinois	638.8	Rhode Island	59.1
Indiana	501.8	South Carolina	258.1
Iowa	169.4	South Dakota	45.7
Kansas	148.0	Tennessee	413.7
Kentucky	429.5	Texas	880.9
Louisiana	293.7	Utah	62.9
Maine	81.8	Vermont	46.0
Maryland	251.2	Virginia	448.0
Massachusetts	299.7	Washington	229.7
Michigan	507.3	West Virginia	135.8
Minnesota	246.5	Wisconsin	306.5
Mississippi	183.3	Wyoming	34.7
Missouri	420.7	District of Columbia	21.5
Montana	48.9		

Source: Tax Foundation estimates based on data from IRS, Bureau of the Census, and Centers for Disease Control.

Chart 3: Top Ten State Contributors to Senate Finance Committee's 20¢ Cigarette Excise Hike ($Millions)

1. California	$1,155.5
2. Texas	880.9
3. Florida	852.0
4. New York	829.5
5. Ohio	801.8
6. Pennsylvania	743.4
7. Illinois	638.8
8. North Carolina	563.5
9. Michigan	507.3
10. Indiana	501.8
	$7,474.5

Source: Tax Foundation estimates based on data from IRS, Bureau of the Census, and Centers for Disease Control.

FOUNDATION MESSAGE

Progress, Little By Little

J.D. Foster
Executive Director
& Chief Economist

"Taxing somebody who doesn't have health insurance to pay for health care for somebody who has an income of $100,000 a year is not right." With that simple statement, Senator Bob Kerrey (D-Neb.) provided the caption for the Senate Finance Committee's efforts to means-test Medicare. Sometimes, in Washington, an issue must be boiled down to such bare-bones essentials for anything to happen.

The Medicare reforms about which Senator Kerrey offered his pithy remark were compelled by the budget deal to which the President and the congressional leadership agreed, more or less. Medicare, in case you didn't know, is on the verge of bankruptcy.

Just exactly what has the Finance Committee done? First, the eligibility age for Medicare recipients would increase from age 65 to 67, phased in over the next 30 years. Bold this isn't.

The plan worked out by Chairman William Roth (R-Del.) and the Finance Committee would also change the Medicare deductible. Currently, all Medicare beneficiaries pay a deductible of $100 annually. Under the Finance Committee's plan, the deductible would increase to $540 for couples with incomes of $75,000, rising to $2,160 for couples with incomes of $125,000 or more. In contrast to the retirement age changes, these are historic changes to a program whose champions continue adamantly to resist change. As bold as these changes are, however, we would still be taxing people who have no health insurance to pay for health care for the wealthy.

The other big game in town, of course, aside from the Emergency Supplemental spending bill debacle and the spectacle of watching the Republican leadership in the House unravel like a cheap suit, is the tax bill. Whether one thinks this is a great bill, a terrible bill, or a big zero, seems to depend most on one's predilection towards optimism, pessimism, or agnosticism.

As we go to press, the Ways and Means Committee has completed a bill and the Senate Finance Committee is about to markup. Both Committees were told to craft bills that appeared to promise something for everyone while providing little to most and nothing to some. With so little to work with, it's fair to say Chairman Archer and the rest of the Committee did an admirable job. They truly managed to stuff two pounds of feathers in a one pound bag.

In quick summary, the bill provides $149 billion in net tax relief, which represents about one percent of the revenue that would otherwise be collected by the federal government. About 80 percent of the net tax relief goes to the middle class, particularly families with children. Lower-income taxpayers and families without children or with children over the age of 18 may have to wait for the next tax bill before they get much relief.

In some respects, the Committee's work is a monument to the income tax. There are over 200 line items in the bill. (There are actually many more tax code changes than that because some line items stand for multiple changes). About a fourth of the items raise revenue, though over half the revenue raised comes from the reinstatement and reform of the Airport Trust Fund excise taxes. Almost a third of the items are listed as having a negligible revenue effect. These are housekeeping provisions which help the IRS administer and taxpayers to comply with the income tax. The balance of the provisions constitute the tax relief. But six provisions provide the most relief: the child tax credit ($150 billion), the Administration's scholarship tax credit ($50 billion), the "Kiddie Save" accounts ($22 billion), capital gains relief ($35 billion), Alternative Minimum Tax reform ($38 billion), and estate tax reform ($29 billion). (All figures are 10 year estimates.)

Assuming the President signs the bill, which he may not do, savers and investors will have their long-sought-for capital gains relief. One reason this change has taken so long to come about is that the Joint Tax Committee continues to show capital gains relief as costing the Treasury money. That cutting the capital gains tax encourages additional saving and investment, thus encouraging real wages to grow, is beyond debate. The only question is the amount, and that may never be resolved.

Rather than debate the unresolvable, we recently asked: How much more rapidly would the economy have to grow each year due to capital gains relief for the resulting increased tax revenue stream to offset the JTC's current projected loss in revenue? If the answer is sufficiently modest, perhaps the best course would be for JTC to show capital gains relief as neither raising nor losing money. As our analysis on page 2 shows, the economy would have to growth by about three-hundredths of a percentage point faster each year to make capital gains relief revenue neutral. Case closed.

One last little irony in this regard. The JTC has resisted a more dynamic scoring on capital gains because, as mentioned, there is no consensus on how much additional growth would result. Desiring to maintain the veneer of accuracy, they stick with what they know and thus assume no additional growth. Curious, then, their willingness to assign estimates of a handful of millions to scores of provisions in the bill. For example, they score a "limitation on treaty benefits for payments to hybrid entities" as costing exactly $10 million over 10 years. No doubt a great deal of thought and effort went into producing this figure, and I do not doubt it is as accurate as data and knowledge will allow. But to indulge in the illusion of accuracy in estimating the cost of such a minor change, while holding hostage to false precision so popular a provision as capital gains reform, is hard to fathom, even by Washington's standards. ●

Will the House's Capital Gains Tax Cuts Bankrupt the Federal Treasury?

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Will capital gains relief, as proposed in the House Ways & Means Committee's new tax proposal, lead to large revenue losses? The Joint Tax Committee's analysis of the tax provisions predicts this will be the case: While the capital gains measure is projected to provide a $2.658 billion gain to the Treasury over the first five years (1997-2002), a reduction in revenues of $34.959 billion is projected over a 10-year period (1997-2007).

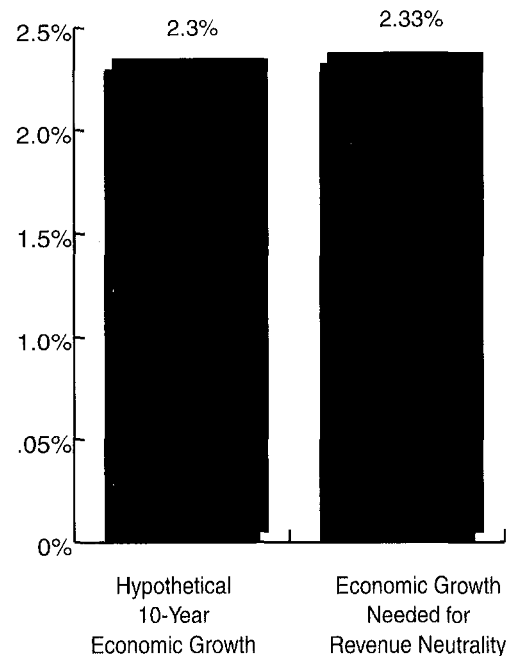
But the problem with this analysis, says Foundation Executive Director and Chief Economist J.D. Foster, is that — due to wide disagreement and uncertainty over how much faster the U.S. economy will grow once these tax changes are enacted — congressional estimators have ignored the positive consequences of capital gains relief.

So the Tax Foundation decided to take a closer look at the issue. Dr. Foster asked the question, "How much faster would the U.S. economy have to grow for the additional revenues from all federal revenue sources to cover the estimated 10-year revenue loss?" The results: The American economy needs to grow by only three-hundredths of a percentage point faster between 1997 and 2007 for the additional revenues to offset the JTC-estimated cost of capital gains relief.

In other words, rather than an average 2.3% growth rate for the U.S. economy between 1997 and 2007, the economy would have to grow 2.33% over the same period in order to offset any capital gains revenue losses. (See chart on this page.)

"We're talking really minor changes here over a 10-year period," said Dr. Foster.

"We may never know by how much more the economy will grow due to a reduction in the capital gains tax," Dr. Foster observed. "And it may not be practically or politically possible to treat capital gains relief as a permanent revenue raiser. On the other hand, when so little additional growth is needed for the relief to be revenue neutral, it's incomprehensible that the Congress would continue to treat capital gains relief as a revenue loss." ●



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