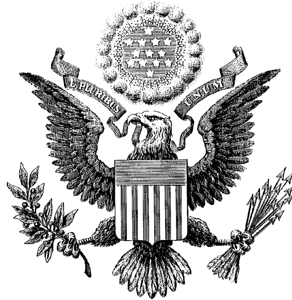
TAX REDUCTION AND THE ECONOMY

A JOINT ECONOMIC COMMITTEE STUDY



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Executive Summary

The current tax system is counterproductive and biased against saving and investment. The tax system imposes large losses on the economy that reduce the economic welfare of households and businesses. The current level of taxation imposes additional costs of about 40 cents at the margin for each dollar collected in revenue. A reduction in the burden imposed by the tax system would make a significant improvement in the economic well-being of American households. Furthermore, if this surplus revenue is not returned to the taxpayers, it appears likely that most of it will be absorbed in federal spending increases.

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Economic Effects of Tax Reduction

Proposals for tax reduction are being presented by policymakers from various points of view. While there is some bipartisan agreement on the desirability of tax relief, the composition and scale of tax legislation are both matters of contention. This paper will examine some of the features of the recently proposed tax bill reported from the House Ways and Means Committee. Although this legislation is quite large and complex, the focus here is on several key components and their potential effects upon the economy.

On the basis of current and ongoing Joint Economic Committee (JEC) research on major tax issues,[1] this paper concludes that the pending Ways and Means Committee proposal would have positive long-term effects on the economy. Although current economic conditions are strong, this economic strength is unlikely to continue indefinitely. Therefore, phased-in tax reduction can be viewed as a type of insurance policy over the long-run.

Equally important is the fact that the current levels of taxation can impose relatively high output and welfare costs on the economy, per dollar of revenue raised, regardless of the current phase of the business cycle. While the range of economic losses imposed by the current level of taxation is rather broad, a conservative estimate is that these excess marginal burdens range from 25 to 40 cents of the last dollars raised in federal revenue; other estimates range much higher.[2]

In other words, the U.S. tax system imposes significant costs on the economy and these costs are present whether the economy is expanding or contracting. Policymakers have no reason to accept these counterproductive losses imposed by the tax system just because the economy is otherwise performing well. A healthy economy would normally be expected to generate a positive fiscal situation that presents the opportunity to remove or modify the most counterproductive features of the tax system. This opportunity should be seized in the current economic environment.

This paper is divided into several sections: the economic impact of taxation, the recent historical record, certain major provisions of the Ways and Means Committee tax bill, and issues related to the tax burden. Among the findings are the following:

- The current tax code penalizes work, saving and investment, and entrepreneurship.
- Tax changes that reduce these penalties will improve long-term economic growth.
- According to an important and growing body of economic research, the current level of taxation imposes large economic "deadweight" losses at the margin; 40 cents in lost economic welfare per dollar of tax would be a reasonable estimate. There is no reason for policymakers to accept such counterproductive results.
- If the tax bill increases the GDP growth rate by about two-tenths of one percentage point annually, it would produce about $240 billion in additional revenue over ten years, enough to offset well over one quarter of the revenue losses of official projections that assume no macroeconomic effects.

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[2] Richard Vedder, and Lowell Gallaway, *Tax Reduction and Economic Welfare,* Joint Economic Committee, April 1999.

- According to JEC research, the evidence shows that for every dollar of budget surplus accumulated, 60 cents will be spent within one year. Budget accounting suggests that these surpluses might be available to reduce the federal debt, but history shows that in reality it is the political system, not accounting statements, that determine federal policies when it comes to taxing and spending. Only by returning it to the taxpayers can a probable squandering of the surplus be avoided; already advocates are preparing various spending proposals.
- Despite misleading tax figures that can suggest otherwise, the shares of the tax burden borne by each income group under the tax system would not be changed under the proposed tax legislation. In other words, the broad-based reduction in tax payments does not shift the tax burden but leaves it essentially unchanged; thus there is no basis for viewing the legislation as skewed in any particular way.

I. Why Certain Tax Changes Can Affect the Economy

In a market economy resources are allocated by the forces of supply and demand. Producers of goods and services expand production to the point where the cost of producing the last unit is covered by the price that can be obtained in the market.

The quantity of inputs to the production process – labor services and capital – is also influenced by changes in market prices. All other things equal, a rise in wage rates, for example, will tend to attract new potential workers and expand the labor force. An increase in the rate of return on saving and investment will tend to elicit more saving and investment. Thus changes in prices can affect the quantity of inputs used in production. This is how the price system allocates resources in a market economy.

Current and especially future prices and costs are not objectively presented, but must be discovered through the market process. Various market participants have differing views of future market conditions and their current implications, and these views are tested by the market process over time. Entrepreneurs whose expectations are especially prescient and accurate will be rewarded, while those who are not will lose their command of productive resources. The entrepreneurial function is the nerve center of the market economy because foresight and the ability to productively use knowledge underlie all the valid assumptions made about costs and prices.

Our economy is not a pure free market economy as in an abstract model, but a market-based system in which market forces allocate resources, but government is also present. Market costs and relative prices are influenced by government taxation and regulation. The general effect of taxes and regulations is to increase production costs. This effect may or may not be offset by other gains, but an increase in cost or a reduction in the return to a factor of production tends to reduce the supply available. This imposes costs on the economy, withdraws resources from production, and lowers economic growth. The result is economic losses for consumers and producers.

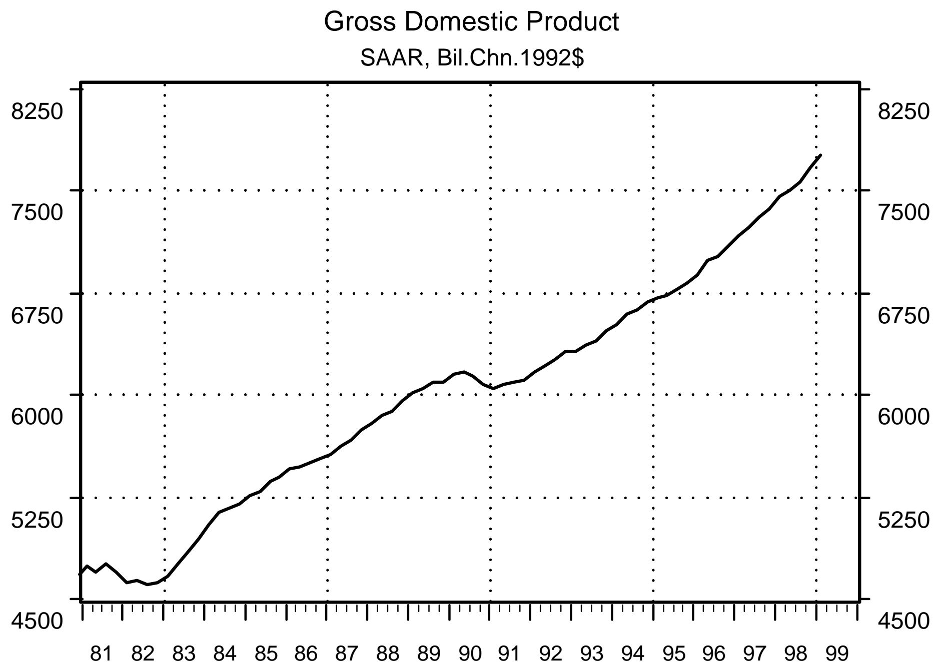
An ideal tax is one that interferes as little as possible with the market allocation of resources. The current tax system is not consistent with this criterion because it is biased against

saving and investment, which are taxed more heavily than consumption. Furthermore, given the current level of taxation, the costs imposed are excessive in relation to the revenue raised. The excess burden of taxation is estimated at about 40% of revenues raised at the margin.

Tax legislation which removes some of the bias against work, saving, and investment, would tend to lower barriers to resources flowing into production. Tax legislation that blunts tax provisions that undermine entrepreneurship and innovation would also tend to facilitate the dynamism and flexibility conducive to economic growth. These positive economic effects can be seen during periods when broad-based tax incentives are in place.

II. Recent Economic Trends and the Role of Tax Policy

The current expansion is now more than eight years old (99 months) and the longest peacetime expansion on record. It followed the 1980s expansion which is the second longest peacetime expansion on record (92 months). In short, we are experiencing back-to-back the first and second longest peacetime expansions in American history. Further, the recession that occurred between these record-breaking expansions was exceptionally short (9 months). We have not experienced a serious recession for more than 16 years.



Source: Haver Analytics

This extraordinarily sustained period of expansion has been associated with lower inflation, lower interest rates, falling unemployment rates, higher labor-force participation, higher investment, and an exceptional degree of innovation and entrepreneurial activity.

There are a number of reasons for this superb macroeconomic performance. Excellent monetary policy, technological innovation, global competition and freer trade together with constrained government spending have all played a role. But tax policy is also central to any explanation of this record-setting, sustained growth. In particular, the substantial marginal income tax rate reductions in the 1980s laid in place an incentive structure that has encouraged and fostered steady and long-run improvements in work effort, investment, innovation and entrepreneurial activity. It is no coincidence that the 1960s expansion -- the longest expansion on record (which included the Vietnam War) --also followed significant cuts in marginal rates of taxation.

Because such tax rate cuts encourage the supply of labor and capital as well as innovation and entrepreneurial activity, they impact aggregate supply and increases in the capacity of the economy to grow; such tax cuts foster economic growth. While some backsliding has occurred with the rate increases in some tax brackets in 1990 and 1993, most marginal tax rates still remain lower than rates which existed in the 1950s, 1960s, and 1970s.

Despite this successful record over the long-term, there are a number of reasons why additional tax relief is still most appropriate at this time. While marginal income tax rates for the most part remain below earlier levels, income tax rates and other forms of taxation have gradually increased in recent years. Increases have occurred in payroll taxes, excise taxes on gasoline, alcohol, tobacco and various luxuries, and federal user fees. Additionally, because significant portions of the tax code are not indexed for (persistent, albeit lower) inflation, taxation has increased for unindexed items such as estate taxation and various elements of corporate and capital taxation. Further, our progressive income tax system -- while indexed for inflation -- is not adjusted for real growth. Hence, as the economy grows, individuals gradually are pushed into higher tax brackets over time and the alternative minimum tax applies to more and more people. Much of this increased taxation not only creates distortions (and adds to deadweight loss) but adds to the multiple layers of taxation on saving and investment, thereby reducing incentives to save, invest, innovate, consequently thwarting longer term growth.

All of these factors help to explain why federal taxation as a percentage of GDP -- or the federal tax burden -- has increased to record levels in recent years. During the current expansion, for example, federal tax revenues have grown significantly faster than the macroeconomy, placing ever-higher burdens on many of those paying taxes. Higher and higher shares of national income are being devoted to paying federal taxes. Not only is the proportion of federal tax revenue to GDP at the highest levels since World War II, but the Presidents' budget projects this tax revenue-to-GDP ratio to remain at or near record levels throughout the entire budget forecast horizon. In short, tax policy is growing more restrictive and burdensome on the overall economy from both the average and marginal rate perspectives. Accordingly, tax rate reduction to relieve some of this increased burden and thereby promote, restore, and sustain efficiency and growth is most appropriate at this time. Legislation to accomplish these objectives is under consideration in Congress.

III. The Ways and Means Tax Legislation

The House tax legislation, by reducing personal tax rates, lowering the capital gains tax rate, phasing out the estate tax, and enhancing incentives for personal saving along with other measures, would lessen the cost of the tax system upon the economy and free resources for more productive uses.

In evaluating the economic effects of growth-oriented tax reduction there are two opposing potential errors. On the one hand, it would be easy to exaggerate the economic effects of tax legislation and produce unduly optimistic and inaccurate revenue projections. On the other hand, it could be equally unrealistic and inaccurate to assume that no positive macroeconomic effects would result from major tax legislation. This latter approach is the standard one used in revenue scoring of tax legislation.

The tax bill is estimated to save taxpayers $792 billion in static revenue terms over 10 years. However, this estimate, following the conventions of static revenue analysis, does not include any possible effects on economic growth. However, an assumed increase in the rate of economic growth of about two-tenths of a percentage point would be quite modest, but even this small increase would produce an additional $240 billion over the 10-year period. This would offset over one-quarter of the projected revenue cost and provide some insurance against the vagaries of long-term budget estimates.

This example illustrates the point that just as long-term forecasts often generate large static revenue losses, they also have the potential to generate considerable revenue offsets if ever modest macroeconomic effects are considered.

Major Provisions That Improve Economic Incentives

Marginal Rate Cuts

The Ways and Means tax plan lowers personal income tax rates. It includes a 10% across-the-board reduction in tax rates, phased in over 10 years. The 15%, 28%, 31%, 36%, and 39.6% rates would be reduced to 13.5%, 25.2%, 27.9%, 32.4%, and 35.7%, respectively. These rate reductions would work to bolster incentives to work, save, invest, and innovate. While the incentive effects would be positive, they would likely not be large since the percentage changes are limited and the program is phased in over an extended time period (so that the annual changes are small). Nonetheless, these rate reductions would work to offset some of the backsliding that has occurred over the years and would undoubtedly be a positive factor reinforcing the incentive structure of the economy and sustaining its growth.

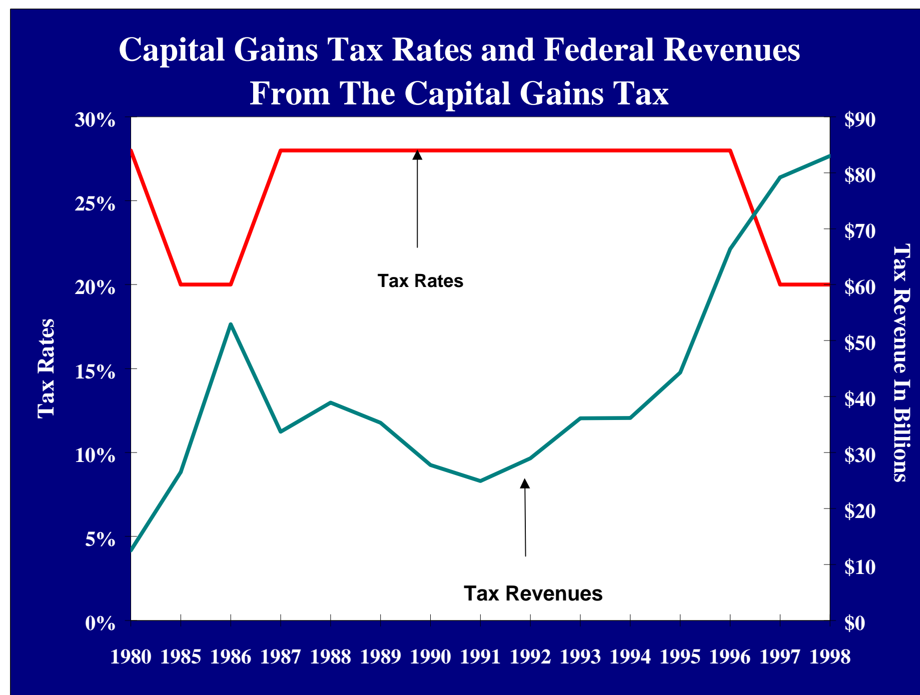
Addressing the Saving Problem

But reducing marginal income tax rates, while quite helpful, does not directly address the problem of multiple layers of taxation that our tax system heaps on saving and investment. Whereas wage income is normally taxed once, income from saving and investment is often taxed twice and sometimes more as assets are sold or passed on into the hands of beneficiaries of

estates. It is at least partly because of these multiple layers of taxation that our savings rate is currently so low (recent data actually show record low and negative savings rates).

Capital Gains Tax Reduction

The Ways and Means tax plan addresses this important issue in a number of ways, including reducing individual capital gains tax rates by 25%. Reducing taxation of capital gains is one way to reduce such excessive taxation of saving and investment. There are several key advantages of reducing capital gains taxation. Such taxation reduces the cost of capital thereby encouraging more investment in various forms. Accordingly, such reduction promotes more economic growth.[3] And because other countries generally have lower rates of capital gains taxation, a U.S. rate cut would also enhance U.S. international competitiveness.



Further, reduction in capital gains taxation has been shown often to be a revenue-raiser. Research suggests an inverse relationship between capital gain tax rate and tax revenue changes.

Since increasing proportions of Americans own investments directly or indirectly in the stock market and own their own homes or businesses, reduction in capital gains taxation can no longer legitimately be labeled a tax cut for the "rich." Increasing numbers of women and younger people would also clearly benefit from such action.

Estate Tax Relief

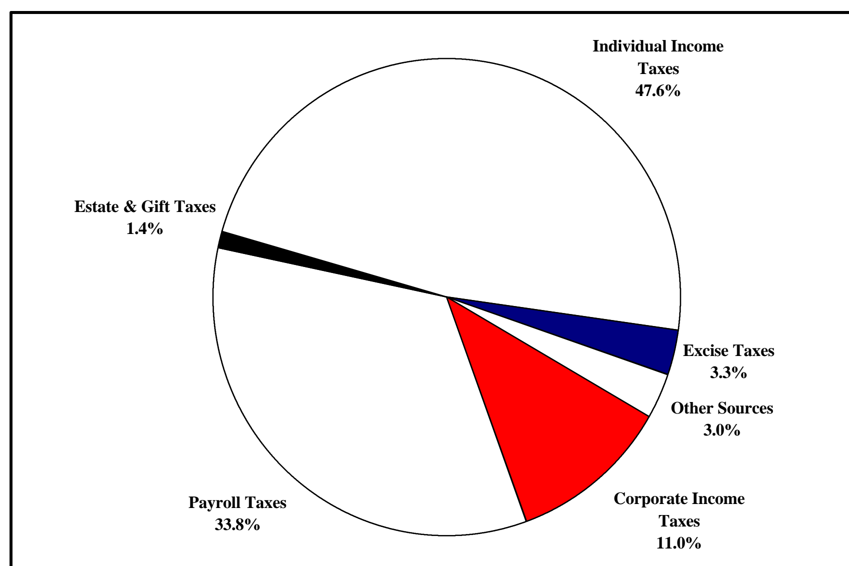
Providing estate tax relief is another way to reduce excessive taxation on saving and investment by reducing the multiple layers of taxation on such activity. The Ways and Means

[3] See Shahira Knight, *The Economic Effects of Capital Gains Taxation*, Joint Economic Committee, June 1997.

phase-in of death tax repeal is a promising way to do this. Extensive research has shown that estate taxes are remarkably costly; their detrimental effects are grossly disproportionate to the modest (if any) amount of federal tax revenue raised. The estate tax's punitive tax rates are the highest of all federal taxes. Additionally, estate tax compliance costs are quite high and the tax is unfair and inefficient.[4]

Because of these extensive costs, estate tax relief would encourage more saving, investment, capital accumulation, entrepreneurial activity, and consequently, economic growth. Many family-run businesses would be preserved instead of prematurely dissolved. And since the estate tax raises little, if any, net revenue for the Federal government, estate tax relief would not be costly from a tax revenue perspective.

Distribution of 1998 Federal Revenues



Saving Incentives

The U.S. national savings rate ranks among the lowest of the G-7 countries. Many economists have found that the low rate of saving is partially caused by tax laws that discourage saving in favor of consumption. Policies aimed at reducing this bias can promote long-term economic growth by increasing the amount of domestic resources available for investment.

One proposal that would help reduce the bias against saving would allow taxpayers to exempt from taxation the first $200 ($400 for joint tax filers) of interest or dividend income earned. Because of the low exclusion caps, such a proposal would primarily benefit low- and middle-income taxpayers and would boost saving incentives for small savers and non-savers. The proposal would interact with other initiatives, such as lower capital gains tax rates and expanded benefits for Individual Retirement Accounts, to create new saving incentives for

[4] See Daniel Miller, *The Economics of the Estate Tax*, Joint Economic Committee, December 1998.

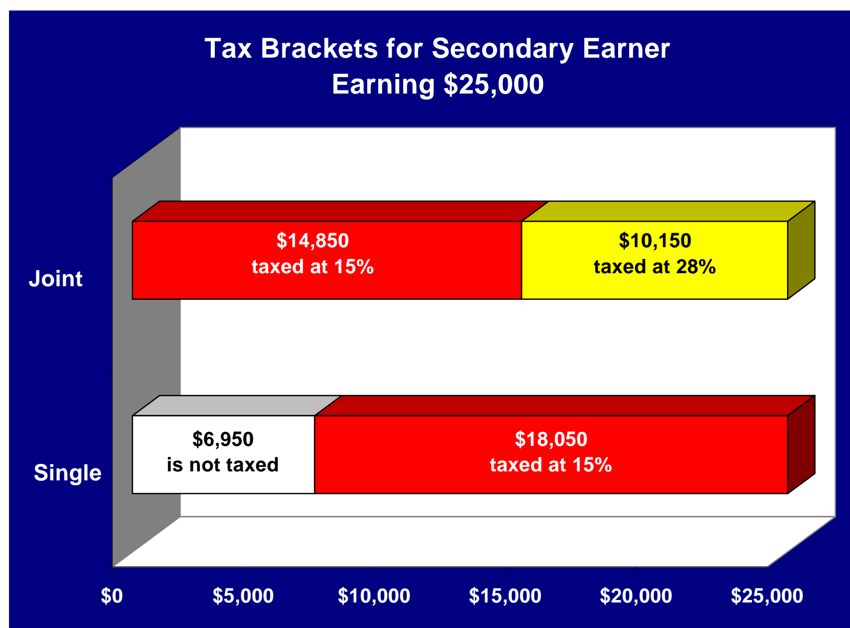
taxpayers across the income spectrum, thus improving the efficiency and neutrality of the tax code.

Estimates by the Joint Committee on Taxation indicate that half of all taxpayers who reported taxable interest income and 35 percent of all taxpayers who reported dividend income would not have paid any taxes on that income if a $200/$400 exclusion were allowed. Overall, 30 million taxpayers would not have paid any taxes on their interest and dividend income. Low- and middle-income taxpayers would receive more valuable tax relief relative to high-income taxpayers when benefits are measured as a percentage of income.

Marriage Penalty

The Ways and Means Committee proposal would reduce the marriage penalty. Marriage penalties and bonuses occur because several provisions in the tax code treat joint tax filers differently than two single filers with the same total income.[5] Marriage taxes most commonly arise because of variations in the size of the standard deduction and the widths of the tax brackets across different filing statuses. At low levels of income, the earned income tax credit (EITC) is the main source of marriage taxes.

Whether a particular couple receives a marriage penalty or bonus (or neither) depends primarily on their division of income. Marriage penalties are more likely to occur if a couple's income is evenly divided between husband and wife. In contrast, marriage bonuses are more likely to occur if a couple's income is largely attributable to one spouse. For a given level of income, the largest penalties are generally paid by two-earner couples with a 50-50 income split, and the largest bonuses are received by one-earner couples (100-0 income split).



[5] See Shahira Knight, *Reducing Marriage Taxes: Issues and Proposals*, Joint Economic Committee, May 1998.

Business Investment and Job Creation

The growth of the U.S. economy continues to be led by business investment that spurs new technologies and job creation. The Ways and Means tax plan improves economic incentives for business investment by reducing the corporate capital gains tax, phasing out the corporate alternative minimum tax ("AMT"), and extending the research tax credit.

Under present law, the net capital gain of a corporation is taxed at the same rate as ordinary income, and subject to graduated tax rates up to 35 percent. The Ways and Means tax plan would allow for the application of an alternative tax on capital gains, beginning with a 34 percent tax rate in 2000. The alternative tax rate would be reduced by one percentage point per year until a 25 percent rate is reached beginning in 2009.

Present law also imposes a minimum tax on a corporation to the extent a corporation's minimum tax liability exceeds its regular tax liability, although preferences, exclusions and phase-outs exist. Furthermore, if a corporation is subject to AMT in any given year, the amount of tax exceeding the regular tax liability may be allowed as a credit ("AMT credit") in subsequent taxable years. The Ways and Means tax plan increases the limitation on the amount of AMT credits allowable to a corporation, including treatment of the AMT foreign tax credit, and eliminates the corporate AMT altogether beginning in 2008.

The research tax credit has provided a major economic incentive for business investment in new technology and helps spur economic growth and job creation by lowering the tax burden on research and development. The Ways and Means tax bill provides for the 10th extension of the research tax credit since its introduction on a temporary basis in 1981. The research tax credit would be extended for five years, covering the period July 1, 1999 through June 30, 2004.

The economic effect of these measures is to reduce the tax bias against investment and innovation. Reducing the corporate capital gains tax rate, providing relief from the corporate alternative minimum tax, and extending the research tax credit would provide incentives and resources for more business investment in new capital and technology, expanding output and employment. Additionally, reducing the corporate capital gains tax rate would reduce the double taxation that occurs in our current tax system when corporate profits are taxed and then distributions to individual shareholders are taxed, as well. Reducing this double taxation increases the return to individual investors and strengthens the economic incentives to save and invest. Furthermore, the extension of the research tax credit will continue to provide businesses an incentive to invest in technology and innovation. By reducing the tax burden through these and other measures, increased incentives are provided for investment in new capital and technology, thus increasing productivity and economic growth.

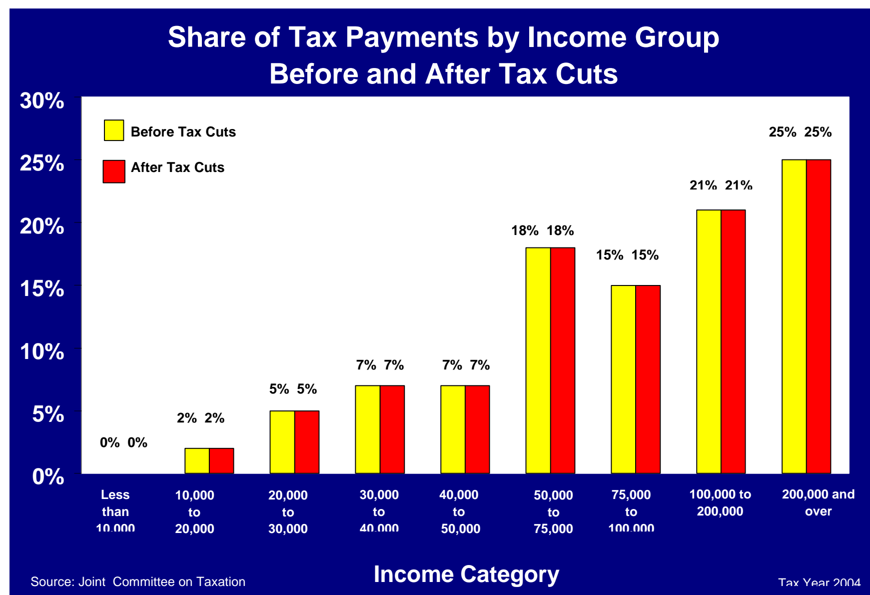
IV. Taxes and Taxpayers

In the debate of tax relief proposals, sometimes it is contended that tax reduction unduly favors the affluent. This point of view is often based on statistical sketches of tax changes in which the benefits appear skewed toward higher-income taxpayers, but in reality only reflect the current pattern of tax payments taken out of context. Very often this kind of information

allocating the benefits of tax changes is circulated without any comparison of the share of tax payments of each income group before and after the effects of the tax reduction legislation are taken into account.

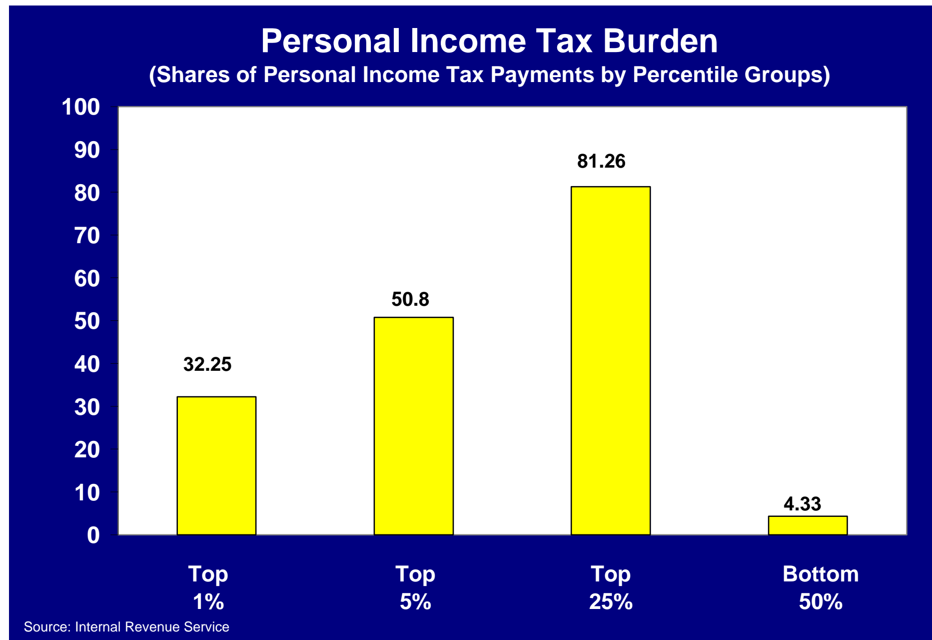
On the other hand, if the relative shares of the tax burden of each income grouping are unchanged before and after a tax change is taken into account, it is hard to establish reasonable grounds to assert that the tax change is skewed unfairly. For example, if the shares of total taxes paid among the bottom, middle, and top fifth are unchanged before and after a tax change is made, there is little factual basis for arguing that the new tax law is any worse than the previous one.[6]

The graph below shows the relative shares of the tax burden before and after the effects of the currently proposed tax relief legislation are taken into account. As one can see, under the House legislation, the *shares* of taxes paid by all income groups are unchanged. The graph also makes the point that "taxpayers" at low income levels pay little or no taxes, while those at middle-and high-income levels pay most of the tax burden.



According to a different set of data prepared by the Internal Revenue Service (IRS), the top one percent of filers pay 32.3 percent of the personal income taxes. The IRS data show that the income tax share of the top 5 percent is 50.8 percent, and that of the top 25 percent is 81.3 percent. Filers in the bottom 50 percent paid 4.3 percent of personal income taxes. Incidentally, the taxpayers in the top quarter of taxpayers qualified by earning more than only $45,833 in 1996. The shares of personal income tax payments are displayed in the graph below.

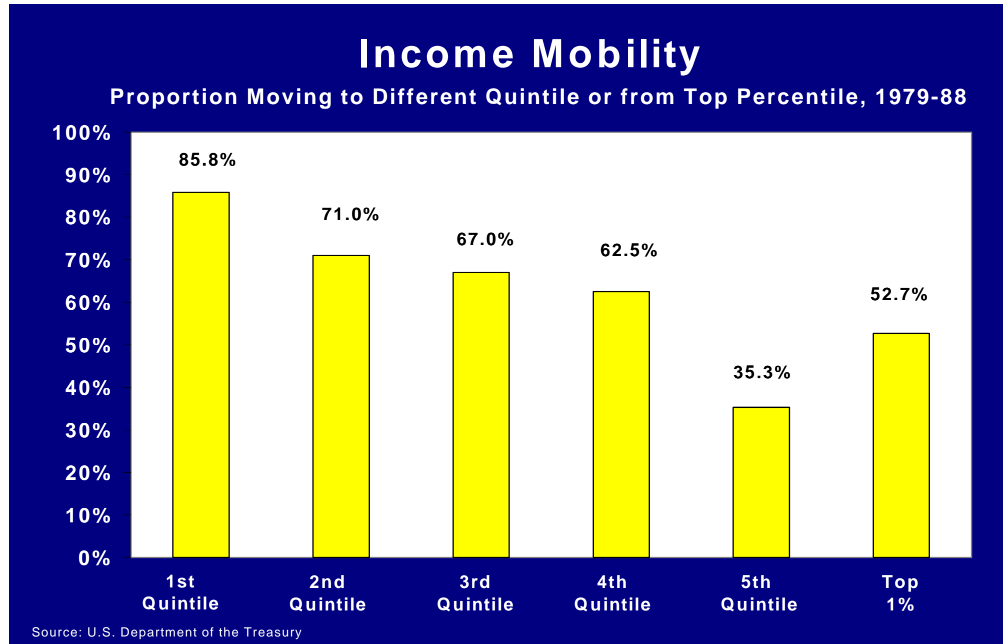
[6] Christopher Frenze, *Treasury Department Estimates of Tax Changes: A Review and Analysis*, Joint Economic Committee, July 1997.



Another serious problem regarding the analysis of the tax changes on taxpayers at various income levels is that those households are not necessarily cemented into specific income classes for extended periods of time. The United States has a dynamic economy in which there are remarkable degrees of income mobility. Over extended periods, many if not most of those in a particular income strata move up or down. Thus, statements based on the assumption that taxpayers are confined to particular income classes over time do not accurately reflect a much more complicated and interesting reality.

For example, according to tax return data, 85.8 percent of filers in the bottom 5th in 1979 had exited this quintile by 1988. The corresponding mobility rates were 71.0 percent for the second lowest quintile, 67.0 percent for the middle quintile, 62.5 percent for the fourth quintile, and 35.3 percent for the top quintile.[7] The long-run impact of tax policy on most taxpayers depends on their tax situations and incomes in the future, not the present. The graph below displays the high degree of income mobility in the U.S. over one ten-year period.

[7] See Christopher Frenze, *Income Mobility and Economic Opportunity*, Joint Economic Committee, June 1992.



As can be seen, America is a fluid and dynamic society, not a caste system. The portrayal of the American economy as a rigid class system is contradicted by the statistical evidence.

Conclusion

The current tax system is counterproductive and biased against saving and investment. The tax system imposes large losses on the economy that reduce the economic welfare of households and businesses. The current level of taxation imposes additional costs of about 40 cents at the margin for each dollar collected in revenue. A reduction in the burden imposed by the tax system would make a significant improvement in the economic well-being of American households. Furthermore, if this surplus revenue is not returned to the taxpayers, it appears likely that most of it will be absorbed in federal spending increases. The Ways and Means Committee tax bill would improve economic incentives, reduce deadweight losses, and provide broad-based relief to households subjected to excessive income taxation.

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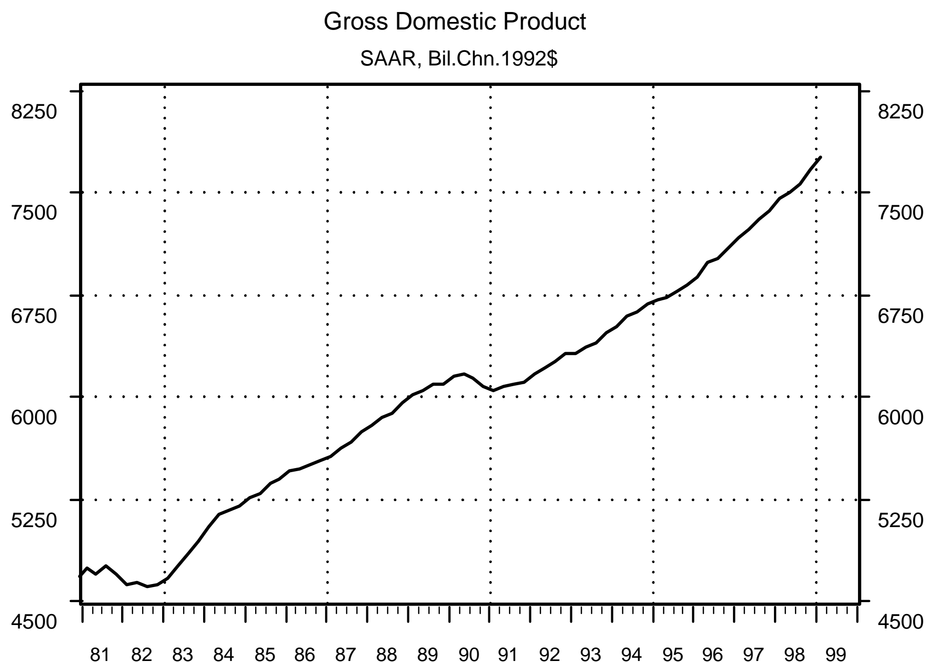


Source: Haver Analytics

This extraordinarily sustained period of expansion has been associated with lower inflation, lower interest rates, falling unemployment rates, higher labor-force participation, higher investment, and an exceptional degree of innovation and entrepreneurial activity.

There are a number of reasons for this superb macroeconomic performance. Excellent monetary policy, technological innovation, global competition and freer trade together with constrained government spending have all played a role. But tax policy is also central to any explanation of this record-setting, sustained growth. In particular, the substantial marginal income tax rate reductions in the 1980s laid in place an incentive structure that has encouraged and fostered steady and long-run improvements in work effort, investment, innovation and entrepreneurial activity. It is no coincidence that the 1960s expansion -- the longest expansion on record (which included the Vietnam War) --also followed significant cuts in marginal rates of taxation.

Because such tax rate cuts encourage the supply of labor and capital as well as innovation and entrepreneurial activity, they impact aggregate supply and increases in the capacity of the economy to grow; such tax cuts foster economic growth. While some backsliding has occurred with the rate increases in some tax brackets in 1990 and 1993, most marginal tax rates still remain lower than rates which existed in the 1950s, 1960s, and 1970s.

Despite this successful record over the long-term, there are a number of reasons why additional tax relief is still most appropriate at this time. While marginal income tax rates for the most part remain below earlier levels, income tax rates and other forms of taxation have gradually increased in recent years. Increases have occurred in payroll taxes, excise taxes on gasoline, alcohol, tobacco and various luxuries, and federal user fees. Additionally, because significant portions of the tax code are not indexed for (persistent, albeit lower) inflation, taxation has increased for unindexed items such as estate taxation and various elements of corporate and capital taxation. Further, our progressive income tax system -- while indexed for inflation -- is not adjusted for real growth. Hence, as the economy grows, individuals gradually are pushed into higher tax brackets over time and the alternative minimum tax applies to more and more people. Much of this increased taxation not only creates distortions (and adds to deadweight loss) but adds to the multiple layers of taxation on saving and investment, thereby reducing incentives to save, invest, innovate, consequently thwarting longer term growth.

All of these factors help to explain why federal taxation as a percentage of GDP -- or the federal tax burden -- has increased to record levels in recent years. During the current expansion, for example, federal tax revenues have grown significantly faster than the macroeconomy, placing ever-higher burdens on many of those paying taxes. Higher and higher shares of national income are being devoted to paying federal taxes. Not only is the proportion of federal tax revenue to GDP at the highest levels since World War II, but the Presidents' budget projects this tax revenue-to-GDP ratio to remain at or near record levels throughout the entire budget forecast horizon. In short, tax policy is growing more restrictive and burdensome on the overall economy from both the average and marginal rate perspectives. Accordingly, tax rate reduction to relieve some of this increased burden and thereby promote, restore, and sustain efficiency and growth is most appropriate at this time. Legislation to accomplish these objectives is under consideration in Congress.

III. The Ways and Means Tax Legislation

The House tax legislation, by reducing personal tax rates, lowering the capital gains tax rate, phasing out the estate tax, and enhancing incentives for personal saving along with other measures, would lessen the cost of the tax system upon the economy and free resources for more productive uses.

In evaluating the economic effects of growth-oriented tax reduction there are two opposing potential errors. On the one hand, it would be easy to exaggerate the economic effects of tax legislation and produce unduly optimistic and inaccurate revenue projections. On the other hand, it could be equally unrealistic and inaccurate to assume that no positive macroeconomic effects would result from major tax legislation. This latter approach is the standard one used in revenue scoring of tax legislation.

The tax bill is estimated to save taxpayers $792 billion in static revenue terms over 10 years. However, this estimate, following the conventions of static revenue analysis, does not include any possible effects on economic growth. However, an assumed increase in the rate of economic growth of about two-tenths of a percentage point would be quite modest, but even this small increase would produce an additional $240 billion over the 10-year period. This would offset over one-quarter of the projected revenue cost and provide some insurance against the vagaries of long-term budget estimates.

This example illustrates the point that just as long-term forecasts often generate large static revenue losses, they also have the potential to generate considerable revenue offsets if ever modest macroeconomic effects are considered.

Major Provisions That Improve Economic Incentives

Marginal Rate Cuts

The Ways and Means tax plan lowers personal income tax rates. It includes a 10% across-the-board reduction in tax rates, phased in over 10 years. The 15%, 28%, 31%, 36%, and 39.6% rates would be reduced to 13.5%, 25.2%, 27.9%, 32.4%, and 35.7%, respectively. These rate reductions would work to bolster incentives to work, save, invest, and innovate. While the incentive effects would be positive, they would likely not be large since the percentage changes are limited and the program is phased in over an extended time period (so that the annual changes are small). Nonetheless, these rate reductions would work to offset some of the backsliding that has occurred over the years and would undoubtedly be a positive factor reinforcing the incentive structure of the economy and sustaining its growth.

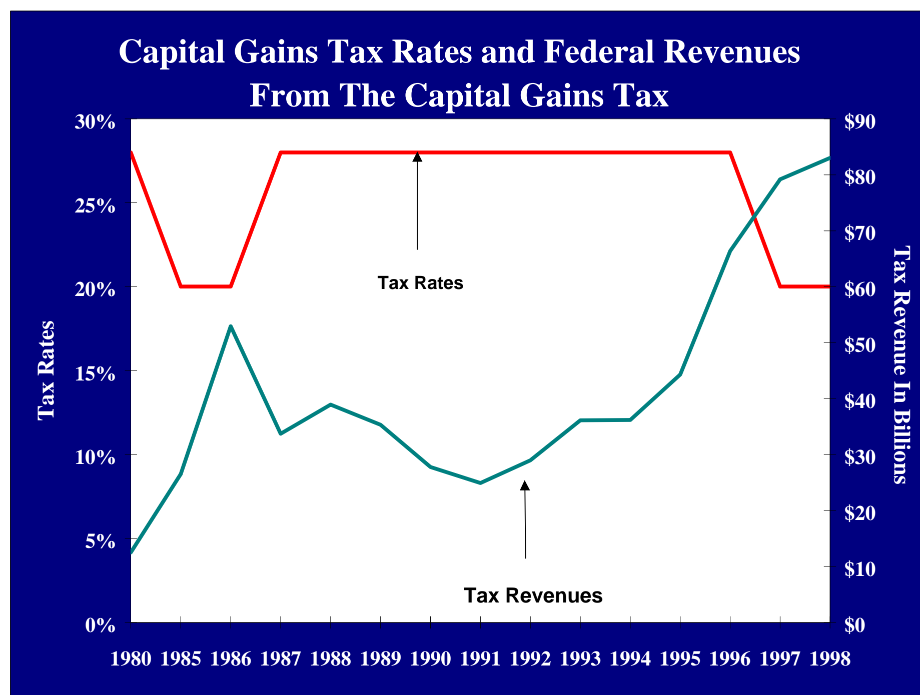
Addressing the Saving Problem

But reducing marginal income tax rates, while quite helpful, does not directly address the problem of multiple layers of taxation that our tax system heaps on saving and investment. Whereas wage income is normally taxed once, income from saving and investment is often taxed twice and sometimes more as assets are sold or passed on into the hands of beneficiaries of

estates. It is at least partly because of these multiple layers of taxation that our savings rate is currently so low (recent data actually show record low and negative savings rates).

Capital Gains Tax Reduction

The Ways and Means tax plan addresses this important issue in a number of ways, including reducing individual capital gains tax rates by 25%. Reducing taxation of capital gains is one way to reduce such excessive taxation of saving and investment. There are several key advantages of reducing capital gains taxation. Such taxation reduces the cost of capital thereby encouraging more investment in various forms. Accordingly, such reduction promotes more economic growth.[3] And because other countries generally have lower rates of capital gains taxation, a U.S. rate cut would also enhance U.S. international competitiveness.



Further, reduction in capital gains taxation has been shown often to be a revenue-raiser. Research suggests an inverse relationship between capital gain tax rate and tax revenue changes.

Since increasing proportions of Americans own investments directly or indirectly in the stock market and own their own homes or businesses, reduction in capital gains taxation can no longer legitimately be labeled a tax cut for the "rich." Increasing numbers of women and younger people would also clearly benefit from such action.

Estate Tax Relief

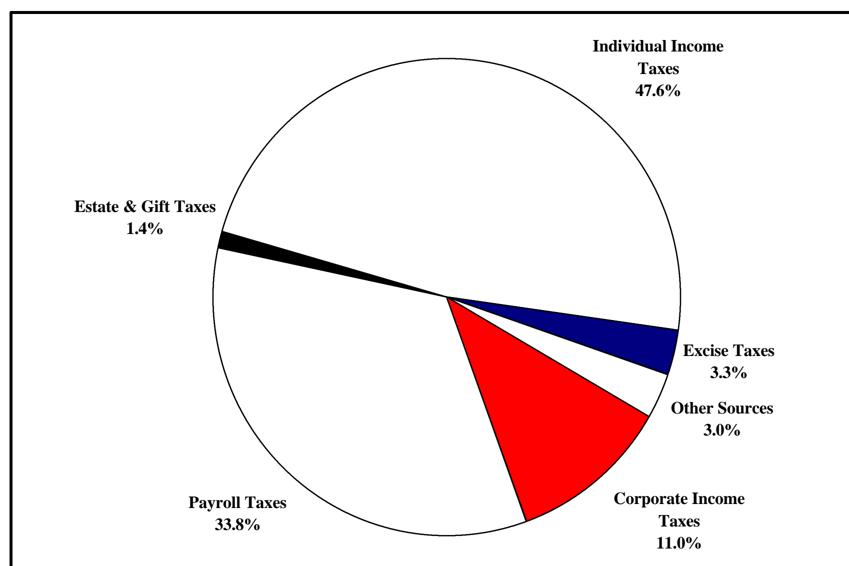
Providing estate tax relief is another way to reduce excessive taxation on saving and investment by reducing the multiple layers of taxation on such activity. The Ways and Means

[3] See Shahira Knight, *The Economic Effects of Capital Gains Taxation*, Joint Economic Committee, June 1997.

phase-in of death tax repeal is a promising way to do this. Extensive research has shown that estate taxes are remarkably costly; their detrimental effects are grossly disproportionate to the modest (if any) amount of federal tax revenue raised. The estate tax's punitive tax rates are the highest of all federal taxes. Additionally, estate tax compliance costs are quite high and the tax is unfair and inefficient.[4]

Because of these extensive costs, estate tax relief would encourage more saving, investment, capital accumulation, entrepreneurial activity, and consequently, economic growth. Many family-run businesses would be preserved instead of prematurely dissolved. And since the estate tax raises little, if any, net revenue for the Federal government, estate tax relief would not be costly from a tax revenue perspective.

Distribution of 1998 Federal Revenues



Saving Incentives

The U.S. national savings rate ranks among the lowest of the G-7 countries. Many economists have found that the low rate of saving is partially caused by tax laws that discourage saving in favor of consumption. Policies aimed at reducing this bias can promote long-term economic growth by increasing the amount of domestic resources available for investment.

One proposal that would help reduce the bias against saving would allow taxpayers to exempt from taxation the first $200 ($400 for joint tax filers) of interest or dividend income earned. Because of the low exclusion caps, such a proposal would primarily benefit low- and middle-income taxpayers and would boost saving incentives for small savers and non-savers. The proposal would interact with other initiatives, such as lower capital gains tax rates and expanded benefits for Individual Retirement Accounts, to create new saving incentives for

[4] See Daniel Miller, *The Economics of the Estate Tax*, Joint Economic Committee, December 1998.

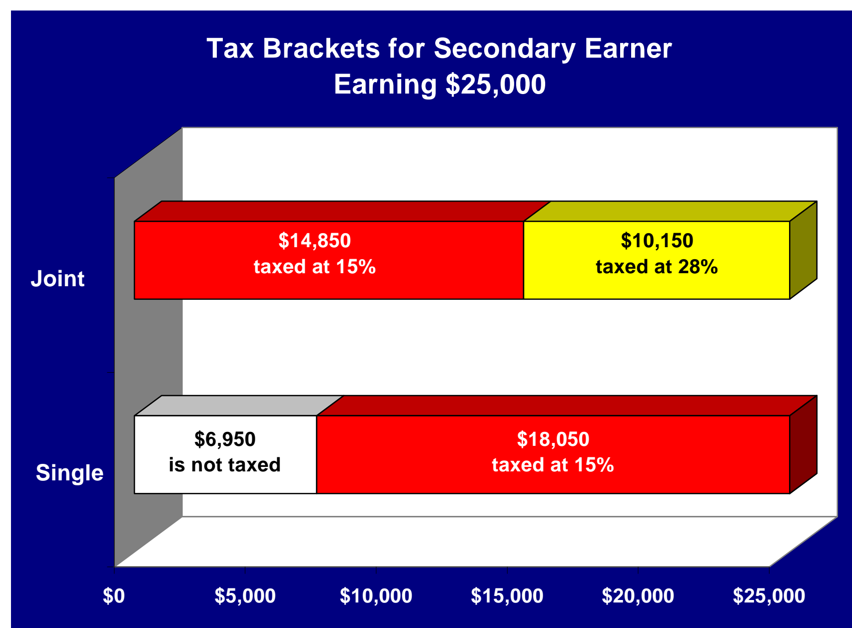
taxpayers across the income spectrum, thus improving the efficiency and neutrality of the tax code.

Estimates by the Joint Committee on Taxation indicate that half of all taxpayers who reported taxable interest income and 35 percent of all taxpayers who reported dividend income would not have paid any taxes on that income if a $200/$400 exclusion were allowed. Overall, 30 million taxpayers would not have paid any taxes on their interest and dividend income. Low- and middle-income taxpayers would receive more valuable tax relief relative to high-income taxpayers when benefits are measured as a percentage of income.

Marriage Penalty

The Ways and Means Committee proposal would reduce the marriage penalty. Marriage penalties and bonuses occur because several provisions in the tax code treat joint tax filers differently than two single filers with the same total income. [5] Marriage taxes most commonly arise because of variations in the size of the standard deduction and the widths of the tax brackets across different filing statuses. At low levels of income, the earned income tax credit (EITC) is the main source of marriage taxes.

Whether a particular couple receives a marriage penalty or bonus (or neither) depends primarily on their division of income. Marriage penalties are more likely to occur if a couple's income is evenly divided between husband and wife. In contrast, marriage bonuses are more likely to occur if a couple's income is largely attributable to one spouse. For a given level of income, the largest penalties are generally paid by two-earner couples with a 50-50 income split, and the largest bonuses are received by one-earner couples (100-0 income split).



[5] See Shahira Knight, *Reducing Marriage Taxes: Issues and Proposals*, Joint Economic Committee, May 1998.

Business Investment and Job Creation

The growth of the U.S. economy continues to be led by business investment that spurs new technologies and job creation. The Ways and Means tax plan improves economic incentives for business investment by reducing the corporate capital gains tax, phasing out the corporate alternative minimum tax ("AMT"), and extending the research tax credit.

Under present law, the net capital gain of a corporation is taxed at the same rate as ordinary income, and subject to graduated tax rates up to 35 percent. The Ways and Means tax plan would allow for the application of an alternative tax on capital gains, beginning with a 34 percent tax rate in 2000. The alternative tax rate would be reduced by one percentage point per year until a 25 percent rate is reached beginning in 2009.

Present law also imposes a minimum tax on a corporation to the extent a corporation's minimum tax liability exceeds its regular tax liability, although preferences, exclusions and phase-outs exist. Furthermore, if a corporation is subject to AMT in any given year, the amount of tax exceeding the regular tax liability may be allowed as a credit ("AMT credit") in subsequent taxable years. The Ways and Means tax plan increases the limitation on the amount of AMT credits allowable to a corporation, including treatment of the AMT foreign tax credit, and eliminates the corporate AMT altogether beginning in 2008.

The research tax credit has provided a major economic incentive for business investment in new technology and helps spur economic growth and job creation by lowering the tax burden on research and development. The Ways and Means tax bill provides for the 10th extension of the research tax credit since its introduction on a temporary basis in 1981. The research tax credit would be extended for five years, covering the period July 1, 1999 through June 30, 2004.

The economic effect of these measures is to reduce the tax bias against investment and innovation. Reducing the corporate capital gains tax rate, providing relief from the corporate alternative minimum tax, and extending the research tax credit would provide incentives and resources for more business investment in new capital and technology, expanding output and employment. Additionally, reducing the corporate capital gains tax rate would reduce the double taxation that occurs in our current tax system when corporate profits are taxed and then distributions to individual shareholders are taxed, as well. Reducing this double taxation increases the return to individual investors and strengthens the economic incentives to save and invest. Furthermore, the extension of the research tax credit will continue to provide businesses an incentive to invest in technology and innovation. By reducing the tax burden through these and other measures, increased incentives are provided for investment in new capital and technology, thus increasing productivity and economic growth.

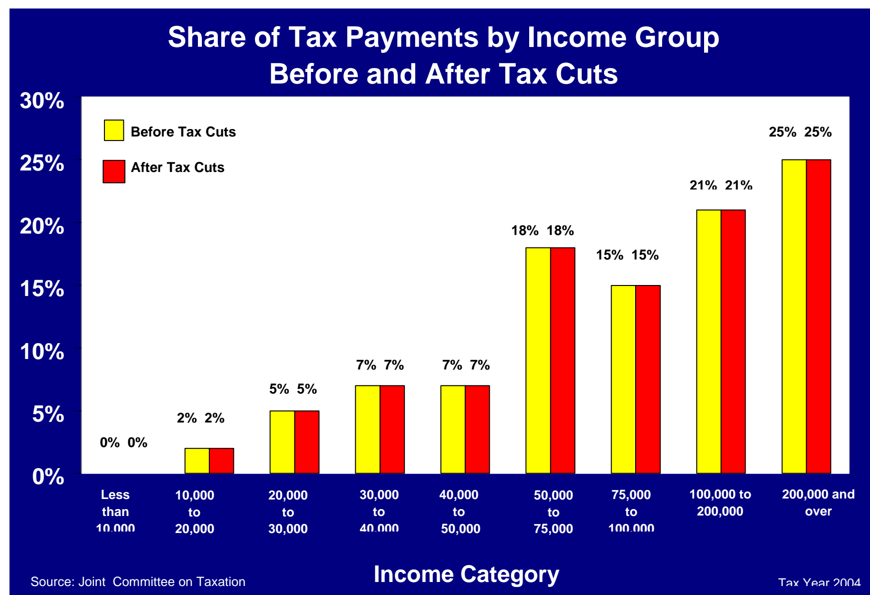
IV. Taxes and Taxpayers

In the debate of tax relief proposals, sometimes it is contended that tax reduction unduly favors the affluent. This point of view is often based on statistical sketches of tax changes in which the benefits appear skewed toward higher-income taxpayers, but in reality only reflect the current pattern of tax payments taken out of context. Very often this kind of information

allocating the benefits of tax changes is circulated without any comparison of the share of tax payments of each income group before and after the effects of the tax reduction legislation are taken into account.

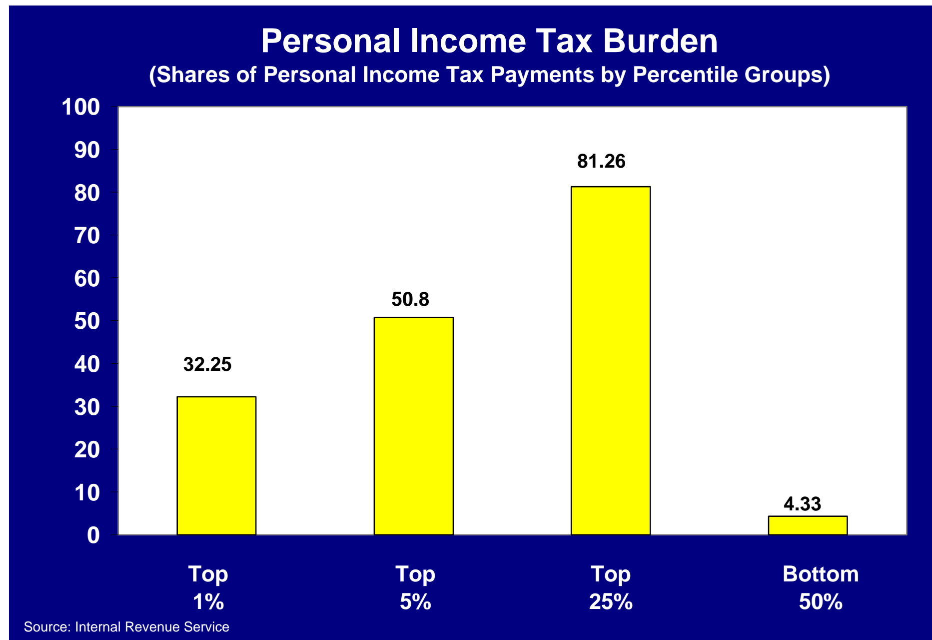
On the other hand, if the relative shares of the tax burden of each income grouping are unchanged before and after a tax change is taken into account, it is hard to establish reasonable grounds to assert that the tax change is skewed unfairly. For example, if the shares of total taxes paid among the bottom, middle, and top fifth are unchanged before and after a tax change is made, there is little factual basis for arguing that the new tax law is any worse than the previous one.[6]

The graph below shows the relative shares of the tax burden before and after the effects of the currently proposed tax relief legislation are taken into account. As one can see, under the House legislation, the *shares* of taxes paid by all income groups are unchanged. The graph also makes the point that "taxpayers" at low income levels pay little or no taxes, while those at middle-and high-income levels pay most of the tax burden.



According to a different set of data prepared by the Internal Revenue Service (IRS), the top one percent of filers pay 32.3 percent of the personal income taxes. The IRS data show that the income tax share of the top 5 percent is 50.8 percent, and that of the top 25 percent is 81.3 percent. Filers in the bottom 50 percent paid 4.3 percent of personal income taxes. Incidentally, the taxpayers in the top quarter of taxpayers qualified by earning more than only $45,833 in 1996. The shares of personal income tax payments are displayed in the graph below.

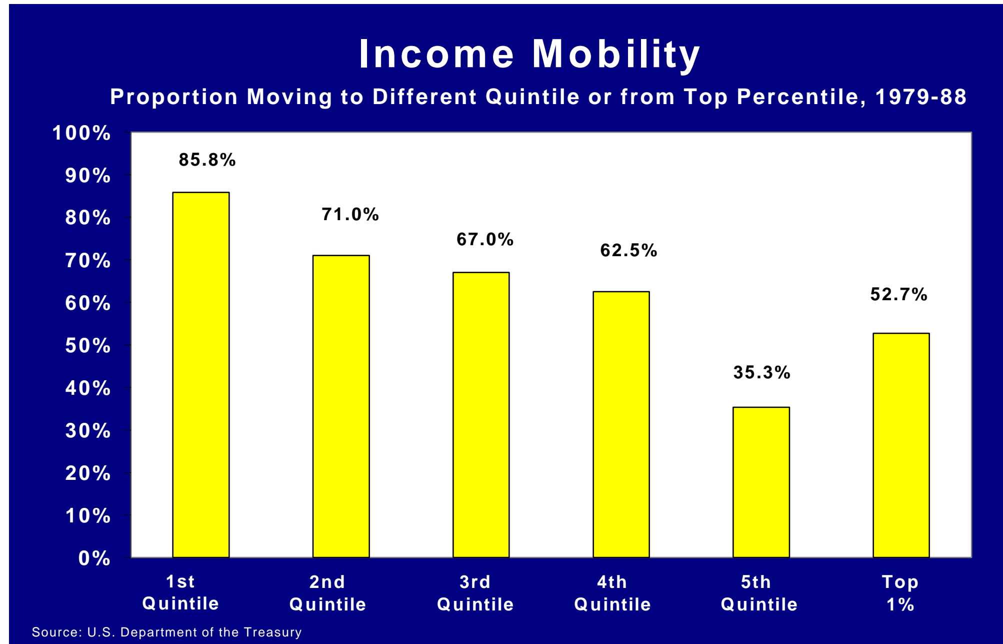
[6] Christopher Frenze, *Treasury Department Estimates of Tax Changes: A Review and Analysis*, Joint Economic Committee, July 1997.



Another serious problem regarding the analysis of the tax changes on taxpayers at various income levels is that those households are not necessarily cemented into specific income classes for extended periods of time. The United States has a dynamic economy in which there are remarkable degrees of income mobility. Over extended periods, many if not most of those in a particular income strata move up or down. Thus, statements based on the assumption that taxpayers are confined to particular income classes over time do not accurately reflect a much more complicated and interesting reality.

For example, according to tax return data, 85.8 percent of filers in the bottom 5th in 1979 had exited this quintile by 1988. The corresponding mobility rates were 71.0 percent for the second lowest quintile, 67.0 percent for the middle quintile, 62.5 percent for the fourth quintile, and 35.3 percent for the top quintile.[7] The long-run impact of tax policy on most taxpayers depends on their tax situations and incomes in the future, not the present. The graph below displays the high degree of income mobility in the U.S. over one ten-year period.

[7] See Christopher Frenze, *Income Mobility and Economic Opportunity*, Joint Economic Committee, June 1992.



As can be seen, America is a fluid and dynamic society, not a caste system. The portrayal of the American economy as a rigid class system is contradicted by the statistical evidence.

Conclusion

The current tax system is counterproductive and biased against saving and investment. The tax system imposes large losses on the economy that reduce the economic welfare of households and businesses. The current level of taxation imposes additional costs of about 40 cents at the margin for each dollar collected in revenue. A reduction in the burden imposed by the tax system would make a significant improvement in the economic well-being of American households. Furthermore, if this surplus revenue is not returned to the taxpayers, it appears likely that most of it will be absorbed in federal spending increases. The Ways and Means Committee tax bill would improve economic incentives, reduce deadweight losses, and provide broad-based relief to households subjected to excessive income taxation.