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MIDDLE-INCOME TAX PROPOSALS

HEARING

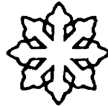
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

MARCH 2, 1995



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CONTENTS

OPENING STATEMENTS

Page

Packwood, Hon. Bob, a U.S. Senator from Oregon, chairman, Committee on Finance 1
Moynihan, Hon. Daniel Patrick, a U.S. Senator from New York 3
Conrad, Hon. Kent, a U.S. Senator from North Dakota 4

PUBLIC WITNESSES

Bauer, Gary, Family Research Council, Washington, DC 4
Bergsten, C. Fred, chairman, Competitiveness Policy Council, Washington, DC 6
Mitchell, Daniel J., McKenna Senior Fellow in Political Economy, Heritage Foundation, Washington, DC 8
Schenk, Deborah H., professor of law, New York University Law School, New York, NY 10
Shapiro, Robert, vice president, Progressive Policy Institute, Washington, DC 12

ALPHABETICAL LISTING AND APPENDIX MATERIAL SUBMITTED

"Background and Information Relating to Three Tax Cut Proposals for Middle-Income Americans," staff report of the Joint Committee on Taxation 53
Bauer, Gary:
 Testimony 4
 Prepared statement 37
Bergsten, C. Fred:
 Testimony 6
 Prepared statement 40
Conrad, Hon. Kent:
 Opening statement 4
Feingold, Hon. Russell D.:
 Prepared statement 1
Grassley, Hon. Charles E.:
 Prepared statement 44
Mitchell, Daniel J.:
 Testimony 8
 Prepared statement 44
Moynihan, Hon. Daniel Patrick:
 Opening statement 3
 Letter from Erwin N. Griswold, with attachment 18
Packwood, Hon. Bob:
 Opening statement 1
Schenk, Deborah H.:
 Testimony 10
 Prepared statement 45
Shapiro, Robert:
 Testimony 12
 Prepared statement 50

MIDDLE-INCOME TAX PROPOSALS

THURSDAY, MARCH 2, 1995

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman of the committee) presiding.

Also present: Senators Moynihan, Bradley, Breaux, Conrad, Graham, Moseley-Braun, Grassley, D'Amato, and Nickles.*

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order, please.

I might say to the Ranking Member, Senator Feingold called me this morning and wanted to know if he could come and testify. I said, of course. Then I discovered the staff has turned down three or four other Senators that wanted to speak this morning and had to call him back and explain.

So I do have a statement of his that I am going to ask unanimous consent to put in the record, and indicate that, but for me, he would have been here, but, in fairness I could not tell him to come after we had turned down three or four others who wanted to speak. So, I will put his statement in at the very start of this hearing.

[The prepared statement of Senator Feingold follows:]

PREPARED STATEMENT OF SENATOR RUSSELL D. FEINGOLD

I thank the Chairman and Ranking Member for allowing me to testify briefly this morning. I very much appreciate your courtesy in allowing me to express my thoughts on the subject.

I have strong reservations with the so-called middle-class tax cut proposals that have been offered by leaders of both parties.

That is why today I am introducing a resolution expressing the Sense of the Senate that enacting an across-the-board or so-called middle class tax cut during the 104th Congress would hinder efforts to reduce the Federal deficit.

Though I would certainly like to support a tax cut measure, especially one that provides a well deserved tax break to middle-class Americans, supporting that kind of proposal is simply not responsible right now, especially given the recent developments with respect to the balanced budget amendment.

During a month of telling debate on the proposal, we have not done one thing that will actually help us achieve the widely shared goal of a balanced budget.

It is time we did.

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*Background and information relating to this hearing, prepared by the Joint Committee on Taxation, appears in the appendix.

We have been making some headway in reducing the deficit. President Clinton's 1993 deficit reduction package was a critical turning point in our fight to reduce the deficit, and we are now in the third straight year of progressively lower deficits.

However, we need to do more, and I firmly believe we not only undermine those needed future efforts but could also jeopardize the progress we have already made by rushing to cut taxes.

Let me emphasize that my opposition to tax cuts is bipartisan—the tax cut proposals of both parties are wrong. I publicly opposed the President's proposed tax cuts the same day he even announced them.

And I think opposition to the tax cut proposals of both parties has bipartisan support.

I want to take this opportunity to publicly thank the Chairman for his support of my Sense of the Senate motion opposing across-the-board or middle-class tax cuts motion that I made as part of the balanced budget amendment debate.

His support, as well as the support of other Republican Senators, was particularly heartening, and I think it reveals a growing consensus that deficit reduction must be a higher priority than tax cuts right now.

The President proposes about $63 billion in tax cuts over the next 5 years, a figure that grows to $174 billion over ten years.

The Republican "Contract with America" has proposed tax cuts totaling $196 billion over 5 years—$704 billion over ten years.

To me, all of those figures represent the cost of a lost opportunity.

The President's tax cuts are part of his budget package, and he has indicated that they are more than offset by $184 billion in spending cuts. And at least some of those supporting the Republican Contract With America tax cut package have indicated they too would be offsetting the cost of those tax cuts with spending cuts.

However, even if they are fully offset—I hope we would agree that to be an absolute minimum requirement—we would do much better to forego those tax cuts.

Eliminating the President's tax cut proposals, while doing nothing else to his budget, would result in $72 billion in additional deficit reduction over the next 5 years—the $63 billion in foregone tax cuts plus $9 billion in interest savings.

Just doing that, and nothing more, would produce a Federal budget deficit of $170 billion in FY 2000, $24 billion lower than the $194 billion projected as part of the President's budget.

The figures for the Contract With America tax cuts are even more dramatic.

Assuming spending cuts are produced to offset that tax cut package, and then assuming we decided not to adopt those tax cuts, doing nothing else to the President's budget would result in $217 billion in additional deficit reduction over the next 5 years—$196 billion in foregone tax cuts plus $21 billion in interest savings.

Just doing that, and nothing more, would produce a Federal budget deficit of $114 billion in FY 2000, $80 billion lower than the $194 billion projected as part of the President's budget.

Over 10 years, we would save $178 billion in *interest costs alone* by *not* adopting the Contract with America tax cut package, and could produce $882 billion in deficit reduction.

Let me conclude by noting that tax cut proposals are grounded in the old politics of the free lunch—promise the people a tax cut *and* a balanced budget. It is the kind of politics that created the fiscal mess which now confronts us and undermined the American people's faith in their government.

By resisting calls for tax cuts, we not only help alleviate pressure on the deficit, we also can begin to restore some of that lost confidence.

I hope the Members of this committee will join me in persuading a majority of the Senate that it is irresponsible to cut taxes as we are trying to reduce the deficit and balance the Federal budget.

The CHAIRMAN. I might say to the witnesses, this is the way Senator Moynihan and I have been theorizing these hearings. We started out early to see if the Tax Code tilted toward consumption. Almost all the witnesses said, yes, it does tilt toward consumption. We are done with those hearings.

The second round was, well, should it tilt toward consumption? And there you had some split. Most people said, no, it should tilt toward savings and investment, but there were some industries that are consumption industries and they like the Tax Code the way it is.

I would just guess it would be maybe four to one in favor of savings and investment if you had to make a choice between savings, investment and capital versus consumption. But it was not as uniform as, does the Tax Code tilt toward consumption?

All right. The third round of hearings. We are in the midst of those now. If we want to tilt toward savings and investment in capital, what is the best way to do it? And here I find with 100 witnesses there are 100 ways. If you are big on selling IRAs, it is IRAs. If you are really into 401(k)s, it is 401(k)s.

Then there are the particular groups into 403s, which are a more limited form of savings for a narrow industry. Then there is a capital formation group, and then there is a Nunn-Domenici group, and a flat tax group, and some from the old Hall-Rabushka days, that they are all variations of forms of flat tax, there are value added tax people.

We are not done with these hearings yet, but if we do not adopt some generic form of tilting away from consumption and toward savings and investment, then what we are left with is attempting to jiggle the present Tax Code, and I fear what I think will happen at that stage. Every single group will want its bauble hung on the Code and they will regard themselves as the lynch pin for savings and investment.

Our tendency in Congress, unfortunately, is not to exactly pick and choose, but if we grant two or three of these we would be inclined to grant five or six because we will not want to say no to the others when we have said yes to some.

I do not mean that as any comment one way or the other on the testimony today. This is a subject we have not covered and there is a lot of testimony here on the family tax credit, and families, and this is part of it.

But I think I can speak for the committee in saying we would like to encourage savings and investment and capital formation, and we are in the midst of trying to figure out the best way to do it.

Senator Moynihan?

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Mr. Chairman, I would like to associate myself with your puzzlement at the limited range of prescriptions the committee has heard in recent weeks, which is not always the case with economists. There is surprising consensus about many, many things.

Dr. Robert Shapiro is going to testify today as to a point which we have heard with some frequency, and I will just quote him, "Since 1970 the total burden on the economy of all Federal, State, and local taxes has not risen but remained remarkably stable, ranging from 28.7 percent of GDP to 29.8."

Contrary to what you might think from some of the debate just this last month, the government's share of GDP has been very steady but savings has gone down. I am not sure that we have a simple econometric fix on this yet.

I look forward to our panel this morning.

The CHAIRMAN. Senator Conrad?

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Thank you, Mr. Chairman. I want to thank you for holding these hearings.

I think we have an excellent panel here today. I know two of the witnesses who will be testifying and have special regard for Fred Bergsten and Robert Shapiro. I have worked with them in the past and think they are just first-rate.

I do not know the other witnesses personally, but I look forward to their testimony as well. In the interest of time, in the interest of hearing them, I will forego any other statement.

The CHAIRMAN. In that case, we might ask the panel to come forward. Gary Bauer, Fred Bergsten, Dan Mitchell, Debra Schenk, and Robert Shapiro.

Unless the panel has worked out some other method among itself in the order of testimony, we will simply take you in the order that you appear on the witness list.

We will start with Gary Bauer, who is the president of the Family Research Council.

STATEMENT OF GARY BAUER, FAMILY RESEARCH COUNCIL, WASHINGTON, DC

Mr. BAUER. Thank you, Mr. Chairman. It is a great pleasure for me to be before the Senate Finance Committee and to spend some time with you and Senator Moynihan and the other members on the issue of family tax relief.

With your permission, I will ask that my prepared statement be submitted for the record. Because I know you all need to move along and have a number of issues to deal with today on the floor, I would like to make just some summary comments about the concerns that we have on this issue.

The whole concept of family tax relief, as you all know, is not particularly new. Ronald Reagan, whom I was very fortunate to work for, made a major step forward in this area in the early 1980's when he, with cooperation of the House and Senate, managed to get a doubling of the personal exemption through the U.S. Congress. I thought that was a tremendous step forward in recovering some of the lost tax benefits that families have suffered since the end of World War II. Unfortunately, in retrospect that doubling of the personal exemption ended up being a high water mark when it came to family tax relief.

One of the criticisms of Washington and of the Congress is that there is too much partisanship, not enough bipartisanship. But, when I look at the issue of family tax relief since about 1982 to now, I find a bipartisanship that unfortunately is negative.

That is, that both Republicans and Democrats have held out the prospect of family tax relief, only to pull it back when it came time to actually vote on it.

We can go back to the task force that Ronald Reagan asked me to head up in the mid-1980's, a task force of the government to figure out what government could do to help American families.

Our number one recommendation was to increase the personal exemption for children. That report received a lot of acclaim in gov-

ernment and a lot of acclaim in the media, but there was no action taken on its central recommendation.

In 1988, President Bush promised pro-family tax relief, and then went even further to give his now infamous pledge of, read my lips, no new taxes, and then, upon taking office, discovered that he could not keep that promise.

In 1991, we had a bipartisan commission headed by Senator Rockefeller. People thought that that commission could come to no agreement on these issues and, in fact, its number one proposal was a $1,000 credit for children. Again, the press, from the Wall Street Journal to USA Today, hailed that recommendation and no action was taken on it.

In 1992, then candidate Clinton promised middle class tax relief and talked about tax relief for the family, and then took office and suddenly said that the deficit was larger than he anticipated when, in fact, he used figures during the campaign that were larger than the deficit he found when he took office.

So, what I see looking over the years and leading up to the Contract With America is that, time and time again, Republicans and Democrats have said that the family needs tax relief, but it never seems to be there.

A few weeks ago I testified before the House Ways and Means Committee, and one of the members of the committee said, well, Mr. Bauer, you know, $500 for a family with one child or a $1,000 for a family with two children; how much difference can that make?

Well, in Washington maybe $1,000 off your taxes does not make a lot of difference, but I still remember where I grew up in a blue collar town. $500 or $1,000 off your taxes meant that a child could go to a community college, or maybe you could get the car repaired that took you to your job every day, or maybe you could buy what was then called Sunday clothes for your children, you know, the one sport coat or suit that you owned for each child.

I think this tax relief is desperately needed and I think there is a growing sense among American families that there is never going to be a time to many in Washington for family tax relief.

When the economy is improving and we talk about a tax break for families, often Washington says, well, we cannot do it, it would be inflationary. And when the economy is turning down, Washington says, we cannot give family tax relief because it will add to the deficit.

I think that the message that millions of families are getting is that, in fact, there are a lot of people in line ahead of them and that families with children will never be allowed to be at the front of that line, although, arguably, they are the most important, the most special interest in the country, of all.

So I would urge you, as you deal with consumption issues and deficit issues and many troubling things that I know that you all have to wrestle with, that you not give short shrift to the idea that the American family with children is overtaxed, that they do not save because they do not have the money to save, and that there are few things Washington could do that would be more important in providing tax relief for those families.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Bauer appears in the appendix.]

The CHAIRMAN. Mr. Bergsten, who has been before this committee many times.

STATEMENT OF C. FRED BERGSTEN, CHAIRMAN, COMPETITIVENESS POLICY COUNCIL, WASHINGTON, DC

Mr. BERGSTEN. Thank you, Mr. Chairman. It is a great pleasure to be back and to testify on this very important issue.

Let me start by asking, what is the problem we are trying to solve? It seems to me that the United States does face a very serious economic problem. That is the fact that the American standard of living has essentially stagnated for the last 20 years.

Yes, we have created jobs, and we have had some growth. But the fact is, our standard of living has stagnated. Median family income—the focus today is on the family—adjusted for inflation is lower today than it was in 1974, despite the fact that the number of families with two wage earners has significantly increased over that period. Average hourly wages, adjusted for inflation, have dropped 12 percent since 1974. So we have a very serious economic problem. The obvious question is what to do about it.

As I analyze the source of that problem, the answer is actually fairly simple. The only way you can increase the standard of living is to increase the productivity of the economy. Only if you produce more out of the amount of resources going into the economy can you get higher real wealth, which can then be distributed in the form of a higher standard of living.

The only way to get higher productivity growth is to invest more. You need a larger share of the economy going into investment and, therefore, less into consumption. But to finance the higher investment you, of course, need higher saving. The economy has to generate more saving in order to get higher levels of investment, to get productivity growth, and to boost the standard of living.

It is true that you can increase your saving by borrowing money from the rest of the world. And that is what we have done, to the tune of about $2 trillion over the last 15 years, converting the United States from the world's largest creditor country to the world's largest debtor country, with the size of the debt rising fast. Therefore, I think more borrowing is not a good option. Indeed, we ought to try to reduce or eliminate our dependence on foreign capital and increase our domestic saving even more.

But the basic line I would take is that to deal with our National economic problem, which is a deep one, we have to increase our National saving very substantially.

As Senator Moynihan said as I was coming in, the opposite has happened. Our national saving rate, which was already the lowest in the industrial world 10 years ago, has dropped further, and, if you can believe it, net national saving in 1993 was only 2 percent of the economy.

We are consuming 98 cents of every dollar we generate and saving only two. In other words, we are eating the seed corn and there ain't no way to increase standards of living when you do that. It is as simple as that.

How do you increase saving? Obviously, there are two possibilities: increase private saving, which would be eminently desirable,

or increase public saving. The sad fact, and you've heard from experts on it in your earlier hearings, is that we have no reliable means to increase the private saving rate.

It was tried in the early 1980's. Indeed, the economic environment created by Reaganomics in the early 1980's should have been an ideal framework within which to increase private saving: high real interest rates and reduced taxation of investment income.

All that should have provided a highly hospitable framework for private saving. The result was the opposite; private saving plummeted. The sad truth is, the only thing we know to do to increase national saving is to correct the Federal budget deficit.

On the calculations I have developed and my Competitiveness Policy Council has advocated, we need, at a minimum, to shift the current budget deficit of something like 3 percent of GDP over into a surplus of a couple of percent of GDP to provide the underpinning for even a modest sustained increase in the standard of living.

My main criticism of the Balanced Budget Amendment is that it is too modest. We need a bigger shift than just what is needed to achieve a balance. Whether it is through the Balanced Budget Amendment or some other technique, we need to move the Federal budget into a position of modest, ongoing surplus.

It is against this background that I would evaluate the proposals that are before you today and I would suggest some criteria for judging those proposals.

The first is that any proposed tax cut has got to be revenue neutral. To tell you the truth, I think this is not the time for tax cuts at all because when we fundamentally need an improvement in the Federal fiscal position you simply make that job more difficult by any tax cuts. But, at a minimum, your tax cuts have to be revenue neutral.

Both the Administration and the Republican Majorities have said that is what they intend to do. In practice, of course, we all know that it is a lot easier to vote tax cuts than spending cuts. I would want to see the spending cuts voted and in place before I voted the tax cuts, or else I would be afraid that we would be making the problem worse rather than better.

A second criterion should be that, if you do any tax cuts, they have to be oriented toward increasing saving and investment because that is the core of the problem. Most of the tax cuts before you today, I am afraid, would not do that.

If you simply cut taxes for people because they have children or some other criterion of that type, unrelated to saving and investment, what people will do is take the tax cut and spend 98 cents of each dollar of the tax cut. They might save two cents of it, but there is no reason to believe that would help deal with our fundamental, underlying problem.

Of the three tax cuts before you, the one that I think has some merit is the proposal for a tuition tax credit, because that v at least improve our investment in human capital and privat ital in the economy.

In my testimony I suggest some fine tuning of that change, mainly to focus it on getting rid of the current perverse incentive in the Tax Code that says you can only deduct education expenses for your current career, job, and occupation, and not a new one.

The CHAIRMAN. I have to ask you to conclude, Mr. Bergsten.

Mr. BERGSTEN. In today's economy, where you have to shift occupations and jobs, you should get rid of that incentive. But to me, that would be the only one of the three that has merit in terms of dealing with the country's basic economic problem.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Bergsten appears in the appendix.]

The CHAIRMAN. Mr. Mitchell?

STATEMENT OF DANIEL J. MITCHELL, McKENNA SENIOR FELLOW IN POLITICAL ECONOMY, HERITAGE FOUNDATION, WASHINGTON, DC

Mr. MITCHELL. Mr. Chairman, members of the committee, my name is Dan Mitchell, with the Heritage Foundation. I appreciate the opportunity to testify today, especially before my former boss, the distinguished Chairman.

We believe there are three fundamental problems with the Tax Code today, and any proposed reform should be judged by whether or not it is solving or helping at least one of those three problems.

The first problem is high marginal tax rates. Lawmakers did make substantial progress during the 1980's in reducing penalties against working, savings, and investment. Tax rates came down from a high of 70 percent to 28 percent. In 1990–1993, however, policy took a turn for the worse and the top tax rate is now over 40 percent, if Medicare and payroll taxes are included.

The CHAIRMAN. Let me ask you a quick question. Are you speaking for the Heritage Association today on this?

Mr. MITCHELL. I work for the Heritage Foundation. The usual disclaimer applies, that we do not try to aid or hinder the passage of any legislation. We are simply looking at the economic policy effects.

The CHAIRMAN. All right.

Mr. MITCHELL. Ironically, these tax policy changes in 1990 and 1993 were done for the alleged purpose of reducing the budget deficit. Consider, however, that in January of 1989, the month President Reagan left office, the Congressional Budget Office projected that the deficit, which was then at $152 billion, would continue falling every year Reagan's policies were left in place. Two large tax increases later, the deficit is $200 billion and it is projected to rise every year in the future.

The second problem is overtaxation of savings and investment. The tax system should be neutral. Neither encouraging nor discouraging different types of activity. The current code, however, is biased against income that is used for savings and investment. This is particularly self-defeating because capital formation is the only way to generate long-term economic growth.

To quote a 1991 Joint Committee on Taxation report, "When an economy's rate of net investment increases, the economy's stock of capital increases. A larger capital stock permits a fixed amount of labor to produce more goods and services.

The larger a country's capital stock, the more productive its workers, and generally the higher its real wages and salaries.

Thus, increases in investment tend to cause future increases in the nation's standard of living."

Now, obviously there is some difference. Whether the tax policy changes in the early 1980's helped that situation, I think there are figures that show it did.

The third problem, is complexity. The economic damage of high marginal rates and overtaxation of savings and investment is compounded by a Tax Code which imposes heavy compliance costs.

According to one survey, taxpayers spend 5.4 billion hours each year to fill out tax returns, at a cost of about 25 cents for every dollar collected. Money Magazine used to conduct an annual survey, asking 50 tax experts to fill out a hypothetical tax return. Almost invariably every answer was different, with some missing the correct figure by wide margins. The personal income tax, incidentally, is a model of clarity compared with the corporate code.

Having stated three criteria that should be used to judge tax policy proposals, let me mention one which should not be used. Policy makers err, we believe, when they allow their decisions to be guided by the short-run distribution of tax cuts by income class.

Consider the case of capital gains. While we believe individuals have a presumptive right to their earnings, the reason to reduce and ideally eliminate the capital gains tax is not to put more money in the pockets of Donald Trump or Bill Gates; instead the capital gains tax should be cut to lower barriers to capital formation, thus allowing the economy to generate more jobs and higher wages for all Americans. It is this second order effect that is important.

Yet, because of the appeal of class warfare, politicians sometimes focus only on the initial income distribution argument and wind up rejecting policies that will lead to broad income gains for the Nation as a whole simply because some rich people will benefit in the short run.

With these principles in mind, we feel a flat tax would be the ideal tax policy and it is against this benchmark that we judge the proposals under consideration today.

The $500 per child tax credit does not change incentives to work, save, or invest, so it should not be considered as economic policy.

As social and family policy, however, this reform is desirable to offset the erosion of the value of the personal exemption. Most flat tax proposals, including the one proposed by House Majority Leader Dick Armey, include generous family allowances. We do not feel that the tax credit is inconsistent with this approach.

Two. The credit to reduce the marriage penalty is likewise in keeping with the goals of a flat tax. The Hall-Rabushka proposal, upon which the Armey plan is based, does not penalize two people for getting married, and elementary fairness would suggest that government policy should move in that direction.

Three. The education and job training deduction in the President's budget does not meet the test outlined above. We believe the Nation would be best served, again, by a flat tax with no deductions, credits, or exemptions outside of the personal allowance.

The education deduction obviously fails this test and creation of a new deduction would probably make genuine long-term tax reform harder to achieve. We also believe that creating a new tax

preference would give colleges and universities yet another reason to raise prices because consumers would be shielded from the direct impact of those price increases.

One final concern. Some have proposed that the family tax credit and the education and job training deduction be phased out at certain income levels. Such caps, however, have the effect of creating income bubbles which are subjected to higher marginal tax rates. As a result, the addition of a cap could take a policy which has little or no positive economic effect and turn it into one that, at least on the margin, reduces incentives to work, save, or invest.

Thank you very much for this opportunity to testify. I will be happy to answer any questions.

The CHAIRMAN. Thank you. Right on the button.

[The prepared statement of Mr. Mitchell appears in the appendix.]

The CHAIRMAN. Professor Schenk.

STATEMENT OF DEBORAH H. SCHENK, PROFESSOR OF LAW, NEW YORK UNIVERSITY LAW SCHOOL, NEW YORK, NY

Ms. SCHENK. Thank you, Mr. Chairman and members of the committee.

I will leave the economic effects of these proposals to others, but, instead, would like to address the tax policy effects of these proposals.

Specifically, summarizing my written remarks, I would like to address these questions: Is there an important tax policy objective to be served here? How well do these provisions do that? Do they eliminate, or even add further complexity to an already burdened system?

The family tax credit addresses the important question of how to adjust tax liabilities for family size. In summary, there are aspects of the credit that make it very difficult to determine what Congress' policy is with regard to the tax treatment of children. Furthermore, the credit should be redesigned to eliminate absolutely unnecessary complexity.

There is some support for the credit in terms of increasing the exemption. It is a way to increase an exemption that has fallen in value over the last several decades. The dollars that are spent to provide a subsistence level of support should not be subject to tax, and there is ample evidence that the current exemption does not serve that purpose.

An easier and theoretically sounder way to accomplish this would be to simply increase the size of the personal dependency exemptions. If so, a phase-out of the amount designed to take family responsibilities into account in measuring ability to pay is totally inappropriate.

An adjustment for family size is appropriate at all income levels. A taxpayer with dependents has less ability to pay than a taxpayer with no dependents, regardless of income levels.

An alternative justification for the credit is that it has nothing to do with ability to pay, but rather it is a subsidy to parents to help ensure a minimum level of well-being for children.

Once again, the phase-out is probably too high. It seems very likely that a subsidy would have little effect on parents at the

$200,000 income level, providing a windfall to those who otherwise would have made identical expenditures for their children. To this extent, it would not affect behavior and is, thus, inefficient.

The proposed credit also raises several design questions. The credit is limited to the taxpayers' income and Social Security tax liability reduced by the earned income credit.

Why is the credit non-refundable? If it is designed as a subsidy, it would seem to be most necessary where income is very low. I would point out that a two child family where the parent earns $15,000 would have less than the full family credit, while a two child family earning $200,000 would be entitled to a $1,000 family tax credit.

Furthermore, there are inconsistencies between the proposed family tax credit and other tax benefits. I would urge you to eliminate these differences. Whatever is adopted should be as simple as possible. Tax benefits that are incomprehensible or that taxpayers have to pay professional preparers to obtain are not worth their face value.

My written testimony includes numerous examples of discontinuities between the dependency exemption, the earned income tax credit, for example, and the proposed tax credit, and I would urge you to eliminate these discontinuities.

The committee is to be commended for addressing the appropriate tax treatment of children, but I urge you to address the technical questions as well so that any tax benefit will be understandable and administrable to the very people you want to help.

Let me now briefly address the proposed credit to reduce the marriage penalty. The marriage penalty created by the Federal income tax is a serious problem. It deserves a serious solution. H.R. 6 is not a serious solution.

By delegating its authority to Treasury, Congress has failed to address the serious policy trade-offs that are required to eradicate the penalty, and the restraints imposed on Treasury by the proposed legislation create serious technical problems.

Congress could create a system with only bonuses, or Congress could create a system with only marriage penalties. But, as is well known, Congress cannot create a progressive joint return system with neither penalties or bonuses; you must choose bonuses, penalties, or some combination.

Instead, the proposed legislation effectively would delegate this authority to Treasury. Given the $2 billion revenue restraint, Treasury cannot design a credit that will eliminate the marriage penalty.

Since it would require far more than that to do so, Treasury apparently must decide the extent to which bonuses and penalties will remain, and to which taxpayers they will apply. This is inappropriate. Treasury will be forced to make difficult trade-offs that should be made by Congress. It is Congress that should choose between marriage neutrality and couple neutrality.

Attempting to tie the credit to the actual amount of the couple's marriage penalty but limiting the overall revenue loss so dramatically is inconsistent. The credit bears no relationship to the size of the marriage penalty problem. I question whether a credit of this magnitude is even worth the effort. If we divided the credit on a

pro rata basis among half of those who filed joint returns in 1993, everyone would receive $91.

In my testimony I include three examples: a low-income couple, a middle-income couple, a high-income couple. Their marriage penalties range between $1,300 and $8,800. Is a couple with an $8,800 marriage penalty going to be assuaged by a $91 credit? It seems highly unlikely to me.

Again, I would urge you to think seriously about the technical problems in the marriage penalty credit. As designed, it is technically unworkable. Treasury will be unable to design a penalty which taxpayers can understand or the IRS can administer.

Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Ms. Schenk appears in the appendix.]

The CHAIRMAN. Mr. Shapiro.

STATEMENT OF ROBERT SHAPIRO, VICE PRESIDENT, PROGRESSIVE POLICY INSTITUTE, WASHINGTON, DC

Dr. SHAPIRO. Thank you. I want to thank the members of this committee and my former boss, Senator Moynihan, for the opportunity to appear today and share with you the views of the Progressive Policy Institute and the Democratic Leadership Council regarding tax relief for American families with children.

We believe, first, that the Federal Tax Code can be responsibly reformed to provide tax relief for families with children. This can be achieved by replacing the current $2,500 dependent exemption with a $700 per child tax credit.

For families in the 15 percent bracket earning roughly $45,000 a year and less, this reform would be equivalent to doubling the value of the current children's exemption, exempting from Federal income tax nearly $4,700, or roughly the amount an average income family spends every year raising a child.

This reform also would end the current regressive distribution under the current law by providing the same benefits to moderate income parents that higher income ones already enjoy. The current $2,500 per dependent exemption already reduces the tax burden of families in the 28 percent bracket by $700 per child, while moderate income families today receive a tax benefit equal to only $375 per child. All of the tax relief under this approach, therefore, would go to moderate income families, while those with higher incomes would be unaffected.

It is important to recognize that moderate income families are under financial stress, not primarily because their taxes have been rising, but mainly because the economy's fundamentals have been weak for a long time. The critical factors are a steady deterioration for the last 25 years in the underlying rates of growth of net investment, productivity, and overall output.

The impact on people's pre-tax incomes has been dramatic. An average American entering the work force at age 20 or age 30 in 1950 more than doubled his or her income, after adjusting for inflation, by working for 20 years. That is, in 1970, at age 40 or 50, the real income of an average family was double what it had been at age 20 or 30 in 1950.

This dramatic mass upward mobility stopped in the 1970's, however. An average person entering the work force at age 20 or age 30 in 1970 found that, in 1990, after 20 years of work, that his or her family's income, adjusted for inflation, had grown by barely 10 percent.

Our first responsibility is to restore the economic conditions for rapid income growth by reducing the deficit, by actively promoting personal savings, by injecting economic common sense into the ways we regulate the private economy, and by expanding vital public investment in education and training, economic infrastructure, and basic research.

Until we achieve these basic course corrections in economic policy, however, we should not burden the child-rearing efforts of average families by taxing the resources they need to raise their children.

Again, however, we should not confuse the social policy goals of family tax relief with genuine economic reform. There is no evidence that the burden of current spending and taxes, in itself, is a factor in the economy's long-run disappointing performance.

Since 1970, the total burden on the economy of all federal, State, and local taxes has not changed, according to statistics from the OECD, ranging from 28.7 percent of GDP to 29.8 percent.

The burden of all government spending at all levels of government as a share of GDP has also been reasonably stable, ranging over the last 25 years from 31.7 percent to 34.2 percent.

There is no economic basis for the common political claim that rising government spending and taxes are behind the deterioration of most people's income gains because, economically, spending and taxes have not been rising. Nor is there sound basis for asserting that our actual levels of taxing and spending harm the economy. Every advanced economy in the world has evolved a substantial public sector, and among all the advanced economies, ours is one of the smallest.

Of the G–7 countries, only Japan has a public sector smaller than ours, and only very modestly so, while the other G–7 countries maintain government sectors that claim 10–15 percentage points more of GDP than do ours.

We also have the lowest total tax burden as a share of the economy of any major advanced country, averaging more than eight percentage points of GDP, less than the average for the other G–7 nations.

Reducing taxes and spending in tandem by $170 billion over 5 years, as called for in the Contract With America, reductions equivalent to one-half of 1 percent of GDP a year, would have no macroeconomic effect.

While family tax relief does not represent economic policy, we can distinguish to what degree it would represent compelling social policy by referring again to the data documenting how people have fared over the last two decades.

This data shows that slow growth has particularly affected moderate income families. Through the 1970's, 1980's, and into the 1990's, while working families have struggled with real income gains of only about 1 percent a year, highly educated and skilled people—roughly the top 25 percent of the work force—have contin-

89-324 O - 95 - 2

ued to achieve average annual income gains of 4–6 percent a year, sufficient to enable them to double their real incomes over 20 years.

In the current budget environment in which any tax reduction by itself reduces the store of investment capital needed by American business to generate jobs and increase productivity and output, it would be a serious economic policy error to reduce private investment in order to increase the post-tax incomes of families whose incomes have been rising substantially and steadily, and who already have the resources to provide their children significant advantages. Moreover, it would cost an additional $10–12 billion a year, which is the equivalent of nearly 15 percent of annual net fixed business investment.

Thank you.

[The prepared statement of Dr. Shapiro appears in the appendix.]

The CHAIRMAN. Let me congratulate the panel, generally, on holding themselves to 5 minutes. The reason I say that, I have seldom seen a great witness that could not say what they wanted in 5 minutes, and we would then ask questions for an hour of that witness. The witness would get to say everything the witness wanted to say.

It is almost inverse in terms of witnesses that take 15 or 20 minutes. We are afraid to ask them any questions for fear they will go on again for 15 or 20 minutes. But this was an excellent panel.

I want to start with Mr. Mitchell, because I am a little confused. You like the flat tax and also the Citizens For A Sound Economy likes the flat tax. But at the very same time you say, but the child credit really almost should not be considered as tax policy, it is just good family policy and, therefore, we should have that, if I understand your testimony.

Mr. MITCHELL. It is certainly true that if you move to a flat tax you do not want to have an exemption and a credit. You would want to figure out whether it is Hall-Rabushka where a family of four would have the first $36,800 exempted, I guess that is the Armey proposal, specifically; Hall-Rabushka is a lower amount. But the upshot is, they all allow for a generous family allowance.

The CHAIRMAN. I understand that. But, therefore, they are all not flat taxes. So, if we are going to use the term, it really does not make much difference. You could say, I have earned $5,000 and I am entitled to a $1,000 deduction, so my taxable income is $4,000 and I pay a percentage of that, or if you say there are no deductions, I pay a percentage of $5,000, but I am entitled to a credit against the tax I then figure. The mathematics are not much more difficult one way or the other, but you would exempt the family credit.

You would also provide for the marriage penalty in some kind of exemption in this because if you are filing a joint return you are going to allow some kind of a deduction for marriage. I am not quite sure what you do with capital gains. I could not tell if you say we should have a capital gains tax, or you would fold capital gains into regular income in a flat tax.

Mr. MITCHELL. Under the Hall-Rabushka proposal, and the Armey plan has the same feature, you, in effect, do not have any

capital gains taxes, you have an unlimited IRA type treatment of savings and investment.

The CHAIRMAN. Well, under the Armey flat tax he just does not tax capital gains.

Mr. MITCHELL. Correct.

The CHAIRMAN. There is no tax. I suppose that is the ultimate flat tax, no tax at all.

Mr. MITCHELL. Well, it is a question of what gives you neutrality, if you believe neutrality is achieved by not taxing a second time the returns from savings and investment.

The CHAIRMAN. Let me tell you what I am up against. I have been trying to run these flat tax figures. I see Ken Kies here, who heads the Joint Tax Committee, and he has been running them for me.

First, Congressman Armey's proposal—Joint Tax has not run this, Treasury has, and I think Joint Tax is going to come out with it—loses about $170–180 billion a year. I do not mean 5 years, I mean a year. It has all kinds of exemptions from a flat tax.

And I think even Congressman Armey has now conceded that, to achieve what he wants, you have got to have a tax rate up around 25, 26, or 27 percent with all of the exemptions and deductions he has. It really is not a flat tax.

The best I can do is around 18 or 19 percent if you throw everything into the base, and I mean everything—fringe benefits taxed from dollar zero, interest on municipal bonds—every conceivable thing you could conceivably count as income, and no exemptions—no real property tax deductions, no income tax deductions at the State level, no home mortgage, no charity, no nothing, no family tax credits, no credits or deductions of any kind—and the only one that I put into it was a personal or a marital exemption, just so the poor did not pay any tax. That gets you at 19 percent.

Now, we can go one of two ways on this. We can say, yes, we want a flat tax, but we do not mean including in the base A, B, C, D, E, F, G, H, and we do not mean eliminating the following deductions, A, B, C, D, E, F, G, in which case, Dan, you are up to 25 or 30 percent. That is higher than most people accept a flat tax to be.

You cannot have it both ways. If you want to go flat tax, I think it is a point well worth debating and discussing, so long as we all understand what it is we are doing. I find that everybody uses this term.

Believe me, I could have another panel of witnesses who would all be flat taxers, and they would have different exemptions than you have got. I would bet you they would have capital gains not in the income base at all and they would somehow rationalize it as good family policy. It is not a question. But I really want to know, do you really want a flat tax with everything in the base and no exemptions?

Mr. MITCHELL. Yes. The answer is yes. It does get into the whole question, though, of what is neutrality. It is probably something that goes well beyond the scope of this hearing, but if you earn income and you have a choice between consuming it or saving and investing it, if you are taxing the return from that savings and in-

vestment, then you might not have that neutrality between consumption and deferred consumption.

It is a very long, complicated issue, but I think I am agreeing with most of what you are saying. We want everything in the tax base, we just want it to be defined in such as way as to be neutral. I do not see that as a terrible contradiction. I think Hall and Rabushka have hashed all of these issues out.

The CHAIRMAN. Hall-Rabushka is not a flat tax. I have read Hall-Rabushka. I have read their book. It is not a flat tax, it is what they call a flat tax but for, and then they have got a whole bunch of "but fors" in it. If that is what we are going to want, that is fine, but let us not call these things flat taxes, let us call them favorite taxes. It is flat but for my favorite.

Mr. MITCHELL. Well, as far as I can tell, the only exemption in Hall-Rabushka is the family allowance. You get a certain amount for a single taxpayer, double the amount for a married couple.

The CHAIRMAN. But it is what they do not count as income. I mean, I can give you a flat tax that would have to be 50 percent if I narrow the income tax base enough so that there is nothing in it, but we will exempt wages to begin with, and we will exempt capital gains, and we will exempt interest on municipal bonds, and we will exempt everything except—well, I cannot think what we would include in the base.

Senator MOYNIHAN. Inheritance.

The CHAIRMAN. Inheritance. And we will have a tax base of 90 percent.

Senator Moynihan?

Senator MOYNIHAN. Mr. Chairman, I have a titular responsibility to protect the rights of the minority on the committee. I do want to say that you do know of our request that we have a flat earth panel, just to see what they think about this subject.

If I can just take up a theme, sir, that is mentioned by Mr. Mitchell, and Ms. Schenk mentioned it, which is the question of complexity and the incomprehensible nature of some proposals.

This afternoon at 3:00 in the great hall of the Department of Justice there will be a memorial service for Erwin Griswold, who began the study of taxation in our country. He tells, as a young man just graduated from the Harvard Law School, he was assigned the subject of taxation in the Solicitor General's Office.

They did not teach taxation at Harvard Law School then. And, as he put it once, "I thought I would go to the Solicitor General and tell him I did not know anything about taxation, but I decided to go to the library instead." Ms. Schenk, you are in the tradition that he began at that moment.

He was in the practice of sending me each year a letter describing his experience in preparing his tax returns, and he filled them out himself until the day he died this year.

Last year, on April 12, I received a letter from Mr. Griswold saying, "I have just filed my tax returns for 1993 by mail. As I have mentioned in writing to you previously, it seems to me that our government makes unreasonable demands on its citizens, not in terms of the aggregate amount of money which they are called upon to pay," Mr. Shapiro mentioned that, "but rather because of

the enormous amount of paper work which is required in the process." Mr. Mitchell, you alluded to that.

"My filings included nine separate returns sent to six different addresses." And then the man who wrote the text, founded the subject as a subject of legal inquiry said, "The net result is an enormous task at which I spent just short of 100 hours."

The CHAIRMAN. This is Professor Griswold?

Senator MOYNIHAN. Erwin Griswold.

The CHAIRMAN. Solicitor General Griswold.

Senator MOYNIHAN. Solicitor General.

The CHAIRMAN. Expert tax lawyer Griswold.

Senator MOYNIHAN. The man who wrote the book. He made a practice throughout his life of filling out returns himself. It took him just under 100 hours. I think you have worked very hard at simplifying matters in the past, and I think this is a subject to be addressed with great seriousness.

I would say two things further, Mr. Chairman. I heard Dr. Bergsten saying that possibly the only leverage we have in the Federal Government on the savings rate is to produce a balanced operating budget and take the surplus from the Social Security Trust Fund—a surplus we generated by taxation—to buy down the privately held public debt such that the inverse is an increase in savings.

That was the proposal of the minority in the Economic Commission in 1989, that we take that Social Security surplus, which was just beginning to burgeon, and buy down the debt and increase the savings rate because we do not seem to have a very good fix on what incentives will increase private savings. As you said, all the incentives were there in the early 1980's and the opposite happened.

To cite to the whole panel and Dr. Shapiro, particularly, what we are talking about in this tax credit for children is very close to that most elemental provision of every democratic society in the world save ours, which is a family allowance. It does not involve another five lines on the tax return. I would leave that as a thought. My time is up, but would the panel recognize that we are talking about a family allowance, the same as any other democratic society in the world has? If there is one that does not, I do not know of one.

Dr. Shapiro?

Dr. SHAPIRO. Absolutely. It is the norm in other advanced nations to provide a children's or family allowance.

Senator MOYNIHAN. Children's allowance.

Dr. SHAPIRO. It is the norm to recognize that government should, to the extent possible, not tax the resources families need to raise children.

Ms. SCHENK. Senator Moynihan, I would agree with you, but I would ask you to recognize that the reason it will not take an additional five lines is because all the instructions will be someplace other than on the return. [Laughter.]

Senator MOYNIHAN. That is right. Erwin Griswold says, "This brings the total of instructions to 50,000 words," and he was a speed reader.

Mr. Chairman, could I ask, in tribute to this great man who is being recognized this afternoon, that we place his letter in the record at this point?

The CHAIRMAN. Absolutely.

[The letter, with attachment, of Mr. Griswold follows:]

April 12, 1994.

Hon. DANIEL PATRICK MOYNIHAN,
Senate Office Building,
Washington, DC.

Dear Pat, I have just filed my tax returns for 1993, by mail. As I have mentioned in writing to you previously, it seems to me that our government makes unreasonable demands on its citizens—not in terms of the aggregate amount of money which they are called upon to pay, but rather because of the enormous amount of paperwork which is required in the process.

My filings included nine separate returns, sent to six different addresses. These include Social Security returns and Unemployment Insurance returns (all on a quarterly basis) as well as the Federal and D.C. Income Tax Return, and the Federal and D.C. Estimated Tax Return for 1994. Since the Social Security and Unemployment taxes are all the result of my wife's disability, it seems to me that a case could be made that we should rather receive an appropriate credit for providing employment to others who need it.

Near my desk here, I have a federal tax file which is three inches thick, and (I estimate) contains more than six hundred pieces of paper. I will have to keep this for several years, in order to be able to respond to any questions which may arise. In addition to the federal tax itself, the booklet supplied to taxpayers contains not only Form 1040 with many schedules, and references to other schedules, which must be applied for, but there are forty-nine pages of "Instructions," which must be carefully examined. These forty-nine pages are mostly three columns each of small print. I estimate that there are at least 1,225 worlds per page. This brings the total of "Instructions" to a total of 50,000 words. But, in addition to the Instructions, there are over thirty-six pages relating to various schedules. The grand total of material accompanying the return is at least 94,000 words, the equivalent of a moderate-sized book.

These Instructions include a great number of "worksheets." I am enclosing Xerox copies of two of these, both of which must be virtually incomprehensible to the ordinary citizen. In particular, I call to your attention the Itemized Deductions Worksheets on page A–5, where you multiply a line by 80%, and then four lines farther along you multiple a line by 3%, all to get a figure which must be quite beyond the understanding of those taxpayers who have to use it, and of the many others who have to find their way through it to see if it is something they have to use in order to complete their returns.

The net result is an enormous task, at which I spent just short of a hundred hours. Among other things, if you find, on checking, that a mistake has been made somewhere in the process of filling out the return, then the whole thing has to be done over again, including all of the complicated computations.

I do not blame the Internal Revenue Service for this extreme complexity. They have no choice. They have to take the law as it is written by Congress. I do think that Congress has failed to meet its basic responsibility to enact legislation that is reasonably comprehensible, and then not to change the statute too often. This was a role which Wilbur Mills handled very carefully and skillfully, but it has been almost completely neglected in recent years. The key man on this is the Chairman of the Ways and Means Committee of the House of Representatives, but the Chairman of the Senate Finance Committee can also have a very considerable impact on it.

Much of the problem goes back to the "reorganization" of Congress which was carried out close to fifty years ago under the leadership of the younger Senator LaFollette from Wisconsin. He was trying to get away from the "Solid South," and the domination of the two Houses of Congress by a few Southern members, who, in effect, had life terms. The net result of the change then made, though, was to weaken the leadership so that there are now 535 different and essentially independent parties in Congress. Each member has his own responsibility for fund-raising, and the result is that there is very little party leadership in Congress. This of course makes it very difficult for Committee Chairmen.

For example, the problem with respect to the Itemized Deductions Worksheet arises because some members (or the Treasury) wanted to save some part of the tax

involved by the deductions allowed by Schedule A without "raising rates." So we have this frightfully complex computation, which is quite unfathomable to most taxpayers. I mention Schedule A only as an illustration. There are many other places where the computations are incomprehensible to ordinary citizens. This Form, and the many other Forms that are required, create a bitter feeling among our citizenry.

For better or for worse, I am one of those who keep his own records and makes out his own tax return. Practically everyone else, whether of substantial or modest income, feels that he must use a "tax advisor" or consultant, at considerable aggregate cost—which cost is deductible in determining the tax. The reason that I make out my own return is that I have been doing so for more than sixty years. I started when the tax could be comprehended, and have not been willing to stop. It is only in the past eight or ten years that the task has become very burdensome. I could have my returns prepared by an accountant, but I figure that it would be nearly as much work for me to gather together the necessary factual material as it is for me to make out the returns. Moreover, I resent the fact that my government forces me to use an accountant for such a matter, particularly when my career in law has been largely in the tax field, and I taught federal taxation in law school for a third of a century, between 1934 and 1967 and published the first casebook devoted solely to Federal Taxation. Paying an accountant to do the work seems to me to be a little like the civil War practice of hiring a substitute in order to avoid the draft. That does not look very good today, and so it is with a system which forces many taxpayers to have their returns made out by people with the most sophisticated computers.

And now the Treasury, with reason, is about to require more paper in order to meet the new rule that there must be a signed receipt for a high proportion of charitable contributions, including a statement that no benefit is received. These receipts must then of course be retained for a number of years.

I venture to suggest that, somehow or other, a better solution to these problems must be found. A tax law can never be as precise as the drafters have been trying to make it over the past several years. It is my earnest hope that the Ways and Means Committee, and the Finance Committee, through the energetic enterprise of their respective chairmen, will take steps to simplify this whole operation, making it possible for the ordinary citizen to comply with his responsibilities, and understand what he is doing in the process.

Keep up the good work.

With best wishes,

Very truly yours,

ERWIN N. GRISWOLD.

If either 1 or 2 applies to you, fill in Form 2106 for all your job expenses. Then, enter on line 19 the amount from Form 2106, line 11.

If you don't have to fill in Form 2106, list the type and amount of each expense on the dotted lines next to line 19. If you need more space, attach a statement showing the type and amount of each expense. Enter one total on line 19.

Examples of expenses to include on line 19 are:

- Travel, transportation, meal, or entertainment expenses. **Note:** *If you have any of these expenses, you must use Form 2106 for all of your job expenses.*
- Union dues.
- Safety equipment, small tools, and supplies you needed for your job.
- Uniforms your employer said you must have, and which you may not usually wear away from work.
- Protective clothing required in your work, such as hard hats, safety shoes, and glasses.
- Physical examinations your employer said you must have.
- Dues to professional organizations and chambers of commerce.
- Subscriptions to professional journals.
- Fees to employment agencies and other costs to look for a new job in your present occupation, even if you do not get a new job.
- Business use of part of your home but only if you use that part exclusively and on a regular basis in your work and for the convenience of your employer. For details, including limits that apply, call Tele-Tax (see page 30) and listen to topic 509 or get **Pub. 587**, Business Use of Your Home.
- Educational expenses you paid that were required by your employer, or by law or regulation, to keep your salary or job. In general, you may also include the cost of keeping or improving skills you must have in your job. For more details, call Tele-Tax (see page 30) and listen to topic 513 or get **Pub. 508**, Educational Expenses. Some educational expenses are not deductible. See **Examples of Expenses You May Not Deduct** on page A-4.

Line 20

Other Expenses

Enter the total amount you paid to produce or collect taxable income, manage or protect property held for earning income, and for tax preparation fees. But do not include any expenses deducted elsewhere such as on Schedule C, C-EZ, E, or F. List the type and amount of each expense on the dotted lines next to line 20. If you need more space, attach a statement showing the type and amount of each expense. Enter one total on line 20.

Examples of expenses to include on line 20 are:

- Tax return preparation fees, including fees paid for filing your return electronically.
- Safe deposit box rental.
- Certain legal and accounting fees.
- Clerical help and office rent.
- Custodial (e.g., trust account) fees.
- Your share of the investment expenses of a regulated investment company.
- Certain losses on nonfederally insured deposits in an insolvent or bankrupt financial institution. For details, including limits on the amount you may deduct, see Pub. 529.
- Deduction for repayment of amounts under a claim of right if $3,000 or less.
- Expenses related to an activity not engaged in for profit. These expenses are limited to the income from the activity that you reported on Form 1040, line 22. See **Not-for-Profit Activities** in **Pub. 535**, Business Expenses, for details on how to figure the amount to deduct.

Line 25

Other Miscellaneous Deductions

Enter your total miscellaneous deductions that are not subject to the 2% AGI limit. List the type and amount of each expense on the dotted lines next to line 25. If you need more space, attach a statement showing the type and amount of each expense. Enter one total on line 25. Only the expenses listed below can be deducted on line 25.

- Gambling losses to the extent of gambling winnings. Report gambling winnings on Form 1040, line 22.
- Federal estate tax on income in respect of a decedent.
- Amortizable bond premium on bonds acquired before October 23, 1986.
- Deduction for repayment of amounts under a claim of right if more than $3,000. Get **Pub. 525**, Taxable and Nontaxable Income, for details.
- Certain unrecovered investment in a pension. Get **Pub. 575**, Pension and Annuity Income (Including Simplified General Rule) for details.
- Impairment-related work expenses of a disabled person.

For more details on these expenses, see Pub. 529.

Total Itemized Deductions

Line 26

People with higher incomes may not be able to deduct all of their itemized deductions. If the amount on Form 1040, line 32, is more than $108,450 (more than $54,225 if married filing separately), use the worksheet on this page to figure the amount you may deduct.

Itemized Deductions Worksheet—Line 26 (keep for your records)

1. Add the amounts on Schedule A, lines 4, 8, 12, 16, 17, 18, 24, and 25 . . . . . 1. ______
2. Add the amounts on Schedule A, lines 4, 11, and 17, plus any gambling losses included on line 25 . . . . . 2. ______
   Caution: *Be sure your total gambling losses are clearly identified on the dotted line next to line 25.*
3. Subtract line 2 from line 1. If the result is zero, stop here; enter the amount from line 1 above on Schedule A, line 26, and see the Note below . . . . . 3. ______
4. Multiply line 3 above by 80% (.80) . . . 4. ______
5. Enter the amount from Form 1040, line 32 . . 5. ______
6. Enter $108,450 ($54,225 if married filing separately) . . . 6. ______
7. Subtract line 6 from line 5. If the result is zero or less, stop here; enter the amount from line 1 above on Schedule A, line 26, and see the Note below . . . 7. ______
8. Multiply line 7 above by 3% (.03) . . . 8. ______
9. Enter the smaller of line 4 or line 8 . . . 9. ______
10. **Total itemized deductions.** Subtract line 9 from line 1. Enter the result here and on Schedule A, line 26, and see the Note below . . . 10. ______

Note: *Also enter on Form 1040, line 34, the larger of the amount you enter on Schedule A, line 26, or your standard deduction.*

IRA Worksheet 2—Lines 24a and 24b (keep for your records)

1. If you checked Filing Status box: 1 or 4, enter $35,000; 2 or 5, enter $50,000; 3, enter $10,000 ($35,000 if you lived apart from your spouse for all of 1993)	1.	
2. Enter the amount from Form 1040, line 23	2.	
3. Add amounts on Form 1040, lines 25 through 29, and any amount you entered on the dotted line next to line 30	3.	
4. Subtract line 3 from line 2. If the result is equal to or more than the amount on line 1, none of your IRA contributions are deductible. Stop here. If you want to make a nondeductible IRA contribution, see Form 8606	4.	
5. Subtract line 4 from line 1. If the result is $10,000 or more, stop here and use Worksheet 1	5.	
6. Multiply line 5 above by 20% (.20). If the result is not a multiple of $10, round it up to the next multiple of $10 (for example, round $490.30 to $500). If the result is $200 or more, enter the result. But if it is less than $200, enter $200. Go to line 7	6.	

Deductible IRA contributions		(a) Your IRA	(b) Your working spouse's IRA
7. For each person, enter wages and other earned income from Form 1040, minus any deductions on Form 1040, lines 25 and 27. Do not reduce wages by any loss from self-employment	7.		
8. Enter IRA contributions you made, or will make by April 15, 1994, for 1993. But do not enter more than $2,000 in either column	8.		
9. Enter the smallest of line 6, 7, or 8. This is the most you can deduct. Enter on Form 1040, line 24a, the amount from line 9, column (a), you choose to deduct. Enter on Form 1040, line 24b, the amount, if any, from line 9, column (b), you choose to deduct. If line 8 is more than line 9, go to line 10	9.		
Nondeductible IRA contributions			
10. Subtract line 9 from the smaller of line 7 or line 8. Enter on line 1 of your Form 8606 the amount from line 10 you choose to make nondeductible	10.		

If filing a joint return and contributions were made to your nonworking spouse's IRA, go to line 11.

Deductible IRA contributions for nonworking spouse		
11. Enter the smaller of line 7, column (a), or $2,250	11.	
12. Add the amount on line 9, column (a), to the part of line 10, column (a), that you choose to make nondeductible	12.	
13. Subtract line 12 from line 11. If the result is zero or less, stop here. You cannot make deductible or nondeductible IRA contributions for your nonworking spouse	13.	
14. Enter the smallest of (a) IRA contributions made, or that will be made by April 15, 1994, for 1993 for your nonworking spouse; (b) $2,000; or (c) the amount on line 13	14.	
15. Multiply line 5 above by 22.5% (.225). If the result is not a multiple of $10, round it up to the next multiple of $10. If the result is $200 or more, enter the result. But if it is less than $200, enter $200	15.	
16. Enter the amount from line 9, column (a)	16.	
17. Subtract line 16 from line 15	17.	
18. Enter the smaller of line 14 or line 17	18.	
19. Enter the smallest of line 6, 7, or 18. This is the most you can deduct. Enter on Form 1040, line 24b, the amount from line 19 you choose to deduct. If line 14 is more than line 19, go to line 20	19.	
Nondeductible IRA contributions for nonworking spouse		
20. Subtract line 19 from line 14. Enter on line 1 of your spouse's Form 8606 the amount from line 20 that you choose to make nondeductible	20.	

Schedule SE. Then, enter on Form 1040 line 25, one-half of the self-employment tax shown on line 5 of Short Schedule SE or line 15 of Long Schedule SE, whichever applies.

Line 26

Self-Employed Health Insurance Deduction

If you were self-employed and had a net profit for the year, or if you received wages in 1993 from an S corporation in which you were a more than 2% shareholder, you may be able to deduct part of the amount paid for health insurance on behalf of yourself, your spouse, and dependents. But if you were also eligible to participate in any subsidized health plan maintained by your or your spouse's employer for any month or part of a month in 1993, amounts paid for health insurance coverage for that month cannot be used to figure the deduction. For example, if you were eligible to participate in a subsidized health plan maintained by your spouse's employer from September 30 through December 31, you cannot use amounts paid for health insurance coverage for September through December to figure your deduction. For more details, get Pub. 535, Business Expenses.

If you qualify to take the deduction, use the worksheet on page 23 to figure the amount you can deduct. But if either of the following applies, do not use the worksheet. Instead, see Pub. 535 to find out how to figure your deduction.

- You had more than one source of income subject to self-employment tax.
- You file Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion.

Caution: *If you can file Schedule EIC, Earned Income Credit, you may also be able to claim the health insurance credit on that schedule. If you do claim that credit, do not use the worksheet on page 23. Instead, get Pub. 596, Earned Income Credit, to figure your self-employed health insurance deduction.*

Line 27

Keogh Retirement Plan and Self-Employed SEP Deduction

If you are self-employed or a partner, deduct payments to your Keogh (HR 10) plan or simplified employee pension (SEP) plan on line 27. Deduct payments for your employees on Schedule C or F.

Caution: *You must be self-employed to claim the Keogh deduction. There are two types of Keogh plans:*

- A defined-contribution plan has a separate account for each person. Benefits are based on the amount paid to each account.
- Payments to a defined-benefit plan are determined by the funds needed to give a specific benefit at retirement. If you deduct payments to this kind of plan, enter "DB" next to line 27.

Get Pub. 560, Retirement Plans for the Self-Employed, for more details, including limits on the amount you can deduct.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. I also thank the panel for their testimony.

I would like to ask a general question. It seems that the American public may sometimes be ahead of the Congress, if not all of the time. And, on this issue it seems that there was a lot of fanfare when both parties proposed, including the President, middle class tax cuts. The President has his Middle Income Bill of Rights for middle income Americans, which includes the tuition tax deduction for families who send their children to school, and a $500 per child tax credit for families with children.

But as the debate goes on, Congress is focusing on the deficit with the discussion and debate of the Balanced Budget Amendment, line item veto, et cetera. Most of the polls are showing that, given a choice between these middle income tax cuts and using revenues to help reduce the deficit, folks are coming back and telling us not to do any of these tax cuts. This is really very unusual because middle income families who are struggling, reducing taxes should be very, very popular.

So I am starting to get the message back that they do not really want this—do not force a tax cut on me—because they are very concerned about the Federal deficit. We are going to have to pay for these tax cuts. It is going to either mean more taxes in some other area, cutting spending, or it is going to mean increasing the size of the deficit.

So is there merit to what we are starting to hear back from the people, that they do not really think this is a good idea?

Mr. BAUER. Senator Breaux, my comment would be that Washington sometimes seems to be somewhat selective about when it listens to the people. From 1983 on the polls have been overwhelming that, in spite of some of the figures we have heard here this morning, that Americans feel that government is too big and that they are overtaxed.

As I am looking at the Senators that have been here, the tax revolt has rolled through almost every State represented today several times. So, I guess I would feel a lot better about all this if the Senate and the House had been much more responsive the last 15 years to this point.

Senator BREAUX. But I was not on the Finance Committee then. Let us talk about prospective work.

Mr. BAUER. All right. Well, I tell you, I would not bank a political career on thinking that the American people would not like family tax relief. I think they would like family tax relief and something done about the deficit, and I do not think they are mutually exclusive.

Senator BREAUX. Fred?

Mr. BERGSTEN. I would strongly support what Senator Breaux said. In my testimony, I argued that the Nation's very serious economic problem can best be addressed by increasing national saving, including getting the budget deficit under control. Tax cuts move in the opposite direction.

I think, as is often the case, the public has a visceral feel for moving in the right direction. Just to support Senator Breaux, the latest New York Times/CBS News poll says 59 percent of those

asked would prefer balancing the budget over cutting taxes, and there were only 37 percent on the opposite side, almost a 2:1 ratio in favor. That is stunning when one considers the apparently political popularity of cutting taxes.

The CHAIRMAN. When was that poll?

Mr. BERGSTEN. This was just last week. It was published in the Times.

The CHAIRMAN. New York Times?

Mr. BERGSTEN. Yes.

The CHAIRMAN. Thank you.

Mr. BERGSTEN. And it seems to me they are exactly right, understanding, perhaps without all the sophistication and detail, the underlying problem of the economy that I tried to outline at the outset. So, I would go with them.

Mr. MITCHELL. If I can make a comment on that. I think the poll, though, is asking the American people a false choice. If you look at the January CBO baseline, we can balance the budget by the year 2002 if you hold the aggregate growth of spending to 2.975 percent a year. So what the poll question should really be asking is to say, we can balance the budget if we hold the growth of spending to almost 3 percent a year——

The CHAIRMAN. And you have no loss of revenues because of tax cuts.

Mr. MITCHELL. Yes. Or would you like to hold the growth of spending to 2 percent a year and get some tax cuts as well. That is the question that should have been asked if they wanted an honest answer. This is the question that was asked presenting tax cuts and deficit reduction as mutually exclusive. It all depends on how much you can restrain the growth of spending, but that is not what the American people were asked.

Senator BREAUX. It is sort of like the balanced budget question, are you for a balanced budget? Yes. Are you for a balanced budget if you have to use Social Security trust funds to help reduce it? No. That is the predicament we find ourselves in.

Anybody else? Robert.

Dr. SHAPIRO. The rule that we have adopted is that if there is going to be family tax relief for moderate income families, as a matter of pressing social policy, we ought to raise $3.00 in deficit reduction for each dollar of tax relief.

My institute has published one catalog of spending cuts and tax reforms to achieve this, focused on those provisions in current spending and the Tax Code which already undermine the economy's capacity to create wealth, that reduce efficiency and reduce productivity by providing subsidies to particular industries.

Senator BREAUX. Is that the corporate welfare issue?

Dr. SHAPIRO. It is called by some corporate welfare. I call it industry subsidies, as traditional economics does.

There is no controversy among economists that subsidies to particular industries make the economy less efficient and less competitive. If our goal in reducing the deficit is to make the economy more efficient and productive, we ought to start by claiming the resources from those programs which actively undermine efficiency and productivity.

Next Monday we will issue another edition of that report detailing 120 subsidies which, if phased out or reformed, would produce $265 billion in savings over 5 years. If we took $50 billion of that for a family allowance for moderate income families, that would leave more than $200 billion over the next 5 years for deficit reduction and public investment.

The CHAIRMAN. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman. At the outset, I would like to commend Mr. Bergsten for the emphasis in his paper—I did not get a chance to hear his testimony—on the employment, training, and education tax proposals.

Certainly, investment in human capital is a direct way to address productivity, and saving, and raising the standard of living in our country. So, I really very much appreciated your putting that part of the proposal in the context of this debate.

However, I want to pick up where Senator Breaux left off and go in another direction. Just this morning we had our town meeting and an individual came up to me and said, keep your $200. I do not want the $200 tax cut, I want to see the deficit resolved. I hear a lot of that when I go out in my State with the people that come to our little town meetings every Thursday morning. What I am hearing also is reflected in the poll that you read, which is, we would rather have deficit reduction.

The whole purpose of talking about deficit reduction—because deficits, in and of themselves, are not the worst thing in the world—is that we need to encourage saving and investment in this economy, and the whole point of that is so we can raise living standards.

The discussion has come up a little bit in this conversation about the flat tax, which is a continuing thread in these conversations. I want to pose the question, first, to Mr. Bergsten, and then to others.

How do you see the flat tax as responding to the question of promoting productivity, increasing productivity, and promoting savings and investment in this economy?

Mr. BERGSTEN. As Mr. Shapiro just said, it is true that if you avoid preferences, industry-specific subsidies, et cetera, et cetera, and flatten out the tax rate as much as possible, you do limit distortions to the economy, improve efficiency, and improve competitiveness.

At the same time, and it is related to that, if we were going to really think about fundamental reform of the tax system, I would want to go to a consumption tax for exactly the reason you just said. As I testified, what we have to do is get saving and investment up. Without that, standards of living just are not going to rise during the next 20 years any more than they did over the last 20.

So, we want to try to shift the balance in the economy away from current consumption to saving and investment. People sometimes do not understand that if we will consume a little less now we will be able to consume an enormous amount more over time. That is hard for people to understand, but it is true. If that is the case, then I think we should really consider a dramatic change in the tax system. All these marginal tinkerings, frankly, will not change behavior.

Senator MOSELEY-BRAUN. Right.

Mr. BERGSTEN. What we are talking about is trying to change the behavior of an entire society. Our society, for the last half century, has brilliantly created the most successful consumer society in history. We set out to achieve it 50 years ago; we did it. The problem is, we eat the seed corn so we do not have the base to consume more in the future.

The Tax Code that we have had for those 50 years, which has essentially supported consumption, subsidized it, and penalized saving and investment, has gradually been moving in the other direction, but doing so in a marginal way that has not yet sunk in and really changed attitudes.

So, if we really want to get serious about this problem, in addition to eliminating the deficits or maybe converting them into modest surpluses for macroeconomic reasons, then if we want to have a supply side behavioral microeconomic effect, let us go to a consumption tax—I would focus on Nunn-Domenici rather than Hall-Rabushka—but, in any event, move in one of those directions.

Mr. MITCHELL. If I can add something to that, though, and this is perhaps how I should have answered the question of the Chairman earlier. Hall-Rabushka is a consumed-income tax as well, so it is simply a question of, do you want a consumed-income tax with a multiple rate level and certain deductions, and so on, and so forth, or do you want a consumed-income tax that has a flat rate and at least a substantial amount of simplicity in it?

The CHAIRMAN. That is a fair statement. When I say Hall-Rabushka is not a flat tax, you are right, it is a consumption income tax. Basically, Nunn-Domenici is a gigantic IRA; you pay a tax on what you consume and you pay nothing on what you save, and that is one way to go in terms of a consumption tax and tilting toward savings. So is a value added tax, so is a national retail sales tax, so is a flat tax. But we should not call Nunn-Domenici and Hall-Rabushka flat taxes. And if you want to go the Hall-Rabushka route, that is fine. I can buy that. But do not call the damn thing a flat tax.

Mr. MITCHELL. Well, I guess flat tax in my mind has always been a single rate that applies to whatever you decide to tax.

The CHAIRMAN. Excuse me. I interrupted. I apologize.

Senator MOSELEY-BRAUN. It is all right. You are the Chairman. Mr. Shapiro?

Dr. SHAPIRO. I certainly believe that we would benefit from introducing a systemic bias into the Tax Code towards savings and investment. There is no necessary relationship between that bias, which I think probably could be best achieved with some form of consumption-based income tax, and a single rate. Those are entirely separate questions. There is no reason why you cannot build as much progressivity into a consumption-based income tax as we have in the current income tax.

The second point I would like to make is that, while I believe that we could modestly increase the personal savings rate by adopting a consumption-based income tax, based on the evidence that we have so far, such a change would not dramatically increase savings rates. There will be a modest change, but not a dramatic change.

Savings rates are driven primarily by the rates of growth of people's incomes. When their incomes are rising quickly they save more, and that is true for lower income people as well as higher income people. We do not change the rates of growth of people's incomes by going to a consumption-based income tax.

There is one other section, however, of policy——

Senator MOSELEY-BRAUN. Mr. Shapiro, I am sorry. The point that you just made about, we are not changing the rate of savings by moving to a consumption tax.

Dr. SHAPIRO. No, the rate of growth in people's incomes. When people's incomes are rising fast, that is when their savings rates go up.

Senator MOSELEY-BRAUN. Right.

Dr. SHAPIRO. Savings is really primarily, in effect, a pre-tax form of behavior. We have found that tax rate changes have relatively little effect on saving behavior. This is what we found from the IRAs in the early 1980's.

We have been throwing tax incentives at savings for the last 15 or 20 years, starting in the mid-1970's. It does have a modest effect, but that effect is only modest. Moreover, it is easily overwhelmed by the income effect. If people's incomes are not rising, a tax incentive for savings will have very, very little effect, if any.

Senator MOSELEY-BRAUN. Thank you.

Mr. BERGSTEN. Could I put in a modest comment on that? Rob is certainly right in terms of analyzing past behavioral changes, but I would reiterate the point I made. Those were behavioral changes in response to marginal tinkerings with the Tax Code. The same point applies with respect to interest rates: saving does not look very sensitive to interest rates. But economists, to be quite honest, cannot tell you what would happen if there were a really big structural change in the underlying parameters.

The CHAIRMAN. That is because we have never done it.

Mr. BERGSTEN. Right. There is no way to tell you. In all honesty, we cannot tell you. But I would, therefore, be a little more open-minded, at least, to the possibility that if one made a really fundamental structural change in the tax system along the lines of Nunn-Domenici, as you were describing, Mr. Chairman, conceivably you might get a bigger pay-off because of the behavioral response.

It is well-known in economics that when you change the underlying system you may get effects not predicted by your analysis of previous marginal changes. This is the so-called Lucas effect, when you really change the fundamental parameters and structure within which things happen. I could not sit here and predict what would happen.

Senator MOYNIHAN. That is Robert K. Mertin, the Law of Unanticipated Consequences.

Mr. BERGSTEN. That is another.

Senator MOYNIHAN. That was in 1935 and he was not an economist, he is a sociologist.

Mr. BERGSTEN. Congratulations to your profession.

Senator MOYNIHAN. I teach government.

Mr. MITCHELL. If I could make a comment on this whole savings issue in defense of what did happen in the 1980's. Savings, as con-

ventionally measured by the Commerce Department, has a lot of problems. It is basically a residual.

We measure income, we measure consumption, and both of those have problems in how they are measured, and we somehow are going to rely on a residual. When you look at broader measures of savings, including what happened to asset prices if you held a portfolio of stocks and they rose by 20 percent, that is an increase in your savings, it is an asset that you hold.

So, if you look at what happen in the 1980's in the context of a broader look at what was happening to the net assets in the country, what were people's debt-to-asset ratios, I think there is a very convincing case that there was some impact, although I would agree that broader systematic reform would likely give you even greater responses.

The CHAIRMAN. Dan Mitchell used to work with me and he knows all of my thoughts. But I also have an advantage, I know all of his. Do you remember the line in Patton, where Patton is fighting Rommel and he says, "I read your book?" You know. You ran all those charts for me initially about, could we balance the budget in 3 years, 4 years, 5 years, depending upon CPI, or CPI minus. Well, I am still using your charts.

Now, you say if we hold spending at 2 percent or 3 percent we will balance the budget in X years, you are absolutely right. Then everybody says, the problem is the entitlements. The entitlements are not rising at 2 or 3 percent a year, they are not rising at 5 or 6 percent a year, they are rising at 5, 10, and 15 percent a year.

We have got 410 entitlements in this government; 400 of them cost about $50 billion a year. The top four, plus interest, cost $900 billion a year. There are all kinds of entitlements. There is a whole serious of wonderful entitlements.

My favorite one is the John Pershing Memorial Fund. It is $114,000 a year to preserve a room in Paris, France that is a memorial to General Pershing. It is now in a hotel, or it is in a building that is going to become a hotel. It is being gutted and the room is going to be gone, but the entitlement continues. I do not know who gets it, I do not know what it is used for, I do not know where it goes, but it is an entitlement.

I have got one on an island in the Panama Canal in that lake where the Panama Canal is. I have got that one. Add them all together, they come to $10 million, these 15 or 20 that I have got. We are not going to solve the problem. The top four, I will emphasize again, go up more each year than the total cost of the bottom 400.

Dan, let us go through them. You say, hold it to two or 3 percent. Social Security you cannot even hold to the cost of living because you have new recipients each year. Not many people that I know are talking about cutting back or holding Social Security to the cost of living. That means if we have more recipients, everybody is going to get slightly less than the cost of living, if you hold the total fund to that.

Medicare is going up 10 percent a year. Medicaid went up, a couple years, 29 and 27 percent. We have brought it, wonderfully, down to 11 percent. Military and civilian retirement, the same problem as Social Security. Give them a cost of living adjustment,

but there are more retirees. Then interest is always two or 3 percent higher than the cost of living.

If you are talking about getting each of those down to maybe 2 percent, and if you are willing to live with that, I can understand it. I defy you to get the votes to get them there, to say to Social Security, you get two percent.

I do not know what you do with entry. You are not going to sell any bonds at 2 percent. I mean, do not worry. We will go to a balanced budget; we will not be able to borrow any money. We will go to balanced budget the afternoon that the bonds are put out and nobody bids on them. It is cash in, cash out. That may be the way to do it, as a matter of fact.

Dan, be serious. Be serious on this. Are you prepared, is Heritage prepared, to recommend that we hold those programs to CPI, or CPI less one or 2 percent? Because, short of that, we are not going to get there.

Mr. MITCHELL. Well, what we are recommending are hundreds of billions of dollars of reductions off the baseline. What we are focusing on is the aggregate level of government spending. We realize interest is truly untouchable, but beyond that I cannot imagine a package of reductions in the growth of spending that we would not support.

Now, to some extent we obviously understand our role is to yell and scream as much on the right to try to pull the debate over in that direction. I am not losing any sleep thinking that somehow magically we are going to dictate some sort of result in Congress that is going to hold the total growth of spending to only 2 percent, and you are going to pass the flat tax tomorrow, but we do see this as sort of a part of a multi-year process.

In my optimistic fantasies I see a flat tax maybe coming in 1997. But, in the interim, we are going to agitate as much as we can, understanding that we are affecting things on the margins. We are even supporting things in terms of means testing entitlements that we have some concerns about, because they have marginal tax rate effects, things like the Medicare part B premium.

So, I mean, we like to think that we do not take a second place to anybody in terms of going after entitlements, and would fully compliment those Senators and members of Congress that had the courage to do so.

I frightened a group to death the other day when I was speaking to them. When this issue of flat tax came up and they said, well, it would be a miracle. And I said, well, if you do not believe in miracles you are not a realist. They said, well, how would you accomplish it?

I said, well, Senator Moynihan and I, Senator Bradley, and three or four others would just take the August recess off and we would meet at your place up at the farm up in New York and we would come back just right around Labor Day, just about 10 days before we are ready to consider reconciliation, and we would have it. We would simply move it out of this committee and put it into reconciliation in limited debate, and that is the way we would get it. These are all lobbyists. Panic as you have never seen before. [Laughter.]

The CHAIRMAN. I talked to Bradley. He says he is free August.

[Laughter.]

I want to go to Mr. Bauer.

Senator BREAUX. I want to be there, too.

The CHAIRMAN. This is one we will have to keep secret. There will be no place we can go that we will not have 500 people around us. I think we can get the police to protect your farm place and we can do it up there.

Mr. Bauer, you indicate, "All of the sponsors of major legislation have pledged to offset pro-family tax cuts with dollar-for-dollar reductions in government spending." This is one where the Joint Tax Committee and Treasury are very close. The Child Tax Credit, over the 10 years, is about $300 billion, and Joint Tax and Treasury are not off $5 billion on that.

Do you have any specific suggestions as to which tax cuts? The reason I ask this, I see Chairman Livingston is having a dickens of a time with just $17 billion in rescissions. His statement this morning is, he is afraid he may not be able to hold those on the floor now that the Balanced Budget Amendment is not going anyplace, and that is only $17 billion in rescissions. Do you have any suggestions as to the cuts?

Mr. BAUER. Well, I think you would find our list is very comparable to the list that Heritage has. There are a number of ways you can get at this. I think Senator Gramm's bill in the Senate proposes a cut of 17 percent in discretionary spending in a number of government programs. Nobody is suggesting that those cuts would be easy, obviously.

Back in the 1980's we went through a process like this and there seemed to be a consensus to do something on some of these issues. I recall, when I used to come up here to testify as Deputy Under Secretary of Education, that it was a very short period of time before you found the hearing rooms packed with special interests all wearing buttons in defense of one particular program or another. In a very short period of time, it became politically infeasible to make any significant cuts in most of these programs.

I happen to still believe, however, that there is a great constituency out there of just plain Americans that just think of themselves as citizens. I would love to see a march of those folks on Washington, or hearing rooms packed with those people. I think if you get the will in the Congress to act on these things you will be surprised at how many citizens are willing to stand with you.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. What are they going to stand for?

Mr. BAUER. I think there is a greater consensus for significant cuts in the budget than, perhaps, Capitol Hill perceives. I certainly would not rely on polls in the New York Times to make my decision about whether I should proceed to try to fulfill the mandate that I think people voted for a few months ago.

Senator D'AMATO. Cut but do not cut my favorite program.

Mr. BAUER. We are all familiar with that phenomenon, that some Americans want to protect their favorite programs. But I also believe there is a lot of evidence——

Senator D'AMATO. I mean, have you not been watching this debate on the balanced budget as it relates? I mean, sometimes do

we not have to get into the real world? I mean, do you look at what is happening?

Do you think that all of my colleagues who say that the reason they are not voting for the Balanced Budget Amendment, those who articulate it is because they are concerned upon a raid of the Social Security system, do you think they really believe that?

Mr. BAUER. I am assuming that you are suggesting they do not.

Senator D'AMATO. Well, I am asking you what you think. I mean, what do you really think and how is it portrayed in the media. I mean, let us get into the real issue. If you mention Social Security—I did not do it; Senator Moynihan is a ventriloquist. [Laughter.]

See, look. You did not even see his lips move, did you? [Laughter.]

Senator D'AMATO. I mean, you try it. Let me just tell you, just try it. I mean, we are in a Catch-22, is what I think I heard the Chairman saying when he talked about the entitlements and the huge growth of them. Now it seems to me that we can do some things.

Mr. BAUER. Senator D'Amato, I am not——

Senator D'AMATO. By the way, I want to talk about this flat tax. I have to tell you. I absolutely am very skeptical about it. I mean, you will put it down at 10, put it at whatever number to get it passed, and then we will just raise it.

So then you are going to have working people who gave up deductions that are important, they are guaranteed. And let me tell you something, the special interest groups, I hope they do come in, preserving the deduction of State and local taxes, the mortgage deductibility.

Is it not a concern of government to encourage certain policies by way of the Tax Code, and have we not done it? And in some cases, you can say there have been abuses. I think we tried, to the best of our ability, to determine where those abuses are and eliminate them.

I think we are doing a better job over the past decade than we have in the past due to the 1986 Tax Bill, and some other things. I think there are some problems in the 1986 bill, but I think basically the direction in terms of eliminating lots of those abuses, and we continue to make some progress. But there are some very beneficial programs as it relates to—and we have encouraged—home ownership, for example, as a result of a tax policy. I think we ought to look at that before we jump into this business of a flat tax rate.

But I cannot, for the life of me, see why some of the sacred cows, Mr. Chairman, cannot be looked at and we cannot do something. I do not know why it is that a certain class of employee and retiree gets cost of living adjustments.

Maybe it is because that constituency is not as quite as powerful or strong, the retirees in the Federal Government, the retirees in the military. We should begin to look at some of that COLA adjustment.

We should look to extend, for example, when they are eligible, as opposed to 20 years, et cetera, which life expectancies and, instead of giving them early outs at huge cost to us. And Medicare and Medicaid, it seems to me, that that is an area by which competi-

tion, and when you say, no, we are not going to continue the same policy, that we cannot keep considerably under 10 percent.

In looking at the CPI—and you have discussed this again—we heard Chairman Greenspan testify, if the CPI more accurately reflected what the real cost is—I mean, are we taking old numbers and ratios that do not apply today—we could save, I guess it was, $150 billion over a period of 7–10 years in the CPI adjustment, something like half a percent. So I do not give up on cutting costs, but I am very, very skeptical of a flat tax, I have to tell you, because I know the way we operate.

And I saw what we did when this Administration needed more money, it just raised the tax. We lowered the tax. Initially we said we were going to do this as an encouragement to do away with some of these deductibles, et cetera. So that is something that this Senator shares.

How do you answer that?

Mr. BAUER. Senator D'Amato, on the flat tax point, we polled the membership of the Family Research Council and, while we found support for the concept of a flat tax, we also found a great deal of fear about exactly the point you raised, the fear that ultimately what the flat tax would end up being was a tax increase, that the flat tax rate would start drifting up over years because of the very hesitancy that you have already referred to of the Congress to deal with getting some of the programs under control. So, I think you raise a valid point.

If I could just make one other point about what we began the discussion on, I think it was ABC the other day that went to veterans and asked them, are you in favor of a balanced budget. They said, yes. Then they said, well, how about cuts in veterans programs? Absolutely not. They did it with senior citizens, and with each group, and it was the same.

But ABC went back to the them all and said, what if you believed and knew that everybody was going to have to take a cut, that it was not going to just be veterans or the elderly, then those focus groups changed. The opinion they gave was, if everybody was going to have to take the same hit, then we are willing to do it, even though it is difficult to do.

I still tend to think that an easier political approach is not cutting individual programs, but, in fact, keeping down the overall percentage rate in the growth of government.

Thank you.

Senator D'AMATO. Thank you.

Thank you, Mr. Chairman.

Senator MOYNIHAN. May I, just for diversion of my colleague, say Social Security? Yes, of course, that has got to be addressed. We know that.

Senator D'AMATO. Well, Mr. Chairman, if you do not mind, it seems to me, because you have been one of the chief architects in saving the Social Security system from bankruptcy, right, that was the council you, if you did not Chair, were certainly an integral part of that commission.

Senator MOYNIHAN. Senator Dole was the Chair.

Senator D'AMATO. Yes. Do the prospective numbers not have us at a particular time, unless we do something with Social Security in the out years, we are going to be in trouble; is that not a fact?

Senator MOYNIHAN. We are going to be in trouble sooner than we think, in large measure because, absent the savings that we have missed in the last two decades and seem to be continuing, the economy is not going to be nearly as productive as we had reason to expect when we went to a partially funded system in 1977. If we had saved that surplus and had the inverse increase in private investment, we would be a different economy when that time comes.

But I would like to agree with Senator D'Amato, and I think the panel would also agree, and I think Rob Shapiro's point, that savings is a pre-tax phenomenon, with some exceptions. I think home ownership has to be influenced by mortgage deductions, is it not?

Dr. SHAPIRO. Oh, yes.

Senator MOYNIHAN. And that is a form of savings, the largest form of savings for most families, is it not?

Dr. SHAPIRO. If I could make one point on housing.

Senator MOYNIHAN. Yes, please.

Dr. SHAPIRO. It is at once a form of savings and a form of consumption.

Senator MOYNIHAN. Right.

Dr. SHAPIRO. Unfortunately, it is, relative to other forms of savings, relatively unproductive in effects on increasing the economy's capacity to create wealth.

Senator MOYNIHAN. It is not a factory.

Dr. SHAPIRO. That is correct.

And the extent of it——

Senator MOYNIHAN. But, wait. It is becoming a factory as people stay home and use their computer.

Dr. SHAPIRO. That is true.

The net fixed residential investment over the last five years, that is, the net increase in the value of the housing stock, was equal to 50 percent of net fixed business investment, which is to say that it is claiming a very large share of the capital available for investment in an area which is, relative to other areas, much less productive over the long term.

If we, recognizing the social policy, imbedded in the mortgage interest deduction to create broad middle class home ownership, we could attenuate the current arrangement for that for the mortgage interest deduction, for example, by reducing the ceiling on the principal against which the interest can be deducted from its current $1 million level to $300,000–350,000. That would affect four percent of home owners; it would leave unaffected 96 percent. In addition, we could certainly eliminate the deduction for home equity loans, which is a direct incentive for consumption.

The CHAIRMAN. If you want to see an interesting dichotomy, pose to an audience of basically upper income people this question. And you are right on your percentages. I figure 3 percent above $250,000 on the mortgage interest. There are relatively few mortgages above $250,000.

If you would limit the mortgage interest deduction to $250,000 you could, dollar-for-dollar, pay for an individual 17 percent capital gains tax rate. Ask them which they would prefer. If you are in Des

Moines, they prefer the capital gain. If you are in downtown San Francisco, they prefer the home.

Dr. SHAPIRO. Yes.

The CHAIRMAN. It is simply a difference of what their cost is in comparison to where they live.

Dr. SHAPIRO. Right.

Mr. MITCHELL. If I could throw in a point on the home mortgage interest deduction, because I think Senator D'Amato raised an important concern. If you go back in the 1980's, in effect we had an experiment with the importance of deductions, because the value of the deduction, of course, fell with the reduction in tax rates; they fell from 70 percent to 28 percent.

And, if you do that throughout history and try to match up different measures, whether it is housing affordability, home prices, the annual increase in home prices, match those up against what happens in the value of the deduction. I do not think that there is a very strong relationship to be found there that home ownership depends on the home mortgage interest deduction.

The CHAIRMAN. You can go even further. Canada has no home mortgage deduction. They have roughly the same percentage of home ownership that we do.

Senator MOYNIHAN. Yes.

Dr. SHAPIRO. There is no other advanced country that provides anything like the extent of tax preference for home ownership.

The CHAIRMAN. George Yin, who used to work for this committee and who now teaches tax law, has written an article that he has concluded that the home mortgage deduction has artificially increased the price of houses because as long as you can deduct some portion of it you are willing to pay a slightly higher price, and that without the mortgage deduction you would have lower-priced new homes.

Ms. SCHENK. That being true, the real problem is the transition problem.

The CHAIRMAN. Yes.

Ms. SCHENK. It is what you do about all those people who have already purchased a home. That is the real issue.

The CHAIRMAN. Oh. As a matter of fact about the $250,000 I mentioned, you could grandfather all existing mortgages and still pay for a capital gains 17 percent, personal, not corporate, capital gains rate.

Senator MOYNIHAN. That was a nice point, Ms. Schenk.

The CHAIRMAN. Senator Moseley-Braun, any others?

Senator MOSELEY-BRAUN. I have lots of questions, Mr. Chairman, but we have to move along.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I want to tell you, I think it is absolutely fascinating, this whole area, as it relates to the mortgage deduction. I just think that it is the cornerstone for home ownership in this country.

It is anecdotal but I have heard it many times, both as a practicing lawyer years ago in terms of the value of being able to deduct the interest on the mortgage, and the fact that a young couple moving from an apartment, and then the savings thereafter, and, that

for literally maybe a few dollars more they have their own home and they have savings.

Do not ever underestimate, notwithstanding that I understand Mr. Shapiro's comments with respect to what creates and what does not, what asset is more productive. The social value—and you did touch on that—of home ownership in this country, I believe, is one of the cornerstones in attempting to deal with the biggest problem this country has, which is the problem of crime, in terms of bringing about stability in neighborhoods and communities, and giving people a sense that they own something. And until they do, they are not going to become involved in many of the social issues and problems of their time. People have got to have the sense that they really own something and that they can do it. I think maybe that it is a costly subsidy, but it is one of the best subsidies that this country has ever come up with.

We could go into factors as it relates to, why is it that Canada has roughly the same home ownership concept that we do. And I would tell you, if you look on the economic basis, et cetera, and we being the home to the kinds of masses of immigrants that come, you have got to factor that in. This is not a homogeneous population, et cetera.

If we are roughly comparable, it demonstrates the vitality of this Nation that we have such high incidence of home ownership. Again, a lot of that has come by way of government policy, G.I. bill. Let me tell you something. Home ownership became a reality to millions, to millions. It was a concept that none of them had until there was a G.I. bill. My pop would not have had a house. G.I. bill gave to our family reality.

So, there are lots of things about saying that we are free, and we are this, and we are that. Are you really free in this country if you are afraid to take a walk in the park, or leave your building at night, or use mass transportation? How free are you? How free are you? I wonder where our priorities are.

But I have to tell you, I would be very, very careful as it relates to that theory that the deduction does not advance home ownership. I would suggest, and, again, it is anecdotal, that it seems to me, from my experiences, that it does. I thank the Chair for holding this hearing.

Senator MOYNIHAN. Mr. Chairman, can I just say one more thing? If we do not do something about our savings rate we really have not done our job. It is palpably a problem. We went from 8 percent to 2 percent in about 15 years.

I think the proposition from Rob, on which I think we saw general agreement, that savings is somehow a pre-tax phenomenon is a very powerful idea. If true, then what? I think we have got to get a handle on this very important subject, and I do not know that we yet have it.

The CHAIRMAN. I am not sure that we have it. Mr. Bergsten is on the right idea. I think they are all on the right idea, but I would be willing to make this trade. We used to be able to count on every generation doubling family income, in essence, and the child could live better than the parent, and the grandchild could live better than the child. This is when we had productivity at 3 to 3.5 percent and we had pretty good savings.

If we could, with the Tax Code—I am not sure any of us know exactly how to do it—accomplish that—I do not know if that is Hall-Rabushka, or flat, or Nunn-Domenici—that would be better for families than any tax credit we could think of, it would be better for income than anything else we could think of, and I would be willing to scrap the marriage deduction, the child deduction, and everything else if we could double family income every 20 years, real doubling of family income.

Senator MOYNIHAN. But you cannot do that in the Tax Code.

The CHAIRMAN. Well, if we cannot do it with the Tax Code, it does not matter what we do with the Tax Code. If nothing will encourage saving, nothing will encourage investment, nothing will do any good, well, then we can lessen the work load of this committee substantially.

Senator MOYNIHAN. Well, there is a line in Erwin Griswold's letter here. He has always made out his tax returns from the time it was very simple to the time it was not. "I taught law school for a third of a century, taught Federal taxation in law school from 1934 to 1967, and published the first case book devoted solely to Federal taxation." He then goes on to say, "Paying an accountant to do the work seems to me a little like the Civil War practice of hiring a substitute in order to avoid the draft." We could get rid of a lot of these things, but I think we are onto a good subject, and I thank you.

The CHAIRMAN. I thank the panel very much. We are adjourned.

[Whereupon, at 11:32 a.m., the hearing was adjourned.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF GARY L. BAUER

Mr. CHAIRMAN, thank you for the opportunity to address your committee today. I appreciate your willingness to consider my input.

Mr. CHAIRMAN, nine years ago, President Reagan asked me to chair a White House Working Group on the Family to explore ways that federal policymakers could help strengthen America's families. That task force issued a report in 1986 entitled, *The Family: Preserving America's Future,* which had as its central recommendation a dramatic expansion in per-child tax benefits. Five years later, after much talk but no action on this issue, the bi-partisan National Commission on Children (on which then-Governor Bill Clinton served) issued a 1991 report which also had as its central recommendation a dramatic increase in per-child tax benefits.

Given that leading officials from both parties have been talking about pro-family tax relief for nearly a decade, the debate we now should be engaged in is one of whether the House GOP's proposed $500 children's tax credit offers adequate relief to America's families or whether instead Congress should move in the direction of the National Commission on Children's call for a $1,000 per-child tax credit.

Sadly, that is not the debate taking place in Washington today. During the last two months, a noisy chorus of critics and naysayers have been raising all sorts of objections to pro-family tax relief. Their criticisms—which are sometimes contradictory—advance six myths. Let's examine them one at a time.

Myth #1. Pro-Family Tax Relief Is An Extravagant Political Giveaway At Odds With The Larger Public Interest.

This idea is advanced frequently by members of the media, who realize just how popular pro-family tax relief is. Rather than thoughtfully considering the merits of various tax-cutting proposals, these reporters and pundits smugly sneer at public officials, accusing them of "pandering" to middle Americans.

Mr. CHAIRMAN, I do not often find myself in the position of defending politicians, but this sort of activity must be recognized for what it is—an attempt by members of the liberal media elite to make you feel guilty about doing what the people elected you to do. It is the flipside to the liberal media's reaction to politicians that advance unpopular tax increases, who are routinely hailed as "profiles in courage."

Mr. CHAIRMAN, may I remind the members of your committee that voters see nothing courageous about broken campaign promises. Indeed, few things have contributed to voter cynicism more than President Bush's failure to keep his "no new taxes" pledge and President Clinton's decision to abandon his promised "middle-income tax cut" soon after the 1992 election.

The American people strongly support pro-family tax relief. They want to keep more of the money they earn. They sense that the well-being of their families—and the well-being of the nation—would improve if they had greater control over their lives.

On this point, they are right. To acknowledge as much is not pandering.

Myth #2. Pro-Family Tax Relief Will Increase the Deficit and Cause Interest Rates to Rise.

It is quite true that the deficit would rise if a pro-family tax cut were adopted *by itself.* It is also quite true that an increase in government borrowing would contract the supply of funds available for private lending, thereby putting upward pressure on interest rates.

But it is important to point out that no one is talking about adopting a pro-family tax cut *by itself*. All of the sponsors of major legislation have pledged to offset pro-family tax cuts with dollar-for-dollar reductions in government spending.

Pro-family tax cuts "paid for" by spending cuts cancel each other out on the balance sheet. They should have no effect on the deficit or on interest rates.

Myth #3. Pro-Family Tax Relief Won't Spur Economic Growth.

This concern comes from many of my conservative friends who believe that tax policy should only serve economic ends, that it should steer clear of social considerations and focus exclusively on promoting economic growth.

There are two problems with this viewpoint. First, much of what is called "economic growth" isn't growth at all. It is a movement of economic activity from the non-market home economy to the quantifiable market economy. For example, when a family that once cared for its own child enrolls the child in a paid day care program, there is no increase in the amount of economic activity. There is simply a shift from the non-market economy to the market economy. Yet this shift is counted as "positive" economic growth even though it often has a "negative" effect on the child's well-being.

True economic growth involves an increase in productivity, not simply in market activity. Until our nation's economic debate is built around this fact, much of what is advanced in the name of "growth" ought not to be adopted.

The second problem with the "pro-family tax cuts don't spur growth" myth is that it pretends that economic policy can be separated from social policy, that the size of a family's tax burden simply affects its economic well-being and decision-making. The truth, of course, is that tax policy not only affects people's economic decision-making (about working, saving, spending, investing, etc.) but also their "non-economic" decision-making (about marrying, childbearing, childrearing, etc.).

While it is true that economic policy should strive to exert as little influence as possible over "non-economic" decisions (so that, for example, people who otherwise would not marry won't get married just for the tax breaks), it is also true that our nation's current economic policy exerts considerable influence over "non-economic" decision-making and that this influence is almost always in an *anti-family direction*.

For example, Allan Carlson of the Rockford Institute has shown that the Social Security system has a pernicious anti-child bias because it robs parents of the social insurance value of their children, thereby creating a disincentive for young couples to invest in childrearing. Indeed, if Congress were to seek to offset this bias via the tax code (which is the only option given Social Security's sacrosanct status), it would have to raise actual per-child savings to roughly $2,100 per child. When one considers that the net value of the current child tax exemption is less than $400 per child (for the average family) and that the high water mark in the current debate is an additional $500 per-child tax credit, it is easy to see why pro-family conservatives like myself are disappointed that the proposals before you aren't even bolder—or to use the media's phrase, more courageous.

Of course, the reason some are reluctant to adopt even a $500 credit is because they are intimidated by the economic "cost" in lost revenue to the government. While I understand that anti-family policies that took more than 50 years to develop cannot be wiped out in 100 days, I do want to remind the committee that there is a social "cost" to inaction or compromise. The social "cost" of weak families is measured in things like divorce rates and crime statistics. And lest the "green-eye shade types" forget, these social problems impose enormous economic costs to our society and our government. Indeed, the best way to reduce the demand for government services is to free families to care for themselves. Conversely, the best way to hinder the dismantling of the welfare state is to leave the tax burden on families with children at or near their current levels.

Myth #4. Pro-Family Tax Relief Should Only Go To Middle-Class Taxpayers.

This concern makes the mistake of viewing tax issues through the prism of class rather than through the prism of family. It is true that middle class Americans often get the shaft in current tax policy. For example, when combined employer-employee payroll taxes are added to income taxes, some middle-income couples actually have a marginal tax rate comparable to affluent individuals in the 28 and 31 percent brackets.

But it is even more true that families with children are shortchanged in current tax policy. For example, during the first four decades after the end of WWII, the income tax burden on singles and childless couples increased only slightly, while it increased more than 200 percent for families with two children. Reagan-era reforms helped to reverse this trend moderately, but the dramatic shift in tax burden from non-parents to parents still dwarfs any shift in tax burden along income lines.

Thus, it is important that policymakers view this as a debate over "pro-family tax cuts," not simply "middle-income tax relief." This is the way my 1986 Working Group viewed the issue and the way then-Governor Bill Clinton's 1991 National Commission on Children saw the issue. Indeed, neither of these reports advocated some type of means-testing on per-child benefits. Both recognized that the principle being advanced was tax relief for families of all incomes to use in raising children, not tax relief to people who happen to fall into an income category that no one considers upper-class (a category that invariably shrinks as public debate progresses).

The fact that tax relief should be first and foremost pro-family does not mean that policymakers should be unconcerned about the distributional impact of these cuts. To its credit, the House GOP plan extends relief in the form of a per-child credit rather than an increased per-child exemption. In actual dollar terms, a credit provides equal relief to all taxpayers; but in percentage-of-tax-burden terms, it offers greater relief to working-class and middle-income taxpayers than to wealthier taxpayers. (Tax exemptions, conversely, skew savings up the income scale offering greater per-child savings to those in higher brackets.)

This is not to say that tax exemptions are always inferior to tax credits (indeed, one of the virtues of the current exemption is that its value rises if tax rates rise, thereby guaranteeing continued horizontal tax equity between parents and non-parents at any income level).

Still, given the tax code's current problems, a non-means-tested tax credit is the best mechanism for helping families with children. Indeed, if Congress wanted to maximize its distributional bang for buck, it might want to consider a non-refundable version of the 1991 National Commission on Children's $1,000 credit (which replaced the existing exemption, thereby offering $600+ in net per-child relief to those in the 15 percent tax bracket, but less than $300 in net per-child tax relief to those in higher tax brackets). Moving in this direction would make it easier for Congress to lift the existing (and newly-proposed) income caps on per-child benefits—a problem that definitely needs addressing since income caps at any level produce marriage penalties. Speaking of marriage penalties, the income caps on the Earned Income Tax Credit have created such a serious anti-marriage effect that Congress should use all of the monies set aside in the marriage penalty section of the American Dream Restoration Act to address the marriage bias facing families earning below the median income. The Talent-Faircloth welfare reform initiative from 1994 called for a $1,000 pro-marriage tax credit. This would be a constructive, problem-solving first step. It ought to be adopted.

Myth #5. Pro-Family Tax Relief Should Tie Benefits to Family Expenses (Like Education) That The Government Should Promote.

This concern springs from the notion that the government knows more about what families should spend their money for than parents do.

Not only is this a false premise, but it leads to all sorts of unproductive economic distortions. Indeed, one of the chief reasons college tuition costs have risen at a pace exceeding the general inflation rate for some time is that many students have been given grants and loans that could only be used for educational purposes. Knowing this to be the case, college administrators have raised the cost of higher education beyond what it would be if students' economic resources were completely fungible and available for multiple uses.

While no one wants to discourage bright young people from pursuing a higher education, the sad truth is that tax cuts earmarked for this or any other family expense will have the effect of increasing the cost of that good or service, thereby exacerbating current problems and putting a college education out of the reach of some interested students.

While it would be counter-productive for Congress to provide tax cuts for specific expenses, it would be helpful for Congress to modify existing Individual Retirement Account (IRA) rules to permit taxpayers to enjoy tax-favored savings for a wider variety of purposes (college tuition, first-time home-buying, etc.). In the first case, Congress would be limiting families' economic freedom, in the second, it would be expanding it.

This is not to say, however, that the Super IRA included in the House GOP Contract should be adopted in its current form. The "back-loaded" nature of its design obligates future generations to an economic promise made today. Given the size of the federal debt, and the pernicious anti-family influence of intergenerational entitlement programs, Congress should steer clear of repeating past mistakes. If tax-favored savings are to be expanded, they should be expanded within the context of a "front-loaded" savings mechanism.

Myth #6. Pro-Family Tax Relief Will Solve America's Family Problem.

While it is important for Members of Congress to recognize the virtues of pro-family tax relief, it is also important for you to recognize the limitations of pro-family tax relief. Pro-family tax relief will not make husbands love their wives or children respect their parents. It will not clear up filthy TV or remove child predators from our streets. In short, pro-family tax relief, by itself, will not magically solve the myriad social problems facing America's families, neighborhoods, and communities.

But pro-family tax relief will make it easier for families to thrive by reducing economic stress. It will make it easier for parents to monitor their children's TV viewing habits or to shield them from other harms by freeing them to spend more of their time with their children and less of their time frantically chasing the almighty, overtaxed dollar.

In short, pro-family tax relief will empower parents to address many family needs that only they can meet.

Mr. CHAIRMAN, America needs parents who want to raise their children well. But we also need policies that empower them to act upon these sentiments. I implore you and the members of your committee to adopt nothing less than $500 in per-child tax relief for all taxpaying families.

Thank you very much.

PREPARED STATEMENT OF C. FRED BERGSTEN

(DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS[1] AND CHAIRMAN, COMPETITIVENESS POLICY COUNCIL[2])

The most serious economic issue confronting our nation today is the fact that American living standards have stagnated for the last twenty years. Median family income, adjusted for inflation, is lower today then it was in 1974 in spite of the fact that the number of families with two wage earners has significantly increased over the same period. Average hourly wages, adjusted for inflation, have actually dropped 12 percent since 1974.

Growing frustration over stagnant incomes has produced a number of proposals aimed at reducing the tax burden on the middle class. *These proposals, however, address only the symptoms of the problem and do virtually nothing to reverse the long-run stagnation of incomes. In fact, if enacted, these proposals could actually exacerbate the long-run stagnation of incomes in the United States.*

In its numerous reports to the President and Congress, the Competitiveness Policy Council has reiterated that *the only way to achieve sustainable improvements in US living standards is to sharply raise productivity growth.*[3] Higher productivity growth requires sharply increased investment, which must be financed through substantially higher saving. The Council has emphasized that we need to achieve this higher saving domestically, since the United States is already the world's largest debtor country and cannot prudently continue to depend on foreign capital. *Only through sharp increases in both private and public saving, and the investment they will finance, can we achieve sustainable improvements in US living standards.*

Net national saving, the amount available for private investment in job-creating activities, has fallen from about 10 percent of net national product (NNP) in 1973 to less than 2 percent of NNP in 1993.[4] Both private and public saving have declined. *Approximately three-fourths of private saving is now being diverted to finance*

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[1] The views expressed in this statement are those of the author and do not necessarily reflect the views of individual members of the Institute's Board of Directors or Advisory Committee.

[2] The twelve-member Competitiveness Policy Council was created by the Omnibus Trade and Competitiveness Act of 1988. The Council includes three business CEOs, three union labor presidents, three government officials (including two from state governments) and three representatives of the public interest. The members are appointed by the President and the joint leadership of the House of Representatives and the Senate. A list of members is attached. The Council has not taken a formal position on many of the issues presented here. Thus the views expressed are those of Dr. Bergsten personally and do not represent those of the Council as a group.

[3] See "A Competitiveness Strategy For America," Second Report to the President and Congress, March 1993, pp. 37–43.

[4] A month ago, the Competitiveness Policy Council, together with the Congressional Economic Leadership Institute, sponsored a day-long forum, just downstairs in this building, to discuss options for promoting more saving. Democratic and Republican members of Congress, senior Administration officials, and representatives from business and labor presented their proposals. The Council plans to sponsor similar meetings around the country to raise public awareness of the need to increase national saving and to discuss the various options of doing so.

the federal budget deficit, leaving less than 2 percent of NNP to invest in job-creating productive activities.

In order to raise national saving, we need to both raise private saving and significantly reduce the federal budget deficit. However, there is wide agreement that it is very difficult to raise the *private* saving rate.[5] The only reliable strategy for raising national saving by anything like the needed amount is to reduce the budget deficit.[6] *Thus the most important action the federal government can take to raise US living standards is to continue reducing the federal budget deficit.*

This is why I have previously testified that it is essential, at a minimum, to eliminate the federal budget deficit. Indeed, the goal of the Balanced Budget Amendment is *too modest* to achieve the saving and investment goals set out by the Council. We need to increase national saving by at least 5 percent of GDP to achieve a sustainable increase in productivity to 2 percent annually, a minimum requirement to achieve acceptable increases in the American standard of living. Even this modest goal requires a shift from the current federal budget deficit of about 3 percent of GDP to a *surplus* of about 2 percent of GDP.

CRITERIA FOR EVALUATING THE IMPACT OF TAX CUTS ON LONG-RUN IMPROVEMENTS IN LIVING STANDARDS

The stagnation of incomes over the last twenty years has several deep-seated causes, as laid out in the Council's four major reports issued to date. Reversing this trend cannot be accomplished by quick fixes or short-term solutions. Against this background, I propose using the following three criteria to evaluate the middle class tax cut proposals (as well as all other proposals aimed at raising US living standards):

1. Any proposed tax cut must be revenue neutral.

Serious action on the budget deficit is a necessary step in reversing the long-run stagnation of incomes. Any attempt to raise the after-tax income of families which results in increasing the budget deficit only serves to move us further away from our goal of attaining a sustainable improvement in living standards.[7] Efforts aimed at raising incomes which exacerbate our national saving problem can be expected to have, at best, only a short-run effect.

Given the current fiscal and macroeconomic environment, the only way to ensure that tax cuts contribute to long-run improvements in income is to ensure that they are revenue neutral. This can only be achieved by offsetting all tax cuts with equal reductions in expenditures or new sources of revenue. The Administration's $500 child credit is expected to cost almost $7 billion in FY 1997. The Republican proposal included in the Contract With America is expected to cost many times more. There are no estimates of the costs of removing the marriage penalty since the Contract does not provide details of the proposal. These initiatives might achieve a shift in the distribution of income toward middle income married couples and people with children but, by adding to the budget deficit, they do nothing to reverse the stagnation of US living standards and in fact may deepen the problem.

Both the Administration and the Republican leadership in the Congress have accepted this criterion rhetorically, indicating that they would actually implement their tax cuts only in a context of fiscal neutrality. In practice, however, both are already finding that it will prove easier to cut taxes than to cut spending. Hence I believe that any tax cuts should be voted only after the equivalent budget savings have been found and voted by the Congress.

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[5] For an excellent recent analysis of this issue, see Alan Auerbach, "Options for Increasing Private Saving," December 1994, prepared for the Competitiveness Policy Council. The last major effort to provide a sharp increase in incentives for private saving (including the sky-high real interest rates that derived from its budget deficits) was the so-called "supply side" strategy of Reaganomics in the early 1980s, but the private saving rate fell sharply in response. There has been no improvement over the past decade and, in fact, the private saving rate reached new record lows in the early 1990s. The data are presented nicely in the excellent Interim Report to the President of the Bipartisan (Kerrey-Danforth) Commission on Investment and Tax Reform, August 1994, especially its first two findings and the accompanying charts.

[6] We cannot of course be certain that raising public saving will raise total national saving by a like amount. Indeed, public and private saving have tended to move inversely throughout most of American history. As noted in the previous footnote, however, both fell sharply in the 1980s and a rise in public saving under current conditions might even induce a rise in private saving rather than an offsetting reduction.

[7] In addition to reducing the budget deficit, and preferably moving it into surplus, we must also shift the mix of government expenditures toward more investment. The Council believes that public investment in education and training, research and development and public infrastructure are desirable per se and also serve as important stimulants to private investment in job-creating activities.

2. Tax cuts should be targeted at promoting more saving and investment.

As noted, the US economy under-saves and under-invests. In order to achieve long-run improvement in incomes, any tax cut should promote more saving and investment.[8]

In 1994, Americans on average saved only 4 percent of their after-tax personal income. Thus nearly all of any increase in after-tax income resulting from the proposed middle class tax cuts is likely to promote consumption rather than saving. The child credit and "marriage penalty" removal proposals should be expected to primarily raise consumption and have little or no impact on national saving and investment.

Of the three proposals being discussed this morning, only the Administration's proposed deduction for education and training expenses directly encourages more investment (in human capital). Investments in human and physical capital are both necessary to raise US living standards. Creating high productivity jobs without a skilled workforce wastes our declining pool of investment capital. Hence the Administration's proposed tuition deduction is the best of the three before you.

But there is little point in raising the skills of our workers unless we can create jobs to employ them. In its 1993 report, the Council recommended the adoption of a permanent investment tax credit. Over the past thirty years, we have granted or eliminated some form of an investment tax credit at least six times. The R&D tax credit is also temporary, and in fact will expire on June 30.

This on-again, off-again treatment sends a poor message to investors. *Improving public and private incentives for education and training will have only a limited effect unless we are also willing to make the kind of investments in physical capital which will create jobs for these workers.* The child credit and marriage penalty removal proposals make no contribution to raising incomes by creating more high-wage, high-skill jobs for US workers. *If budget dollars are available for tax cuts, I would rather pair the Administration's education and job training tax deduction (as modified below) with new or expanded incentives for private investment* rather than utilizing them for the family and marriage penalty removal proposals.

3. Tax cuts should encourage life-long learning.

Life-long learning begins with basic education and moves from the school-to-work transition to active worker training and then retraining of dislocated workers.[9] Progress in one area cannot be viewed as a substitute for progress in another. We must work simultaneously at improving our efforts and outcomes in each of these areas.

In the area of basic education, the Competitiveness Policy Council applauds the Congress and the President for establishing the National Standards Committee and for the steps which have already been taken toward achieving high national standards for all students. Our educational system currently invests 7 times more resources in the 25 percent of high school students who complete college than it does in the 75 percent of students who do not complete college. For those college-bound students, we must aim for better results from the large amount of resources we are already spending.

But the United States under-invests in preparing non-college-bound students for work, and in providing training for active workers and dislocated workers. All of the empirical evidence suggests that, while average incomes have been stagnant over the last twenty years, they have actually been *falling* for the less educated. In order to achieve long-run improvements in incomes, we need policies to encourage more investment in these three groups. The Council is encouraged by the Clinton Administration's commitment to continue and expand the school-to-work programs begun during the Bush Administration. On the other hand, the Council has been disappointed by the record of both the Bush and Clinton Administrations on active worker training and dislocated worker retraining.

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[8] The Council's Capital Allocation Subcouncil, co-chaired by Robert Denham, Chairman of Salomon Inc. and Michael Porter of Harvard Business School, has been examining potential changes in the tax, pension, and financial regulatory systems to improve the efficiency of private investment in terms of its contribution to productivity growth, wages, and job creation. Their recommendations will be highlighted in the Council's next report to the President and Congress, which will be released in the spring.

[9] For a more complete discussion of life-long learning see *Building High-Performance Workplaces*, Report of the Training Subcouncil to the Competitiveness Policy Council, March 1993, and *Building a Standards-Based School System*, Report of the Education Subcouncil to the Competitiveness Policy Council, March 1993.

The Administration has proposed a tax deduction for all post-secondary training and education expenses.[10] This proposal has merit, as noted above, because it would represent an increase in national investment in our human capital. However, given the limitation of resources, we should target all of our efforts to get the greatest "bang for the buck."

The only way we can attain satisfactory living standards in the new global economy is to promote labor market flexibility here at home. Most of our parents' generation retired from the jobs in which they began their careers. In our generation, many of us have changed jobs and locations throughout our careers—but we have stayed pretty much within our initial occupations. Our children's generation will almost certainly not retire from the occupations in which they start. They will change locations, jobs, *and* occupations several times throughout their careers, continuously adapting to changing economic realities. Our educational system and job market must promote this kind of flexibility to allow our citizens to reap the full benefits of the dynamic world economy.

Our tax system was designed to respond to the economic realities of yesterday. The best example is that, under our current system, one can only deduct education and training expenditures if they relate to one's current profession. *A steelworker with a high school education who may want to learn computer programming in order to help find a new job cannot deduct her expenses, while a computer programmer with a Ph.D. can deduct the cost of a software class. This clearly contradicts our need to promote flexible labor markets. The Administration's proposal would correct this "perverse incentive" and thus has considerable merit.*

On the other hand, the proposal may focus too much on college-bound students. As currently designed, the Administration's tuition tax deduction will primarily benefit those who are college-bound. While we may want to provide every student the opportunity to attend college, this does not mean that we should encourage—or subsidize—every student to do so. Encouraging more students to attend college may not be best for the students, the colleges and universities, or the economy as a whole.[11]

Moreover, Tom Kane of the Brookings Institution has suggested that the Administration's proposal would have only a limited effect in attracting more students to enroll in college. He also notes that students from upper-income families would benefit most from the tax deduction and that public universities might be encouraged to raise their tuition. The proposal would thus subsidize many college students who do not need it. Hence a tuition tax deduction for parents is not a very efficient way of helping get more people to attend college. The same amount of money invested in Pell Grants or the Americorps program might be more effective in achieving that goal.

In addition, we need to focus more of our efforts on how non-college-bound students make the transition from school to work. As mentioned above, they constitute the vast majority of the student body and the workforce. The recent expansion of the school-to-work programs throughout the country is only a start in dealing with this issue. One option would be to provide a voucher to non-college-bound students which they could use to offset tuition costs in a certified school-to-work program. Such a targeted program would probably cost less than a broad tuition tax deduction.

CONCLUSION

Most Americans have been experiencing stagnant incomes for much of the last twenty years. We need to pursue policies which will reverse this trend. It is not clear, however, that tax cuts aimed at the middle class will have any lasting payoff on the incomes of American workers. Given the current fiscal environment, we must be even more vigilant than usual to ensure that all new initiatives are cost-effective in producing the desired results.

I would therefore suggest that you adhere to the three criteria outlined above. Any proposed tax cut should be revenue neutral. Any tax cut should be targeted at promoting saving and investment. And all tax cuts should encourage life-long learning.

In terms of the specific proposals before the Committee, this leads me to favor a reoriented tuition tax deduction that will ease the transition from school to work

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[10] Although commonly described as a "$10,000" tuition deduction, the Administration proposes to limit the deduction to $5,000 a year until 1999.

[11] The Pell Grants and the Administration's Americorps program are two examples of efforts already in place that aim to assist college-bound students. Both of these programs seem to be better targeted to do so than providing parents with a tax deduction for their children's college tuition. Allowing a tax deduction for college tuition would in fact lower the after-tax value of the Pell Grants and the tuition award component of the Americorps program.

and encourage workers to continually improve their skills, thereby assisting them meet the challenges of today's flexible labor market. In line with my first criterion, any such deduction should be approved only after offsetting spending cuts have been approved by the Congress.

PREPARED STATEMENT OF SENATOR CHARLES E. GRASSLEY

Mr. Chairman, I, for one, want to go on record as favoring a middle income tax cut. I worked on legislation in 1991 and introduced it in 1992. the House Republicans and a number of Senate Republicans ran on this winning issue last year after President Clinton dropped the ball on his promised tax cuts. This year, the President was forced to pick the issue back up and include it in his budget.

Now, we're hearing from somethat we can't do the tax cuts, and that we've got to deal with the deficit. Well, we do have to deal with the deficit, and as a senior member of the Budget Committee, I was one of the two main sponsors of the Exon-Grassley Amendment that was the only real attempt at deficit reduction last year.

But, I'm ready to make the hard choices that are necessary to accomplish both. It's true we aren't likely to achieve the magnitude of cuts that are in the House's contract. But, as I've said before, we've got to make a reasonable attempt.

There is a basic question that has to be asked and answered, and that is just whose money is this? Are taxpayers' income that they earn with hard work and sacrifice really the government's money, and the government gets to decide how much income a taxpayer gets to keep? Or is a taxpayer's hard earned money his or her own? It seems to me that's where we have to start.

In addition, if you believe it's the taxpayer's money and not the government's then you believe the taxpayer is better able to decide what to do with it. And that's why, as we reduce excessive spending, it's important that taxpayers get some tangible return in the form of tax relief. $300 to $500 may not sound like much to many of us overpaid Senators. But, I can tell you that for many people in my State of Iowa, that amount could be the difference between making the rent payment or buying some new clothes for the kids.

So, I look forward to the task ahead, as we work to honor our commitments in both providing tax relief and reducing the deficit.

PREPARED STATEMENT OF DANIEL J. MITCHELL

Mr. Chairman, members of the Committee, my name is Daniel Mitchell of the Heritage Foundation. I appreciate the opportunity to speak before you today and applaud the committee for examining ways to reduce the burden of taxes on the American economy.

We believe there are three fundamental problems with the tax code today, and any proposed reform should be judged by whether it solves one or more of these problems or makes them worse. The three problems are:

(1) High marginal tax rates. Lawmakers made substantial progress on tax rates in the 1980s, reducing them from a high of 70 percent down to 28 percent. In 1990 and 1993, however, policy took a turn for the worse, and rates are now in excess of 40 percent if the Medicare payroll tax is included. Ironically, this was allegedly done for the purpose of reducing the budget deficit. Consider, however, that in January of 1989, the month Reagan left office, the Congressional Budget Office projected that the budget deficit, which was then $152 billion, would keep falling every year Reagan's policies were left in place. Two large tax increases later, the deficit is $200 billion and is projected to rise every year into the future.

(2) Over-taxation of savings and investment. The tax system should be neutral, neither encouraging nor discouraging different types of activity. The current code, however, is biased against income that is used for savings and investment. This is particularly self-defeating because capital formation is the only way to generate long-term economic growth. To quote a 1991 Joint Committe on Taxation report:

> When an economy's rate of net investment (gross investment less depreciation) increases, the economy's stock of capital increases. A larger capital stock permits a fixed amount of labor to produce more goods and services. The larger a country's capital stock, the more productive its workers and, generally, the

higher its real wages and salaries. Thus, increases in investment tend to cause future increases in a nation's standard of living.[1]

(3) Complexity. The economic damage of high marginal rates and over-taxation of savings and investment is compounded by a tax code which imposes heavy compliance costs. According to one survey, taxpayers spend 5.4 billion hours each year to fill out tax returns, at a cost of about 25 cents for every dollar collected. Money magazine used to conduct an annual survey asking 50 tax experts to fill out a hypothetical tax return. Almost invariably, every answer was different, with some missing the correct figure by wide margins. The personal income tax, incidentally, is a model of clarity compared to the corporate code.

Having stated three criteria that should be used to judge tax policy proposals, let me mention one that should not be used. Policy makers err when they allow their decisions to be guided by the short-run distribution of tax cuts by income class. Consider the case of capital gains. While we believe individuals have a presumptive right to their earnings, the reason to reduce, and ideally eliminate this tax is not to put more money in the pockets of Donald Trump or Bill Gates. Instead, the capital gains tax should be cut to lower barriers to capital formation, thus allowing the economy to generate more jobs and higher wages for all Americans. It is this second-order effect that is important. Yet because of the appeal of class warfare, politicians sometimes focus only on the initial income distribution argument and wind up rejecting policies that will lead to broad income gains for the nation as a whole simply because some rich people will benefit in the short run.

With these principles in mind, we feel a flat tax would be the ideal tax policy. And it is against this benchmark that we judge the proposals under consideration today.

(1) The $500 per child tax credit does not change incentives to work, save, or invest, so it should not be considered as economic policy. As social and family policy, however, this reform is desired to offset the erosion of the value of the personal exemption. Most flat tax proposals, including the one proposed by House Majority Leader Dick Armey, include generous family allowances. Thus, the credit is consistent with moving toward a flat tax that allows families to shield a significant portion of their income from taxation.

(2) The credit to reduce the marriage penalty is likewise in keeping with the goals ofa flat tax. The Hall/Rabushka proposal, upon which the Armey plan is based, does not penalize two people for getting married and elementary fairness would suggest that government policy should move in that direction.

(3) The education and job training deduction in the President's budget does not meet thetest outlined above. We believe the nation would be best served by a flat, low-rate tax with no deductions, credits, or exemptions outside of the personal allowance. The education deduction fails this test, and creation of a new deduction would make genuine tax reform harder to achieve. We also believe that creating a new tax preference would give colleges and universities yet another reason to raise prices by shielding consumers from the impact of higher costs.

One final concern. Some have proposed that the family tax credit and the education and job training deduction be phased out at certain income levels. Such caps, however, have the effect of creating income bubbles which are subject to higher marginal tax rates. As a result, the addition of a cap can turn a policy which has little or no positive economic effect and turn it into one that reduces incentives to work, save, and invest.

Thank you very much for this opportunity to testify. I would be happy to answer any questions.

PREPARED STATEMENT OF DEBORAH H. SCHENK

Mr. Chairman and Members of the Committee: My remarks address three "middle income" tax cut proposals: the family tax credit and the reduction of the marriage penalty, both of which are part of the Contract with America, and the higher education tuition deduction, which is contained in the President's Fiscal 1996 Budget Proposal.

One possible justification for "middle class" tax cuts is to spur economic growth. I will leave viability of that rationale to the economists, but I note that economic judgement seems to be unanimous that the cuts will be unsuccessful in spurring economic growth. Another possible basis for the provisions, which I will speak to,

[1] ("Tax Policy and the Macroeconomy: Stabilization, Growth, and Income Distribution," Joint Committee on Taxation report for the House Committee on Ways and Means, Washington, D.C., December 12, 1991, p. 21.)

is that they carry out some important tax policy objective, regardless of their effect on the economy. My remarks are limited to addressing these questions: Is there an important tax policy objective to be met? How well do these provisions meet that objective? Do they eliminate or add even further complexity to a burdened tax system?

The family tax credit addresses the important question of how to adjust tax liabilities for family size. In summary, aspects of the credit make it difficult to determine Congress' policy with regard to the tax treatment of children. Furthermore, the credit could be redesigned to eliminate unnecessary complexity.

Taxpayers with dependent children have less ability to pay taxes than taxpayers who are childless. There is some debate as to whether certain expenditures made for children are consumption—like the purchase of records or books—and thus should not be taken into account in determining tax liability. There is virtual agreement, however, that dollars spent to provide a subsistence level of support should not be subject to tax. In other words, ability to pay tax arises only from income exceeding the income used to provide subsistence support. The personal exemption serves to exclude the subsistence support a taxpayer provides for himself; the dependency exemption excludes the subsistence support provided for a dependent.

Consider two families: Family A has two parents, two children, and $30,000 in income. Family B is a childless couple with $25,000 of income. If $2,500 is a subsistence level of income, each family only has an ability to pay taxes on $20,000. Excluding $2,500 for each family member accomplishes this goal. If, however, $2,500 is less than a subsistence level of support, then we overtax both families. There is ample evidence that the current exemption, which is set approximately at $2,500, is not sufficient. If this is so, the proposed family tax credit could be viewed as a way to increase the level of the exemption and thus more accurately measure the ability of families to pay tax. The family tax credit, however, appears to be available in addition to the personal and dependency exemptions. An easier and more theoretically sound way to accomplish this goal simply would be to increase the size of the personal and dependency exemptions. If the goal is to measure income based on ability to pay, an exemption is the proper way to exclude subsistence amounts. Combining a credit with the exemption, however, has the effect of providing different levels of relief for taxpayers in different marginal rate brackets.

Furthermore, a phaseout of an exemption amount designed to take family responsibilities into account in measuring ability to pay is inappropriate. An adjustment for family size is appropriate at all income levels; a taxpayer with dependents has less ability to pay than a taxpayer with no dependents, regardless of income level. For example, a single taxpayer with $200,000 of income has a larger taxpaying capability than a taxpayer with $200,000 of income and five dependents. It is possible to argue that at the level where the exemption is not necessary to assure that basic welfare needs will be met by the parents, it should be phased out. If that is the rationale, then a phaseout at $200,000 is set at far too high a level.

An alternative justification for the credit has nothing to do with ability to pay. Rather the credit might be offered as a subsidy to parents to help insure a minimum level of well being for children. If this is the motive, a credit is a better response than an exemption, which produces a larger subsidy for a higher-bracket taxpayers. Further, a phase-out would be appropriate because higher income taxpayers would not need a subsidy to insure adequate spending on children. Once again, the phaseout is probably too high. It seems likely that the subsidy would have little effect on parents at the $200,000 income level, providing a windfall to those who otherwise would have made identical expenditures for children. To the extent it would not affect behavior, it is inefficient.

When would it be appropriate to provide both an exemption and a credit, as this proposal does? A credit can be combined with an exemption when Congress chooses both to measure income and to provide a subsidy. Where that is the case, the exemption should exclude from tax subsistence level income and the credit should provide the desirable subsidy. If, however, the exemption does not adequately exempt subsistence level income—and there is no evidence that Congress has made that determination—then a credit/exemption combination will not be targeted correctly.

The proposed credit raises several design questions other than the phase-out. First, the credit is limited to the taxpayer's income and social security tax liability reduced by the earned income credit. Why is the credit nonrefundable? If designed as a subsidy, it would seem to be most necessary where income was very low. For example, a two-child family, where the parent earns $15,000, would have less than the full family credit because the total income and social security tax liability of $3,159 ($864 and $2,295 using 1994 numbers) reduced by the EITC of $2,490 would leave only $669. A two-child couple earning $200,000, however, entitled to a $1,000 family tax credit.

Second, there are inconsistencies between the proposed family tax credit and other tax benefits. I would urge you to eliminate these differences. Whatever is adopted should be made as simple as possible. Tax benefits that are incomprehensible or that taxpayers have to pay professional preparers to obtain are not worth their face value.

Although it is laudable that the definition of qualifying child roughly corresponds to the definition for EITC purposes, it is less salutary that it differs from the dependency exemption definition. This is particularly troubling if the credit is intended to effectively increase the exemption amount and in any event, the discontinuity adds needless complexity. For example, a qualifying individual for EITC purposes is a child who has not reached the age of 19 unless s/he is a full-time student who is under age 24. A qualifying child for the family tax credit is a child under the age of 18. Another inconsistency is that a noncustodial parent can obtain the dependency exemption but could not obtain the child credit even if the noncustodial parent provides the entire support for the child. Yet another discontinuity is found in the phase-out provision. The dependency exemption is phased out for taxpayers with adjusted gross income in excess of $114,700 for single taxpayers, $143,350 for heads of households and $172,050 for married filing jointly. The family tax credit is phased out beginning at $200,000 for all taxpayers. Are there explanations for these variations?

The proposed credit also raises interpretation questions. For example, a child might not qualify as a dependent, but nevertheless, could be a qualifying individual for the family tax credit which, unlike the dependency exemption, does not have a support requirement. Could the child take her own personal exemption even though the parent is taking the family tax credit? As another example: Who gets the credit when grandmother, daughter and child all live together in one residence? And why is there a special rule for foster children? A child placed with a foster family on January 2 does not produce a credit even though total support may be provided by the foster parent.

The Committee is to be commended for addressing the appropriate tax treatment of children, but I urge you to address these technical questions so that any tax benefit is understandable and administrable.

Let me now address the proposed credit to reduce the marriage penalty. The marriage penalty created by the federal income tax is a serious problem, deserving of a serious solution. H.R. 6 is not a serious solution. By delegating its authority to Treasury, Congress has failed to address the serious policy tradeoffs that are required to eradicate the penalty and the restraints imposed on Treasury by the proposed legislation create serious technical problems.

The only way to avoid marriage penalties and bonuses is to require all taxpayers, regardless of marital status, to file separate returns, but this would violate the principle that equal income couples should pay equal taxes. The joint return preserves that principle by creating so-called couple neutrality. But as has been well-established, it is impossible to have a joint return system with progressive marginal rates, which is also neutral towards marriage. If a married couple has a tax liability that is different from the combined tax liability that would have been imposed if the spouses had remained single, they either suffer a penalty or enjoy a bonus. Our current system has both. A one-earner couple is permitted to split income and enjoys a bonus. Treating the marital unit as one taxpayer equalizes the tax on two couples, each of whom, for example, has $20,000 of income, regardless of how the $20,000 is apportioned between them. If, however, each spouse earns $10,000, the couple suffers a penalty as they will pay more than two single people with $10,000 income. This results from the progressive rate schedule where the brackets for a couple are wider than the brackets for single taxpayers, but not twice as wide. Spouses with equal incomes suffer a penalty because they lose the income split they would have as single taxpayers. As other analysts have noted, two-earner couples with equal incomes suffer the largest marriage penalties, while many single-earner couples enjoy a marriage bonus. The tax law thus has a tendency to bolster traditional gender roles, particularly encouraging one spouse—usually the wife—to remain at home.

Congress could create a system with only bonuses by making the rate brackets for joint returns exactly twice as wide as those for single taxpayers. Or Congress could create a system with only marriage penalties by taxing the total income at single taxpayer rates. But Congress cannot create a progressive joint return system with neither penalties or bonuses. You must choose: bonuses, penalties or some combination.

Instead, the proposed legislation effectively would delegate this authority to Treasury. Given the $2 billion revenue restraint, Treasury cannot design a credit that will eliminate the marriage penalty. Since it would require approximately $50

billion to eliminate the marriage penalty, Treasury apparently must decide the extent to which bonuses and penalties will remain and to which taxpayers they will apply. This is inappropriate. Treasury will be forced to make difficult trade-offs that should be made by Congress. It is Congress that should choose between marriage neutrality and couple neutrality.

Attempting to tie the credit to the actual amount of a couple's marriage penalty, but limiting the overall revenue loss so dramatically is inconsistent because the credit appears to bear no relationship to the size of the marriage penalty problem. How then should Treasury exercise its discretion to allocate the credit? Should Treasury first solve the problems of those who suffer the most severe penalties or should all married couples be treated equally? Should Treasury favor one class of taxpayers over another?

I question whether a credit of this magnitude is even worth the effort. In 1993, 44 million joint returns were filed. Assume, simply for the sake of exposition, that one-half of them would be entitled to a credit and Treasury decided to allocate it on a pro rata basis. Thus, each couple would receive $91. This would hardly make a dent in the tax penalty for most taxpayers. Consider three examples:

> Using the 1994 standard deduction, exemption amounts and rate brackets, a couple who files jointly where each earns $30,000, would owe $8,710 in taxes. If they were single, they would owe a total of $7,385. Thus, they bear a marriage penalty of $1,325.
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> The marriage penalty is more stark as income increases, especially at levels where the exemptions are phased out. A couple, each of whom earns $100,000 and took the standard deduction would owe $57,713 in taxes and would owe $48,904 if they were single. This couple bears a marriage penalty of $8,809.
>
> Marriage penalties are not limited to middle and high income taxpayers. They are especially acute with respect to the earned income tax credit, which uses identical phase out percentages for married and single taxpayers. For example, using 1994 rates, two single taxpayers each earning $13,000 would be entitled to a $1,174 EITC or a combined $2,348. If they married, they would have no EITC. Their marriage penalty is $2,348 or 9% of their total income.

Will any of these three couples be satisfied with a $91 credit?

How is Treasury to choose between these individuals? Perhaps the entire $2 billion should be allocated to the penalty created by the EITC because it is so severe and affects those taxpayers most in need and those whose behavior is most likely to be affected by the marriage penalty. Alternatively, if you are interested in "middle class" tax relief, perhaps the tax credit should not affect the EITC and should be phased out for upper income taxpayers. If, on the other hand, simplicity is important, Treasury might award each dual-earner couple a fixed credit regardless of the actual amount of the marriage penalty.

As you know, the United States has had some experience with the last solution. Between 1981 and 1986, married couples who filed jointly were permitted to deduct 10% of the earnings of the lower-earning spouse, with a maximum deduction of $3,000. In general, such a provision would be less complex and more easily structured within the desirable revenue constraints. I caution however, that there are significant policy issues that must resolved in considering re-adoption of the deduction. Most important is the interplay between the EITC and the deduction. The EITC is significantly larger than it was when the two-earner deduction was adopted in 1981 and thus a renewed deduction ideally should be able to alleviate marriage penalties arising from both rate differentials and the EITC.

While a two-earner deduction would avoid the complexities of a credit geared to a couple's precise marriage penalty, its simplicity could also result in mistargeting. Couples with large marriage penalties could receive the same benefit as those with a small penalty (for example couple A with a $20,000/$30,000 income split and couple B with a $20,000/$40,000 income split) and some couples who actually enjoy a marriage bonus would receive a deduction (for example, a couple with a high-low income split)

In addition, there are significant technical problems with the suggested form of the credit that Treasury is to develop. Those Committee members who are concerned with the complexity of the Code should be aware that the credit in its proposed form would add enormous complexity for all married taxpayers.

H.R. 6 provides a credit for married taxpayers filing a joint return if their tax liability would be higher than the tax that they would have paid if they were not married. This seems to imply that you would compare the married couple's tax liability as shown on their joint return with the combined tax liability on their separate incomes if they were not married. After these three calculations were made, a fourth would determine actual tax liability. This proposal would require all mar-

ried taxpayers to calculate their tax liability three times for federal purposes—an exercise not likely to fit on a postcard.

It would be almost impossible to calculate the hypothetical single taxpayer liabilities accurately or simply. Because spouses pool both consumption and assets, it will be difficult to allocate income and expenses. To give you a flavor of the issues presented: How would itemized deductions be allocated? Could one spouse claim a standard deduction and one itemize? There are a variety of rules and phase-outs in the Code. Would they apply as if the two taxpayers were single? Who would claim exemptions? The child care credit? How would investment income from assets be allocated? By economic ownership? By title?

This procedure assumes that taxpayers would behave in an identical manner if they were not married as they behave when married. This is an unwarranted assumption. It is certain that if arbitrary rules were adopted for the allocation of income and deductions, taxpayers would conform their economic arrangements to maximize the marriage penalty credit.

The credit, as currently structured, is not limited to the penalty associated only with earned income. Limiting the credit to earnings would dramatically increase administrability, reduce the taxpayer burden and eliminate concerns that married couples will shift ownership of income-producing property to maximize the credit. Furthermore, one of the strongest arguments in favor of the credit is that the penalty discourages the second spouse—usually a woman—from entering the work force because of the higher marginal rate that applies when her income is stacked on her husband's. A credit targeted at earned income would address this problem more efficiently.

Finally, you should be cognizant that the credit, while taking a small step to alleviate the marriage penalty, also will take a small step towards eliminating couple neutrality. The penalty credit could result in a married two-earner couple having a lower tax liability than a one-earner couple with the same total income and deductions. Return to the example where the couple each earned $30,000 and owed $8,710 in taxes. If they were able to take a $90 credit, for example, their taxes would be $8,620. If, however, one spouse earned $50,000 and the other earned $10,000, there would be no marriage penalty and the spouses would not be entitled to a credit. Their taxes would be $90 higher than the other couple although both couples have the same economic income. Whether this lack of couple neutrality is more offensive than the marriage penalty is an example of the difficult tradeoffs that must be made. Whether it is more important for the tax system to treat marriage neutrally or for equal income couples to pay equal taxes is a difficult question and one that should not be left to Treasury.

Finally, I turn to the President's proposed tuition deduction. A taxpayer would be permitted to deduct up to $5,000 (and when phased in, $10,000) of higher education expenses paid during the taxable year for the taxpayer, the taxpayer's spouse, or the taxpayer's dependents. While this creates a limited amount of parity with a student who receives a scholarship or attends a subsidized state school, it does not create complete parity. A student who receives a $20,000 scholarship to attend college has no taxable income. A student who works part-time and earns $20,000, which he uses to pay tuition, would pay taxes on $15,000. Even more bizarre, because the proposed legislation would reduce the deduction by any amount of nontaxable scholarship received by the individual, A who receives a $10,000 scholarship, could exclude the entire amount, but B who received a $5,000 scholarship and earned $5,000 to pay the remaining tuition would have no deduction and only a $5,000 benefit. It is unclear why wage earners should be treated more harshly that scholarship students.

Returning briefly to the marriage penalty, this proposal creates another example. Apparently, two married students paying their own tuition would be limited to one $5,000 deduction. The deduction is unavailable if they filed separate returns. If, however, they did not marry, each would be able to take a $5,000 deduction. Alternatively, if they qualified as dependents, each set of parents could take a $5,000 exemption. Their marriage would result in the loss of a $5,000 deduction.

The deduction is limited to expenses paid for a taxable year in which the student is enrolled in college. This either may effectively preclude a deduction for those who must borrow to pay tuition or may force the parent to be the borrower. Presumably, one reason the student may need to borrow is insufficient income. If so, the deduction will be useless when the tuition is paid. When the loan is repaid and the taxpayer has taxable income, the deduction will be unavailable. The deduction is equally worthless to a low income taxpayer who works to pay tuition, but whose income is so low that there is no tax liability.

Furtherm[illegible] is likely that the vast majority of the deductions would go to high-income pa[illegible] is both inequitable and inefficient. If viewed as a subsidy

(which it surely is), it would provide a larger benefit to a taxpayer in the 30% bracket than a taxpayer in the 15% bracket. Furthermore, the deduction is not likely to change the behavior of those in higher brackets, most of whom would pay tuition regardless of whether it was subsidized. Finally, it is not clear who would actually benefit from a deduction. If the current cost of higher education is effectively cut because of the tax benefit, the supplier—the university—may recoup some of that benefit through higher tuition charges.

I hope my testimony is helpful in addressing both the policy considerations of proposed tax reform as well as technical issues. I would be happy to work with your staffs in revising these proposals or other alternatives.

PREPARED STATEMENT OF ROBERT J. SHAPIRO

I want to thank the members of this Committee for the opportunity to appear here today and offer the views and recommendations of the Progressive Policy Institute (PPI) and the Democratic Leadership Council regarding tax relief for American families with children. It is a matter of genuine social and economic importance.

Allow me to first state my conclusions and then offer the underlying analysis and evidence.

First, the federal tax code should be reformed to exempt from federal income tax the private resources which a moderate-income or middle-income family needs to raise its children. This can be achieved by replacing the current $2,500 dependent exemption with a $700 per child tax credit. For families in the 15 percent tax bracket, earning roughly $45,000 a year and less, this reform would be equivalent to doubling the value of the current children's exemption—exempting from federal income tax nearly $4,700 or roughly the amount an average-income family spends every year raising a child. This reform also would end the regressive distribution of the current law by providing the same tax preference to moderate-income families that higher-income ones already enjoy: The current $2,500 per-dependent exemption already reduces the tax burden of families in the 28 percent bracket by $700 per child, as compared to a per-child benefit of $375 for moderate-income families in the 15 percent bracket. All of the tax relief from this reform, therefore, would go to moderate-income families, while those with higher incomes would be unaffected. In addition, the credit, like the current exemption, should be indexed for inflation. This reform would reduce federal revenues by roughly $50 billion over five years.

Second, additional tax relief should be limited to families in moderate income families. In the current budget environment, in which any tax reduction by itself will reduce the store of investment capital needed by American business to generate jobs and to increase productivity and output, family tax relief should be limited to those families whose limited incomes may impair their ability to adequately raise their children. I further urge the Committee to reject any additional measures that would further reduce revenues. If and when Congress and the President eliminate the federal deficit or otherwise substantially increase the national savings rate, I would urge you to consider expanding the extent and coverage of tax relief for families with children.

Third, family tax relief should be approvedonly if it is financed by other revenue reforms which raise equivalent resources on a permanent basis, and only if it is accompanied by deficit reduction of at least equivalent magnitude. Tax relief should not be approved if it is to be financed by this year's proposed cuts discretionary spending, 'nor if it consumes all or most of the total resources which Congress is prepared to cut. These conditions are fundamental to any serious agenda to help children, because they are intended to preserve the existing federal revenue base and ensure that this reform does not inadvertently undermine our children's economic prospects by expanding the federal deficit.

Since its founding, the Progressive Policy Institute has advocated federal tax reforms to relieve the economic stresses facing moderate-income and middle-income families raising children. It is important to recognize that these families are under financial stress not because their taxes have been rising sharply, but mainly because the economy's fundamentals have not been strong for a long time. The critical factors in this disappointing economic performance have been the gradual and steady deterioration for the last 25 years in our underlying rates of growth in net investment, productivity, and overall output. The impact on pre-tax incomes has been dramatic. An average American entering the work force at age 20 or age 30 in 1950 more than doubled his or her income, after adjusting for inflation, by working for 20 years. This dramatic, mass upward mobility stopped in the early-1970s. An average person entering the work force at age 20 or age 30 in 1970 found that in 1990, after 20 years of hard work, his or her real family income had grown by

barely 10 percent. And this protracted downdraft in income gains by American parents has directly reduced the time and care many of them can provide their children, since most two parent-families today require two workers to maintain their incomes and a large share of single parents must now hold two jobs.

The first responsibility of the Congress and the President is to restore the economic conditions for rapid income growth through broad reforms that can elevate the economy's underlying rates of investment, productivity and output-reduce the deficit, actively promote personal savings, inject some economic common sense into the ways we regulate the private economy, and expand vital public investment in education and training, the economic infrastructure, and basic research. Until the federal government achieves these basic course-corrections in economic policy, it should not burden the child-rearing efforts of average families by taxing the resources they need to raise their children.

Permit me to restate this point from a different perspective: Family tax relief is sound social policy which also should not be confused with genuine *economic* reform. In particular, there is no evidence that the burden of current spending and taxes, in itself, is a factor in the economy's long-run disappointing performance. Since 1970, the total burden on the economy of all federal, state and local taxes has not risen but remained remarkably stable, ranging from 28.7 percent of GDP to 29.8 percent. The burden of all government spending as a share of GDP has been reasonably stable as well, ranging from 31.7 percent to 34.2 percent. There is, in short, no compelling economic basis for the common political claim that rising government spending and taxes are behind the economy's lackluster performance or the deterioration in most people's income gains.

Nor is there sound basis for asserting that the our actual levels of taxes and spending harm the economy. Every advanced economy in the world has evolved a substantial public sector, and among them ours is one of the smallest—despite our far greater security responsibilities and geographical size. Of the G-7 countries, only Japan has a public sector smaller than ours-and only modestly so-while on average the other G-7 countries maintain government sectors claiming 10-to-15 percentage points more of GDP than does ours. The United States also has the lowest total tax burden, as a share of the economy, of the advanced countries, our tax burden averaging more than 8 percentage points of GDP less than the average for the other G-7 countries. And reducing taxes and spending in tandem by $170 billion over five years as called for in the Contract with America-reductions equivalent to 0.5 percent of GDP a year-would have *virtually no macroeconomic impact.*

Tax relief for families with children, in short, represents social policy to relieve economic pressures that affect children, not economic policy, and therefore family tax relief that does not serve a pressing social purpose cannot be justified.

We can distinguish family tax relief which would serve such a compelling purpose, from that which would not, by referring to the data documenting how Americans have fared over the last 25 years. This data show that slow growth has particularly affected moderate-income people, as compared to those with relatively higher incomes: Through the 1970s, 1980s and into the 1990s, while most working families have struggled with real income gains of about only one percent a year, highly-educated and skilled people were able to maintain the healthy rates of progress which nearly everyone had enjoyed in the 1950s and 1960s. Roughly the top 25 percent of the work force—principally professionals and managers-have continued to achieve average annual incomes gains of 4-to-6 percent a year, sufficient to enable them to double their real incomes over 20 years. In any event, as noted earlier, for these families in the 28 percent tax bracket, the current $2,500 per-child exemption is already equivalent in value to the $700 per-child tax credit we propose for moderate- and middle-income families.

Every dollar of tax reduction either increases the deficit or offsets the economic benefits of a corresponding spending reduction; in either case, tax relief reduces the effective pool of private capital available for business investment in the plant, equipment, training, and technological advances necessary to restore mass upward mobility. Under current conditions, only the long-term economic pressure on moderate-income families justifies their tax relief. And it would be a serious economic-policy error to reduce potential private investment in order to increase the post-tax incomes of families whose incomes have been rising substantially and steadily and who already have the resources to provide their children significant advantages. Providing comparable tax relief to higher-income families would reduce potential private investment by another $10 billion to $12 billion a year, the equivalent of nearly 15 percent of annual net fixed business investment in recent years.

Furthermore, Congress must provide a *permanent* stream of resources to finance tax relief for moderate-income families, to ensure that the reform does not reduce the economic prospects of these children by expanding the deficit. The *only* ways to

provide such permanent financing is by raising other revenues or reforming entitlement programs. Reductions in annually-appropriated discretionary spending cannot provide this assurance. Financing family tax relief through a legislative cap on discretionary spending also will not protect future generations from the deficit implications of tax relief, for a spending cap represents only a promise to find the necessary resources in the future.

Finally, in order to support the prospects of American children, in both the near-term and the long-run, Congress should provide family tax relief as part of larger package of spending and tax changes which reduce the deficit by at least $2 for every $1 of tax reduction. These resources should come, first, from current spending and tax programs which actively undermine the economy's basic efficiency and productivity, principally tax and spending subsidies for particular industries which in the past have exercised inordinate influence over Congress and the Executive Branch.

These subsidies-from farm subsidies, below-market priced power from federal hydroelectric facilities, and federal payments to Amtrak, to special tax provisions for oil and gas, business entertainment and large credit unions-reduce the economy's efficiency and growth rate in two principal ways. First, they interfere with the market allocation of resources by placing every industry that does not receive special preferences from the government at a disadvantage in the market competitive for capital and labor. Second, these subsidy programs artificially underwrite the rate of return of the industries enjoying them, insulating them from normal competitive pressures to figure how to be more efficient, productive and innovative.

Last year, the Progressive Policy Institute published a report, *Cut and Invest to Compete and Win, A Budget Program for American Growth,* identifying 68 instances of spending and tax subsidy programs serving no overriding social or economic purpose, and totalling $225 billion over five years. Next week, PPI will publish a second edition of this report cataloguing 120 subsidies for particular industries, along with reforms that would provide $265 billion in resources. In this package, tax relief for moderate-income families with children claims only 20 percent of the savings, leaving the lion's share for deficit reduction and public investment.

We are gratified that the President and both parties in Congress have endorsed tax relief for financially-strapped American families. We urge you to enact this reform on a sound and proper basis. Until the deficit is eliminated, tax relief should be provided only to those families which most need it; it should be financed on a permanent basis; and it should be part of a larger effort to reduce the deficit, focused on subsidies and other ineffective federal activities that now undermine economic growth and the long-term prospects for upward mobility.

BACKGROUND AND INFORMATION RELATING TO THREE TAX CUT PROPOSALS FOR MIDDLE-INCOME AMERICANS: A $500 PER-CHILD TAX CREDIT, A REDUCTION IN THE MARRIAGE PENALTY, AND A DEDUCTION FOR EDUCATION AND JOB TRAINING EXPENSES

Scheduled for a Public Hearing

Before the

SENATE COMMITTEE ON FINANCE

on March 2, 1995

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

March 1, 1995

JCX-7-95

CONTENTS

	Page
INTRODUCTION	1
A. Family Tax Credit	2
B. Tax Credit for Families with Young Children	4
C. Education and Job Training Tax Deduction	7
D. Credit to Reduce the Marriage Penalty	10
APPENDIX: BACKGROUND INFORMATION ON THE MARRIAGE PENALTY	11

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 2, 1995, on three tax cut proposals for middle-income Americans: a $500 per-child tax credit, a reduction in the marriage penalty, and a deduction for education and job training expenses.

This document,* prepared by the staff of the Joint Committee on Taxation, provides background and information related to these three tax cut proposals. Part A provides a description of present law and the family tax credit contained in the American Dream Restoration Act (H.R. 6, part of the House Republicans' proposed "Contract with America" (Contract)). Part B provides a description of present law and the tax credit for families with young children contained in the Middle-Class Bill of Rights Tax Relief Act of 1995 (H.R. 980 and S. 452, part of the President's fiscal year 1996 budget proposal). Part C provides a description of present law and the education and job training tax deduction contained in that same bill. Part D provides a description of present law and the credit to reduce the marriage penalty contained in the American Dream Restoration Act. An appendix provides background information on the marriage penalty.

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A. Family Tax Credit (sec. 2 of H.R. 6)

Present Law

Present law does not provide tax credits based solely on the number of dependent children. Taxpayers with dependent children, however, generally are able to claim a personal exemption for each of these dependents. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income (AGI) in arriving at taxable income. The amount of each personal exemption is $2,500 for 1995, and is adjusted annually for inflation. The amount of the personal exemption is phased out for taxpayers with AGI in excess of $114,700 for single taxpayers, $143,350 for heads of household, and $172,050 for married couples filing joint returns.

In addition, eligible low-income workers are able to claim a refundable earned income tax credit (EITC). The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has one, more than one, or no qualifying children, and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. In 1995, the maximum credit is $3,112 for taxpayers with more than one qualifying child, $2,093 for taxpayers with one qualifying child, and $314 for taxpayers with no qualifying children. For taxpayers with earned income (or AGI, if greater) in excess of the phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the phaseout threshold. The credit is not allowed if earned income (or AGI, if greater) exceeds the phaseout limit. In 1995, the phaseout limit is $26,676 for taxpayers with more than one qualifying child, $24,388 for taxpayers with one qualifying child, and $9,234 for taxpayers with no qualifying children.

Description of Proposal

The bill would provide taxpayers with a maximum refundable tax credit of $500 for each qualifying child.

The credit would be phased out ratably for taxpayers with AGI over $200,000, and would be fully phased out at AGI of $250,000. In calendar years beginning after 1996, the maximum credit amounts and beginning point of the phaseout range would be indexed annually for inflation.

To be a qualifying child, an individual would have to satisfy a relationship test, a residency test, and an age test. The individual would satisfy the relationship test if the individual is a son, stepson, daughter, or stepdaughter of the taxpayer, a descendent of a son or daughter of the taxpayer, or a foster or adopted child of the taxpayer. A foster child would be defined as an individual whom the taxpayer cares for as the taxpayer's own child. An adopted child would include a child who is legally adopted or who is placed with the taxpayer by an authorized placement agency for adoption by the taxpayer. If the qualifying child is married at the close of the taxpayer's taxable year, the

taxpayer generally must be entitled to a dependency deduction for the taxable year with respect to such qualifying child in order to claim the credit.

An individual would satisfy the residency test if the individual has the same principal place of abode as the taxpayer for more than half the taxable year (the entire year for foster children). The determination of whether the residency requirement is met would be made under rules similar to those applicable with respect to whether an individual meets the requirements for head-of-household filing status. Thus, for example, certain temporary absences due to education or illness would be disregarded for purposes of determining whether the child had the same principal place of abode as the taxpayer for over half the year. Also, the residence would have to be in the United States.

An individual would satisfy the age test if the individual has not attained the age of 18 as of the close of the calendar year in which the taxable year of the taxpayer begins.

The maximum amount of credit, regardless of the number of qualifying children, could not exceed an amount equal to the sum of (1) the taxpayer's income tax liability (net of applicable credits), and (2) the taxpayer's Railroad Retirement Tier 1 tax and Social Security tax (SECA and the employee and employer share of FICA), less the taxpayer's allowable EITC amount. For these purposes, Social Security tax would not include any amounts to the extent the taxpayer is entitled to a special refund under section 6413(c) (relating to overpayment of certain employment taxes). Also, any amounts paid pursuant to an agreement under section 3121(l) (relating to agreements entered into by American employers with respect to foreign affiliates) would be treated as Social Security tax for purposes of this credit

The bill would provide that couples who are married at the end of the taxable year must file a joint return to receive the credit unless they lived apart for the last six months of the taxable year and the individual claiming the credit (1) maintained as his or her home a household for the qualifying child for more than one half the taxable year and (2) furnished over one-half the cost of maintaining that household in that taxable year

Effective Date

The provision would be effective for taxable years beginning after December 31, 1995.

B. Tax Credit for Families with Young Children

(Sec. 101 of H.R. 980 and S. 452 and sec. 101(c) of H.R. 981 and S. 453)

Present Law

In general

Taxpayers generally may claim a personal exemption for each dependent, including dependent children. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income (AGI) in arriving at taxable income. The amount of each personal exemption is $2,500 for 1995, and is adjusted annually for inflation. The amount of the personal exemption is phased out for taxpayers with AGI in excess of $114,700 for single taxpayers, $143,350 for heads of household, and $172,050 for married couples filing joint returns.

In addition, eligible low-income workers are able to claim a refundable earned income tax credit (EITC). The amount of the credit an eligible taxpayer may claim depends upon whether the taxpayer has more than one, one, or no qualifying children and is determined by multiplying the credit rate by the taxpayer's earned income up to an earned income threshold. The maximum amount of the credit is the product of the credit rate and the earned income threshold. In 1995, the maximum credit is $3,110 for taxpayers with more than one qualifying child, $2,094 for taxpayers with one qualifying child, and $314 for taxpayers with no qualifying children. For taxpayers with earned income (or AGI, if greater) in excess of a phaseout threshold, the credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the phaseout threshold. In 1995 the phaseout threshold is $11,290 for both taxpayers with more than one qualifying child and taxpayers with one qualifying child, and $5,130 for taxpayers with no qualifying children. The credit is not allowed if earned income (or AGI, if greater) exceeds the phaseout limit. In 1995, the EITC is phased out at $26,673 for taxpayers with more than one qualifying child, $24,396 for taxpayers with one qualifying child, and $9,230 for taxpayers with no qualifying children.

Mathematical errors

The Internal Revenue Service (IRS) may summarily assess additional tax due as a result of a mathematical error without sending the taxpayer a notice of deficiency and an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and a period of 60 days to request that the IRS abate its assessment. The IRS may not proceed to collect the amount of the assessment until the taxpayer has agreed to it or has allowed the 60-day period for objecting to expire. If the taxpayer files a request for abatement of the assessment specified in the notice, the IRS must abate the assessment. Any reassessment of the abated amount is subject to the ordinary deficiency procedures. This procedure is the only one a taxpayer may use for

contesting an assessment arising out of a mathematical or clerical error.

Description of Proposal

The proposal would provide taxpayers with a maximum credit of $300 for each eligible child for taxable years 1996, 1997 and 1998. The maximum amount of the credit would be increased to $500 for each eligible child for taxable years beginning after December 31, 1998.

The credit would be phased out ratably for taxpayers with AGI over $60,000 and would be fully phased out at AGI of $75,000. In the case of a taxable year beginning after calendar year 1999, the maximum credit and the beginning point of the phaseout range would be indexed annually for inflation. For each year in which the maximum amount of the credit exceeds $500, the size of the phaseout range would be increased from $15,000 (i.e., $75,000 minus $60,000) to 30 times the maximum amount of the credit in that year. For purposes of all these AGI tests, the taxpayer's AGI would be increased by any amount otherwise excluded from gross income under Code sections 911, 931, or 933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively).

To be an eligible child, an individual would have to satisfy a dependency test, a relationship test, an age test, and an identification test.

An individual would satisfy the dependency test if the individual is a dependent of the taxpayer with respect to whom the taxpayer is entitled to claim a dependency deduction.

An individual would satisfy the relationship test if the individual is a son, stepson, daughter or stepdaughter of the taxpayer, a descendant of a son or daughter, or a foster or adopted child of the taxpayer. A foster child would have to have as his principal place of abode the home of the taxpayer and be a member of the taxpayer's household. An adopted child would include a child who is legally adopted by the taxpayer or who is placed with the taxpayer by an authorized placement agency for legal adoption by the taxpayer.

An individual would satisfy the age test if the individual has not attained the age of 13 as of the close of the calendar year in which the taxable year of the taxpayer begins.

An individual would satisfy the identification test if the individual's taxpayer identification number is included on the taxpayer's return for such taxable year. Rules similar to those made applicable by the Administration proposals to the EITC would apply. If a taxpayer fails to provide a correct taxpayer identification number, such omission would be treated as a mathematical or clerical error and thus any notification that the taxpayer owes additional tax because of that omission would not be treated as a notice of deficiency.

The maximum amount of the credit for each taxable year could not exceed an amount equal to the sum of: (1) the taxpayer's regular income tax liability (net of applicable credits) less (2) the sum of the taxpayer's tentative minimum tax liability and earned income tax credit allowed.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

C. Education and Job Training Tax Deduction

(Sec. 102 of H.R. 980 and S. 452)

Present Law

Taxpayers generally may not deduct education and training expenses. However, a deduction for education expenses generally is allowed under section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee's current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed two percent of the taxpayer's adjusted gross income (AGI).

Education expenses that are reimbursed by the employer are excludable from the employee's gross income as a working condition fringe benefit (sec. 132(d)) if the education qualifies as work related under section 162 A special rule allowed an employee to exclude from gross income up to $5,250 paid by his or her employer for educational assistance, regardless of whether the education maintained or improved a skill required by the employee's current position (sec 127) This special rule for employer-provided educational assistance expired after 1994.

Another special rule, section 135, provides that interest earned on a qualified U.S. Series EE savings bond issued after 1989 is excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[1] "Qualified higher education expenses" include tuition and required fees for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at certain colleges, universities, or vocational schools The exclusion provided by section 135 is phased out for certain higher income taxpayers, determined by the taxpayer's AGI during the year the bond is redeemed. To prevent taxpayers from effectively avoiding the income phaseout limitation (through issuance of bonds directly in the child's name), section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old

Section 117 excludes from gross income amounts received as a qualified scholarship by an

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[1] If the aggregate redemption amount (i e., principal plus interest) of all Series EE bonds redeemed by the taxpayer during the taxable year exceeds the qualified education expenses incurred, then the excludable portion of interest income is based on the ratio that the education expenses bears to the aggregate redemption amount (sec. 135(b)).

individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for education below the graduate level provided to employees of certain educational organizations.

Description of Proposal

A taxpayer would be allowed an above-the-line deduction for qualified educational expenses paid during the taxable year for the education or training of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents at an institution of higher education. The deduction would be allowed in computing a taxpayer's AGI, and could be claimed regardless of whether the taxpayer itemizes deductions In 1996, 1997, and 1998, the maximum deduction allowed per taxpayer return would be $5,000 In 1999 and thereafter, the maximum deduction would be increased to $10,000. The deduction would be phased out ratably for taxpayers with modified AGI between $70,000 and $90,000 ($100,000 and $120,000 for joint returns). Modified AGI would include taxable Social Security benefits and amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions). Beginning in 2000, the income phase-out range would be indexed for inflation.

Qualified educational expenses would be defined as tuition and fees required for the enrollment or attendance of an eligible student (e.g., registration fees, laboratory fees, and extra charges for particular courses) at an institution of higher education. Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal expenses unrelated to a student's academic course of instruction would not be deductible. The expenses of education involving sports, games, or hobbies would not be qualified educational expenses unless the education is part of a degree program (or relates to the student's current profession)

An "eligible student" would be one who is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an institution of higher education The student must pursue a course of study on at least a half-time basis or must be enrolled in a course which enables the student to improve current job skills or to acquire new job skills In addition, the student cannot be enrolled in an elementary or secondary school, and cannot be a nonresident alien Educational institutions would determine what constituted a half-time basis for individual programs

The term "institution of higher education" would be defined by reference to section 481 of the Higher Education Act of 1965 Such institutions must have entered into an agreement with the Department of Education to participate in the student loan program. This definition includes

colleges and universities, and certain vocational and proprietary institutions.

Any amount taken into account as a qualified educational expense would be reduced by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the deduction. Thus, qualified educational expenses would be reduced by scholarship or fellowship grants excludable from gross income under section 117 (even if the grants are used to pay expenses other than qualified educational expenses) and any educational assistance received as veterans' benefits. Similarly, qualified educational expenses would be reduced by proceeds from Series EE savings bonds that are excludable by the taxpayer under present-law section 135. However, no reduction would be required for a gift, bequest, devise or inheritance within the meaning of section 102(a).

Qualified educational expenses would be deductible in the year the expenses are paid, subject to the requirement that the education commences or continues during that year or during the first three months of the next year. Qualified educational expenses paid with the proceeds of a loan generally would be deductible (rather than repayment of the loan itself). Normal tax benefit rules would apply to refunds (and reimbursements through insurance) of previously deducted tuition and fees.

The proposal would not affect deductions claimed under any other section of the Code, except that any amount deducted under another section of the Code could not also be deducted under this provision. A student would not be eligible to claim a deduction under this provision on his or her own tax return if that student could be claimed as a dependent of another taxpayer.

Effective Date

The proposal would be effective for qualified educational expenses paid after December 31, 1995

D. Credit to Reduce the Marriage Penalty (sec. 3 of H.R. 6)

Present Law

A married couple generally is treated as one tax unit that must pay tax on the unit's total taxable income. Although married couples may elect to file separate returns, the rate schedules and provisions are structured so that filing separate returns usually results in a higher tax than filing joint returns. Other rate schedules apply to single persons and to single heads of household.

A "marriage penalty" exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A "marriage bonus" exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return (if they were to marry).

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, a general rule is that married couples whose earnings are split relatively evenly (between 50-50 and 70-30) suffer a marriage penalty Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus

Description of Proposal

Married couples who file a joint return and have a larger tax liability than if they were unmarried and filed individual returns would be eligible for a nonrefundable credit against their income tax liability. The amount of the credit would be determined by the Department of the Treasury so that the estimated reduction in revenues to the Treasury would not exceed $2 billion per fiscal year In no event would the credit for a particular taxpayer be larger than the size of the marriage penalty the couple would face without the provision.

Effective Date

The provision would be effective for taxable years beginning after the date of enactment.

APPENDIX: BACKGROUND INFORMATION ON THE MARRIAGE PENALTY

In general

A marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A marriage bonus exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, as a general rule married couples whose earnings are split more evenly than 70-30 suffer a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus

Prior to 1993 (and continuing under present law for the 15-, 28- and 31-percent brackets), the bracket breakpoints[1] and the standard deduction for single filers were roughly 60 percent of those for joint filers and those for head of household filers were about 83 percent of those for joint filers The rate changes in the Omnibus Budget Reconciliation Act of 1993 (OBRA '93) exacerbated the existing marriage penalty because the new bracket breakpoints did not provide the customary ratios across filing statuses[2] For the new 36-percent bracket, the breakpoint for single filers and for head of household filers are 82 percent and 91 percent, respectively, of the breakpoint for joint filers For the 39 6-percent bracket that results from the "surtax", the bracket breakpoint is $250,000 regardless of filing status

Marriage neutrality versus equal taxation of married couples with equal incomes

Any system of taxing married couples requires making a choice among three different ideas of tax equity One principle is that the tax system should be "marriage neutral"; that is, the tax burden of a married couple should be exactly equal to the combined tax burden of two single persons where one has the same income as the husband and the other has the same income as the wife A second principle of equity is that, because married couples frequently consume as a unit, couples with the same income should pay the same amount of tax regardless of how the income is divided between them (This second concept of equity could apply equally well to other tax

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[1] A bracket breakpoint is the dividing point between two marginal rate brackets.

[2] Taxpayers who were not subject to the new rate brackets generally faced no change in their marriage penalty or bonus Some taxpayers receiving the earned income tax credit (EITC) may have faced slightly larger or smaller marriage penalties or bonuses because of the OBRA '93 changes in the EITC, but the magnitude of these changes was generally small relative to the previously existing marriage penalties or bonuses for these taxpayers.

units that may consume jointly, such as the extended family or the household, defined as all people living together under one roof.) A third concept of equity is that the tax should be progressive; that is, as income rises, the tax burden should rise as a percentage of income

These three concepts of equity are mutually inconsistent. A tax system can generally satisfy any two of them, but not all three [3] The current tax system is progressive: as a taxpayer's income rises, the tax burden increases as a percentage of income. It also taxes married couples with equal income equally: it specifies the married couple as the tax unit so that married couples with the same income pay the same tax But it is not marriage neutral.[4] A system of mandatory separate filing for married couples would sacrifice the principle of equal taxation of married couples with equal incomes for the principle of marriage neutrality unless it were to forgo progressivity It should be noted, however, that there is an exception to this rule if refundable credits are permissible. A system with a flat tax rate and a per taxpayer refundable credit would have marriage neutrality, equal taxation of couples with equal incomes and progressivity.[5]

There is disagreement among commentators as to whether equal taxation of couples with equal incomes is a better principle than marriage neutrality. (This discussion assumes that the dilemma cannot be resolved by moving to a proportional tax system.) Those who hold marriage neutrality to be more important argue that tax policy discourages marriage and encourages unmarried individuals to cohabit without getting married, thereby lowering society's standard of morality. Also, they argue that it is simply unfair to impose a marriage penalty even if the penalty does not actually deter anyone from marrying

Those who favor the principle of equal taxation of married couples with equal incomes argue that as long as most couples pool their income and consume as a unit, two married couples with $20,000 of income are equally well off regardless of whether their income is divided

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[3] See the addendum for a derivation of this result

[4] Even if the bracket breakpoints and the standard deduction amounts for unmarried taxpayers (and for married taxpayers filing separate returns) were half of those for married couples filing a joint return, the current tax system would not be marriage neutral. Some married couples would still have marriage bonuses As described below, the joint return allows married couples to pay twice the tax of a single taxpayer having one-half the couple's taxable income. With progressive rates, this income splitting may result in reduced tax liabilities for some couples filing joint returns For example, consider a married couple where one spouse has $60,000 of income and the other has none By filing a joint return, the couple pays the same tax as a pair of unmarried individuals each with $30,000 of income. With progressive taxation, the tax liability on $30,000 would be less than half of the tax liability on $60,000. Thus the married couple has a marriage bonus the joint return results in a smaller tax liability than the combined tax liability of the spouses if they were not married

[5] Such a system could not have standard deductions See footnote 12 for further explanation

$10,000-$10,000 or $15,000-$5,000 Thus, it is argued, those two married couples should pay the same tax, as they do under present law By contrast, a marriage-neutral system with progressive rates would involve a larger combined tax on the married couple with the unequal income division. The attractiveness of the principle of equal taxation of couples with equal incomes may depend on the extent to which married couples actually pool their incomes [6]

An advocate of marriage neutrality could respond that the relevant comparison is not between a two-earner married couple where the spouses have equal incomes and a two-earner married couple with an unequal income division, but rather between a two-earner married couple and a one-earner married couple with the same total income. Here, the case for equal taxation of the two couples may be weaker, because the non-earner in the one-earner married couple benefits from more time that may be used for unpaid work inside the home, child care, other activities or leisure It could, of course, be argued in response that the "leisure" of the non-earner may in fact consist of necessary jobhunting or child care, in which case the one-earner married couple may not have more ability to pay income tax than the two-earner married couple with the same income.

Brief history of the marriage penalty

The marriage penalty in the rate structure dates from changes in the structure of individual income tax rates in 1969 [7] To understand the effect of those changes, one needs to go back to 1948, when separate rate schedules for joint filers and single returns were introduced Before 1948, there was only one income tax schedule, and all individuals were liable for tax as separate filing units With a progressive income tax, a married couple with only one spouse earning income could reduce its combined tax liability if it could split the income and assign half to each spouse While the Supreme Court upheld the Commissioner's right to deny contractual attempts to split income,[8] it ruled that in States with community property laws, income splitting was required for community income [9] As income tax rates and the number of individuals liable

[6] For some recent articles calling into question the justification for joint returns and the assumption of pooling of income among members of a household, see Marjorie E. Kornhauser, "Love, Money, and the IRS Family, Income Sharing, and the Joint Income Tax Return", 45 *Hastings L. J.* 63 (1993), Edward J McCaffery, "Taxation and the Family A Fresh Look at Behavioral Gender Biases in the Code", 40 *UCLA L. Rev* 983 (1993), and Lawrence Zelenak, "Marriage and the Income Tax", 67 *S Cal. L. Rev.* 399 (1994)

[7] In 1951, a separate rate schedule was created for unmarried heads of household with dependents ("head of household" status) Since the bracket breakpoints and standard deduction were more than half of those for joint returns, marriage penalties arose for some taxpayers eligible for filing as head of household

[8] *Lucas v. Earl*, 281 U.S 111 (1930)

[9] *Poe v. Seaborn*, 282 U.S 101 (1930)

for income taxes increased before and during World War II, some States adopted, or considered adopting, community property statutes to give their citizens the tax benefits of income splitting.

In the Revenue Act of 1948, income splitting was allowed to all married couples by establishing a separate tax schedule for joint returns. That schedule was designed so that married couples would pay twice the tax of a single taxpayer having one-half the couple's taxable income. (This relationship between rate schedules is the same as that between joint returns and separate returns for married couples under present law.) While this new schedule equalized treatment between married couples in States with community property laws and those in States with separate property laws, it introduced a marriage bonus into the tax law for couples in States with separate property laws.[10] In 1969, an individual with the same income as a married couple could have had a tax liability as much as 40 percent higher than that of the married couple. To address this perceived inequity, which was labeled a "singles penalty" by some commentators, a special rate schedule was introduced for single taxpayers (leaving the old schedule solely for married individuals filing separate returns). The bracket breakpoints and standard deduction amounts for single taxpayers were set at about 60 percent of those for married couples filing joint returns. This schedule created a marriage penalty.

Marriage penalty for low-income individuals under present law

There are three features of the current individual income tax system that create a marriage penalty for low-income individuals: the variation of the size of the standard deduction by filing status, the phaseout of the earned income tax credit (EITC) as income increases, and the variation of the size of the EITC by number of dependent children.

Under present law, the size of the standard deduction and the bracket breakpoints follow certain customary ratios across filing statuses. The standard deduction and bracket breakpoints for single filers are roughly 60 percent of those for joint filers. The standard deduction and bracket breakpoints for head of household filers are about 83 percent of those for joint filers. With these ratios, unmarried individuals have standard deductions whose sum exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals. Furthermore, because of the way the bracket breakpoints are structured, as joint filers they may have some of their taxable income pushed into a higher marginal tax bracket than when they were unmarried.

As an example of the marriage penalty caused by the rate structure, consider two individuals, each with one dependent child and with wage income of $10,000 (and no income from other sources). Filing as heads of household in 1995, each would have had a standard deduction of $5,750 and two personal exemptions worth $2,500 each. The sum of the standard

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[10] Since income splitting had been available in community property States prior to 1948, a marriage bonus had already existed in such States.

deduction and the $5,000 in personal exemptions would have exceeded each individual's adjusted gross income and thus would have reduced taxable income to zero. If they had married and filed a joint return with wage income of $20,000, they would have had a standard deduction of $6,550 and four personal exemptions ($10,000), leaving them with taxable income of $3,450, resulting in a $518 tax liability at a 15-percent rate.[11]

To eliminate the marriage penalty caused by the rate structure, the standard deduction and bracket breakpoints for all unmarried filers would have to be 50 percent of those for joint filers. This is the current ratio for individuals who are married, but file separate returns.[12]

Even if the marriage penalty caused by the rate structure could be eliminated, other features of the tax code conditioned on income can still cause marriage nonneutrality. For low-income individuals with dependent children, the EITC is one such feature. Because the EITC increases over some range of income and then is phased out over another range of income, the aggregation of incomes that occurs when two individuals marry may reduce the amount of EITC for which they are eligible.[13] Consider again the two individuals in the previous example, each with one dependent child and with wage income of $10,000. In 1995, each would have qualified for the maximum one-child EITC credit of $2,094 (giving the pair a combined total credit of $4,188). If they had married and filed a joint return with wage income of $20,000, they would then be in the phaseout range of the EITC, so the two-child credit only would have been $1,350, a reduction of $2,838 from the combined amount they would have received as unmarried individuals. Therefore the combined effect of the higher tax liability and the reduced EITC would have been a marriage penalty of $3,356 ($2,838 + $518).

Marriage may reduce the size of a couple's EITC not only because their incomes are aggregated, but also because the number of dependent children is aggregated. Because the amount of EITC does not increase when a taxpayer has more than two dependent children, marriages that cause the resulting family to have more than two dependent children will result in a smaller number of children giving rise to the EITC than when their parents were unmarried. And even when each unmarried individual brings just one dependent child into the marriage

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[11] This calculation looks only at the tax liability and ignores any possible credits. The effect of the EITC is considered below.

[12] Note that even with such a rate structure, a marriage bonus would exist in the case of an individual with no taxable income marrying an individual with taxable income. The individual with no taxable income is, in essence, allowing some of his or her standard deduction to go "unused". By marrying an individual with taxable income, some of the taxable income of the couple can be reduced by the "unused" portion of the standard deduction.

[13] In the case of two individuals with very low wage income, marriage may *increase* the amount of their EITC available for a dependent child. If the individual with the dependent child is in the phase-in range of the EITC the aggregation of incomes upon marriage could increase the amount of the EITC.

there is a reduction in the amount of EITC, since the maximum credit for two children is generally much less than twice the maximum credit for one child.

These three features can cause unmarried individuals who are eligible for the EITC to face significant marriage penalties. For example,[14] in 1995, two individuals each with one dependent child, one with wage income of $14,000 and the other with wage income of $10,000, faced a marriage penalty of $3,841

Eliminating the marriage penalty

The marriage penalty could be eliminated in two ways. One is through restructuring of rates (across different filing statuses) and phaseout ranges (for numerous provisions). The other is by giving married couples the option to calculate their tax liability as if they were unmarried The revenue effects of the marriage penalty are sizable. A recent National Bureau of Economic Research paper by Daniel R Feenberg and Harvey S. Rosen estimated that in 1994, 52 percent of married couples would face a marriage penalty, with an average penalty of about $1,244, while 38 percent would face a marriage bonus, with an average bonus of about $1,399 [15]

To eliminate the marriage penalty through a change in the rate structure, the brackets for all unmarried taxpayers (both singles and heads of household) would have to be half as large as the married, filing joint brackets. This change could either gain or lose revenue — depending on whether unmarried individuals have their rate brackets shifted down or joint filers have theirs shifted up Another effect of such a step would be that single individuals and heads of household with identical incomes would find their tax liabilities nearly the same (they would differ only because of extra personal exemptions for the head of household's dependents and any EITC) Relying solely on extra personal exemptions to adjust for family size would result in unmarried individuals with dependents receiving smaller tax benefits than they now receive by filing as head of household Such a change in rate structure would also bring back the "singles penalty" that led to the creation of an unmarried filing status (separate from married, filing separately) in 1969

Allowing joint filers the option of calculating a combined tax liability as if they were not married would fix the problem at the cost of complicating the tax return To take advantage of the provision, taxpayers would have to calculate their tax liability under two alternatives and then choose the smaller liability Either rules would have to prescribe how taxpayers would allocate deductions and dependent exemptions (if any) between the two spouses or the spouses could be allowed to allocate them in the most favorable manner. In many cases, it would be

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[14] The amount of the marriage penalty would have been even larger if each individual had two or more children

[15] Daniel R Feenberg and Harvey S Rosen, "Recent Developments in the Marriage Tax", NBER Working Paper No 4705, April 1994

difficult for the Internal Revenue Service to enforce detailed rules short of upon audit; in practice, taxpayers could have wide latitude to allocate deductions and unearned income in the most favorable way.

A second issue for the optional unmarried filing is what filing status to allow taxpayers with dependents to use. Should married filers be allowed to file as heads of household on the grounds that they could get divorced and do so? Or should they be constrained to file using the single rate schedules? The answer would depend upon the frame of reference. If one measures the marriage penalty relative to what tax treatment the spouses would get if they divorced, then head of household filing is appropriate. If one measures the marriage penalty relative to the tax treatment before the time of marriage, then the answer hinges upon whether the dependents arose before or after the marriage

An alternative approach to reducing the marriage penalty is to return to the 1982-1986 second-earner deduction, which allowed joint filers a deduction for ten percent of the lesser of the earned income of the lower-earning spouse or $30,000. This approach reduces the marginal tax rate on the lower-earning spouse, but does not eliminate the marriage penalty, especially if the size of the deduction is capped, as was the 1982-1986 deduction. What this approach lacks in tailoring the remedy to the particular situation of a married couple, it makes up for in simplicity of administration Because it is a deduction, its value rises as the couple's marginal tax rate rises This feature does not necessarily track the size of the marriage penalty, which is much larger for individuals in the bottom (in relative terms) and top (in dollar amounts) marginal tax brackets Also, a second-earner deduction allows a tax break even if the couple suffers no marriage penalty (because the second-earner earns such a small amount of the combined income)

Description of attached charts

In the addendum are "contour maps" showing the size of marriage penalties and bonuses for individuals of different filing statuses under projected tax schedules for 1996. For all of these calculations, all of the income of the individuals is assumed to be earned income. The separate income of one spouse is shown on the horizontal axis, the separate income of the other spouse is shown on the vertical axis The point at the intersection of two income levels indicates the marriage penalty or bonus for the couple Marriage penalties are shown as positive numbers in the map, marriage bonuses are shown as negative numbers

ADDENDUM

The inconsistency of progressivity, equal taxation of couples with equal income and marriage neutrality can be shown mathematically as follows: Consider four individuals, A, B, C and D. Assume that A and B have equal incomes, C has an income equal to the combined incomes of A and B, and D has no income. Let T(A), T(B), and T(C) be the tax burdens of the three individuals with income. If the tax system is not proportional,

$$T(C) \neq T(A) + T(B). \quad (1)$$

Now assume A and B marry each other, as do C and D, and let T(AB) and T(CD) be the tax burdens of the married couples. The principle that families with the same income should pay the same tax requires that

$$T(AB) = T(CD). \quad (2)$$

and marriage neutrality requires both that

$$T(A) + T(B) = T(AB) \quad (3)$$

and that

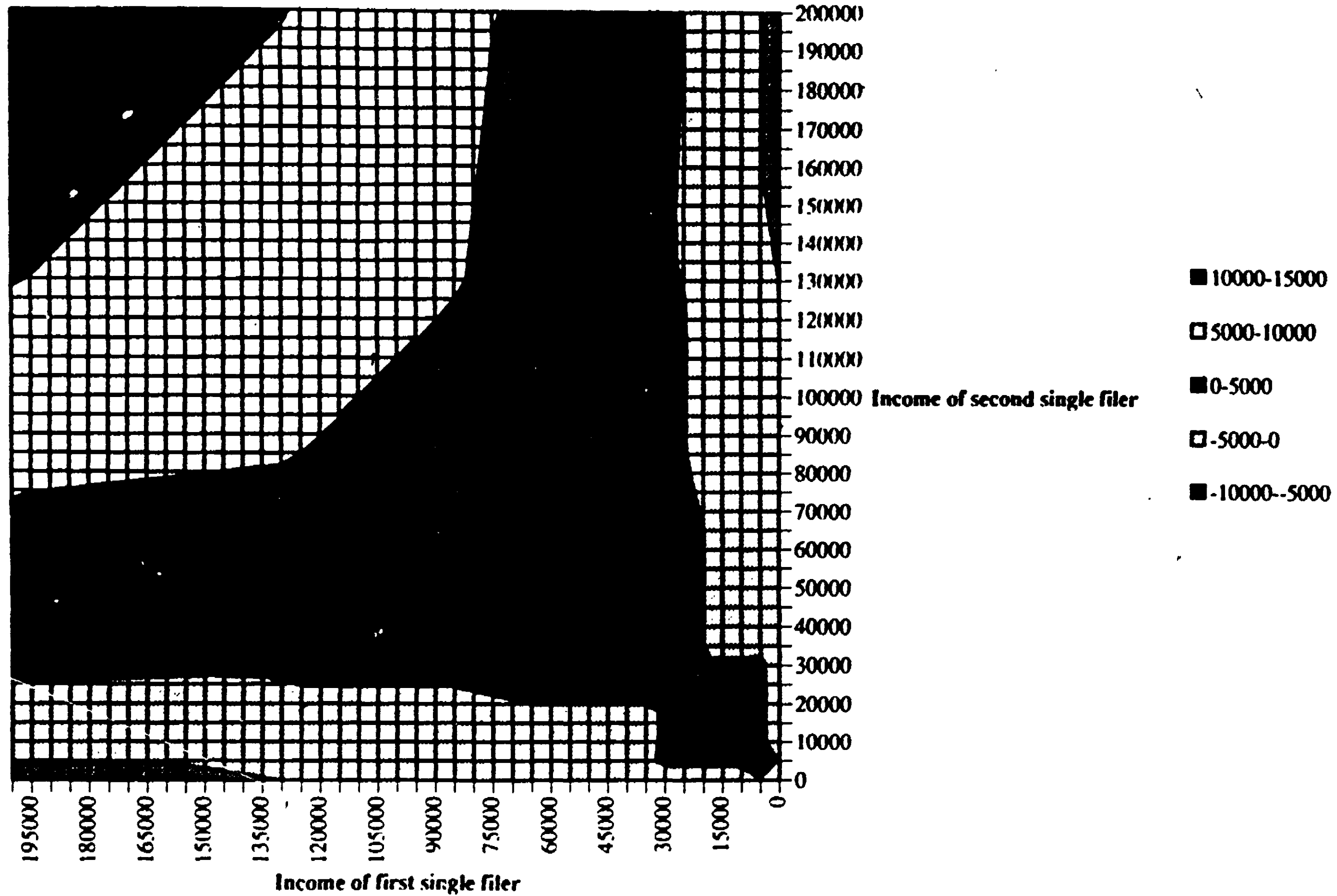
$$T(CD) = T(C) \quad (4)$$

Substituting (3) and (4) into (2) yields

$$T(A) + T(B) = T(C) \quad (5)$$

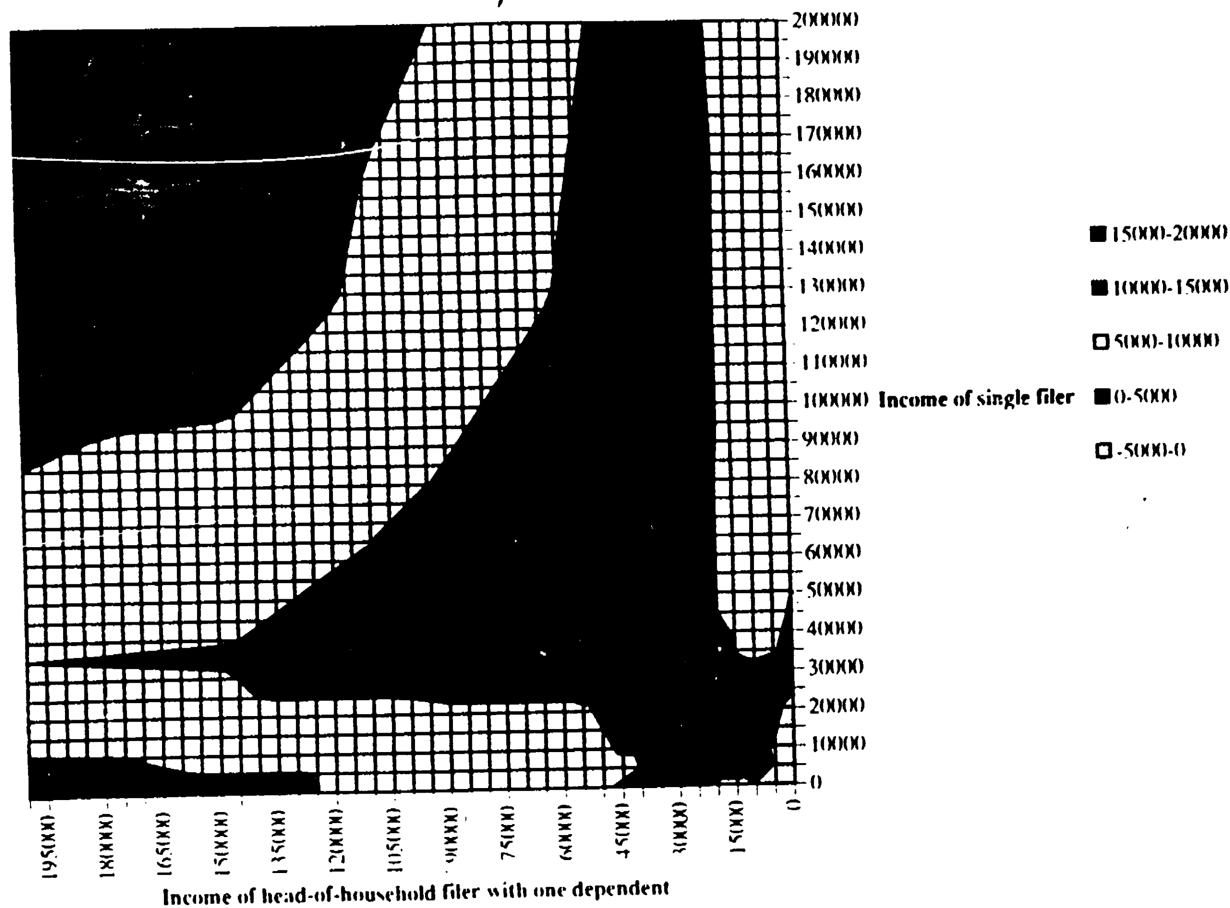
This, however, contradicts equation (1), indicating that equations (2) and (3) can only both be true in a proportional tax system

Marriage penalty / (bonus) for two single filers



1996 Projection
Both filers are assumed to take the standard deduction.
All income is assumed to be earned income.

Marriage penalty / (bonus) for single filer and head of household filer with one dependent

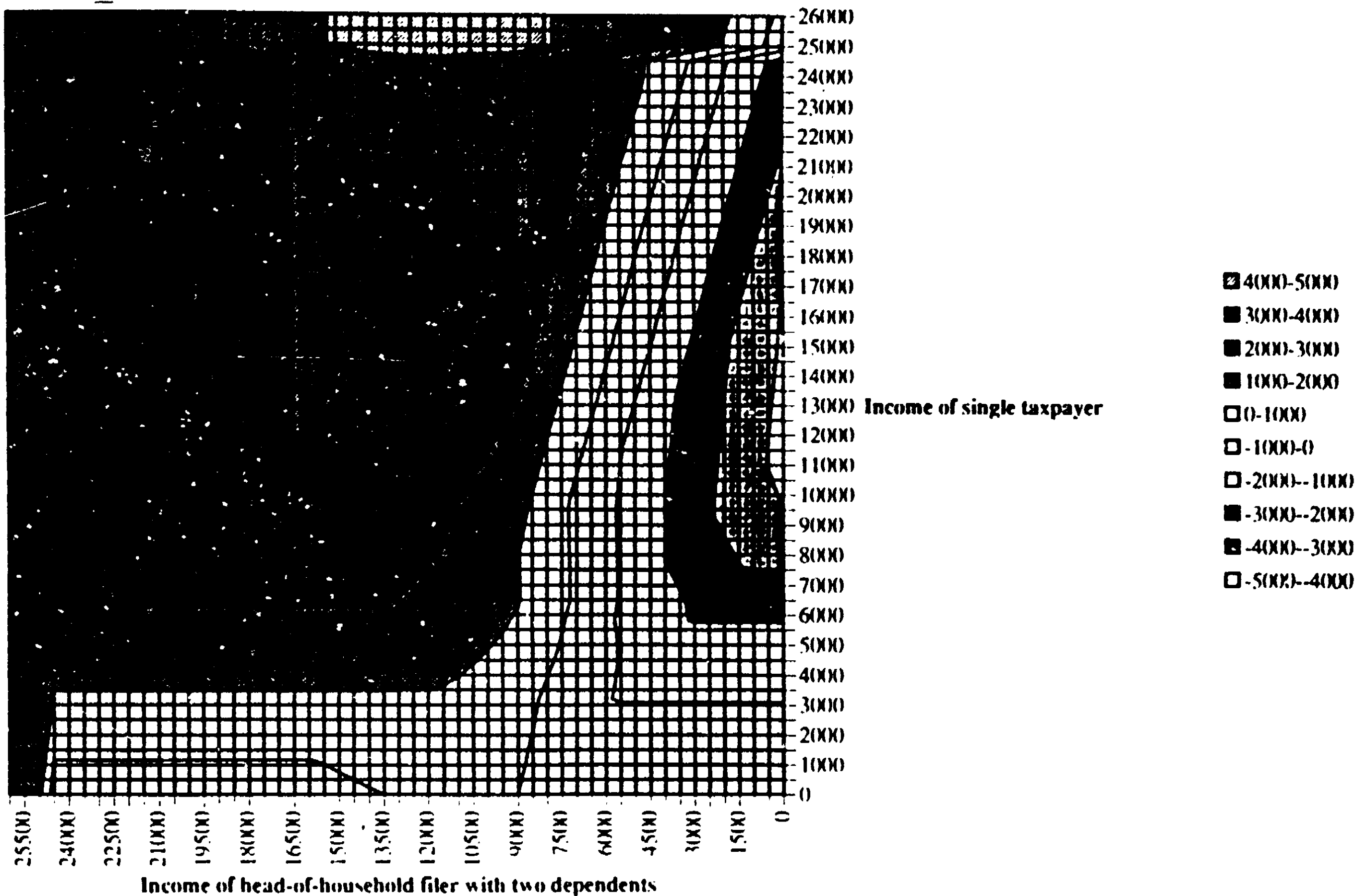


1996 Projection

Both filers are assumed to take the standard deduction.

All income is assumed to be earned income.

Marriage penalty / (bonus) for single filer and head of household filer with two dependents



1996 Projections
Both individuals are assumed to take the standard deduction
All income is assumed to be earned income

89-324 (80)