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Archer Tax Proposal Uses Social Security Funds For Inefficient and Poorly Targeted Tax Cuts

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Summary

House Ways and Means Committee Chairman Bill Archer has proposed a tax cut that costs $80 billion over the next five years, paid for out of the budget surplus that is projected to materialize over the next decade. The net effect of this proposal is to divert portions of the surplus designated by statute for the Social Security system to finance tax cuts that include several inefficient and poorly-targeted provisions and several provisions that benefit the highest-income taxpayers in the country.

- Mr. Archer claims his tax cut proposal is prudent because 90 percent of the surplus would remain "until we find a solution to Social Security's problems." But *all* of the surpluses the Congressional Budget Office projects over the next five years — and 98 percent of the surpluses CBO projects over the next 10 years — are Social Security funds that reflect the building of reserves in the Social Security system. Far from facilitating a long-term solution for Social Security funding, diverting 10 percent of the unified budget surplus for tax cuts now, when most of those funds are Social Security revenues, would make rescuing Social Security solvency more difficult.

- If a recession occurs in the near future, even the unified budget surplus projected for the next five years — the budget surplus inclusive of the Social Security surplus — could disappear. According to a recent CBO analysis, a recession beginning in late 1999 could transform the unified budget surplus of $520 billion over the next five years that CBO currently projects into a $44 billion deficit over this period.

- Except for the reserve building in the Social Security system, which is needed to help cover the large Social Security costs the nation will face when the baby-boom generation retires in large numbers, there will be no significant surpluses until 2006, according to CBO projections. A projection of a non-Social Security surplus that does not begin until 2006 is a slim reed on which to base a tax cut in 1998. Projections of surpluses are

notoriously difficult to make accurately that far into the future, as they depend on a myriad of fluctuating economic factors.

The Archer proposal risks spending an uncertain future surplus, for the purpose of funding a tax cut package that in part will benefit middle-income taxpayer but in part also is poorly targeted and inefficient in a number of respects.

- The proposed "marriage penalty" tax relief does not distinguish between couples that need marriage penalty relief and those that do not. It gives new tax cuts to couples for whom marriage already reduces their taxes under current law. As a result, it costs about twice as much as it would if it targeted benefits only on those who experience marriage penalties under current law.

- This proposal differs significantly from marriage penalty tax relief proposals such as those put forth earlier in the year by Senator Phil Gramm, Representatives Jim McDermott and Richard Neal, and Senator Tom Daschle. Unlike the proposals of these other members, the Archer proposal does nothing to relieve the marriage penalties experienced by low- and moderate-income working families that arise as a result of the phase-out of the Earned Income Tax Credit. As a result of these aspects of the Archer proposal, some couples who already receive marriage bonuses through the tax code would get a tax cut, while some who are at lower income levels and face significant marriage penalties would get no relief at all.

- Another provision in the tax bill would allow the first $200 of interest or dividend income ($400 for a couple) to be excluded from income. Mr. Archer says this exclusion would be of great benefit to families who have only a small amount of such income, allowing them to file a more simple version of the tax form. He fails to note, however, that the exclusion he proposes would not be capped, so the highest-income taxpayers in the country also would be able to exclude their first $200 or $400 of interest and dividend income. It is higher-income taxpayers who are more likely to have dividend and interest income and thus to make heavier use of the exclusion. IRS statistics show that 38 percent of tax filers with income below $25,000 have some interest income, as compared to 96 percent of tax filers with incomes of $100,000 or more. Moreover, an exclusion provides more than twice the tax reduction benefit to a high-income taxpayer in the 39.6 percent tax bracket than to a middle-income taxpayer in the 15 percent tax bracket.

- Mr. Archer also proposes to accelerate the reduction in the estate tax enacted in 1997, claiming that the accelerated tax relief is necessary "...to allow parents and grandparents the right to pass their life savings onto their children without the government confiscating it." But more than 98 percent of the population — all but the very wealthiest — already can pass their estate free of tax to their heirs under current law. Even for the wealthiest two percent, the estate tax is not confiscatory; the estates of the wealthiest two percent consist in large part of appreciated assets such as stocks, bonds, and real estate for which capital gains taxes are forgiven at death. These profits consequently would escape taxation completely were it not for the estate tax.

Should the Surplus Fund a Tax Cut?

In using the concept of a "90-10 tax cut" — 90 percent of the surplus for Social Security and 10 percent for a tax cut — Mr. Archer glosses over several key points about the surpluses the Congressional Budget Office projects for the next 10 years. Specifically, Mr. Archer proposes to spend amounts that substantially exceed the sum of the non-Social Security surpluses over the next 10 years, and he proposes to spend these amounts long before *any* significant non-Social Security surpluses are projected to exist. The risk of spending future surpluses on the basis of long-term projections is heightened by the possibility that adverse economic conditions could result in a unified budget deficit over the next five years.

Using 10 percent of the projected surplus for tax cuts as Mr. Archer proposes entails financing the tax cuts with monies designated by statute for Social Security purposes. All of the surpluses CBO projects in the unified budget over the next five years are attributable to the building of reserves in the Social Security system. CBO projects that the non-Social Security budget will run a net *deficit* of $137 billion over the five-year period. Over the next 10 years, CBO projects accumulated surpluses in the unified budget of $1.55 trillion, of which only two percent — or $31 billion — would be in the non-Social Security budget.

Stated another way, over the next five years, there is *no* surplus except for the reserve building in the Social Security system. The Social Security reserve is needed to cover some of the large Social Security costs the nation will face when the baby-boom generation retires in large numbers.

Moreover, it is not even certain there will be a surplus in the unified budget over the next five years. If a recession should occur in the next few years, the country could once again experience deficits in the unified budget. CBO projects that a recession similar to the one in the early 1990s could transform the unified budget surplus expected over the next five years into a deficit. Instead of the $520 billion surplus in the CBO baseline projection for this period, a recession beginning in late 1999 would result in a $44 billion deficit in the unified budget.[1]

Marriage Penalty Tax Relief

The Archer proposal would decrease marriage penalties for many middle-income couples by increasing the standard deduction that couples may use in determining their taxable income. Under current law, the standard deduction in 1998 is $4,250 for single filers and $7,100 for joint filers. Thus, two unmarried people filing as single individuals will together claim standard deductions totaling $8,500 but must use the joint filer standard deduction of $7,100 once they marry. The smaller standard deduction results in larger taxable income and thus a higher income tax. The Archer proposal would set the standard deduction for couples at two times the standard deduction for single filers, thereby eliminating this source of "marriage penalties."

As this example illustrates, marriage penalties are not an explicit tax on joint filers. Instead, they arise when a couple experiences greater tax liability than it would if the two members were to file as single individuals. The current tax code also creates "marriage bonuses," which occur when a couple reduces its tax liability by marrying. For example, consider a single taxpayer using the $4,250 standard deduction prior to marriage who marries someone with no income. This taxpayer’s income does not increase as a result of marriage, but the ability to use the joint filer standard deduction of $7,100 rather than the $4,250 single’s deduction will reduce his — and thus the couple’s — taxable income and tax.[2]

Overall, the current tax system results in slightly more marriage bonuses than marriage penalties. Using one set of assumptions, the Congressional Budget Office finds that 51 percent of all families filing joint tax returns receive marriage bonuses while 42 percent experience marriage penalties. Under these assumptions CBO reported that the amount of marriage bonuses exceeded the amount of marriage penalties by $4 billion in 1996. Under an alternative set of assumptions, CBO finds that

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[1] CBO, Letter to Senator Frank Lautenberg, Committee on the Budget, September 8, 1998.

[2] Other features of the tax code, such as the structure of the tax brackets, play a significant role in creating marriage penalties and bonuses. For a fuller discussion of this topic, see Congressional Budget Office, *For Better or For Worse: Marriage and the Federal Income Tax*, June 1997; Jane Gravelle, *The Marriage Penalty and Other Family Tax Issues*, Congressional Research Service, August 4, 1998; and Iris J. Lav and Alan Berube, *Marriage Penalties and Bonuses in the Income Tax*, Center on Budget and Policy Priorities, September 10, 1998.

57 percent of families have marriage bonuses and 39 percent experience penalties, with bonuses exceeding penalties by $30 billion. The actual situation is probably somewhere between these two sets of assumptions.[3]

The Archer proposal does not distinguish between those couples that need marriage penalty relief and those that do not. It substantially increases the size of marriage bonuses for many couples that already receive such bonuses under current law.

As Table 1 shows, the marriage penalty for two people each earning $32,000 who marry is reduced from $1,400 to $1,008 under the Archer plan. But the second example in Table 1 shows how marriage bonuses increase under the proposal. Under current law, a couple in which one person earns $52,000 and the other person earns $12,000 receives a reduction in their combined income tax bill as a result of marriage from nearly $10,100 to $8,900, a marriage bonus of $1,160. The Archer proposal would increase such a couple's marriage bonus by nearly $400.

This increase in marriage bonuses has two implications. First, the Archer proposal costs more than twice as much as it needs to cost for the amount of marriage penalty relief provided. For example, a bill introduced by Senator Tom Daschle that allows a second-earner deduction for couples with incomes below $60,000 provides a similar level of marriage penalty relief (and, as discussed below, also extends that relief to low- and moderate-income working couple families for which the phase-out of the EITC causes marriage penalties) at a cost of less than $3 billion a year or $15 billion over five years. The Archer marriage penalty approach costs approximately $6 billion a year when fully in effect, or $30 billion over five years.

Moreover, expanding marriage bonuses exacerbates "singles penalties" — that is, the extent to which a single person pays a higher income tax than a married person earning the same amount of income. The third example in Table 1 shows that if a single person and a married person whose spouse stays at home work side-by-side and each earn $64,000, the single person pays 42 percent more income tax under current law than the married person. The Archer proposal would expand that differential, resulting in the single taxpayer paying 49 percent more than the married taxpayer. Although this discrepancy already is large, expanding the discrepancy further may be viewed as

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[3] Congressional Budget Office, *For Better or For Worse: Marriage and the Federal Income Tax*, June 1997. In deriving the first estimate, CBO assumed that prior to marriage, the first child of the couple was on the tax return of the higher-earning spouse, the next child was assigned to the lower-earning spouse, and all additional children were assigned to the higher-earning spouse. The second estimate assumed that all children are claimed by the lower-earning spouse prior to marriage. A Congressional Research Service report points out that it may be more realistic to assume that children are claimed by the lower-earning spouse prior to marriage because 85 percent of children who live with one parent live with the mother.

Table 1
1998 Tax Liability Under Archer Plan to Increase Standard Deduction

	Current Law		Archer Plan
	Single	**Married**	**Married**
Two People Each Earning $32,000	$7,515	$8,915	$8,523
Bonus or (penalty)		($1,400)	($1,008)
Bonus/(penalty) as percent of income		(2.2%)	(1.6%)
Couple with one spouse who earns $52,000 and one spouse who earns $12,000	$10,076	$8,915	$8,523
Bonus or (penalty)		$1,161	$1,553
Bonus/(penalty) as percent of income		1.8%	2.4%
Couple with one earner who earns $64,000	$12,679	$8,915	$8,523
Bonus or (penalty)		$3,764	$4,156
Bonus/(penalty) as percent of income		5.9%	6.5%
Note: These calculations assume the couple has no children.			

unfair by single taxpayers. Enlarging the disparity could give rise to future demands for additional tax relief for single taxpayers.

No Relief for EITC Marriage Penalties

Lower-income families also experience marriage penalties. For such families, these penalties stem largely from the structure of the Earned Income Tax Credit.

The EITC is a refundable credit for low- and moderate-income taxpayers who have earnings from work. The credit is structured so it phases out gradually for families with incomes in excess of a specific level. The phase-out begins at $12,260 in 1998. To the extent that combining the earnings of two people as a result of marriage boosts a married couple's income to a point in the phase-out range at which the couple receives a smaller credit than one or both of them would have received if still single (or raises their income to a level that makes them ineligible for the EITC), the couple experiences a marriage penalty.

A low-income marriage penalty related to the EITC would occur, for example, if a low-income man married a low-income woman who had similar earnings and was

Table 2
Low-Income Marriage Penalty Example
1998 Taxes

	Man (no children)	Woman (2 children)	Couple (2 children)
Income	$10,712	$10,712	$21,424
Exemptions	($2,700)	($5,400)	($10,800)
Standard Deduction	($4,150)	($6,250)	($7,100)
Taxable Income	$3,762	$0	$3,528
Tax (at 15%)	$564	$0	$529
Child Credit	$0	$0	$529
Tax after Child Credit	$564	$0	$0
EITC	($0)	($3,756)	($1,826)
Liability / (Refund)	$564	($3,756)	($1,826)
Combined Refund	($3,192)		($1,826)
Marriage Penalty			**$1,366**

raising two children. Table 2 shows how the marriage penalty comes about for such a man and woman if they each work full time throughout the year at the federal minimum wage. If unmarried, the man would file as a single taxpayer, while the woman would file as a head of household and claim an EITC for her two children. When they are unmarried, the man pays $564 in income tax while the woman qualifies for a $3,756 refund — the maximum EITC for a family with two children in 1998. Their combined refund thus is $3,192. If they marry, the couple's combined income of $21,424 puts them in the phase-out range of the EITC. As a result, their combined refund is reduced from $3,192 to $1,826, yielding a marriage penalty of $1,366.[4]

[4] The EITC creates marriage bonuses as well as marriage penalties. When a person raising a child has little or no earnings and marries someone who has modest earnings, the family can become newly eligible for the EITC or eligible for a larger EITC and thus receive a sizeable marriage bonus.

Increasing the standard deduction for married couples does nothing to address the marriage penalties associated with the EITC unless specific language is included to modify the EITC benefit structure so that the EITC reflects the increase in the standard deduction for married filers. In contrast to the Archer proposal, the standard deduction increase introduced earlier this year by Senators Phil Gramm and Pete Domenici — a proposal the Senate passed as an amendment to the McCain tobacco legislation — included specific language of this nature to allow the standard deduction increase to benefit families receiving the EITC.[5]

Cost of Encouraging Marriage

Some proponents of marriage penalty tax relief claim that reducing the "marriage tax" can affect the decision to marry. The available research suggests the effect on the marriage decision for every tax dollar foregone is small. Economists James Alm at University of Colorado and Leslie Whittington at Georgetown University compared 40 years of data on the percentage of women between the ages of 15 and 44 who were married with a measure of the changes in income taxes that women could expect with marriage in each of those 40 years.[6] The results of this research imply that the approach taken in the Archer proposal might over time lead the number of married women who are married to increase from 31.5 million to 31.6 million. If the Archer proposal were to lead to this result, it would be at a cost of more than $250,000 for each additional woman who marries.

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[5] The Gramm amendment, which increased the standard deduction for married couples with incomes below $50,000, included a provision that effectively increased the income level at which the EITC phase-out begins by changing the definition of income for purposes of the EITC phase-out. Under current law, the income used to determine where in the EITC phase-out range a family falls is the family's adjusted gross income or total earnings, whichever is larger. In the Gramm proposal, a married-couple family's adjusted gross income or earnings for EITC purposes would be reduced by the increase in the standard deduction. That would increase the amount of income a couple could earn before its EITC began to phase out, increase the income at which the EITC was fully phased out, and increase the amount of the EITC for couples in the phase-out range. The specific language in the Gramm amendment states: "Section 329(c)(2) of the Internal Revenue Code of 1986 (defining earned income) is amended by adding at the end the following new subparagraph: '(C) Marriage Penalty Reduction. — Solely for purposes of applying subsection (a)(2)(B), earned income for any taxable year shall be reduced by an amount equal to the amount of the deduction allowed to the taxpayer for such taxable year under section 222 [the additional standard deduction for couples].'"

[6] James Alm and Leslie Whittington, "Does the Income Tax Affect Marital Decisions?," *National Tax Journal*, December 1995.

Interest and Dividend Exclusion

Another provision in the Archer bill would allow the first $200 of interest or dividend income ($400 for a couple) to be excluded from income. Mr. Archer says this exclusion would be of great benefit to families that have only a small amount of such income, because it would permit them to file a more simple version of the tax form. His language implies that small savers would be the only or primary beneficiaries. That is not the case. While small savers would benefit, the highest-income taxpayers in the country would receive a greater benefit than small savers.

The proposal does not limit the interest and dividend exclusion to small savers or middle-income taxpayers. Steve Forbes and Bill Gates, along with the small saver, would be able to exclude their first $200 or $400 of interest and dividend income. This is significant, because higher-income taxpayers are far more likely to have dividend and interest income than lower-income taxpayers are. IRS statistics show that 38 percent of tax filers with income below $25,000 have some interest income, as compared to 96 percent of tax filers with incomes of $100,000 or more. (See Table 3.) While fewer than two-fifths of low- and moderate-income taxpayers would benefit, virtually all high income taxpayers would receive a tax reduction as a result of this provision.

Moreover, while both moderate-income and higher-income taxpayers would be able to exclude the same amount of interest and dividend income, the higher-income taxpayers would get a bigger tax break as a result of this exclusion. A $200 exclusion provides a $79 tax reduction to a high-income taxpayer in the 39.6 percent tax bracket ($200 X .396), but the tax reduction is worth no more than $30 to a middle-income taxpayer in the 15 percent tax bracket.

Table 3
Dividend and Interest Income by Income Class

Adjusted Gross Income	Percent of Tax Returns in Income Class With:	
	Interest Income	Dividend Income
$1 to $25,000	37.6%	12.0%
$25,000 to $50,000	63.9%	20.4%
$50,000 to $100,000	85.1%	38.1%
$100,000 and up	95.9%	69.4%

Source: Internal Revenue Service, *Statistics of Income*, Winter 1997-98.

Finally, there is yet another way in which this provision favors higher-income taxpayers. Because the exclusion lowers adjusted gross income, it will lessen the extent to which higher-income taxpayers are subject to the phase-outs for itemized deductions and personal exemptions and also to the Alternative Minimum Tax.

Estate Tax

Another provision in the Archer proposal would accelerate the increase in the amount of an estate that is exempt from taxation, a tax break that was enacted as part of the Taxpayer Relief Act of 1997. The 1997 law gradually raised the amount of an estate that is exempt from taxation from $600,000 in 1997 to $1 million in 2006. The Archer provision would raise the estate tax exemption to $1 million in 1999.

In announcing the provision, Mr. Archer claimed the accelerated tax relief is necessary "...to allow parents and grandparents the right to pass their life savings onto their children without the government confiscating it." In saying this, he implied that ordinary people are not able to pass their savings to their offspring, a misleading statement. Under current law, more than 98 percent of the population — all but the very wealthiest — can pass their entire estate to any and all heirs free of any tax. Of all people who die in any year, only the two percent with the largest estates are affected by the estate tax.

Moreover, the estate tax is not confiscatory even for the wealthiest two percent of decedents. The estates of the wealthiest two percent consist in large part of appreciated assets such as stocks, bonds and real estate. The appreciation on these assets has never been taxed, because capital gains income is not taxed until the assets are sold. If an asset is held until the owner dies, the gain in the value of the asset is *never* subject to capital gains taxation. The heirs inherit the assets valued at the market price at the time of death and are not required to pay tax on any appreciation that took place during the life of the decedent. If it were not for the estate tax, the appreciation on these assets would escape taxation entirely. With the estate tax, the largest two percent of all estates pay some tax on the appreciated assets.

Finally, some may argue that the acceleration of the phase-in schedule for the 1997 estate tax cut is not a new tax reduction and so does not represent a new tax cut for the wealthy. This is not necessarily the case. The Republican leadership already has indicated it considers the Archer tax proposal a down payment on a larger tax package and announced its intention to return next year with a more extensive agenda. Accelerating the phase-in of the $1 million estate tax exemption and putting the full 1997 estate tax cut in place now clears the way for additional estate tax reductions next year that could raise the exemption to still higher levels or eliminate the estate tax altogether.