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Major Tax Issues in the 107th Congress

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SUMMARY

Early indications are that the principal tax issue in the first part of 2001 will be whether to cut taxes and, if so, by how much. In part, this issue continues a debate that occurred through 1999 and 2000, as the federal budget began to register surpluses for the first time in nearly 30 years. Also, federal taxes as a percent of gross domestic product (GDP) reached post World War II highs in fiscal years 1998-2000. These and other factors led some policymakers (especially Republicans) to argue that the time was right for a tax cut. And, indeed, the congressional budget resolutions in 1999 and 2000 called for sizeable cuts. In general, supporters of tax cuts argued that some or all of the non-Social Security "on budget" surpluses should be returned to taxpayers as a tax cut. Critics maintained that the tax cuts were too large and those that were actively considered favored upper income individuals. Instead, they maintained that the surpluses should be used to pay down the national debt or increase spending.

The precise outlines of the congressional tax agenda for the first part of the 107th Congress have yet to take shape. But if tax cuts are considered in 2001, one place to look for their possible shape is the tax measures that were considered (and in some cases passed) by Congress in 1999 and 2000, but that were not adopted due to opposition by the Clinton Administration. In 1999, Congress passed the Taxpayer Refund and Relief Act (TRRA). The bill's most prominent provisions included an across-the-board cut in tax rates, a "marriage penalty" tax cut for couples, repeal of the alternative minimum tax, cuts in capital gains taxes, more general rules for individual retirement accounts, and repeal of the estate and gift tax. The bill was estimated to reduce revenue by $792 billion over 10 years. President Clinton argued that the tax cuts were too large and vetoed the bill.

In 2000, Congress revisited many of the proposed tax cuts that were in the TRRA, but with a series of narrower, stand-alone bills rather than with one omnibus tax-cut package. Over the course of the year, Congress approved a tax cut for married couples and repeal of the estate tax. However, President Clinton vetoed both measures. In addition, the following tax cut proposals passed either the House or Senate (or both, albeit in different forms): tax cuts for small business linked to a minimum wage increase; tax benefits linked with retirement and pensions; repeal of taxes on Social Security benefits; repeal of the telephone excise tax; and tax benefits linked with education.

The new Congress may also consider the tax proposals made by President-elect Bush during the election campaign. Governor Bush proposed a $1.3 trillion tax cut over the period 2002-2010. Prominent specific tax cuts in his proposal were a cut in statutory tax rates, doubling of the child tax credit, a tax cut for married couples, and repeal of the estate and gift tax.

Most Recent Developments

Early indications are that the question of whether to cut taxes will be perhaps the most prominent tax issue that the 107th Congress will face in its early months. While the exact nature of the tax agenda remains unclear, one possibility is that Congress will reconsider many of the same tax cut proposals that it considered in 1999 and 2000, some of which passed Congress but were vetoed by President Clinton. The latter included tax cuts for married couples and repeal of the estate and gift tax, as well as numerous other tax proposals. President-elect Bush has proposed a $1.3 trillion tax cut over the period 2002-2010 and has argued that such a cut would be insurance against an economic slowdown.

Background and Analysis

The Economic Context

The State of the Economy

At times in the past, tax cuts have been employed as a fiscal stimulus – that is, as a means of boosting economic activity so as to revive a sluggish economy. For example, the tax cut enacted by the Revenue Act of 1964 is thought by many to have boosted economic growth and reduced unemployment. At the outset of 2001, however, the U.S. economy has recorded over nine consecutive years of continuous expansion – the longest uninterrupted expansion in U.S. history. Given this unprecedented prosperity, tax policy has not been called upon in recent years as a tool to solve an economic crisis. Moreover, economists have increasingly come to regard fiscal policy as a less effective tool than monetary policy for addressing economic cycles because of time lags and adjustments in the international economy.

But this may change in 2001 – indeed, the advisability of a tax cut as a fiscal stimulus has emerged as one of the first tax policy debates in which the incoming Bush administration has engaged. During the election campaign, President-elect Bush proposed a large tax cut, including an across-the-board cut in marginal tax rates. And in December, both President-elect Bush and Vice President-elect Richard Cheney have pointed to signs of weakness in the economy and have argued that enactment of their tax-cut proposal would be insurance against a recession.

There have, indeed, been indications of slowing economic growth: gross domestic product grew at a substantially slower pace in the second quarter of 2000 than in the first; a recent Federal Reserve survey found weakness in auto sales, manufacturing, and construction. And Federal Reserve Chairman Alan Greenspan stated in early December that U.S. economic growth had slowed "appreciably," and early in January the Fed cut interest rates by half a percentage point. At the same time, however, the outgoing Clinton Administration has maintained that economic performance is still sound and a large tax cut would not be prudent.

For further information, see: CRS Report RL30329, *Current Economic Conditions and Selected Forecasts.*

Taxes and the Budget

In fiscal year (FY) 1998, the federal budget registered a surplus for the first time in nearly 30 years. The surplus is expected to grow steadily through FY2010, from 1.4% and 2.4% of GDP in FY1999 and FY2000 respectively to 4.2% by FY2005 and 5.5% by 2010. While these surpluses have been expected, they occurred sooner than anticipated and are larger than expected. According to the Congressional Budget Office (CBO), revenues are the cause of the unexpected size of the surpluses. Rapid economic growth and changes in the character of income have generated faster than expected growth in revenues. In particular, the types of income that are taxable – corporate profits and wages and salaries – have grown relatively rapidly, as has the share of income earned by upper income families who are subject to high tax rates. In addition, growth in the volume and value of stock markets has increased capital gains revenues.

The large number of individuals born during the surge in population growth following World War II will begin to retire and start collecting Social Security and Medicare payments within 20 years. This group of retirees is likely to experience an increase in life expectancy and may face increased medical costs from improved technology. The combination of these factors over time will rapidly increase the share of GDP devoted to health and retirement programs and could produce – absent policy changes – a return to deficits in the long run.

The long-run budget outlook has been an important element in the current debate on whether to cut taxes. For example, should near-term budget surpluses be returned to taxpayers in the form of a tax cut? Recent congressional budget resolutions have stated that "on budget" surpluses – that is, the surpluses excluding Social Security and Medicare payments and revenues – should be returned to taxpayers as a tax cut. Opponents argue that a larger share of near-term budget surpluses should be used to retire federal debt, which, they contend, might promote economic growth that would delay the advent of future deficits, thereby setting aside part of surpluses to finance the expected growth in health and retirement costs.

For further information, see: CRS Issue Brief IB10052, *The Budget for Fiscal Year 2001: Issue Brief*; and CRS Report RL30583, *The Economics of the Federal Budget Surplus*.

The Federal Tax Burden[1]

During the 106th Congress, some pointed to the relatively high aggregate level of federal taxes compared to the economy as evidence of the desirability of a tax cut. As a percentage of gross domestic product (GDP), federal taxes were at their highest level since the end of World War II in fiscal year 1999, at 20.0%. This level is not a dramatic departure from the past; since the mid 1950s, federal taxes as a percentage of GDP have remained within a range of between 17% and just below 20% of GDP. Growth in the economy combined with, to a lesser extent, federal legislation to reduce the budget deficit (tax increases in 1990 and 1993)

[1] Authored by Gregg A. Esenwein, Specialist in Public Finance, Government and Finance Division.

have produced a slight increase in federal revenues as a percentage of GDP over the last several years. In FY1990, federal taxes accounted for only 18.0% of GDP. Over the same period, however, the federal budget has improved from a deficit of 3.9% of GDP in FY1990 to a surplus of 1.4% of GDP in FY1999.

While there have been some fluctuations in the distribution of the federal tax burden over the last 20 years, the fluctuations have been concentrated at the ends of the income spectrum. During the 1980s the federal tax burden increased for lower-income families and decreased for upper income families. This trend was reversed in the 1990s with tax reductions at the lower end of the income spectrum and tax increases at the upper end of the income spectrum. Families in the middle income brackets, however, experienced very little change in their federal tax burdens over this period, despite legislated tax cuts. Some of the benefits of the tax changes contained in the tax cut enacted with the 1997 Taxpayer Relief Act did not necessarily accrue to middle-income families. The $500 child tax credit likely reduced federal taxes for middle income families, but only those families with qualifying children. The benefits of reductions in the tax on capital gains, expanded IRAs, and other savings and investment incentives tended to accrue to families at the upper-end of the income spectrum.

For further information, see CRS Report RS20059, *The Federal Tax Burden,* and CRS Report RS20087, *The Level of Taxes in the United States, 1941-1999*.

Long-Run Economic Growth

As noted above (see the section entitled "The State of the Economy"), President-elect Bush has stated that a tax cut is desirable early in 2001 because the economy is beginning to show signs of slowing down. This position suggests a view of tax cuts as a useful tool for countering down-turns in the business cycle, as well as for other purposes. Many of the tax cut proposals in the previous Congress, however, were intended to promote long-run economic growth in an already-booming economy by increasing private saving and investment. In that context, the impact of these previous congressional proposals on saving is perhaps the most prominent economic performance issue they presented. First, can tax incentives for saving or tax benefits for investment actually boost the nation's rate of private saving and investment? Second, total national saving consists of private saving minus government borrowing. Thus, is any expansion the proposals may cause in private saving larger than any increase they also cause in the federal budget deficit (or decrease in the federal budget surplus)? If provisions actually cause an increase in total national saving, the nation's capital stock expands, resulting in higher economic growth. Yet economic analysis is not clear on whether and by how much private savings responds to tax incentives.

A number of the tax provisions that were considered provided favorable tax treatment to particular types of economic activity, extending special tax credits, deductions, or exclusions to certain activities. In these cases, economic theory suggests that favorable treatment for the specified activities can distort the economy's ordinary decision making and channel more resources into the favored activity than would otherwise occur. Since the economy's resources are limited, this effect also means that resources are simultaneously drawn away from activities that are not tax-favored. The question that economic analysis pursues is whether a specific intervention in resource allocation actually improves overall economic performance.

An important aspect of any tax proposal is its effect on federal revenues and the federal budget deficit or surplus. Deficit reduction has been a primary focus of budget debates over the past several years. The effects on federal revenue of several elements of the various tax proposals have been questioned. For instance, as noted earlier, economic analysis does not provide clear-cut answers about the extent to which economic activity might increase in response to tax incentives. As a result, the ultimate revenue effects of broad-based tax cuts or tax incentives for saving are unclear. In addition, several changes — notably, those involving IRAs, depreciation, and capital gains — would likely register a much larger revenue impact a number of years in the future rather than in the near term. Their supporters, however, generally argue that the measures would stimulate economic growth that would shrink any revenue loss.

Tax Proposals in the 106th Congress

If Congress actively considers a tax cut in 2001, its precise shape is as yet unclear. However, one guide to possible congressional action may be proposals that were considered in 1999 and 2000, but that were vetoed or not adopted.

- **Tax cuts for married couples**. This proposal is designed, in part, to offset current law's so-called "marriage penalty" that results in two persons paying more as a married couple than they would if they were single. (Many couples, however, receive a marriage bonus rather than penalty under current law; the proposals passed by the 106th Congress would have given tax cuts to these couples also.) A tax cut for couples was a prominent part of the vetoed Taxpayer Refund and Relief Act of 1999 (TRRA) and was passed in 2000 as H.R. 4810, which was also vetoed by President Clinton.

- **Repeal or reduction of the estate and gift tax**. Because of its exemption amount and other special provisions, only a small fraction of estates pay the federal estate and gift tax. The tax has been criticized by some, however, as discouraging saving and placing a burden on the cash-flow of small businesses. The TRRA would have repealed the tax as would have H.R. 8, which passed Congress in 2000. Both were vetoed by the President.

- **Tax cuts for small business**. The House passed several bills – H.R. 3081 and the Taxpayer Relief Act of 2000 (TRA2000; H.R. 2416) – increasing the minimum wage. The bills included a number of tax cuts that were designed to offset part of the burden of the minimum wage increase for small business. Prominent among the cuts were an increase in the so-called "expensing" allowance for small business investment, an increase in the allowable business meals deduction, and more generous rules for accounting for installment sales.

- **Tax benefits for health insurance and long-term care**. Both TRRA99 and TRA2000 included deductions for health insurance costs and long-term care insurance that would be available to non-itemizers and a deduction for caretakers of family members. Both bills also included a number of other tax cuts related to health insurance and long-term care.

- **Tax cuts related to pensions and retirement**. TRRA99 and TRA2000 also contained a set of tax reductions related to pensions and retirement savings. Prominent among these was a proposal in TRA2000 to increase contribution limits for Individual Retirement Accounts (IRAs).

- **Tax benefits for education**. In 2000 the House Ways and Means Committee approved H.R. 7, which contained a number of tax cuts related to education. The bill expanded tax-favored savings accounts for education and provided expanded tax benefits for bonds used to finance school construction and rehabilitation. The bill was never considered by the full House.

- **Telecommunications excise tax**. In 2000, Congress passed a repeal of the federal excise tax on communications as part of H.R. 4516, which also included appropriations for several federal agencies and the legislative branch. President Clinton vetoed the bill for reasons not directly related to the tax's repeal.

- **Tax on Social Security benefits**. In 2000, the House passed H.R. 4865, which repealed the tax on Social Security benefits that was enacted in 1993. The Senate did not consider the measure.

- **Alternative minimum tax**. In recent years, concern has increased in some quarters over the likelihood that an increasing number of taxpayers will become subject to the alternative minimum tax (AMT) – a consequence of new tax benefits that have been enacted in recent years and the erosion of the real value of the AMT exemption by inflation. To address these concerns, TRRA99 would have repealed the AMT altogether; Public Law 106-170 provided for the applicability of personal tax credits against the AMT, but only through 2001.

- **Tax cut for capital gains**. Supporters of tax cuts for capital gains argue that such reductions stimulate savings, investment, and economic growth; opponents of capital gains cuts maintain they favor upper-income individuals. One of the most prominent provisions of TRRA99 was a reduction in capital gains tax rates. The proposal was not one of the issues addressed by "stand alone" bills in 2000.

- **Across-the-board tax rate reduction**. TRRA99 included a reduction in the statutory individual income tax rates. As with capital gains, the provision was not included in a stand alone bill in 2000. A broad cut in tax rates, however, is part of the tax plan set forth by President-elect Bush during the presidential campaign.

The Bush Tax Proposals

Another possible set of proposals Congress may consider are those set forth by President-elect Bush during the 2000 election campaign. The Bush tax proposals call for a tax cut what would total an estimated $1.3 trillion over the 2002-2010 period. His plan includes the following proposals.

- **Reduction in individual income tax rates**. The plan would replace the current rate structure with rates of 10%, 15%, 25%, and 33%.
- **Increased child credit**. The credit would be doubled to $1,000 from current law's $500.
- **Tax cut for married couples**. Married couples would be allowed a deduction equal to 10% of a second-earners wages, up to $3,000.
- **Elimination of estate and gift taxes**.
- **Permanent research and experimentation tax credit**. Current law's credit is scheduled to expire June 30th, 2004.
- **Charitable contribution deduction for non-itemizers**.
- **Education savings accounts**. Current law's annual contribution limit of $500 would be increased to $5,000.
- **Elimination of the Social Security earnings test**.

A Closer Look at Selected Issues

Marriage Tax Penalties and Bonuses[2]

Defining the married couple as a single tax unit under the federal individual income tax conflicts with the principle of marriage neutrality. Marriage neutrality means that the tax system should not influence the choice of individuals with regard to their marital status. However, under the current federal income tax system, some married couples pay more income tax than they would as two unmarried singles (a marriage tax penalty) while other married couples pay less income tax than they would as two unmarried singles (a marriage tax bonus). A marriage-neutral income tax is an elusive goal. Marriage neutrality conflicts with two other concepts of equity: progressivity and equal taxation of couples with equal incomes. Regardless of how these three concepts of equity are juggled, an income tax can achieve any two of these goals but cannot simultaneously achieve all three.

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[2] Authored by Gregg Esenwein, Specialist in Public Finance, Government and Finance Division.

A number of bills were introduced in the 106th Congress that tried to mitigate marriage tax penalties. For instance, H.R. 2488, the Taxpayer Refund and Relief Act of 1999, contained a provision that would have increased the standard deduction for a married couple filing a joint return to twice the amount of the standard deduction for a single return, doubled the width of the lowest income tax bracket for married couples, and raised the phase-out range of the Earned Income Tax Credit for married persons. H.R. 4810, which Congress passed in 2000, adopted the same approach. Other bills in the 106th Congress took alternative approaches, including a tax deduction for a couple's second earner, and permitting married persons the option of filing separately as singles.

For further information, see: CRS Report RL30420, *Marriage Tax Penalties: Legislative Proposals in the 106th Congress*; and CRS Report RL30419, *The Marriage Tax Penalty: An Overview of the Issues*.

The Estate Tax[3]

The estate tax was enacted in 1916 as a revenue source for World War I. As with wealth taxes before it, and like most other taxes, revenue was the primary rationale for the tax. Why the estate tax rather than other possible sources of revenue? There were essentially two reasons: first, the estate tax is viewed as a type of fee for the services by the government in protecting property during lifetime, as well as a fee to cover part of the cost of probating the estate at death. More importantly, the estate tax was chosen over other taxes for reasons of equity and to reduce the concentration of wealth. In 1998, only 4.2% of decedents left estates large enough to file a tax return. Further, due primarily to the marital deduction, less than half of those required to file a return (2.0% of all estates) owed tax.

The federal estate tax is a tax on wealth and as such, it raises some of the same economic issues as annual wealth taxes, which are economically equivalent to annual capital income taxes. The accumulation of wealth is, in large part, the result of an individual's decision to postpone consumption, to save and accumulate capital during one's life of work and investment, and to take risks. The estate tax is a tax on accumulated savings imposed at the end of one's life. And the tax is paid out of the economy's total supply of private savings — reducing private sector savings and increasing government savings (i.e, tax revenue). But an important economic question is what is the effect, if any, on the lifetime savings behavior of individuals? Does the estate tax reduce savings rates? Does the tax reduce the incentives to accumulate capital? To what extent do individuals compensate for the tax by increasing their accumulation of pre-tax wealth such that enough after-tax wealth is accumulated to bequeath to their heirs?

The estate tax is part of the overall cost of bequeathing wealth to one's heirs. The existence of the estate tax is believed to reduce the level of planned bequests. If so, reducing the estate tax is likely to increase planned bequests, but according to economic theory, the effect on savings is uncertain. The estate tax does create incentives for lifetime gift giving, for estate planning, for substantial charitable donations, and for the establishment of trusts. With federal marginal estate tax rates reaching 55%, significant resources and time may be expended at minimizing the estate tax burden. And a relatively large estate planning industry

[3] Authored by Sal Lazzari, Specialist in Public Finance, Resources, Science, and Industry Division.

— accountants, lawyers, and financial advisors — is available to wealth holders to minimize any potential estate tax burden.

One economic effect — the effect on farms and small businesses — has dominated the recent debate over the estate tax and played a key role in the estate tax cuts enacted as part of the Taxpayer Relief Act of 1997. The estate tax is imposed on business capital and wealth — land, equipment, stock, buildings, etc. — in addition to personal wealth. It is argued that this takes capital out of farms and small businesses, inhibiting their transfer to heirs and retention in the family; that the tax can cause the break-up or dissolution of family farms and small business. A sale of the assets to or merger of the enterprise with a large competitor could reduce market competition and inhibit economic efficiency. These effects were a principal reason for the 1981 estate tax reductions, and have been a key impetus for most of the recent proposals to reduce the estate tax. However, the estate tax is only one of many possible causes for the sale of farm or business assets outside the family at death, and not always the principal cause – especially since only a small fraction of family businesses pay the tax.

For further information, see: CRS Report RL30600, *Estate and Gift Taxes: Economic Issues*; and CRS Report RS20593, *Asset Distribution of Taxable Estates: An Analysis.*

The Alternative Minimum Tax for Individuals[4]

To make sure that everyone pays at least a minimum of taxes while still preserving the economic and social incentives in the tax code, Congress created, in 1969, what is now known as the individual alternative minimum tax (AMT). In essence, the AMT is a tax on the use of tax incentives and preferences and was primarily targeted at upper-income taxpayers who were thought to overuse these preferences to reduce or eliminate their regular income tax liabilities. However, since its inception, the value and effectiveness of the minimum tax has routinely been the subject of congressional debate. Recently, many analysts have voiced concern over the expected increase in the number of upper-middle income taxpayers who may be subject to AMT coverage in the near future. This increase will occur because of the combined effects of inflation and recent legislative changes to the regular income tax.

The structural components of the regular income tax are indexed for inflation while the structural components of the AMT are not. Consequently, the gap between tax liabilities under the regular income tax and the AMT will shrink over time and many taxpayers could end up subject to the unindexed AMT or experience reductions in their nonrefundable tax credits under the regular income tax solely as the result of inflation. The potential problems of an indexed regular tax and an unindexed AMT have long been recognized by tax analysts. The Joint Committee on Taxation (JCT) released estimates showing that in 1997, approximately 605,000 taxpayers were subject to the AMT but that the number of taxpayers subject to the AMT will increase to around 9.2 million by tax year 2007. These estimates, however, were made prior to the passage of the Taxpayer Relief Act of 1997. When the effects of both inflation and the 1997 legislative changes are taken into account, preliminary estimates indicate that by 2007, the number of taxpayers falling under either the AMT or AMT limits on their tax credits under the regular income tax will grow to almost 12 million.

[4] Authored by Gregg Esenwein, Specialist in Public Finance, Government and Finance Division.

In general, nonrefundable personal tax credits under the regular income tax are limited to the amount by which a taxpayer's regular income tax liability exceeds his tentative minimum tax. Hence, even if a taxpayer owes no AMT, the AMT could reduce the value of his nonrefundable personal tax credits under the regular income tax.

The child tax credit and the HOPE tax credit are the two changes contained in the 1997 act that would have the largest impact in increasing the number of taxpayers subject to the AMT, either directly or indirectly. Many taxpayers in the upper-middle income ranges likely will see the value of these two credits reduced or eliminated because of the AMT. The fact that the AMT is now going to affect many upper-middle income taxpayers who were not subject to the tax in the past has prompted some calls in Congress for action to remedy the situation. Congress did take limited action in 1998 by including a provision in the Omnibus Consolidated and Emergency Supplemental Appropriations Act (PL. 105-277) that will mitigate part of the problems with the AMT for tax year 1998. Under this provision, nonrefundable personal tax credits are fully allowed against a taxpayer's regular income tax liability for 1998 even if the credits are in excess of the amount by which the taxpayer's regular income tax exceeds the amount of his tentative minimum tax.

For further information, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals* and CRS Report RL30485, *The Individual Alternative Minimum Tax: Interaction with Marriage Penalty Relief and Other Tax Cuts.*

Capital Gains[5]

Since the enactment of the individual income tax in 1913, the appropriate taxation of capital gains income has been a perennial topic of debate in Congress. Capital gains income is often discussed as if it were somehow different from other forms of income. Yet, for purposes of income taxation, capital gains income is essentially no different from any other form of income from capital, such as interest or dividend income. A capital gain or loss is the result of a sale or exchange of a capital asset. If the asset is sold for a higher price than its acquisition price, then the transaction produces a capital gain. If an asset is sold for a lower price than its acquisition price, then the transaction produces a capital loss.

Current law's treatment of capital gains differs from what would occur under a theoretically pure income tax. Ideally, a tax consistent with a theoretically correct measure of income would be assessed on real (inflation-adjusted) income when that income accrues to the taxpayer. Conversely, real losses should be deducted as they accrue to the taxpayer. In addition, economic theory indicates that any untaxed real appreciation in the value of capital assets given as gifts or bequests should be subject to tax at the time of transfer. Under the current income tax, however, nominal (non-inflation adjusted) capital gains income is taxed when it is realized (sold or exchanged) by the taxpayer. Capital losses (within certain limits) are also deducted on a nominal basis when they are realized by the taxpayer. Currently, the untaxed appreciation in the value of capital assets transferred at death is not subject to tax.

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[5] Authored by Gregg Esenwein, Specialist in Public Finance, Government and Finance Division.

Under current law, capital assets are separated into four categories. Assets that have been held for 12 months or less are considered short-term assets. Assets that have been held longer than 12 months are considered long-term assets. Collectibles (art work, antiques, coins, stamps, etc.) are the third category of assets and the fourth category of capital gains assets includes the portion of gain attributable to previously taken depreciation deductions on section 1250 property (depreciable real estate). Short-term capital gains are taxed at regular income tax rates. Long-term capital gains are taxed at a maximum tax rate of 20%. The tax rate is 10% for long-term gains that would have been taxed at a 15% regular tax rate. Collectibles held longer than 12 months are taxed at 28%. The un-recaptured section 1250 gain attributable to depreciation deductions is taxed at a maximum tax rate of 25%.

Effective for taxable years beginning in 2001, assets that have been held for at least five years and would have been taxed at a 10% tax rate will be taxed at an 8% tax rate. For assets which are held more than five years and whose holding period begins after December 31, 2000, the maximum tax rate will be 18% rather than 20%. Net capital losses are deductible against up to $3,000 of ordinary income, that is, non-capital gain income. Any portion of the net loss in excess of the $3,000 limit can be carried forward and used to offset gains in succeeding tax years. Excess net losses can be carried forward indefinitely and without limit on the amount of losses that can be carried forward.

Under current law, taxpayers are allowed to exclude from taxable income up to $500,000 ($250,000 in the case of single returns) of the gain from the sale of their principal residences. To qualify the taxpayer must have owned and occupied the residence for at least two of the previous five years prior to the date of sale. Under current law, capital gains transferred at time of death are not subject to tax. On transfer at death, the basis of the asset (original cost plus changes in the value due to improvements or depreciation) is stepped up to the market value of the asset on the date of death.

For further information, see CRS Report 98-473, *Individual Capital Gains Income: Legislative History*; CRS Report 96-769, *Capital Gains Taxes: An Overview*; and CRS Report RL30040, *Capital Gains Taxes, Innovation and Growth*.

Tax Treatment of Saving

The appropriate tax treatment of saving has been one of the most prominent tax policy debates in recent decades and will likely be so again in the 107th Congress. It incorporates such topics as individual retirement accounts (IRAs), capital gains taxes, investment incentives, and corporate income taxes, to name a few. The issue of savings has links to both economic performance and equity, which has helped make it controversial. An increased saving rate generally increases the country's capital stock, which in turn makes possible higher economic growth and a higher standard of living in the future. If tax incentives can boost saving, targeted tax cuts may thus be able to boost economic growth. On the other hand, income from investments is a higher proportion of income at higher income levels; tax benefits for saving thus reduce the progressivity of the tax system.

Economics suggests that the efficacy of tax incentives for saving depends heavily on how responsive individuals' savings rates are to changes in the rate of return to saving, after taxes. If individuals respond to tax incentives by increasing their saving, tax benefits may be an effective tool for increasing economic growth. On the other hand, if saving is unresponsive to targeted tax cuts, their efficacy for that purpose is questionable. Economic theory provides no clear answer on this issue and instead identifies two countervailing effects of tax incentives for saving. One effect (known as the substitution effect) leads individuals to save more because the aftertax rate of return has increased; a second effect (the income effect) works in the opposite direction, because a tax cut enables an individual to reach a given savings target with a lower savings rate.

The ambiguity of economic theory in this case passes the burden of proof to empirical evidence, and there have indeed been a plentitude of statistical studies. But taken as a group, these studies too produce no clear answer; some find a positive and significant relationship between tax incentives and saving — that is, they find that targeted tax cuts increase saving. Other studies find no relationship, and still others find a negative relationship. Thus, the impact of taxes on saving is unproved. However, even if individuals were to respond positively to savings incentives, that does not necessarily mean incentives are good economic policy. First, what matters for economic growth is not simply private saving but national saving — that is, the private saving rate minus any government dissaving by means of a budget deficit. Thus, the effect of tax cuts for saving in reducing government tax revenue may at least partly offset any positive effect they may have on private saving. Second, even though increased saving produces higher standards of living in the future, a tax-induced distortion that increases saving may not actually increase economic welfare. Absent market failures, economic theory suggests a tax is more efficient the less it changes behavior. And if saving is unresponsive to tax changes, it may be less damaging to economic welfare than alternative sources of tax revenue. Again, however, evidence on the responsiveness of saving is conflicting. Indeed, this statement summarizes what economics has to say about tax incentives for saving: theory and evidence on the efficacy of savings incentives is ambiguous and conflicting.

Tax benefits for saving in the current tax code are numerous. Among the most prominent are Individual Retirement Account (IRAs), 401(k) retirement savings plans and other qualified employer-sponsored retirement plans, life insurance policies and annuities, qualified state tuition programs, and medical savings accounts (MSAs). In addition, the favorable tax treatment of owner-occupied housing can be thought of as a saving incentive, as can the reduced tax rates for capital gains under the individual income tax.

For further information, see CRS Report RL30255. *Individual Retirement Accounts (IRAs): Issues, Proposed Expansion and Universal Savings Accounts (USAs)*

Fundamental Tax Reform Proposals[6] (Including Flat Tax Plans)

The idea of replacing our current income tax system with a "flat-rate tax" is receiving renewed congressional interest. Although often referred to as "flat-rate taxes," many of the recent proposals (introduced in the 104th, 105th, or 106th Congresses) go much further than merely adopting a flat-rate tax structure. Some involve significant income tax base-broadening while others entail changing the tax base from income to consumption. Most of the recent tax reform proposals (the Armey, Shelby, Domenici/Nunn, English, Specter,

[6] Authored by James M. Bickley, Specialist in Public Finance, Government and Finance Division.

Lugar, Tauzin, Linder, Souder, Gramm, Faircloth, and Largent/Hutchinson plans) would change the tax base from income to consumption. Others are not consumption tax proposals. Representative Gephardt would keep income as the tax base but broaden the base and lower the tax rates. Representative Crane's proposal would levy a tax on the earned income of each individual as a replacement for the current individual income tax, corporate income tax, and estate and gift taxes. Representative Snowbarger's proposal would permit each taxpayer to choose between the current individual income tax return and an alternative individual tax return with a flat rate. Senator Dorgan's proposal would allow most taxpayers to choose between the current individual tax system and his "shortcut" tax plan under which taxes withheld would equal the employee's tax liability.

The flat tax controversy has focused on shifting from the present system, which is predominantly an income tax system, to a consumption tax system as a way to raise the savings rate, improve economic efficiency, and simplify the tax system. There is, however, no conclusive empirical evidence that a consumption tax will or will not increase the personal savings rate and consequently the level of national savings. Highly stylized life-cycle models show that a consumption tax would cause a substantial increase in the savings rate, but these models are controversial because of their idealized assumptions. To raise the same amount of tax revenue, a consumption-based tax would require higher marginal tax rates than would an income tax (since consumption is smaller than income). Distortions caused by these higher marginal rates could offset (or even exceed) other advantages of the consumption tax. Hence, whether an income tax system or a consumption tax system is more efficient is unknown.

Proponents of some flat tax proposals argue that integration of the current corporate and individual income taxes as well as simple returns would result from a consumption tax. The current income tax system is complex. The federal tax code and the federal tax regulations are lengthy and continue to expand. However, in tax year 1999, approximately 70% of individual taxpayers took the standard deduction, which made complexity less relevant. In comparison to the current income tax, a flat rate would do little to reduce complexity for most taxpayers who currently just look up their tax liability in a table, although it might reduce complexity for a significant minority. Finally, some argue that it is "unfair" to compare the current income tax system with an uncomplicated, "pure" consumption tax that could become complicated by the time it is enacted.

It has been argued that some flat tax proposals would reduce the balance-of-trade deficit since imports would be taxed but the tax would be rebatable on exports. Economic theory, however, suggests that border tax adjustments have no effect on the balance-of-trade because the balance-of-trade is a function of international capital flows; border tax adjustments would be offset by exchange rate adjustments.

The United States is the only developed country without a broad-based consumption tax at the national level. Other developed nations have adopted broad-based consumption taxes, but as adjuncts rather than as replacements for their income based taxes.

For further information, see CRS Issue Brief IB95060, *Flat Tax Proposals: An Overview.*