Issue Brief

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An Analysis of the Financial Freedom Act of 1999

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The Republican-controlled House has signaled that it wants to return to taxpayers most of the trillion-dollar, non-Social Security surplus the federal government now expects over the next decade. Anchored by a 10 percent, across-the-board reduction in income tax rates, the Ways and Means Committee voted out a bill that would cut taxes by $864 billion over the next ten years. Negotiations to bring the Financial Freedom Act of 1999 to the floor for a vote by the full House pared that amount back to $792 billion.

This issue brief examines the major features of the Ways and Means bill[1] and discusses the economic and budgetary effects.[2] Results from our quantitative analysis would generally hold for the House bill.

Major Features of the Ways & Means Tax Bill

Family Tax Relief

Classified under the heading of "Family Tax Relief," the biggest item in the Ways and Means bill is a 10% across-the-board cut in income tax rates. Rates would be lowered by 2.5% for 2001 through 2004, 5.0% for 2005 through 2007, 7.5% in 2008, and 10% in 2009. With a Joint Committee on Taxation (JCT) price tag of $405.2 billion over ten years, the rate reduction accounts for almost half the total tax cut. [See Table 1 for JCT estimates of major provisions.]

Another major item under family tax relief is repeal of the Alternative Minimum Tax (AMT). Originally meant to catch a few upper-income taxpayers for not paying their "fair" share, the AMT is encroaching increasingly into the middle-class. Government analysts forecast that the number of returns paying the AMT, which jumped from 368,964 to 590,649 between 1994 and 1997, could reach 9 million by 2007.[3] The Ways and Means bill would phase out the AMT over six years starting in 2003.[4] Because of the rapid growth in taxpayers caught by the AMT, gradual repeal is the second largest tax cut provision at a cost of $81.5 billion.

"…the AMT is encroaching increasingly into the middle class."

The bill also would lower the marriage penalty by increasing the standard deduction for married couples filing joint returns to double that of a single taxpayer and increase the income limit for Roth IRA conversions. Marriage penalty relief would cost $47.5 billion over ten years.

Encouraging Saving and Investment

The biggest item under saving and investment would come from cutting the capital gains tax rate on assets held over one year from 20% to 15% (10% to 7.5%).[5] JCT estimates that the cost between 1999 and 2009 would be $51.6 billion.

Allowing an exclusion for income from interest and dividends is the other major provision under this heading. Couples filing joint returns could exclude up to $200 ($100 for all other filers) in 2001 and 2002. After that the exclusion would increase

Table 1
Static Revenue Estimates from the House Ways & Means Tax Bill

Source: Joint Committee on Taxation, "Estimated Revenue Effects Of The Financial Freedom Act Of 1999," Scheduled For Markup By The Committee On Ways And Means Beginning On July 13, 1999.

Static Revenue Estimates from the House Ways & Means Tax Bill
[Billions of Dollars]

Provision	Fiscal Years			
	1999-2004	2005-2009	1999-2009	%Total
Family Tax Relief Provisions	**-98.9**	**-435.3**	**-534.2**	61.8%
10% across-the-board Rate Cut	-73.8	-331.3	-405.2	46.9%
Marriage Penalty Relief	-15.2	-32.4	-47.5	5.5%
Repeal the Individual Minimum Tax	-9.9	-71.6	-81.5	9.4%
Savings and Investment Tax Relief Provisions	**-29.9**	**-47.2**	**-77.1**	8.9%
Exclusion of interest and dividend income	-7.5	-16.6	-24.0	2.8%
Lower top capital gains rate to 15%	-21.9	-51.6	-51.6	6.0%
Death Tax Relief Provisions	**-18.3**	**-57.1**	**-75.3**	8.7%
Health Care Tax Relief Provisions	**-12.2**	**-38.9**	**-51.0**	5.9%
International Competitiveness Provisions	**-7.6**	**-27.6**	**-35.2**	4.1%
Business Investment and Job Creation Provisions	**-5.8**	**-24.2**	**-30.0**	3.5%
Extension of Expired and Expiring Provisions	**-16.3**	**-3.8**	**-20.1**	2.3%
Pension Reform Provisions	**-4.3**	**-10.2**	**-14.5**	1.7%
Small Business Tax Relief Provisions	**-4.9**	**-9.0**	**-13.9**	1.6%
Education Tax Relief Provisions	**-1.9**	**-5.3**	**-7.2**	0.8%
Miscellaneous Provisions	**-1.6**	**-4.6**	**-6.2**	0.7%
Distressed Communities and Industries Provisions	**-1.4**	**-1.4**	**-2.8**	0.3%
Real Estate Tax Relief Provisions	**0.1**	**-0.8**	**-0.7**	0.1%
Tax-Exempt Organization Provisions	**-0.1**	**-0.1**	**-0.2**	0.0%
Technical Correction Provisions	**0.0**	**0.0**	**0.0**	0.0%
Revenue Offset Provisions	**3.1**	**1.5**	**4.5**	-0.5%
Total	**-199.9**	**-664.0**	**-864.0**	

to $400 for joint returns and $200 for all others beginning in 2003.[6] The JCT price tag on this provision is $24 billion.

Getting Rid of the Death Tax

Currently estates valued at more than $650,000 are taxed at a 37% rate which rapidly rises to 55% on estates over $3 million.[7] Starting in 2001, the Ways and Means bill would lower rates each year so that the estate tax is gone by 2009.[8] At the same time, an exemption of equal value would replace the unified credit. The JCT puts the cost of gradually repealing the death tax at $75.3 billion over ten years.

"…the Ways and Means bill would lower rates each year so that the estate tax is gone by 2009."

However, the bill also would change the way assets are valued when they pass to heirs. Currently, assets receive what is known as a *step-up (or step-down) in basis*. That means that the fair market value at the time of transfer such as stock or real estate becomes the new basis for determining capital gains if and when the heir decides to sell. Under the bill, after the estate tax is repealed, there would be a *carryover basis* for assets from estates valued over $2 million.[9] That is, heirs would assume the same basis as the decedent for capital gains purposes.

Health Care Tax Relief

Currently, people who receive health insurance through the workplace do not pay income or payroll taxes on the value of the insurance. But those buying insurance on their own do not receive any favorable tax treatment. The Ways and Means bill would allow such individuals to deduct the cost of their health insurance from adjusted gross income. This *above-the-line* deduction would phase in starting at 25 percent in 2001 and rise to 100% in 2008.[10]

Other health care provisions include an above-the-line deduction for long-term care insurance, an expansion of Medical Savings Accounts and an extra deduction for caretakers of elderly family members. The health care provisions would cost $51 billion over ten years.

Corporate Tax Cuts

Tax cuts aimed directly at business would lower the gradually lower the tax rate corporations pay on capital gains from 35% to 25%.[11] The bill also would phase out the corporate alternative minimum tax by 2008.[12] JCT estimates the business tax cuts to cost $30 billion over ten years.

Other Provisions

The provisions just discussed account for almost 90 percent of the tax cut over the period 1999 to 2009. Also included in the bill are numerous proposals falling under the general categories of education, distressed communities and industries, small business, international, tax-exempt organizations, real estate and pension reform.

Economic Effects

Using our general equilibrium, neoclassical model we have estimated how the Ways and Means tax bill would affect the economy.[13] As a whole, the bill would result in a faster growth of output, jobs and capital formation than what is anticipated in the baseline. [See Table 2 for a summary of the economic effects of the tax bill.]

Table 2
Economic Effects of the House Ways and Means Tax Bill

Estimates from the Fiscal Associates Model.

Economic Effects of the House Ways and Means Tax Bill
(Measured as a Change from the Baseline)

Calendar Year	GDP ($bil)	GDP %Change	Growth Rate (% points)	Jobs (thous)	Jobs %Change	Capital Stock ($bil)	Capital Stock %Change
2000	6.3	0.1%	0.07%	10	0.0%	19.7	0.1%
2001	26.9	0.3%	0.22%	87	0.1%	143.6	0.5%
2002	42.5	0.4%	0.14%	212	0.2%	217.9	0.8%
2003	64.4	0.6%	0.19%	361	0.3%	306.3	1.0%
2004	84.9	0.8%	0.16%	484	0.4%	420.0	1.4%
2005	118.8	1.0%	0.26%	627	0.5%	588.9	1.8%
2006	146.9	1.2%	0.18%	793	0.6%	736.1	2.2%
2007	178.8	1.4%	0.19%	966	0.7%	928.8	2.7%
2008	234.5	1.7%	0.34%	1,197	0.9%	1,174.1	3.2%
2009	300.9	2.1%	0.38%	1,505	1.1%	1,471.9	3.9%
2000-04	**224.9**	**0.4%**	**0.16%**	**484**	**0.4%**	**420.0**	**1.4%**
2005-09	**979.9**	**1.5%**	**0.38%**	**1,505**	**1.1%**	**1,471.9**	**3.9%**
2000-09	**1,204.9**	**1.0%**	**0.38%**	**1,505**	**1.1%**	**1,471.9**	**3.9%**

By the year 2004:

- Accumulated gross domestic product would be $224.9 billion higher than otherwise, and annual GDP would be $84.9 billion, or 0.8 percent, above the baseline.
- The real growth rate would be 0.16 percentage points higher than the baseline.
- The economy would have created 484,000 more jobs than otherwise and
- Added saving and investment would have increased the U.S. stock of capital by $420 billion more than otherwise.

By the year 2009:

- The economy would have produced a total of $1.2 trillion more in GDP than otherwise. Annual GDP would be $300.9 billion, or 2.1 percent, above the baseline.
- Real growth would be 0.38 percentage points higher than the baseline.
- The economy would have created an extra 1.5 million jobs and generated almost $1.5 trillion more in capital formation than otherwise.

Revenue and Budgetary Effects

The added growth would lead to more income, payroll, excise and other revenue for federal, state and local governments. Over the next ten years, the extra $1.2 trillion in GDP stimulated by tax cuts in the Ways and Means bill would produce an additional $257.9 billion in revenue for the federal government and another $158.6 billion for states and localities. [See Table 3 for the dynamic revenue effects.]

Table 3
Dynamic Revenue Effects of the House Ways and Means Tax Bill

Estimates from the Fiscal Associates Model.

Dynamic Revenue Effects of the House Ways and Means Tax Bill
(Measured as a Change from the Baseline)

Calendar Year	Federal Receipts		State & Local Receipts		Federal Surplus	State & Local Surplus	Total Government Surplus
	($bil)	%Change	($bil)	%Change	($bil)	($bil)	($bil)
2000	0.5	0.0%	0.7	0.1%	0.5	0.8	1.3
2001	4.8	0.2%	3.3	0.2%	4.9	3.7	8.6
2002	8.7	0.4%	5.5	0.4%	9.3	6.2	15.5
2003	20.4	0.9%	10.0	0.7%	22.1	11.3	33.4
2004	17.7	0.8%	11.0	0.7%	21.3	13.3	34.6
2005	25.1	1.0%	15.3	0.9%	31.6	19.0	50.6
2006	31.1	1.2%	19.3	1.1%	42.0	24.6	66.5
2007	37.5	1.4%	23.8	1.3%	54.2	31.3	85.5
2008	49.3	1.7%	30.7	1.5%	74.1	41.3	115.4
2009	62.8	2.1%	39.0	1.9%	98.5	53.6	152.1
2000-04	**52.0**	**0.5%**	**30.6**	**0.4%**	**58.1**	**35.3**	**93.3**
2005-09	**205.8**	**1.5%**	**128.0**	**1.4%**	**300.4**	**169.7**	**470.2**
2000-09	**257.9**	**1.1%**	**158.6**	**1.0%**	**358.5**	**205.0**	**563.5**

Extra revenue from growth would offset about 30 percent of the static loss from the tax cuts over the next ten years. After 2009, dynamic gains would offset even more of the static loss because phased-in tax cuts, such as repeal of estate and AMT taxes, would be in full effect. [See Table 4 for static and dynamic federal effects.]

Table 4
Static and Dynamic Revenue Effects of the House Ways and Means Tax Bill

Estimates from the Fiscal Associates Model.

[1] Additional federal income, payroll, excise and other revenues due to higher economic growth.

[2] Loss in federal income or estate tax revenues as measured from the baseline.

[3] Difference between static and dynamic revenue effects.

[4] Net effect including federal interest.

Static and Dynamic Revenue Effects of the House Ways and Means Tax Bill
(Amounts in $billions)

Calendar Year	Dynamic[1]	Static[2]	Net[3]	With Interest[4]
2000	0.5	-5.6	-5.1	-5.1
2001	4.8	-35.5	-30.7	-31.0
2002	8.7	-44.8	-36.1	-37.9
2003	20.4	-57.1	-36.6	-40.2
2004	17.7	-62.2	-44.5	-50.0
2005	25.1	-93.1	-68.0	-75.9
2006	31.1	-101.6	-70.4	-82.0
2007	37.5	-112.0	-74.6	-90.0
2008	49.3	-156.0	-106.7	-126.4
2009	62.8	-204.6	-141.8	-167.4
2000-04	51.9	-205.1	-153.2	-164.4
2005-09	205.8	-667.3	-461.4	-541.7
2000-09	257.7	-872.4	-614.6	-706.0

Critics charge that the true costs would be higher because of interest charges if the surpluses are not used to pay down the debt. If the surpluses aren't spent — a big if — the growth dividend would still be more than enough to cover the higher interest payments.

To put the tax cuts in better perspective, remember that the federal government is expected to raise $22.8 trillion in revenue over the next ten years.[14] In contrast, the Ways and Means tax cut would amount to a less than 3.5 percent reduction in revenues between now and 2009. Keeping in mind that revenue forecasting errors of up to 5 percent are considered acceptable by the Washington scoring community (and often occur), we should not lose too much sleep over the size of the proposed tax cut.

"…the Ways and Means bill would amount to a less than 3.5 percent reduction in revenue.…[since] revenue forecasting errors of up to 5 percent are considered acceptable by the Washington scoring community, we should not lose too much sleep…"

Bang for the Buck

On the whole, the Ways and Means tax bill would generate $1.47 in extra GDP for every dollar of static revenue loss over the next ten years. Some provisions provide more economic stimulus than others, however. Tax cuts with the potential to do the most economic good are those that provide the biggest reduction in tax rates on the next dollar of income earned through work, saving and investment.

The component of the Ways and Means tax bill that has the biggest payoff is the reduction in individual capital gains tax rates, returning almost $17 in added GDP for every dollar of static revenue loss. The reason for this seemingly high number is because the static revenue loss is low. Thanks to evidence coming in on the 1997 change, which lowered the top rate on capital gains from 28% to 20%, the Joint Committee on Taxation has scored the current proposal at a cost of only $5 billion a year.

Other proposals that provide the most bang for the buck – between $2 and $2.50 of extra GDP for every dollar of static revenue loss – include gradual repeal of the death tax and lower business taxes. The item with the biggest price tag, the across-the-board rate cut, would return $1.34 in GDP. Provisions returning less than a dollar include the interest and dividend exclusion and marriage penalty relief. [See Table 5 and Figure 1 for the return by specific provision.]

Table 5
Which Tax Cuts Provide the Most "Bang for the Buck?"

Which Tax Cuts Provide the Most "Bang for the Buck?"

Provision	Static Revenue Loss[1]	Economic Growth[2]	Bang For the Buck[3]	Revenue Returned by Tax Cut[4]
Reduce Individual Capital Gains Rates	5.2%	35.4%	$16.87	$2.90
Other Business Changes	6.8%	7.4%	$2.52	$0.55
Death Tax Relief	8.5%	8.7%	$2.27	$0.44
Repeal the Corporate Minimum Tax	1.5%	1.4%	$2.02	$0.51
Reduce Corporate Capital Gains Rates	2.0%	1.9%	$2.01	$0.43
Other Individual Changes	10.0%	7.1%	$1.52	$0.34
Across-the-Board Income Tax Rate Cut	49.4%	32.2%	$1.34	$0.31
Repeal the Individual Minimum Tax	9.4%	4.9%	$1.08	$0.29
Exclusion of Interest and Dividend Income	2.9%	0.9%	$0.72	$0.16
Marriage Penalty Relief	4.3%	0.2%	$0.12	$0.06
Entire Package	100.0%	100.0%	$1.47	$0.29

[1] The share of each provision in the total static revenue loss from 2000 through 2009.

[2] Estimates from the Fiscal Associates Model.

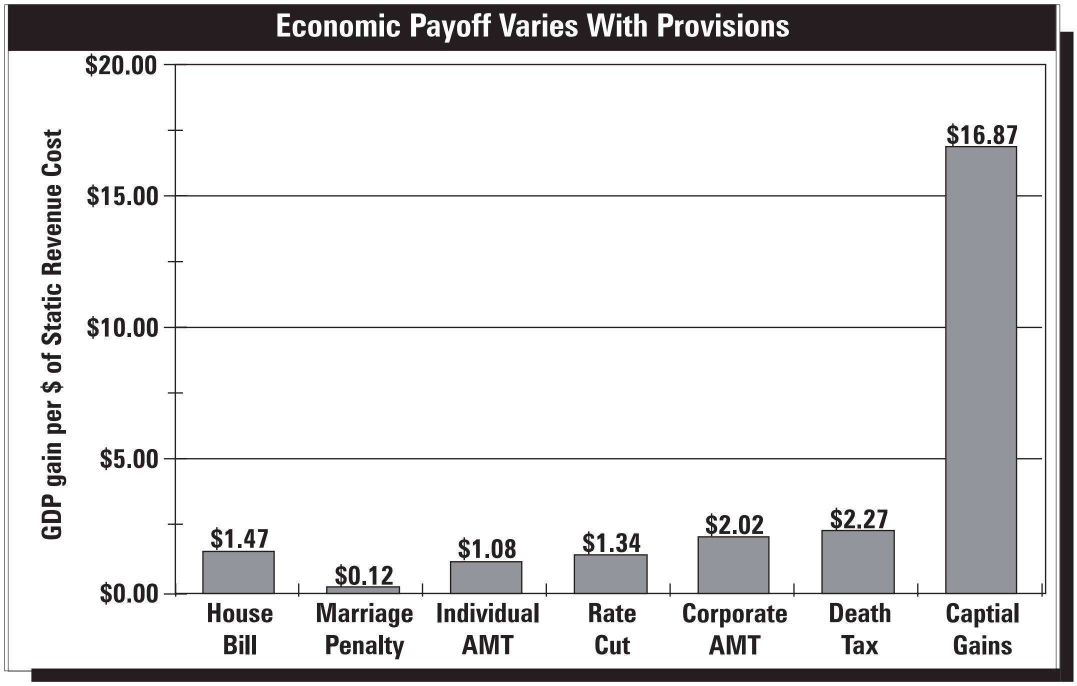
[3] The total increase in GDP between 2000 and 2009 that would result from the provision divided by its static revenue loss.

[4] The total dynamic revenue increase between 2000 and 2009 from the provision divided by its static revenue loss.

Distributional Effects

Different pictures of who benefits from the Ways and Means tax bill emerge depending on whether distributional effects are measured on a static or dynamic basis and on whether they are measured against who currently pays taxes. For example, on a static basis, two-thirds of the individual income tax cuts, which make up about 80% of the whole package, would go to the top 20 percent of taxpayers while the bottom 20 percent would get only 0.1 percent. But, considering that the top quintile pays 68 percent of taxes while the bottom pays only 0.1 percent, the distribution of the tax cut makes perfect sense.

Figure 1
Economic Payoff Varies With Provisions



"The Ways and Means tax cut would generate $1.47 in extra GDP for every dollar of static revenue loss over the next ten years."

Moreover, people care less about the size of their tax bill and more about their after tax income. Taking dynamic growth effects into account, the average aftertax income of the bottom quintile would go up by 1.3 percent, or more than ten times the static change in tax. The second, third and fourth quintiles would likewise experience a bigger jump in aftertax income than the static change in tax. Only for the top quintile would the income change be less than the tax cut. The reason? More of the benefits of growth accrue to workers through higher wages and faster job creation than to owners of capital, and lower and middle-income taxpayers derive more of their income from wages. [See Table 6 for distributional effects of the tax bill in the year 2009.]

Table 6
Distributional Effects of the House Ways and Means Tax Bill, 2009

Estimates from Fiscal Associates Tax Model.

[1] Includes only the individual income tax cuts.

[2] Includes the dynamic effects of the entire tax bill.

Distributional Effects of the House Ways and Means Tax Bill, 2009

Quintiles	As Percent of Total				As Percent Change from Baseline	
	Baseline AGI	Baseline Tax	Static Change in Tax[1]	Change in Aftertax Income[2]	Percent Change in Tax	Percent Change in Aftertax Income
All Quintiles	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**-11.0%**	**4.5%**
First Quintile	0.8%	0.1%	0.1%	1.3%	-7.4%	6.5%
Second Quintile	8.8%	4.3%	4.5%	6.5%	-10.8%	3.1%
Third Quintile	16.0%	10.7%	10.6%	13.0%	-10.9%	3.5%
Fourth Quintile	23.0%	17.1%	16.8%	19.7%	-11.2%	3.7%
Fifth Quintile	51.4%	67.8%	68.0%	59.5%	-11.0%	5.5%

Compared to taxes that would be paid under current law, the top 80 percent of tax-payers would receive an 11 percent tax cut while the bottom quintile would get 7.4 percent. Compared to the aftertax income under current law, the bottom quintile would get the biggest boost (6.5%) while increases for the others would range from 3.1 to 5.5 percent.

Conclusion

The modest, 3.5 percent tax cut passed by the House of Representatives is a good effort for several reasons. By adding about $1.50 in GDP for every dollar cut, its benefits to the economy would outweigh the costs. By gradually phasing out the death tax and the alternative minimum tax, it would get rid of two of the worst features of the tax system. By returning part of the $3 trillion in surpluses back to their origin, the pockets of taxpayers, it would blunt some of the temptation to increase spending, thereby improving, not harming, our nation's ability to meet future challenges posed by entitlement programs like Social Security and Medicare.

Endnotes

1 Details on specific provisions come from the report prepared by the staff of the Joint Committee on Taxation, "Description of the Financial Freedom Act of 1999," Washington, DC, JCX-42-99, July 12, 1999.

2 The principle change was a slightly slower phase in of the major provisions in the bill.

3 Internal Revenue Service, *Statistics of Income Bulletin*, Spring 1999, Washington, DC, 1999, Table 1, p. 152 and Gary and Aldona Robbins, *Complicating the Federal Tax Code: A Look at the Alternative Minimum Tax (AMT),* Institute for Policy Innovation, TaxAction Analysis, Policy Report No. 145, March 1998.

4 Only 80 percent of the full AMT liability would be imposed in 2003, 70 percent in 2004, 60 percent in 2005, 50 percent in 2006 and 2007, and full repeal in 2008. Individuals could offset the entire regular tax liability (without regard to the minimum tax) by the personal nonrefundable credits. The proposal also would repeal the provision where the AMT can reduce the refundable child credit.

5 The proposal would lower the rate on unrecaptured section 1250 gains from 25% to 20% and repeal the 8% and 18% rates on certain gain from property held more than 5 years. Lower rates also would apply to the AMT.

6 The exclusion would apply to all interest and dividends except tax-exempt interest, capital gain dividends, cooperative patronage dividends, and dividends from employee stock ownership plans.

7 For analysis of the estate tax, see Gary and Aldona Robbins, *The Case for Burying the Estate Tax,* Institute for Policy Innovation, TaxAction Analysis, Policy Report No. 150, March 1999 and Joint Economic Committee, "The Economics of Estate Taxation," Washington, DC, December 1998.

8 Beginning in 2001, estate and gift tax rates above 50 percent would be repealed, as would the 5-percent surtax, which phases out the graduated rates. Beginning in 2002 and through 2004, each of the rates would be reduced by 1 percentage point. Beginning in 2005 and through 2008, each of the rates would be reduced by 2 percentage points. These reductions would be coordinated with the across-the-board rate cuts so that the highest estate and gift tax rate would not be below the top individual tax rate and the lower estate and gift tax rates would not be below the lowest individual tax rate. Beginning in 2009, the estate, gift, and generation-skipping (GST) taxes would be repealed.

9 Transfers to surviving spouses would continue to receive step-up in basis. The carryover basis regime would be phased in for estates valued between $1.3 and $2 million.

10 The deduction would not be available to an individual for any month in which he or she is covered under an employer-sponsored health plan at least 50 percent paid for by the employer.

11 An alternative tax would apply to the net capital gain of a corporation if that tax is lower than the corporation's regular tax. For taxable years beginning in 2000, the rate of the alternative tax would be 34%. It would be reduced after that by one percentage point a year until a 25% rate is reached in 2008.

12 The bill would repeal the 90% limit on foreign tax credits beginning in 2002. It also would allow AMT credit carryovers to offset the current year's minimum tax liability: 20% in 2003, 30% in 2004, 40% in 2005, 50% in 2006 and 2007. After repeal in 2008, unused AMT credit carryovers may be used to offset 90% of regular tax.

13 The Fiscal Associates Inc. Model incorporates taxes through their effects on the returns to labor and capital. Economic effects are expressed as a change from a baseline forecast that describes how the economy would perform without any change in policy. The Model baseline, which currently has the U.S. economy growing at a long-run, real rate of 2.5 percent a year, is similar to those used by the Congressional Budget Office and the Office of Management and Budget. For more on the Model see Gary and Aldona Robbins, *Accounting for Growth: Incorporating Dynamic Analysis into Revenue Estimation*, Institute for Policy Innovation, Policy Report No. 138, July 1996.

14 Congressional Budget Office, "The Economic and Budget Outlook: An Update," Washington, DC, July 1, 1999, Table 7.

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