IPI Insights

The Newsletter of the Institute for Policy Innovation December 1998

INSIDE: Divorcing The Marriage Penalty

Congress' UpHill Challenge

By Stephen Moore

Only a few short years after the conservative revolution in Washington, today congressional leaders seem devoid of any coherent or unified budget reduction strategy. In 1997 and 1998 there was no willpower on Capitol Hill to cut anything out of the budget—not peanut butter research grants, not Jimmy Carter's "energy crisis"–era home heating subsidies, not military funding to build skating rinks in Fairbanks, Alaska, not taxpayer handouts to Fortune 500 companies.

Consider the $500 billion omnibus spending bill that Republicans patched together in October. It included $20 billion of phony "emergency" funding for Clintonite social programs, the International Monetary Fund, welfare for farmers, and a record expansion of the Department of Education budget. David McIntosh, the Republican from Indiana, accurately lambasted this effort as "anemic and an embarrassment."

Here are eight steps toward a bold and freedom-oriented alternative vision to the Nanny State.

Worse yet, this pre-election spending spree came on the heels of a $200 billion highway bill that contained a record 1,500 special projects—or roughly three slices of bacon for every congressional district. As one conservative leadership aide conceded, "Democrats believe in wasting money in Washington on social welfare programs. We believe in wasting it on pouring cement."

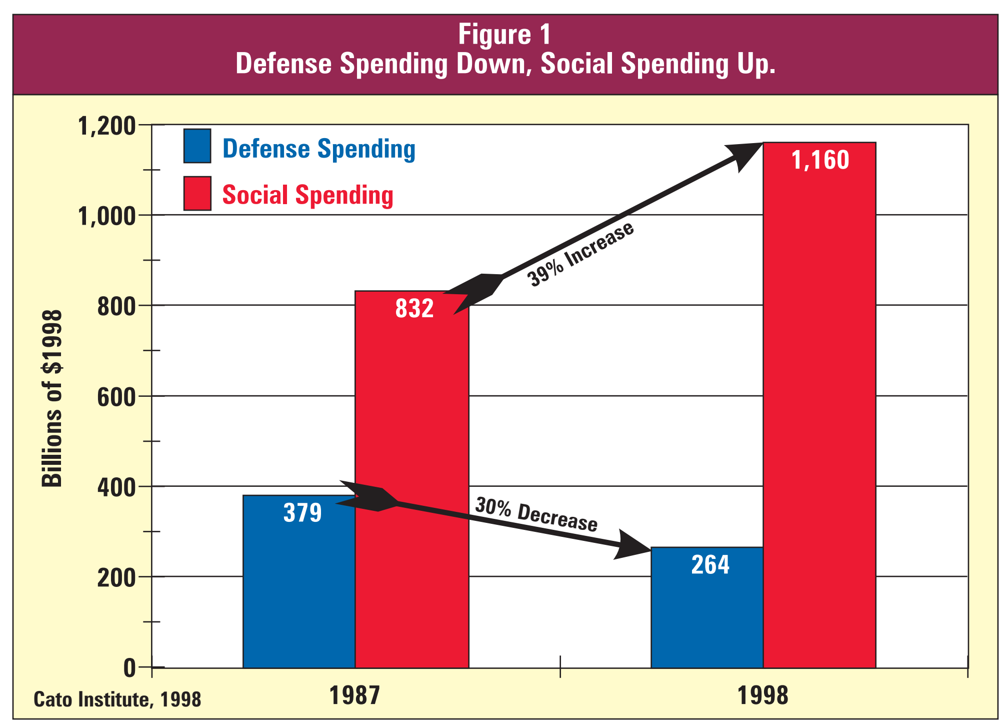
Yes, Republicans (and moderate Democrats) deserve high praise for helping produce the first balanced budget (at least in terms of the unified federal budget) in 30 years. As economist Larry Kudlow and I first forecast in an IPI study earlier this year, not only did we finish 1998 with a $70 billion surplus, but those surpluses will grow larger in every year in the future if we can avoid a recession.

The improvement, however, has not been a result of any shrinkage in the size or scope of the welfare state. Almost all of the budget progress has resulted from:

- a robust economic expansion;
- a record tax burden; and
- continued cuts in the military budget, resulting from the end of the Cold War.

Figure 1 (next page) shows that *every $1 of real defense cuts has led to nearly $3 in new domestic spending.*

For fiscal conservatives, budget surpluses have been at best a mixed blessing. We have finally ended the fiscal child abuse of borrowing from future generations to pay for our ➤



ravenous federal budget appetite today. Unfortunately, Congress and the President have responded to surplus tax receipts by abandoning any pretense of budget restraint. Instead, they have become preoccupied with dividing up the spoils.

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The "Contract with America" budget that Budget Committee Chairman John Kasich bulldozed through the House in April of 1995 was a courageous and visionary blueprint for the nation. It called for mothballing 300 obsolete federal programs and even terminating 3 cabinet agencies. What happened? By my calculations, spending actually *rose* by 2 percent from 1995-98 for the 40 biggest programs originally slated for termination in 1995. AmeriCorp's budget was $426 million when the GOP took Congress. Now it's $504 million. The odious Goals 2000 education program—"free money" that some states have actually rejected because of the meddlesome strings attached—has nearly tripled in size, from $231 to $688 million. The Appalachian Regional Commission budget rose by 6 percent (even Clinton wanted to freeze this agency); and the World Bank budget was inflated by a whopping 33 percent.

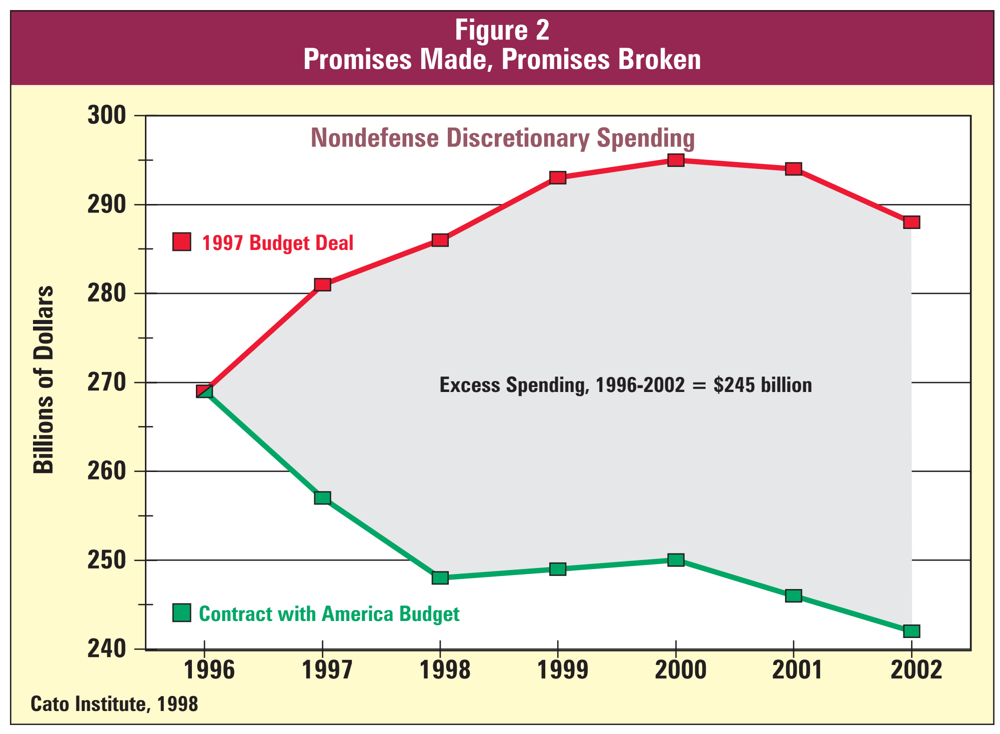
Figure 2 compares the spending totals in that budget versus the actual spending over the period. This signifies a fiscal retreat of depressing magnitude.

Getting Back on Track

How can fiscal conservatives regain the offensive in the 106th Congress? By presenting the American public with a bold and freedom-oriented alternative vision to the Nanny State. They must offer the voters of the country not incremental (and ultimately meaningless) policy changes, but big changes that will dramatically impact their family finances and will offer Americans more power over their own lives. Here are a few key steps toward that goal:

❶ **Remove Social Security from the federal budget once and for all.** The public is on to the gambit of stealing money from the Social Security trust fund to pay for Lawrence Welk Museums, subsidies to the Pillsbury doughboy, and mass transit grants. Social Security should be formally walled off from the rest of the "operating budget" and we should no longer include Social Security surpluses in federal budget calculations.

❷ **Save Social Security first through individual investment accounts**. The current financing structure of Social Security is not just economically inequitable, it is morally unjust. It is robbing young workers in America of their right to save and invest for their futures. Workers should be given the right to immediately opt out of the pay-as-you-go system and invest the full 12 percent of their paychecks ➤



(after all, it is *their* money) into personal security accounts (PSAs). This would allow the average worker to control his own destiny and in most cases obtain a 2-3 times higher retirement income than Social Security offers. At least to start this process, the $100 billion surplus Social Security payroll tax money should be immediately diverted to PSAs.

What is needed is a tax cut that would at a minimum reduce the average family's tax bill by $1,000 a year.

❸ **Enact a five-year, $1 trillion tax cut.** Conservatives have veered off track on tax policy in recent years. The tax bills have been too small, too gimmicky, and too targeted to generate widespread public support or to promote prosperity. What is needed is a tax cut that would at a minimum reduce the average family's tax bill by $1,000 a year. It should be financed not through deficits, but through operating budget surplus funds and through domestic spending reductions.

❹ **End Corporate Welfare.** The federal government currently spends $70 billion a year on direct subsidies to business. If Congress were to eliminate all corporate spending subsidies, the savings would be large enough to entirely eliminate the capital gains tax and the federal estate tax.

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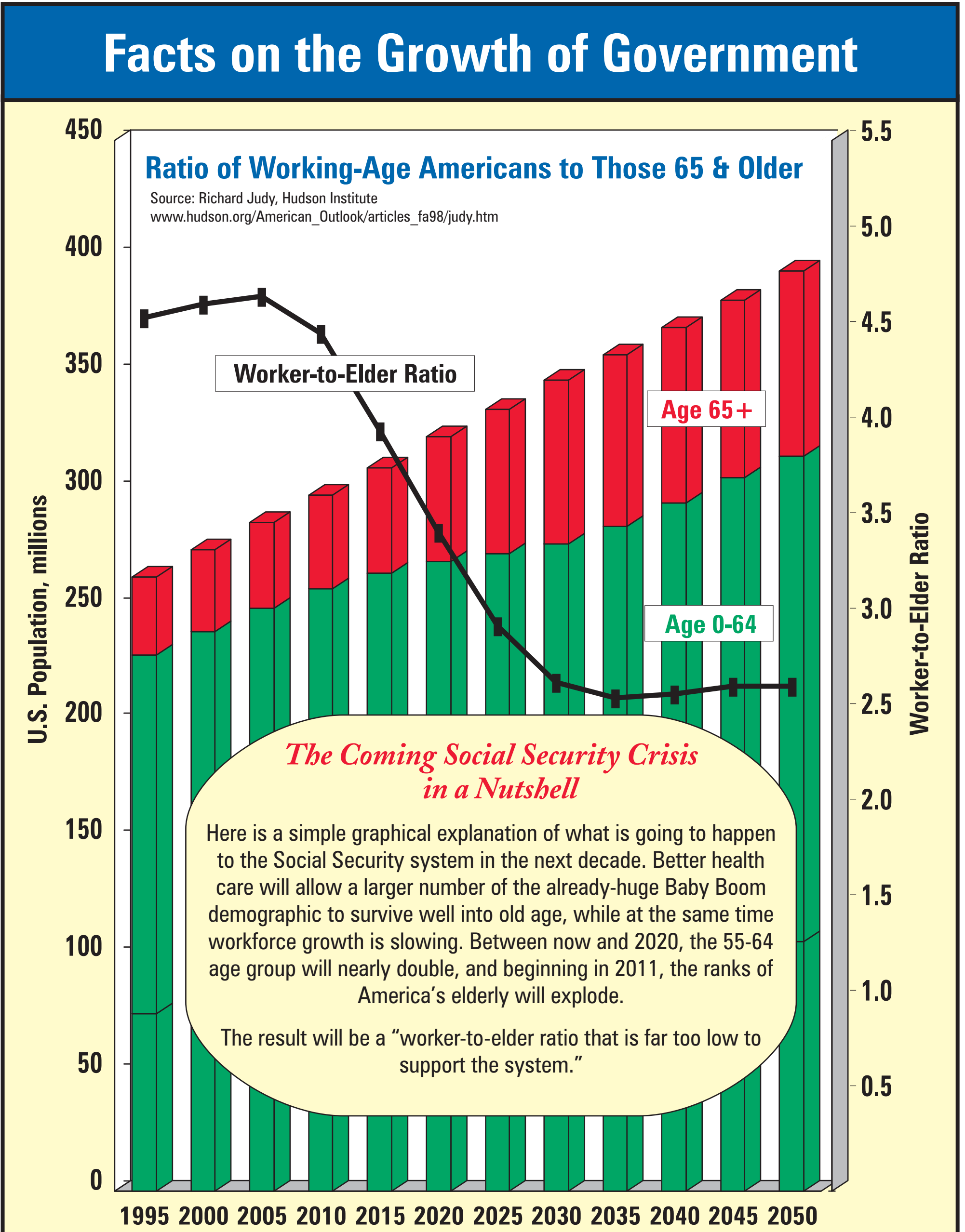
❺ **Terminate hundreds of low-priority domestic programs.** In private industry—which is driving this remarkably bullish economic expansion—sweating out waste and unproductive operations to cut costs has allowed American firms to outcompete international rivals. Over the past 20 years almost no obsolete or ineffective federal government agencies—out of thousands—have been shut down. Nearly $100 billion a year is spent on domestic programs that have been identified as candidates for termination by such independent agencies as the Congressional Budget Office, the General Accounting Office, the Grace Commission, and even by President Clinton himself in budget submissions during his first term.

❻ **Devolve all federal welfare programs to the states and private charities.** The 104th Congress took the first positive step in 30 years to end a morally corrosive welfare state that discourages work and encourages family disintegration. Welfare caseloads have fallen by an average of 30 percent in the states since the 1995 bill was enacted. Congress should finish the job by getting out of the welfare business entirely and leaving the funding to the states and private sector.

❼ **Offer tax-free medical savings accounts (MSAs) for all Americans as a way to reduce government involvement in health care.** Although the Clinton health care plan was soundly rejected by voters, over the past 4 years the White House (with the tacit ➤

Facts on the Growth of Government



approval of Congress) has moved us incrementally toward a national health system.

One defense against a national health insurance system is to make tax-free medical savings accounts (MSAs) widely available as quickly as possible. An MSA is like an IRA where money is put into the account tax free and then can be drawn on to pay for basic, routine medical costs. With an MSA the worker is free to go to any doctor or any hospital he or she wishes. An MSA of $3,000 combined with catastrophic insurance coverage for the occasional, expensive medical procedures would give Americans vastly more control of their personal health care.

❽ **Challenge the constitutionality of federal spending programs.** The Constitution very clearly constrains government power to tax and spend. Nowhere does it grant Congress authority to run the ➤

RIP

The Taxpayer Relief Act of 1998

The Taxpayer Relief Act of 1998 was DOA (dead on arrival) when it landed on the Senate floor. Along with it died this year's hopes that big government would stop growing bigger.

But what better time is there for a tax cut, when the federal government is extracting billions of dollars of excess taxation from the private economy? After all, that's what a federal budget surplus is—excess taxation being extracted from the private economy.

The proposed "Taxpayer Relief Act of 1998" would have been a down-payment on a significant, Reagan-sized tax cut,lowering taxes by $80.1 billion, or 0.8 percent, between 1999 and 2003. Although these proposals did not pass this year, the new Congress will probably start with these proposals as part of their 1999 legislative agenda.

Marriage Penalty:

Marriage penalties occur mainly because, in an attempt to achieve progressivity, the federal income tax (1)removes some income from tax through personal exemptions and the standard deductions. and (2)taxes higher levels of income at higher rates.

Several proposals are currently under debate (see page 7) regarding the best way to eliminate the marriage penalty. The one considered by Congress this year would have doubled the standard deduction for joint returns to nearly twice that of a single non-itemizer. While not significantly impacting economic growth, this proposal would return $28.1 billion to the American taxpayer over five years.

Interest and Dividends:

This provision would allow individuals to exclude up to $200 ($400 for joint returns) a year in interest and dividend income. Such a revision to tax code would promote saving and investment while returning $15 billion over the next five years to American taxpayers.

Estate and Gift Taxes:

Current law exempts the first $625,000 of gross estate from federal estate tax. Last year the exemption was gradually raised to $1 million by 2006. The proposal considered by Congress in this year's tax bill would accelerate the $1 million exemption to 1999. It is estimated that this would account for a $17.9 billion savings to taxpayers between 1999 and 2003.

Alternative Minimum Tax:

This somewhat obscure tax affects relatively few taxpayers today (about one out of every 150), but government forecasters project that one in 14 will be hit by 2007. This change in the method of calculating the AMT would return $8.1 billion to taxpayers over the next five years.

With the economy slowing and with the U.S. economy laboring under the highest tax burden since World War II, Congress could do worse than to immediately implement these leftovers from 1998 as part of a larger 1999 tax cut. ❏

More detailed information on these proposals can be found in IPI Issue Brief, An Analysis of *"The Taxpayer Relief Act of 1998"* by Gary and Aldona Robbins. Copies are available upon request, or from our website at www.ipi.org

health care industry, hire teachers, dictate the price of milk, electricity, or computer software, lend money to business or foreign governments, require businesses to give their employees mandatory leave when they have a child in the hospital, or build football stadiums and tennis courts.

For far too long, Congress has simply asserted an unlimited power of the purse. That attitude has undermined the Constitution. It has also helped create the most expensive government in the history of the world.

Conclusion

President Clinton has cleverly trumped conservatives politically with his gradualist approach to growing the government. Year after year he invents a vast catalog of spending proposals (i.e., family leave for doctor's appointments), as if he believed there were not a single problem in America that cannot be solved with a new government program in Washington.

Where the President offers more Nanny-state programs, conservatives need to counter with a clear and concise agenda that diminishes Washington's role in our lives and offers us a financial dividend for this vision in the form of large scale tax reduction. By nearly two-to-one margins Americans say that if given a choice between more government services and more taxes, on the one hand, or less government and less taxes on the other, they would opt for less of both. Conservatives have floundered of late because they have not offered Americans that alternative. ❑

Stephen Moore is Director of Fiscal Policy Studies at the Cato Institute, and a frequent contributor to *IPI Insights*.

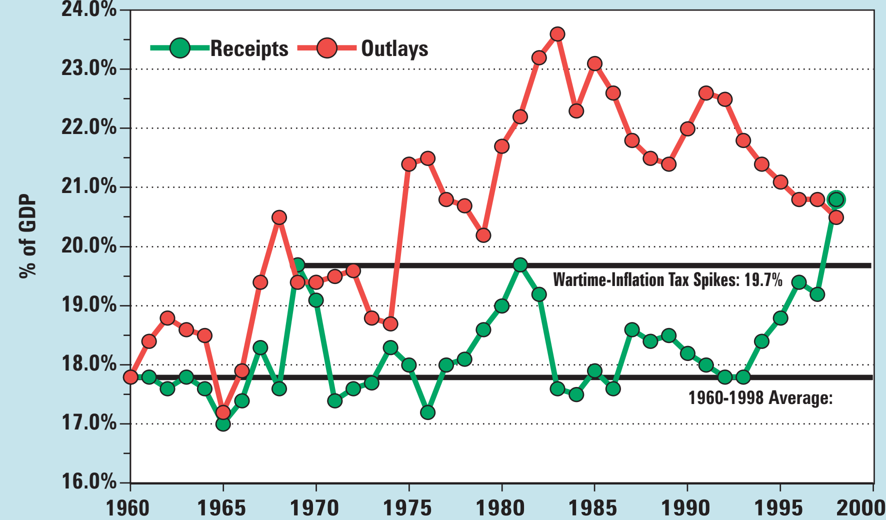
PayGo: A Rule Made to be Broken

A child's toy called a Bump and Go Train doesn't run on a track—it just rolls along the floor noisily until it bumps into an obstacle, then it goes another direction until it meets the same fate. Congress lately seems a lot like that Bump and Go Train. They make a lot of noise about tax cuts, but keep bumping into obstacles that keep them from going forward on a pro-growth tax cut agenda.

A major obstacle that Congress keeps bumping into is a rule of the budget process called pay-as-you-go (Paygo). Paygo requires any tax cuts that would enlarge the deficit to be offset either with tax increases or cuts in entitlement programs. The law specifically prohibits paying for tax cuts with reductions in discretionary programs such as defense.

In the fall of 1997 the debate over how to deal with any budget surplus began. House Ways and Means Chairman Bill Archer promised significant tax cuts. His plan was to return the surplus to taxpayers by reducing or eliminating the marriage penalty, simplifying and reducing capital gains taxes, and repealing the estate tax, among other items. But in a letter to Senate Budget Committee Chairman Pete Domenici, the director of the Congressional Budget Office (CBO) ruled that the Pagyo provision would still control tax policy even if the budget were in surplus. The reason, cited by the Director, is because a *surplus is merely a negative deficit*.

Paygo Balances Budget Up, Locks In Wartime-Inflation Tax Spikes



So even with a budget surplus, tax cuts cannot be made unless they are offset with entitlement cuts or other tax increases, according to the budget experts in Washington.

The Paygo rules virtually guarantee a steady increase in the tax burden because progressive tax rates cause revenues to rise faster than incomes.

Although Paygo rules were supposed to limit entitlement growth and irresponsible tax reduction, Paygo's greatest effect has been inhibiting tax cuts, while allowing spending and revenues to grow.

So while Congress has been derailed by the Paygo obstacle, it has the ability to remove it and get back on track. If Congress is serious about cutting taxes and controlling big government, their options are simple: cut entitlements, waive the rules, or repeal this obsolete law.

More information about the budget rules and Paygo can be found in IPI Policy Report #146, *Budget Rules For Good Times: Ending the Budget Game as We Know It*, by George A. Pieler. Copies are available upone request, or from our website at www.ipi.org

Divorcing The Marriage Penalty

In the tax code, a "marriage penalty" occurs when the sum of the taxes owed by two unmarried individuals is less than that owed if the two individuals were married and filed a joint return.

It is also possible to receive a "marriage bonus". A bonus can occur when one spouse earns all or significantly more than the other. For example, let's say that same couple's $30,000 income was raised entirely by one spouse. As a single filer, the earner would pay $3,458 in tax, which would be $833 more than what was owed when filing jointly.

There would be no marriage penalty if the standard deduction and bracket amounts for joint returns were double those for single returns. But the standard deduction for joint returns is currently only 1.67 times that of single returns.

A uniform (flat) tax on income would be the obvious way to end marriage penalties and bonuses, as well as the other numerous penalties and bonuses in the current tax code. But because broad-based reform still seems a ways off, four proposals for eliminating the marriage penalty have received the most consideration:

Optional Filing Status:

This proposal would eliminate the marriage penalty by giving couples the choice of how to file—joint or single on the same return.

When itemizing, labor income (such as wages and pensions) would belong to the spouse who received it. Income from capital (such as dividends, capital gains and interest) would be divided based on asset ownership.

If not itemizing, each spouse would claim the standard deduction for singles. Other deductions would go to the spouse having the income to which the deduction relates. Each spouse would claim one personal exemption and the same share of any dependent exemptions as the spouse's share of income. Credits would be based on the couple's combined tax.

Income Splitting:

This idea allows couples to split taxable income in half and determine tax liability using the rate schedule for singles. Couples who do not itemize would use a standard deduction twice that for singles. Or, another approach to income splitting would be to make the standard deduction and bracket amounts used by joint filers double those of single filers.

Either way, the marriage penalty stemming from the standard deduction and rate schedule would be eliminated. However, because income-splitting operates on taxable income, marriage penalties resulting from other parts of the tax code would remain.

Second-Earner Deduction:

Under this proposal, couples with two earners could deduct from adjusted gross income 10 percent of the smaller of: (1)the earnings of the spouse with the lesser income, or (2) $30,000. The deduction would be "above the line" and have a maximum value of $3,000.

This limited deduction to the second wage earner would ease the burden of marriage penalties resulting from the standard deduction and bracket amounts. It would not affect penalties arising from other parts of the tax code, but would expand marriage bonuses received by couples with a second earner.

Optional Tax Calculation:

With this proposal a couple would prepare their tax return in the same way they do under current law up to the point of calculating taxes owed. The couple would then: (1) calculate tax using the standard deduction and rate schedule for joint returns, or (2) split their income, deductions and exemptions in proportion to earned income and each use the single standard deduction and rate brackets to figure the tax owed.

This proposal would completely eliminate the marriage penalty arising from the rate schedule and standard deduction while not adding to marriage bonuses. It would, however, preserve most of the other tax penalties.

None of these proposals could be said to be a pro-growth tax cut, because none would have the effect of lowering marginal tax rates on labor and capital. But some would argue that tax policy should have other goals such as equity.

Unlike the issues of taxation and economic efficiency, there is no scientific basis for deciding the right answer to the "fairness" question. However, if the aim is to reduce marriage penalties, the optional filing status or tax calculation proposals should do so without creating more windfalls.

This article was extracted from a recent IPI Issue Brief entitled, *Reducing the Marriage Penalty: A Good Way to Cut Taxes?*, by Gary and Aldona Robbins. Copies are available upon request, and are also available on our website at www.ipi.org

Notes From

Despite Balanced Budget, Signs of Trouble

Declining Corporate Profits, Plummeting Personal Savings Suggest Need for Stimulus

In the latest issue of TaxAction Analysis' **Economic Scorecard**, IPI Senior Research Fellows Gary and Aldona Robbins report that, although the economy reported an unexpectedly high 3.3 percent rate of growth in the third quarter, there are troubling signs beneath the surface. Policy makers would do well to take note of these indicators of potential economic slowdown, and take action now to forestall a downturn.

The good news is that inflation is still nowhere to be found. The 0.8 percent rise in the GDP price deflator was even smaller than expected, and lower than the rate of the previous two quarters. Year-over-year inflation is only up between 0.9 and 1.5 percent, depending on which index is used.

Consumer spending was strong, but perhaps too strong. In fact, consumers spent more than they earned during the most recent period, and September data reported *the first decline in personal saving in 60 years*.

Declining Personal Savings

In fact, personal savings have been plummeting in recent quarters—a very disturbing trend. Personal savings sank from $151.9 billion in the second quarter of 1997 to $25.6 billion this year. Personal savings in the third quarter sank even further to only $5.9 billion, *a 94 percent drop from a year ago*. This pattern of declining personal savings bodes ill for the economy, to say nothing of the fate of consumers.

Declining Corporate Profits

Corporate profits continue a slowing trend begun last year. Although Commerce Department figures aren't yet available, Wall Street estimates indicate that third quarter profits fell by 3 percent.

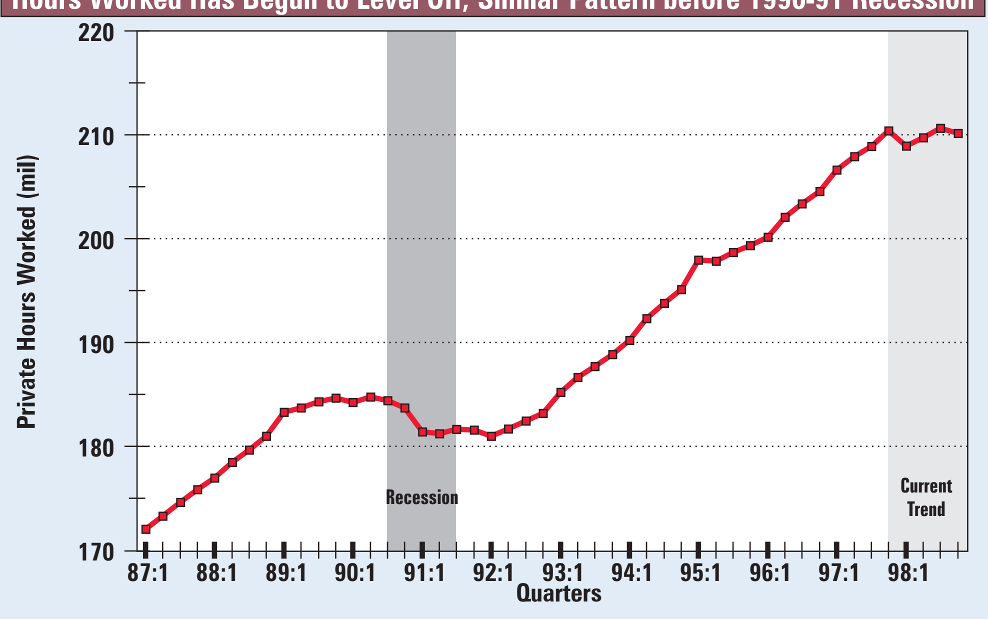
Lower corporate profits means a decreasing investment return to capital, which makes investment less attractive. So it should not be a surprise that business investment, which has fueled much of the recovery, is starting to stall. Year-over-year, its rate of growth slipped from 12.2 percent to 9.4 percent.

Slowdown in Hours Worked

The trend in hours worked is disquieting. Until this year, private hours worked had been steadily climbing since the end of the 1990-91 recession. But in the first quarter, the private sector worked fewer hours than during the last three months of 1997, a pattern reminiscent of the lead into the last recession (see chart).

This all adds up to mean that the possibility of a recession is higher today than three months ago.

Hours Worked Has Begun to Level Off; Similar Pattern before 1990-91 Recession



Does a Recession Threaten Budget Surpluses?

Some are concerned that a possible recession would endanger the budget surplus. In fact, a recession would lower the level of the surplus, and a downturn of more than 1.3 percent of real GDP could even produce a budget deficit. But the inevitable rebound in the 3 to 5 percent range would more than provide enough revenue to restore $100 billion annual surpluses.

Conclusion

The U.S. economy is in its most vulnerable position since the 1990-91 recession, and another recession could be in the offing if investment doesn't pick up.

What should policy makers do? *Clearly balancing the budget has done nothing to forestall an economic slowdown,* despite claims to the contrary. Personal savings are in a free fall that cannot be compensated for by burgeoning government surpluses.

The approach should be to encourage new and increased investment by cuts in marginal tax rates, liberalizing depreciation schedules, and expanding individual retirement accounts. The time is ripe for a tax cut, to forestall an economic slowdown and to provide much-needed tax relief to Americans. ❏

TaxAction Analysis is the tax policy arm of the Institute for Policy Innovation. TaxAction Analysis publishes **Economic Scorecard**, a quarterly newsletter, as well as additional commentary on tax policy. If you are not receiving **Economic Scorecard** and other TaxAction Analysis Publications, call or write for more information.

The full version of our latest **Economic Scorecard** is available from our website at www.ipi.org

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Parting Shots

The Government mandates that poor parents send their children to schools that fail them in every way. These institutions do not teach them how to read, write or compute. They do not teach them the love of learning or the joys of overcoming academic challenges.

I am not anti-public education. I am pro-child. I am in favor of the main factor that makes schools work: competition. Bad schools will always be bad unless someone threatens to put them out of business.

– Representative J.C. Watts, Jr. in Hillsdale College's Imprimis

If all the merchandising might of Hollywood couldn't make America's teenagers buy "Godzilla", why does anyone think that a five-year, $1 billion government ad campaign is going to make kids swear off drugs?

While partisans on all sides of the drug wars have condemned the ad campaign as wasteful, arguing that the money might be better spend on more law enforcement or more after-school programs and drug treatment, the public has been mum. This only encourages Washington to think of advertising as the new instant remedy to fool voters into believing that it is addressing intractable problems. It's enough to make you pine for the usual government gimmick of appointing blue-ribbon commissions to finesse hard policy questions. These commissions don't do anything either, but at least they don't cost us a billion bucks.

– Frank Rich, New York Times

Unless taxpayers become more effective politically than they have been in the past, the anticipated Federal budget surpluses will be directed mainly toward increased spending rather than devoted to reducing taxes. But aroused and politically powerful taxpayers may yet be able to overcome the flypaper effect and force politicians to give them back some of their own money through substantial tax relief.

– Gary Becker, BusinessWeek

It is not the economy, stupid! Contrary to conventional wisdom, our schools do not exist just to train tomorrow's workforce. They exist, primarily, to product a well-educated citizenry. As instructors teach literature, algebra, history and physics, on a deeper level their schools are recreating American society. When they falter, our cultural legacy—even our civilization—is what is truly "at risk." That is why school success and pupil achievement matter—not just for the gross domestic product.

– Michael Petrilli and Gregg Vanourek, Hudson Institute

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Publisher . . . . Tom Giovanetti
Editor & Designer . . . . Betty Medlock
Typography & Layout. . . . . Jim Hart

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