Issue Brief

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An Analysis of "The Taxpayer Relief Act of 1998"

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Today, the American economy labors under a historically-high tax burden. The Congressional Budget Office (CBO) now projects that federal taxes will claim 20.5 percent of gross domestic product this year and 20.6 percent next year. Although CBO expects the tax bite to decline a bit over the next ten years, it still should average 19.9 percent.[1] Before last year, the most federal taxes had taken out of the economy was 19.7 percent, in 1969 and 1981, years that were followed by recessions.

"Federal taxes will claim 20.5 percent of gross domestic product this year and 20.6 percent next year."

A spate of recent economic crises around the globe is turning sentiment from bullish to bearish. On Wall Street stock markets have retreated as much as 20 percent from highs reached in mid-July while on Main Street consumer confidence is showing signs of waning. And, the term "recession" is cropping up more often in forecasts for next year. As a remedy for an economic slowdown, some policymakers are calling for tax cuts both to spur growth and return some of the budget surplus, now expected to total almost $1.6 trillion between now and 2008, to taxpayers.

House Republicans just took a very modest step in that direction, passing the "Taxpayer Relief Act of 1998" by a vote of 229 to 195. This issue brief looks at the major proposals and the bill's economic and revenue effects.

Major Provisions in the "Taxpayer Relief Act of 1998"

The "Taxpayer Relief Act of 1998" would lower taxes by $80.1 billion, or 0.8 percent, between 1999 and 2003.[2] Over 80 percent of the cuts would come from four proposals aimed at lowering federal individual income and estate taxes. [See Table 1 for the static revenue estimates of the major tax provisions.]

Increasing the Standard Deduction for Joint Returns

The largest, single tax cut would reduce the so-called *marriage penalty*. The marriage penalty occurs if a couple filing a joint return pays more in total tax than they would if each could file a single return. 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 deduction. and (2) taxes higher levels of income at higher rates. We estimate that the marriage penalty inherent in the federal income tax amounts to roughly $20 billion a year.[3]

The "Taxpayer Relief Act of 1998" addresses the marriage penalty that arises because the standard deduction for joint returns is only 1.675 times, instead of twice, that for single returns. In 1999, the standard deduction

Table 1
Cost of Major Provisions in the "Taxpayer Relief Act of 1998"

Source: Joint Committee on Taxation, "Description of Major Provisions Contained in the 'Taxpayer Relief Act of 1998' Scheduled for a Markup by the House Committee on Ways and Means On September 17, 1998, Washington, DC, September 15, 1998.

Cost of Major Provisions in the "Taxpayer Relief Act of 1998" (in $millions)	
	1999-2003
I. FAMILY TAX RELIEF PROPOSALS	**-51,157**
Increase Standard Deduction for Joint Returns	-28,074
Allow $200 Exclusion for Interest & Dividends	-14,954
Individual AMT Credits	-8,075
II. EDUCATION AND INFRASTRUCTURE PROPOSALS	**-4,097**
III. SMALL BUSINESS AND FARMER TAX RELIEF PROPOSALS	**-24,222**
Raise Estate and Gift Tax Exemption to $1 million in 1999	-17,926
100% Health Insurance Deduction for Self-Employed	-5,111
Faster Expensing for Small Businesses	-1,059
IV. EXTENSION OF EXPIRING PROVISIONS	**-6,167**
V. REVENUE OFFSET PROPOSAL	**5,569**
TOTAL OF REVENUE PROVISIONS	**-80,074**
VI. SOCIAL SECURITY PROVISIONS	**20**
Accelerate Increase in Social Security Earnings Limit to $30,000	-550
Delay Benefit Recomputation	570
NET EFFECT OF PROVISIONS	**-$80,054**

for joint returns that do not itemize will be $7,200 while single non-itemizers will be able to deduct $4,300.

The proposal is to double the standard deduction for joint returns (to $8,300 in 1999), thereby reducing only a fraction of the marriage penalty. Some of tax cut actually would go to couples who are not paying a marriage penalty. The Joint Committee on Taxation (JCT) estimates the cost at $28.1 billion over five years.

Speedup the Increase in the Estate and Gift Tax Exemption

Current law exempts the first $625,000 of gross estate from federal estate tax.[4] Last year's tax bill gradually raises that exemption to $1 million by 2006.[5]

"Government forecasts project that one in 14 will be hit [by the AMT] by 2007."

The proposal would raise the exemption to $1 million for decedents who die after 1998. The JCT puts the cost at $17.9 billion between 1999 and 2003.

Partial Exclusion for Interest and Dividends

Under current law, income from interest and dividends are included in adjusted gross income. The tax bill would allow individuals to exclude up to $200 ($400 for joint returns) a year in interest and dividend income beginning in 1999. JCT estimates put the cost at $15 billion over five years.

More Favorable AMT Treatment of Personal Credits

The Alternative Minimum Tax (AMT) is supposed to make sure that all taxpayers pay their "fair share" of taxes. Although the AMT affects few taxpayers today (less than one out of every 150), government forecasts project that one in 14 will be hit by 2007.[6]

Calculating the AMT requires affected taxpayers to compute their taxes twice. The first time the taxpayer follows the normal rules, using allowable deductions to reduce taxable income and allowable credits to reduce the amount of taxed owed. If the AMT applies, the taxpayer must make a second computation using a set of complicated AMT rules which add back many of the deductions available under the regular income tax.

Present law also reduces or eliminates certain nonrefundable personal tax credits, such as the child credit passed last year or the dependent care credit, for taxpayers affected by the AMT.[7] In general, the amount of these credits allowed in any tax year may not be more than the extent to which the taxpayer's regular income tax liability is more than his or her AMT liability.

The proposal would allow taxpayers to use nonrefundable personal tax credits to offset both their regular income tax and AMT liability. JCT estimates the cost to be $8.1 billion over five years.

"It is the tax at the margin, not the average, that influences people's decisions to engage in more economic activity."

Other Provisions

The remaining tax cuts are directed toward small businesses and farms ($6.3 billion), education ($4.1 billion) and extensions of expiring provisions ($6.2 billion). Also included in the package is a change in the treatment of distributions from Real Estate Investment Trusts that is supposed to raise $5.6 billion over the next five years and two small changes to Social Security.

New Estate Tax Model

Analysis of estate tax proposals requires a special model based on estate tax returns. The Fiscal Associates Model now incorporates an estate tax calculator that includes the latest estate tax return data available from the Internal Revenue Service. Besides the proposal to increase the estate tax exemption analyzed in this Issue Brief, the estate tax model can assess a wide variety of proposals ranging from rate reduction, provisions aimed at closely-held business, capital gains treatment to outright elimination.

IPI plans to publish a series of reports on the nature and consequences of estate taxes. The first, forthcoming this fall, will place the development of estate taxes in the United States into historical perspective. For example, the estate tax exemption in 1916 was $50,000, far less than today's $625,000 exemption. However, adjusting for the growth in wealth, today's exemption would have to be $8.8 million to be comparable to that of 1916. The study also will measure how much the current tax is costing society in terms of foregone capital formation, jobs and output.

Economic Effects

Using our general equilibrium, neoclassical model of the U.S. economy and new estate tax model [See "New Estate Tax Model" above], we have estimated the economic effects of the "Taxpayer Relief Act of 1998." The neoclassical model incorporates taxes through their effects on the returns to labor and capital. A tax cut that allows workers to keep more of the next dollar earned will increase the amount of labor they are willing to supply. Similarly, an increase in the aftertax return to capital, at the margin, will bring forth more saving and investment. Increases in the amount of capital and labor available to the economy will lead to more output, income and growth.[8]

Simulating economic effects requires a baseline forecast about how the economy would perform without any change in policy. We use a baseline similar to those of the Congressional Budget Office and the Office of Management and Budget. Over the next fourteen years, our baseline projects the U.S. economy growing at 2.5 percent a year after inflation.

Table 2
Economic Effects of the "Taxpayer Relief Act of 1998"

Estimates from the Fiscal Associates Model.

Economic Effects of the "Taxpayer Relief Act of 1998" (Measured as a Change from Baseline)				
CY	**Estate Tax**	**Standard Deduction**	**Other Provisions**	**All Provisions**
GDP ($bil)				
2003	**11.0**	**7.4**	**16.2**	**33.9**
(%change)	0.10%	0.07%	0.15%	0.32%
2008	**6.0**	**4.2**	**26.0**	**36.9**
(%change)	0.04%	0.03%	0.19%	0.27%
1999-2008	**77.2**	**54.9**	**170.4**	**306.2**
Stock of U.S. Capital ($bil)				
2003	**159.4**	**27.8**	**61.4**	**246.5**
(%change)	0.55%	0.10%	0.21%	0.84%
2008	**36.9**	**21.3**	**112.3**	**172.6**
(%change)	0.10%	0.06%	0.31%	0.47%
Employment (thous)				
2003	**25.5**	**77.5**	**35.9**	**135.8**
(%change)	0.02%	0.06%	0.03%	0.11%
2008	**18.7**	**26.6**	**58.9**	**111.7**
(%change)	0.01%	0.02%	0.04%	0.08%

As a whole, the "Taxpayer Relief Act of 1998" would cause output, jobs and capital to grow a little faster than in the baseline. [See Table 2 for a summary of the tax bill's economic effects.] By the year 2003:

- Annual gross domestic product would be $33.9 billion, or 0.32 percent, above the baseline.
- The stock of U.S. capital would be $246.5 billion, or 0.84 percent, higher than in the baseline.
- The economy would create 135,800 more jobs than in the baseline.

"By the year 2008, the economy would have produced a total of $306.2 billion more in GDP than otherwise, and annual GDP would be $36.9 billion (0.27 percent) above the baseline."

By the year 2008, the economy would have produced a total of $306.2 billion more in GDP than otherwise, and annual GDP would be $36.9 billion (0.27 percent) above the baseline. However, although there would be more capital and jobs than in the baseline, the increases would be less than they were in 2003. The explanation for this seeming anomaly lies in the estate tax provision.

Estate and Gift Tax Exemption Provision Has Biggest Effect

Accelerating the step-up in the estate and gift tax exemption would initially have the biggest economic effect per dollar of revenue cost. At the end of the first five years. it would account for 65 percent of the additional capital from the whole bill.[9] But, after ten years, the estate tax provision would account for only a fifth of the added capital, and the total increase in capital stock over the baseline would be less than it was in 2003. Why? The positive effects of increasing the estate tax exemption to $1 million are already built into the baseline because that is the level it will reach under present law by 2006. In other words, the speedup simply would move the positive effects already contained in law forward in time.

Allowing some credits to reduce AMT liability and the $200 exclusion ($400 for joint returns) for interest and dividends also would provide some modest growth stimulus. However, increasing the standard deduction for joint returns—the provision with the biggest price tag—would do little to boost growth.[10] Why? While a higher standard deduction lowers a taxpayer's total tax bill, it does not lower taxes on the last dollar of income earned as much as the other provisions. And, it is the tax at the margin,

not the average, that influences people's decisions to engage in more economic activity.

Revenue Effects

On a static basis, we estimate that the "Taxpayer Relief Act of 1998" would lose $79.7 billion in federal revenue over calendar years 1999 through 2003, about the same as the JCT estimate on a fiscal year basis. Over the next ten years, the cost would be $150.8 billion.

However, Treasury would actually lose less than that because higher growth would increase the incomes of workers, investors and businesses. The extra $306.2 billion in GDP over the next ten years stimulated by the tax cut would yield $79.6 billion more in federal revenue. As a result, the net federal revenue loss would be $71.2 billion. In other words, the growth stimulus—coming mainly from the estate, AMT and interest and dividend provisions—would offset 53 percent of the static revenue loss. [See Table 3 for the federal static and dynamic revenue effects of the tax bill.]

Because of interest charges, the net revenue loss from the tax bill would reduce the expected $1.6 trillion in budget surpluses over the next ten years by $92.3 billion.

Table 3
Static and Dynamic Revenue Effects of the "Taxpayer Relief Act of 1998"

Estimates from the Fiscal Associates Model.

[1] Static plus dynamic.

[2] One minus the ratio of net to static revenue effects.

Static and Dynamic Revenue Effects of the "Taxpayer Relief Act of 1998"
(in $billions)

CY	Estate Tax Exemption	Standard Deduction	Other Provisions	All Provisions	Effect on Budget Surplus
Static Revenue Effects					
1999-2003	-19.6	-31.3	-28.8	-79.7	
1999-2008	-22.0	-67.3	-61.5	-150.8	
Dynamic Revenue Effects					
1999-2003	8.9	9.6	19.4	37.5	
1999-2008	15.4	14.2	48.6	79.6	
Net Revenue Effects[1]					
1999-2003	-10.7	-21.6	-9.4	-42.2	-47.3
1999-2008	-6.6	-53.1	-12.8	-71.2	-92.4
Revenue Returned by Tax Cuts[2]					
1999-2003	45.4%	30.8%	67.3%	47.0%	
1999-2008	70.0%	21.1%	79.1%	52.8%	

Conclusions

The "Taxpayer Relief Act of 1998" would provide a modest stimulus for the economy. Most of the extra growth would come from the estate, alternative minimum tax (AMT) and interest and dividend provisions. Taxes on the increased economic activity would offset about half the static revenue losses.

"The growth stimulus—coming mainly from the estate, AMT and interest and dividend provisions—would offset 53 percent of the static revenue loss."

The bill also directs much of its relief toward two areas which will "increasingly become sore spots with taxpayers. Because the exemption has not kept up with inflation, the estate and gift tax has become a growing problem for more and more taxpayers. Speeding up the higher exemption will provide relief for at least some of them. Allowing personal credits to count against the AMT will keep many taxpayers eligible for features enacted last year, like the child credit, from having to pay the higher AMT.

Finally, the partial exemption for interest and dividends may be the most important item because it recognizes the need to help people save more. Hopefully, future tax policy will focus even more strongly on ways to best promote saving and investment for the economy as a whole and less on targeted provisions that extend special treatment to favored groups.

Endnotes

1. Congressional Budget Office, *The Economic and Budget Outlook: An Update*, Washington, DC August 1998, Table 2-3.
2. All the government revenue estimates cited in this report come from the Joint Committee on Taxation, "Description of Major Provisions Contained in the 'Taxpayer Relief Act of 1998' Scheduled for a Markup by the House Committee on Ways and Means On September 17, 1998, Washington, DC, September 15, 1998.
3. Other parts of the tax code that set limits or phase out deductions or credits based on marital status exacerbate the marriage penalty. While the Earned Income Credit also can penalize married couples, we have not included it in the $20 billion figure cited above. See Gary and Aldona Robbins, "Reducing the Marriage Penalty: A Good Way to Cut Taxes?," Institute for Policy Innovation, *IPI Issue Brief*. July 15, 1998.
4. The exemption is achieved through a unified estate and gift tax credit which may be used to offset gift tax liability during the donor's lifetime and, if unused at death, is available to offset the decreased donor's estate tax liability.
5. Scheduled increases are: $650,000 in 1999; $675,000 in 2000 and 2001; $700,000 in 2002 and 2003; $850,000 in 2004; $950,000 in 2005; and $1 million in 2006 and thereafter.
6. Line 48 of the form 1040 instructs taxpayers on how to determine whether they are affected by the AMT. For more on the economic effects of the individual and corporate AMT see Gary and Aldona Robbins, *Complicating the Federal Tax Code: A Look at the Alternative Minimum Tax,* Institute for Policy Innovation, Policy Report No. 145, March 1998.
7. Other nonrefundable personal tax credits include the credit for the elderly and disabled, the adoption credit, the credit for interest on certain home mortgages, the HOPE and lifetime learning credits, and the D.C. homebuyer's credit.
8. For more on the model see Gary and Aldona Robbins, *Accounting for Growth: Incorporating Dynamic Analysis into Revenue Estimation*, Lewisville, TX: Institute for Policy Innovation, Policy Report No. 138, July 1996.
9. As Table 2 shows, the estate tax provisions accounts for $159.4 billion compared to $246.5 billion for the whole bill.
10. Setting the joint standard deduction at twice that of singles accounts for a third of the static revenue loss from tax cut provisions but only 18 percent of the added growth.

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