INSIDE: AMT: Ticking Timebomb

IPI Insights

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Spring 1998

Will Taxpayers Be Last In Line For Budget Surpluses?

by: Lawrence A. Hunter

Talk of federal budget surpluses is in the air, and President Clinton wants to spend them. Accordingly, he has devised a clever preemptive strategy to prevent those surpluses from becoming tax cuts. He says projected surpluses are uncertain, and therefore it would be imprudent to cut taxes before surpluses materialize. In the meantime, if surpluses do accumulate, the President says he wants to "put Social Security first" by reserving every dollar of any surplus for Social Security. A growing number of congressional Republicans, led by Senate Budget Committee Chairman Pete Dominici and House Speaker Newt Gingrich, appear to be taking the bait.

What About the President's Plan?

While the President's proposal may sound reasonable and straightforward, it is neither. First, projected surpluses will likely never become actual surpluses. The very act of projecting surpluses sets in motion irresistible political forces that will invariably claim and then consume most if not all of the surpluses before they ever appear in reality. "Surpluses" will thus be spent in some way long before they accumulate.

Already both Congress and the President plan to violate the spending caps passed just last year and claim spending rights to these "surplus" funds. Witness President Clinton's breath-taking proposals to expand Medicare and Medicaid, create a new child-care entitlement, triple funding for training dislocated workers, provide the largest increase in history for the National Institutes of Health, the National Science Foundation and the National Cancer Institute, bail out the IMF and fund 100,000 new public school teachers—none of which were provided for in last year's 5-year balanced budget agreement.

Any proposal to "wait and see" before cutting taxes should, therefore, be seen for what it is: a tactic to freeze tax-cut proponents in place while the surpluses are absorbed into higher spending. By forging a wait-and-see consensus, politicians guarantee that current high tax rates—justified in earlier years to "fight the deficit"—remain fixed in place to retire the national debt (technically, "debt held by the public") and increase spending. This year, federal revenues will amount to 20.1 percent of gross domestic product, the highest level ever except for two years at the height of World War II. *A federal government that consumes over 20% of total GDP is the real burden on the American economy, not the national debt.*

"Austerity Economics"

Second, even if a surplus materializes, reserving it is anything but straightforward. There is no way for the federal government actually to reserve, save, or set aside a surplus. The federal government, by law, is not permitted to save or invest surplus revenues in the sovereign debt of foreign nations nor may it invest them in private equities or debt instruments.

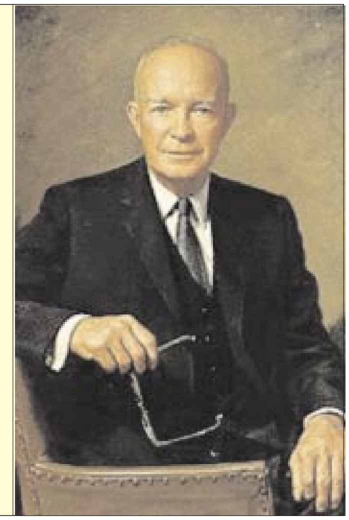
If the federal government collects tax revenue, it must spend it on government programs or use it to retire outstanding debt. And, unless debt retirement is aimed specifically at retiring the debt held in the Social Security Trust Fund, it is deceptive to claim that the surplus is being "reserved for Social Security." Retiring the national debt does not put Social Security first, it puts taxpayers last. In fact, borrowing money from Social Security to retire the national debt, as the President proposes, does not even stop the debt from growing.

Deja Vu All Over Again

Eisenhower-Era Mistakes Revisited

There are striking similarities between the 1950's and the 1990's. In a period of "peace and prosperity," the perception of the economy was rosier than the reality. Then, as now, balancing the budget and paying down debt was the central tenet of federal policy. A historically-high tax burden was justified as necessary to reduce the deficit. But the high tax burden exerted a drag on the economy. Real economic growth averaged about a half percentage point below the postwar trend.

It is instructive to note that by following policies of "austerity economics," the party in power (Republican) slowed the economy, lost their majority in Congress for forty years, and lost the support of the American people to a candidate promising tax cuts to "get the economy moving again," John F. Kennedy.



> ***A federal government that consumes over 20% of total GDP is the real burden on the American economy, not the national debt.***

Those who would claim to strengthen Social Security by paying down the national debt have a heavy burden of proof. They must demonstrate that the current level of federal debt prevents the economy from achieving its full potential; that if the national debt were retired, interest rates would fall, saving and investment would rise, and the economy would grow faster generating more revenue to support Social Security. The problem with this theory—call it "austerity economics"—is that it has precious little empirical evidence to back it up. In fact, practical experience and economic theory suggest that "austerity economics" is counter-productive and ultimately self-defeating. [See box above]

The Best Use of Surpluses

Instead of seeking to accumulate budget surpluses by keeping tax rates higher than they otherwise need to be, tax rates should be reduced and the surpluses left in the private economy where they will do the most good. This is precisely what Ronald Reagan did back in 1981 when the Congressional Budget Office was projecting huge budget surpluses as far as the eye could see. The subsequent deficits arose not because Reagan cut tax rates but rather because of a congressional spending binge and a precipitous drop in inflation. [See IPI Policy Reports #139 and #141 for more on the truth about the 1980s].

Consider, for example, a small businessman who finally begins to show a profit. His banker sees the business's potential and says, "Don't worry about paying back the principal right now, I will roll it over as long as you continue to pay the interest at the going rate. Plow all of your profits back into the business so that you can grow faster." The banker knows that the stronger the business becomes, the less a burden the existing debt imposes.

Would that small businessman refuse such an offer, pay down his debt and forego the new investment? Of course not—it wouldn't make any sense.

In similar fashion, would a homeowner pay off a 7% mortgage early and give up the opportunity of putting that money to work in a retirement growth fund that earns 12% or 15%? Of course he wouldn't.

So, why should the American public be asked to make the mistake of choosing to retire the national debt over a more productive use of excess tax revenue? Framing the issue in this manner illustrates the fallacy of "austerity economics." It fails to account for more productive uses of the revenue and ignores the high burden of taxes on the private economy.

Empirical studies reveal that the current federal tax system is so burdensome and inefficient that the process of collecting each additional dollar in tax revenue from individuals and firms retards economic growth by about $1.50. Even in the extreme, if each additional dollar of public debt retired would produce a dollar increase in GDP—which no one seriously believes—it still would make no sense to keep taxes higher than they need to be just to retire debt. It's like taking two steps forward and three steps back.

> ***There is no way for the federal government actually to reserve, save, or set aside a surplus.***

What Should Be Done?

Cut Taxes

If retiring debt held by the public is not the answer, how should projected federal budget surpluses be used? The most straightforward way would be to replace the current tax code and overhaul Social Security. The first step could be to cut Social Security payroll taxes and roll back the Bush and Clinton income tax rate increases, *which were justified on the grounds of deficit reduction.*

In the current political environment, regrettably, conservatives obsessed with the national debt have joined with liberals who want to block tax cuts at all costs. Hence, this straightforward use of surplus revenues, while preferable, may be politically impossible.

> ***"Retiring the national debt does not put Social Security first, it puts taxpayers last. In fact, borrowing money from Social Security to retire the national debt, as the President proposes, does not even stop the debt from growing."***

> ***"Tax rates should be reduced and the surpluses left in the private economy where they will do the most good."***

Fortunately, it may be possible to break up this alliance of austerity conservatives and anti-tax cut liberals with a proposal that cuts taxes, strengthens Social Security, retires part of the national debt and keeps the lid on spending. It can be done by putting Social Security debt first in line to be retired.

Retire Social Security Debt First

Every year since 1983, workers have paid more in payroll taxes than were needed to pay Social Security benefits. Treasury took this Social Security surplus in exchange for "special issue" federal bonds. These bonds are held in trust by the Social Security system and are shown on Treasury's books as outstanding debt of the United States government. The cash "borrowed" from the Social Security Trust Fund was then spent on non-Social Security government programs and activities.

Over the next 5 years, cumulative Social Security payroll tax surpluses are projected to equal $310 billion. President Clinton proposes a new shell game where $98 billion of those borrowed funds would be used to retire debt and the remaining $212 billion would be spent on non-Social Security programs. [See Table 1.]

Instead of borrowing money from Social Security to retire public debt, debt held by the Social Security Trust Fund should be put first in line to be retired. Congress should instruct the Treasury Department to use the payroll tax revenue it borrows from Social Security to repurchase part of the national debt held in trust by the Social Security Trust Fund. The proceeds of the sale of those bonds should then be returned to payroll taxpayers by rebating the funds into personal retirement accounts.

As shown in Table 1, if excess payroll tax revenues are reserved for Social Security by rebating them into private retirement accounts, the true overall fiscal situation of the federal government is revealed. Rather than being in surplus immediately, the unified budget will remain in slight deficit through the year 2001. The good news is that even if the entire payroll tax surplus is reserved in personal retirement accounts, the budget is balanced on the same schedule as envisioned in last year's balanced budget agreement and with smaller deficits in the interim.

Conclusion

An unholy alliance of liberal spenders and conservatives obsessed with the national debt is hiding behind Social Security and putting taxpayers last by proposing to retire the public debt. Unless immediate action is taken to break up this coalition, at least part of the projected surpluses will vanish into thin air before they ever materialize, and any surpluses that do materialize will be wasted. Government spending will rise, the tax burden will remain at historically-high levels, and economic performance will suffer.

Short of a significant tax cut, an alternative is to stop the raid on Social Security and begin to repay the Social Security Trust Fund. If the funds used to repay the Trust Fund are then reserved into private retirement accounts to begin pre-funding the retirement of today's workers, it would be possible to say truthfully that we have put Social Security first. ❑

Dr. Lawrence A. Hunter is Chief Economist at Empower America.

Table 1

Federal Budget Surpluses/(Deficits)
(billions of dollars)

	1998	1999	2000	2001	2002	Five-Year Totals
1997 Balanced Budget Agreement	(91)	(90)	(83)	(53)	2	(315)
March, 1998 Baseline[1]	8	9	1	13	67	98
Social Security Cash-Flow Surpluses[2]	54	60	64	64	68	310
Surpluses/(Deficits) Without Social Security	(46)	(51)	(63)	(51)	(1)	(212)

[1] *Economic and Budget Outlook: FY 1999-2008,* Congressional Budget Office, March, 1998.
[2] Congressional Budget Office 1997 Baseline Projections, unpublished.

Those who have recently performed the arduous task of filing their taxes will take no comfort in knowing that in coming years, they may have to do their taxes twice. Over the next few years, more and more taxpayers will find themselves having to deal with an extremely complex provision of the tax code called the alternative minimum tax, or AMT. Currently this tax affects less than one out of every 150 taxpayers. However, by the year 2007, government analysts project that it will affect ten times as many, or one out of 14 taxpayers.

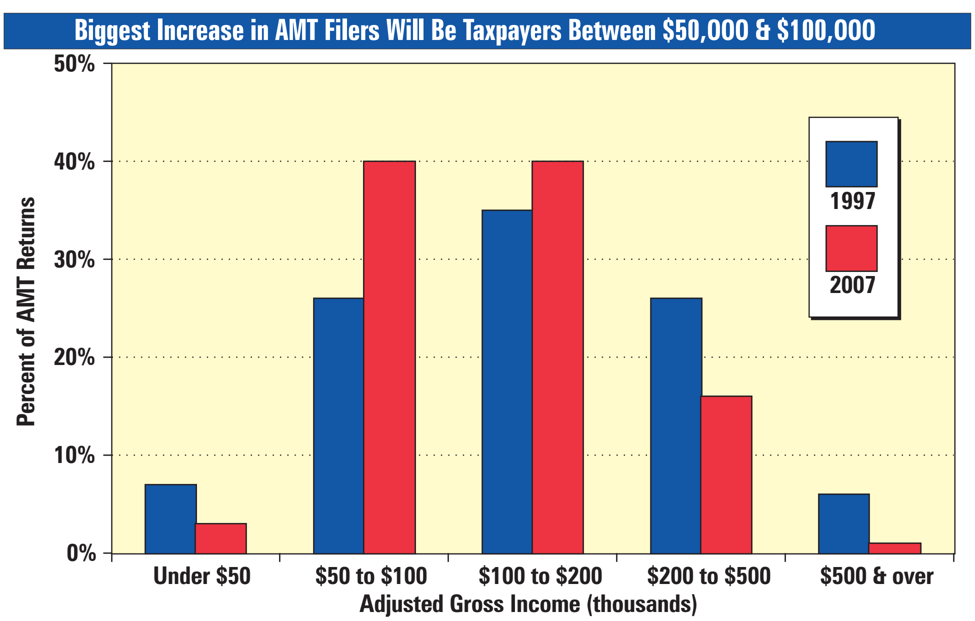
Over the years the AMT has been adjusted numerous times in nine separate tax reform bills, most recently the Taxpayer Relief Act of 1997. The result of the legislation has left the AMT time-consuming and confusing at best. At worst, the AMT can produce inefficiencies harmful to economic growth. Currently, the alternative minimum tax affects only a few taxpayers and accounts for little revenue, but that is about to change dramatically over the next decade.

Gunning For The Middle Class

Government forecasters project that the AMT will hit 9 million taxpayers by 2007. Many of those taxpayers will not come from the ranks of those the AMT was designed to reach. That is, they will neither be "rich" nor have a lot of deductions sheltering them from taxes. According to projections from the Joint Committee on Taxation Individual Tax Model, the biggest increase in AMT filers over the next ten years will be taxpayers with between $50,000 and $100,000 in adjusted gross income. [See chart below]

To understand why so many taxpayers will soon "qualify" for the AMT, it is important to know how this tax is computed. Unlike the regular income tax, key AMT tax parameters are not indexed for inflation, causing more and more taxpayers to fall under the AMT for several reasons.

Under the regular income tax, as nominal income increases with inflation so do personal exemptions, standard deductions and bracket amounts. Inflation-indexing slows the increase in taxable income. In contrast, the AMT exemption and bracket amounts are fixed and not indexed for inflation. As nominal income increases, more of it becomes taxable under the AMT, and more of taxable AMT income is taxed at the higher, 28 percent rate. As the gap between tax liability under the regular, indexed income tax and the unindexed AMT widens, more taxpayers, particularly the non-"rich", will have to pay the higher, alternative minimum tax.



Blasting Corporations

The AMT for corporations works in much the same way as the individual AMT. That is, it reduces the amount of deductions and credits that a corporation can use in computing its AMT tax base, thereby increasing the amount of tax owed.

Besides adding complexity to the tax code, another unfortunate property of the AMT is that it runs counter to the business cycle. That is, its burden is greatest when the economy is weakest

and least when the economy is booming. The most revenue ever collected under the AMT came during the 1990 recession.

What causes this undesirable effect? During recession, the income growth of companies slows and may even decline. Under the regular income tax, tax liability likewise falls or the company posts a new operating loss that can be used to reduce future tax liability. Because the AMT denies or reduces many of these deductions or credits, corporate AMT liability will be higher than that under the regular income tax, triggering AMT taxes. In other words, financially pinched companies have to pay extra federal income taxes at a time when they can least afford to do so. [See chart below]

It is easy to see why the alternative minimum tax is onerous to taxpayers. But there are also consequences that carry over into the entire economy.

The complexity of computing the AMT makes it a very expensive tax to collect. It is conservatively estimated that AMT paperwork and record-keeping cost individuals and businesses at least $1.5 billion each year. True compliance costs are even higher because they do not include the costs the IRS incurs to police and collect the AMT. These compliance costs amount to at least 30 percent of the current AMT revenue.

An Economic Bombshell

Although considerable, AMT compliance costs are only part of the burden the tax poses on the economy. More serious is the damage to economic incentives. Government forecasts wrongly assume that increasing either the corporate or individual AMT by a dollar raises a dollar. But this prediction is wrong. In fact, government gains would be considerably less because lower growth means a smaller tax base and lower income, payroll, excise, sales and property taxes for federal, state and local governments.

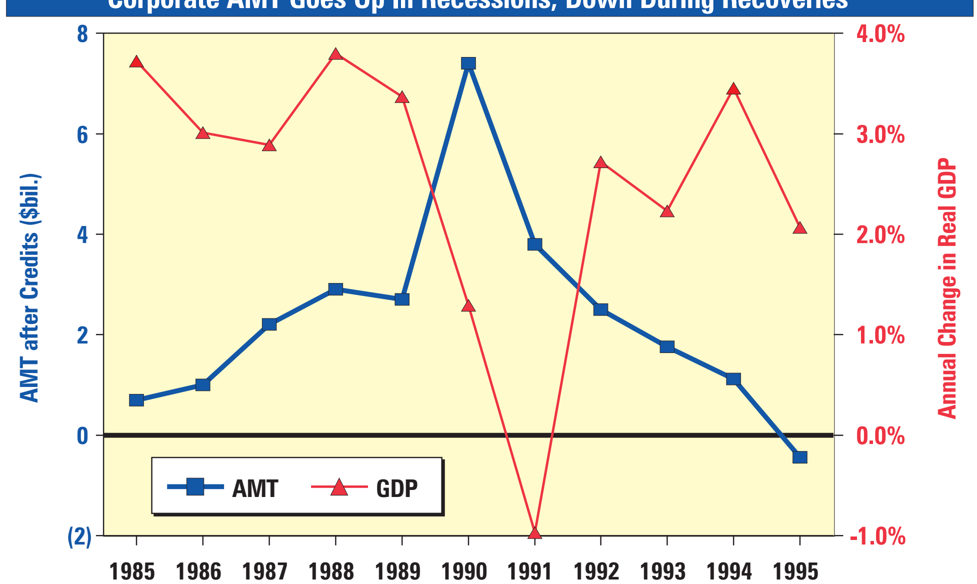
For every dollar the government expects to raise from increasing the corporate AMT by $1 billion, the total government sector picks up only 8 cents, and the economy forgoes $2.87 in GDP. For every dollar the government expects to raise from increasing the individual AMT by $1 billion, the total government sector picks up 47 cents and the economy forgoes $1.72 in GDP.

Conclusion

The AMT is a complex, burdensome tax that imposes stiff costs on taxpayers and society while raising little revenue. Despite these costs, the AMT does not deliver on its stated purpose, that is, to assure that all taxpayers pay some tax. In fact, an argument can be made that the AMT detracts from tax fairness because it tends to hit businesses and individuals hardest in times of economic distress. Finally, because of its flawed structure, the AMT threatens to ensnare millions of individual taxpayers over the coming decade. ❑

For a complete copy of IPI policy report #144, entitled *Complicating the Federal Tax Code: A Look at the Alternative Minimum Tax.* written by Gary Robbins, John M. Olin Senior Research Fellow and Aldona Robbins, Bradley Senior Research Fellow, please contact IPI (see page 8) or vist our website at www.ipi.org.

Corporate AMT Goes Up In Recessions, Down During Recoveries



The Golden Rules For Making A Million

Economists Richard McKenzie and Dwight Lee looked at those who have become millionaires. They wanted to see what lessons the rest of us can learn about becoming rich. "Remarkably, the rules for acquiring substantial wealth are few, simple, and well worn," they wrote in a recent report, published by the Center for the Study of American Business.

So what are the rules?

The first rule for becoming rich, according to the authors, is *have a reasonable income base*. Most Americans, they contend, would fall into this category.

The second rule is to *take the power of compound interest seriously and to do so very early in life.* For example, if a 22 year old person places $2,000 in an account that earns a 10 percent compounded rate, and places no more money in that account over the years, his one-time investment would be worth $120,000 by the time he is 65 years old.

The third rule for being rich is to *begin saving a lot early in life and do it consistently.* Self-made millionaires save, on average, 15 percent of their income each year. But most Americans don't save anywhere near that amount.

The fourth rule, the authors admonish, *is avoid frivolous temptations*. Most rich people have a lifestyle that's just slightly higher than middle-class.

While those rules are the top four ways to achieve the American Dream, the authors found several "auxiliary" tenets to get a person headed in the right direction.

A key element to getting your nest egg started is to get an education. Choose your education wisely, knowing up front that some occupations are less likely to provide an avenue to financial freedom.

Other important tips are: be willing to work and work diligently for a long time. Work at something that benefits many others. Fortunes have been made by providing a unique service or product that is used by the masses.

The authors recommend marriage, especially to someone with an education level equal to or higher than his/her own. The median value of married couples' assets is nearly two-thirds higher than the median assets of all households.

The final rule for getting rich: Take some risks. Start a new business, or invest in an unproven new one.

"Becoming rich," the authors said, "normally takes decades and a lot of hard work. Above all, for most Americans, it takes denial, dedication and perseverance." ❏

Tax Freedom Day!

No, Not Yet

Most of us think of April 15th as the day that we are finally free from the IRS. Our taxes are done and filed (hopefully), and we can get on with the rest of the year's business.

Not so fast.

You may have finished your tax *paperwork*, but odds are, you're still working for the government.

In fact, the average American works until May 10th this year to pay taxes. In other words, every penny earned during the first five-and-a-half months of the year go toward taxes.

That's right—over five months out of a twelve month year.

Want more bad news? Tax Freedom Day moved forward for 1998 from last year's Tax Freedom Day of May 9.

Because the Tax Freedom Day calculation includes state and local taxes, Tax Freedom Day varies by state. To get state-by-state information, or for more information about Tax Freedom Day, call the Tax Foundation at (202) 783-2760, or visit their website at www.taxfoundation.org.

How Your Tax Dollar Will Be Spent in 1998

Note: Total does not add up to 100¢ due to rounding

Source: Tax Foundation

Notes From

TaxAction Analysis

Getting Hit From Both Sides

Adjusting CPI Downward Cuts Entitlements And Raises Taxes

Each month investors anxiously await news of the latest Consumer Price Index (CPI), a key inflation gauge, produced by the Bureau of Labor Statistics (BLS). If the CPI comes in higher than expected, prices of bonds and stocks often drop. Besides being important to the investors, the CPI is extremely important to those concerned with the federal budget.

In 1996 a commission headed by Michael Boskin (chairman of the Council of Economic Advisers under President Bush) estimated that the current CPI overstates increases in the cost-of-living by 1.1 percentage points because of mathematical shortcomings in the formula for computing the CPI and in the ways price information is gathered. This finding has sparked significant interest in the public policy community because lowering the CPI calculation would result in an increase in government revenue.

In our tax code, the personal exemptions, standard deduction, and income brackets are also adjusted based on the CPI. Lowering the CPI would cause these to increase more slowly. This would increase the amount of income that is subject to tax and push taxpayers into higher brackets sooner than otherwise. Bottom line—more taxes would be collected.

Spending for 57 percent of federal entitlement programs is adjusted annually based on the CPI. So then, reducing the CPI would also reduce the spending increases in these programs. For example, a reduction of 1 percentage point in the CPI would lower Social Security outlays over the next ten years by $224.4 billion dollars. Would this solve Social Security's insolvency problem? No, it would only push the future bankruptcy a few more years into the future.

Thus, the net effect of lowering the CPI is to raise taxes and lower government spending.

The recent change in the CPI calculations, beginning last January 1, is a step in the right direction. But, because the CPI is used as an inflation adjustment in entitlement programs and the tax code, it will remain a politically charged issue. What must be avoided, however, is to allow federal programs to be adjusted for political rather than sound economic reasons. ❑

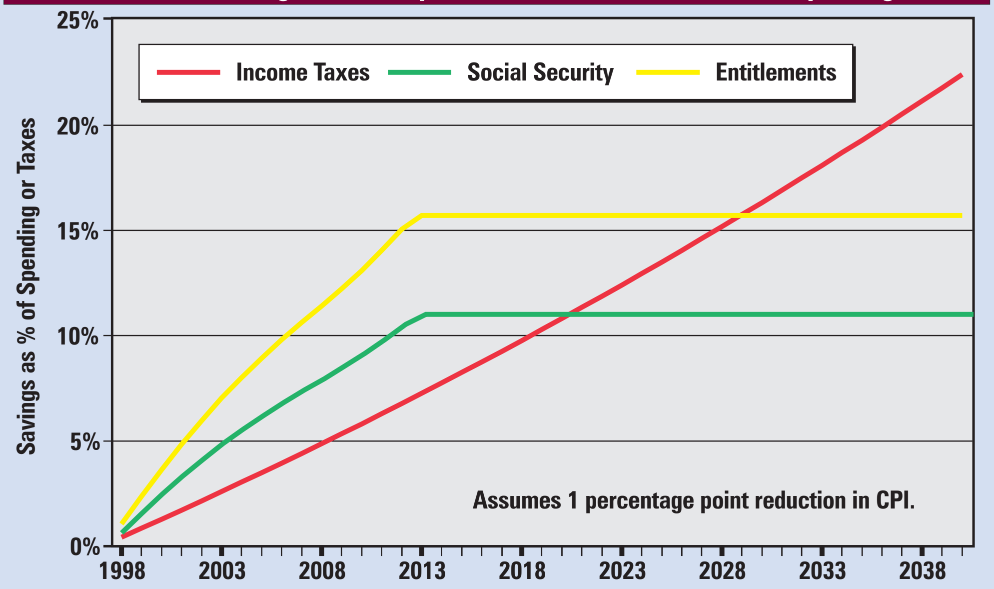
Table 1

Change In Federal Spending, Outlays & Deficit
From 1 Percentage Point Reduction in CPI
(By fiscal year, in $billions)

	1998 to 2002	2003 to 2007	1998 to 2007
Revenues	**51.2**	**167.8**	**219.0**
Outlays	**-76.8**	**-244.6**	**-321.4**
Social Security	-54.4	-170.0	-224.4
Railroad Retirement	-0.8	-2.3	-3.1
Supplemental Security Income	-4.1	-15.5	-19.6
Civil Service Retirement	-6.2	-19.5	-25.7
Military Retirement	-4.4	-14.3	-18.7
Veteran's Benefits	-2.7	-8.5	-11.2
Earned Income Credit	-6.1	-24.5	-30.6
Other	-0.3	-0.8	-1.1
Offsets	2.4	10.4	12.8
Debt Service	**-13.1**	**-99.3**	**-112.4**
Deficit	**-141.1**	**-511.7**	**-652.8**

Figure 1

Entitlement Savings Eventually Level Off But Tax Increases Keep Going



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For a complete copy of IPI policy report #144, *Adjusting the Consumer Price Index*, written by Gary Robbins, John M. Olin Senior Research Fellow and Aldona Robbins, Bradley Senior Research Fellow, please contact IPI (see page 8) or vist our website at www.ipi.org.

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A General Accounting Office study released by Sen. Dick Lugar found 26,000 cases of deceased individuals being reported on food stamp rolls over the past two years in the states of California, Florida, Texas and New York. The GAO estimated that $8.5 million would have been spent on food stamps for the dead people.

– *Newsday*

A disturbing trend for professional pollsters is the spiraling refusal rate for public opinion surveys. More than half those contacted for (these) surveys now refuse to participate or even take the call, spawning a debate within the polling profession about the validity of such results. Pollsters cite that the dramatic increase in the use of answering machines and Caller ID make it more difficult to get an accurate representation of the general public. "You can compensate for some measure of refusals, but when you reach the 50-60 percent range, it's hard to know if people who don't respond are the same as people who do respond, said Everett Ladd, director of the Roper Center for Public Opinion Research.

– *Dallas Morning News*

The Administration boasts of economic gains since 1993, notably "an increase in family income of nearly $2,200". Median family income did rise from $40,131 in 1993 to $42,300 in 1996. But 1993 was the year in which the President added two new tax brackets for couples earning more than $140,000 and began taxing 85% of Social Security benefits of retirees who made the mistake of working or having saved. And 1993 was the year in which median family income was the lowest it has been since 1985. In 1987 median family income was higher than in 1996. So the "increase in family income" turns out to have been no increase at all—for nine years!

– *National Review*

Before it was purchased by Time Warner, Paragon Cable of New York City reported that collection of overdue bills improved dramatically when the company stopped punishing customers who owed money by cutting off service. Instead, deadbeat subscribers had their signals locked on C-SPAN.

The Pacific SunPoliticians are interested in people. Not that this is always a virtue. Fleas are interested in dogs.

– *P.J. O'Rourke*

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