Treasury
Middle Class
Tax Cut

October 13, 1995

TO: GENE SPERLING

FROM: MARK MAZUR
PAULINE ABERNATHY

SUBJECT: POSSIBLE MIDDLE-INCOME CAPITAL GAINS PROPOSALS

You asked about the possibility of crafting a "middle income" capital gains tax cut proposal, perhaps one limited to taxpayers in the 15 percent and 28 percent tax brackets. This memo responds to your request.

The House-passed capital gains proposal permits taxpayers to index the basis of assets, provides a 50 percent exclusion for net capital gains, and repeals the 28 percent maximum capital gains tax rate. Treasury estimates this to cost about $73 billion over 10 years. (Note that other Treasury estimates presented below are <u>very preliminary</u> and subject to change.)

Limit exclusion to taxpayers in 15 or 28 percent tax brackets

As you know, present law provides a maximum 28 percent rate on capital gains income, regardless of the taxpayer's actual marginal tax rate. Implementing this current law provision requires a complicated schedule that effectively stacks capital gains income last, and then reduces a person's tax liability to the extent the marginal tax rate on these last bits of income exceeds 28 percent.

In principle, it is possible to develop a proposal that reverses this computation. Such a proposal would tax all capital gains income at ordinary rates, and then reduce tax liability to the extent that income attributed to capital gains is taxed at either 15 or 28 percent. The tax reduction could come in the form of a percentage exclusion (e.g., 30 percent) of the amount of net capital gain. However, this proposal would require rather complicated calculations, and would be inconsistent with a desire for tax simplification.

There are probably better ways to accomplish the goal of a middle income capital gains tax cut. A few examples follow:

Phased-out exclusion

Provide a 50 percent exclusion for net capital gains income, but phase out the availability of the exclusion between adjusted gross incomes of $75,000 and $100,000. This effectively targets the tax benefit at those with middle incomes and does it in a way that is both transparent and easy to comply with (i.e., there is no need for fill out a complicated schedule to claim the tax benefit). Treasury has estimated a proposal along these lines as costing about $10-15 billion over 10 years.

Annual exclusion of $5,000 net capital gain

Only about 10-12 percent of taxpayers have a capital gain in any year and the average gain is only about $10,000. Therefore, it should be possible to exclude a fixed amount of gain from tax for everyone and have the bulk of the benefits flow to the broad middle class. (After all, for those with very high incomes, a $5,000 exclusion is not very valuable.) Treasury has examined a proposal along these lines and concluded that it would cost about $30-35 billion over 10 years.

50 percent exclusion up to $1 million over a lifetime

Permit taxpayers to exclude 50 percent of net capital gains, up to a $1 million lifetime limit. About 35,000 taxpayers each year have net capital gains of over $1 million, so these taxpayers would only get one year's worth of benefit. However, most Americans will not be constrained at all by the lifetime cap, and this proposal simply provides them with the same benefit the House-passed 50 percent exclusion provides. It would be interesting to see the House Republicans try to argue for their proposal over this alternative. Treasury has estimated that this would cost approximately $30-40 billion over 10 years.

Exclude gains on all personal residences

Permit taxpayers to never pay tax on any capital gain on their personal residence. Under present law, taxpayers can roll over gains from a personal residence if they purchase another of equal or greater value. Moreover, taxpayers over 55 get a one-time exclusion of up to $125,000 gain on their residence. This proposal builds on current law and would provide a lot of simplification to homeowners who no longer would need to maintain records of basis, etc., in order to compute eventual gain on their house. Treasury estimates that this would cost around $10-15 billion over 10 years.

File:
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Proposed

Agenda (Meeting with Office of Tax Policy)
May 24, 1994

I. Background -- Discussion of President's campaign commitment

II. Children's Tax Credit or Allowance vs. Middle Class Tax Cut -- POTUS prefers the first.

a. Advantages: Pro-Family
Can be targeted
Less costly

III. General Parameters: Limit to $60,000 AGI and below;
Above EITC;
Phaseout after five years, allowance after age nine;

IV. Next Steps: Cost estimate
Treasury review -- produce details on paper

V. Timing POTUS unveil in January.

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EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS

DATE: 5/24/94

TO: Bruce Reed

FROM: Mark Mazur

Here are 2 items that you might find useful.

One is the conference report description of the middle income tax cut passed by the Congress in March 1992 (and subsequently vetoed). Note that the House chose to go with a payroll tax credit (costing about $20 billion per year, I think) while the Senate (Secretary Bentsen's staff) went with a child-based tax credit (costing about $5-6 billion per year, I believe).

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS

DATE:

TO:

FROM:

The second item is a memo we sent to the President on the EITC and the marriage penalty.

I hope you find these helpful.

Mark

From H.R. 4210 - passed by Congress in March 1992 - vetoed by Pres. Bush

I. Income Tax Treatment of Working Families

1. TAX CREDIT FOR MIDDLE-INCOME TAXPAYERS

Present law

Present law provides no income tax credit based on social security tax liability. Under present law, a payroll tax is imposed to finance social security programs through the old-age, survivors, and disability insurance (OASDI) and hospital insurance (HI) trust funds. As of January 1992, the employer and employee each pay an OASDI tax equal to 6.20 percent of the first $55,500 of covered earnings and an HI tax equal to 1.45 percent of the first $130,200 of covered earnings. Self-employed individuals pay tax at the combined employer-employee rate, but are permitted to deduct one-half of the payment as a business expense in determining their income tax liability.

Present law provides no income tax credit to taxpayers on the basis of whether taxpayers have a child residing with them. However, present law permits a personal exemption deduction from gross income for each of the taxpayer's dependent children. For 1992, the amount of this deduction is $2,300 for each exemption claimed. This exemption amount is adjusted annually for inflation.

In addition, low-income workers with children are able to claim a refundable earned income tax credit (EITC) of up to 17.6 percent (18.4 percent for taxpayers with more than one qualifying child) of the first $7,520 of earned income for 1992. The maximum amount of credit for 1992 is $1,324 ($1,384 for taxpayers with more than one qualifying child). This maximum credit is reduced by 12.57 percent (13.14 percent for taxpayers with more than one qualifying child) of earned income (or adjusted gross income, if greater) in excess of $11,840. The EITC is totally phased out for workers with earned income (or adjusted gross income, if greater) over $22,370. The maximum amount of earned income on which the EITC may be claimed and the income threshold for the phaseout of the EITC are indexed for inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates for the EITC change over time under present law, as shown in the following table.

Year	One qualifying child—		Two or more qualifying children—	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1992	17.6	12.57	18.4	13.14
1993	18.5	13.21	19.5	13.93
1994 and after	23.0	16.43	25.0	17.86

House bill

The House bill provides a refundable income tax credit in calendar years 1992 and 1993 for up to 20 percent of an employee's social security tax liability. The employee's social security tax liability equals the sum of the employee share of OASDI and HI tax liability and not the employer portion. In the case of self-employed individuals, the base of the credit will be one-half total OASDI and HI tax liability. The maximum credit is $200 for single taxpayers and $400 for married couples filing joint returns. The income tax credit will not reduce social security trust fund reserves.

Effective date.—The provision is effective for taxable years beginning after December 31, 1991. The provision will not apply to taxable years beginning after December 31, 1993.

Senate amendment

The Senate amendment provides a $300 income tax credit for each qualifying child of the taxpayer. A "qualifying child" is defined as a child under age 16 who resided with the taxpayer for more than 6 months during the taxable year. The tax credit offsets regular tax liability and is not refundable (although, through the offset of tax liability, the tax credit could act to increase the amount of refund from the earned income tax credit that a taxpayer might receive). The credit amount is indexed annually for inflation (though no indexing occurs until the inflation adjustment is greater than $50). In addition, the credit is phased out ratably for taxpayers with adjusted gross income between $47,500 and $60,000 (the phaseout range is not adjusted for inflation).

Effective date.—The provision is effective for taxable years beginning after December 31, 1991.

Conference agreement

The conference agreement follows both the House bill and the Senate amendment, with modifications.

For 1992 and 1993, the conference agreement provides an income tax credit for up to 20 percent of an employee's social security tax liability. In the case of State and local government workers who do not pay FICA taxes, contributions to a retirement plan maintained by the State or local government will be considered equivalent to social security tax liability. The maximum credit is $150 for unmarried taxpayers and $300 for married couples filing joint returns. The tax credit is phased out ratably for taxpayers with adjusted gross income between $50,000 and $70,000 (married taxpayers filing a joint return), or between $35,000 and $50,000 (unmarried taxpayers filing as single or as head of household). The tax credit is refundable to taxpayers with a "qualifying child", for purposes of this credit generally defined as a child under age 19 who resided with the taxpayer for more than 6 months during the taxable year.

For taxable years beginning in 1994 and thereafter, the conference agreement provides a nonrefundable $300 income tax credit (indexed for inflation) for each qualifying child of the taxpayer. For purposes of this credit, a "qualifying child" is defined as a child under age 16 who resided with the taxpayer for more than 6 months during the taxable year. The credit is phased out ratably for taxpayers with adjusted gross income between $50,000 and $70,000 (the phaseout range is not adjusted for inflation).

2. SIMPLIFICATION AND EXPANSION OF EARNED INCOME TAX CREDIT

Present law

Eligible low-income workers are able to claim a refundable earned income tax credit (EITC) of up to 17.6 percent of the first $7,520 of earned income for 1992 (18.4 percent for taxpayers with more than one qualifying child). The maximum amount of credit for 1992 is $1,324 ($1,384 for taxpayers with more than one qualifying child). This maximum credit is reduced by 12.57 percent of earned income (or adjusted gross income, if greater) in excess of $11,840 (13.14 percent for taxpayers with more than one qualifying child). The EITC is totally phased out for workers with earned income (or adjusted gross income, if greater) over $22,370. The maximum amount of earned income on which the EITC may be claimed and the income threshold for the phaseout of the EITC are indexed for inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates for the EITC change over time under present law, as shown in the following table.

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1994 and after	23.0	16.43	25.0	17.86

A supplemental young child credit is available to taxpayers with qualifying children under the age of one year. This young child credit rate is 5 percent and the phase-out rate is 3.57 percent. It is computed on the same income base as the ordinary EITC. The maximum supplemental young child credit for 1992 is $376. If a taxpayer claims the supplemental young child credit, the child that qualifies the taxpayer for such credit is not a qualifying individual for purposes of the dependent care tax credit (sec. 21).

A supplemental health insurance credit is available to taxpayers who provide health insurance coverage for their qualifying children. This health insurance credit rate is 6 percent and the phase-out rate is 4.285 percent. It is computed on the same income base as the ordinary EITC, but the credit claimed cannot exceed the out-of-pocket cost of the health insurance coverage. In addition, the taxpayer is denied an itemized deduction for medical expenses of qualifying insurance coverage up to the amount of credit claimed. The maximum supplemental health insurance credit for 1992 is $451.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

THE CHAIRMAN

October 1, 1993

MEMORANDUM FOR THE PRESIDENT

THROUGH: LAURA D. TYSON

FROM: MARK J. MAZUR

SUBJECT: EITC and the Marriage Penalty

In a recent article in the New York Times, Jonathan Marshall criticized the expansion of the earned income tax credit (EITC) contained in OBRA 1993 for creating a substantial marriage penalty for lower income individuals. You asked how this perceived problem could be "fixed". The problem noted does not lend itself to a simple fix. Instead we are providing some suggestions on how to respond to this type of criticism.

Background on Marriage Penalty: A marriage penalty (or subsidy) exists whenever (i) the income tax rates are progressive; and (ii) there is a filing status that permits individuals to pool incomes and file a return as a single earning entity. Generally, the marriage penalty is larger when the individuals involved have similar incomes.

Application to the EITC: The increase in the EITC contained in OBRA 1993 made the income tax system more progressive for lower income taxpayers. Moreover, since EITC receipt does not turn on marital status, the legislated EITC increases will exacerbate any marriage penalties and subsidies that existed in pre-OBRA 1993 law.

Observations: First, it is impossible to completely eliminate the marriage penalty without eliminating progressive income tax rates in the income-eligibility range or eliminating the potential for married couples to "pool" their incomes and be treated as a single earning entity. Second, it would cost many billions of dollars to substantially reduce the marriage penalty inherent in the EITC expansion by maintaining the same maximum credit and reducing the phaseout rate (which would extend the credit to a relatively populous part of the income distribution). Third, it would probably be politically impossible to reduce the marriage penalty by reducing the maximum credit allowed.

Suggested Actions: Given the foregoing, we suggest making the following points, which address, but don't fix, the problem.

(1) The EITC increase contained in OBRA 1993 both increased and decreased marriage penalties, with the outcome depending on actual household composition and on the size of relative incomes.

(2) Marriage penalties contained in other tax/transfer system programs may be more significant than those for the EITC (e.g., the marriage penalty for an AFDC recipient can be enormous in some States). The issue of marriage penalties is not a concern for just the EITC or for the income tax system.

(3) The Welfare Reform Working Group is aware of the potential for large marriage penalties in tax/transfer system programs and is working to ensure that these are reduced wherever possible as part of its reform package.

Income Distribution

Background

It is widely accepted that income and wage disparities have been growing in this country over the last two decades. The table below shows the fraction of total pre-tax income going to different population segments in 1972 and 1992, the amount of money that would have to be transferred from/to each group to return the income shares to their 1972 levels, and the fraction of income for that group that that amount represents.

Quintile of Family Income Distribution	Income Shares 1972	Income Shares 1992	Shift of Income Needed to Restore 1972 Shares (bil. 92 $)	% Change in Income Needed to Restore 1972 Shares	Change in Effective Average Tax Rate 1977 to 1994
Top 5th	.414	.446	-$97 bil.	-7%	-6.3%
2nd 5th	.235	.240	-$15 bil.	-2%	+1.0%
Middle 5th	.175	.165	+$30 bil.	+6%	-0.3%
4th 5th	.122	.105	+$52 bil.	+16%	+1.9%
Bottom 5th	.054	.044	+$30 bil.	+22%	-3.8%

The last column of the table shows the change in effective average tax rates from 1977 to 1994 (computations for 1972 and 1992 are not readily available).

About half of the growth in wage inequality over the last decade can be explained by a widening of income differences between more and less educated people. College educated workers today earn about 12 percent more relative to high-school educated workers than they did in 1980. Over this period the real incomes of college educated workers rose while the incomes of high school educated workers fell. These changes are attributed to faster increases in the demand for more educated workers at the same time that the rate of increase in the supply had slowed. Therefore, an obvious response is to attempt to increase the supply of more educated workers. James Heckman has analyzed the question of how much would have to be spent on education to 1) raise the earnings of those with a high-school education or less to their 1979 levels and 2) to restore the ratio of incomes between those with a college education and those with less to their 1979 levels without reducing the incomes of college graduates. He concludes that 1) would require at least 640 billion and that 2) would require at least 1.66 trillion. Using a different methodology we estimate that the cost of restoring the high-school/college income ratio to its 1973 level by paying all costs (including foregone earnings) of a one-time increase in the number of college graduates would be about $500 billion.