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THE PEACE DIVIDEND: IT BELONGS TO THE PEOPLE, NOT CONGRESS

INTRODUCTION

As soon as the first holes were punched through the Berlin Wall, and Eastern Europe began its breathtaking rush toward democracy, there was talk in Washington of a "Peace Dividend" and of ways to spend it. With the Cold War now ending, the argument goes, major cuts can be made in the United States defense budget, freeing billions of dollars to tackle America's domestic problems. Indeed, many organizations and lawmakers have held press conferences to outline their views of how this windfall should be spent.

The popular notion of a Peace Dividend available for new federal programs, however, raises two issues that advocates of new spending seem determined to ignore.

The first is whether there really will be such a dividend. A prudent household actually banks the returns on its investments before it spends the money. So far there is no big dividend and there will not be any so long as Eastern Europe and the Soviet Union remain in turmoil and so long as there is no consensus in the U.S. regarding America's future defense needs. Yet the Peace Dividend lobby blithely urges Congress to commit the federal government to huge new programs.

Escaping Spending Limits. The spending lobbies, of course, have a strong incentive to declare the dividend to be real and available, and to press for funds to be committed as soon as possible. This would allow escape from the straitjacket of the Gramm-Rudman-Hollings budget ceiling which has held back the natural appetite of lawmakers to spend. And by committing funds now, and creating the agencies and their satellite interest groups, programs

can be established which will prove politically impregnable should the Peace Dividend turn out to be a financial mirage.

Signs of Instability. There are good reasons to fear that it may be a mirage. For one thing, the euphoria of late 1989 in Eastern Europe is beginning to give way to the stark reality that democracy is a fragile thing. An unstable Eastern Europe, with the Soviet Union on its doorstep, poses many potential security threats to the West. For another thing, increasing signs of instability within the Soviet Union itself — a nuclear superpower — are deeply worrying. It is hardly time to dismantle Western defenses.

The second issue concerns the way any real Pentagon savings should be treated. The Peace Dividend lobby assumes that the only way to solve any problem is to create a new federal program and spend money. As Senator Phil Gramm, the Republican from Texas, observes, as the Vietnam War was winding down, the defense budget was cut by $74 billion between 1970 and 1977. The government spent every penny saved and increased the budget deficit. Yet many of the country's problems, from young families finding it hard to pay for day care to older workers worried about potential nursing home bills, could be solved by tax law changes that put money back in the pockets of Americans. Several tax relief strategies, moreover, are partially self-financing, since they generate new employment and thus new taxpayers and new revenue.

If a Peace Dividend materializes, Congress should consider a number of tax relief strategies. Among them:

♦ ♦ **Roll back the Social Security payroll tax.** This tax strangles job creation and boosts unemployment and welfare dependency among the unskilled. Rolling back the tax to lower rates would reduce welfare and unemployment costs and provide new employment opportunities for Americans.

♦ ♦ **Provide tax relief for the purchase of nursing home insurance.** Many Americans worry about crippling long-term nursing home costs. Some lawmakers want an expensive new federal program to fund such care. A much sounder policy would be to foster the use of long-term care insurance through tax incentives.

♦ ♦ **Increase the personal exemption.** The financial pressures on young families with children have prompted calls for federal day care centers and other programs. But the financial pressures stem in large part from the growing burden of federal taxation. Increasing the federal tax code's personal exemption would return money to these families, reducing or eliminating the need for direct services.

♦ ♦ **Expand the Earned Income Tax Credit (EITC).** The liberal establishment continually argues for more welfare programs, despite mounting evidence that these do very little to reduce long-term poverty and do very much to increase dependency. An alternative would be to give a strong incentive for the poor to join the workforce by expanding the EITC, a wage subsidy

to low-income workers. This would use federal assistance to make work far more attractive to those currently on welfare.

These and similar measures return tax dollars to Americans in ways that address social problems. This is much better than creating new programs to spend taxpayers' dollars in ineffective ways. The Peace Dividend debate offers Congress and the White House the chance to prove that the only way to solve any problem is not to tax and spend. The debate should highlight the benefits of tax relief strategies.

A MENU FOR TAX RELIEF

For each major new spending program now being offered to deal with American problems, there are tax relief strategies that would be more effective. In aggregate, these strategies would cut taxes more than a Peace Dividend would save. Thus the strategies constitute a menu from which lawmakers can select. Several of the proposals, such as cutting the capital gains tax, would yield new revenues or spending reductions that would cover all or much of their cost. In other cases, such as an expanded Earned Income Tax Credit, they would trim costs of existing programs. Even without a Peace Dividend, therefore, many of these proposals would improve policies while reducing the deficit.

Although treated independently, some of these tax relief proposals do overlap. Example: The "toddler tax credit" and the EITC reform assist similar populations of low-income families. If the "toddler tax credit" were enacted, the EITC expansion could be scaled back without a loss of income to low-income parents. Thus the cumulative revenue cost of all the proposals, if enacted together, would be well below the cumulative total of the estimates for each program.

Among the most important tax-relief strategies lawmakers should consider:

1) Roll Back Social Security Payroll Taxes and Return Social Security to Pay-As-You-Go Financing.

Revenue Reduction:[1] $55 billion per year after 1990.

Offsetting New Revenues:[2] $15 billion in income tax and payroll taxes from new jobs.

Ever since the Social Security system was created in 1935, the burden of federal payroll taxes on middle-income families has risen continuously. In 1937, the payroll tax was set at two percent of payroll income under $3,000; by 1980 it was 12.3 percent; and this year it climbed to 15.3 percent of income

1 Estimated reduction in revenues from the specific tax.

2 Estimated new revenues from other taxes, or reduction in outlays, from the policy change.

under $51,300. Half of these taxes are paid directly by the worker and half paid indirectly by the worker as payments by the employer. Counting the employer's contribution, in 1990 an American worker will pay up to $7,800 in payroll taxes.

As a result of seven payroll tax hikes in the 1980s, the vast majority of American workers now pay a larger share of their total income in federal taxes than they did in 1980. This means that for most of middle-income America, creeping Social Security tax increases have eroded all of the income tax relief provided by Congress and Ronald Reagan in 1981. Moreover, 80 percent of American families now pay more in federal payroll taxes than in federal income taxes.

Worthless IOUs. Today's high payroll tax rates are not necessary to keep the Social Security program in the black for at least the next three decades. Nor are they being used to build up a Social Security trust fund reserve to pay benefits in the next century when the "baby boom" generation retires. Rather, Congress continues to raid the Social Security trust fund to pay for other programs. There is no money in the "trust fund"; all that is there is a stack of government IOUs. When the baby boomers retire in the next century and demand payment of their retirement benefits, the Social Security trust fund will be holding as much as $12 trillion of worthless IOUs. To redeem them, the Treasury will have to raise taxes, borrow, or print money.

Social Security taxes should be enough only to finance current outlays -- a pay-as-you go system. This would allow the payroll tax to be trimmed by about 2.2 percentage points, giving Americans a $62 billion tax cut over the next two years and even more in future years. Senator Daniel Patrick Moynihan, the New York Democrat and Chairman of the Senate Finance Subcommittee on Social Security, has proposed such a plan. He correctly emphasizes that such a tax cut would not affect Social Security benefits; it simply would end the fiction that contributions are being put aside to pay for future benefits.

Fueling Growth. More important, a payroll tax cut would fuel productivity growth, job creation, and higher American living standards. The payroll tax has proved to be one of the most economically destructive ways for the government to raise revenues because it deters businesses from hiring new workers and expanding output. Former U.S. Treasury economists Aldona and Gary Robbins estimate that the 1988 and 1990 payroll tax hikes rob the American economy of 510,000 jobs and reduce the nation's GNP by $320 billion over ten years. By contrast, they argue, every dollar reduction in Social Security taxes would expand economic output by 68 cents.

Some critics, however, complain that today's high Social Security taxes are needed to keep the retirement program solvent in the next century. But a decade of experience convincingly demonstrates that Congress is unable to avoid the temptation to spend excess Social Security funds. With or without a tax cut, no reserve funds will be accumulated. The best way to ensure the ability of the Social Security system to pay future benefits is through pro-growth tax policies today, so that future workers are able to finance future

benefits without heavy taxes. For instance, if real per capita income in the U.S. rises 2 percent per year between now and the year 2030, about the rate during the 1980s, real incomes will be twice what they are today. Cutting payroll taxes will make such growth more likely. Allowing recent payroll tax hikes to remain in place will slow down growth.

Those who argue that the payroll tax should not be cut because this will inflate the budget deficit also are mistaken. Regressive Social Security taxes were never intended to finance the budget deficit or any government program other than Social Security. Moreover, a payroll tax cut would not preclude a balanced budget by 1994. The deficit can be eliminated, without new taxes, by freezing all non-Social Security spending for the next four years. Alternatively, if all non-Social Security spending is held to 2 percent growth for four years, the budget deficit will fall to below 2 percent of gross national product in 1994. This would be one-third the level of annual debt ten years earlier and below the deficit rate for most industrialized countries. Neither of these projections, moreover, assumes the stimulative economic effect of the payroll tax cut. Yet a tax cut would spur faster job creation, thereby increasing income tax revenues and reducing welfare outlays, thus helping to reduce the deficit.

2) Reduce the Tax Burden on the Elderly by Eliminating the Social Security Earnings Test.

Revenue Reduction: $5 billion per year

Offsetting New Revenues: $2.6 billion per year in taxes from extra work performed by the elderly.

Federal tax policies are keeping out of the labor pool a group of workers that is growing in number and possesses needed skills – Americans over age 65. The federal government now slaps the working elderly with so many tax penalties that hundreds of thousands literally find it too expensive to work. The most onerous of these tax penalties is taxation of Social Security benefits and the "earnings test," which reduces Social Security benefits for working senior citizens. These taxes and benefit reductions impose marginal tax rates of 50 percent to 70 percent on many elderly workers. Americans who continue to work after age 65, and do not apply for any Social Security benefits, do receive a 3 percent increase in their monthly Social Security benefits when they eventually retire. This is known as the Delayed Retirement Credit. Yet the credit is insufficient to restore lifetime Social Security benefits to those who continue to work after the age of 65.

Today more than 80 percent of all men and 90 percent of all women over age 65 are fully retired, many because they no longer find it worthwhile to work. The federal tax code should not discourage older Americans from working and contributing to economic growth. To end this disincentive, the Social Security earnings test for workers between ages 65 and 69 should be eliminated (there is no penalty on those older than 70). The earnings test re-

quires workers in this age group with earnings over $9,360 to forfeit one dollar of Social Security benefits for every three dollars earned from working. This is an effective 33 percent tax on earnings, on top of all the other federal, state, and local taxes that are deducted. The main effect of this heavy tax is to drive many low- and middle-income senior citizens out of the labor force. Some 500,000 moderate income seniors with incomes below $40,000 per year are penalized by the earnings test. The average Social Security benefit is now about $600 per month, and many retirees who depend only on Social Security income live at or near the poverty level. Many must work to supplement their Social Security payments to make ends meet. But today, elderly Americans with earnings as little as $5.00 an hour can be hit by the earnings test work penalty.

"Freedom to Work." Senator William Armstrong, the Colorado Republican, introduced legislation last session that would raise the income threshold level on the earnings test gradually so that it affects fewer moderate income elderly. This would be a desirable reform. Better would be the "Older Americans' Freedom to Work Act," sponsored last year by Representative Dennis Hastert, the Illinois Republican. This bill, with more than 100 cosponsors, would repeal the earnings test entirely.

Some in Congress claim that eliminating the earnings test would increase benefit payments substantially and thus add to the federal budget deficit. The Congressional Budget Office has estimated that earnings test repeal would cost up to $5 billion annually. But these estimates ignore the work incentive of eliminating the tax. Extra work by the elderly means more regular income tax revenue. The additional taxes paid by the elderly who increase their hours worked would recapture about one-half of these costs, according to a study by Stephen Entin of the Washington-based Institute for Research on the Economics of Taxation.

3) Index Social Security Benefits for Inflation.

Revenue Reduction: $430 million per year

Offsetting New Revenues: Negligible.

One of Ronald Reagan's primary economic policies was to stop government from using inflation to capture an increasing share of each American's paycheck through the tax code. Reagan successfully urged Congress to index federal tax rates, so that inflationary rises in income would not push taxpayers into ever higher tax brackets. Indexing taxes for inflation now extends to most aspects of the tax code.

Penalizing Senior Citizens. Yet for the elderly, the group generally most harmed by inflation's erosion of savings, the tax code still explicitly penalizes gains due exclusively to rising prices. The reason: All Social Security benefits collected by elderly Americans with gross income over $25,000 are treated as taxable income at a rate of 50 cents for every additional dollar earned. This

pushes an elderly worker in, say, the 28 percent tax bracket into an effective 42 percent bracket, and thus destroys work incentives. The income tax threshold level of $25,000 ($32,000 for working couples), moreover, is not indexed to inflation, unlike the rest of the personal income tax code. Hence, when incomes are raised to keep up with inflation, a larger number of middle income elderly are subject to the tax, even though their real incomes have not risen. Failure to index the tax on Social Security benefits to inflation is Congress's back door way of raising taxes on senior citizens.

Even if congressional supporters of repealing the Social Security earnings test are successful, the beneficial impact of this reform would be reduced because of the tax treatment of benefits. Some 300,000 working elderly already are subject to both the earnings test and the Social Security benefits tax. To end this unfair tax penalty on the elderly, Congress should index the income threshold level of the benefits tax so that inflation does not reduce real incomes of elderly working Americans.

4) Increase the Personal Exemption to $6,300 for Each Child Under Age 18.

Revenue Reduction: Raising the personal exemption from $2,000 to $6,300 per child under age 18 would cut income tax revenues by about $40 billion a year.

Offsetting New Revenues: None

The federal income tax burden on American families with children has soared by over 2,500 percent since 1948 from 0.3 percent of income to 8 percent. Four decades ago, a family of four at median family income paid virtually no income taxes, and only $60 a year in Social Security taxes (2 percent of income). This year, the equivalent family will pay $2,787 in income taxes and over $5,000 (15.3 percent of income) in employee and employer shares of the Social Security tax. Single individuals and married couples without children have not had their taxes increased to the same extent and today pay about the same portion of their income in income taxes as they did in the 1950s.

The main reason that young families now pay a disproportionate share of taxes is the erosion of the value of the personal exemption. In 1948, the personal exemption of $600 equalled 42 percent of average personal per capita income, which was then $1,434. Over the following 35 years, the personal exemption lagged far behind as income rose and inflation soared. While the 1986 tax reform has raised the exemption to $2,000, this only partially offsets the erosion in value since the 1940s. To have the same value relative to income it held in 1948, today's personal exemption would have to be raised to around $6,300.

Young families are hard-pressed to meet the housing, health, education, and day care costs of raising children. The financial difficulties experienced by families have led to a call for government assistance in the form of new or

larger social programs, such as day care, additional health benefits, and help in renting or purchasing a home. If the tax burden on families were reduced, however, most families could meet their children's needs according to their own priorities and would not need new government programs.

The current $2,000 personal exemption for children under age 18 should be returned to its post-World War II value; this would be $6,300. At this level, the personal exemption would shield from taxes about the same portion of income as it did in 1948. This "children's exemption" would allow families to keep more of their income to pay for the costs of raising children and the pressure for new federal programs would be reduced.

5) Provide Tax Credits to Households to Cover Medical Expenses and Health Insurance Premiums.

Revenue Reduction: $40.9 billion (in 1991 dollars) when fully enacted.

Offsetting New Revenues: $40.9 billion (in 1991 dollars) when fully enacted.

The U.S. spends far more than any other country on health care (over 11 percent of GNP) yet as many as 37 million Americans lack health insurance, while inflation plagues the health care system. Prices have been rising rapidly because most Americans receive health care benefits through their employers as tax-free income. Employees tend to view these benefits as "free" and therefore have little concern about the cost of health care services they use. Similarly, health care providers know that their patient is not paying directly for his or her care and so they, too, have little incentive to curb costs.

The tax code, meantime, favors company-based health plans, while individuals purchasing their own health insurance generally must pay the full cost for protection, without tax relief. Thus workers in small firms (which do not tend to provide health benefits), or workers in firms that do not cover dependents, are discouraged by the tax code from purchasing adequate health insurance.

Incentive to Insure. The problems of escalating health cost and gaps in insurance coverage can be addressed by changing the tax treatment of medical care and health insurance premiums. Congress gradually should end the tax-free fringe benefit status of company-based health plans, thereafter counting the value of such plans as a taxable part of each employee's wages. Then, to help employees carry this extra cost, Congress should replace this tax benefit with a new system of tax credits in the personal income tax code to offset the cost of purchasing health insurance or health services directly. This would give the uninsured a tax incentive to purchase adequate insurance, while those currently with insurance would have a greater incentive to question the cost of their medical services and insurance since they would be paying for it directly.

Specifically, a 20 percent federal tax credit should be provided for the purchase of insurance coverage that meets basic requirements. In addition, a

credit should be available for out-of-pocket medical expenses. This percentage credit would increase as total medical expenses rise as a percentage of family income. By providing a larger credit for out-of-pocket expenses, this reform would encourage families to pay directly for routine, inexpensive services and to reserve insurance for potentially higher costs. This would encourage patients to "shop around" for routine services and to question costs more aggressively, thereby helping to moderate charges.

The first stage of such a tax incentive for medical insurance is contained in legislation passed last year (S. 5) by the Senate. The measure, introduced by Senator Lloyd Bentsen, the Texas Democrat and Chairman of the Senate Finance Committee, provides a tax credit for insurance to cover children not covered by a company plan. Congress should expand this credit, first to all dependents and then to all households, and offset the revenue loss with a gradual phase-out of the tax-free status of company-provided health plans.

6) Provide Tax Incentives for the Purchase of Long-Term Care Insurance.

Revenue Reduction: $560 million per year.

Offsetting New Revenues: None.

Working Americans increasingly are concerned that long-term nursing home costs could wipe out their savings retirement. Some in Congress argue that the way to remove these fears is to create a new federal entitlement program for nursing home care, with the federal government paying for these costs. But such an entitlement would invite a surge in nursing home charges, and the prospect of Uncle Sam ultimately paying for care would remove all incentive for today's workers to save for their own potential long-term care costs. Congress should recognize instead that the best way to protect savings and other assets from the ravages of nursing home costs is through insurance. Americans use life insurance and homeowners' insurance to protect their assets from catastrophes. They should be encouraged to purchase long-term care insurance for the same purposes.

Currently very few Americans buy long-term care insurance. To change this, the tax code should encourage working Americans to buy long-term care insurance as a routine way to protect their assets, just as they routinely buy life insurance. In addition, the government could give today's elderly tax assistance to pay for nursing home costs. This could be done in several ways. First, holders of Individual Retirement Accounts (IRAs), 401(k) plans, and similar tax-deferred savings plans could be allowed to withdraw funds, tax free, to purchase long-term care insurance. Second, Americans could use the tax credits detailed above for purchases of long-term care insurance and nursing home costs. And third, there should be no tax on "benefits" that insurance companies permit policyholders to draw down from life insurance policies to pay for nursing care during a terminal illness. The Prudential Insurance Company of America, and some other companies, already do offer policyholders

the right to receive benefits before death in certain circumstances. But it is unclear whether these benefits are taxable under current law. They should be treated the same as life insurance benefits paid out when the policyholder is deceased, which are not taxable.

7) Designate 100 Federal Enterprise Zones to Spur Economic Development in the Inner Cities.

Revenue Reduction: $660 million per year.

Offsetting New Revenues: The tax losses would be offset by reductions in federal outlays thanks to reduced rates of unemployment, lower demand for welfare services, and a long-term tax base broadened by increased employment and the creation of new businesses. These savings could equal the direct revenue losses of the program.

For decades the federal government has poured billions of dollars into America's inner cities with little impact on the economic and social condition of these neighborhoods. Indeed, ill-conceived federal projects and increased welfare dependency seem to have hastened the decline of many cities.

In the late 1970s, however, several politicians and scholars proposed a new approach to combat urban blight, known as "enterprise zones." In contrast to the traditional strategy of pouring government programs into the inner cities, the enterprise zone proposal involved reducing government intervention by reducing federal regulatory and tax burdens to provide incentives for economic development. The idea was to remove costly barriers to local entrepreneurs. The enterprise zone concept, pioneered in Britain, was introduced in the U.S. in 1979. A majority of states now have some enterprise zone programs. There is evidence that the economic activity generated by these zones in many cases more than compensates for revenue lost through the incentives. A 1988 report commissioned by the New Jersey Department of Commerce, Energy and Economic Development, for instance, finds that the state enterprise zone program has created between 16,000 and 42,000 new jobs in depressed urban areas and raised between $1.90 and $5.20 in new state tax revenue for every dollar lost.

Dropping Barriers. The states, however, can only provide partial enterprize zone incentives. Many of the tax burdens stifling inner city enterprise are federal. Comprehensive federal enterprise zone legislation thus is needed to complement local versions by reducing the federal tax burden.

A system of federal zones would mean federal tax and regulatory relief in addition to state incentives and thus remove more barriers to inner city ventures. A federal enterprise zone should remove regulatory barriers to development, ease the transition of new employees to work from welfare, and help new businesses maintain cash flow and attract investment. Federal legislation also should offer tax incentives, as proposed last year by Housing and

Urban Development Secretary Jack Kemp, and contained in several congressional bills, including measures introduced by congressional leaders of both parties. These bills include such incentives as an increase in the earned-income tax credit to low-income employees, a one-time capital gains tax exemption of $100,000 for the owner-operator of a small business, and capital gains tax relief for investments in zone-based businesses.

8) Reduce the Capital Gains Tax.

Revenue Reduction: None
Offsetting New Revenues: $3.2 billion annual average.

The capital gains tax, which stood at 25 percent through most of the 1950s and 1960s, was increased by the federal government starting in 1968, until it reached a top rate of 34.13 percent in 1978. The rates then were brought down over the next decade, falling to 20 percent by 1982. Then the 1986 tax reform law brought the rates back up to a maximum of 33 percent.

A tax on gains realized from the sale of such capital assets as stocks, bonds and land discourages productive investments, and slows economic growth by discouraging investment. Making matters worse, the current capital gains tax constitutes a triple tax on risk-taking investment. The first tax, the corporate tax, is paid by the enterprise on its profits. A second tax, on personal income, is paid when profits are distributed to shareholders in the enterprise. The third tax, the capital gains tax, is paid on the increased value of the stock when it is sold – and part of this is a tax on a mere paper gain because of inflation.

Spurring Investment. The capital gains tax thus penalizes and discourages productive new investments and movements of capital from less productive to more productive uses. High capital gains taxes also mean less money for the Treasury. Lower rates encourage greater business activity and stock turnover and bring in more tax revenue, as they did in 1979 and 1982 after cuts in the capital gains tax. Harvard economist Lawrence B. Lindsey, now Associate Director for Domestic Economic Policy at the White House, estimates that the federal Treasury will lose between $27 billion and $110 billion dollars in revenue between 1987 and 1991 due to the 1986 increase in the capital gains tax from 20 percent to 33 percent in 186. Lindsey suggests that the rate that will produce maximum federal revenue is around 15 percent.

Cutting the capital gains tax from the current 33 percent rate to 15 percent would spur greater productive investment in the U.S., creating more jobs and making America more competitive. But it would also generate more revenue for the federal government, allowing greater tax cuts in other areas.

9) Expand the Earned Income Tax Credit.

Revenue Reduction: $12 billion per year if combined with an increase of the personal income tax exemption for children to $6,300.

Offsetting New Revenues: None.

The goal of welfare policy should be to strengthen families and encourage self-sufficiency. Welfare programs thus should reinforce the efforts of the poor to help themselves rather than promoting the prolonged dependency that is harmful to the recipient and costly to the taxpayer. Because two-parent families provide a healthier environment for raising children and are less prone to poverty than single parent families, government policy should protect and promote two-parent families wherever possible.

Tax Relief. Today's welfare system, however, generally promotes family disintegration and dependency. An exception to this is the Earned Income Tax Credit (EITC). The EITC is a tax credit for low-income workers. This tax relief is, in effect, an earnings subsidy, obtained from the Treasury, to supplement the take-home wages of these workers. Moreover, the EITC is "refundable," meaning that if the worker's credits exceed his total tax liability he receives the difference in a check from the government. The credit is restricted to low-income employed parents with children. Currently parents can receive a credit equal to 14 percent of their earnings below $7,000 per year. As earnings rise above $7,000, the credit gradually is phased out.

The EITC promotes family stability and self sufficiency. First, it targets assistance to those in greatest need – low-income families with children. Second, it is available to intact two-parent families as well as single parent families, unlike many other welfare benefits. Third, it is linked to work rather than to inactivity. And fourth, it encourages work by providing higher benefits as work effort increases.

Encouraging Self-Sufficiency. Expanding the EITC would increase the incentive for low-income families to take a job and become self sufficient. Currently the credit is not adjusted for family size. The value of the credit should be increased, and the credit should rise with the number of children so that families in the greatest need get a larger credit. An additional credit also should be awarded for dependent spouses to encourage the formation and maintenance of intact two parent families.

A restructured EITC should provide a credit equal to 8 percent of earnings up to $9,000 per year for a dependent spouse and each school age child within the family, up to a maximum of three credits per family. Each pre-school child or dependent spouse caring for a pre-school child should receive a credit equal to 12 percent of the family's earned income, up to a maximum of three credits per family.

Under this system a two-parent family with two school age children would receive a maximum credit of 24 percent of family income, or $2,250 a year. A two-parent family with two preschool children would receive a maximum credit of 36 percent of income, or $3,240 per year.

Escaping Poverty. This EITC expansion would go a long way toward eliminating poverty among working families. When combined with other welfare programs such as food stamps, the expanded EITC would give a single working mother with one or two children a family income above the poverty level even if the mother earns only the minimum wage. A two-parent family with two children would have an income above the poverty level if the father worked a full year and the mother worked a quarter of the year at the minimum wage.

How much revenue the Treasury would lose because of an expanded EITC would depend mainly on the rate at which the credits were phased out for families with incomes above $9000. Phasing out the EITC gradually is necessary because losing the credit means the family in effect faces a higher marginal tax rate. The more rapid the phase out of the credit, the higher becomes the family's marginal tax rate. But if an expanded EITC were to be combined with an increase to $6000 of the personal exemption for children in the federal income tax, the proposed EITC credits could be phased down to zero for families with incomes above $23,000 without imposing unduly high marginal tax rates.

10) Provide a Toddler Tax Credit

Revenue Reduction: $10 billion per year.

Offsetting New Revenues: None.

The major problem facing American families today is overtaxation. In 1950 the median family of four paid just 2 percent of its income to the federal government in taxes. Today that same family pays 24 percent of its income to the federal government. This overtaxation places severe financial pressures on most families, particularly on families with pre-school children. These families either must forego the income of a second parent, so that this parent can care for children in the home, or must pay high costs for non-parental day care.

The current "child care crisis" is caused by this excessive government taxation. Government tax policy is pushing millions of parents of infant children into the labor force contrary to their wishes; these parents are forced to place their children in paid non-parental care despite the fact that nearly all parents agree that parental care is best for children.

Over 80 percent of the pre-school children using day care come from two-parent two-earner families. Nearly all mothers say that they would prefer to remain at home with their children if they could financially afford to do so.

Day Care Industry. The liberal response to these pressures on the modern family is to tax families even more heavily and create a system of government-approved secular day care centers. Under this plan, money would be taken from the pockets of families and given to an industry funded by taxpayers to care for America's children. Polls show, however, that this is the childrearing

option parents least prefer. The alternative is to eliminate the original financial problem by reducing the tax burden on families with young children. Parents could use the added take-home pay to allow a parent to stay home to care for pre-school children in the home. Or parents could use the extra income to pay for day care that they, not the government, select: care by relatives, friends, neighbors, and religious day care organizations, for example.

One proposal to reduce taxes on families is known as the "toddler tax credit." Under this plan, a tax credit equal to 10 percent of earned income would be available to families with an annual income below $10,000 for each pre-school child (up to a maximum of two children per family). The credit also would be refundable, meaning that if the available credit exceeded the family's tax liability, that family would receive the difference in a check from the Treasury. For families with earned incomes between $10,000 and $30,000 the credit would equal $1,000 per child with a maximum limit of $2,000 per family. The credit would be phased down to zero for families with incomes between $30,000 and $40,000.

11) Expand Individual Retirement Account Eligibility.

Revenue Reduction: $4.5 billion per year.

Offsetting New Revenues: Negligible.

By historical standards, Americans do not save enough. An Individual Retirement Account is an excellent vehicle to encourage savings. With an IRA, a taxpayer can obtain a tax deduction for deposits made into such accounts with both interest and profits on such deposits accumulating tax free until they are drawn out upon retirement. The Tax Reform Act of 1986 sharply restricted IRAs.

Before this IRAs were the only vehicle available to virtually all workers in all circumstances. IRAs avoid all vesting problems, since funds paid into an IRA immediately belong to the worker. The accounts avoid all portability problems, since the IRA funds are under the worker's ownership and control wherever she or he goes. Other pension plans usually are not fully available to a worker unless she or he remains for several years with a particular company. Thus IRAs offer workers greater freedom and control than Social Security or work pensions.

Expansion of IRA eligibility also would help raise America's savings rate by eliminating some of the discrimination in the tax code against savings. The current tax system discourages savings by effectively taxing it twice: first when it is accumulated through earnings and again when the savings generate interest. In effect, the tax code makes it twice as costly to save as to consume. The IRA deduction reduces the impact of this double taxation by allowing Americans to defer taxes until retirement.

Stimulating Savings. The evidence suggests strongly that IRAs stimulate private saving. A study by economists David Wise of Harvard and Steven Venti of Dartmouth finds that 45 percent to 55 percent of IRA contributions are new savings by individuals, 35 percent constitutes money that would have been taxed had it not been deposited in an IRA, and only 10 percent to 20 percent represents money that would have been saved anyway and is merely shifted to an IRA from some other form of savings.[3]

Other countries provide various tax incentives to stimulate saving. Japan, for example, effectively exempts interest income from taxes – it also enjoys one of the highest personal savings in the world. Canada gives tax relief on up to $1,000 of investment income each year on Canadian investments.

To encourage savings and to help Americans better plan for their retirement, IRA eligibility should be restored to all individuals, whether they are under private pension plans or not. Further, the amount that can be deposited in an IRA for a non-working spouse should be raised from $250 to $2,000.

CONCLUSION

The headlong rush in Washington to spend the anticipated Peace Dividend is symptomatic of two instincts of Congress: to use any excuse to create a new program; and to create a spending program rather than to reduce taxes, since a new program suggests that lawmakers are "doing something" to solve a problem. New programs create a constituency of providers and service recipients who are inclined to be grateful at election time.

But the range of problems now facing Congress, from concerns about day care to worries about the cost of nursing home care, are examples of how returning money to Americans, through carefully-crafted tax cuts, would be far better than taking dollars from Americans and then giving them services to offset their lack of personal resources. The prospect of a Peace Dividend is like a new jar of honey for the interest groups in Washington and lawmakers who have an electoral interest in serving these constituencies. It has given new vigor to a Congress that has been constrained for years by the need to keep within Gramm-Rudman-Hollings guidelines for reducing the deficit. Suddenly lawmakers can claim that billions of dollars are now available for new programs.

3 Steven Venti and David Wise, "Tax-Deferred Accounts, Constrained Choice and Estimation of Individual Saving," *Review of Economic Studies*, August 1986, pp. 579-601. See also Steven Venti and David Wise, "Have IRAs Increased U.S. Saving?: Evidence From Consumer Expenditures Surveys," National Bureau of Economic Research *Working Paper* No. 2217, April 1987; and R. Glenn Hubbard, "Do IRAs and Keoghs Increase Savings?" *National Tax Journal*, March 1984, pp. 43-54.

Dividend for Taxpayers. Americans should be skeptical about the Peace Dividend. They should insist on seeing real defense savings materialize before those savings are committed to new programs. And they should remind their representatives in Congress that dividends normally are paid to investors, not kept by the corporation. To the extent that there is a Peace Dividend, it should be returned to taxpayers in ways that address the problems faced by ordinary Americans, and not kept in Washington to finance a congressional spending spree.

The Heritage Foundation
Domestic Policy Studies Staff

Stuart M. Butler, Ph.D., editor