The Clinton Tax Plan: The Tax Policy Pendulum Swings Back

John E. Chapoton

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I. INTRODUCTION

When Ronald Reagan took office in January of 1981, the highest individual income tax rate was 70% and the highest corporate tax rate was 46%.[1] By the time President Reagan left office in January 1989, the highest individual income tax rate was 28% and the highest corporate tax rate was 34%.[2] This drastic swing of the tax policy pendulum toward favoring saving and capital investment coincided with dramatic economic expansion and unprecedented budget deficits. With ever growing deficit pressures and Congress's inability to control spending, President Clinton's revenue package will swing the tax policy pendulum back toward increasing the share of taxpayers' income claimed by the government.

This Essay will examine President Clinton's fiscal program, why it has been forced on us, why it has been forced on *him*, and then try to predict its future. The Clinton program is not all taxes by any means. It is really a three-part program: stimulus, investment, and deficit reduction. The now defunct short-term stimulus package was designed to get the economy moving again and, considering the size of the U.S. economy, was quite small—$16 to $20 billion in short-term spending and another $5 or $6 billion in tax stimulus.[3] The second part of President Clinton's program is the "investment" package, which is a longer term spending package.[4] The third part of the package is the deficit reduction effort; thus, this part of the package received the most attention during the campaign.[5]

II. AN OVERVIEW OF THE CLINTON PROGRAM

A. Stimulus

The stimulus package was referred to in the Clinton camp as a down payment: speeded-up spending on infrastructure, technology, and urban

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1. HOUSE WAYS AND MEANS COMM., 102D CONG., 1ST SESS., OVERVIEW OF THE FEDERAL TAX SYSTEM 55-57, 72 (Comm. Print 1991).

2. *Id.* at 55-57, 72.

3. *See* STATEMENT OF COUNCIL OF ECONOMIC ADVISORS CHAIR LAURA D'ANDREA TYSON BEFORE JOINT ECONOMIC COMM., Feb. 23, 1993, at L-3 to L-4 (describing economic stimulus as originally proposed) [hereinafter ECONOMIC ADVISORS]; Alexander Polinsky, *Jobs Bill Defeat May Put Pressure on Tax Bill*, 59 TAX NOTES 593 (May 3, 1993) ("Unified Senate Republican opposition to President Clinton's $16 billion job stimulus program resulted in a stunning legislative defeat for the new administration on April 21").

4. *See* ECONOMIC ADVISORS, *supra* note 3, at L-4 to L-5 (describing investment program).

5. *See id.* at L-5 to L-6 (describing deficit reduction program).

development programs, environmental and energy measures, and the investment tax credit. In an economy with a gross national product approaching $6 trillion dollars,[6] a $20 billion stimulus package would have had little effect. Indeed, there is some question whether it would have had any nonpolitical effect whatsoever.

B. Investment

The longer term "investment" program has a number of facets. President Clinton labels this part of the investment program "Rebuild America."[7] It includes proposals dealing with transportation, the environment, and energy. While some feel that infrastructure spending has been neglected for a number of years, it is questionable how much of a stimulating effect government spending can have. Again, in an economy of our size, government can spend $100 billion or $150 billion, and it is still a mere drop in the bucket. Only private sector spending can produce a major sustained impact on the United States economy; this is a point President-elect Clinton had himself made during the Little Rock "economic summit" in late 1992. Nonetheless, a major prong of the Clinton package is a spending program. While it is politically popular to vote for spending packages, it is also politically risky this year because of the budget deficit. For the first time in many years, people are worried about deficits; thus Congressmen are worried about voting for spending without having an opportunity to vote for deficit reduction at the same time. That is the dilemma they are now facing, and it is thus a problem for President Clinton as well.

C. Deficit Reduction

That brings us to the third part of the package—deficit reduction. We can thank in large part Mr. Perot's television appearances and the charts he used in those presentations for bringing the deficit front and center in the public eye like it has never been before. Mr. Perot argued persuasively that the deficit is a monumental problem on which we must take decisive action soon. Then President Clinton, in his speech to the joint session of Congress on February 17, did an extremely effective job of describing what the deficit will do to us and our children if we fail to act.[8] The President was particularly persuasive in pointing out the large portion of the federal budget that will be consumed by interest expense and health care costs if

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6. Gene Steuerle, *Fiscal Stimulus and a Growing Economy*, 57 TAX NOTES 1597, 1598 (Dec. 14, 1992).

7. *See* ECONOMIC ADVISORS, *supra* note 3, at L-4.

8. Dana Priest, *For Clinton, Health Care Reform Is Not Mere Political Hyperbole*, WASH. POST, Feb. 19, 1993, at A18 (describing President Clinton's "State of the Union" address including portion on deficit impact).

we do nothing. The questions are: how will President Clinton's program work, and who is going to suffer the pain?

The first phase of the Clinton deficit reduction program contains some reductions in government spending. Because it is very difficult to talk about specific government spending in a speech to Congress, the President talked in general terms, stating simply that he was proposing 150 specific cuts.[9] The complaint then, now, and over the next several months is going to be whether there are enough real spending cuts. There are some real spending cuts. There are cuts in government pay—including a freeze on government salaries for a year, and then a slower than scheduled increase—and there are even some cuts in the entitlement programs, though not many.[10] But politically the issue is whether the spending cuts are both real and are large enough in relation to the tax increases the President proposes.[11]

A second phase of the deficit reduction part of the Clinton program is what I refer to as reverse spending cuts. Several of the items labeled "spending cuts" in the Clinton package are in actuality increased taxes on government benefits or user fees for government services. For example, the Administration originally listed the proposed increased tax on social security benefits as a spending cut.[12] Under current law, 50% of social security benefits received by taxpayers with an income of more than $25,000 is subject to tax.[13] Clinton is proposing that 85% of social security benefits (again for taxpayers who have more than $25,000 in income) be subject to tax.[14] Although in my view this is an appropriate change in the law, it is clearly a tax increase and not a reduction in government spending. (The Administration has since recategorized it.)[15]

The third phase of Mr. Clinton's deficit reduction program is straightforward tax increases. Individual rates would increase to 36%[16] plus a surtax for the highest incomes; corporate rates would rise to 36%[17] as well. Further, a new and complex energy tax would be imposed.[18]

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9. David S. Broder, *Clinton Plan Arouses Skepticism*, WASH. POST, Feb. 19, 1993, at A14.

10. *See* ECONOMIC ADVISORS, *supra* note 3, at L-5.

11. *No More Something for Nothing . . . We're All in This Together*, BOSTON GLOBE, Feb. 18, 1993, at 14 (discussing President Clinton's call for freeze on salaries of federal employees).

12. *See* ECONOMIC ADVISORS, *supra* note 3, at L-5.

13. I.R.C. § 86 (1988).

14. Gene Steuerle, *Taxing Social Security Benefits*, 59 TAX NOTES 699 (May 3, 1993).

15. *See generally id.* While beyond the scope of this essay, treatment of social security and medicare and medicaid in the future is a generational problem that bears significant attention. These programs tax the current workers of America to support the retired workers of America. Current demographical trends result in fewer and fewer workers for each retired person, social security is a very expensive thing to promise.

16. TREAS. DEP'T, SUMMARY OF THE ADMINISTRATION'S REVENUE PROPOSALS 34 (1993) [hereinafter ADMINISTRATION'S PROPOSALS].

17. *Id.* at 44.

18. *Id.* at 64-65 (discussing "Btu Tax").

III. The Tax Specifics

A. Individuals

President Clinton proposes to increase the top marginal rate from 31% to 36% on joint returns with taxable income of more than $140,000.[19] In addition, the proposal would add a (1) "millionaire's" surtax (a 10% surtax on incomes over $250,000),[20] (2) an increase in the alternative minimum tax rate (from 24% to 28%),[21] and (3) a removal of the cap on wages subject to the Medicare hospital insurance tax (having the effect of a 1.45% additional tax on income over $135,000).[22] So the rate increases add up: 31% to 36% over $140,000 of income, 39.6% over $250,000 of income, plus the 1.45% hospital insurance tax over $135,000 of income, resulting in a top tax rate on upper income individuals of over 41%.[23] An increase in individual marginal rates from 31% to over 41% will affect a lot of people—individuals that operate small businesses as sole proprietorships, partnerships, or S Corporations.

Given these significant increases in tax rates on upper income individuals, one might expect a substantial reduction in the budget deficit, but that does not necessarily follow. These taxes would raise approximately $35 billion per year when fully effective in 1998, a significant amount of revenue.[24] However, with an annual deficit of over $300 billion, it is obvious that these tax increases alone will not solve the deficit problem.

B. Domestic Corporations

There are also a number of provisions in the President's proposal affecting corporations. The president would raise the top rate on corporations from 34% to 36%.[25] This provision would add approximately $6 billion per year to federal revenues by 1998.[26]

The President's proposal also contains a plethora of miscellaneous items affecting corporations. First, Mr. Clinton would reduce the deduction for business meals to 50% of cost from 80%.[27] This will produce fervent opposition by the restaurant lobby and may not ultimately survive the legislative process. Second, Mr. Clinton would deny completely the deduc-

19. *Id.* at 34.

20. *Id.* at 35.

21. *Id.* at 34.

22. *Id.* at 36.

23. 39.6% + 1.45% = 41.05%. Self-employed persons pay another 1.45% hospital insurance tax, resulting in a top rate of 42.5%.

24. *See Treasury Department Estimates for Revenue Provisions of President Clinton's Economic and Deficit Reduction Plan*, Daily Tax Rep. (BNA), Feb. 18, 1993, L-1, L-19 [hereinafter *Treasury Estimates*].

25. Administration's Proposals, *supra* note 17, at 44.

26. *Treasury Estimates*, *supra* note 27, at L-19.

27. Administration's Proposals, *supra* note 17, at 38.

tion for club dues.[28] Third, the President would deny corporations a deduction for salaries in excess of $1 million.[29] This item has received significant attention because some Chief Executive Officers (CEOs) and others in companies have received huge salaries and it has become popular to say that these salaries are just too much. The Securities Exchange Commission examined this issue,[30] and now the tax writers want to get into the act by denying the deduction. Some argue it is not a tax problem and should not be solved by a change to the Internal Revenue Code.

All the items affecting domestic corporations, including the rate increase to 36%, will raise only $10 billion in annual revenues when fully phased in by 1998.[31]

C. International Corporations

President Clinton's program also has provisions affecting international companies. During the campaign, Mr. Clinton said that the United States undertaxes foreign multinational companies operating in this country, and we ought to impose a heavier tax burden on them. He said we can raise $45 billion a year by taxing these foreign corporations.[32] Everyone familiar with multinational taxation knew that was not possible. If the United States arbitrarily increased taxes on foreign companies operating in this country, foreign countries would begin to tax our companies operating in their lands at higher rates. The foreign taxation portion of President Clinton's legislative proposals is more comprehensive than he discussed during the campaign, but will only raise $2.2 billion per year by 1998.[33]

D. Energy Tax

The largest single item in the Clinton tax package is the energy tax. Mr. Clinton would impose a British Thermal unit (Btu) tax, that is, a tax on the Btu content of all energy consumed in this country.[34] This tax will raise approximately $22.4 billion annually by 1998.[35] Unfortunately, the Clinton energy tax is very complex. It will be very difficult to administer a tax on oil, natural gas, hydroelectric power, coal, and nuclear power—

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28. *Id.* at 39.
29. *Id.* at 40.
30. *Boards Urged to Keep Eye on Executive Pay*, CHIC. TRIB., Feb. 11, 1993, at 36 (discussing SEC move for increased disclosure of top executive pay).
31. *Treasury Estimates*, *supra* note 27, at L-19.
32. Tom Hamburger & Eric Black, *Neither Side Talks Whole Truth About Compaign Numbers*, STAR TRIB., Nov. 1, 1992, at 25A (discussing candidate Clinton's assertion regarding revenue potential of revision in taxation scheme for international companies).
33. *Treasury Estimates*, *supra* note 27, at L-19.
34. ADMINISTRATION'S PROPOSALS, *supra* note 17, at 64-65.
35. *Treasury Estimates*, *supra* note 27, at L-19.

many different types of energy, supplied in many different ways to many different types of consumers. While we certainly will see extended debate on the best way to impose a tax on energy, people are beginning to accept that Congress will impose some type of energy tax because we need the revenue. The energy tax may be the least painful way of raising significant amounts of new revenue in a short time frame. However, there are still a lot of industries, particularly heavy energy users like paper, aluminum and steel, that will be made less competitive in world markets by an energy tax. These industries are concerned about the impact on their competitiveness in world markets, where the products of their foreign rivals will bear no such tax, and they are making their concerns known.

Testimony by several economists before the Senate Energy Committee on the subject of energy taxes indicated a tax of $22 billion a year would not be enough to have a major impact on U.S. industry and that industrial users could offset most of the cost of an energy tax of this size through conservation measures.[36] These arguments are persuasive, but they are less compelling when the specific numbers of very high energy consuming companies are examined. An alternative to the Btu tax is a simple increase in the federal gasoline tax. A one cent gasoline tax raises approximately $1 billion.[37] Thus, a twenty-cent gasoline tax would raise roughtly the same amount as the very complicated energy tax proposed by Mr. Clinton. Moreover, a gasoline tax could be put in place immediately, versus the two-year phase-in proposed for the Btu tax. The burden of a gasoline tax would fall mainly on motorists and of course truckers. It would not fall as hard on industry in general. An argument against a gasoline tax is that it has very different regional impacts. People in the West drive longer distances than do people who live in the East; this makes a gasoline tax politically difficult. There is a possibility, however, when everyone throws up their hands in trying to agree on collection points for the Btu tax and resolve the other administrative difficulties, that we might go back to a very simple gasoline tax. It would of course raise the price of gasoline, which probably ought to be done for environmental purposes alone, but that high visibility is a political negative.

E. Investment Tax Credit

The President's proposal also includes tax incentives. For example, Mr. Clinton's program would renew the investment tax credit (ITC) that was

36. *See Effects of Value-Added and Broad-Based Energy Taxes: Hearings Before the Sen. Comm. on Energy and Natural Resources* (1993), *reprinted in* TAX NOTES TODAY (Feb. 25, 1993) (LEXIS, FEDTAX Library, elec. cit. 93 TNT 45-85) (statement of Senior Economist Roger C. Dower).

37. *See Tax Relief and Economic Growth Proposals: Hearings Before House Ways and Means Comm.* (1993), *reprinted in* TAX NOTES TODAY (Feb. 7, 1993) (LEXIS, FEDTAX Library, elec. cit. 92 TNT 29-74) (statement of James D. Davidson).

repealed in 1986.[38] Through the ITC Congress gives a company that makes a $100 investment a tax credit of $7. In effect, the government will pay $7 of the cost of that piece of equipment. The ITC has been used in this country for a long time—on and off since 1962—to encourage modernization of plant and equipment. The Clinton tax credit, however, unlike all previous investment tax credits, is a temporary "incremental" credit (very small enterprises would be allowed a traditional, nonincremental, permanent investment tax credit).[39] That is, it only applies to the amount of increase in a company's investment, not the first dollar invested. Mr. Clinton does not want to give companies a tax credit for the first dollar of investment they make in equipment because the company would spend that amount on mere replacements; he wants to provide an incentive for companies to increase their purchase of plant and equipment. In addition, an incremental credit provides a much smaller tax benefit to companies, and costs the Treasury much less in lost revenues. Unfortunately, an incremental ITC is very difficult to administer. The President's package averages a company's annual capital investment over a three-year period, and applies the credit to new investment in excess of 70% of the average investment. For example, if a company invested $1 million over the prior three years, the current year's investment in excess of $700,000 would qualify for the new 7% investment tax credit. In all probability, the ITC proposal will not be enacted by Congress due to its administrative complexity, and because of the relatively small tax benefit it provides to its intended beneficiaries.

IV. The Future

A. *Public Reaction*

Some economists are very critical of the Clinton economic package. Some say the stimulus is so small as to be meaningless, and the taxes will be a serious drag on the economy. Other economists say the benefits from deficit reduction, particularly lower interest costs, will more than offset the ill effects of increased taxes. The package will probably pass, although there will be changes. The CEOs of the country who would have the most reason to oppose it are not doing so. Generally, they feel that something must be done to address our chronic deficits and the President is tackling the problem. Maybe there are not enough spending reductions in this package, maybe there is too much reliance on tax increases, but at least Mr. Clinton is doing something, and so the CEOs of this country are, by and large, supporting the President's effort. In addition, Mr. Clinton has been a very effective salesman. Congressional offices received a lot of negative calls

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38. Administration's Proposals, *supra* note 17, at 5-8 (proposing small business investment tax credit and temporary incremental investment tax credit).

39. *Id.* at 7-8.

when the package was first released. Back in their districts, however, when they visited home, Congressmen generally found a great deal of support for the package.

B. A Future VAT?

A different type of tax being talked about is a broad-based consumption tax—a value-added tax (VAT)—which all countries who are our major trading partners have adopted.[40] A VAT is a sales tax, but a sales tax that is imposed on each level of production. For example, I make a widget in my plant. It costs me $100 to make it. I sell it for $120. I have added $20 value to the process. I pay a VAT on $20. I sell it to a wholesaler. He sells it for $130. He pays a VAT on the next $10. The retailer sells it for $135 and pays a VAT on the extra $5. It is an incremental tax, very popular in the European Economic Community, and now has recently been adopted in Japan. A lot of people think the United States will have to adopt a VAT at some point. While I personally do not favor adoption of a VAT, it has many desirable features and Congress definitely will discuss a VAT in the future, perhaps to meet the price tag of the Clinton health care plan.

V. A Policy Retrospective

President Reagan came into office in 1981 and proposed reducing income tax rates across the board—he was able to reduce the top individual tax rate from 70% to 50%, and in doing so he received very strong support from both sides of the political aisle. While the Republicans were in the White House at the time, marginal rate reduction was strongly supported by Democrats as well. During Mr. Reagan's acting career, income tax rates reached 91%; he saw professionals who would refuse to make another movie during a particular year because government would take 91% of any profits earned. He thought high tax rates were a terrible disincentive to the movie industry, and he thought they must be bad for other industries as well. This experience emblazoned in him the belief that reduction of income tax rates was a positive thing, and he held that view strongly when he entered the White House in 1981. Led by Mr. Reagan, the entire decade of the '80s was characterized by reduction in tax rates. Many of our trading partners reduced their tax rates as well.

In 1993, the tax policy pendulum is swinging the other way. We are seeing tax rate increases proposed by President Clinton—without substantial opposition politically. While a lot of people do not like tax increases, there is no organized opposition on either side of the aisle to increasing the top tax rates.

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40. *See generally* Rick Wartzman, *Value-Added Tax Is Mulled in White House*, Wall St. J., Feb. 22, 1993, at 2A.

Whether this swing of the tax pendulum succeeds in reducing the deficit depends on whether President Clinton will lead Congress to enact real spending reductions as well as revenue increases. Mounting layers of additional taxes will provide disincentives to economic growth and without economic growth the tax base will shrink. Congress and the Administration could easily be caught in a cycle of increased taxes, shrinking tax bases, and further rate increases—"Tax and spend." To prevent this, President Clinton should lead the Congress in reducing federal expenditures by more than the revenue increases. Only in this way can the new Administration avoid the haunting malaise of its Democratic predecessors and profit from the current momentum of the tax policy pendulum.