THE PRESIDENTIAL CANDIDATES' NEW TAX PROPOSALS – OCTOBER 27, 2008
By Roberton Williams

In response to the deterioration of the economy and the decline in asset values, both presidential candidates offered new proposals related to unemployment compensation, retirement savings, taxation of capital gains, and job creation. Although the proposals would provide some benefit, they have significant shortcomings.

Senator McCain proposes to exempt unemployment compensation from federal income tax in 2008 and 2009 for most taxpayers, suspend required distribution rules for IRAs, lower the tax on some withdrawals from retirement savings accounts, increase the limits on the deductibility of capital losses, and lower the tax rate on long-term capital gains. Senator Obama would eliminate all taxation of unemployment compensation, allow limited penalty-free withdrawals from retirement savings account, and provide firms a refundable credit of $3,000 for each additional employee they hire. All of those proposals would be temporary and expire by 2010 or 2011.

Most of the proposals are very poorly targeted and would do very little to address the fundamental problems caused by the economic downturn. The proposal to eliminate tax on some or all unemployment benefits, for example, which is supported in different forms by both candidates, would most help unemployed workers who have substantial other income. A better option would be to extend unemployment benefits for workers who suffer long spells of unemployment. Most of the other proposals would do little good and could have unintended and counterproductive side effects.

Senator McCain's Proposals

Senator McCain's proposals deal with unemployment compensation, retirement savings, and capital gains and losses.

- *Exempt unemployment insurance benefits from federal income tax in 2008 and 2009 for taxpayers making less than $100,000.* This proposal effectively increases unemployment benefits for some lower- and middle-income people depending on their tax rate: the higher the tax rate, the greater the benefit. For example, a person who gets $1,000 of unemployment compensation would effectively receive a $100 benefit increase if he is in the 10 percent tax bracket but a $250 benefit if his tax rate is 25 percent. Those with the lowest incomes

receive no benefit at all from the proposal. The $100,000 income cap keeps the highest-income people from benefiting from the exemption, but the proposal is still poorly targeted. Extending eligibility for unemployment benefits or increasing benefits across the board could provide a larger share of assistance to those most in need of help at the same cost to the federal government.

- *Suspend rules that require distributions from IRAs at age 70½.* Owners of traditional individual retirement accounts (IRAs) must withdraw specified percentages of account assets starting at age 70½. The required distribution is a fraction of the account's value as of the end of the previous year; the fraction rises with age. The requirement is intended to prevent account owners who made their deposits out of pre-tax earnings from continuing to defer tax on those earnings until they die and the accounts go to their heirs. Roth IRAs (purchased with after-tax dollars) are not subject to this requirement.

  The sharp decline in asset values this year and the link of required distributions to last year's account value mean that an account owner who did not withdraw required amounts early in the year must take out a larger percentage of her account's current value than the stated percentage amount in the law. Although people may reinvest some of the proceeds of these withdrawals in equities or other assets—and therefore need not spend down their wealth faster or change the overall composition of their holdings—they do lose the tax deferral offered by retirement accounts on the additional amounts withdrawn. Temporarily suspending the distribution requirement would let retirees conserve their retirement account assets and withdraw them after asset values have recovered. Benefits of the suspension would go disproportionately to wealthier retirees, both because they gain more from tax deferral (because they are in higher tax brackets) and because they are more likely to have other assets available and thus not need to draw on retirement accounts to pay for current consumption.

- *Tax the first $50,000 of withdrawals from IRAs and 401(k)s at 10 percent in 2008 and 2009 for taxpayers age 60 or over*. Withdrawals from tax-deferred retirement accounts are subject to federal income tax at ordinary tax rates up to 35 percent. This proposal would lower that tax rate to 10 percent, the lowest regular tax rate. The greatest benefit would go to those in the highest tax brackets, both because they are most likely to have large balances in their retirement accounts and because they would otherwise pay the highest tax rates on withdrawals. For example, a taxpayer in the 35 percent tax bracket who takes out $50,000 would receive a $12,500 tax saving from a 10 percent rate, while a taxpayer in the 15 percent bracket would get a tax cut of just $2,500.

  For those who would have withdrawn $50,000 or more in 2008 and 2009 without the tax change, or would have withdrawn less but don't change their behavior, the benefit is a pure windfall. (Given that the proposal is unlikely to be enacted before 2009 and account holders probably won't expect any change in 2008, the entire tax saving in 2008 is likely to be a windfall.) Some people, however, might accelerate their withdrawals into 2009 to benefit from the lower tax rate. People need not sell equities at a loss to accelerate withdrawals, as they could withdraw other assets (if their portfolios are not entirely invested in equities) or withdraw equities and immediately reinvest in the same assets outside of retirement accounts.

Taxpayers would lose any further tax deferral on the funds withdrawn, but gain from having the funds taxed at only 10 percent instead of rates up to 35 percent for funds withdrawn in 2010 and later.

- *Reduce the tax rate on long-term capital gains to 7.5 percent in 2009 and 2010*. Long-term capital gains—gains on assets owned for at least a year—currently are untaxed for people in the 15 percent tax bracket or below and face a 15 percent tax for those in brackets above 15 percent. Senator McCain would cut the latter tax rate in half for gains on assets sold in 2009 or 2010. The lower tax rate would induce many people to sell appreciated assets in 2009 and 2010 that they would otherwise have sold in 2008 or after 2010 (or even held until death). Past experience with temporary cuts or delayed increases in the capital gains tax rate suggests that tax revenues would be much higher in 2009 and 2010 than they otherwise would have been, but the increase would come at the expense of larger revenue losses in future years. Over the long-term, the proposal represents a very large revenue loss to the Treasury and the benefits would go disproportionately to high-income households—two-thirds of the tax savings would go to those with incomes over $1 million. It is also not clear why the government should be encouraging much more selling at a time when financial markets are very unstable.

  The McCain campaign says that the purpose of this proposal is "to raise the incentive to save and invest" but a temporary tax cut provides little or no incentive to make new investments. Such a cut merely shifts realizations of capital gains from high-tax years into low-tax years at a high cost in lost revenue. And it's questionable whether even a permanent cut in the capital gains tax rate would boost the economy.[1]

- *Increase the amount of capital gains that can be deducted against ordinary income to $15,000 in 2008 and 2009*. Taxpayers who have net capital losses may deduct up to $3,000 against ordinary income in calculating their income tax liability and carry forward excess losses to future years. Senator McCain would quintuple that amount to $15,000 for two years. In principle, there is an argument for allowing unlimited deduction of losses. In practice, however, such a rule would enable taxpayers to defer gains and realize losses on balanced portfolios and thus claim net tax losses even if their asset values were increasing. This would allow unlimited tax sheltering—wealthy taxpayers would never have to pay any income tax. It also would allow taxpayers to offset gains taxed at favorable capital gains rates with losses in subsequent years taken at ordinary income rates. Increasing the loss limit would treat taxpayers with net losses on their entire portfolio more equitably, but would also allow more taxpayers with net unrealized gains to shelter more income by selectively selling off some of their assets with losses. Making the increased loss limit temporary, however, would encourage more taxpayers to take losses immediately and thus could further depress stock prices—although that effect would likely be quite small.

[1] See "Capital Gains: What is the effect of a lower tax rate?" in Tax Policy Center, *Tax Policy Briefing Book*, http://www.taxpolicycenter.org/briefing-book/key-elements/capital-gains/lower-rate.cfm.

Senator Obama's Proposals

Senator Obama's proposals deal with unemployment compensation, retirement savings, and job creation.

- *Eliminate the taxation of unemployment insurance for 2008 and 2009*. Like Senator McCain, Senator Obama would temporarily eliminate the taxation of unemployment benefits but, unlike McCain, he would not impose income limits on the benefit. The effect would be similar to McCain's proposal, except that some additional benefits would go to higher-income taxpayers in the top tax brackets. This would increase the revenue loss and skew the benefits even more toward those who least need help.

- *Allow penalty-free withdrawals of up to 15 percent (but no more than $10,000) from retirement accounts*. Withdrawals from retirement accounts by people under age 59½ are generally subject to a 10 percent penalty as well as federal income tax.[2] Senator Obama would allow anyone to withdraw as much as $10,000 or 15 percent of the account's value without incurring the penalty. Withdrawals would still be subject to income tax. This proposal aims to make funds available without penalty for people who face economic hardship and could thus provide much needed resources at a critical time. However, its use is not limited to people in financial difficulty. Policymakers already worry that people raid their retirement assets to pay for current consumption, particularly when they move between jobs, even in the face of current penalties. As traditional retirement pensions become increasingly rare, retirees now have to rely more on their own savings than in the past. Any relaxation of rules that enables people to use retirement funds during their working years jeopardizes the availability of those resources in retirement. It is also not entirely clear why policymakers should encourage people to sell assets when the market may be temporarily depressed.

- *Provide a refundable $3,000 per employee credit for increases in employment for firms with growing employment*. Senator Obama would provide a refundable tax credit for each additional worker hired in 2009 or 2010 by firms that increase their employment. The proposal is similar to a proposal enacted under the Carter Administration in 1977 and then converted to a much more limited credit for disadvantaged workers in 1978. (The Carter credit was non-refundable and applied to changes in payroll costs, not number of employees.) It aims to subsidize increases in employment without paying firms a credit for workers they already employ. The basic problem is that the base number of workers who would otherwise be employed by a firm is unobservable and the previous year's employment is a poor proxy for what firms would otherwise do. The new credit would favor firms in expanding industries over those experiencing a reduction in demand and only provide an incentive for expanding firms, without discouraging other firms from laying off more workers. That is, it would help the firms that least need assistance while doing nothing for those that are in distress.

[2] The penalty does not apply to withdrawals made in specific circumstances such as to pay certain medical or educational expenses or purchase a first home.

In addition to numerous equity issues, designing such a proposal would pose many practical and administrative issues. Legislation would have to specify how long a worker has to remain employed to count because without a minimum employment period, firms could churn workers to collect multiple credits. There would be demands to adjust baseline payroll for distressed industries and Congress would need to weigh those claims against revenue costs and enforcement issues. In general, the more stringent the definition of additional workers, the fewer firms would qualify for the credit, but easing law requirements would allow more firms to game the system to maximize their tax gains without raising employment.