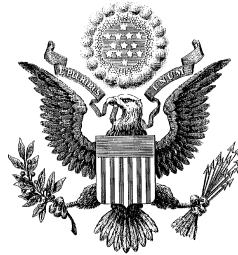


THE EFFECTS OF ALLOWING AN INTEREST AND DIVIDEND EXCLUSION



Chairman Jim Saxton (R-NJ)

**Joint Economic Committee
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Abstract

A proposal that would allow taxpayers to exclude a low level of interest and dividend income from taxation would primarily benefit low- and middle-income taxpayers and would boost saving incentives for small savers and non-savers. If signed into law, such an exclusion would interact with other initiatives, such as lower capital gains tax rates and expanded benefits for Individual Retirement Accounts, to provide new saving incentives to taxpayers across the income spectrum, thus improving the neutrality and efficiency of the U.S. tax code.

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THE EFFECTS OF ALLOWING AN INTEREST AND DIVIDEND EXCLUSION

Executive Summary

The U.S. national saving rate ranks among the lowest of the G-7 countries. Many economists have found that the low rate of saving is partially caused by tax laws that discourage saving in favor of consumption. Policies aimed at reducing this bias can promote long-term economic growth by increasing the amount of domestic resources available for investment.

One proposal that would help reduce the bias against saving would allow taxpayers to exempt from taxation the first \$200 (\$400 for joint tax filers) of interest or dividend income earned. Because of the low exclusion caps, such a proposal would primarily benefit low- and middle-income taxpayers and would boost saving incentives for small savers and non-savers. The proposal would interact with other initiatives, such as lower capital gains tax rates and expanded benefits for Individual Retirement Accounts, to create new saving incentives for taxpayers across the income spectrum, thus improving the efficiency and neutrality of the tax code.

Saving Incentives

A \$200/\$400 interest and dividend exclusion would enhance saving incentives to the extent that it affects taxpayers' decisions at the margin (i.e., their decision to save an additional dollar of income.) The proposal would, therefore, enhance saving incentives among small savers and non-savers who earn less than \$200/\$400 of investment income. These taxpayers would earn a tax-free rate of return on an additional dollar of saving, thus encouraging them to save more.

Saving incentives for high-income taxpayers would be negligible because most wealthy households already generate more than \$200/\$400 of interest or dividend income. For these taxpayers, an exclusion capped at \$200/\$400 would not yield any additional benefits at the margin.

Tax Relief

A \$200/\$400 exclusion would provide tax relief to the majority of American taxpayers, but relatively more valuable benefits would accrue to low- and middle-income households. Based on 1995 tax data:

- 57 percent of all taxpayers could have taken advantage of an interest or dividend exclusion.
- 23 percent of these taxpayers had adjusted gross incomes (AGI) between \$1 and \$15,000; 67 percent had AGI between \$1 and \$50,000.
- Because high-income taxpayers receive high levels of investment income, they would derive insignificant benefits from an exclusion capped at \$200/\$400. In contrast, low- to middle-income taxpayers would earn a tax-free rate of return on a substantial amount of their saving.
- Estimates by the Joint Committee on Taxation indicate that half of all taxpayers who reported taxable interest income and 35 percent of all taxpayers who reported dividend income would not have paid any taxes on that income if a \$200/\$400 exclusion were allowed.
- Overall, 30 million taxpayers would not have paid any taxes on their interest and dividend income.
- Low- and middle-income taxpayers would receive more valuable tax relief relative to high-income taxpayers when benefits are measured as a percentage of income.

Representative Jim Saxton (R-NJ)
Joint Economic Committee

THE EFFECTS OF ALLOWING AN INTEREST AND DIVIDEND EXCLUSION

Over the years, many economists have acknowledged that the U.S. tax code is biased against saving relative to consumption. This bias impedes long-term economic growth by lowering the level of saving in the United States. Equalizing the treatment of saving and consumption through policies that enhance saving incentives can increase the potential for long-term economic growth. The Taxpayer Relief Act of 1997 includes some provisions toward this goal, such as capital gains tax rate reductions and expanded benefits for Individual Retirement Accounts (IRA).

Another proposal that would reduce the bias against saving would allow taxpayers to exempt a specified amount of interest and dividend income from taxation. Such an exclusion would provide tax relief to the majority of American taxpayers and would enhance saving incentives for small savers. Low- and middle-income households would receive relatively more valuable benefits.

BACKGROUND

Since 1964, Section 116 of the Internal Revenue Code allowed taxpayers to exclude from adjusted gross income (AGI) the first \$100 of dividend income received from domestic corporations.¹ Husbands and wives filing joint returns were each allowed a separate \$100 exclusion based on dividend income earned by that spouse. The dividend exclusion was designed to provide taxpayers with some relief from the multiple taxation of saving and investment.

The Crude Oil Windfall Profit Tax Act of 1980 doubled the exclusion to \$200 and expanded the coverage of Section 116 to include interest income. A \$400 exclusion was available to joint tax filers regardless of which spouse earned the income.² The new rules were in effect for only one year before they were repealed in the Economic Recovery Tax Act (ERTA) of 1981 in favor of more extensive saving incentives.

ERTA reinstated the \$100/\$200 dividend exclusion under Section 116 and established a variety of new saving incentives, including lower marginal income tax rates and expanded IRA benefits. In addition, for tax years after 1984, individuals would be allowed to exclude 15 percent of up to \$3,000 of net interest income from AGI. Joint tax filers would be allowed a 15 percent exclusion of up to \$6,000 of net interest income.³ Thus, the maximum interest exclusion for individuals and joint tax filers would be \$450 and \$900, respectively.

¹ A \$50 dividend exclusion had been in the law since 1954.

² The expanded coverage and increased exclusion were allowed for tax years 1981 and 1982. After 1982, the law was scheduled to revert to its original text, although the rule applying to the treatment of joint returns was permanently revoked.

³ Net interest income equals interest income minus interest expenses. Mortgage interest payments and interest paid in relation to business or trade was not subtracted from interest income under this approach. This definition was used to discourage arbitrage, a practice in which taxpayers can profit by borrowing money and saving an equal amount so that net saving remains unchanged.

Table 1. Legislative History Regarding the Treatment of Interest and Dividend Income	
1964	\$100/\$200 dividend exclusion allowed
1980	Crude Oil Windfall Profit Tax Act <ul style="list-style-type: none"> ▪ \$200/\$400 dividend <i>and</i> interest exclusion allowed for tax years 1981 and 1982
1981	Economic Recovery Tax Act <ul style="list-style-type: none"> ▪ \$200/\$400 interest exclusion repealed for tax year 1982 ▪ \$100/\$200 dividend exclusion reinstated ▪ 15% net interest exclusion effective for tax years after 1984 ▪ Expanded IRA benefits ▪ Top marginal tax rate reduced to 50%
1984	Deficit Reduction Act <ul style="list-style-type: none"> ▪ 15% net interest exclusion repealed
1986	Tax Reform Act <ul style="list-style-type: none"> ▪ \$100/\$200 dividend exclusion repealed for tax years after 1986 ▪ Restrictions on IRA eligibility instituted ▪ Tax structure reduced to 2 brackets and top marginal tax rate reduced to 28%

The expansion of IRA benefits significantly increased saving in IRAs, thus increasing short-term revenue losses beyond forecasters' expectations. The unexpected increase in saving and the associated reduction in short-term revenue led policy makers to repeal the 15 percent interest exclusion in 1984 before it was scheduled to take effect the following year.

In 1986, Congress enacted the Tax Reform Act (TRA). TRA permanently repealed the \$100/\$200 dividend exclusion provided in Section 116 and placed income restrictions on IRA participation. The revenue generated from these changes helped finance broad-based tax reform that lowered the maximum marginal tax rate on income from 50 percent to 28 percent and reduced the 15 bracket tax structure to only two tax brackets.

The saving incentives created by the TRA tax reforms were diminished by subsequent legislation. In 1991, a 31 percent tax bracket was added to the tax code, and in 1993, two more tax brackets

were added, raising the maximum marginal income tax rate to 39.6 percent.

Reviving the \$200/\$400 interest and dividend exclusion would be an important component of a series of initiatives aimed at encouraging new saving. Because of the low exemption levels, such an exclusion would primarily benefit low- and middle-income taxpayers and would boost saving incentives for small savers. According to preliminary estimates by the Joint Committee on Taxation (JCT), the proposal would reduce federal government revenue by approximately \$15 billion over five years.

TAX TREATMENT OF SAVING AND CONSUMPTION

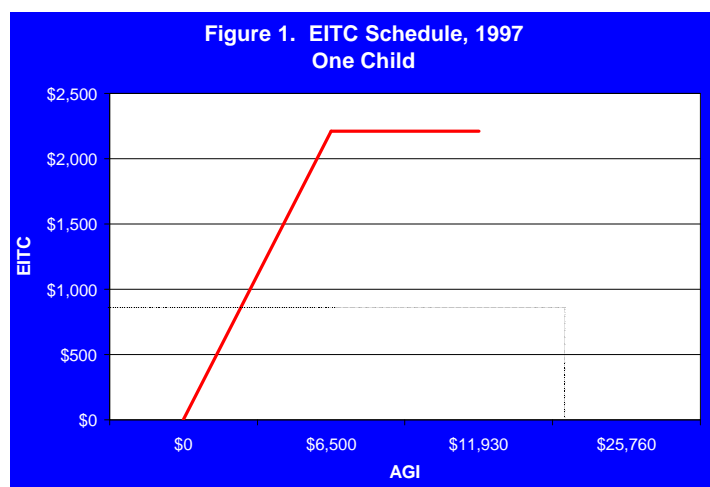
The legislative changes affecting the taxation of interest and dividend income reflect an effort to increase saving by reducing the tax bias against saving. Under current law, income used for consumption is taxed once as personal income, but income used for saving is taxed at two or three different levels—once as personal income, again as investment income, and if the saving generates a dividend or capital gain, it is taxed at a third level as corporate income.

For instance, if a worker earned \$30,000 in 1997, he/she would incur a federal income tax liability of \$3,480, assuming the worker claims the standard deduction and one personal exemption. The worker's after-tax income would be \$26,520. If the worker saves \$3,000 of this after-tax income in a saving account earning 5 percent annually, the investment would yield \$150 of interest income after one year. This interest income generates a further tax liability of \$22.50 so that the worker keeps only 85 cents of each dollar of earnings—an after-tax rate of return of only 4.25 percent. In contrast, if the worker spends all of the income, the consumption

generates no additional tax. Thus, the benefit derived from saving is taxed, but the benefit derived from spending is not taxed.

Saving Incentives and the Earned Income Tax Credit (EITC)

The additional penalty to saving is more severe for some low-income households that are eligible for the EITC, a tax credit for the working poor. Households eligible for the EITC receive a tax credit based on their AGI and number of children. The credit increases as a percentage of income up to a maximum amount; the maximum credit remains constant over a range of income; it then decreases as a percentage of income over a phase-out range until it reaches zero. Households with incomes in the phase-out range of the credit are discouraged from saving because any investment income they earn not only increases their tax liabilities, but it also reduces the size of their credits.



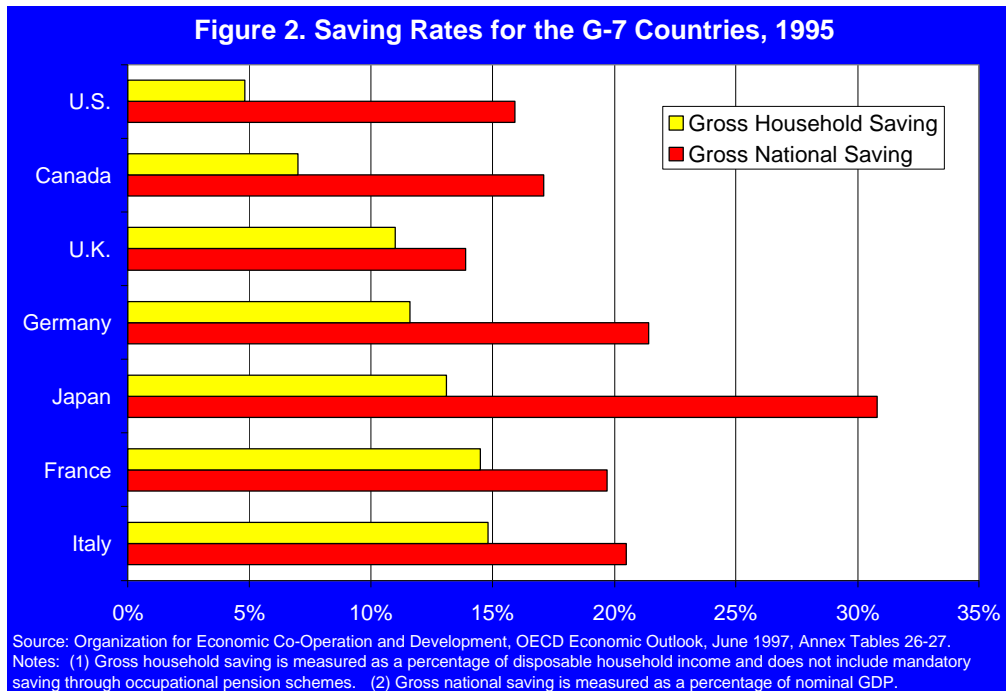
Consider a married couple with one child and a combined AGI of \$20,000 in 1997. If the family claims the standard deduction and three personal exemptions, their tax liability would be \$773. Figure 1 shows that the family would receive an offsetting credit of \$920, making their total tax liability negative \$147. If the family saves \$1,500 of their after-tax income in a saving account earning 5 percent annually, they would earn \$75 of interest income after one year. Because the family falls within the phase-out range of the EITC, they face

a marginal tax rate of 31 percent—an additional dollar of income is subject to a 15 percent increase in their federal income tax and a 15.98 percent reduction in their tax credit. Thus, the \$75 of interest income generates a tax liability of \$23.24 so that the family keeps only 69 cents of each dollar of earnings. Taxing the family's interest income lowers their after-tax rate of return to only 3.5 percent, thus lowering the benefit of saving for future consumption.

In sum, the interest rate represents the benefit of saving for future consumption. In other words, it is the relative price of current consumption. Taxing investment income artificially lowers the benefit of saving, and thus, lowers the relative price of current consumption. This distortion creates an inherent bias against saving that reduces the efficiency and neutrality of the tax code by distorting taxpayers' decisions regarding current and future consumption.

Many economists believe that the bias against saving contributes to a low national saving rate by penalizing households that save for future consumption.⁴ Figure 2 below shows that U.S. saving rates compare unfavorably to those of the other G-7 countries (Group of Seven industrial democracies). In 1995, the U.S. household saving rate was the lowest among the G-7 countries, and the national saving rate was among the lowest, exceeding that of only the United Kingdom.

⁴ National saving is defined as private saving (saving done by households and businesses) and government saving (government surplus/deficit). Private business saving has remained fairly constant since 1950, but private household saving has been declining since the early 1980s, and therefore, is a concern to policy makers.



The low level of national saving limits the amount of domestic capital available for investment, thus reducing the overall level of investment in the economy.⁵ Investment, in turn, is a key determinant of long-run economic growth and productivity improvements that generate new jobs, higher wages and better living standards.

EXPANSION OF SAVING INCENTIVES

A \$200/\$400 interest and dividend exclusion would help reduce the inequity between the treatment of saving and consumption by shielding some investment income from taxation. If the family earning \$20,000 were allowed a \$400 interest exclusion, none of their interest income would be taxed, allowing them to keep the \$75 generated by the saving. Moreover, their marginal tax rate on saving would fall from 31 percent to zero percent so that an additional dollar saved would not be taxed. This benefit increases the after-tax rate of return on saving an additional dollar of income, thus encouraging the family to save more.

Some analysts argue that increasing the rate of return on saving has an ambiguous effect on the saving rate because of offsetting behavioral effects. Individuals may increase their saving because the relative price of saving falls (substitution effect), but they may also reduce their saving and still reach a desired target (income effect). Thus, the net effect on saving is ambiguous. However, for households that do not save at all and for households that are net borrowers, the two effects reinforce each other so that an increase in the rate of return on saving unambiguously increases saving.⁶ Therefore, a low-level exclusion of interest and

⁵ When national saving is less than investment demand, investors must compete for scarce financial resources, thus creating upward pressure on interest rates. Higher interest rates attract foreign capital, allowing investment to rise even when domestic saving is low. However, reliance on foreign capital creates two undesirable effects: (1) profits from the investment flow overseas so that less benefit accrues to the U.S. economy, and (2) the borrowing must be repaid with interest so that future generations inherit a less wealthy, more burdened economy. In addition, higher interest rates increase the cost of capital so that the level of investment is lower than it otherwise would be.

⁶ M. S. Feldstein and S. C. Tsiang, "The Interest Rate, Taxation, and the Personal Savings Incentive," *The Quarterly Journal of Economics*, Volume LXXXII, No. 3, August 1968, pp. 419-434.

dividend income would most likely encourage new saving among low- to middle-income households that are typically non-savers or net borrowers. It would also make saving more attractive to small savers who generate less than \$200/\$400 of investment income by allowing them to earn a tax-free rate of return on an extra dollar of saving.

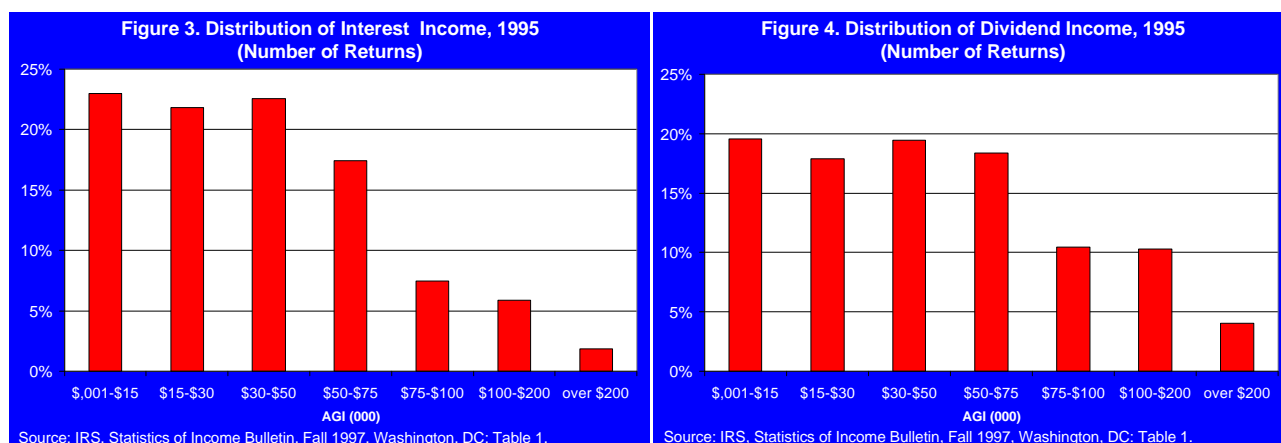
Saving incentives for high-income individuals, however, would be limited because of the low exclusion levels. Most wealthy households already earn more than \$200/\$400 of interest or dividend income. Thus, the exclusion would not lower the marginal tax rate on an additional dollar of saving, and therefore, is unlikely to encourage new saving at high levels of income.

In sum, the saving incentives created by a \$200/\$400 exclusion of interest and dividend income would primarily affect small savers and non-savers. If enacted, the proposal would not eliminate the double taxation of saving, but it would move the tax code in the right direction and interact with other initiatives, such as lower capital gains tax rates and expanded IRA benefits, to provide new saving incentives to taxpayers across the income spectrum. Although completely eliminating the bias against saving requires structural reform of the tax code, interim policies that incrementally enhance saving incentives are important because they help lay the foundation for broad-based reform, thus facilitating the transition to a more efficient and neutral tax system in the future.

TAX RELIEF

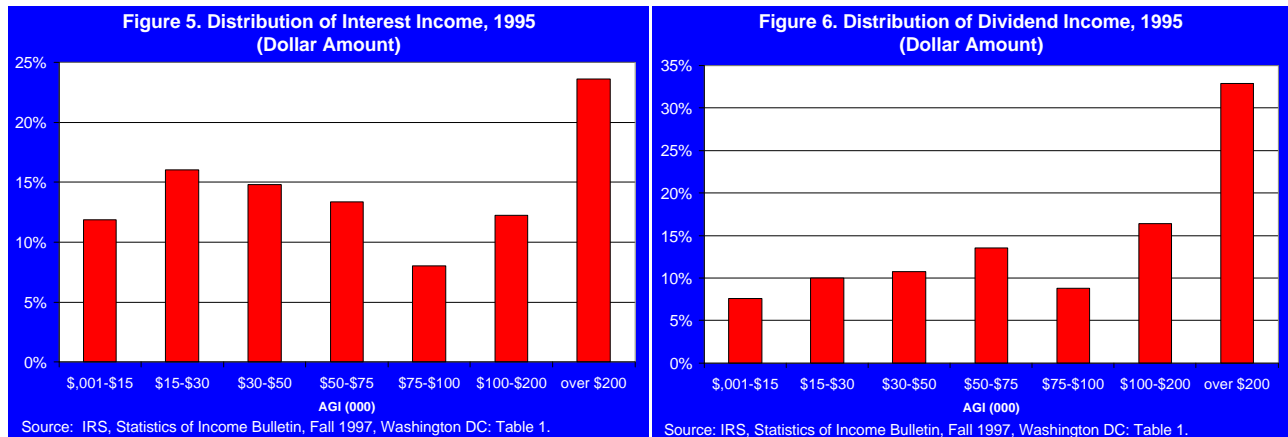
A \$200/\$400 interest and dividend exclusion would provide tax relief to the majority of American taxpayers. Tax data from the Internal Revenue Service (IRS) show that 57 percent of all tax returns filed in 1995 reported taxable interest income, and 22 percent reported dividend income.⁷ (Statistics for each state are contained in the Appendix.)

Figures 3 and 4 show that the majority of these tax returns were filed by low- and middle-income taxpayers. Of the 66 million returns claiming taxable interest income, 23 percent were filed by taxpayers with AGI between \$1 and \$15,000, and 67 percent were filed by taxpayers with AGI between \$1 and \$50,000. Similarly, of the 26 million returns reporting dividend income, 20 percent were filed by taxpayers with AGI between \$1 and \$15,000, and 57 percent were filed by those with AGI between \$1 and \$50,000.



⁷ Statistics do not include tax returns with negative AGI, which account for 0.8 percent of all tax returns filed in 1995.

Although a majority of taxpayers could take advantage of an interest or dividend exclusion, the tax benefits would be relatively more valuable to small savers with low incomes. Figures 5 and 6 show that taxpayers with AGI more than \$100,000 earned 36 percent of the total value of all taxable interest income claimed in 1995 and almost half of the total value of all dividend income claimed. Because high-income taxpayers receive high levels of investment income, they would derive insignificant benefits from an exclusion capped at \$200/\$400. In contrast, low- and middle-income taxpayers are generally small savers with low levels of investment income. In 1995, taxpayers with AGI between \$1 and \$15,000 earned 12 percent and 8 percent, respectively, of the total value of all taxable interest and dividend income claimed. The data suggest that low- and middle-income taxpayers would, therefore, earn a tax-free rate of return on a substantial amount of their savings.



Households that generate less than \$200/\$400 of interest and dividend income (and no capital gains) would have the double taxation of saving entirely eliminated. In 1981, the only year in which the \$200/\$400 exclusion was allowed, one out of four taxpayers claiming an exclusion paid no taxes on their interest or dividend income.⁸ JCT estimates indicate that half of all taxpayers reporting taxable interest income in 1995 and 35 percent of all taxpayers reporting dividend income would not have paid taxes on that income if a \$200/\$400 exclusion was allowed. Overall, 30 million taxpayers would not have paid taxes on their interest and dividend income.

Moreover, a \$200/\$400 exclusion would be relatively more valuable to low- and middle-income households when benefits are measured as a percentage of income. Table 2 shows that a \$200 exclusion is worth \$30 to a taxpayer in the 15 percent tax bracket and is worth \$72 to a taxpayer in the 36 percent tax bracket. However, the exclusion reduces the taxable income and tax liability of the low-bracket taxpayer by 0.86 percent in this example, whereas the taxable income

	15%	36%
Marginal tax rate	15%	36%
Taxable Income		
Current law	\$23,200	\$135,200
\$200 exclusion	\$23,000	\$135,000
Tax liability		
Current law	\$3,480	\$37,443
\$200 exclusion	\$3,450	\$37,371
Value of \$200 exclusion	\$30	\$72
Reduction in taxable income	-0.86%	-0.15%
Reduction in tax liability	-0.86%	-0.19%

⁸ Internal Revenue Service, Statistics of Income, 1981 Individual Tax Returns, Washington, DC: Table 1.3.

and tax liability of the high-bracket taxpayer are reduced by only 0.15 percent and 0.19 percent, respectively. Thus, the exclusion provides relatively more valuable tax relief at lower levels of income although the dollar value of the exclusion is greater at higher levels of income.

An interest and dividend exclusion would benefit low-income households for other reasons as well. These households are usually small savers with a low tolerance for risk and a preference for liquid assets. They often invest in interest-bearing checking or saving accounts with very low rates of return and often cannot afford the minimum deposit requirements for higher yielding bank assets. Consequently, these small savers are more likely to earn very low rates of return on their savings.⁹ Taxing their interest income further reduces their rates of return and penalizes them for the tradeoff between current and future consumption. Many small savers may even earn negative rates of return over time when inflation is taken into account. An interest income exclusion would be a simple way of providing relief to these low-income taxpayers.

CONCLUSION

Saving rates in the United States are low compared to those of the other G-7 countries. Many economists believe that the low level of U.S. saving is partially caused by tax laws that discourage saving in favor of current consumption. Policies aimed at increasing the saving rate through enhanced saving incentives can improve the potential for long-term economic growth.

One proposal that would help equalize the treatment of saving and consumption would allow taxpayers to exempt the first \$200 of interest or dividend income from taxation (\$400 for joint tax filers). A \$200/\$400 exclusion would provide insignificant benefits for high-income taxpayers and would have a limited effect on saving incentives at high levels of income.

An interest and dividend exclusion would provide more significant benefits for low- and middle-income taxpayers. These taxpayers are generally small savers or non-savers who earn less than \$200/\$400 of investment income annually. A low-level exclusion of interest and dividend income would, therefore, allow these taxpayers to earn a tax-free rate of return on a substantial amount of their savings. This benefit would enhance saving incentives and encourage new saving. In addition, the tax relief provided to low- and middle-income taxpayers would be relatively more valuable than that provided to high-income taxpayers when measured as a percentage of income.

The Joint Committee on Taxation estimates indicate that 50 percent of all taxpayers reporting taxable interest income in 1995 and 35 percent of all taxpayers reporting dividend income would not have paid taxes on that income if a \$200/\$400 exclusion were allowed. Overall, 30 million taxpayers would not have paid taxes on their interest and dividend income.

Shahira E. Knight
Economist

⁹ Prepared statement of Honorable Donald C. Ludwick for hearings before the Committee on Ways and Means, House of Representatives, *Tax Incentives for Savings*, January 29, 30, 31, 1980.

APPENDIX

Tax Returns Claiming Interest and Dividend Income by State, 1995				
State	Interest Income		Dividend Income	
	Number	% of total	Number	% of total
Alabama	821,019	45.2%	278,911	15.3%
Alaska	180,942	49.8%	80,177	22.1%
Arizona	935,671	50.9%	396,052	21.5%
Arkansas	473,807	45.0%	178,980	17.0%
California	7,214,418	53.9%	2,826,305	21.1%
Colorado	1,066,133	59.8%	459,336	25.8%
Connecticut	1,102,097	70.5%	485,472	31.0%
Delaware	196,614	57.2%	91,687	26.7%
District of Columbia	132,226	48.7%	52,653	19.4%
Florida	3,438,200	52.5%	1,527,733	23.3%
Georgia	1,456,209	45.4%	581,689	18.2%
Hawaii	380,518	69.2%	129,732	23.6%
Idaho	276,673	55.9%	101,889	20.6%
Illinois	3,272,339	60.2%	1,357,345	25.0%
Indiana	1,517,211	57.1%	506,475	19.1%
Iowa	845,130	65.6%	330,767	25.7%
Kansas	690,177	60.8%	273,459	24.1%
Kentucky	802,381	49.8%	265,306	16.5%
Louisiana	764,935	43.4%	281,139	15.9%
Maine	349,282	62.3%	115,734	20.6%
Maryland	1,442,779	61.0%	571,438	24.1%
Massachusetts	1,933,566	67.8%	743,153	26.0%
Michigan	2,563,792	59.4%	1,026,007	23.8%
Minnesota	1,371,163	63.8%	570,525	26.6%
Mississippi	406,569	36.8%	140,773	12.7%
Missouri	1,311,362	55.2%	547,215	23.0%
Montana	243,709	62.0%	101,211	25.7%
Nebraska	482,164	62.9%	188,540	24.6%
Nevada	350,764	46.5%	137,385	18.2%
New Hampshire	369,952	65.8%	138,264	24.6%
New Jersey	2,487,427	65.4%	1,102,660	29.0%
New Mexico	352,666	47.9%	130,879	17.8%
New York	5,046,918	63.7%	1,992,886	25.2%
North Carolina	1,669,092	50.3%	623,868	18.8%
North Dakota	187,512	64.0%	65,284	22.3%
Ohio	3,016,595	57.0%	1,172,329	22.2%
Oklahoma	673,567	49.3%	231,378	16.9%
Oregon	848,219	59.4%	323,062	22.6%
Pennsylvania	3,469,903	63.5%	1,399,631	25.6%
Rhode Island	281,097	62.2%	97,003	21.5%
South Carolina	738,009	44.8%	272,148	16.5%
South Dakota	195,955	59.0%	73,221	22.0%
Tennessee	1,122,422	47.2%	367,146	15.4%
Texas	3,618,332	44.9%	1,358,818	16.9%
Utah	478,619	58.9%	142,202	17.5%
Vermont	181,415	66.3%	68,157	24.9%
Virginia	1,701,605	56.4%	743,688	24.6%
Washington	1,511,355	60.8%	587,325	23.6%
West Virginia	382,627	53.5%	123,445	17.3%
Wisconsin	1,616,125	67.7%	618,170	25.9%
Wyoming	130,720	59.3%	53,347	24.2%
Other areas	449,457	42.3%	202,030	19.0%
United States	66,551,439	56.0%	26,234,029	22.1%

Source: Internal Revenue Service, Statistics of Income Bulletin, Spring 1997, Table 2.