

WITHHOLDING ON INTEREST AND DIVIDEND INCOME:  
OPTIONS, ALTERNATIVES, AND EFFECTS ON SAVINGS INCENTIVES

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## PREFACE

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There has been a substantial amount of interest in the President's proposal to institute a system of withholding for interest and dividend income. Spokesmen for the financial community as well as individual investors have raised many objections, and both proponents and opponents have had questions about the plan. This paper is an attempt to evaluate the withholding proposal and possible alternatives which may increase the level of tax compliance for investment income. It was requested by Chairman Henry S. Reuss of the House Committee on Banking, Finance and Urban Affairs. Because of the recent concern of the Congress with stimulating saving and investment, the relationship between withholding and saving incentives is also covered. Finally, a preliminary evaluation of the two-year interest and dividend income exemption has been included.

The paper was written by John E. Osborn of the Tax Analysis Division, under the direction of James M. Verdier. In keeping with the mandate of the Congressional Budget Office to provide objective analysis, this report contains no recommendations. The author is grateful for the helpful comments and suggestions of Mark Steitz and Marvin Phaup. The manuscript was edited by Francis Pierce, and typed by Linda Brockman and Shirley Hornbuckle.

Alice M. Rivlin  
Director

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## SUMMARY

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Maintaining compliance with the tax laws is a continuing concern of the Congress. Noncompliance in the case of interest and dividend income is thought to be particularly widespread, and estimates in a recent report on the underground economy indicate that over \$20 billion in such income goes unreported every year.

To increase compliance, the President has proposed withholding 15 percent of interest and dividend income at the time the interest or dividend payment is made. (In the case of interest paid on accounts with depository institutions, an institution could elect to withhold the tax annually.)

Some have asked whether withholding is the best way to increase the rate of compliance, and whether it is necessary to do anything to increase tax compliance in this area. If the estimates in the underground economy report are reasonably accurate, over \$2 billion in revenues is lost annually for want of compliance. The question arises whether the administrative costs of withholding might be so great as to consume most of the gains. The cost for financial institutions has been estimated by industry representatives at between \$200 and \$300 million per year, but no comparable estimates exist for the costs to corporations or the government. Secretary of the Treasury G. William Miller has stated that the costs would be "not significant" after the system had been established.

The most frequently suggested alternative to withholding is increased enforcement of the tax laws. No formal estimate has been made of the cost of this alternative. The IRS has said that it does not believe the collection of lost tax revenues on investment income should be its top priority, opting instead to focus on areas with greater tax avoidance rates, and on general auditing. Thus, even if the additional funds were appropriated by the Congress, they would be used in other ways unless they were targeted specifically at this problem.

Withholding would be a means of collecting taxes that are due, and not be meant to increase the tax burden on investors. It would, however, lower the return on investments by transferring funds to the government earlier than if the taxes were not with-



held. Investors would be deprived both of the use of their money for a part of the year, and of a small portion of the interest that would have been earned.

This may seem to create a dilemma for Members of Congress who wish to promote saving and at the same time to increase the level of interest and dividend income reporting. While the issues overlap to a degree, the respective goals are not necessarily contradictory; specific measures to increase saving can be devised that would more than offset the effects of withholding.



The President recently proposed withholding a portion of most interest and dividend payments in order to increase the level of tax compliance in this area, and so raise revenues. This would not impose a new tax, but rather would be a means of collecting taxes that are now due on interest and dividend income, and that are not being paid.

The Treasury Department estimates that between 8 and 16 percent of all interest and dividend income is not reported by taxpayers, representing about \$20 billion annually. Withholding would raise \$2 billion to \$3 billion a year of additional revenue, partly by increasing the compliance rate and partly by collecting the tax at the time the income is earned rather than at the year's end.

While there is no disagreement that all taxes that are due should be paid, there has been substantial criticism of the withholding plan. Many people argue, for example, that withholding would act as a disincentive to save at a time when the Congress is enacting tax incentives designed to increase personal investment and saving. In addition, many feel that the revenue gain that would result from the increased compliance is outweighed by the administrative costs, both public and private.

This paper examines the withholding proposal and its potential benefits and problems. Because of the current interest in stimulating investment and increasing productivity, the relationship between withholding and investment incentives is also discussed. A section on savings incentives has been included as an appendix.



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## CHAPTER II. BACKGROUND

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Interest and dividend income is now earned by over 37 million taxpayers, and comes from many sources other than the traditional savings account in a bank, savings and loan association, or credit union. About 60 percent of such income is earned from investments in corporate and government bonds, stocks, money market certificates, and other financial assets. At present, interest and dividend income earnings of more than \$10 must be reported by financial institutions and corporations to investors and to the federal government.<sup>1</sup> Taxpayers are also expected to report their interest and dividend income on their returns, accompanied by copies of the information statements they receive from the sources of their income.

Income from wages and salaries, on the other hand, is subject to withholding at the source. This procedure is in keeping with the concept that taxes are due at the time the income is earned. It is generally thought that without the current withholding system, the collection of taxes on wages and salaries would be much more difficult and costly. Taxes are withheld according to income tables devised by the Treasury, with allowance for the number of claimed exemptions. Individuals who expect to incur no tax liability during the year may file a form to exempt them from withholding.

### WITHHOLDING IN THE PAST: LEGISLATIVE HISTORY

U.S. employers have been withholding portions of employees' wages and salaries for 37 years, but comprehensive withholding of interest and dividend income has never been attempted. From 1913 to 1916, taxes were withheld on certain types of interest income;





withholding on dividends (other than payments to foreigners) has never been enacted. Since 1942, however, the House of Representatives has passed four bills providing for interest and dividend withholding that did not become law.

In 1942, in response to the need for increased revenues during World War II, the House approved a measure to withhold taxes on wages, salaries, dividends, and bond interest. The Senate Finance Committee responded by approving a "victory tax"--5 percent withholding on wages and salaries--but deleted the withholding requirement for interest and dividends.<sup>2</sup> The following year the Treasury Department recommended withholding on wages, salaries, and dividends, but omitted interest income from the proposal. The Congress then passed the Current Tax Payment Act of 1943, which wrote into law the principle of taxation at the time the income is earned by establishing withholding on wages and salaries together with the estimated tax system for non-wage earners. Interest and dividend income was not included.

In 1950, the House included in the Revenue Act of 1950 a provision to withhold 10 percent of all dividend income with no exemptions. This was rejected by the Senate Finance Committee; some of its members arguing that potential overwithholding could hurt individuals with little or no tax liability, as well as tax-exempt organizations.<sup>3</sup>

In 1951 and 1962, the House also approved measures that would have instituted withholding on interest and dividends, and in 1962 patronage dividends were also included.<sup>4</sup> The Senate Report in 1951 indicated that the Senators did not see the need to establish

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2. Description of Proposals Relating to Withholding on Interest and Dividends, Joint Committee on Taxation (April 29, 1980), p. 5.

3. S. Report 2375, 81 Cong. 2 sess. (1950), p. 521.

4. Patronage dividends are amounts paid generally by cooperatives to members according to their purchases. Some have argued that patronage dividends ought not be taxed since they do not represent a dividend in the traditional sense, but rather a return of money paid earlier by the recipients. However, to the extent that patronage dividends reflect profits on purchases by nonmembers, they probably should be considered taxable income.



withholding as yet, since there had not been a sufficient investigation of the problems of underreporting.<sup>5</sup> While withholding was not passed in 1962 either, the Senate Finance Committee included as a substitute for withholding the present requirement that businesses and other interest and dividend payors report the payment of over \$10 in such income both to the government and to the recipients.<sup>6</sup>

#### THE ADMINISTRATION'S CURRENT WITHHOLDING PLAN

As part of its fiscal year 1981 budget, the Administration proposes to withhold 15 percent--one percent more than the minimum marginal tax rate--of nearly all interest and dividend income, starting in January 1981. Withholding would be required on practically all types of interest and dividend payments, with the exception of payments to corporations, and on mortgage income of individuals. The Administration has stated that such a comprehensive plan would avoid distorting investment decisions; shifting of assets would not occur because the relative return on different types of investments would remain constant.

Withholding would take place at the time the investment income was earned, except in the instance of income earned in accounts (generally passbooks) with depository institutions. Usually, withholding would occur when interest was posted to an account, but depository institutions would have the option of withholding only once a year, even if the interest was recorded quarterly or daily. Exemptions from the withholding requirement would be available for all corporate recipients of investment income, and for taxpayers who filed exemption forms. The latter category would include tax-exempt organizations, noncorporate dealers in securities, individuals who anticipated having no tax liability, and groups of taxpayers who would be exempted upon

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5. S. Report 781, 82 Cong. 1 sess. (1951), p. 504.

6. S. Report 1881, 87 Cong. 2 sess. (1962), p. 824. Compliance data were not kept prior to 1962, so an evaluation of the reporting requirement is difficult to make. Reported interest and dividend income, however, did not increase significantly in the years immediately after the requirement went into effect.



review by the Treasury if withholding would create a special burden for them.<sup>7</sup>

#### OTHER CONGRESSIONAL PROPOSALS

Four bills are now pending in Congress that would attempt to increase the rate of compliance on interest and dividend income:

- o H.R. 1040, a comprehensive tax reform bill sponsored by Rep. James C. Corman (D-California), would require all interest and dividend payors to withhold 10 percent of the amount paid to recipients. The payor would then file a return at the end of each quarter, and would be required to pay the withheld amounts no later than one month following the close of each quarter of the payor's taxable year.
- o S. 47, sponsored by Senator Mark Hatfield (R-Oregon), also would require all interest and dividend payors to withhold 10 percent for tax purposes. The portion on withholding is but one part of a comprehensive proposal to "reform and simplify the federal individual income tax." Under the bill, the income tax rates would be modified so that the amount being withheld would equal the amount owed. All interest and dividend payments would be treated the same as wages for a given payroll period.
- o S. 1565, sponsored by Senator Henry Bellmon (R-Oklahoma), is similar to the Administration proposal in that it too calls for the withholding of 15 percent of all interest and dividend income. Withholding would not occur if an exemption certificate was filed in advance with the anticipation that no tax liability would be incurred in the coming year, and if no tax liability was incurred in the previous year. In addition, no withholding would occur if the anticipated tax liability for interest income did not exceed \$15. Persons over 65 would be exempt from withholding if their total tax liability did not exceed \$100.

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7. For a more detailed description of the Administration's withholding plan, see Description of Proposals Relating to Withholding on Interest and Dividends, Joint Committee on Taxation, pp. 18-20.



- o H.R. 7559, sponsored by Rep. Joseph Fisher (D-Virginia), would require the IRS to match all of the 1099 forms it receives from financial institutions and corporations with the appropriate tax returns, and to send out letters whenever there is an apparent discrepancy. The bill also expresses the sense of the Congress that it will appropriate whatever money is needed for the IRS to adequately enforce the tax laws regarding interest and dividend income. The IRS has testified that the success rate for such letters is about 50 percent, and Rep. Fisher has stated that this proposal will avoid the unfairness of an indiscriminate withholding scheme as well as the cost and complexity of an elaborate exemption system.





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### CHAPTER III. INCREASING TAX COMPLIANCE: AN ANALYSIS OF WITH- HOLDING AND THE ALTERNATIVES

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This chapter compares the expected gains from withholding with the costs it would entail. Since there may also be less costly alternatives to withholding that would be equally effective in increasing the compliance rate for reporting interest and dividend income, these options are examined as well.

#### BENEFITS

##### Reduction of Tax Avoidance

Taxes on income earned as wages and salaries are withheld at the source, while those on interest and dividend income are not. This enables interest and dividend recipients to avoid taxation by neglecting to report the income on their tax returns. Many argue that withholding on interest and dividend income is needed because it is the remedy most certain to reduce tax avoidance and fraud. Currently, it is estimated that between 84 and 90 percent of all interest income is reported, and between 84 and 92 percent of all dividend income, while the corresponding figure for wages (most of which are subject to withholding) is approximately 97-98 percent. Thus, the rate of noncompliance for investment income is between four and eight times as great as that for wages.<sup>1</sup>

##### Revenue Effects

It is estimated that withholding would raise about \$3 billion a year in revenues (Table 1). The basis for the revenue estimate is a report published by the IRS in 1979, which set the amount of unreported interest and dividend income in 1976 at between \$7.5

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1. Testimony by Secretary of the Treasury G. William Miller before the Committee on Ways and Means, U.S. House of Representatives (April 30, 1980).



billion and \$14.1 billion.<sup>2</sup> Because of some uncertainty with the original base figures, they have been modified by CBO in arriving at the estimates shown in Table 1. The actual revenue gain could be significantly higher or lower than estimated, depending on the effectiveness of the withholding program and on the behavior of taxpayers.

The gain from increased compliance may be understated because of the assumption that taxpayers who have been underreporting in the past will continue to do so in the future. Thus only 15 percent of the income (the amount of the proposed withholding) is assumed to be collected, and not 25 percent (the average marginal tax rate). If some taxpayers were led to report their investment income fully, an effective tax rate approaching 20 percent or more might be achieved. On the other hand, CBO assumes that there would be a certain amount of inevitable slippage in any system of withholding. Moreover, a \$200/\$400 interest and dividend exclusion has been incorporated into this estimate, and it is assumed that it will continue indefinitely.<sup>3</sup> This would reduce the amount of the revenue gain by no more than 5 percent, however, since so little investment income is earned by taxpayers with less than \$200/\$400 in such income.

The portion of the gain resulting from a speed-up in tax receipts has been the subject of some controversy. The speed-up has been seen by some as simply a gimmick enabling a more rapid transfer of tax dollars from citizens to the government. The

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2. Internal Revenue Service, "Estimates of Income Unreported on Individual Income Tax Returns," Publication 11045 (September 1979).

3. Section 404 of P.L. 96-223, The Crude Oil Windfall Profit Tax Act of 1980, exempts the first \$200 of interest and dividend income (\$400 for joint return filers) from taxation. The provision is effective for income earned in 1981 and 1982.



TABLE 1. REVENUE EFFECT OF WITHHOLDING (Billions of dollars)

Fiscal Year	Increased Compliance <sup>a</sup>	Speed-up of Tax Receipts <sup>b</sup>	Total Gain
1981	1.0	2.4	3.4
1982	2.2	0.3	2.5
1983	2.5	0.3	2.8
1984	2.8	0.4	3.2
1985	3.1	0.4	3.5
Five-year revenue gain			15.4

Note: The revenue estimate is consistent with those of the Joint Committee on Taxation and the Treasury, but differs from an estimate in an earlier CBO publication. A revenue gain of \$6.5 billion for fiscal year 1981 was included in the section on withholding of Reducing the Federal Budget: Strategies and Examples (Congressional Budget Office, February 1980), and was later cited in The New York Times, the Congressional Record, and elsewhere. When the details of the President's withholding plan were later announced, some of the assumptions (and thus the estimate itself) were invalidated. For example, the estimate assumed a full-year effect from increased compliance, while a January 1, 1981, effective date would only result in a half-year effect.

- a. Revenue gain attributable to the taxing of interest and dividend income that was previously unreported.
- b. Revenue gain resulting from the collection of tax receipts in an earlier fiscal year than if withholding were not adopted.

speed-up is essentially a one-time effect that occurs because two quarters of withholding are collected in the first fiscal year but not applied to taxpayer accounts (reducing taxes owed or increasing refunds) until the following fiscal year. The same type of speed-up occurred when withholding on wage and salary income was initiated in 1943. In effect, the speed-up is an inevitable



result of a plan to increase tax compliance, with the related revenue increase reduced to a minimal amount after the first fiscal year.

### COSTS

These revenue gains are not costless. Expenses are involved in increasing the compliance rate for reporting interest and dividend income, and in collecting the corresponding revenue gain. The costs to both the government and the financial community will eventually be passed on to taxpayers and investors. The following discussion seeks to compare the costs of several alternative methods of ensuring compliance with the tax laws, and to determine whether the costs outweigh the potential benefits. This is an extremely difficult task, because objective cost comparisons of the alternatives are not available.

### Withholding by Financial and Corporate Institutions

Although a reporting system already exists for the financial industry, the withholding proposal would entail additional administrative costs. Treasury Secretary Miller has admitted that there are always costs when an existing system is modified.<sup>4</sup> But he stressed the fact that 87 percent of the interest and dividend income covered by the withholding plan is already subject to the reporting requirement. An additional economy would come from making the exemption forms (the handling of which would be the primary cost for most institutions) permanent until they are declared to be superseded so that an annual exemption form, as in the case of wages, would not be required.

The costs withholding would be paid by the investors in banks, savings and loan associations, corporations, and other financial institutions. Banks and savings and loans may not be able to pass on all of their costs, and this may account for the substantial amount of public criticism of the withholding proposal by the financial community. Corporate and other financial

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4. Testimony by G. William Miller before the Committee on Ways and Means, U.S. House of Representatives (April 30, 1980), p. 7.





institution sources concede that the widespread use of computers will "keep the paperwork headaches to a minimum."<sup>5</sup>

Many small banks and savings and loan associations located in rural and suburban areas do not currently utilize computers in their daily operations, and withholding would require them to add an additional element to their accounting procedures. While many of these smaller institutions will undoubtedly be able to use the computer facilities of larger banks and companies, the additional costs may still be significant.

A spokesman for the Independent Bankers Association of America, 80 percent of whose members are banks with less than \$25 million in assets, has reported that many still utilize manual posting of accounts. Start-up costs for those members with computers would average about \$30,000 to \$50,000, and annual costs would range from \$1.85 to \$2.00 per account. For those using manual procedures, the costs of implementing the system are thought to be lower than those of administering it on a year-to-year basis. Exact cost figures for banks without computer facilities were not available. The total annual cost for all commercial banks was estimated to be between \$200 million and \$300 million per year.<sup>6</sup>

The Treasury does not have an estimate of what the costs of withholding would be for the financial industry, and is not planning to develop a detailed estimate of the costs in the near future. It states, however, that the costs will not be substantial, and that the only major problem will involve the exemption

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5. Tim Metz, "Administrative Difficulty Is Seen in Plan to Withhold Interest and Dividend Tax," The Wall Street Journal (March 19, 1980). In another account, industry analysts were quoted as saying that "the withholding plan wouldn't be much of a problem at all." Art Pine, "Congress May Kill Tax-Cut Golden Egg," The Washington Post (May 2, 1980).
  6. Testimony by Thomas F. Bolger, Independent Bankers Association of America (May 1, 1980), p. 5.



forms.<sup>7</sup> Thus, while withholding may very well be the most cost-effective method of increasing compliance, there is not (as yet) any solid evidence to substantiate that claim.

#### An Alternative: Increased Appropriations

Although it is clear that a significant portion of interest and dividend income is not reported, many maintain that a withholding system is not the most effective, efficient, or equitable way to ensure payment of taxes on this income.

During testimony before the House Committee on Ways and Means, almost every witness representing the financial community suggested that more stringent and effective review of tax returns by the IRS would be preferable to withholding. Testimony by Edward T. Fergus is representative of the prevalent view of the financial community:

Interest and dividends in the billions are now reported to the IRS by financial institutions. However, the IRS has been unable or unwilling to properly match this data to tax returns in its audit surveillance programs. . . . To impose tax withholding is admitting IRS should expand its audit programs to have the capacity of completely matching all documents received from financial institutions to tax returns. . . . We recommend that Congressional support is needed to provide the IRS with the audit capability to match all of the income that is the subject of this hearing.<sup>8</sup>

Even if all the bits of information on the magnetic tapes that are sent to the IRS were matched with tax returns, however,

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7. According to Secretary of the Treasury G. William Miller, "With a reporting system largely in place, we do not anticipate high continuing costs of the system to withholding agents." Testimony before the Committee on Ways and Means, U.S. House of Representatives (April 30, 1980), p. 7.
  8. Testimony of Edward T. Fergus, President, Wall Street Tax Association, Committee on Ways and Means, U.S. House of Representatives (May 1, 1980), pp. 1-2. Also see testimony by Roscoe L. Egger, Jr., for the United States Chamber of Commerce, p. 9.



the service lacks the means to pursue and collect from all of the taxpayers whose returns indicate discrepancies. The IRS says it now matches about 80 percent of the over 300 million bits of information it receives each year, and finds about 10 million discrepancies. To contact over 10 million people, many of whom owe only small amounts of tax, would not be economical, the Treasury has testified, and "would inevitably be regarded as harrassment of the 'little people'."<sup>9</sup> A series of verifications would first have to be made to ascertain whether the apparent discrepancy was the result of an oversight or an error. The IRS has found that only about half of all taxpayers are likely to respond to the initial contact and pay the tax that is due, and further expense would be necessary to collect from the remainder. The position of the Administration, then, is that these many millions of discrepancies can best be eliminated through a system of withholding. This would enable the IRS to concentrate its rather limited resources on more complex and high-yielding returns--those of corporations, partnerships, and upper-income individuals.

The IRS estimates the cost of an auditing program designed to bring interest and dividend income compliance up to the level that presently exists for wages at somewhere in the range of "hundreds of millions of dollars."<sup>10</sup> But even if more money was provided for auditing and enforcement, it might not be used in the area of interest and dividend income since there are other areas in which compliance is far worse, including earnings of independent contractors, rents and royalties, and income gained illegally. Moreover, general audit rates have been gradually decreasing, and some in IRS want to divert additional appropriations to this area. Table 2 illustrates the extent of the compliance problems in areas outside that of interest and dividend income.<sup>11</sup>

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9. Response by Secretary of the Treasury G. William Miller to questioning before the Committee on Ways and Means, U.S. House of Representatives (April 30, 1980).

10. Interview with Stan Koppelman, Special Assistant to the Commissioner, Internal Revenue Service (June 26, 1980).

11. Committee Report, Underground Economy Hearings, Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives (July 16, September 10, October 9, 11, 1979), p. 98.



TABLE 2. ESTIMATED AMOUNT OF UNREPORTED INCOME FOR 1976 AS PERCENT OF REPORTABLE AMOUNT, BY TYPE OF INCOME

Type of Income	Reportable on Tax Returns	Reported on Tax Returns	
		Total <sup>b</sup>	As a Percent of Amount Reportable <sup>a</sup>
Legal-source income:			
Self-employment income <sup>c</sup>	\$ 93 - \$ 99	\$ 60	60 - 64
Wages and salaries	902 - 908	881	97 - 98
Interest	54 - 58	49	84 - 90
Dividends <sup>d</sup>	27 - 30	25	84 - 92
Rents and royalties	9 - 12	6	50 - 65
Pensions, annuities, estates, and trusts	31 - 33	27	84 - 88
Capital gains	22 - 24	19	78 - 83
Other <sup>e</sup>	9 - 10	7	70 - 75
Total	1,148 - 1,172	1,073	92 - 94

SOURCE: Internal Revenue Service, "Estimates of Income Unreported on Individual Income Tax Returns," Publication 11045 (September 1979), p. 8.

- a. Sum of components may not add to totals due to rounding. Percents of amounts reportable were computed from unrounded figures.
- b. Small amounts of illegal-source income are included in the figures below. These inclusions do not significantly affect the percentages shown in the right-hand column.
- c. A conceptual issue should be noted here. For certain kinds of income, TCMP records separate estimates of both gross and net income underreporting. The first is confined to understated gross while the second adds overstatement of allowable offsets. All TCMP-based figures in this report refer to estimated underreporting of net income. In the case of schedule C and F income, this conceptual choice actually makes little difference since the lion's share of adjustments to net income estimated by TCMP are in the area of gross receipts, with only a small proportion (6 percent) attributable to overstated business expenses. For some other kinds of income, such as rents, the situation is reversed, with slightly less than two-thirds of the underreported net rental income being attributable to overstated offsets and slightly more than one-third to understated gross rents.
- d. Dividends include an estimated portion of distributed net profits of qualified small business corporations.
- e. Excludes from the NIPA income concept which defines income as earnings arising from the current production of goods and services.





### An Alternative: Increasing the Penalty for Tax Evaders

Currently, if a taxpayer is audited and is discovered to have underreported his interest and dividend income, he is generally required to pay the tax plus accrued interest. Since the probability of being audited is small for most taxpayers, this type of minimal penalty is not likely to deter many evaders. A penalty of three or four times the amount of unpaid tax might be much more effective. On the other hand, it might fail if those accused of underreporting interest and dividend income were to plead ignorance or negligence, thus obtaining reduced fines.

### OTHER CRITICISMS OF WITHHOLDING

#### Exemption Forms and Procedural Difficulties

Although no detailed outline of the procedures involved in withholding has yet been made public, the Treasury has indicated the basic steps that banks and other financial institutions would be required to take in order to comply with the proposal. Banks would withhold annually at their option on passbook accounts, and at maturity, or the end of the year, for certificates of deposit. They would be responsible for remitting the taxes once a month, just as they must now remit taxes withheld on wages. At present they send information statements on gross income to investors, and magnetic tape with the same information to IRS. Should withholding be instituted, the information statements would also show the amount of taxes withheld.

As mentioned previously, the principal difficulties arise with the matter of exemptions, and more specifically with exemption forms for current customers. A new investor could apply for an exemption at the time of opening an account by supplying the necessary information (a checkmark or a code filled in at the appropriate place) on the card containing his or her name, Social Security number, and account number(s). Investors with existing accounts would need to fill out an additional card. This might be arranged by sending cards to all depositors along with the previous year's information statement. A similar system could be used by corporations for their dividend recipients. Since the exemption would be valid indefinitely, this need be done only once.

The IRS would be responsible for publicizing the new withholding system, for checking exemption eligibility, and for



acquainting investors with the need to fill out exemption forms if no tax liability is expected. In the process the IRS would probably receive better information, since investors are more careful in filling out personal information if they know that it will count toward the payment of taxes. The IRS has found far fewer mistakes on tax returns due a refund than on those owing additional tax.

#### The Potential for Overwithholding

Another criticism that has been directed at the withholding plan is that it would result in overwithholding for people who incur little or no tax liability during the year. To ensure that overwithholding would be minimal, Secretary Miller proposed the widespread use of exemption forms by those who believed they would not have sufficient tax liability. Overwithholding should not be a substantial problem; there would be several special exemptions, and moreover a withholding rate of 15 percent would be only one percent over the minimum marginal tax rate. But it is conceivable that some taxpayers, especially those who were not well informed about the exemption process, might be overwithheld.

The inconvenience and loss of interest income from overwithholding would be reduced if the majority of depository institutions elected to withhold the tax on an annual basis. This would mean that a refund could be secured soon after the tax was withheld. The government could also elect to refund the amount of interest lost as a result of overwithholding. There has been some concern about withholding tax on interest and dividend income that is tax-exempt under the current \$200/\$400 interest and dividend income exemption. The Treasury has stated that taxpayers below the \$200/\$400 level would be able to adjust their withholding on wages or on their quarterly estimated tax payments in order to compensate. The Treasury thinks that this would offset the potential overwithholding in most cases.

Table 3 shows the potential extent of the overwithholding problem. The 7.1 million taxpayers with no tax liability would be able to file exemption forms, while the 18.4 million taxpayers with interest and dividend income under the \$200/\$400 exclusion would be able to adjust their withholding on wages or on their estimated payments.<sup>12</sup>

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12. Description of Proposals Relating to Withholding on Interest and Dividends, Joint Committee on Taxation, p. 27.



TABLE 3. RETURNS WITH INTEREST AND DIVIDENDS THAT HAVE NO INTEREST AND DIVIDEND LIABILITY (1979 income levels, returns in thousands)

Expanded Income Class (thousands)	Returns Reporting Interest and Dividends	Non- Taxable Returns	Returns With Less Interest and Dividends than the \$200/\$400 Exclusion
Below \$ 5	6,179	4,889	780
5 - 10	7,222	1,801	2,377
10 - 15	6,802	202	3,086
15 - 20	6,607	79	3,389
20 - 30	10,776	70	5,711
30 - 50	6,720	23	2,743
50 - 100	1,888	2	331
100 - 200	339	—	20
200 and over	90	—	2
Total	46,622	7,067	18,439

SOURCE: Description of Proposals Relating to Withholding on Interest and Dividends, Joint Committee on Taxation (April 29, 1980), p. 27.

#### Burdening the Elderly

Since the elderly depend much more on investment income than other taxpayers, withholding could impose a disproportionate additional burden on them. Secretary Miller has stated that fully 70 percent of all senior citizens would not be subject to withholding, and that special considerations might reduce the likelihood of their being withheld still further. As an example of such special considerations, Miller suggested that an exemption from the withholding requirement be provided for all married couples filing jointly who are 65 or older, whose interest and dividend income for the current and prior year is less than \$15,000, and whose total tax liability does not exceed 10 percent of their investment



income.<sup>13</sup> Even with such an exemption, however, it would still be possible for the elderly to be overwithheld, since persons over 65 earn 56 percent of all taxable interest and dividend income, and this investment income comprises 36.8 percent of their total income.<sup>14</sup> Moreover, some might be unable or unwilling to file for an exemption from the withholding requirement: older taxpayers are generally less mobile than others, and they also may not have access to sources of information that would alert them of the need to file for an exemption.

Table 4 shows that of the approximately 7.9 million taxpayers aged 65 or older who report interest and dividend income, nearly 30 percent, or 2.3 million, are nontaxable and would not be subject to withholding. An additional 400,000 earn interest and dividend income in amounts less than the \$200/\$400 exemption levels. These taxpayers would be able to adjust their estimated tax payments to compensate for the withholding, unless this is their sole source of income—in which case they would almost surely be overwithheld.

#### Miscellaneous Objections

Withholding has been criticized by some who feel that it is tantamount to forcing the private sector to perform a government function, the collecting of taxes. But taxes on wages and salaries have been withheld since 1943. Social Security taxes are also withheld. Thus, a consistent stand against this approach to tax collection would necessitate widespread changes in the current system.

Another objection is that the payment of taxes should not be made easy; rather, it should be painful in order to ensure that citizens are aware of the cost of government. Withholding, some think, siphons off taxes before taxpayers realize they have paid

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13. Testimony by G. William Miller (April 30, 1980), p. 7.

14. Tax Calculator, 1979 income levels, 1979 law.





TABLE 4. RETURNS WITH INTEREST AND DIVIDENDS FILED BY TAXPAYERS AGED 65 OR OVER WHO HAVE NO INTEREST AND DIVIDEND LIABILITY (1979 income levels, returns in thousands)

Expanded Income Class (thousands)	Returns Report- ing Interest and Dividends	Nontaxable Returns	Returns With Less Interest and Dividends than the \$200/\$400 Exclusion
Below \$5	1,322	1,225	5
5 - 10	2,409	911	63
10 - 15	1,617	89	157
15 - 20	820	21	82
20 - 30	899	29	63
30 - 50	474	8	17
50 - 100	262	1	5
100 - 200	66		
200 and over	26		
Total	7,895	2,284	392

SOURCE: Description of Proposals Relating to Withholding on Interest and Dividends, Joint Committee on Taxation (April 29, 1980), p. 28.

anything, while the conscious act of paying taxes at the end of the year leads them to scrutinize the government's use of tax dollars more closely. But this again is an objection to all types of withholding, not just to withholding a portion of interest and dividend income.

Finally, withholding is criticized as yet another example of government harassment of citizens. The alternative to withholding most often suggested, however (increased appropriations for auditing and collections by the IRS), could involve an even greater degree of "harassment." The Administration has argued that a system of withholding at the time the investment income is earned would be preferable for this reason. Either option would represent an additional entry of the government into the lives of citizens. The only way to avoid this would be to accept the degree of tax evasion that presently exists.



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#### CHAPTER IV. SAVING INCENTIVES AND WITHHOLDING

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There has recently been much anxiety over the declining rate of saving in the United States. It is widely believed that the low rate of productivity increase and the high rate of inflation are directly attributable to a low rate of personal saving, now approximately 4 percent of disposable income.<sup>1</sup> By comparison, the rate of saving in western European nations and Japan is between four and five times that in the United States.<sup>2</sup> Many proposals designed to increase the rate of productivity by creating incentives to save and invest have been introduced during this Congress, including accelerated depreciation and various other incentives. A \$200/\$400 interest and dividend income exemption was recently passed by the Congress as an amendment to the windfall profits tax bill (discussed in some detail as an appendix to this paper).

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1. Martin Feldstein and Charles Horioka, Domestic Saving and International Capital Flows (Harvard Institute of Economic Research, April 1979), examine the relationship between saving and investment. MAPI Capital Goods Review No. 114 (April 1980), "Savings Levels and Productivity Growth: Comparative Trends in Major Industrial Countries, 1960-1977," goes further, suggesting that "the relative level of gross savings is a significant explanatory factor [for a slow productivity growth rate in the United States], and there is also a close relationship between the personal savings ratio [the ratio of savings to disposable personal income] and productivity growth."
  2. In 1979, the rate of personal saving in the United States averaged 4.5 percent, with the figure dropping to 3.7 percent for the first quarter of 1980. Survey of Current Business, U.S. Department of Commerce (May 1980), p. 8. Corresponding figures for 1979 obtained from economists at the International Monetary Fund are 13.5 percent for West Germany, 16.7 percent for France, 15.8 percent for the United Kingdom, and 18.7 percent (estimated) for Japan.



## IS WITHHOLDING A DISINCENTIVE TO SAVING?

Many Members of Congress and some economists have expressed the opinion that establishing a system of withholding on interest and dividend income would run counter to efforts to create incentives for saving and investment. They fear that withholding a portion of investment income would only serve to discourage people from investing, after the passage of an interest and dividend income exemption had made it clear that the Congress was seeking to promote saving and other forms of investment.

The respective goals of investment incentives and withholding need not contradict each other. These goals (increasing investment and increasing tax compliance on interest and dividend income) can be pursued simultaneously; tax evasion need not be accepted simply because a higher personal saving rate is desired. The proposal to withhold is simply a means to ensure that taxes that are legitimately owed are paid. Tax incentives make it more attractive to save by lowering or eliminating the tax liability on investment income, while withholding would simply attempt to collect the tax that is due--regardless of the effective tax rates on such income.

Withholding would, however, introduce some disincentive to save because the government would be holding a portion of interest and dividend income that would almost certainly have continued to earn additional investment income were it not for the withholding system. When taxes on wages are withheld, wage-earners are immediately deprived of the use of that portion of their income. In the case of interest and dividend income, on which taxes are not currently withheld, the recipient may retain and make use of the income for up to one year from the date it is earned before paying taxes. While the use of funds for a year is a distinct advantage in itself, the advantage is accentuated by high rates of inflation. Because the value of the dollar is steadily declining, a tax paid one year in the future is smaller in real terms than a tax paid now. Therefore, the wage-earner receives less income than an investor earning the same amount of money, but whose income is not subject to withholding.

A numerical example will illustrate the extent of the disincentive to save that could result from withholding. If an investor earns \$2,000 in interest and dividend income each year on assets of \$20,000, then \$75 would be withheld each quarter. This would result in an annual loss of just under \$20 in investment



income, assuming an average return on investment of 10 percent.<sup>3</sup> Since only about 25 percent of all investors earn over \$2,000 in such income, the majority would, of course, lose much less than \$20 per year. While the loss in the above example constitutes only about one percent of the taxpayer's total investment income, it may nevertheless serve as a disincentive to invest for some people. The disincentive would be much smaller or even nonexistent for those who now pay estimated taxes each quarter.

The advantageous tax treatment that is conferred on investment income (and its recipients) is justified by some who think there are substantial differences between wages and investment income. For example, income from investment is seen as the reward for deferring consumption until some future time. Because investment contributes to productivity and reduces inflation, it is argued, it should be given special encouragement; it should not be treated simply as ordinary income and withheld for tax purposes.

#### WITHHOLDING AND THE PHASE-OUT OF REGULATION Q

An amendment to P.L. 96-221 provides for the gradual phase-out over six years of Regulation Q, which sets interest rate ceilings on deposits at banks, savings and loan associations, mutual savings banks, and credit unions. The passage of the bill ensures that interest rates on accounts with depository institutions will increase and, correspondingly, the amount of interest earned by depositors. The portion of interest income earned in such accounts makes up approximately 40 percent of all interest and dividend income currently reported; an increase in the interest rate on the average savings account from 5 percent to 8 percent would result in an increase of about 60 percent of interest income in these accounts alone, assuming (conservatively) that deposits do not increase in response to the higher interest

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3. Withholding in the first quarter would result in a full year's loss of interest on  $.15 * \$500 = \$75$ , or \$7.50. Each successive quarter's loss to the taxpayer would be about one-fourth less than the previous quarter. Thus, the total loss in one year would be approximately  $\$7.50 + 5.62 + 3.75 + 1.87 = \$18.74$ . The Treasury has made a similar calculation, showing that a rate of return of 9 percent is reduced to 8.93 percent if one year's interest is lost because of withholding.





rates.<sup>4</sup> Such an increase in the amount of investment income would make the task of ensuring tax compliance in this area even more difficult than at present. As the amount of investment income (and very possibly the amount of avoidance) increases, withholding may appear more attractive and more efficient than increased IRS auditing. In addition, the increased return to investors would more than offset the small disincentive to saving that results from withholding.

#### WITHHOLDING AND THE \$200/\$400 INTEREST AND DIVIDEND EXEMPTION

As mentioned previously, Congress approved a \$200/\$400 interest and dividend exemption as an amendment to H.R. 3919, the oil windfall profits tax bill. The amendment is an attempt to stimulate investment by small savers who would be attracted by the possibility of tax-free income. The appendix to this paper examines the interest exemption amendment in detail. Aside from its merits as an investment stimulus, the proposal may have implications for a system of withholding as well.

Under the exemption, which does not require investors to increase their interest and dividend income to be eligible for the tax reduction, many taxpayers will cease to owe taxes on their limited amount of investment income, while others will owe significantly less than in the past. If it is assumed that all investors (large as well as small) neglect to report their interest and dividend income in relatively similar proportions, then the revenue gain from withholding will be somewhat reduced. This is because some taxpayers who have previously neglected to report their investment income will now cease to owe taxes on that income, and will not be withheld. However, although taxpayers earning interest and dividend income below the \$200/\$400 threshold level constitute almost 50 percent of all taxpayers with interest and dividend income, their investment income comprises less than 3 percent of the total.<sup>5</sup> Thus, the effect of the exemption will not be to significantly reduce the potential revenue gain, or the need for withholding, since over 97 percent of all investment

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4. Currently, approximately \$700 billion is on deposit in personal savings accounts in banks, credit unions, and savings and loan associations. An average increase in the interest rate of 3 percent would result in \$21 billion more interest income each year, from the present \$35 billion to \$56 billion.

5. Tax Calculator, 1979 income levels, 1979 law.



income will still be taxable and a portion of this will almost assuredly continue to go unreported.



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## APPENDIX.            TAX INCENTIVES FOR SAVING

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Exempting some portion of savings interest from taxation would add to the incentive to save, possibly creating funds for investment. The extent of added saving depends on (1) how much money is diverted from consumption to saving because of the higher after-tax return, and (2) what savers decide to do with the tax savings on existing interest earnings. CBO has examined the amendment to H.R. 3919, the Windfall Profits Tax, which exempts from taxation the first \$200 of interest and dividend income (\$400 for joint returns) earned in 1981 and 1982.

Investment incentives (such as the investment tax credit) need a pool of potential savings on which to draw if they are to be effective rather than simply inflationary. An effective saving incentive will reduce consumption and free resources for investment purposes. There is no evidence, however, that the \$200/\$400 interest and dividend exclusion will prompt large amounts of new saving.

### SAVINGS AND INVESTMENT GAINS

A tax exemption for interest will prompt an increase in saving by some of those who do not presently earn enough interest to receive the maximum exemption. These people will have an incentive to raise their savings balances and investment holdings because the additional income earned will not be taxable, giving them a higher effective yield on their holdings. People who now hold savings balances generally do not have excess liquid assets that could be deposited in a savings account, so in order to save more they will need to reduce their consumption expenditures. The shift will take place over several years as people gradually alter their consumption and saving decisions. However, CBO estimates the total increase over time at only \$2.5 billion--not a large sum when compared to the present total of approximately \$700 billion on deposit in individuals' accounts in commercial banks, savings and loan associations, and credit unions.

A further increase in saving and investment will occur under this exemption because people will save a portion of their tax reduction. This effect is present under any type of general tax



cut, however. For those taxpayers who already have interest and dividend income of a sufficient amount to qualify for the full exemption, the bill offers no new incentive to increase their saving or investment. The only savings increase from this group will result from their willingness to save or invest a portion of the decrease in their tax liability. This source of added saving will recur each year, but is estimated at only about \$100 million annually.

The estimates in Table A-1 assume that the demand for savings balances increases with the rise in after-tax yields for savers who earn less than \$200 (\$400) of interest and dividends annually. CBO assumes an elasticity of saving with respect to after tax yield of 0.4.<sup>1</sup> Savers who already earn at least \$200 (\$400) in interest and dividend income add to their savings only because the tax exemption slightly increases their after-tax incomes. CBO also assumes they still save the same proportion of disposable income. Because many lower- and middle-income families will not have the resources to increase their saving and investment even though the effective yield is greater, this incentive effect may produce less additional saving than the estimate shown below. CBO believes the estimate shown in Table A-1 is an optimistic view of the likely increase in saving resulting from the \$200 (\$400) interest and dividend exemption.

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1. This is the percent change in saving divided by the percent change in the after-tax rate of return. Michael J. Boskin, "Taxation, Saving, and the Rate of Interest," Journal of Political Economy, p. 516. The estimate falls in the upper range of estimates for this type of response. Therefore, the resulting estimates of increased saving and investment may be overstated.





TABLE A-1. SAVING AND INVESTMENT INCREASE (In millions of dollars)

	Incentive Effect <sup>a</sup>	Annual Income Effect <sup>b</sup>	Totals
Large savers (over \$200/\$400 interest and dividend income)	\$ 0	\$ 77	\$ 77
Small savers (under \$200/\$400 interest and dividend income)	2,490	25	2,515
Total	\$2,490	\$102	\$2,592

a. The amount of additional saving resulting from the incentive to bring interest and dividend income levels up to the amount of the exemption (\$200 for single return filers, \$400 for joint filers).

b. The portion of the tax reduction that will be saved.

#### DISTRIBUTION OF TAX SAVINGS

Exempting interest and dividend income from taxation will obviously benefit those who already have savings balances. As shown by Table A-2, most people who will have their taxes reduced by the interest and dividend exemption would receive a similar break if an across-the-board tax cut were approved. Because of the dollar limitation on the current exemption for interest, the over-\$50,000 income group would benefit proportionately more from a reduction in tax rates than from this interest exemption. Yet, the people who will benefit most in dollar value from the exemption are those who already earn \$200 (\$400) in interest and dividend income and will not have to alter their behavior to have their tax liability reduced. About 51 percent of all households in the United States have annual interest and dividend earnings of \$200 (\$400) or more, and these large savers earn almost 98 percent of all interest and dividend income.

Shown below is a comparison of the distribution of benefits from a proportional tax cut, and from the \$200/\$400 per person interest and dividend exemption:



TABLE A-2. DISTRIBUTION OF TAX SAVINGS BY INCOME CLASS

Income	Across-the-Board Tax Cut	\$200/400 Interest and Dividend Exemption
Less than \$5,000	0.4	1.1
5,000-10,000	5.2	9.5
10,000-15,000	10.7	12.4
15,000-20,000	14.5	15.0
20,000-30,000	25.8	27.3
30,000-50,000	19.7	23.2
50,000 and over	23.7	11.6
	<u>100.0</u>	<u>100.0</u>

SOURCE: Tax Calculator, 1978 income levels, 1979 law.

#### REVENUE LOSS

The estimated direct revenue loss for a \$200/\$400 interest and dividend exclusion is shown below. As will be noted from Tables A-1 and A-2, an estimate which makes generous assumptions of the response to the incentive results in a one-time addition to saving that is nearly the same as the recurring annual revenue loss. As mentioned previously, the recurring addition to saving is quite small in comparison to the current aggregate amount of personal saving.

TABLE A-3. REVENUE LOSS FROM INTEREST EXCLUSION BY FISCAL YEARS  
(Millions of dollars)

1981	1982	1983	1984	1985
314	2,275	2,410	2,552	2,508



The economic stimulus arising from the income effect will be the same as in any other tax cut proposal, and will offset a portion of the gross revenue loss. However, to the extent that the incentive prompts additional amounts of investment, the feedback effect will be greater than that of an across-the-board tax reduction.

#### EVALUATION OF EXEMPTION PROPOSALS

The primary shortcoming of this and similar plans is that most of the tax benefits will go to people who already have enough interest and dividend income to qualify for the full exemption. As discussed earlier, for these taxpayers it provides no new incentive to increase savings or investment holdings. This "wind-fall" gain constitutes approximately 75 percent of the total tax reduction under the described plan.

Another difficulty is that there is nothing in the plan that would prevent people from borrowing money, investing the borrowed funds, and getting a tax break on the interest and dividend income while deducting the interest payments on the borrowed funds. This defeats the real purpose of incentive proposals, which is to decrease the rate of consumption in favor of saving and investment. Admittedly, most people cannot borrow at a lower rate than their investment would earn. But some taxpayers may be encouraged to refrain from eliminating a debt that is already established so they can continue to earn tax-exempt income on savings accounts or other liquid investments.

Investors will have an incentive to retain a higher level of capital stock to the extent that the income earned on these investments will not be taxable, but the proposal can only be expected to generate an additional \$100 million in saving and investment per year, and this could be achieved by any individual tax cut of approximately \$2 billion.

In summary, this plan does not provide a new saving incentive to the group that has the resources to increase savings and investment holdings--large savers. The maximum likely increase in available capital is small in comparison with the amount that is needed by the economy. Finally, most of the revenue loss is generated by tax exemptions to taxpayers who will not increase their savings or investment.



#### ALTERNATIVES TO A SAVINGS EXEMPTION

The recently passed phase-out of Regulation Q, which will allow interest rates on savings accounts to rise to the market level, should prompt new investment. Another option that might shift resources from consumer spending to saving would be a tax based on consumption rather than income.

As an alternative to extending the \$200/\$400 tax exemption, a more effective tax incentive for saving and investment could be provided by giving a credit for new saving above an established threshold level. The threshold level could start at a small percentage of adjusted gross income for low incomes, and rise to about 10 percent of AGI for large incomes. Thus, the credit would be available only to taxpayers who save in excess of the average for their income bracket. This would reduce, but not eliminate, the windfall gains for those who already save normal amounts, yet would offer an incentive for all to increase their savings and investment. A plan of this kind would be quite complex, however, and for this reason may be impractical.

