

IN THIS ISSUE

- The Alternative Minimum Tax and Effective Marginal Tax Rates
- Taxing Corporate Capital Gains
- Good Versus Bad Inflation: Lessons from the Gold Standard Era
- How College Savings Can Reduce Wealth

The Alternative Minimum Tax and Effective Marginal Tax Rates

The Alternative Minimum Tax (AMT) is a provision of the U.S. income tax code that currently affects a modest number of taxpayers, but will become increasingly important over the next decade. The AMT was established in 1978. The AMT base includes all the components of Adjusted Gross Income (AGI), the capital gains exclusion, as well as such income tax preferences as oil depletion and accelerated depreciation. The AMT applies only when the resulting tax base exceeds an exclusion amount, which is \$58,000 for joint filers in 2004, but declines to \$45,000 beginning in 2005. For single filers, the exclusion is \$40,250 in 2004, and \$33,750 beginning in 2005. While most of the other key parameters of the tax code are indexed for inflation, the exclusion level for the AMT is not. Inflation, in conjunction with the reductions in income tax liability that were legislated in recent tax reforms, has therefore led to a growing number of AMT taxpayers in the last decade. Much more rapid growth is projected for the balance of the current decade.

In **The Alternative Minimum Tax and Effective Marginal Tax Rates** (NBER Working Paper No. 10072), NBER Research Associates **Daniel Feenberg** and **James Poterba** examine the impact of the AMT on the marginal tax rates that apply to various components of taxable income. They also consider the impact of several AMT reform proposals on the number of AMT taxpayers, total AMT liability, and the marginal tax rates that apply to wages, capital income, and deductions such as local and state taxes

and charitable gifts. Using the NBER's TAXSIM model, which calculates federal income tax and payroll tax liabilities for a representative sample of U.S. families, the authors project federal personal income tax liabilities as well as AMT liabilities between 2003 and 2013.

Feenberg and Poterba find that the AMT has only a modest impact on the average marginal tax rates for most sources of income because it

and interest income, are affected only modestly by growth in the AMT. In 2010, for example, the authors project that the AMT will raise the weighted average marginal tax rate on wage income by 1.3 percentage points relative to what it would be if the AMT were repealed, and no other tax changes were enacted. For interest income, the effect of the AMT on the weighted average marginal tax rate

“The AMT has only a modest impact on the average marginal tax rates for most sources of income because it raises marginal tax rates for some taxpayers and lowers marginal tax rates for others.”

raises marginal tax rates for some taxpayers and lowers marginal tax rates for others. They project rapid growth in the number of AMT taxpayers and in AMT liability until 2010. By that date, approximately 37 million taxpayers, or nearly one in four, will be subject to the AMT. The AMT will account for nearly 9 percent of total income tax revenue, or approximately \$125 billion. After 2010, when many provisions of the 2001 tax reform are scheduled to phase out, the number of AMT taxpayers should decline. But even if these 2001 reforms are phased out, the number of AMT taxpayers will rise again in subsequent years.

The authors use the TAXSIM data on more than 100,000 individuals to calculate the weighted average of the individuals' marginal tax rates on different income components. They find that average marginal tax rates on many individual income components, such as wages

is just below one percentage point.

These changes conceal larger changes in marginal tax rates for individual households. Some are pushed from marginal rates of 15 or 25 percent under the ordinary income tax into the AMT brackets of 26 and 28 percent. Others drop from marginal rates above 30 percent under the income tax to the AMT rate of 28 percent.

The authors' projections show that modest increases in the AMT exclusion level would substantially reduce the number of AMT taxpayers. Indexing the AMT to inflation would reduce the number of AMT payers in 2010 from 37 million to 14 million. Although that would reduce AMT liability from \$125 billion to \$48 billion, the resulting revenue loss slightly more than 5 percent of total personal taxes projected for 2010. These changes would also reduce the AMT's impact on average marginal tax rates.

— Les Picker

Taxing Corporate Capital Gains

To mitigate the possibility of a third layer of taxation on corporate income, the U.S. tax code allows corporations a partial deduction for dividends received from other corporations; however, returns earned as capital gains on intercorporate holdings do not receive any such relief. Instead, U.S. corporations face the same tax rate on capital gains as on ordinary income. In **The Character and Determinants of Corporate Capital Gains** (NBER Working Paper No. 10153), NBER researchers **Mihir Desai** and **William Gentry** find that capital gains taxes imposed on corporations are increasing in importance; they interact with other distortions in important ways; and they deter firms from realizing gains, thus impeding the reallocation of assets to their most efficient owners.

Desai and Gentry isolate the importance of corporate capital gains by comparing them to individual realizations of capital gains and to other corporate income subject to tax. Corporate capital gains realizations amount to 30 percent of individual capital gains realizations over the last half a century, and have grown in relative importance through the 1990s. Corporate capital gains also appear to have increased in importance relative to other sources of income for corporations — by 1999, capital gains realizations were 21 percent of income subject to tax for U.S. firms.

These large realizations are associated with a distinct set of distortions and policy implications relative to individual decisions about realization, according to Desai and Gentry. In particular, these taxes might impede the reallocation of assets between firms in an economy in a way that is not operative for

individual shareholders where the identity of the owner is unlikely to impact the productivity of the asset. Additionally, firms have been shown to face a variety of costs from raising external finance, and a realization-based tax on intercorporate holdings may exacerbate those costs by making asset disposal — an alternative to raising external finance — more costly. Finally, the favorable tax treatment of intercorporate dividends relative to capital gains earned by corporations may distort the pattern of stock ownership and is likely to trigger a number

level tax rates to identify how corporate capital gain realization behavior is influenced by these taxes. Controlling for firm characteristics and time-varying investment opportunities, Desai and Gentry find that the sales of investments and property, plant, and equipment are more likely and considerably larger in low-tax years. In addition to this evidence on disposal behavior, the likelihood and volume of gains, rather than losses, is particularly guided by tax considerations as predicted by the rules on corporate capital gains.

“Capital gains taxes imposed on corporations are increasing in importance; they interact with other distortions in important ways; and they deter firms from realizing gains, thus impeding the reallocation of assets to their most efficient owners.”

of tax planning efforts, detailed in the paper, to benefit from this tax rate differential.

In order to identify the impact of these taxes on corporate behavior, Desai and Gentry use time-series tests of aggregate realization behavior and panel data on individual firm realization behavior. The time-series tests provide evidence of elasticities for corporation capital gains taxes that are significantly higher than those for individual realizations. Given the highly correlated nature of individual and corporate realizations, Desai and Gentry include controls for a number of other possible omitted factors — including measures of market sentiment — and the measured elasticities are robust to the inclusion of these controls.

Given the difficulties inherent in such time-series tests, Desai and Gentry next use proxies for firm-

Desai and Gentry conclude by noting that the distortions to realization behavior that they identify are just one dimension of the distortions associated with this tax system. Specifically, they point out that “these taxes are likely to influence business planning on a variety of margins — including merger activity, the initiation and termination of lines of business, and the patterns of cross-holdings. In combination with the curious distinction between the treatment of intercorporate dividend payments and intercorporate capital gains, the results in this paper and these broader consequences suggest that tax policy for corporate capital gains may be ripe for reevaluation and that much more needs to be understood about how corporate capital gains taxes influence firm behavior.”

Good Versus Bad Deflation: Lessons from the Gold Standard Era

In **Good Versus Bad Deflation: Lessons from the Gold Standard Era** (NBER Working Paper No. 10329), authors **Michael Bordo**, **John Landon Lane**, and **Angela Redish** look back at deflationary periods of the late 19th century. These economists find that, contrary to conventional wisdom, deflation may well be more positive than negative.

Bordo, Landon Lane, and Redish focus on the price level and growth experience of the United States, Britain, and Germany during the late 1800s. This period, not unlike the present era, was notable for low inflation or even deflation, for rapid expansion resulting largely from technological innovation, and for a credible and internationally accepted gold standard. The researchers work from the premise that deflation might be good, bad, or even neutral. Good deflation, they maintain, occurs when aggregate supply of goods (say from technological advances, improved productivity, and the like) increases faster than aggregate demand, resulting in falling prices. Bad deflation in turn occurs when aggregate demand falls faster than any growth in aggregate supply. Negative money shocks, for example, that are non-neutral over a significant period — such as occurred later during the Great Depression — would generate “bad” deflation. Indeed, the authors say, such might be the case in Japan today. A neutral impact of deflation, meanwhile, might occur where monetary neutrality holds despite negative money shocks.

The researchers identify separate “supply shocks,” “money supply shocks,” and “non-monetary demand shocks” on output and prices. Their analysis is grounded in a model of money supply under the international gold standard. Their

results indicate that deflation in the three leading industrial nations in the late 19th century reflected both positive aggregate supply shocks and negative money supply shocks. Yet the latter had only a minor effect on output. The evidence thus suggests that deflation in the 19th century was primarily good, or at the very least neutral.

Bordo, Landon Lane, and Redish believe their findings have relevance for today’s economies, even though differences between the environment of their study and that of the modern era must be

Redish further acknowledge that their study does not deal with several issues in the current debate about the possible onset of deflation. Unlike today, for example, in the era before 1914 central banks rarely used monetary policy to stimulate national economies. Moreover, Bordo, Landon Lane, and Redish do not explicitly distinguish between the effects of actual versus expected price level changes. It is unexpected deflation, they stress, which produces negative consequences.

Finally, Bordo, Landon Lane, and Redish stress that although 19th

“Historically, the negative view of deflation may be attributed to the fact that deflation had been largely unanticipated. The negative view of deflation in the United States, no doubt, was reinforced by farmers who believed that the prices of the commodities they produced had fallen faster than the manufactured goods they consumed.”

borne in mind. Three such differences are significant. First, the 19th century was the classical gold standard regime, during which all three countries adhered to the gold standard convertibility rule and all faced a common money shock — the fluctuations in the demand and supply for gold. Second, aggregate supply appears to have been a significant source of the shocks in the 19th century. This stands in contrast to the deflation that occurred in 1920-1, as well as later following the stock market crash of 1929, and in the economic woes that beset Japan in the 1990s, which were demand driven. Third, the negative demand shocks that occurred only had minimal effects on output. This, the analysts note, contrasts sharply with the experience of 1929-33, a period in which many observers attribute the declines in output in the face of monetary contraction to nominal rigidities, such as wages.

Bordo, Landon Lane, and

century deflation was chiefly of the good variety, people hardly perceived it as good. The common view at the time in the United States, Britain, and Germany was that deflation was a clear sign, if indeed not a direct cause, of economic depression. Such a position in fact accounts for the concern about deflation that persists today in the United States, Europe, Japan, and China. Yet the researchers believe that, “historically, the negative view of deflation may be attributed to the fact that deflation had been largely unanticipated. The negative view of deflation in the United States, no doubt, was reinforced by farmers who believed that the prices of the commodities they produced had fallen faster than the manufactured goods they consumed.” The re-emergence of deflation today, the researchers conclude, would no doubt be equally unpopular.

— Matt Nesvisky

How College Savings Can Reduce Wealth

Under current tax and financial aid policies, saving for their children's college education can make parents worse off than if they had never saved at all. Although tax-advantaged education savings accounts are intended to increase assets, people with more assets, or with assets of the "wrong" sort, can get less financial aid. The treatment of assets by the federal formula that determines college aid depends heavily on the savings vehicle, and the name in which assets are held.

In **Tax Policy and Education Policy: Collusion or Coordination? A Case Study of the 529 and Coverdell Saving Incentives** (NBER Working Paper No. 10357), author **Susan Dynarski** picks her way through two labyrinths, taxes and financial aid, to calculate how much financial aid may be lost for each dollar held in various savings vehicles. Given the historically high levels of tuition nowadays, even relatively well-off families can qualify for need-based aid, and thus be affected by the aid rules. Dynarski finds that about half of families with income between \$40,000 and \$100,000 are affected by the aid tax.

Further, she finds that the parents of a high school senior who attends four years of college can

face a per dollar reduction in need-based aid of 15 cents if the funds are held in a 529 savings plan, between 26 and 39 cents if the funds are held in an IRA, and 40 cents if the funds are held in a mutual fund account in the parents' name. Funds held in a Coverdell

She argues that taxing equally all assets in the aid calculation, including home equity and retirement savings, would reduce the waste caused when families hide assets to avoid the aid tax. It would also treat different sections of the country more equally. At present, homeowners on

"Funds held in a Uniform Transfer to Minors Act account can reduce aid by as much as \$1.24 per dollar saved."

educational savings account can reduce need-based aid by \$1.22 per dollar saved. (The treatment of Coverdell savings accounts changed in early 2004, after this paper was completed.) Funds held in a Uniform Transfer to Minors Act account can reduce aid by as much as \$1.24 per dollar saved.

This variation in asset treatment has a cost, because it distorts decisions about the composition of savings. There is no concomitant benefit, however, because these wildly varying tax rates do not improve the targeting of aid toward needy students. Dynarski lays out a variety of policies that could better balance the goals of encouraging saving and steering financial aid toward those with fewer resources.

the East and West coasts can shield more assets because of their higher home values.

Unless assets and asset income are completely disregarded in the distribution of need-based aid, the aid determination process inevitably reduces asset returns and perhaps saving rates. At present, the aid tax distorts savings decisions without improving the targeting of need-based aid. Dynarski writes "[A]rbitrary tax variation undermines the goals of need-based aid, in that families with identical financial positions receive very different levels of aid, depending on whether they are savvy enough to steer their savings toward the right vehicles."

— Linda Gorman

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