"matching tax credit," which provides a match rate for voluntary contributions, are phased out. The phaseout ranges differ for the two types of subsidies, and yet another phantom is created for those with and without an employer-provided pension.

These complications all but ensure that an employer would have trouble figuring out how much to adjust wage withholding because of USA account activity. We already have much experience here; the main reason the credit is reflected in withholding for most employees is that the amount of the credit varies so much with income and family status that it is hard to know how much is likely to be available until after the end of the year. During the year, few have any idea of how much credit they will be eligible to receive.

For a variety of reasons, the administration set up the USA accounts separately from other retirement accounts held by individuals. For instance, withdrawals are much more restricted before age 65. Unfortunately, individuals already have multiple retirement vehicles — individual retirement accounts, 401(k) plans, money purchase plans, profit sharing plans, and so forth. That extremely messy universe would just be made messier.

A much simpler arrangement would have been simply to cap the subsidy without phasing it out.

The attempt to create maximum progressivity with the small amount of revenues available created yet another phantom. A large percentage of low-income and even middle-income individuals do not contribute to retirement plans like IRAs. Treasury decided, therefore, that it would grant large portions of the credit to individuals regardless of their level of contributions. Where there was to be a match, moreover, the match rate would be very high — either dollar-for-dollar at low-income levels or 50 percent at middle-income levels and above, as long as some eligibility was sustained. Because there was limited revenue to use for matching, the high match rate required that a taxpayer’s maximum subsidized deposits be limited to very modest amounts.

This distributional arrangement is also very different from what is offered in the rest of the private and public pension system. Subsidies for private pension plans are usually capped, rather than phased out (although there are exceptions). Social security achieves its redistributational objectives by causing high-income individuals with higher earnings higher levels of benefits, although less than proportional to earnings and taxes paid.

A much simpler arrangement would have been simply to cap the subsidy without phasing it out. There is no reason that the social security benefit formula could not be adjusted to provide the slight offset needed. Or one could freeze caps on maximum private pension contribution levels for a year or two and effectively create an offset to any gains at the top of the income distribution. In effect, there are a lot of ways to deal with distributive issues without all the machinations of the USA account proposal.

There are some other glitches. In an attempt to permit individuals with very low labor force participation from getting a windfall, the taxpayer would have to earn at least $5,000 to get the government subsidy. That would create a cliff effect at $4,899 or demand yet another phase-in schedule. All the phase-ins and phaseouts and cliffs, including this one, also create new marriage penalties.

Still, I don’t want to pick and pick away at the details. There are a lot of problems, as well, with existing private pension subsidies and with some of the redistribution within social security that goes to the rich, not the poor. The idea of a government-match plan is not a bad one, it simply has to be better coordinated with existing law. On net there should be some simplification, not additional complexity, as well as a better rationalization of the overall array of subsidies in the combined system. Or else the idea of a government match is simply too complicated to merit being patched onto the existing system. (For part one of this series, see Tax Notes, May 24, 1999, p. 1229; for part two, see Tax Notes, May 31, 1999, p. 1365. For prior coverage of the USA proposal, see Tax Notes, Apr. 19, 1999, p. 292, 332.)

Have you ever wondered if there is a simple way to increase your firm’s market value? There may be — by reducing the firm’s effective tax rate.

Every firm pays a different effective tax rate. Although statutory tax rates are the same, effective rates vary dramatically. Statutory rates are the rates stated in tax tables. Federal tax rates for most companies are 35 percent; state/local rates vary between zero percent and 10 percent; and foreign rates vary between zero percent and 40 percent. But these rates don’t matter; it is effective rates that matter. Effective rates take into account deductions, credits, and other special rules that can make the actual tax rate lower or higher than the statutory tax rate. Typically, effective rates are measured as actual taxes paid divided by actual income. Effective rates can be reduced by tax planning, and by lobbying for tax relief.

Federal effective rates are most often reduced by interest deductions (on debt), depreciation, and overseas operations. Unfortunately, other tax planning methods have been made impossible by legislation over the last 12 years. On the other hand, state/local and international taxes permit much more planning.

Gene Steuerle is a senior fellow at the Urban Institute and an economic consultant to Tax Notes.

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TAX NOTES, June 7, 1999

viewpoint

Increasing Stock Market Value By Reducing Effective Tax Rates

by Charles W. Swenson

This article describes a simple way by which firms might be able to increase their market value. By reducing its effective tax rate relative to industry standards, a company’s market value (and the value of executive stock options) can potentially increase.

Charles W. Swenson, CPA, PhD, is Professor of Accounting and Entrepreneurial Research Fellow at the University of Southern California. He is the author of numerous tax publications, including the book Strategic Tax Planning for MBA and Graduate Tax Students (Southwestern Press, forthcoming). He can be reached at (213) 80-4854.

The Bottom Line and Stock Performance

Income tax expense reduces bottom line earnings reported to shareholders. Since tax rates are largely controllable through planning and lobbying, it is no wonder that the stock market perceives a low-tax firm as a more profitable firm. What is interesting is the higher P/E ratios associated with low-tax firms.

To see this, I examined all publicly traded firms’ stock prices and financial statements from 1992 through 1997 inclusive. I examined firms’ effective federal, foreign, and state/local tax rates. Figure 1 reports firms’ P/E ratios, added together by eight industry groupings. These are the same industry groupings as used by W.F. Sharpe (“Factors in the New York Exchange Security Returns 1933–1970,” Journal of Portfolio Management 8:5-9, 1982).

The lighter bars are the median P/Es for firms whose federal effective tax rates are above the median industry effective tax rate. The darker bars show median P/Es for firms whose effective rate is below the industry median rate. As can be seen, in most industries low-tax-rate firms have higher median P/Es than their high-tax-rate counterparts.

I conjecture that the market views low-tax firms as better at controlling costs than their high-tax-industry counterparts.

A similar analysis can be done for foreign tax rates. Figure 2 shows this. The lighter bars are the median P/Es for firms whose effective foreign rates are above the median industry effective foreign tax rate. The darker bars show firms whose effective foreign tax rates are below the industry median rate. The chart shows that most low-foreign-tax firms have higher P/Es than their high-tax-industry counterparts.
Figure 1
Federal Taxes

Figure 2
Foreign Taxes

Figure 3
State Taxes

Figure 4
The Sine
by C.W. Swenson ©1999

Finally, we can do the same analysis for state/local effective tax rates. The chart above (Figure 3) shows that effective state/local tax rate firms have higher P/E's than their high effective tax rate counterparts.

The above results are not a fluke. I find very similar results whether I examine the data by two-digit or four-digit SIC code, and if I examine means (instead of medians). I conjecture that the market views low-tax firms as better at controlling costs than their high-tax industry counterparts.

Getting to the Top of the Sine
Figure 4 shows how firm overall effective tax rates relate to the firm’s relative P/E ratio. Relative P/E ratio is the ratio of the firm's P/E to the average P/E ratio for the industry. Overall effective tax rates include federal, state, and local taxes paid. Using an econometric (statistical) method and the aforementioned data, I estimate a sime-like functional form, that, if graphed, appears as shown below.

The figure shows that generally, lower effective tax rates are associated with higher relative P/E ratios. The exceptions occur at very low tax rates (under 5 percent) and at very high tax rates (above 55 percent); the market appears to dismiss such rates as temporary or as a "fluke." These two extreme tax rates give the sime-like pattern at the tails.

Effects on Executive Stock Options:
Because stock options are so highly leveraged, even small movements in your company's P/E ratio can put them in the money and increase your compensation.