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SEVEN REASONS FOR SAVING THE TAX CUT

INTRODUCTION

The corner has been turned. Nearly every economic indicator is signaling a strong recovery. Housing starts are running at 1.7 million a year, up from 900,000 units a year in June 1982. GNP is growing at 4 percent a year. The Stock Market has surged 40 percent since July 1982. New unemployment claims are down 500,000 and the unemployment rate fell from 10.8 percent in December to 10.3 percent in March. Economic indicators have surged to a one-month record high.[1]

But the recent spate of good economic signs does not appear to have trickled down to Congress. The House Budget Committee's first budget resolution for FY 1984 attacked the President's economic program as "the experiment that failed." The Committee's call for $30 billion in tax increases in 1984 is widely seen as taking aim at the July 1 income tax cut, the final 10 percent installment of the Economic Recovery Tax Act of 1981.

The repeal of the third tax cut would raise more than $28 billion in 1984, according to the Office of Management and Budget, just about sufficient to meet the House Committee's revenue recommendations. The specter of twelve digit budget deficits in the next years has convinced many Congressmen that the government cannot afford any revenue reductions. They claim that the third year is just another sop to the rich and must be repealed to prevent interest rates from rising again to levels that would choke off economic recovery.

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1 "First Concurrent Resolution on the Budget-Fiscal Year 1984." Report of the Committee on the Budget, House of Representatives, H. Con. Res. 91, March 21, 1983, pp. 27 and 282.

Those calling for repeal of the third year tax cut, however, are asking the Congress to make a grave mistake. There are least seven reasons for saving the tax cut:

1) to create jobs;
2) to boost small business;
3) to encourage savings;
4) to foster productive investment;
5) to shift the tax burden to the rich;
6) to help the average American; and
7) to counter bracket creep.

Repealing the third year tax cut would hit hardest middle- and lower-income Americans, and it would stifle the recovery now taking place. The tax cut is one of the most potent economic medicines Congress could administer to a recovering economy. The tax cut will create jobs, encourage capital formation to finance business expansion and the government deficit and put money into the pocketbooks of working Americans for more saving and consumer spending. Repeal of the third year tax cut, on the other hand, would throw a wrench into the gears of economic recovery.

The repeal of the third year tax cut would severely hurt small business--the most powerful generator of new jobs and new technology. Most smaller American businesses are either sole proprietorships or partnerships taxed through individual tax returns, rather than through the corporate income tax system. A July tax increase on this dynamic sector of the economy could cause the bottom to fall out of the economic recovery.

The repeal of the third year tax cut would also drive many taxpayers back into tax shelters, just when the tax cuts have begun to lure many taxpayers away from these nonproductive activities and into the financial markets. One indication of this shift: estimated income tax payments generally made by upper income individuals, reports Forbes magazine, are 10 percent higher in 1982 than the year before. The Treasury had predicted that the cut in the top bracket rate from 70 percent to 50 percent would actually reduce tax collections by $5 billion.

The repeal of the tax cut, however, would hit hardest of all the middle- and lower-income American. Households making between $10,000 and $50,000 a year pay about two-thirds of all income taxes. These Americans will get about 72 percent of the benefits from the 1983 tax cut. The scheduled 10 percent rate reduction will provide about $175 billion in tax relief between 1983 and 1986. About $125 billion will go to those families making below $50,000 a year. Those earning above $100,000 will get only 9 percent of the tax relief although they pay 15.7 percent of all income taxes.

The third year rate cut, in fact, provides average- and middle-income Americans with the first real income tax relief. The 1981 and 1982 income tax cuts, Treasury statistics indicate,

were completely wiped out by bracket creep and Social Security tax increases. If the third year tax cut is eliminated, only the rich will come out ahead. The wealthy received the bulk of their tax cut in 1981, when the top marginal tax rate was reduced from 70 percent to 50 percent. If the July cut is eliminated, those making between $10,000 and $50,000 a year will lose over 30 percent of the tax relief from the cumulative three-year tax reduction. They will face tax increases in the first year of repeal of between $31 and $828. Those making over $200,000, on the other hand, would lose only 13 percent of the three-year tax cut benefits.

The third year of the tax cut should not be put on the chopping block--not even in an attempt to reduce budget deficits. In fact, there is no clear evidence that government deficits have raised interest rates or delayed economic recovery. Between March 1981, the Administration's first budget forecast, and January 1983, the Administration's latest full budget report, estimates of the total budget deficits for 1982-1986 increased by nearly 2,500 percent. Interest rates on government T-bills, however, dropped by 50 percent between March 1981 and January 1983. Those who now claim that budget deficits will sabotage recovery by running up interest rates must explain why interest rates fell so dramatically in 1981 and 1982.

After Reagan's three-year tax reductions, the tax share of GNP will finally come closer to the level that it was during the last period of sustained, healthy growth. The tax share was about 18 percent of GNP in the mid-1960s, and the economy then grew by a robust 5 percent and created approximately one million jobs a year. On the day Reagan took office, the tax share was approximately 20 percent. And even with the full three-year Reagan tax cut and indexing, tax revenues will still constitute about 19 percent of GNP in 1988.

Those who claim that the third year cut creates a tax "shortfall" conveniently overlook that fact. Tax revenues, even if the full program of tax cuts becomes effective, will increase by about 8.5 percent a year between 1981 and 1986. In 1986, federal revenues are expected to be $841.9 billion--up nearly 50 percent from the 1981 tax take of $559.3 billion. Tax revenues are forecast to increase on average by $57 billion a year between 1981 and 1986.

The deficit problem, therefore, does not stem from too little revenue. It stems from too much spending and a lackluster economy. The tax cut medicine will help cure these underlying problems. And it is clear that the prescription is beginnning to work. Congress should not hold back the last dose of medicine just as the patient shows signs of recovery. There are at least seven reasons why this medicine is needed.

Reason No. 1: Creates Jobs

The only means of creating new jobs is through economic growth. A 5 percent real growth rate, according to one rule of thumb, generates enough jobs in one year for all the new entrants into the workforce and creates one million additional jobs for the unemployed. The July tax cut lays the foundation for an economic upswing that promises to put the unemployed back to work.

Repeal of the July tax cut at this stage of the recovery, however, would hurt productivity, savings and investment. The February report of the Congressional Budget Office (CBO), an organization generally unsympathetic to supply-side economics, warned of the dire consequences of raising taxes in a recession. "Increasing taxes during this recession," the CBO cautioned, "could well make it worse and delay economic recovery." Tax increases should be cautiously considered even when the economic recovery is underway, recommended the CBO, since "such increases could, if not carefully designed, inhibit long-term investment and economic growth." Even Keynesian Nobel economist James Tobin recently noted in the New York Times, "President Reagan, to his credit, remembers what even most Democrats forget, the perversity of raising taxes in hard times."

In short, the economic recovery hinges to a large extent on the July cut. The unemployed steel worker in Pennsylvania, the laid-off auto worker in Detroit, and the jobless textile worker in North Carolina desparately need the economic recovery as a lifeline to a new job. The repeal of the July tax cut threatens to cut that lifeline for them and millions of other unemployed workers and first-time job seekers.

Reason No. 2: Boosts Small Business

Repeal of third year of the tax cut would mean a sizable tax increase on the small business sector that is usually the locomotive of economic recovery. About three-fourths of all businesses in the country are not corporations and they do not pay corporate income tax.[2] They report their business income through individual tax returns. A repeal of the third year personal tax cut would raise their taxes, slow the return to full output, and reduce investment in new plants and equipment.

Small businesses, recent evidence shows, are on the cutting edge of job creation and technology development. David Birch and Susan McCracken of the MIT Center on Neighborhood and Regional Change estimate that two-thirds of all net new jobs are generated by businesses with fewer than 20 employees, and about 80 percent

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[2] Bruce Bartlett, "The Future of Small Business in America," Cato Institute, Policy Report, February 1983.

by firms with 100 or fewer employees.[3] These small businesses also generate 48 percent of the nation's business output, 43 percent of the GNP, and more than 50 percent of all industrial inventions and innovations. Small business is already being taxed at a higher rate than most large corporations; a tax increase on this crucial sector could stop the economic recovery in its tracks.

Reason No. 3: Encourages Savings

The repeal of the third year cut would slow the recent surge in new saving, which was up 30 percent in the third quarter of 1982 to 6.9 percent of personal disposable income. The increased pool of saving is a direct result of both the personal tax cuts and the reduction in inflation and is one of the most important conditions for a sustained recovery. Seventy percent of all new enterprises, according to a National Federation of Independent Business survey, obtain their seed capital from personal savings.[4] A major problem for new enterprises and small businesses recently has been the scarcity of such funds. An enhanced environment for capital formation is therefore the key to increasing the number of new business starts, and the pace of economic growth. A repeal of the third year cut would deaden this important stimulus to capital formation.

Reason No. 4: Fosters Productive Investment

Repeal of the third year tax cut could induce some taxpayers to withdraw their money from taxable investments and shift it once again into tax-exempt bonds, tax shelters or nontaxable consumption expenditures--leaving those who cannot afford such options to toil under a heavier income tax load. For this reason, the proposal to restrict the tax cut to low- and middle-income Americans is particularly dangerous.

One such proposal would limit the tax cuts to $700 per return, which would eliminate the third year of the tax cut for all families with an annual income greater than $46,500 ($35,700 for single return). This cap would raise only some $18.7 billion between 1984 and 1986. Yet it could wreak havoc with the economy, because savings would be seriously reduced. Those who make an after tax income above $50,000 a year save over 64 percent of their post-tax income, while those who make $10,000 a year after tax income manage to save only 12 percent.[5]

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3 David Birch, "Who Creates Jobs?" The Public Interest, No. 65 (Fall 1981); see also The Venture Capital Industry--A Brief Overview (Wellesley Hills, Massachusetts: Capital Publishing Corporation, 1982), p. 64.

4 Jonathan A. Scott, Assistant Professor of Finance, Southern Methodist University, statement before the Subcommittee on Tax, Access to Equity Capital, and Business Opportunity of the House Small Business Committee, Washington, D.C., May 20, 1982.

5 U.S. Department of Labor, Bureau of Labor Statistics, Bulletin No. 1997 and 1985, 1972.

Reason No. 5: Shifts Tax Burden to the Rich

As Forbes magazine reported, there are now strong indications that the first two stages of the Reagan tax cuts may have generated much higher tax revenues from upper-income Americans than the Treasury had predicted. Estimated quarterly income tax payments for FY 1982 are far above Treasury expectations. These quarterly tax payments, generally made by those in the higher tax brackets, had been expected to fall from $77 billion in FY 1981 to about $72 billion in 1982, largely because of the reduction in the top marginal rate from 70 percent to 50 percent. But the actual tax take was $85 billion, 10 percent more than in 1981. Writes Malcolm S. Forbes, Jr.: "If you let people keep a little more of each additional dollar they earn, everyone, including the tax collector, comes out ahead."[6] The best way to "soak the rich" it seems, is to lower their tax rates.

This will come as no surprise to economists who have studied past tax cuts. Both the Mellon tax cuts in the 1920s and the Kennedy tax cuts in the 1960s shifted the tax burden substantially toward upper-income taxpayers, while cutting rates on that group.[7] In 1921, Americans with incomes over $50,000 paid 44 percent of all the personal income taxes collected. But in 1928, following the Mellon cuts, this income group paid 78 percent of the income taxes.

In 1963, the top 5 percent of all taxpayers contributed 35.6 percent of all personal income tax revenue. Following the Kennedy cuts in 1965, those taxpayers contributed 38.5 percent of the income taxes. While the full IRS figures for 1982 are not yet available, it appears that the Reagan tax reductions are shifting the tax burden to wealthier taxpayers, even though the tax rates on high incomes have been cut.

Reason No. 6: Helps the Average American

The income tax cut is the major tax relief plank for the average American in the three-year Reagan package. It will be the first rate reduction of the Reagan program that will actually cut the tax rates of middle and low income taxpayers after taking into account bracket creep and Social Security. People who make between $10,000 and $50,000 a year will pay about 67 percent of the personal income taxes in 1984 and they will get about 72 percent of the tax relief from the third year tax cut. Those making above $200,000 a year, on the other hand will receive only 1.8 percent of the tax relief, although they pay 7.1 percent of all personal income taxes (see Chart I).

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6 Forbes magazine, February 14, 1983, p. 31.

7 Chris Frenze, "The Mellon and Kennedy Tax Cuts: A Review and Analysis," Joint Economic Committee, June 18, 1982. See also Thomas M. Humbert, "A Surcharge: The Worst Tax?" Heritage Foundation Backgrounder No. 180, April 23, 1982.

CHART I
The Effect of the Third Year
Rate Reduction Distributed by
Adjusted Gross Income Class
(1981 Levels, 1984 Law)

Adjusted gross income class	Share of all taxes paid under 1984 law	Share of benefits from the third year rate reduction
($000)	(percent)	(percent)
Less than 10	2.1%	2.6%
10 - 15	5.8	5.8
15 - 20	8.1	8.5
20 - 30	20.7	23.1
30 - 50	29.9	32.1
50 - 100	17.7	18.8
100 - 200	8.6	7.2
200 and over	7.1	1.8
Total	100.0%	100.0%

Source: Office of the Secretary of the Treasury
Office of Tax Analysis

Assumes 4.5 percent rate of inflation for prior year.
Note: Details may not add up to totals due to rounding.

Wealthy Americans received the bulk of their tax benefits in 1981 when the top marginal tax rate was reduced from 70 percent to 50 percent. Those making over $200,000 a year, for instance, receive about 13 percent of the total tax relief package from the third year tax reduction. The third year cut, in other words, gives them relatively little. Middle- and lower-income taxpayers, however, receive about one-third of their relief from the third year tax reduction.[8]

Those who say the tax cut is only for the rich ignore the fact that the rich get a greater tax cut in money terms only because they pay much more in taxes. The family earning $10,000 is scheduled to receive a $31 reduction in taxes in 1984, while a family earning $100,000 a year will receive a $2,368 tax cut. That is not unreasonable given that the $100,000 income family pays $24,424 in federal personal income taxes, while the $10,000 income family pays just $322. The only fair way to view the tax cut is as a percentage of a taxpayer's current tax liability. (see Chart II).

[8] "Description of Possible Options to Increase Revenues," Joint Committee on Taxation and the Committee on Finance (JCS-24-82), June 15, 1982, p. 85.

Chart II
Reductions in 1984 Income Tax Liability Due to
the Third Phase of the Across-the-board Rate Reductions Enacted in ERTA

Four-person, One-earner Family

(dollars)

Income	1984 Tax liability without 3rd rate reduction	Reduction in tax liability from 3rd rate reduction	
		Amount	Percentage
$ 10,000	$ 322	$ 31	9.6
20,000	1,713	164	9.6
30,000	3,363	360	10.7
40,000	5,394	520	9.6
50,000	7,993	828	10.4
100,000	24,424	2,368	9.7
200,000	62,566	4,366	7.0

Source: Office of the Secretary of the Treasury
Office of Tax Analysis

Note: Tax liabilities are calculated assuming deductible expenses equal to 23 percent of gross income and that all income is wages.

Reason No. 7: Counters Bracket Creep

All income groups depend on the third year tax cut to offset bracket creep. During the 1970s, taxpayers whose income simply kept pace with inflation found themselves shoved into ever higher tax brackets. The result: their after-tax purchasing power actually decreased, because the government took a greater and greater tax bite from their incomes.

Even the three-year Reagan tax cut package will not offset the tremendous bracket creep of the 1970s. Yet it will provide most Americans with some relief from further inflation-induced income tax increases. A family of four earning $25,000, for instance, received a basic tax cut of $305 in 1982--thanks to the Reagan package.[9] Assuming that the family's income rose at the rate of inflation, bracket creep measured from 1980 raised that family's taxes by $302. Bracket creep, therefore, eliminated virtually all of the tax cut. In July, when the third stage of the income tax cut takes effect, the family's 1983 tax cut will grow to $609. Bracket creep will take $423, leaving a net tax cut of $186. Even this reduction, however, will be offset by a

[9] These and the following figures on bracket creep and tax cuts assume that a family's income keeps pace with inflation and are based on Treasury projections of inflation rates. Bracket creep is figured using 1980 as the base year and Social Security tax hikes are increases from 1980 rates.

$152 Social Security tax increase from the 1980 rates. In all, Social Security tax increases and bracket creep will eradicate about 94 percent of the tax reduction in 1983. If the third year cut is eliminated by Congress, the same family in 1983 will experience a substantial tax increase over its 1980 taxes.

Similarly, a family of four earning $15,000 is counting on this year's 10 percent tax cut to keep ahead of bracket creep and Social Security taxes. In 1982, this family received a tax cut of $151, but bracket creep actually increased its taxes by $154, for a net tax boost of $3. Social Security tax hikes from 1980 rates added a further burden of $85. Rather than receiving a tax cut in 1982, the $15,000-a-year family actually paid $88 more in taxes. In 1983, this family is due to receive a $248 tax cut, but 86 percent of the tax cut ($214) will be offset by bracket creep. With a Social Security tax hike of $90, the family will suffer a $56 net tax increase in 1983--even with the July cut.

Upper-income taxpayers also feel the ill effects of bracket creep and Social Security levies. The family making $40,000 is due to receive a $1,318 tax cut in 1983. Yet bracket creep will take $1,008, offsetting 76 percent of the tax cut. After the Social Security tax hike of $362, the $40,000 taxpayer will actually face a $52 net tax hike in 1983. Again, the July "cut" is no more than a slowdown in tax increase.

This situation will not change in later years. The $40,000 family will still pay $21 more in taxes in 1984 than in 1980, after bracket creep and planned Social Security tax hikes. By 1988, the tax bill will be $477 more than in 1980, even if Congress allows the full Reagan tax cut program to go into place. And these numbers don't even include the effects of last summer's enormous $100 billion tax bite, the gasoline tax increase or the huge new Social Security tax hikes recently passed by Congress.

Indeed, almost every income group will face, at best, only a modest tax cut--even with the third income tax cut in place. If that 10 percent tax cut is repealed, virtually every income group, save the very rich, will pay steeply higher taxes than before the Reagan Administration took office. In short, the promise to give average- and lower-income taxpayers some relief from bracket creep and Social Security taxes can only be fulfilled if the third year of the tax cut remains on the statute book.

THE ISSUE OF DEFICITS

Those seeking repeal of the third year tax cut say that government deficits, especially in future years, will sabotage economic recovery. They claim that as the economy begins to recover, the private demand for new investment capital will collide with the government's voracious credit appetite, and the resulting competition for funds will bid up interest rates to levels that will abort economic recovery. Repeal of the July cut, say these critics, is needed to reduce the deficit pressure.

Their theory, however, ignores reality. There is no simple or direct correlation between government deficits and interest rates. In March 1981, the cumulative federal deficit was projected at $33 billion for the period 1982 to 1986. The President's January 1983 budget message revised this total to $850 billion, an almost 25-fold increase. According to the scenario sketched by opponents of the tax cut, these soaring deficits should have driven up interest rates. They did not. Instead, while deficit projections have skyrocketed, interest rates have plummeted. The rates on government Treasury bills, for example, reached a high of 16.3 percent in May 1981, but dropped to 7.81 percent by January 1983. The prime rate fell from a high of 20.5 percent in August 1981 to 11 percent in January 1983.

In short, deficits have climbed 2,500 percent since March 1981 while interest rates have dropped nearly 50 percent. The recovery is proceeding briskly, despite the deficits and contrary to the fears of many of the President's own advisors.

A far more dangerous threat to economic recovery is the lurking possibility of another tax increase. At this stage of the economic recovery a new hike would probably plunge the federal budget into an even deeper deficit, rather than curb it. As Chart III shows, higher taxes have not reduced budget deficits. They are, in fact, associated with higher government outlays and deficits. All that tax increases seem to do is reduce the pressure on lawmakers to cutback spending.

CHART III
Tax Receipts, Government Spending, and Deficits

Period	Tax Receipts as a a percentage of GNP	Federal Deficits as a percentage of GNP	Federal Spending as a percentage of GNP
1950-54	18.6	-.06	18.6
1955-59	18.1	+.06	18.1
1960-64	19.0	-.29	19.0
1965-69	19.7	-.30	19.7
1970-74	20.5	-1.14	20.5
1975-79	21.8	-2.19	21.8
1980-82	23.8	-3.12	23.8

Source: Economic Report of the President, February 1983

Tax increases simply unleash more government spending, rather than stem the flow of budget red ink. Tax receipts grew from $40 billion in 1950 to a projected $659 billion for 1984, a sixteen-fold leap in revenues. Receipts grew 1.4 times faster than GNP and 3.8 times faster than inflation. But even this could not cover Congress's spending explosion. Government outlays over the same period skyrocketed twenty-fold, from $43 billion to almost $850 billion for 1984. Outlays increased 1.2 times faster

than government revenues, 1.6 times faster than GNP and 4.5 times faster than the inflation rate. As a result, government deficits grew from .06 percent of GNP to 3.12 percent of GNP in 1982.

The unbalanced budget is a symptom--not a cause--of the economy's poor economic performance. Rising unemployment automatically increases expenditures for income support programs, while recessions reduce profits and wages and, along with them, government revenues. The budget will not conceivably come into balance unless there is a strong recovery. And that will not happen if Congress taxes yet again.

There is strong recent evidence to support the view that tax increases expand, rather than contract, the deficit. Consider last summer's $100 billion tax hike. Paul Craig Roberts, former Assistant Secretary of the Treasury, explained in a Wall Street Journal article, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) was supposed to "narrow the budget deficit by $100 billion over the 1983-1985 period and by $229 billion over 1983-1987."[10] Instead, Roberts discovered, "the five-year deficit projections widened by $612 billion between the mid-session review (summer 1982) and the end of the year." The only way to reduce the deficit is to maintain and extend the tax cuts.

According to the usual rule of thumb, four years of 5 percent real economic growth will lower the unemployment rate by four percentage points. A four percentage point drop in the unemployment rate would reduce the expected $200 billion deficits by between $120 billion and $140 billion. What are the chances of attaining this high level of economic growth for a sustained period? Nobody knows for certain, of course. But one thing is clear: the repeal of the third year tax cut would lower the trajectory of U.S. economic growth--just as it appears the economy is recovering--making it far less likely that the budget gap will be reduced or new jobs generated.

CONCLUSION

The repeal of the July tax cut would put the burden of balancing the budget onto the backs of working and lower-income Americans, leave them with the effects of past bracket creep and deny them their promised tax cut. The campaign to repeal the July tax cut betrays a callous cynicism when it comes to the plight of working Americans. It seems motivated only by Congress's determination to continue its spending splurge. If the third year tax cut is eliminated, the recovery will slow, deficits will rise and income taxes on average Americans will soar to higher levels than at the end of the Carter Administration.

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[10] Paul Craig Roberts, "Big Taxes and Big Deficits," The Wall Street Journal, January 14, 1983.

The budget can be balanced only through vigorous economic growth, coupled with spending reductions. The July cut promises to spur the economy into a robust and sustained recovery that will help generate more revenues to balance the budget. The recovery has already been launched successfully; it is no time to change the flight plan.

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