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RESEARCH REPORT

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THE REAGAN TAX PROPOSAL

by Marcia Marley

Editor's Note: As we go to press, President Reagan is preparing to address Congress to argue for passage of a wide-ranging package of personal and business tax cuts, among other economic programs. As all working people suffering the double burden of high taxes and inflation know, tax relief is desparately needed. But how much, what kinds and for whom? Will Reagan's proposals in fact decrease wage earners' taxes, spur investment, and create jobs? In this Report, Marcia Marley, a Research Associate at the Institute of Industrial Relations, examines the present tax structure, the President's proposals for tax reform, and their likely impact on families' real incomes and on investment and economic growth. She concludes with a summary of alternative tax proposals now before Congress, including that of the AFL-CIO.

I. HOW IS THE CURRENT TAX SYSTEM'S BURDEN DISTRIBUTED AMONG BUSINESSES, AND AMONG UPPER, MIDDLE AND LOWER INCOME GROUPS?

We need to begin with some facts about taxes and the tax structure:

1) The federal tax as a percentage of output has not increased significantly since 1950. However, local and state taxes have mushroomed. The total tax burden has increased, not because of the insatiable appetite of those in Washington, but because property taxes have become unbearable as a result of inflation.

2) Within the federal tax structure, the individual income tax, as a percentage of total federal taxes, increased about 20% from 1930 to 1960. However, since 1960 this percentage has not changed.

3) Corporate income tax as a share of total federal taxes declined from 28% in 1950 to 15% in 1978.

4) Payroll taxes (social security, unemployment benefits, and workers compensation) as a proportion of total taxes tripled from less than 10% in 1950 to 31% in 1979. Payroll tax rates increased from 4.8% of wages under $7,800 to 6.6% of those under $29,700.

5) The federal income tax is less progressive now than it was in 1939. That is, the share of total taxes paid by middle income groups has increased while that paid by the wealthy has decreased. In 1939, the top 20% of income earners paid over 75% of the total income tax. By 1955, they paid just under 50%, and in 1976 these top income earners paid under 40% of total federal taxes. The groups whose share increased were middle income earners. The average family's share of the federal income tax increased from 5% in 1939 to 18% in 1976. Lower middle-income earners paid between 3 and 4% of the total income tax in 1939, and 12% in 1976.

The overall implication of these trends is that an increasing percentage of federal tax revenues are derived from middle and lower-middle income wage earners. There are several reasons why these wage earners are paying more of the federal tax burden.

First, the total payroll tax burden is paid by wage earners or consumers, not businesses, even though businesses contribute half. This is because if the business is competitive, then the firm can shift its half of the contribution to the wage earner in the form of lower wages. If pricing policies are based on cost plus, then consumers pay for a portion of the business tax and wage earners pay the other part.

Secondly, all incomes below the top bracket, and the incomes of wage earners in particular, are subject to an economic disease called "bracket creep" during times of inflation. For instance, a family of four with one wage earner whose income in 1970 was $15,000, would have required $34,349 in 1980 to maintain the same after-tax purchasing power! Not only does inflation decrease your real income (unless you can bargain effectively to maintain real purchasing power), also, inflation puts you in a higher tax bracket - and thus a larger percentage of your income is taken out. Wage earners and middle income groups bear the brunt of bracket creep, because increases to wealth through capital gains can be deferred in years of high inflation, and because 60% of all capital gains are not taxed. The consequences of "bracket creep" are that workers have to work overtime, take a second job or increase the number of earners in the family just to maintain purchasing power.

There is no doubt that tax relief is desparately needed. The question that Congress must decide is what types of cuts are desirable and for whom?

TABLE I

PERCENTAGE OF FEDERAL TAXES
PAID BY INCOME GROUP (in $1,000's)

INCOME GROUP	RETURNS	INCOME TAXES	SOCIAL SECURITY TAXES
Below $5	5.7%	0.2%	13.1%
5-10	17.0	2.5	7.2
10-15	17.3	5.7	10.2
15-20	14.3	8.0	12.3
20-30	21.9	20.3	27.6
30-50	18.0	29.8	30.0
50-100	4.8	17.9	8.0
100-200	0.8	8.4	1.3
200+	0.3	7.3	0.3

II. REAGAN'S CUTS: VOODOO ECONOMICS, NEEDED RELIEF OR SOCIAL DISASTER?

The President has proposed to Congress a 53.9 billion dollar package of individual and business tax cuts. These include a thirty percent cut in marginal tax rates for individuals and an accelerated depreciation allowance for businesses known as the 3-5-10 plan. The Admininstration argues that this tax package provides strong incentives to savings and investment, in contrast to the present tax system, which they feel deters work and thrift. They argue that hard work, savings, and investment will in turn create more jobs, higher income and growth.

Individual Tax Breaks - How Are The Gains Distributed?

Reagan has proposed a 10% across the board reduction in marginal tax rates (the rate you pay on the last dollar amount) for each of the next three years. This reduction in rates will eliminate the distinction between earned and unearned income. Under the present system, income from dividends or property can be taxed at a maximum rate of 70%, while the maximum rate for earned income is 50%. Because 60% of capital gains may be excluded, the effective tax rate on capital gains will be reduced from 28% to 20% over the three year period. As a result of this major reduction in the tax rate on property income, a large proportion of the benefits from the Reagan plan go to upper income groups. Under the President's proposal, 30% of the total benefits go to those making above $50,000, and over 60% of the benefits go to those with incomes over $30,000.

Congressional critics of Reagan's tax cuts have opposed these proposals on the grounds that they are not sufficiently progressive (they benefit the rich more than the poor) and that they may be inflationary by giving people more money to spend on goods and services. But most have conceded Reagan's main point: That the tax cuts will return more money to the nation's beleagured taxpayers and thus act as an incentive to work harder and provide more funds for investment.

But is this true? The answer is: only if inflation is radically reduced in the next few years. Because Reagan's proposals do not contain an indexing provision, only the top-income earners will benefit under his plans if inflation continues at high rates.

Consider the effect of Reagan's tax proposal on four different families. The Smiths, with modest annual earnings of $15,000 for their family of two, are just below the average family income. In the best of all possible worlds - with no inflation for the next three years - the Smiths would have their marginal tax rate reduced from 21% to 15% in 1984 if Congress enacts the President's tax plan. Their total tax burden would be reduced from $1,640 in 1980 to $1,199 in 1984. But if the inflation rate is 12% per year until 1984 (a plausible assumption, given the 12.5% rate for last year), the story for this couple with an income of $15,000 is quite different. If we assume that either by obtaining wage increases or increasing the hours worked this couple maintains real 1980 income of $15,000, they would have to earn a taxable income of $23,603 in 1984 just to stay even. Their marginal tax rate in 1984 would remain at 21% even with the 30% reduction proposed by Reagan. With the tax cuts they would pay $3,085 in

1984 in federal income taxes. This couple's after-tax real income would <u>decline</u> under Reagan's plan by $290. (These figures do not include Social Security taxes. If they did, real income would decline even more with high inflation rates.)

To sum up: if inflation stops completely, the Smiths will come out ahead - to the tune of about $441 in the fourth year. But if inflation clips on at 12% a year, the Smiths will fall behind by $290 in real income terms. That is hardly a great reward for productivity!

Our next family of two, the Jones, have a more substantial 1980 annual income of $25,000. Assuming no inflation and no change in their income over the next four years, they would receive a reduction in 1984 of $677 from their present tax bill of $4,064. However, if the inflation rate were 12% a year, this family would need to earn $39,340 to maintain gross purchasing power. Their tax in 1984 under Reagan's plan would be $7,270 and their after-tax real income would <u>decrease</u> by $510.

The Browns are a two-career professional couple making $60,000 in 1980. Assuming no inflation, they will see their marginal tax bracket reduced from 54% to 40% over the next four year term. Their total income tax liability would decrease from $19,680 to $14,450 in 1984. If we allow for an inflation rate of 12% over the period and again assume that this couple was lucky enough to maintain the same real taxable income, behold we find that their real after-tax income went up by $1680.

Finally, the Greens, in addition to high paying jobs have inherited wealth which provides them with substantial yearly income. They make a <u>taxable</u> income of $120,000. Their real disposable income under Reagan's plan will increase substantially ($8,241) even with a 12% inflation rate - assuming that their gross taxable income keeps up with inflation during the President's term.

For the majority of Americans, the truth of the Administration's claim of promised higher real incomes depends on whether inflation can be brought under control. Yet even members of Reagan's own party feel this is impossible under the present budget. (The Senate voted down the total Reagan package on the grounds that it would feed inflation, not bring it down.) And without indexation or a larger tax cut in 1981, there is a good chance that any improvement in tax liability will be wiped out by inflation over the four year period.

To summarize, what is wrong with Reagan's income tax proposal?

1) It does not index the tax brackets.

2) The benefits are strung out over four years: only 5% in 1981, 10% in 1982, 10% in 1983, and 5% in 1984. By the time you receive them, bracket creep will take them away.

3) It is not progressive. For instance, it does not help those low income groups hurt by cuts in social programs.

4) It does not relieve the Social Security tax burden which has been increasing drastically in the last ten years. Decreasing income taxes may not decrease the total federal tax burden if Social Security taxes continue to rise.

The Business Tax Cuts: Will They Spur Investment?

The 10-5-3 depreciation plan advocated by the Administration will allow industries to write off their equipment over a shorter period of time than the current tax law allows. The label 10-5-3 refers to the minimum depreciation time allowed for different types of buildings or equipment. For example, structures can be depreciated over a ten year period instead of over the useful life of the building, which may be 20 to 30 years. The President argues that these liberalized depreciation laws, when coupled with more disposable income (from income tax cuts) and reduced regulation costs, will provide the incentive and the funds for firms to invest in new manufacturing equipment, technology, and plants, thus stimulating output and jobs.

It sounds good, but on closer examination we find that this argument has some incorrect assumptions, and that many of the economic relationships have not been verified by the evidence. Here are just some of the problems:

* The depreciation allowances actually favor industries whose equipment is used over many years (such as steel and utilities), and provide less relief for sectors where technologies change rapidly. Thus the benefit in high growth sectors is less. Do we really need more investment in nuclear reactors - an obvious beneficiary of the President's plan?

* Surveys have shown a majority of Americans plan to spend not save their projected tax cuts. This could further spur inflation and push taxpayers into higher brackets, thus discouraging work and investment.

* If the tax cuts increase individual savings, that will not necessarily increase the amount of money available to corporations for investment. In our complex financial markets, much excess capital can be expected to flow to money market accounts and other relatively safe assets, rather than to corporations through the purcahse of stocks and bonds.

* If the tax cuts and accelerated depreciation allowances make more funds available to corporations, these funds will not necessarily be invested in domestic production facilities. Recent increases in corporate cash flows (profits have not been declining) have been used primarily for mergers or investment overseas.

* Not all investment stimulates growth, and not all growth in output comes from investment. Most investment in equipment will replace old models rather than improve the quality or productivity of the machine. Economists have estimated that at most, 31% of growth in output can be attributed to increases in the capital stock - machines, factories, etc. Growth in output also depends on labor productivity, which depends on the skill level and education level of workers, and on adequate funding for research and development.

* Not all investment creates jobs. Investment in capital intensive firms may actually decrease employment, if these firms out-compete labor intensive companies producing similar products or services. Investment that is targeted to areas of high unemployment or to human resources such as training programs both creates jobs and increases productivity.

* Because the accelerated depreciation allowances will be phased in over several years under Reagan's plan, the short term effect of the policy may actually be to retard investment, as businesses will hold off investment in expectation of the new depreciation schedules.

* Building new plants and developing new technologies takes time. Any growth which does result from Reagan's policies is not likely to come quickly enough to break the inflationary psychology.

* The Reagan Administration has favored a tight money policy (high interest rates) to fight inflation. Such a policy depresses investment by making funds more expensive, thus counteracting the effects of the tax cuts and the new depreciation allowances.

TO SUM UP: There is not much evidence that <u>any</u> increased savings from the individual tax cuts or increased profits from depreciation allowances will be channeled into new domestic technology, plants and equipment. Further, economists are not even sure that if we stimulate investment, growth and jobs will be the result. Thus Reagan's proposals could result in increased inequality, as lower income groups fail to keep up with inflation, coupled with slow growth or no growth - and still no jobs.

III. ALTERNATIVE TAX PROPOSALS

The Administration's tax proposals are not the only ones in Washington which attempt to increase incentives for work and investment, and to give tax relief to Americans. Among the others now before Congress:

<u>Social Security Tax Cuts</u>

The Gephardt proposal is to give a 10% income tax credit against Social Security taxes for both workers and businesses (See Table II for distribution effects). Many small businesses favor this bill over Reagan's depreciation allowances, since it would reduce their costs significantly.

The AFL-CIO proposal is for a refundable individual tax cut of 20% on Social Security taxes in 1981, and for a 5% tax-cut on employers' payroll costs. In addition, other investment tax cuts were proposed for specific industries.

The main advantage of a Social Security tax reduction is that it gives relief to the middle income workers whose federal tax burden has increased enormously over the last few years. Also, it rewards those who work, and it would be progressive in the dsitribution of benefits. Under the AFL-CIO proposal, for example, 60% of the tax cut would go to 80% of the taxpayers, compared to only 20% of the taxpayers in Reagan's plan. Further, there is evidence that such a tax cut would <u>reduce</u> inflationary pressures, because <u>increases</u> in the tax are passed on to the consumer in higher prices.

The main disadvantage of a Social Security tax reduction is that Social Security will need increased funding over the next four years no matter what type of tax bill is passed by Congress. The Gephardt and AFL-CIO proposals suggest increased funding of Social Security from general revenues, which would distribute tax burdens more evenly. However, unless these proposals were combined with bracket indexation for inflation, "bracket creep" would not be eliminated.

Income Tax Cuts

The Finance Committee proposal is for an increase in the personal exemption from $1,000 to $1,100, an increase in the zero bracket, and a 1 to 3% reduction in the tax rate. Elimination of the marriage penalty was also proposed (See Table II).

The Chair of the Ways and Means Committee (Rostenkowski) has proposed what he calls a compromise between the need for increased cuts for middle and low income groups, and the need for increased incentives for investment. He proposes a one year cut in individual taxes, either by reducing the rates or by expanding income-tax brackets (indexation) to cancel out the effects of inflation. Like the Administration's proposal, Rostenkowski's plan would stimulate savings by dropping the tax rate on unearned income from 70% to 50%, but would do it in one year, instead of the phased-in reduction suggested by the Administration. Other suggestions include reductions in the marriage penalty and increased allowances for contributions to individual retirement plans. Business cuts would include a liberalized depreciation allowance, increases in the tax credit for rehabilitation of structures and an increased research and development tax credit, in addition to a liberalized investment credit.

The Finance Committee's proposal favors lower income groups, and is less inflationary than the Administration's proposal. The bracket indexation in Rostenkowski's plan would lower the burden of taxation for the middle income earners, and the benefits would materialize this year, not four years in the future. Also, Rostenkowski's plan gives specific investment tax cuts. But neither of these plans addresses reductions in Social Security payments, and the increasing burden on wage earners that will develop with increases in the retirement population. Further, Rostenkowski's plan would probably increase the inequality of income due to the substantial benefits given to higher income groups from the reduction in tax rates for dividends and property income. In addition, the large one year tax cuts offered by Rostenkowski would be inflationary.

TABLE II

PERCENTAGE REDUCTIONS FOR INCOME GROUPS UNDER DIFFERENT TAX PROPOSALS
(in $1,000's)

INCOME GROUP	PRESIDENT	FINANCE COMMITTEE	GEPHARDT	AFL-CIO
5-10	3.1%	6.9%	7.2%	10.3%
10-15	6.4	8.7	10.2	10.2
15-20	8.7	9.8	12.3	12.3
20-30	21.1	23.6	27.6	27.6
30-50	31.0	32.2	30.0	30.0
50-100	18.0	12.6	8.0	8.0
100-200	6.7	3.1	1.3	(
				(1.6
200+	4.9	2.1	0.3	(

IV. SUMMARY

The primary need for tax relief and reform must be related to past increases in payroll taxes, especially the Social Security tax, and the increasing burden of inflation which lowers the real income of most Americans. Reagan's proposal is not tax reform, but just an across the board tax cut. If it is passed, and if inflation continues at its present rate, real disposable income will decrease for wage earners below $40,000, unless they are lucky or have enough bargaining power to keep up with inflation and the tax drain. The distributional consequence of Reagan's tax proposal is to increase the inequality of income.

Some claim that this may be the price which must be paid at least for the next two years for increased growth. They argue that in the longer run, the stimulus to investment will decrease inflation, increase output, and decrease unemployment. But there is not enough evidence to indicate that investment will take off, or that investment will necessarily increase growth, or even that new investment will create employment. The result of Reagan's tax and budget proposals is more likely to be increased unemployment, and less real income for wage earners.

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