

July 13, 1981

## ***AN ANALYSIS OF THE REAGAN TAX CUTS AND THE DEMOCRATIC ALTERNATIVE***

### **BACKGROUND**

President Reagan won a major victory June 25 as the Senate Finance Committee passed a tax-cut bill containing nearly everything he wanted. Included in the tax bill is a 25 percent across-the-board tax rate reduction phased in over three years and an accelerated depreciation plan that would cut business taxes 40 percent by 1985. The magnitude of the tax cut recommended by the Finance Committee was close to Reagan's original proposal, with cuts of \$37 billion in the fiscal year beginning October 1, 1982, \$93.05 billion in fiscal 1983, \$149.5 billion in 1984 and \$182.9 billion in 1985. The Finance Committee's bill also contains a series of amendments to spur saving and investment and eliminate certain tax inequities which Reagan had originally wanted to redress in a second tax bill later this year. Among these amendments are a measure to reduce the marriage penalty tax, a large reduction in the estate and gift tax, and the indexation of income tax brackets to the inflation rate. The President is supportive of these amendments, but reportedly is skeptical of a few others which the Finance Committee has attached to his original proposal. Reagan appears not to support, for instance, the all-savers certificates, a measure designed to bail out the ailing savings and loan industry. Senator Robert Dole (R-Kansas), however, says Reagan has embraced the Senate Finance Committee's tax cut package wholeheartedly and will push hard for its passage on the Senate and House floors.

Meanwhile, the Democratic alternative was developing in the House Ways and Means Committee under the leadership of Representative Dan Rostenkowski (D-Ill.). The Democratic alternative, soon expected to pass in the Democrat-controlled Committee, targets tax cuts to the lower- and middle-income classes. Under the Democratic bill, 67 percent of the tax cuts are provided to those earning between \$15,000 and \$50,000, while the Reagan measure

gives this group 57 percent of the tax cuts. The plan lowers personal income taxes by 15 percent over two years, raises the zero bracket amount (formerly the standard deduction), increases the earned income tax credit, and permits the write-off of equipment investments in the year of purchase after the phase-in period. The Democratic alternative would aid "distressed" industries by allowing "carry backs" of investment tax credits against past taxes. Among a host of other measures designed to increase incentives for saving, the Democrats recommended the creation of tax-exempt all-savers certificates to be issued only by the ailing savings and loan industry.

### SUPPLY-SIDE TRIUMPH

In a similarity often overlooked, the Democrat and Republican proposals represent a triumph of supply-side thought in our nation's tax policy. In language not heard since John F. Kennedy's 1964 tax cut, both Democrats and Republicans speak of the necessity of stimulating saving and investment, eliminating disincentives to work, and cutting tax rates on rich and poor alike.

For all the rhetoric about targeting the tax cut to the poor and middle class, even the Democratic alternative promises 33 percent of its personal tax cut to those earning over \$50,000 yearly. Moreover, this figure underestimates the degree of relief Democrats promise to upper-income brackets. The House Ways and Means Committee is expected to recommend a cut in the minimum capital gains tax from 28 percent to 20 percent and the maximum marginal rate on investment income from 70 percent to 50 percent -- measures which will initially aid persons predominately in upper-income brackets.

The Democrats and Republicans also agree on the need for a supply-side tax cut for business. Reagan has proposed a 40 percent tax cut for business in the form of accelerated depreciation schedules. The Democratic depreciation plan, according to the Institute for Research on the Economics of Taxation (IRET), actually provides a business tax cut of greater magnitude than the accelerated depreciation plan offered by Reagan.<sup>1</sup> The Democrats, in fact, have proposed what supply-siders have been trying to achieve for years: a depreciation plan which allows the full expensing of equipment investment in the year of purchase.

What this all evidently means is that Democrats and Republicans seem to agree on the urgent need to expand the national product. In recent years, the chief preoccupation of policymakers has been to redistribute the economic pie more fairly. Currently,

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<sup>1</sup> David Raboy, "The Business Tax Cut -- A Comparison of Two Problems," Economic Report #5, Institute for Research on the Economics of Taxation (IRET), July 10, 1981.

legislators on both sides of the aisle appear to recognize that a stagnant economy with declining productivity and a deteriorating capital stock is detrimental to the welfare of all economic classes -- rich and poor alike. "A rising tide lifts all boats," commented John F. Kennedy nearly 20 years ago in an insight which recognized that a dynamic and innovative economy was the great benefactor of the poor.

There can be no "rising tide" of economic activity, however, unless the punitive taxes on initiative and saving are lifted. The devastating combination of high inflation and steeply progressive taxes has served to levy an effective tax rate on investment income of 75 percent -- leaving only 25 percent to the providers of capital. Few entrepreneurs will be willing to risk their capital and labor to open factories or stores or invest in stocks and bonds when for every one dollar return on their investment, they receive 25¢ after taxes. Congress did not need to legislate such an increase in capital taxes -- inflation performed the task automatically. Simply due to the effects of inflation, capital taxes have risen by 20 percent since the late 1960s. As inflation pushed up the nominal value of plant, equipment, inventory, stock, and other investments, the national treasury gained by taxing illusory capital gains. Martin Feldstein found that business profits were overstated by nearly \$50 billion in 1979.<sup>2</sup> Thus, inflation alone raised the corporate tax liability by over \$20 billion in 1979.

Savers are in an even worse position. Alan S. Binder of the National Bureau of Economic Research testified recently that income from saving such as dividends or interest is subject to taxes greater than 100 percent when adjusted for inflation.<sup>3</sup> America is one of the few industrial nations that taxes savings twice: first, the income saved is taxed at rates up to 50 percent when earned, and second, the interest or dividends arising from saving is taxed at rates up to 70 percent. Not surprisingly, the U.S. has one of the lowest saving rates in the Western world.

With such high marginal tax rates, it is not surprising that American business investment has lagged badly. According to Feldstein, net business investment in plant and equipment has averaged only some 3 percent of the nation's GNP -- less than half the average of other major industrial nations. Even this low rate of investment has been falling sharply. Since the second half of the 1960s, capital investment in plant and equipment has fallen by over 40 percent, down to 2.6 percent of the GNP from 4.2 percent in the late 1960s.

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<sup>2</sup> Martin Feldstein, "Reviving Business Investment," Wall Street Journal, June 19, 1981.

<sup>3</sup> Reported by George Gilder, "Forum -- Inside the Supply-Side, It Encourages Workers to Work and Investors to Invest," New York Times, November 23, 1980.

The tax rates on labor income have also been leaping higher. The American Enterprise Institute has estimated that the average American faces a marginal tax rate of over 50 percent on his labor income.<sup>4</sup> With individuals keeping only 50¢ of each additional dollar earned, it is understandable that more and more Americans are opting to participate in the untaxed underground economy or simply refusing to work extra hours -- or at all. The personal tax burden on Americans has dramatically increased during the seventies as a result of what is called tax-bracket creep. The phenomenon results from inflation pushing taxpayers into higher and higher tax brackets. Between 1972 and 1980, tax rates have increased by over 33 percent for a taxpayer earning \$20,000 yearly in 1972 -- simply as a result of inflation-induced bracket creep. If this bracket creep continues into 1984, the tax rate for a family of four will have increased by 60-74 percent.<sup>5</sup> Yet even this staggering tax increase does not take into account the increases in social security taxes. Over this same period, social security taxes increased 182 percent for a median income family of four.

In an economic environment where taxes are increasing 80 percent faster than inflation and 20 percent faster than personal income, the economic growth necessary to lift all Americans to greater prosperity simply will not be forthcoming. Wealth, of course, is not spontaneously generated. High marginal tax rates on saving and work only serve to make consumption and leisure that much more attractive. Indeed, Martin Feldstein found in a study that for nearly a million workers, the income from untaxed unemployment compensation is higher than they could hope to earn after-tax by working.

This is why the current talk of returning incentives to our tax policy is refreshing. The Reagan proposal, as the analysis below shows, is, on the whole, more satisfactory to supply-siders. There are at least three reasons why supply-siders think the Reagan proposal will stimulate greater economic growth: (1) the Democrats' tax cut is smaller in magnitude than Reagan's proposal -- 15 percent vs. Reagan's recommendation of 25 percent; (2) the Democrats' proposal is shorter in duration than Reagan's proposal -- two years vs. three years for Reagan's initiative; and (3) the Reagan proposal is an across-the-board cut in marginal rates while the Democratic alternative skews its cuts to the low- and middle-income tax brackets.

While total revenue comparisons between the Reagan and Democratic proposals are not yet available, the Reagan proposal is estimated to provide an individual tax cut of significantly greater magnitude than that of the Democrats. Reagan's proposal in calendar year 1982 provides a \$41.4 billion cut in individual

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<sup>4</sup> Gilder, *op. cit.*

<sup>5</sup> W. R. Grace & Company, Wall Street Journal, July 1, 1981, p. 13.

taxes, while the Democrats have provided a \$40 billion individual tax cut. In calendar year 1983, the Reagan tax cut totals \$84.8 billion compared to \$56 billion for the Democrats. After 1983, the gap between the Reagan and Democratic individual tax cuts continues to widen. This occurs because in 1983 Reagan has recommended an additional 10 percent proportional reduction in tax rates affecting 77 million taxpayers. The Democrats have chosen to forfeit any personal tax cuts that year. The third-year tax cut of 10 percent recommended by Reagan provides taxpayers at least \$43 billion more in relief in 1984 than the Democratic alternative. In later years, the difference in the magnitude of the tax cuts will grow even larger.

In reality, even the Reagan proposal is not a tax cut at all; it only offsets the tax increases due to inflation-induced tax-bracket creep expected over this period. It is estimated that the Reagan tax cut offsets 98 percent of the tax increase expected over the next four years due to inflation -- leaving the tax burden about the same that it is today.<sup>6</sup> The Democratic alternative, however, does not even come close to offsetting the expected tax increases due to inflation, not to mention the social security tax increases expected over this period. This occurs because the Democrats have chosen not to enact a tax cut in the third year, while Reagan has recommended a 10 percent across-the-board reduction. Thus, if the Democrats' smaller tax cut is enacted, the total tax burden on the American public can be expected to grow substantially larger over the next three years.

The Reagan tax cut is also of a longer duration than the Democratic alternative. The length of the tax cut is vital to producing significant supply-side effects. If business investment and saving are to be stimulated now, the assurance of a tax cut effective over a number of years is crucial. Businesses, as well as individuals, require the assurance of a stable and predictable economic environment to make sizeable investments now in plant and equipment. Government taxation and spending plans often represent the greatest destabilizing force on the future business environment. The Reagan tax cut, by promising a three-year tax reduction, helps to assure business of a favorable future climate for their investments. The longer the tax reduction mandated, the greater the stimulus to business and personal investment today.

Most importantly, the Democratic alternative is not a proportional cut in taxes for each income bracket, but is focused on low- and middle-income taxpayers. Only an across-the-board marginal tax cut will stimulate saving and personal initiative. Changing marginal rates, in essence, changes the relative price of consumption and leisure. The price of leisure is the income

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<sup>6</sup> W. R. Grace, op. cit.

forgone if one had worked, and the price of consumption is the income one could have saved. The lower the marginal tax on saving and labor income, the more income one forgoes by enjoying leisure and consumption. In this fashion, lowering the marginal tax rates makes leisure and consumption more expensive while working and saving are rendered cheaper.

The Democrats' tax cut is skewed toward low- and middle-income taxpayers, and therefore will neither elicit as much saving and investment nor create as large revenue reflows in the national treasury as Reagan's across-the-board marginal tax cut. Indeed, the Democrats' proposed tax bill can more aptly be described as a Christmas tree decorated with an assortment of ornaments and lights, each placed to attract the support of some special interest. The Democratic alternative, for instance, promises certain "distressed" industries a government check for unused investment tax credits. The troubled savings and loan industry receives a multi-billion dollar bailout in the form of tax-exempt all-savers certificates. Inner-city commercial interests receive liberalized rehabilitation credits on commercial buildings, and high technology firms are bestowed with R&D tax credits. Even the personal income tax cuts are skewed toward attracting the support of special interest groups.

Coalition politics is not new to the American political scene. However, coalitions forged by redistributing income from one group to another more favored will not engender economic growth. Transferring funds from one pocket to another will assuredly not increase one's total income. The Reagan tax cut promises a new approach. Rather than redistributing income, the Reagan marginal tax cut does not dictate national economic goals; rather, it permits more resource allocation to be arbitrated in the free market according to individual initiative. The underlying assumption, of course, is that individuals left to pursue their self-interest relatively unhindered by government will generate enormous productive activity to the benefit of the whole nation. A new surge of economic vitality promises renewed progress towards ameliorating the plight of our nation's poor. The Reagan proposal may not be sufficient to solve all our economic problems, but it appears that the national trend toward higher and higher taxes may finally be reversed.

Below is a comparison of the tax cut proposals recommended by President Reagan and the Senate Finance Committee with those suggested by House Democrats on the House Ways and Means Committee.

## INDIVIDUAL TAX CUTS

### Reagan Proposal

\* Three-year across-the board tax cuts of 25 percent -- 5 percent October 1, 1981, 10 percent July 1, 1982, 10 percent July 1, 1983.

- \* Reduction of marginal rates on investment income from a range of 14 percent to 70 percent under present law to a range of 11 percent to 50 percent starting January 1, 1982.
- \* Reduction of capital gains taxes from a top rate of 28 percent to 20 percent effective June 10, 1981.
- \* Reduction of the so-called marriage penalty tax.

#### Democrat Alternative

- \* Two-year tax cut of 5 percent October 1, 1981, followed by a 10 percent cut on July 1, 1982, with no personal tax cut in 1983. The cut in rates is not proportional across tax brackets but is skewed toward providing relief for Americans earning between \$15,000 and \$50,000.
- \* Maximum tax on investment income reduced to 60 percent in 1982 and to 50 percent in 1983.
- \* Reduction of capital gains taxes from a top rate of 28 percent to 24 percent on January 1, 1982, and to 20 percent on January 1, 1983.
- \* Zero bracket amount (formerly the standard deduction) raised by \$200 (to \$2,500) for a single taxpayer and \$400 (to \$3,800) for a married couple. The earned income tax credit increased from 10 percent to 11 percent of \$5,000 and phased out between \$8,000 to \$12,000 (versus \$6,000 to \$10,000 currently).
- \* Marriage penalty tax reduced.

#### ANALYSIS OF THE INCOME TAX REDUCTION PROPOSALS

An important reason for a personal income tax cut is to help offset the effects of bracket creep and the massive social security tax increase. W. R. Grace & Company has recently published a table analyzing the effects of the Reagan 25 percent across-the-board tax cut with the tax increases due to bracket creep.<sup>7</sup> The chart below shows that Reagan's tax cut offsets 98 percent of \$236.7 billion increases due to bracket creep. Without the Reagan tax cut, salaries will be 5-13 percent lower in 1984, even if salaries keep up with inflation.

Even Reagan's tax cut plan offsets only 72 percent of the expected \$320 billion increases due to inflation and social security.

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<sup>7</sup> W. R. Grace, op. cit.

PROPOSED COMPROMISE TAX CUT VS. TAX BRACKET CREEP  
(Billions of Current \$)

	Reagan Compromise Tax Cut	Bracket Creep Increase	Reagan Compromise Cut as a Percent of Bracket Creep
1981	\$ 3.7	\$ 17.4	21.3%
1982	36.7	38.3	95.8
1983	78.0	71.5	109.1
1984	113.6	109.5	103.7
Cumulative Four-Year Total	\$232.0	\$236.7	98.0%

Unfortunately, the Democratic tax cut proposal provides even less of an offset to inflation and social security tax increases. The Democrats' proposal forgoes the 10 percent cut in personal income tax rates Reagan has scheduled for July 1, 1983, and thereby consigns 77 million taxpaying Americans to losing billions of dollars in relief from higher taxes. Unless these escalating tax burdens are reduced, Americans will undoubtedly lose their fight to maintain their present standard of living.

The Reagan proposal is also superior to the Democratic alternative because it cuts marginal tax rates and not just effective taxes. All decisions are made at the margin. By cutting marginal tax rates -- that is, the rate on additional dollars earned -- the Reagan proposal will induce a greater stimulus to labor and saving. The Reagan proposal is not only a larger tax cut -- 25 percent versus the Democrats' 15 percent cut -- but the Reagan package reduces all marginal tax rates by an equal percentage. This means that the higher income taxpayers will receive an equal percentage reduction in their taxes as lower-income taxpayers. This type of reduction stimulates economic growth because higher income individuals are disproportionately involved in the saving, investing, and entrepreneurial activity in our country. The increased investing and entrepreneurial activity will simultaneously produce jobs and wealth for all income classes -- rich and poor alike.

The Democratic proposal, on the other hand, increases the standard deduction and earned income tax credit while targeting tax cuts to low- and middle-income brackets.

The Democratic proposal, however, is not a cut in marginal tax rates across-the-board but a cut in effective taxes paid. To the extent the Democratic tax cut serves to redistribute income rather than reduce marginal rates, it will have less effect on increasing incentives for productive effort and saving.



Finally, the Reagan tax cut is over a three-year period, while the Democrats have recommended a two-year cut. The assurance of a three-year cut is vital to stimulating supply-side effects. Changing government laws and regulations present the most destabilizing factors to business plans, especially capital expenditure and investment. By mandating a three-year tax cut, the government declares its intentions in advance and allows business to anticipate better the future economic environment. Assurance about the future will allow business to make spending and investment plans now. One need not wait three years to see the effects of the tax cuts since business will change their economic behavior immediately in anticipation of future tax benefits. The greater the stability and predictability concerning government tax laws and regulations, the more businessmen, investors, and savers will be stimulated toward productive economic behavior today.

The Democratic proposal would unnecessarily delay the full reduction of capital gains and investment income tax for two years, rather than making the reduction all at once. Such a delay not only discourages productive business investment, but it reduces government tax revenues: after the last cut in capital gains taxes, tax receipts actually grew by 14 percent. The reduction of the 70 percent marginal rate on investment income would almost certainly have a similar revenue-increasing consequence.

#### MARRIAGE PENALTY TAX

The so-called marriage penalty tax is the difference between the taxes paid by a married couple with two incomes and the lower taxes they would pay if they were single. The tax arises because incomes are added together for tax purposes and the two spouses are subject to the higher progressive rates. The problem arises because the marginal rate which applies to the last dollar of the first spouse's income is used as the starting tax rate for the second spouse's income. If the two were single, each would start at the lowest tax bracket of 14 percent. The dramatic rise in two-earner households has made over 32 million Americans subject to the marriage tax. Both the Democrat and Republican proposals should help restore work incentives by reducing the marginal tax rates on second-wage earners. However, the Democratic proposal goes further in reducing those high marginal rates than the Republican initiative. The Senate Finance Committee has suggested that the lowest paid spouse be allowed to deduct from taxable income 10 percent of income up to \$30,000. The phased-in reduction would amount to a \$3,000 tax credit by 1983. The Democratic proposal is more generous. The Democrats would allow a \$5,000 tax deduction against the marriage penalty tax by 1982. Unfortunately, neither proposal completely eliminates the higher tax burden of families with two wage earners. If one wanted to make the tax system completely neutral in its effect on marriage, one would want to allow married taxpayers the option of filing as single individuals.

## BUSINESS TAX CUTS

Reagan Proposal

- \* Depreciation write-off periods reduced to:
  - 15 years for the cost of building;
  - 5 years for the cost of machinery;
  - 3 years for vehicles and the equipment used in R&D.
- \* Investment tax credit:
  - 15 year category 10 percent tax credit;
  - 5 year category 10 percent tax credit;
  - 3 year category 6 percent investment tax credit.
- \* Full expensing of equipment up to \$10,000 phased in over a 5-year period.
- \* Elimination of the \$100,000 limit on the amount of used property eligible for the investment tax credit.

Democratic Alternative

- \* Full reduction of cost of equipment in the year it is purchased (after five year phase-in period).
- \* Immediate \$25,000 write-off of new equipment permitted as an option for small business.
- \* Investment tax credit disallowed.
- \* Phase down of corporate rate from 46 percent to 34 percent by 1987.
- \* Distressed industries -- airlines, mining, paper, railroads, steel, automobiles -- allowed to "carry back" unused tax credits to claim against taxes paid since enactment of the credit in 1962.

## ANALYSIS OF BUSINESS TAX REDUCTION PROPOSALS

Both the Reagan and Democratic plans are highly regarded by businessmen and economists. Both plans are a move closer to the optimal capital recovery system -- immediate expensing. If assets were written off immediately, inflation would have a neutral effect on business investment decisions. Capital formation would be increased since the 75 percent marginal rates on business income would be reduced significantly.

As mentioned above, in a report recently released by IRET, the Democratic proposal was found to provide business with a

greater tax cut than Reagan's proposal, even in the phase-in period. The Democratic proposal also achieves the optimum in business depreciation: immediate write-off (expensing). While Reagan's proposal of accelerated depreciation and investment tax credits approximates the optimum, it does not achieve the degree of simplicity and neutrality in economic decision-making attained by the Ways and Means Committee proposal.

The original 10-5-3 depreciation plan proposed by the Reagan Administration provides enough relief to offset an inflation rate of 8 percent for typical investment in plant and equipment, according to Martin Feldstein.<sup>8</sup> Above 8 percent, the Reagan proposal falls short of a full offset to increased capital taxes. A complete write-off of business equipment investment in the year of purchase would, however, offset most of the effects of inflation. The Democratic proposal, therefore, becomes progressively more attractive to business as inflation increases. Similarly, the tax effects of the two proposals become less important at lower inflation rates.

#### Corporate Income Tax Reductions

The Democrats' proposal is also more advantageous to non-capital intensive industries such as service industries and the electronics industry. The Democrats have included a provision to reduce the corporate income tax from 46 percent to 34 percent. The Reagan plan gives no corporate income tax reductions aside from accelerated depreciation schedules. The Democrats' corporate income tax rate reduction benefits all business regardless of its capital intensity. The liberalized depreciation measures proposed by Reagan, on the other hand, will mostly benefit capital-intensive industries. It should be pointed out, however, that capital-intensive industries have borne the greatest tax burden due to inflation.

#### Distressed Industries Proposal

The Democratic plan provides "carry backs" of unused investment tax credits against taxes paid in earlier years. This provision would help industries which have not generated enough income to use their investment tax credit, especially the steel and auto industries. The Democratic proposal amounts to a tax subsidy for unprofitable firms. Although the problems of distressed industries are in many cases caused by the government itself, the cause of economic growth and productivity is not served by sending government checks to unprofitable businesses. As less innovative or poorly managed firms are displaced by competitors, economic resources are freed to flow to new, faster-growing business, often engendering new technologies and new jobs.

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<sup>8</sup> Feldstein, op. cit.

## ESTATE TAX RELIEF

Reagan Proposal

- \* Raises the amount excluded from estate taxes to \$600,000 from \$175,000 after a 5-year phase-in.
- \* Gift tax exclusion rises to \$10,000 from \$3,000, and current tax on transfers between spouses is eliminated.

Democratic Alternative

- \* Changes promised but precise choices not yet worked out in Committee as of July 10.

## ANALYSIS OF ESTATE TAX RELIEF

Inflation has caused the value of even modest estates to be pushed into very high tax brackets. An estate worth \$100,000, for example, is subject to a tax of 30 percent. Estates over \$10,000,000 are taxed at 70 percent.

Recent research by Laurence J. Kotlikoff and Laurence Summers of the Bureau of Economic Research and the Massachusetts Institute of Technology has determined that a chief motivation behind the decision to save is to generate bequests for one's children.<sup>9</sup> Inheritance, therefore, represents a pool of savings from one generation to another. The high taxes on inheritances may cause a serious disincentive to saving and investment. As such, the inheritance tax produces a serious impediment to economic growth.

In addition, the inheritance tax falls preponderantly on farmers and small businesses. The natural desire of factory owners and farmers to pass their businesses on to their progeny may be an important incentive to their work effort. Punitive tax on these bequests may severely hinder capital formation, innovation, and investment, especially by small business entrepreneurs. The Reagan proposal seeks to lift this impediment to economic growth by reducing the number of bequests taxed from 3 percent to 0.3 percent; only 6,500 estates would be taxed annually compared with 56,000 today.

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<sup>9</sup> As reported by Tom Persky, Mike Schuyler, and David Raboy, "An Introduction to the Economics of Estate and Gift Taxes," Economic Report #4, Institute for Research on the Economics of Taxation, June 11, 1981.

## SAVINGS INCENTIVES

Reagan Plan

- \* Tax-exempt all-savers certificates created for a one-year period, October 1, 1981 to September 30, 1982, paying 70 percent of the one-year Treasury bill rate -- \$1,000 of interest exempted from tax (\$2,000 for couples filing joint returns).
- \* Tax deductions increased for contributions to retirement plans both for those now covered by company plans and for those not now covered by any plan.
- \* Repeal, after 1981, of the \$200 interest and dividend exclusion (\$400 for a joint return) and a return to the \$100 per taxpayer dividend exclusion of prior law.

Democratic Alternative

- \* All-savers certificates authorized, but only thrift institutions (not commercial banks) may issue them.
- \* Liberalized tax deductions for contributions to retirement plans.
- \* Repeal after 1981, of the \$200 interest and dividend exclusion (\$400 for a joint return) and a return to the \$100 per taxpayer dividend exclusion of prior law.

Problem

The savings and loan industry is in very poor financial shape. The S&Ls' proximate ills stem from borrowing short-term at high interest rates and lending long-term at lower interest rates. This squeeze in the cost of funds caused over thirty S&L mergers to be arranged last year at a cost to the Federal Savings and Loan Insurance Corporation of \$1.3 billion. This year, the rate of imminent bankruptcies has increased to fifty. Losses industry-wide this year may total a staggering \$6 billion and next year a stiff \$2.7 billion.

Both Democrats and Republicans alike worry that the ills of the S&Ls may choke-off the supply of funds into the much-depressed homebuilding industry. Worse still, a large-scale collapse of S&L institutions could overwhelm the S&L Insurance Fund instituted to handle such emergencies.

Analysis

Both the Democrats and Republicans appear headed toward the enactment of some variant of the all-savers certificates to bail out the industry. While Reagan has agreed to accept the entire Finance Committee package of tax cuts, he has expressed disapproval

of the all-savers certificates proposal. The Democrats have embraced the concept as a method of stimulating savings and lending a hand to the S&Ls.

The all-savers certificates will not prove successful in stimulating saving and investment in the economy. Their major contribution will be to divert funds primarily from present tax-exempt investments into the all-savers substitute. If Congress wishes to stimulate savings, it should cut the present high marginal taxes on interest and dividend income.

The all-savers certificate should work -- albeit inefficiently -- as a measure to bail out the ailing S&Ls. The measure allows S&Ls to issue tax-exempt certificates at 70 percent of the Treasury bill rate. This provision permits the issuing banks to borrow funds at two-thirds the cost necessary to attract funds. The legislation should turn the estimated \$2.7 billion pre-tax industry loss in 1982 into a \$440 million profit.

As a bailout measure, however, the certificates are inefficient. While costing the Treasury as much as \$6 billion in lost revenue, they add less than \$4 billion in profits to the industry in 1982. It would be less costly if the \$4 billion were just given to the industry.

There are other reasons to be wary of the all-savers certificates. The certificates would pay 70 percent of the T-bill rate. At this rate, they would only be attractive to those in at least the 30 percent tax bracket or better, roughly those making \$40,000 a year. Moreover, low- and middle-income taxpayers would lose, since the legislation eliminates the \$400 (joint couple) dividend and interest deduction. Under the Republican and Democratic proposals, the law would revert to an exclusion of \$100 (\$200 for a joint return) for dividends only.

If one accepts the importance of bailing out the S&Ls, the House Ways and Means bill is a superior means to that end. The Democratic plan limits the privilege of issuing the tax-exempt certificates to S&Ls, precluding commercial banks. Both measures, however, distort credit allocation, provide yet another precedent for industry bail outs, generate economic inefficiency, and cost the Treasury \$6 billion in 1982 alone.

Alternative reforms that involve less government regulation rather than more intervention have been suggested by the Wall Street Journal:<sup>10</sup> (1) permit thrifts to make all types of loans and enlarge the types of investments they can make besides low-return mortgages; (2) allow mergers across state lines; and (3) permit the reorganization of S&Ls into stock companies rather than as mutual organizations to allow investors to take advantage of tax write-offs.

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<sup>10</sup> "Thrift Sale," Wall Street Journal, editorial, June 29, 1981, p. 20.

### IRA and Keoghs

Both Democrat and Republican plans permit an additional \$500 deduction (from \$1,500 to \$2,000) for contributions to individual retirement plans. Both proposals extend the eligibility for IRAs to active participants in employee-sponsored pension plans with a \$1,500 limit on deductible contributions. The bills would raise the tax-deductible contribution of self-employed people to Keogh retirement plans to \$15,000 from \$7,500.

These measures are expected to have only modest effect on saving. Currently, only a small percentage of those eligible for the plans choose to enroll. Of course, if all interest income were tax-free, there would be no reason to set up this "tax loophole."

### OTHER TAX CODE PROVISIONS

There are other provisions included in either the House Committee bill or the Senate Finance Committee bill which will be mentioned only briefly.

#### Windfall Profits Tax

The Senate Finance Committee has passed an amendment offered by Senator David Boren (D-Okla.) to drop the current 30 percent tax on newly discovered oil to 25 percent in 1983, 20 percent in 1985, and 15 percent in 1986 and thereafter. The House Ways and Means Committee is not expected to include this provision to cut in half the windfall profits tax enacted last year.

#### Stock Options

Both the House and Senate bills contain provisions to give more favorable treatment to the exercise of stock options. Under the bills, employees would not pay tax on stock received from a company stock option plan until they sold it. At that time, the difference between the option price and actual price would be taxed as a capital gain. The business expense deduction for the difference in price would be eliminated.

#### Commodity Straddles

In the Senate Finance Committee bill, all commodity futures profits would be taxed on December 31 of each year regardless of whether the position is closed out. Sixty percent of the profit would be taxed as a long-term capital gain; the rest would be taxed as ordinary income. The House Democrats on the Ways and Means Committee are expected to enact a similar provision.

#### Overseas Employment Income

The Senate measure would reduce the tax on income from overseas employment. The first \$50,000 of income would be excluded

entirely as well as one-half of the next \$50,000; excess housing costs would also be excluded.

#### Oil Royalty Income

The Senate Finance Committee bill offers a tax credit of \$2,500 against the windfall profits tax on oil companies' revenue. The exemption would apply only to estates, family farms, and individuals.

#### R&D and Historical Building Deductions

Both Democrats and Republicans are expected to offer a similar treatment. The Senate Finance Committee offers a 25 percent credit on increases in wage expenditures in R&D up to \$10,000 in 1986 and thereafter. The Senate Finance Committee has passed a tax credit of 15 percent for 30-39 year old commercial or industrial buildings, 20 percent for such buildings at least 40 years old, and 25 percent for certified historical structures. The Democrats have promised rehabilitation credits that range from 15 percent to 20 percent depending on the age of the structure.

#### Motor Carrier Losses

The Senate Finance Committee permits a tax deduction for the loss in value of motor carrier operating certificates due to the deregulation of the trucking industry.

### CONCLUSION

The Reagan tax cut package appears to present the best opportunity our nation has to renew its economic vitality, a vitality which is imperative if our country is to attain the means to rebuild its national defenses, provide economic opportunity to the poor, and restore a measure of upward mobility to workers. The Reagan tax cut promises to unleash productive economic activity not through demand stimulation, but by altering relative prices: consumption and leisure is made more expensive while saving and initiative is made more rewarding.

The Reagan initiative started out as a simple across-the-board tax cut of 10 percent in each of three years with accelerated depreciation schedules for business. The Senate Finance Committee added many new amendments of its own -- some of which subsidize special interests -- and scaled down the tax cuts to 25 percent. But the essential features of the Reagan initiative remain: across-the-board reductions of marginal rates on labor and investment income, and a tax cut which extends over three full years. The battle lines between the Reagan proposal and the Democrat alternative as it is shaping up in the House Ways and Means Committee appear to be drawn on these points. The Democrats appear adamantly opposed both to proportional tax cuts and to a measure of three-years' duration. President Reagan appears



equally adamant in opposing any greater compromise on his proposal. Which tax cut package ultimately prevails will be determined in upcoming votes in the House and Senate, votes which are expected to occur before the August recess. The outcome of the votes will not only determine the level of government revenues for the next four years, but, if supply-siders are correct, the possibility of an American economic renaissance.

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