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A SURCHARGE: THE WORST TAX?

INTRODUCTION

Faced with a twelve-digit deficit and a budget impasse, the Reagan Administration has been considering a variety of measures designed to satisfy its critics. Among the worst being considered is a punitive income tax surcharge for upper-income Americans. Proponents say that a tax surcharge is necessary to reduce the federal deficit and counter the liberal attempt to portray the Administration as favoring the rich. The proposal, however, is seriously flawed. The income tax surcharge is too small to reduce the deficit appreciably, yet large enough to further depress economic activity, increase unemployment, and delay recovery.

A tax surcharge on upper income Americans is potentially the most destructive and distortionary of all tax increases for it raises the marginal tax rates on the most productive groups. A 4 percent surcharge on incomes over $40,000, for example, would lift the top marginal tax rate from 50 percent to 52 percent and the 40 percent marginal rate currently applied to households earning over $40,000 would be raised to 41.6 percent. Fully 40 percent of the 10 percent tax rate reductions in 1982 would be rescinded for those affected by the surcharge. And for what benefit? No one thinks the $4-6 billion a year raised by a 4 percent surtax would lower interest rates or speed economic recovery. To the contrary, the tax rate reductions, especially for upper-income Americans, lay the foundation for recovery and should not be diluted at the last hour by a tax surcharge.

Ironically, while pressure builds for destructive tax increases, federal deficit estimates are being scaled down considerably. The five-month revenue figures for FY 1982 indicate that OMB may be overestimating the budget deficit by between $25 to $35 billion. Warren T. Brookes, a Boston-based economics

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analyst for The Heritage Foundation, argues that, barring a real depression, the deficit could be in the $65 billion range instead of $100 billion as many now claim. OMB has been predicting revenue growth of 4.6 percent over 1981, but the actual revenue figures from October 1981 to February 1982 present a far different picture. Actual federal revenues are growing by 12.9 percent. High level Treasury officials indicate that they are puzzled by the better-than-expected revenue figures.

In actuality, economic predictions are always mainly educated guessing games and, as such, the deficit projections are never very reliable. But the current deficit projections have taken on a heightened importance since the apparent OMB deficit overstatement has the effect, planned or otherwise, of stampeding Congress and even the President into accepting a tax hike contrary to his supply-side strategy. If the deficits could be limited to the $65 billion range, as Brookes estimates, pressure to raise taxes would accordingly be relieved.

Even if the federal deficit is closer to OMB's higher predictions, new taxes on income are not the solution, especially in a recession. Tax hikes depress private sector initiative and saving as much, if not more, than government borrowing to finance the deficit. Raising taxes on the most productive members of our society in the name of stimulating economic recovery makes no economic sense.

Many think that upper-income Americans are currently reaping a bonanza from the recent tax rate reductions. For the most part, however, the tax cuts only keep rates from going higher. The marginal rates -- even for upper income brackets -- will be essentially the same in 1983 as they were in 1978. Without the Reagan tax cuts, marginal tax rates on middle and lower incomes would have been 30 to 40 percent higher. The tax rate reductions passed last year will at least offset the effects of inflation-induced tax bracket creep expected over the next three years, but the high rates existing in 1978 will continue.

The tax surcharge currently being proposed is a 4 percent increase in taxes for income brackets over $40,000. Taxes would first be computed in the regular fashion for income classes above the income cutoff and then a given percentage, say 4 percent, would be added on to the bill. For an upper-income family, the proposed 4 percent tax surcharge would wipe out 40 percent of the 10 percent tax rate reduction they were scheduled to receive in 1982. When the final stage of the tax cut becomes effective in 1983, the surcharge will offset fully 20 percent of the rate reduction then in place. And finally in 1984, for those Americans subject to the surcharge, over 16 percent of the tax relief offered by Reagan in the initial tax reduction package will be erased by the tax surcharge.

A typical family affected by the surcharge will find in 1983 that the lion's share of their promised tax cut will be taken

away by the surcharge or by inflation. Simple arithmetic tells the story. A two-earner household making $50,000 a year in 1980 paid a marginal income tax rate of 43 percent. Their marginal tax rate is scheduled to drop to 40 percent in 1983 as a result of the Reagan tax bill. A 4 percent surcharge, however, will raise the family's tax liability in 1983 to 41.6 percent. As a result, the tax surcharge will wipe out over 50 percent of the already small marginal tax reduction.

One does not need to shed tears for families earning $40,000 or more a year to understand the devastating effects of higher marginal tax rates on the important saving and investing activity carried on by Americans in this tax braket. Two-thirds of all U.S. personal saving comes from the 5 percent of all income earners making more than $50,000 a year. At a time when the U.S. needs more saving and investment, an additional tax increase on productive Americans will simply depress an already capital-starved private sector.

Table I
Income Share & Saving Rate
By Income Category
(1978)

Income Category (1978)	Income Share (%)	Saving Rate (%)
Under $6,000	8.4	(65.0)
$6,000-10,000	11.4	(10.0)
$10,000-16,000	17.8	2.8
$16,000-25,000	26.5	11.0
$25,000-50,000	26.8	19.5
Over $50,000	9.1	35.0

Source: A. Gary Shilling & Company, Inc.

THE LESSON OF THE 1968 TAX SURCHARGE

In 1968, the last time an income tax surcharge was levied, the tax revenue collected was largely offset by reductions in savings. There is no reason to think a similar tax today would have a different economic impact.

Unfortunately, economic history is often forgotten -- or ignored. In 1968, Congress legislated a 10 percent tax surcharge, much like the one currently recommended, on income taxes paid by individuals retroactively to April 1, 1968, and by corporations retroactively to January 1, 1968. The Revenue and Expenditure Control Act of 1968 also reduced government spending in that year and established a ceiling on government spending for the fiscal

year 1969. The tax surcharge was explicitly recognized as temporary and was slated to expire in June 1969, although it later was extended for six months and then extended another six months at a reduced rate of 5 percent.

Arthur Okun, then a member of Lyndon Johnson's Council of Economic Advisors, justified the tax surcharge as a means to reduce inflation and the high level of aggregate demand. Congress passed the surcharge in June 1968 to reduce the budget deficit, then climbing to over $10 billion. The results of that tax surcharge are instructive for policymakers today considering a similar policy, not this time to reduce consumption expenditures and inflation but rather to lower interest ratess by reducing the budget deficit.

As Table II indicates, tax revenues increased $11 billion between the second quarter and third quarter of 1968 in response to the tax increase. And by FY 1969, the federal budget enjoyed a $5.2 billion surplus, up sharply from the $12.3 billion budget deficit the previous year. The first lesson of the 1968 surcharge: tax surcharges can reduce deficits, and, if large enough and applied to a sufficiently large number of income tax brackets, may even raise enough revenues to eliminate sizable budget deficits. But over this same period, personal saving sharply declined by $9 billion, offsetting almost 80 percent of the revenues raised by the tax surcharge. The personal saving rate declined by 7.6 percent of personal income in the second quarter of 1968 to a low of 5.3 percent in the second quarter of 1969. Hence Lesson Two for policymakers considering a tax surcharge: A tax surcharge may help balance the federal budget, but only at the cost of a substantial reduction in saving. In short, a tax surcharge may reduce the federal demand for credit to finance the deficit, but only at the expense of the pool of savings. From the lessons of 1968, it seems certain that an income tax hike will not reduce interest rates or relieve pressure on the capital markets.

Table II
The Effects of the 1968 Tax Surcharge on Consumption and Saving
(Billions of dollars at annual rates)

	1968/II	1968/III	Change
Personal Income	681	699	18
Less: Taxes, etc.	93	104	11
Equals: Personal disposable income	588	595	7
Less: Consumption	543	559	16
Equals: Personal saving	45	36	-9

Source: Survey of Current Business, 1973 Supplement

The Saving Rate in Response to the 1968 Tax Surcharge

1967	1968				1969				1970
	I	II	III	IV	I	II	III	IV	
7.3	7.2	7.6	6.0	6.2	5.3	5.3	6.6	6.8	7.9

Source: W. L. Springer, "Did the 1968 Surcharge Really Work?" American Economic Review, September 1975.

At the same time that taxes were being raised by President Johnson, the Federal Reserve was pursuing an expansionary monetary policy. Many are demanding that Reagan follow a similar course today. According to Senator Roger Jepsen (R-Iowa), the loose money-higher tax policy of 1968-1969 failed to reduce interest rates, keep inflation low, or encourage economic expansion. To wit, soon after the tax surcharge was imposed:

1. "Interest rates rose. By December 1968, interest rates were generally higher than they were in June. They moved still higher in 1969. The three-month Treasury bill rate average 5.3 percent in the first half of 1968 and 5.5 percent in June. It averaged 5.9 percent in December 1968, 6.5 percent in June 1969 and 7.7 percent in December 1969. Other interest rates also increased by a similar amount.

2. "Inflation accelerated. The CPI rose 3.0 percent in 1967, 4.7 percent in 1968, and 6.1 percent in 1969.

3. "Economic growth slowed. Real growth of the gross national product declined from 5.1 percent in the four quarters ending in June 1968 (and an annual rate of 6.4 percent in the first half of 1968) to an annual rate of 3.5 percent in the second half of 1968 and 2.4 percent per year in the first half of 1969. A recession began in the second half of 1969."

There is no apparent reason why a combination of a tax surcharge and monetary expansion would produce a different economic outcome today.

TAX CUTS: WELFARE FOR THE RICH?

Some justify an income tax surcharge by saying that the Reagan tax cuts disproportionately benefit the rich. A new economic report conclusively shows that proportional tax cuts like the ones enacted last year, far from being "welfare for the rich," actually shift the tax burden toward the wealthy. According to a recent article in Economic Review by economists James Gwartney and Richard Stroup, proportional tax rate reductions for all income brackets provide the greatest incentives to persons in upper-income brackets to expand their taxable income by shifting

their resources from tax-sheltered investments and consumption into productive activities generating tax revenue. The effect of reducing marginal tax rates both in 1964 and in the 1920's, the economists point out, has been to shift the tax burden toward higher income groups.

Gwartney and Stroup present potent evidence that the best means of "soaking the rich" is to lower their taxes, in essence, coaxing rich Americans to engage in taxable economic activity rather than non-taxable consumption. After the 1964 tax reductions, for example, the number of tax returns reporting an adjusted gross income of $50,000 or more grew rapidly, reaching 272,000 by 1966; previously these high-income returns ranged only between 125,000 to 162,000. As Table III indicates, these upper-income individuals bore proportionately more of the total tax burden of the country after they received a tax cut than before.

Table III
The Share of Tax Revenue Collected from Various Percentile Groupings Ranked According to Adjusted Gross Income Prior to and Subsequent to the 1964 Reduction in Tax Rates

Percentile of All Returns (Ranked from Lowest to Highest Income)	Tax Revenue Collected from Group (in billions of 1963 dollars)*			Percent of Personal Income Taxes Collected from Group*	
	1963	1965	Percent Change	1963	1965
Bottom 50 percent	$ 5.01	$ 4.55	-9.2	10.4	9.5
50 to 75 percentile	10.02	9.61	-4.1	20.8	20.0
75 to 95 percentile	16.00	15.41	-3.7	33.2	32.1
Top 5 percent	17.17	18.49	+7.7	35.6	38.5
Total	$48.20	$48.06	-0.3	100.0	100.0

*These estimates were derived via interpolation.

Source: Internal Revenue Service, Statistics of Income: Individual Income Tax Returns (1963 and 1965).

Before the tax cut, the top 5 percent of income earners bore 35.6 percent of the total tax burden, but in 1965 those in the highest tax brackets paid the larger proportion of 38.5 percent of income taxes. Conversely, the bottom 50 percent of income earners contributed proportionately less of total income taxes after the tax cut: a drop from 10.4 percent in 1963 to 9.5 percent in 1965. Tax revenues collected from these upper income groups expanded rapidly. Before the 1964 tax cut, real revenue collected from returns with income above $50,000 rose at an annual rate of 6.1. percent. After the tax cut, Gwartney and Stroup discovered "tax revenues collected from these taxpayers grew at an annual rate of 14.1 percent. Even though the average

(and more importantly the marginal) tax rate of taxpayers with incomes of $50,000 or more decline, the constant dollar growth rate of revenues collected in this category rose substantially."

In contrast to tax reductions, Gwartney and Stroup discovered that proportional tax hikes tend to reduce the reported gross income of upper-income taxpayers, lower the proportional contribution of upper-income Americans to total tax revenue, and shift the tax burden to lower-income classes. In response to the 1932 tax hike, for example, the net income reported to the IRS fell by 4.7 percent in the first year of the tax increase. The largest decline in reported income occurred with incomes above $300,000. In constant dollars, reported net income from this class fell 49.1 percent in a single year. In response to the tax hike, all income classes paid more income taxes to the government. However, the growth of tax revenues was more modest for higher tax brackets. Income categories less than $25,000 increased their tax contribution from 21 to 36.5 percent while the proportional income contribution of individuals making over $300,000 actually declined from a 23.5 percent share of total revenues to 18.4 percent. Other high income brackets shifted a portion of the total tax burden to lower-income brackets.

In short, Gwartney and Stroup conclude that criticism of tax rate reductions for upper as well as other income classes is misplaced: "Far from shifting the tax burden toward the poor, the Reagan program will shift the tax burden toward the rich." A tax surcharge on upper-income Americans, on the other hand, would have the opposite effect; that is, increase the tax burden on the lower-income classes, just as it did in the 1932 tax hike.

CONCLUSION

It would be ironic if a tax surcharge is levied to soak the rich, only to find, as in the 1932 tax increase, that the rich withdraw their money from investment and shift it to tax-exempt bonds or consumption expenditures -- leaving those who cannot afford such options to toil in the marketplace under a proportionally heavier tax load than before the tax increase. And yet, if the tax surcharge is enacted, the incentive structure will be twisted to encourage the rich to take a trip to Monte Carlo or buy a bauble rather than invest in taxable activities that will earn them too small an after-tax return.

Many assumed that Reagan was committed to reforming the tax system so that the incentives ceased being biased in favor of non-productive activities. Whether the deficits are $65 billion or $100 billion, it makes no sense to drive a class of productive taxpayers into hiding just as they are returning to the marketplace after sitting it out for so many years.

But the deficit still remains, as we are constantly reminded -- many times by those who supported extravagant spending measures

in the past and continue now to resist spending cuts. What is to be done with the surging red ink? The Administration should reassert its commitment to cutting the budget, especially the rapidly-expanding entitlement programs, as the only means of reducing the current budget deficits. National public opinion polls still indicate broad support for further budget cuts. A tax increase will simply give government officials more money for yet higher levels of spending. The most effective means of reducing the federal budget is to deny the government further revenues.

Ronald Reagan was not elected to raise taxes; he was elected to reduce the burden of government on our daily lives. An income tax surcharge on upper-income Americans would signal a disappointing retreat from that goal. And if political expediency demands some "enhancement" of revenues, the worst means of doing so would be the income tax surcharge.

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