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BREACH OF FAITH: THE TAX PACKAGE

INTRODUCTION

A tax rebellion is brewing in Congress. Its message? No tax hikes without budget cuts. In a letter drafted by Representatives Jack Kemp (R-NY) and Robert Walker (R-PA), over 70 House GOP conservatives have served notice to the President that they will not accept the Senate Finance Committee's package of tax hikes unless the Congress first considers the $40 billion in budget cuts envisioned by the Budget Resolution passed last June.

These conservative Congressmen believe they will be breaching faith with Reaganomics and the 1980 election mandate if they pass $100 billion in tax increases with only a faint hope that budget cuts will follow. Conservatives have accepted tax increases as half of a compromise with moderates and liberals that includes as the second half substantial budget cuts. Now these House conservatives feel betrayed because the tax increases are sailing through Congress while the budget cuts are bottled up in House committees. According to the letter sent to President Reagan Tuesday: "House conservatives were assured that there was only one way to achieve substantial savings in spending: to 'hold our noses' and swallow the largest peacetime legislated tax increase in history."

The House Democrats are now "welching" on the deal to cut reconciliation. According to the letter, "What they hope is that Republicans are foolish enough to pass a tax increase." "Quietly, without debate," the letter continues, "the Republican Party is in danger of making a U-turn back to its familiar role of tax collector for Democratic spending programs. This is potentially an explosive scenario politically because the GOP clearly will take the blame for any tax increase passed by Congress."

The conservative House Republicans hope that the growing tax rebellion will prompt Reagan to delay or even call a stop to the tax hikes in the final hour. Such presidential courage is not without precedent. Last January, Reagan nixed the call for excise tax increases against the advice of nearly all his political and economic advisors. Is the President ready to repeat this bold action? Perhaps he will be when it becomes apparent that the Senate Finance Committee package he endorsed is actually the largest tax increase in peacetime history.

Torpedoing tax increases is even more justified today since the House appears to have rejected the budget cuts that were the crucial part of the compromise package which attracted reluctant conservative support. According to a recent minority report of the House Budget Committee, the House has acted on only some $15 billion of the $40 billion in cuts over three years recommended by the Budget Resolution. If these cuts evaporate, as now appears likely, the ratio of budget cuts to tax increases will be about $1 in cuts for every $7 in tax increases. This is hardly the budget compromise that House conservatives had in mind. As the budget cut momentum has stalled, however, the tax hikes have moved swiftly through Congress and have sharply increased from the original recommendation of $21 billion in the first year alone to the current proposal of $24 billion. Some high-level Treasury officials also suspect that, if the current tax levies receive the congressional nod, the tax-raisers will be back next year with a new package of tax "reform" measures.

BOTTLED UP BUDGET CUTS

In direct contrast to the clear sailing through Congress of tax increases, budget cuts are foundering on a legislative sandbar. According to the Committee on the Budget, the House has refused to carry out even the limited budget cuts recommended in the Budget Resolution passed last June. According to the Minority Budget News, the First Concurrent Resolution on the Budget for Fiscal Year 1983 instructed nine House committees to report spending reductions of $6.57 billion in FY 1983 and $27.1 billion over three years. "Based on preliminary staff estimates as to expected Committee action," says the report, "total spending will be reduced by $4.1 billion in FY 1983 and $15 billion over three years." This represents a shortfall in budget cuts of over $2.5 billion in 1983, growing to almost $12 billion over three years.

The Budget Resolution also envisioned non-reconciled savings--that is, budget cuts that are not mandated but are nonetheless recommended by the Budget Committees. These additional budget cuts, amounting to about $14 billion, virtually have been ignored by the House committees. Only one House committee thus far has moved on these non-reconciled savings. Only about 2 percent of the budget cuts have been implemented in this area, and no House committee has scheduled further action. In total, the Budget Committee estimates that only some $15.7 billion of the $41

Chart 1
(Outlays in millions)

	FY 83	FY 84	FY 85	3-Year Totals
Reconciliation Savings (Table 1)				
Resolution Assumptions	6,573	9,268	11,312	27,153
Action to Date	4,026	5,655	5,706	15,387
Difference	-2,547	-3,613	-5,606	-11,766
Additional Non-Reconciled Savings (Table II)				
Resolution Assumptions	3,126	4,874	5,623	13,623
Action to Date	90	100	104	294
Difference	-3,036	-4,774	-5,519	-13,329
TOTAL DIFFERENCE BETWEEN SAVINGS ASSUMED IN THE BUDGET RESOLUTION AND LEGISLATIVE ACTION				
Budget Resolution Assumptions	9,699	14,142	16,935	40,776
Action to Date	4,116	5,755	5,810	15,681
Difference	-5,583	-8,387	-11,125	-25,095

Source: Committee on the Budget, Minority Budget News, July 27, 1982.

billion in budget cuts recommended in the Budget Resolution will be enacted.

Perhaps the most egregious example of a House Committee's breaching faith is the House Post Office and Civil Service Committee. On July 21, the Committee ignored its budget instructions and refused to place a four percent cap on annual cost-of-living adjustments (COLAs) for federal retirees--the largest portion of budget savings in the reconciliation package. The Committee's rejection of the cap means that less than 1/30 of the savings envisioned by COLA reforms will be realized. The committee was directed to make cuts totalling $3.2 billion through 1985, but the panel instead voted to cut only some $113 million. The Committee's defiance also dooms the Armed Services Committee's commitment to cap military retirement benefits and the Foreign Affairs Committee's power to cap Foreign Service personnel COLAs.

It is clear that budget-cutting strategy is unravelling in the House. As one committee balks at making cuts in its jurisdiction, other committees, no longer attracted to cutting funds for special interests in their jurisdiction, refuse to consider budget cuts. The only major appropriations being cut from the levels suggested by the Budget Resolutions are defense and military construction and Foreign Assistance--hardly measures that conservatives can support warmly.

Although the hour is late, it is not too late for the Administration to reconsider support of the largest tax increase in history. The Finance Committee's tax package is a fundamental betrayal of Reaganomics and a massive denial of supply-side principles. It is not just the obvious point that imposing the largest tax increases in peacetime history will have devastating consequences on a weak economy. But also that the current tax package raises taxes in the worst possible way. Even now, Administration officials do not refer to the package as tax increases. It has been sold to the public and the President as a measure to plug loopholes, enhance taxpayer compliance, and impose relatively harmless tax increases on consumption. Yet, for the most part, the package raises taxes on saving, investment, and productive activities. Only relatively small sums are to be raised from taxing consumption. While the package masquerades as tax reform, it really represents a triumph of the liberal Democrat's wish list to soak business, professionals, and other productive investors.

One particularly capital-destructive measure is withholding of interest and dividend income. Touted as a tax compliance provision rather than a tax increase, withholding on dividends and interest will, for the most part, increase the implicit tax on saving and stock investment, essentially by denying investors the use of their income for up to a year after it was earned. Thus, a major goal of Reaganomics--stimulating savings--will be violated. The withholding provision will smother financial institutions with paperwork and cost hundreds of millions to administer. Opposition from financial institutions, at first very strong, has been neutralized by the promise of a 30-day "float" on withheld money. The interest-free loan to financial institutions, however, comes at the expense of the already beleaguered saver and stock investor.

Is this the goal of Reaganomics? Last year the President promised help to the nation's highly taxed saver and stock investor. He said that insufficient saving was the chief cause of lagging capital formation and sluggish economic growth. It makes no sense this year to raise the implicit tax on savers and investors while wrapping financial institutions in yet more government red tape.

The highest single increase of the tax package hits business investment. It totals $37 billion over three years. Last year the President promised to spur business investment by expanding depreciation allowances and other capital formation incentives. Congress responded by reducing taxes on business investment by some $68 billion over three years. This sensible strategy will be turned on its head if the Senate Finance Committee has its way. Now the word is that a tax increase on businesses is necessary to reduce deficits which, in turn, is supposed to spur economic recovery. What this means is that the Senate Finance Committee is trying to cancel approximately half of the tax incentives it passed last year by restricting depreciation and other investment tax credits. What does Congress really believe? That business tax increases spur economic recovery--that they depress it? Accelerated depreciation either stimulates business investment, or it depresses it; Congress cannot have it both ways.

Although reduction of deficits is a worthy economic objective, tax hikes crowd out productive economic activity as much as, if not more than, budget deficits. A cutback of last year's business incentives will teach business not to trust Congress. The lesson will be: what Congress gives in tax incentives one year, it will take back the next. If a fickle Congress impulsively changes the economic rules of the game, distrust and instability mount within the business and investing communities. In such an unpredictable economic environment, business is not likely to commit the capital necessary for an economic recovery.

The Senate Finance Committee's tax proposal also raises taxes on middle and upper income individuals by limiting medical and casualty deductions. Individual income tax deductions can be eliminated, the Committee says, because the individual income tax cuts enacted last year provided individuals with overly generous tax relief. In fact, however, taxpayers face huge tax increases in coming years because of inflation and mandated Social Security hikes. A glance at Chart 2 below, in fact, shows that the tax increases suggested by the Finance Committee, combined with tax bracket creep and Social Security tax levies, wipe out the entire personal income tax relief promised over the next three years.

The tax cut, as it turns out, is not overly generous. In fact, it is not a tax cut at all, but a net tax increase of almost $7 billion, if the Senate Finance Committee has its way. Congress should not be considering further tax increases at all, but an acceleration of the 1983 tax cuts. Only then will taxpayers have real protection against inflation and Social Security tax hikes already in the making..

Chart 2

	FY 1983	FY 1984	FY 1985	Total
	(in billions)			
Tax Increases due to Inflation and Social Security	$50	$ 78	$110	$238
Finance Committee's Recommendations	$20.9	$ 34.2	$ 43.9	$ 99
Total Tax Increases	$70.9	$112.2	$153.9	$337
Personal Income Tax Reductions*	$70.1	$113.6	$146.56	$330.26
Net Tax Increase (+), Tax Cut (-)	$ +.8	$ -1.4	$ +7.34	$ +6.74

*rate cuts, marriage penalty, indexing.

Source: Senate Budget Committee

As for the budget deficit, the quickest way to reduce it is by economic recovery. An early recovery would substantially reduce expenditures for social welfare programs and increase tax revenues. Over four-fifths of the recent estimated increase of the deficit is caused by a deteriorating economy, not by the tax cuts. Expenditures for unemployment compensation, food stamps, and other entitlements have increased rapidly, while the slower than expected economic recovery has depressed tax revenues. A reinvigorated economy could eliminate most of the budget deficit. The Congressional Budget Office estimates that for each percentage point decline in the unemployment rate, the deficit shrinks $25 billion. A reduction in unemployment from the current 9.5 to, say, 6 percent would erase the lion's share of the budget decicit predicted for the next three years. A tax-cut acceleration, not an increase, is what is needed.

Cutting taxes, moreover, remains the surest road to trimming spending. Economist Milton Friedman argues that the only way to force Congress to reduce government spending and contain government deficits is to cut government off at the source: tax revenues. He contends that those raising the loudest concerns with deficits are simply favoring tax increases to be followed by further spending increases. According to Friedman, "The reason they are born-again budget balancers and are now talking about raising taxes is not because they've fundamentally changed their view, but because they recognize that the most effective way to hold down government spending is to hold down government revenue."

Would raising taxes result in a balanced budget? Friedman does not think so. "They are talking as if their concern is to enact higher taxes in order to keep budget deficits down," he says. "Their real motive is to keep taxes up so that the government can resume big spending programs as soon as the present public drive for lower taxes and spending passes."

The GOP conservatives are sending a strong message that they will not dance to this spending and taxing minuet. They know that the way to cut government spending and reduce deficits is to hold tax increases hostage to progress on budget cuts. If Congress acquiesces to tax increases, the Democrat controlled House Committees almost surely will gleefully balk at budget cut after budget cut. And they will be back again next year with an additional package of tax "loopholes" to plug and tax "compliance" measures to enact. They will mouth reassuring words about punishing the tax cheats, fat-cats, and big business.

CONCLUSION

A victory for the Senate Finance Committee's package will set in motion the tax-and-tax, spend-and-spend cycle that Reagan has come so close to breaking. Congress still has the chance to keep its faith with the American people and reject the Senate tax package. If it does not, it is up to the White House. To fail to veto the tax hike is to breach faith with Ronald Reagan's America.

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