# SABOTAGING THE TAX CUT

It took an agonizing legislative battle last year to enact the Reagan Economic Recovery Act which sharply cuts marginal tax rates. Now Congress is flirting with measures that would destroy a major part of the Reagan program for economic recovery. The Senate Finance Committee has adopted a package of tax increases that abandons the incentive-enhancing tax strategy at the core of Reaganomics.

Not all tax increases, of course, are equally damaging or distasteful. But every tax increase depresses and distorts the economic marketplace to varying degrees. It would seem that the federal government, with revenues in FY 1983 exceeding $660 billion, ought to be satiated. Indeed, federal taxes now consume some $7,000 of the ordinary taxpayer's income. Isn't this enough?

A sampling of the tax hikes that Congress is being asked to support demonstrates that the package is a major reversal of Reagan's supply-side economic strategy. Among them:

<u>INTEREST AND DIVIDENDS</u>. Requires withholding of 10 percent on interest and dividend payments, with exemptions of certain tax exempt institutions, corporations and low-income or elderly individuals. The provision is expected to raise $4.2 billion in 1983, $3.5 billion in 1984, and $3.9 billion in 1985.

Withholding requirements on interest and dividends may impose economic costs on the investing community which far outweigh the revenue gains to the U.S. Treasury. Withholding requirements would be especially costly to savings institutions, smothering them with paperwork. By denying investors and savers the use of the portion of their income withheld, withholding raises the marginal tax on saving and stock investment. By making these investments relatively less attractive, such withholding directly opposes the major thrust of Reaganomics. Many commentators have pointed out that the IRS currently has all the information it needs to assure proper payment of tax on dividends and interest income; it simply lacks the computer expertise to match up already collected information with returns. The IRS should not impose more withholding cost on the investing public to make up for its own failure.

<u>MEDICAL AND CASUALTY DEDUCTIONS</u>. Limits deductions for medical expenses to amounts above 10 percent of adjusted gross income instead of 3 percent and imposes a similar limit on casualty losses, which now have no floor. The measure is expected to raise $0.3 billion in 1983, $3.0 billion in 1984, and $3.2 billion in 1985.

Increasing the floor beneath the medical and casualty deductions would mean a substantial tax increase falling mainly on middle and lower income taxpayers. The floor under the casualty losses, for example, would disallow almost 90 percent of the current deduction users.

CORPORATE INCOME TAX. Accelerates payments, primarily by increasing the size of estimated tax bills. The measure is expected to raise $0.8 billion in 1983, $1.2 billion in 1984, and $1.1 billion in 1985.

CORPORATE MINIMUM TAX PREFERENCES. Reduces certain corporate tax preferences by 15 percent and limits the amount of tax that may be offset by the investment tax credit to 85 percent. The measure is expected to raise $0.7 billion in 1983, $1.2 billion in 1984, and $1.1 billion in 1985.

DEPRECIATION. Repeal scheduled 1985 and 1986 acceleration of depreciation deductions for property placed in service after 1984. When it takes effect in 1985, the tax change will raise $1.5 billion.

There is a dark, disturbing pattern developing. While individually small, these corporate tax hikes compound to erode significantly the investment incentives which Congress enacted last year. The major purpose of last year's tax bill, of course, was to increase the after-tax return on investment in new capital equipment. The tax increases suggested by Senate Finance, however, pull strongly in the opposite direction: they increase tax rates on corporate investment, sharply raise the cost of doing business and significantly add to the complexity of corporate tax laws.

TAXPAYER COMPLIANCE. Reduces noncompliance by improving information reporting, increasing penalties for cheating, revising withholding rules for pension distributions, collecting taxes from restaurant owners on tip income and urging an increase in the Internal Revenue Service budget. While revenue predictions are difficult, the Joint Committee on Taxation estimates that the package will raise $4.3 billion in 1983, $5.9 billion in 1984, and $7.3 billion in 1985.

Even some Finance Committee staffers wonder whether wrapping the taxpayer in more regulation, red tape, and tax penalties will create more respect for the tax code. A more potent means of enticing business and individuals from the underground economy and discouraging tax cheating is to simplify the tax laws and reduce marginal tax rates.

CLEARLY, ENACTING TAX increases of the size and scope recommended by the Finance Committee will undermine much of the benefit expected from last year's tax reduction package--just when evidence is appearing that the tax incentives are beginning to pull the nation from economic doldrums. If Congress is really concerned with deficits, it should cut spending. If Congress is really concerned with high interest rates, it should not raise taxes which devour the available pool of saving and productive resources like some insatiable PAC MAN.

Thomas M. Humbert, Walker Fellow in Economics

---

For further analyses see: "Description of Possible Options to Increase Revenue," Joint Committee on Taxation Report JCS-23-82, June 15, 1982. See also "How the Senate Finance Committee Would Boost Revenue," National Journal, July 10, 1982, p. 1228. Watch for upcoming Heritage Backgrounder on the harmful effects of the tax increases.