# A TAX CAP: BAD ECONOMICS, BAD POLITICS

Thwarted in his attempt to eliminate completely the third year of the tax cut, House Speaker Tip O'Neill now is attempting to gain support for an effort to cap the benefits of the July 1 income tax cut at $700. Given the Speaker's record of voting for practically every spending measure within reach, his conversion to balanced budgets is a little surprising. A more likely explanation for the proposal is that the House leadership simply wants to bring in more tax revenue so that it can unleash more federal spending.

Many Congressmen sincerely believe, of course, that the deficit and interest rates can be lowered painlessly by tapping the rich for a few more tax dollars. Yet even if increased tax revenues were the answer to budget deficits--which they are not--the tax cap is perhaps the worst option Congress could choose. The cap would wreak havoc on capital investment, seriously deplete the savings pool, and drive affluent Americans from the taxable financial markets and into non-taxable consumption expenditures and tax shelters.

The tax cap is supposed to bring in more tax revenues, and so reduce the crowding out effect of government deficits. But higher tax rates on more affluent Americans would also discourage savings and distort incentives, slowing the flow of funds into the capital markets by at least as much as the current projected deficits will suck from it. It makes no difference to interest rates or the capital markets whether crowding out occurs because of deficits or less private saving.

The tax cap proposal is so destructive to capital formation because it is the upper-income groups who do most of the saving and investing in the U.S. Americans who make over $50,000 a year typically save over 35 percent of their income; those in the $10,000 to $16,000 bracket save only 2.8 percent. Upper-income Americans also are the main creators of new small businesses and are heavy investors in the stock and bond markets. The tax cap would sharply reduce small business investment, since about three-fourths of all businesses pay tax according to the personal income tax schedule, rather than corporate rates.

The tax cap would also induce many affluent Americans to shift their money into tax exempt bonds, tax shelters, non-taxable consumption. According to Treasury figures, the cap would cause marginal tax rates at the $35,200 taxable income level to jump from 28 percent to nearly 37 percent. Taxpayers around this breaking point would think twice about working longer hours or making investments that would shift them into a much higher tax bracket.

If congressional leaders really wanted to soak the rich, they would not only protect the July tax cut, but actually cut taxes further for upper-income Americans. When the top marginal tax rate was cut by 23 percent, in 1964, the number of tax returns reporting an adjusted gross income of $50,000 or above skyrocketed. In the five years preceding the 1964 tax cut, the number of such returns ranged between 125,000 and 162,000, according to a study by economists James Gwartney and Richard Stroup. But after the top marginal rate reduction, the number of these high income returns surged to 272,000 by 1966. Tax revenues from this income group also grew sharply. In the three years prior to the tax cut, tax revenues from returns of taxpayers earning $50,000 or more grew at an annual rate of 6.1 percent. But in the three years after the tax cut, taxes from the same group grew at a 14.1 percent annual rate.

The same pattern can also be detected with the Reagan tax cut. As the Wall Street Journal has reported, the Treasury had been expecting revenue loss of about $2 billion in 1982 from taxpayers in the top bracket, thanks to the 1981 tax changes. Instead, estimates suggest that the revenue in fact grew by about $8 billion. Higher tax rates only cause the rich to flee into tax avoidance schemes, leaving the middle- and lower-incomes to suffer the consequences.

The tax cap scheme is hardly attractive from a political standpoint. Notwithstanding the anti-rich rhetoric of its supporters, the tax cap would mainly hit middle-income Americans. The $700 cap would begin to take effect at $35,200 of taxable income for joint returns. The many Americans in that income group facing a monthly mortgage payment and college expenses would hardly consider themselves rich.

Those now so assiduously fanning the flames of envy against the rich ignore the fact that Americans with adjusted gross incomes above $50,000 a year pay 34 percent of all personal income taxes even though they constitute only 5 percent of all taxpayers. According to figures provided by W. R. Grace and Company, if the government absconded with every penny of taxable income in the income brackets above $50,000 a year, the Treasury would have raised only $76.4 billion in 1980, barely enough to cover one-third of this year's budget deficit.

Upper-income taxpayers, like all other taxpaying groups, deserve the full July tax cut because they have experienced sharp tax increases due to bracket creep. A taxpayer earning $50,000 of gross income in 1983, who had only just kept pace with inflation during the previous decade, would have experienced a cumulative tax increase of around $7,500, solely due to bracket creep, says W. R. Grace. The third stage of the tax cut will offset less than 10 percent of that hidden tax hike. If the July tax cut is capped, the full burden will remain.

In the end, efforts to "soak the rich" hurt everyone, by discouraging investment, saving, and entrepreneurship. Congress should quickly reject the faulty logic of the tax cap scheme, and honor the promise it gave in the 1981 tax act to cut taxes across-the-board. Tinkering with the cut at this stage would be both a breach of faith and a body blow to the recovery.

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For further information see:

Thomas M. Humbert, "Seven Reasons for Saving the Tax Cut," Heritage Foundation Backgrounder #260, April 12, 1983.

James Gwartney and Richard Stroup, "Tax Cuts: Shifting the Burden," Economic Review, March 1982, p. 19.

"Voodoo Economics," editorial, The Wall Street Journal, June 7, 1983.