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THE DOLE TAX PACKAGE: SELLING AMERICA ANOTHER LEMON

INTRODUCTION

Congress is locked in yet another rending slugfest over tax increases. In one corner is Senate Finance Committee Chairman Robert Dole (R-Kan.), who set off the bruising campaign last year that resulted in a $99 billion tax hike. That package promised three dollars in budget cuts for every one dollar in tax increases. It turned out to be a lemon. The actual result was 21 cents in spending increases for every one dollar in tax hikes. Yet Senator Dole is now back again seeking an additional $75 to $100 billion in tax hikes, with the promise of "further" spending cuts. He claims that these hefty tax hikes are the necessary price for major cuts in federal spending.

In the other corner are those who believe that Dole is offering only a mirage of budget cuts in return for certain and disastrous tax increases. Ronald Reagan has entered the fray with the declaration that he intends to veto any tax increase that reaches his desk. Tax hike opponents see many parallels between this new Dole proposal and the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA). They see the new package as a re-run of that poor bargain--a real lemon for the American economy.

* Both tax measures were advertised as closing loopholes and enhancing taxpayer compliance. Yet both TEFRA and the current Dole proposal are a mixture of investment, saving, and business taxes that retard economic growth and destroy jobs.

* Both measures promise deficit reductions. TEFRA did not reduce the budget deficit because Congress--despite its pledges--failed to cut the budget. The budget cuts in the Dole tax package are even less likely to be delivered.

This history of empty promises and disappointing results has prompted Senator Robert Kasten (R-Wisc.) to ask his colleagues in Congress to deliver on the 1982 bargain before contemplating a new one. To attain the 1982 promise of three dollars in budget cuts for every one dollar in tax increases, Congress would have to cut government spending by $167 billion.

The centerpiece of the Dole proposal is a change in tax indexing and cost of living allowances (COLA). Indexing and COLAs, in their own ways, aim at insulating tax brackets and recipients of government benefits respectively from inflation. The Dole measure would slash this inflation protection by limiting it to the rate of increase of the Consumer Price Index (CPI) minus 3 percent. This would mean, for example, that if inflation increased by 3 percent, there would be no inflation adjustment for both tax indexing and COLAs.

If this limitation were in place for three years, the typical elderly couple would lose about $788 annually by 1986 in real social security benefits. And by gutting tax indexing for at least two years, the same couple would also pay $50 a year more in income taxes by 1986--a 19 percent tax hike.

Poor and middle income Americans also would be hurt. The family earning $10,000 faces a 9.4 percent increase in income taxes in just one year. The $200,000 income family, on the other hand, would pay less than 1 percent more in income taxes. Families earning less than $50,000 a year would bear about 80 percent of Dole's taxes.

Congress should have learned from TEFRA that tax increases do not cut the deficit and that spending reduction proposals are long on promises and short on results. The last thing that the country needs is another TEFRA, with real tax increases and mythical spending cuts. Perhaps Senator Dole will see the flaws of his plan and withdraw it before it seriously damages the economy.

THE DOLE PROPOSAL

The Senate Finance Committee already has approved a tax hike totaling $13 billion over three years. This measure would, among other things, curb leasing arrangements undertaken by governmental and nonprofit groups, shorten the capital gains holding period, and reduce the value of income averaging.

Dole is also pressing ahead with a three year plan for a a huge $150 billion "deficit-reduction" package that purportedly includes about equal amounts of tax increases and budget cuts. The tax proposals under consideration apparently include the following:

1. An *ad valorem* tax on energy, collected at the refinery level, and designed to raise an estimated $39 billion over three years.

2. A 5 percent surtax on individual income taxes during 1984, planned to raise $15 billion.

3. A plan to limit income tax indexing to the rate of the CPI minus 3 percent, rather than the full CPI as under current law. The revenue gain from this is estimated at $14 billion between 1985 and 1986.

4. A new corporate income tax to raise between $11 billion and $26 billion.

5. A proposal to tighten various tax-compliance measures and to end some tax preference items. This is expected to generate $10 billion.

The Dole proposal also suggests budget cuts equalling the recommended tax increases. These cuts cover Medicare, defense programs, social security, farm programs, government pay, and various other domestic programs. The largest single proposed cut is a three year limit of the social security COLA to the CPI minus three percent, starting in February 1985. This provision would raise $28 billion over three years.

THE BUDGET SAVING ILLUSION

The Dole budget cuts, upon closer examination, prove to be an illusion. Far from being a genuine trade-off for real tax increases, even the alleged savings amount to substantially less than the tax increases. Senators William Roth (R-Del.) and Robert Kasten are particularly critical of this spending reduction plan. As Chairman of the Governmental Affairs Committee, Roth would be responsible for some of the cuts; he noted in a letter to his colleagues that the Dole plan "contains mostly illusory savings on the spending side but very real and permanent increases on the tax side."

Examples:

1) Dole has listed $12.4 billion budget cuts in such programs as Medicare, federal pay, and retirement COLAs. Roth reports that over $9 billion of the presumed $12.4 billion budget savings already have been recommended by his Governmental Affairs Committee. The Dole package merely duplicates action already underway--and thus counts these savings twice.

2) About $8 billion in Dole's cuts assume successful presidential vetoes of congressional spending programs. These can hardly be called congressional budget cuts. The President can achieve these budget cuts on his own. Congress would be giving the President nothing by graciously granting him

"permission" to take what may be a politically costly step of vetoing spending bills.

3) The Dole package includes $10.3 billion in cuts from the Labor Department, Health and Human Services (HHS), Housing and Urban Development (HUD), railroad retirment funds, and general revenue sharing. These savings, however, are already enacted or in conference so they require no tax concessions by the President. In any case, the $10.3 billion are not real budget cuts, just a trimming of the huge budget hikes contained in the First Budget Resolution--already $32 billion above the President's budget request.

4) An additional $32 billion in savings is attributable under the legislation to the reduction in COLAs, primarily in social security. This is unlikely to pass the Congress in an election year, especially when social security will bear $28 billion in cuts. The President has already confirmed that he will not cut social security. Were these savings somehow to pass, one Finance Committee proposal simply would spend the savings in other spending programs. The social security "savings," for instance, would be credited automatically to the Health Insurance (HI) Trust Funds and then spent. Medicare savings in the reconcilation bill also might be earmarked for HI. So neither are real budget cuts.

5) At least $6 billion of the claimed budget reductions arises from supposed debt service savings. These depend on the other spurious budget cuts described above.

SON OF TEFRA

Congress and the President have been down this road before with the 1982 TEFRA tax hike when the nation swallowed genuine tax increases in return for promised budget cuts that never materialized. Congress in 1982 vowed $280 billion in spending reductions ($146 billion in non-defense budget cuts) in return for $100 billion in tax increases.[1] Americans got the full amount of tax increases, but total non-defense spending projections for FY 1983, FY 1984, and FY 1985 are $167 billion higher (exclusive of interest payments) than expected when TEFRA was passed.[2] Though Congress promised three dollars in budget cuts for every one dollar in tax increases, non-defense spending was not cut at all--it increased by as much as 21 cents for every dollar of taxes raised.

Will Americans allow themselves to be bamboozled for a second time? Senator Kasten is trying to prevent just this by asking Congress to make good on its past promise of three dollars in cuts for every one dollar in tax increases before enacting further revenue increases.

Dole claims that tax increases will reduce the budget deficit, just like he did when campaigning for TEFRA. The TEFRA

experience, however, supports the view that tax increases expand, rather than contract, the deficit. As economist Paul Craig Roberts, former Assistant Secretary of the Treasury, noted in a Wall Street Journal article, TEFRA was supposed to "narrow the budget deficit by $100 billion over the 1983-1985 period, and by $229 billion over 1983-1987." Instead, reveals Roberts, "the five-year deficit projections widened by $612 billion between the mid-session review (summer 1982) and the end of the year."[3] Dole has yet to provide Congress with any evidence that his new plan will lead to a different result.

THE ASSAULT ON INDEXING

Starting in 1985, taxpayers will no longer have to pay higher income taxes simply because inflation might have pushed them into a higher income tax bracket. Brackets, exemptions, and the standard deduction will be adjusted for inflation. The result: real tax burdens will remain constant. This "indexing" of the individual tax burden was the most important part of Reagan's 1981 jobs creation tax program.

The Dole package essentially would wipe out indexing for at least two years. Taxpayers should be outraged at this for tax indexing protects them against back-door taxation--tax hikes that are not explicitly legislated by Congress but which Congress winks at as inflation shoves Americans into higher brackets. Indexing should not be bargained away under any circumstances--particularly for a few promised illusory budget cuts. Without tax indexing, Congress has incentives to engage in inflationary economic policies. Higher inflation generates a tax revenue windfall, which Congress always seems to use for more spending, not for deficit reductions.

Cost of Living Adjustments also protect Americans from inflation. They keep spending at the same pace as inflation; and if government did not inflate, COLA spending would not go up. Inflation, not COLAs or indexing, is the problem.

Why then do Dole and others want to curtail indexing and COLAs? One reason: deficits. Dole's measures could, in theory at least, slice the budget deficit by about $46 billion through 1986. A number of crucial considerations, however, weigh heavily against the CPI minus three formula as a sensible strategy:

1) The nation would have to stomach some $60-$90 billion in additional tax hikes, according to the Dole proposal. These tax hikes would far exceed the actual budget reductions.

2) The plan curtails tax indexing for only two years, but it is difficult to believe that Congress would return to full tax indexing after obtaining two years of windfall tax revenue. Federal deficits will still be a problem in 1986.

3) Even if the indexing changes expired after two years, the proposal would mean permanent tax increases--but only temporary budget cuts. Taxpayers would pay permanently higher income taxes as a result of bracket creep, yet the social security COLA cuts would be temporary, since the payment reductions apply only to current retirees and those retiring before 1986. The three year COLA limit means a permanent 9 percent reduction in real social security benefits for current retirees. After 1986, however, new retirees would not face cuts since the initial payment levels are not affected by the Dole plan. Such a gap between current and future retirees would be very unfair.

4) The Dole proposal is especially harmful to retirees, since it hits them twice. First, social security payments would be cut by 9 percent; and second, the income tax burden on retirees' outside income would increase. The typical retiree, according to the Treasury, receives $8,500 in social security benefits and $9,500 in outside income. Under Dole's proposal, the typical retiree's social security payment would drop $788 dollars annually by 1986 and his income taxes would jump $50 dollars, a 19 percent real increase in taxes. By 1986, the Dole proposal would result in a $838 reduction in the couple's real annual income. Limiting tax indexing would also hit middle and lower income groups in general. A taxpayer with $10,000 of income would see his tax liability increase by 9.4 percent in just one year. The $200,000 income earner, by comparison, would be hit with only a 0.9 percent tax increase. Those earning less than $50,000 a year would bear about 80 percent of the increased taxes from curtailing tax indexing.

5) The fundamental criticism, however, is that the COLA adjustment proposal is not politically feasible. Congress and the President are not about to cut social security in an election year. A bargain struck on that flawed premise cannot be delivered.

THE DAMAGE TO SAVING AND INVESTMENT

The indexing provision is only one of the harmful tax provisions in Dole's tax package. Over two-thirds of the Dole tax increases would likely fall directly on saving, investment, and business. Yet the alleged purpose of the tax increases is to reduce the deficit, so that interest rate pressure on business expansion would be reduced. But they will not be reduced if the nation's capital pool shrinks because of higher taxes. Crowding out due to taxes is no better than crowding out caused by budget deficits.

The tax hikes proposed by Dole would impose a heavy cost in jobs, economic growth, and living standards. Example:

1) The ad valorem tax on energy would ripple through the economy as higher producer and consumer prices for goods and services. The tax also could reduce the incentive for oil companies to explore for new energy, engage in research, and modernize plants and equipment.

2) The 5 percent income tax surtax on upper-income individuals would punish saving, enterprise, and investment. This tax would threaten the economic recovery.

3) The new corporate income tax would discourage business investment and cost jobs.

4) Tax compliance measures are often thinly disguised tax increases on average Americans. Tax preference items--so called tax loopholes--often shield productive activities from high marginal tax rates.

THE FAULTY LOGIC OF TAX INCREASES

Congress seems determined not to admit that it is the level of government spending, not the deficit, that is the real measure of the government's burden on the economy. As Milton Friedman long has argued, a $600 billion government budget combined with a $200 billion deficit is much healthier for the economy than an $800 billion government budget that is in balance. Substituting taxes for deficits is no cure.

A recent Department of Treasury study confirms from historical evidence that government spending, not deficits, causes high real interest rates.[4] It is government spending, concludes the study, that crowds out investors from the capital markets. In short, if high interest rates endanger the recovery, the high level of government spending is the culprit, and not budget deficits.

Some tax hike enthusiasts maintain that the 1981 tax cut caused the deficit. They ignore the evidence, however. As the chart below shows, tax receipts as a share of GNP will be far greater in 1983-1988 than in 1975-1979. The cause of the deficit

OUTLAYS AND RECIEPTS AS PERCENT OF GNP

	Receipts	Outlays
1983-1988 (annual average)	19.7	24.8
1982	20.4	24.6
1981	20.9	23.6
1980	20.1	23.0
1975-1979 (avg.)	19.0	22.1
1964-1974 (avg.)	18.7	19.8

Source: U.S. Treasury Department

is not a revenue shortfall, but steadily rising spending. Despite White House boasts--and despite cries of anguish from big spenders--there have been no cuts in the non-defense budget under President Reagan.

CONCLUSION

The Dole budget cuts and tax increases package is based on a flawed premise: that government deficits, rather than the level of government spending, are the problem. President Reagan should stand firm in his position that the only way to reduce budget deficits without compounding the problem is through budget reductions. Only genuine budget cuts will release resources to the private sector, increase capital formation, reduce real interest rates, and create jobs.

Tax increases--especially on saving and investment as in the Dole bill--are at least as bad as a budget deficit. Both taxes and deficits crowd out investment; both co-opt resources from private sector; both absorb saving. When legislators forget this, they end up supporting higher and higher taxes. But experience shows that such a policy only leads to more spending and wider deficits.

Senator Dole claims his package is balanced. But there is nothing balanced about a proposal that increases taxes on average and lower income Americans above levels they paid during the Carter Administration. There is nothing balanced in raising taxes on saving and investment which would further undermine incentives for economic growth. And there is nothing balanced about hitting retirees with a curtailment of COLAs.

Congress and the President have heard promises before of massive budget cuts in return for a package of tax compliance and "loophole closing" measures. In falling for the 1982 bargain, Americans bought a lemon--a package which gave them a tax increase but failed totally to deliver on the budget cuts. Senator Kasten is now asking Senator Dole to complete the first bargain by cutting $167 billion from spending before Congress contemplates the next one. What could be more reasonable than this?

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ENDNOTES

1. There is some controversy over whether Congress did, in fact, promise three dollars in budget cuts for every one dollar in tax increase. Congress's First Concurrent Resolution on the Budget for FY 1983 (S. Con. Res. 92), passed April 13, 1982, did recommend a $100 billion tax increase and about $280 billion in budget cuts. See also the Conference Report on the First Concurrent Budget Resolution, Report No. 97-478, June 18, 1982.

President Reagan cited the Congressional Budget Resolution's recommended budget cuts as the condition for his support of TEFRA. The President on August 9, 1982, concluded that "The budget resolution passed this year (1982), if Congress sticks to its targets, will decrease the red-ink in the budget by almost $400 billion through 1985. The tax bill's new revenues are only one-quarter of that total. The remaining three-fourths--$280 billion in deficit reductions--is to come from lower outlays. We worked with Congress on this resolution and that was the price of my support--$3 saved in outlays for every $1 in increased revenue."

2. Compare the projections contained in the FY 83 First Concurrent Resolution on the Budget Conference Report, June 1982 with the projections in the Economic and Budget Outlook: An Update, The Congressional Budget Office, August 1983.

3. Paul Craig Roberts, "Big Taxes and Big Deficits," The Wall Street Journal, January 14, 1983.

4. U.S. Department of the Treasury, Office of the Secretary, "Government Deficit Spending and Its Effects on Prices of Financial Assets," May 1983. See also Charles I. Plosser, "Government Financing Decisions and Asset Returns," Journal of Monetary Economics, Volume 9, 1982.