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The Supply Side Revolution: 20 Years Later

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The Revolution in Tax Policy

by Stephen J. Entin

In 1979, and again in 1980, the Congressional Joint Economic Committee issued Annual Reports containing major views and recommendations supported by all of its Members, Democrat and Republican. This was the first time in 20 years that such a unified report had been possible, and it has not happened since.

The coincidence of views was the result of the peculiar economic developments of the 1970s. Whereas the 1960s had generally been marked by strong growth with limited inflation, the 1970s were a turbulent period culminating in rapid inflation and falling living standards. Finding a way out of the troubles of the 1970s required a new understanding of the workings of the economy and a new set of economic policies.

The Economy and Economic Policies of the 1960s and 1970s

The Kennedy Tax Cuts

In response to nearly back to back recessions between 1957 and 1961, President John F. Kennedy introduced a number of successful tax reductions. He created the investment tax credit (ITC) and reformed depreciation rules in 1962, and cut the corporate tax rate in two steps, from 52% in 1963 to 48% in 1965. He proposed his famous across-the-board cut in marginal tax rates for individual taxpayers, which was enacted after his death and signed into law by President Lyndon B. Johnson. That tax cut reduced marginal tax rates across the board by roughly 25 percent, from a range of 20% to 91% to a range of 14% to 70%. There followed a strong economic recovery which served as an important example for later tax policies, and was an important bit of evidence in the search for a better model of economic behavior and government's role in economic affairs.

Johnson and Nixon

The post-Kennedy expansion was brought to a halt by a vacillating monetary policy that first permitted a surge of inflation, then moved to choke it off, coupled with President Johnson's 10% Vietnam individual and corporate tax surcharge, effective 1968-1970. The result was the 1969-1970 recession.

The top tax rate on wage and **salary** income was reduced to 50% under President Nixon. However, efforts to hold down interest rates and to finance the Vietnam war with money growth eventually forced the United States off the gold standard, which further sheltered policy makers from the consequences of excessive money growth. Dollar devaluation and continued rapid money supply growth fueled inflation in the early 1970s.

Rather than deal with the monetary source of the inflation, the Nixon Administration resorted to wage and price controls, with disastrous results. Workers and employers found their wages and **prices** frozen. Resources were misallocated. Some businesses could not attract the workers, materials, or inventory they needed. Spot shortages were common. Other businesses that could not recover their costs were forced to close. On the evening news, there were **films** of farmers stuffing baby chicks into steel drums and closing the lids to suffocate them "humanely" because the cost of feed was greater than the regulated price the chickens would bring at maturity.

Recap: the Impact of 1970s Policies on the Economy, Individuals and Businesses

Deteriorating Conditions

The 1970s were a time of rapid inflation and unacceptable levels of real growth and unemployment, a combination labeled "stagflation". (See chart 1.) From 1973 to 1980, the U.S. economy grew at a real rate **of just** over 2 percent per year, less than 60 percent of the 3.8 percent real growth rate from 1950 to 1973, and less than half the 4.5 percent real growth rate achieved between 1962 and 1969. Since the late 1960s, inflation and unemployment had been trending upward. CPI inflation, less than 2 percent in the early-to-mid 1960s, exceeded 12% in 1974 and again in 1979-1980. Unemployment ran as low as 3.4 percent in the late 1960s, but remained stubbornly above 5.7 percent in even the best years of the late 1970s. Interest rates were rising; the three month Treasury bill rate was just over 4 percent in 1971 and 1972; in 1980 it averaged 11.5 percent. Toward the end of the decade, productivity and real incomes, after-taxes, began to decline. There were bitter labor disputes and strikes.

By the end of the 1970s, the public was demoralized and unhappy with the triple burdens of inflation, taxation, and unemployment. The prevailing Keynesian economic theory and policy offered no apparent way out of these difficulties. Any effort to fight the inflation was presumed to require a prolonged increase in unemployment. Any policy that could reduce unemployment was presumed either to generate higher inflation or result in unacceptable increases in the federal budget deficit. Elected officials were groping for alternative policies to restore price stability and vibrancy to the economy.

Inflation, Bracket Creep, and Rising Tax Burdens on Capital

A new way of thinking about the economy and about fiscal and monetary policy was needed. These new insights were provided by monetarist and neoclassical (supply-side) economists. The effect of money growth on inflation and of inflation on taxes and economic performance provided the clues necessary to discover a new set of policies to deal with the dilemma.

Starting late in the late 1960s, and continuing throughout the 1970s, inflation did significant damage to the economy through its interaction with the federal tax system.

Higher nominal wages, either **from** real wage gains or cost of living increases, were forcing workers into higher tax brackets, raising their marginal tax rates. Higher inflation also raised taxes on saving. Taxes were imposed on inflated interest earnings and capital gains, and the depreciation allowances for plant and equipment were not adjusted for inflation, raising the cost of capital.

Marginal tax rates rose sharply on most taxpayers between 1965 and 1981. Before 1981, there were 15 tax brackets with rising marginal tax rates. Marginal tax rates went up every few hundred or few thousand dollars of income. These brackets, and the personal exemptions and standard deductions, were not automatically adjusted for inflation.

As workers received cost of living increases, more of their income was subject to tax, and their higher nominal wages spilled over into higher marginal tax rate brackets. Their real tax burdens rose, even though their real incomes had not increased. Although there were a dozen changes in exemptions or deductions between 1965 and 1980; **each lowered** the tax on the first few dollars of income, while leaving the remainder taxed at increasing marginal tax rates. So-called "bracket creep" raised taxes 16% for each 10% increase in

and the erosion of their value by inflation, the deductions are reduced in present value far below the real cost of the assets. As a consequence, business expenses are understated, and reported profits exceed real profits. The result is an increase in the effective tax rate on the earnings of capital. The higher is the rate of inflation, the higher is the resulting tax rate, and the lower the return to the owners of capital.

The following table shows the dip in the effective corporate tax rate after the Kennedy tax reductions of the early 1960s, and the sharp increase in effective tax rates in the 1970s as inflation increased. Capital intensive industries suffered the most. A study of 1979 inflation-adjusted financial data by Price Waterhouse reported that the real effective tax rate for financial corporations was only 28 percent, but hit 72 percent for automotive firms, 75 percent for petroleum, and 78 percent for utilities. Even worse, when dividends are added to tax liabilities, many firms were paying out more than 100 percent of their real profits. Utilities paid out over 500 percent of their real after-tax income in 1979. Automotive firms paid out 139 percent of real after-tax profits. These businesses were, in effect, liquidating.

Effective Corporate Tax Rates										
1960	1962	1964	1966	1968	1970	1972	1974	1976	1978	1980
54.1%	47.0%	43.3%	43.3%	49.3%	58.4%	50.4%	76.8%	53.6%	50.9%	58.6%
Nonfinancial corporate tax liabilities as percent of corporate profits with inventory valuation adjustment and depreciation of fixed assets adjusted to replacement costs at double declining balance over 75 percent of Bulletin F service lives. Taken from Paul Craig Roberts, <i>The Supply Side Revolution</i> , Harvard University Press, Cambridge, Massachusetts, p. 73.										

In the late 1970s, as the cost of investment increased, and the rate of return on investment fell, there was less willingness to add to the stock of plant and equipment. Investment failed to keep pace with the growth of the labor force. Productivity and real wage growth turned negative.

The adverse effects of inflation on real corporate earnings did not escape the attention of the stock market. Between 1968 and 1979, large capitalization stocks were virtually flat in nominal terms, and had lost over half their real value. Even with dividends, the real return over that period was a loss of more than 25%.¹

Any way out of the difficulties of the 1970s would have to take into account these adverse effects of inflation on incentives to work, save and invest.

Rethinking Economics: Switch from Keynesian to Monetarist & Neoclassical (Supply-Side) Insights

Keynesian economics could not explain the inflation and low real growth of the 1970s, nor offer any policy prescriptions to cure the disorder. This failure led to the reassertion of the role of money in creating or eliminating inflation, and the micro-economic role of tax rates in affecting prices, incentives, and individual behavior.

Keynesian Emphasis on Macroeconomics and Aggregate Demand

Keynesians assume that the productive capacity of the economy and the supply conditions of labor are largely a given, at least in the short run. None of the incentive effects on the supply of labor and capital described above enter into their calculations. They assume that all government policies act primarily on aggregate demand — total spending on goods and services. Monetary policy acts on demand by adjusting

An increase in government spending will not increase aggregate demand if it is financed by borrowing, because higher government borrowing will “crowd out” an equal amount of borrowing by investors and consumers, and curtail private demand to offset the increase in government demand. An increase in government spending financed by taxes will likewise reduce private demand by reducing private consumption or, more likely, by reducing private saving and investment. In any case, the government will simply be taking real resources (labor, materials, and the use of plant and equipment) that would have been employed by the private sector. Similarly, a tax cut in the absence of a government spending **cut** must be financed by higher government borrowing, which borrows back the increase in disposable income and prevents an increase in aggregate demand. With spending unchanged, no real resources are released to expand the private sector.

Monetarists agreed that faster money creation by the central bank would increase aggregate demand. Indeed, the only time that a fiscal deficit increases aggregate demand is if the central bank “accommodates” the fiscal change with faster money growth, in which case the stimulus is really from the change in monetary policy, not fiscal policy.

However, the monetarists warned that the economy was generally in or close to a state of full employment, and that “money illusion” on the part of workers was a myth. Faster money growth would increase not only demand and the prices of output, but would also boost wages and the cost of capital, because the public would quickly begin to expect higher prices and to demand higher wages and higher returns on capital to compensate. There would be no lasting gain in real output, only an increase in the price level.

If the Federal Reserve kept trying to increase employment by continually increasing the money supply, there would be inflation, not just a one-time jump in the price level. As people’s expectations adjusted to any given rate of inflation, any temporary benefit with regard to higher real output would fade. The Federal Reserve would have to raise the rate of money growth and inflation again and again to fool the public into increasing output beyond capacity for any length of time. Each time, both supply and demand would adjust to the new higher rate of inflation (point **E2** on chart 3). Therefore, monetary policy cannot promote abnormal levels of employment on a permanent basis, and any effort to do so would trigger unacceptable inflation.

Consequently, monetarists recommended that the Federal Reserve devote itself to price stability. Once people realized that prices were remaining stable, they would adapt their wage and price expectations to the new reality, and the markets would achieve the optimal level of real output and employment, with no lasting ill effects.

Supply-Side or Neoclassical Economics-the Excise Effects of a Tax

Fiscal policy, especially tax policy, has important microeconomic consequences. Microeconomics is the study of the behavior of individuals, businesses, and markets, It studies how these participants in the economy respond to changes in relative prices. In the microeconomic world, it is changes in prices (not changes in the government’s spending or tax revenue, nor changes in the public’s disposable income) that drive economic behavior. Neoclassical economics is the development of a picture of how the economy as a whole behaves on the basis of microeconomic principles. Supply-side economics is the popular term for the neoclassical economic revival of the 1970s and 1980s.

Since the work of Alfred Marshall in the 1890s and early 1900s, economists have regarded taxes as affecting behavior by changing prices and rewards. (See chart 4.) When an excise tax is imposed (or increased) on a product, the cost of the product to the consumer rises (PC), and the price received by the producer falls (Pp). The spread between the consumer’s price and the producer’s receipt equals the tax rate.

current consumption in order to save. Higher tax rates on the earnings of capital raise the cost of obtaining additional income through saving and make current consumption relatively more attractive.

As taxes at the margin reduce the reward to work, saving and investment, people reduce the amount of labor and capital they are willing to supply. The supply of capital is more sensitive to taxes than is the supply of labor. (See charts 5a and 5b.) People seem quite willing to consume instead of save, or to invest abroad instead of in the United States. They have somewhat less ability to fine tune the amount of work they must do, especially if they are not self-employed, but there is still a significant response of the labor supply to changes in after-tax wages.

With tax rates rising virtually across the board, the reduction in the supply of labor and capital would inevitably result in reduced market output. The rise in the price of the taxed factors would not be confined to increasing the relative price of a few products; it would raise the price of all market activity relative to leisure and it would raise the cost of saving and investment relative to consumption. Resources would retreat from the market, and total output would fall or grow more sluggishly than otherwise. Since income is the payment for producing output, output equals income, and income would fall as well.

With a decline in total income, aggregate demand would be reduced too. Note, however, that the tax would not cause the decline in output by first reducing disposable income and demand, as in the Keynesian view. Rather, the adverse incentive effects of the tax on the supply of labor and capital would curtail the desire to produce, and the resulting reduction in gross market earnings of the suppliers would reduce demand in line with supply. The “first order” excise effect of the tax would lead to the reduction of aggregate supply, which would then lead to the “second order” income effect that would reduce aggregate demand. In the neoclassical world, taxes affect the economy by affecting prices and rewards, not by sloshing money around.

Marginal Tax Rate Reduction to Expand the Economy

Conversely, a reduction in marginal tax rates on labor or capital income would expand aggregate supply and expand the economy. (See chart 6.) Cutting the payroll tax rate or the personal marginal income tax rates would reduce the gross-of-tax cost of labor to the employer while raising the after-tax wage to the worker. Cutting the personal marginal income tax rates and the corporate tax rates, reducing the tax rate on capital gains, enhancing capital cost recovery allowances (depreciation write-offs), or implementing an investment tax credit, would reduce the gross-of-tax cost of capital to investors in plant and equipment. The supply of labor and capital services to the economy would increase, as suppliers of these services would be encouraged to substitute labor for leisure and saving for current consumption. There would be greater output. Those furnishing additional labor and capital to the production process would be paid, and then, and only then, would demand increase.

The increase in the supply of labor and capital services expands the capacity of the economy. Demand rises only in line with the added output. There is no inflationary pressure from a supply-enhancing tax reduction. The real price level (reflecting the real productivity of the labor force and the capital stock in turning materials into output) should remain unaffected or even decline as the government-imposed barrier to output is lowered.

The effect on the nominal price level from a supply-enhancing tax rate reduction would depend on the response of the Federal Reserve. If the Fed were to leave the money supply unchanged, the price level would probably fall as output rose relative to the money supply. If the Fed were to increase the money supply in line with the expansion of the real economy, the nominal price level would remain roughly unchanged.

Consequently, in meeting any given deficit target, there was a distinct tendency for budget resolutions to raise the spending ceilings and then require the Finance Committee to raise taxes to match.

Senator Long was understandably interested in any theory that could demonstrate that tax cuts were better for the economy than spending increases, and that appropriately structured tax reductions could recoup some or all of their static revenue loss by expanding the economy. Senator Long was convinced that the surge in capital gains realizations and revenues following the 1978 capital gains tax cut was proof that the public did respond to tax changes, and was willing to support research in that areas. He arranged a \$250,000 grant to Mike Evans, builder of the Chase Econometrics model, to build supply-related elements into a new model that could better assess the effects of federal fiscal policy on the economy.

Senator Orrin Hatch, a member of both the Joint Economic Committee and the Senate Budget Committee, tried unsuccessfully to get the Budget Committee to hold hearings on the major economic models that were often used to forecast the result of changes in government policy. There had been several years of correspondence between various members of Congress, the model builders, and model users at the Office of Management and Budget, the Treasury, and the Congressional Budget Office. These letters and reports had revealed that the supply-side incentive effects of tax changes were missing from the models. The Senate Budget Committee staffs, both majority and minority, and the CBO fiercely resisted opening up the issue of the models or the CBO's methods.⁴

In the House, Representatives John Rousselot (R-CA) and Marjorie Holt (R-MD) tried repeatedly to amend various Budget Resolutions to lower the revenue targets to leave room for across the board tax rate cuts. They argued that correctly designed tax cuts would not cost as much as the static revenue estimates from the Joint Tax Committee and the Congressional Budget Office indicated. Opponents of the tax cuts charged that the revenue reflows were speculative. Rousselot and Holt subsequently called for matching spending and tax reductions, and attracted considerable support for their efforts.⁵

Senator Bill Roth (R-DE) and Representative Jack Kemp (R-NY) responded to the academic focus on marginal tax rates and incentives by introducing a 30 percent across the board tax rate cut modeled on the Kennedy tax reductions. It was offered as an amendment to the 1978 tax bill, and received 30 votes.

Another supply-side amendment was offered to that same bill. Senators Sam Nunn (D-GA) and Lawton Chiles (D-FL) felt that a smaller but significant tax rate reduction was justified by events if accompanied by spending restraint. They proposed significant marginal rate cuts, combined with restriction of the growth of federal spending to inflation plus 1%, leading to a projected budget balance by 1982. The amendment passed the Senate 65 to 20. In an unusual move, the House, which had already passed its version of the tax bill, voted to instruct its conferees to accept the Senate substitute. Despite the consensus in both Chambers that it was time for a supply-side tax cut, the President threatened a veto. The Conference Committee leadership blocked the Nunn Amendment and reported back a far less effective bill.⁶

In 1979, the Joint Economic Committee Annual Report noted shortcomings in the econometric models. In 1980, the Committee held a hearing on the major commercial forecasting models and the use of such models by the Congressional Budget Office. At the hearing, several leading economic modelers and tax analysts discussed the role of supply-related incentives in economic theory. The majority of the witnesses testified that the major models were based largely on Keynesian principles, and could not correctly simulate the supply-enhancing effects of tax changes that increased the rewards to labor versus leisure or saving and investment versus consumption. Several told the Committee that they were investigating substantial changes to their models as a result of the growing evidence that these incentive effects were important.⁷

The **reports** declared that it was possible to have real growth and rising employment while reducing inflation through this new mix of policies. They declared these policies to be mutually reinforcing. Lower inflation would reduce the tax burden on capital by reducing the loss of real value of the depreciation write-offs (bringing the capital consumption allowances more nearly into line with the replacement cost of plant, equipment, and structures). Lower inflation would reduce the tax bracket creep that was increasing on labor, which was putting upward pressure on wage demands and labor costs.

The main report stopped short, however, of endorsing lower marginal income tax rates for individuals and indexation of the tax bracket **structure**. The idea that the labor force did respond significantly to the **after-tax** wage (had a significantly positive **elasticity** of supply) was still too controversial in the economics profession. Some members may have felt that lowering marginal tax rates across the board gave too much to the "rich", or **feared** that indexing would deprive the Congress of a nice, low-profile source of **ever-increasing** revenues. Whatever the reasons, the majority of the committee was not yet prepared for further steps. They focused on lowering taxes on business investment, which had the strong support of the business community; they felt that any money that businesses got would be used for investment, which would raise productivity and wages.

It is **ironic** that this bipartisan support for tax relief was focused exclusively on business investment at the behest of the Democratic majority. It is also ironic that, today, candidates of both parties are ignoring or raising business taxes to focus all tax relief on individuals (and too much of that in a manner that provides no supply-side incentives).

The Reagan Program & the Economic Recovery Tax Act of 1981 (ERTA) — a Supply-Side Solution

The Economic Program

The policy approach of the incoming Reagan Administration incorporated the general approach outlined in the 1979 and 1980 Joint Economic Committee unified reports and went further to address some of the issues raised in the Minority Views in the 1978 and 1979 Reports. **The Reagan program** had four parts:

- A gradual slowdown in the rate of growth of money creation to fight inflation.
- Reduction in government spending as a share of GDP to release real resources (manpower and materials) to the private sector.
- Reduction in marginal tax rates on work, saving, and investment to spur real output, and protection of the individual rate **structure** from inflation.
- Reduction in government regulation of the economy to reduce production costs and improve economic efficiency.

Tax Rates and Tax Bases

It must be stressed, and it must be remembered, that the 1981 tax reduction program addressed the whole tax system, not just pieces. In particular, ERTA addressed two key issues, the level of the statutory marginal tax rates and the definition of the tax base. Furthermore, it did so at two levels, the individual level and the business level. All were **necessary** to roll back the high effective marginal tax rate disincentives that had built up during the 1970s.

in more slowly. The **final** bill provided for a 5% cut on October 1, 1981; 10% on July 1, 1982; and 10% on July 1, 1983. The cut was not fully effective for an entire tax year until 1984. Furthermore, they were compounded (not full cuts from the original rates, but sequential.) The effective calendar year/tax year reductions amounted to a 1.25% cut in 1981, 9.75% in 1982, 14.5% in 1983, 18.8% in 1984, **and 23%** in 1985. Tax indexing was not made effective until 1985.

The acceleration of depreciation permitted for equipment under previous law (200 percent declining balance method instead of straight line) was temporarily scaled back to 150 percent declining balance. It was scheduled to be restored in stages (175 percent in 1985 and 200 percent in 1986).

Recession

Implementation of the Reagan program was not as coordinated as it might have been. The Federal Reserve shifted to an anti-inflationary posture in November, 1980, virtually the day after the election, and pursued stop-and-go money growth policies throughout 1981 and 1982. The small portion of the income tax cut effective in October of 1981 was less than the scheduled payroll tax rate increase of that year, and was inadequate to offset that year's underlying inflation-related bracket creep. By the second quarter of 1981, a few months before the tax bill was enacted, the economy entered recession.

Tax Policy Since 1981

The Tax Equity and Fiscal Responsibility Act of 1982 -a Tax Hike on Investment

No sooner was ERTA signed into law in August of 1981 than the Congress began having second thoughts. Because some businesses were indicating greatly expanded investment plans as a result of the safe-harbor leasing provision (which was the intent of the provision), the Finance Committee worried that it might substantially reduce tax receipts. Senator Bob Dole, Chairman of the Finance Committee after the Republican capture of the Senate, indicated that he would move to repeal safe-harbor leasing and otherwise trim back the business provisions of ERTA. The result was TEFRA, the Tax Equity and Responsibility Act of 1982, which **was misnamed on both counts.**

TEFRA repealed the restoration of accelerated depreciation scheduled for 1985 and 1986 under ERTA. That repeal revoked 80% of the ultimate reduction in the cost of capital for equipment promised in the 1981 Act. TEFRA also repealed safe harbor leasing.

TEFRA's timing was terrible. The economy appeared to begin a recovery in the summer of 1982, and the upturn might have taken off from there. Unfortunately, in anticipation of TEFRA's repeal of safe harbor leasing, major companies canceled tens of billions of dollars in major investment projects in 1982. The loss of that investment was sufficient to trigger renewed weakness in real economic output in the summer of 1982, which delayed the **recovery** by another six months. The extended downturn led to further deterioration in federal revenues.

Deficit Concerns

The budget deficits of the early 1980s were erroneously blamed on the tax rate reductions and led to calls for further tax increases. In fact, the deficits were due to the recession and to the sudden collapse of inflation.

Tax Reform Act of 1986 -Lower Rates, Broader Base, Bigger Bias Against Saving & Investment

The Tax Reform Act of 1986 (**TRA86**) reduced the number of tax brackets and sharply lowered individual income tax rates. It created two basic tax rates, 15% and 28%. Over a range of upper-middle income, a 5% surtax resulting in a 33% rate “bubble”, recaptured the benefit of the 15% bracket, **after** which the tax became a flat rate of 28% on all income above exemptions and deductions.

TRA86 has been described as “broadening the tax base” by closing “loopholes” in order to lower the tax rates. Because of the low individual marginal income tax rate structure, **TRA86** is often referred to as the ultimate supply-side tax bill. That is a misperception. In fact, **TRA86** offset the static revenue loss of the personal rate reductions with several improper changes to the tax base that increased the income tax bias **against** saving and investment, overstating income from capital or otherwise subjecting it to increased double taxation. The net effect was to worsen the tax treatment of capital formation, both in absolute terms and relative to consumption uses of income. In particular, **TRA86**:

- Repealed the ITC and lengthened the asset lives of depreciable assets in a manner that eliminated the remaining investment-specific cuts in the cost of capital in ERTA; Congress dropped the Administration’s request that longer asset lives be offset by indexing depreciation write-offs for inflation. **TRA86** partially offset the impact of these changes by reducing the corporate tax rate to 40% in 1987 and 34% in 1988;
- Curtailed, for upper income taxpayers, the deductible IRA provisions of ERTA that provided neutral tax treatment of saving;
- Tightened “passive loss” rules that denied normal business deductions for investors who were not active managers of the affected enterprises, thereby overstating their actual income from the properties;
- Eliminated the 60% capital gains exclusion, resulting in ordinary income treatment of capital gains, but with the rate capped at 28% for assets held a year or more. The change increased *the* “double taxation” of business earnings.

Some of the existing real estate tax “shelters”, such as non-recourse loans, were unjustified and worthy of repeal. However, the lengthening of asset lives for structures and the passive loss rules seriously affected the market for commercial and multi-family residential real estate, damaged the savings and loan industry, and weakened the banking system. With mortgage lending curtailed, the damage spread to single family home construction as well. The government was forced into a multi-billion dollar bail-out of the financial industry, the cost of which far exceeded any revenue raised by the harsher tax treatment of investment in real property.

Tax Rate Hikes in 1990 and 1993

Not only was the tax base made less neutral by the 1986 Tax Reform Act, but once the so-called “shelters” were repealed the individual rate cuts were gradually rescinded by later tax bills.

The 1990 tax act substituted a 31% top rate for the 33% bubble and the top portion of the 28% rate. That Act contained a temporary provision requiring the phase-out of personal exemptions and deductions for

many of the steps taken to reduce tax rates have been repealed; and many more steps that should be taken are not even under serious consideration.

The tax code still raises revenue for the government in a highly complex, economically destructive manner. It employs high marginal tax rates imposed unevenly across individuals and across different types of economic activity. There is a significant tax bias against the use of income for saving and investment, and graduated tax rates that punish people the harder they work and the more they produce. Some of the marginal tax rates are explicit and visible to the taxpayer/voter. Other high rates are hidden and disguised to squeeze more revenue from an unsuspecting public without triggering a voter backlash.

High marginal tax rates, however disguised; depress work, saving, investment, productivity, output, and income. They trap the poor in poverty. They punish people who would like to save for their retirement or to help their children, which saving would also contribute to economic development that would benefit everyone. They drive experienced workers from the labor force.

The key tasks remaining in the area of tax policy are to reform the tax base to eliminate the anti-saving, anti-investment biases in the tax code; to lower and flatten the statutory tax rates; and to eliminate complexity. These goals are compatible because the biases in the code are the chief sources of the complications. One additional goal should be the adoption of dynamic scoring of the revenue consequences of tax proposals based on their microeconomic (supply side) incentive effects and the resulting supply responses of the taxpayers and the associated changes in gross domestic product and income.

Tax Biases Against Saving

Ferretting out and eliminating the high marginal tax disincentives to work, save, and invest requires a close look at the biases hidden in the tax code.

Under the broad-based income tax, most income is taxed when first earned (except limited amounts deferred in pension or IRA contributions). If it is used for consumption, there is generally no additional federal tax (except for a few selective excise taxes) on the enjoyment of the goods and services.

If the income is saved, however, there is an additional tax (sometimes more than one) on the **earnings** of the savings (the "service" being bought when the assets are acquired): there is a tax on interest in the case of a bond or bank account, a tax on rent in the case of ownership of real estate, and the corporate income tax in the case of ownership of stock. These added layers of tax are the **basic** income tax bias against saving. Whenever income that is saved and the returns on the saving are both subject to tax, the tax raises the cost of saving by more than it raises the cost of consumption, hence the bias. (See chart 7.)

Additional biases are created by taxing after-tax corporate earnings a second time as dividends, or, if they are retained and increase the value of the company, as capital gains when the shares are sold. Note that corporate dividends and retained earnings are both subject to this added layer of tax. In its latest study of corporate tax integration, the Treasury Department pointed out the advisability of dealing evenhandedly with this excess layer of tax on dividends and capital gains.*

The combined corporate and personal income taxes on dividends exceed 60% for some savers, leaving the highest-taxed shareholders less than \$0.40 in after-tax return on each dollar of corporate earnings paid as dividends. The tax rate on retained earnings resulting in a long term capital gain reaches 48%.

Phase-Ins and Phase-Outs Produce Hidden Rate Hikes

In some cases, earning an extra dollar of income causes taxable income to go up by more than \$1 because a tax credit or exemption is “phased-out” or a tax is triggered on Social Security benefits. And sometimes the tax rules mismeasure (overstate) a taxpayer’s actual income to inflate Treasury revenue. All these cases result in a higher effective marginal tax rate. All such phase-outs or phase-ins should be eliminated, or replaced with a less destructive method of including the income in the tax base.

There are at least two dozen examples of phase-outs and phase-ins in the tax code, and more are added with each new, piece of tax legislation. The complexity is astonishing and frustrating to taxpayers. ¹⁰

Upper income taxpayers must phase out their personal exemptions and part of their itemized deductions as their income exceeds certain thresholds. The phase-out raises the top tax rates by about 2.5 to 5 percentage points for a couple, depending on the number of their dependents. The top marginal income tax rate is effectively pushed into the low forties.

Almost all the personally-managed retirement and education saving incentives and child credits in the tax code are phased out as incomes increase.

Even the poor face high marginal tax rates. Working parents with between \$ 19,000 and \$30,000 in income face an extra 2 1% implicit tax rate as they earn additional money, because their Earned Income Tax Credit is phased out by 21 cents for each additional dollar they earn. They also face a 15 percent income tax rate and a 15.3 percent payroll tax rate on an extra dollar of wages. Their combined tax penalty on added income is over 50%.

Social Security recipients face particularly high marginal tax rates. Their Social Security benefits are phased in to taxable income at a rate of 50 or 85 for each dollar by which the sum of their interest, dividends, and pension income (plus half of their Social Security benefits) exceeds certain thresholds. The extra jump in taxable income effectively raises tax rates on those sources of income. Marginal tax rates can reach 42% or 52%. The taxation of benefits can boost the implicit marginal tax rates on wage income in excess of the thresholds to 65%. For wage income that is also subject to the Social Security earnings test, the combined federal income tax rates and loss of benefits can cost retirees 109% of their added income, even before state income taxes. (See chart 8.) These terrible tax rates could be avoided if a portion of benefits were exempted from tax to protect people with low income and the rest were simply added to taxable income without reference to other income received by the taxpayer.

Taxing Income More than Once Makes Effective Rates Soar

Phase-ins are bad, but so is taxing the same income more than once, The payroll tax hits wage income a second time, adding 15.3% to the tax rate on labor compensation. The cure is to privatize retirement saving, eliminate the payroll tax, and allow individuals to put the money into their own personal retirement plans.

That second layer of tax on saving can be offset by deferring tax on all saving and taxing it on withdrawal, as is allowed for limited amounts contributed to a deductible IRA or pension plan. It can also be offset by taxing the money before it is saved, but not taxing the returns, as in a Roth IRA. Either the saving-deferred method or the returns-exempt method puts the saving on an even par with consumption.

Fundamental Reform

All the major **fundamental** tax reform proposals eliminate the multiple taxation of saving and investment inherent in the broad-based income tax and provide a neutral tax system. The national sales tax and the individual portion of the USA Tax (**Nunn-Domenici**) are, in effect, saving-deferred taxes. The **Arney Flat Tax** is a returns-exempt tax for individuals, and a saving/investment-deferred tax for businesses. A simple, single rate saving-deferred cash flow tax for individuals would be another possibility, and the clearest way to show taxpayers what they are paying for government.^{1 1}

One way or another, we need to reform this crazy tax system. A single rate tax, unbiased against saving, with no double taxation of business income and no tax on estates, could eliminate these hidden, high marginal tax rates. Moving to neutral tax treatment of saving and investment could add 25% to 30% to the stock of capital, boost productivity and wages, and raise national income by 10% to 15% over about 15 years. That would boost the average family income by \$4,000 to \$6,000 a year. It would guarantee a far more secure retirement for future generations. Fundamental tax reform would work hand in glove with the privatization of Social Security to benefit people during their working and their retirement years. In short, fundamental tax reform would reward people for improving their situations instead of forcing them into continued dependence on Big Brother government, and bring about a new burst of economic and political freedom for the new millennium.

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Chart 2 Keynesian Demand Management

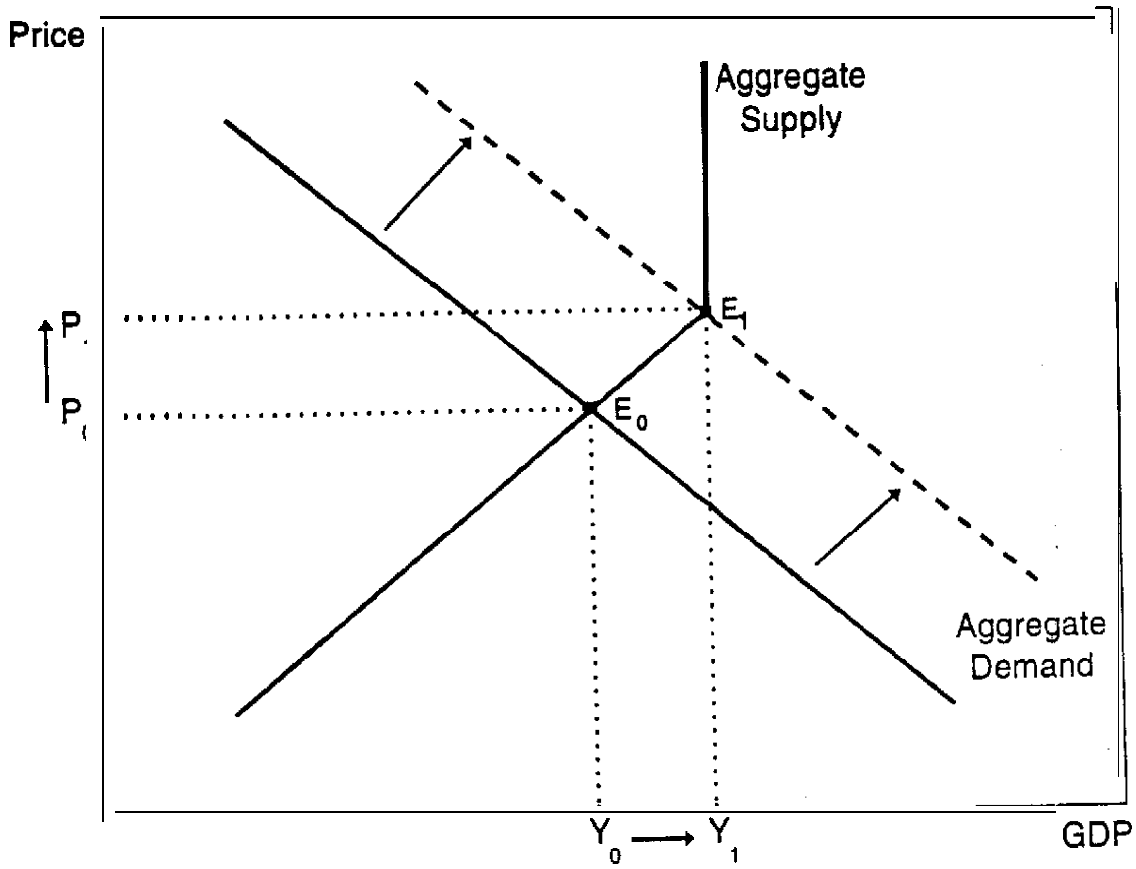
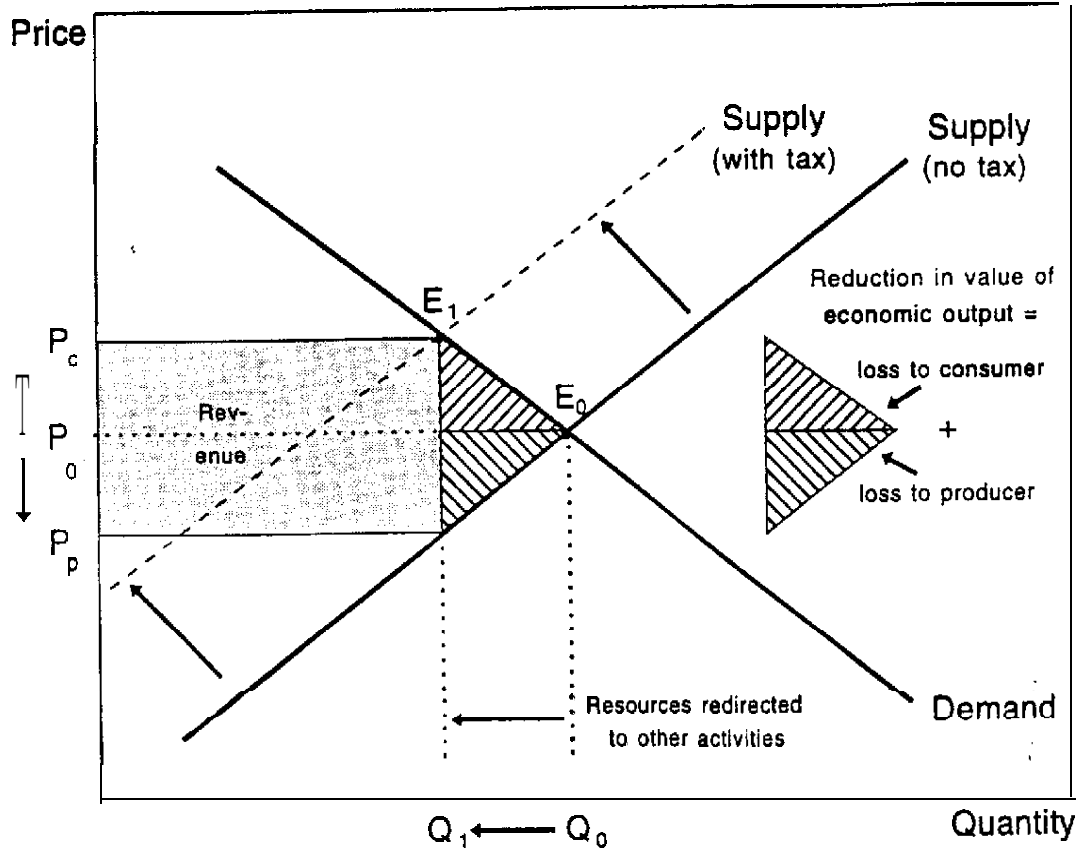


Chart 4 Imposition of a Tax



**Chart 6 Expanding Capacity By
Reducing Taxes At The Margin**

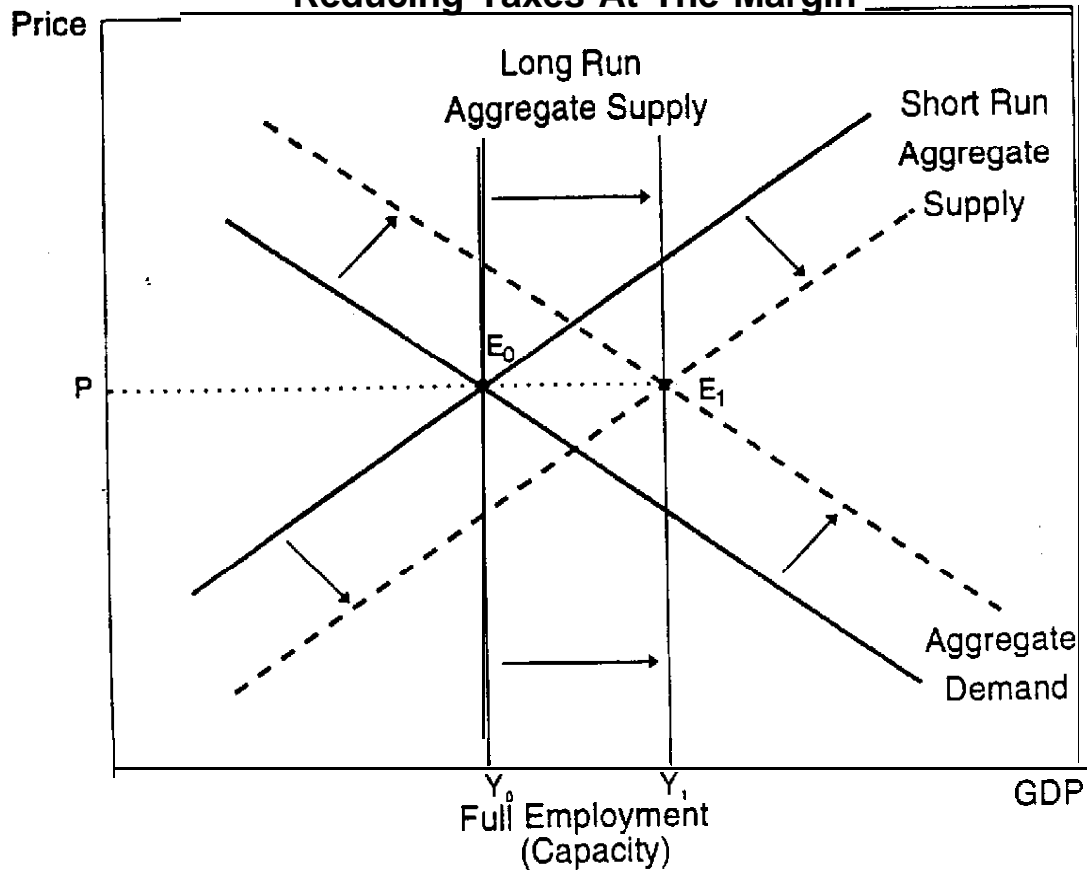


Chart 8 Effective Federal* Marginal Tax Rates for Social, Security Recipients

Statutory income tax rate	Marginal tax rates as Social Security benefits become taxable, in tier 1 (50% phase-in range) or tier 2 (85% phase-in range)			
	Income from savings, pensions		Wage income below earnings test threshold	
	Tier 1 (150% of statutory income tax rate)	Tier 2 (185% of statutory income tax rate)	Tier 1 (adjusted income plus payroll tax rate**)	Tier 2 (adjusted income plus payroll tax rate**)
15%	22.5%	21.8%	37.2%	42.1%
28%	42%	51.8%	56.2%	65.3%
	Wages subject to the Social Security earnings test, payroll and income taxes**			
	Ages 65-69		Ages 62-64	
	Tier 1	Tier 2	Tier 1	Tier 2
15%	68.1%	71.2%	85.4%	88.9%
28%	84.9%	90.7%	102.7%	109.3%

* Add 4 to 6 percentage points for typical state income tax rates.

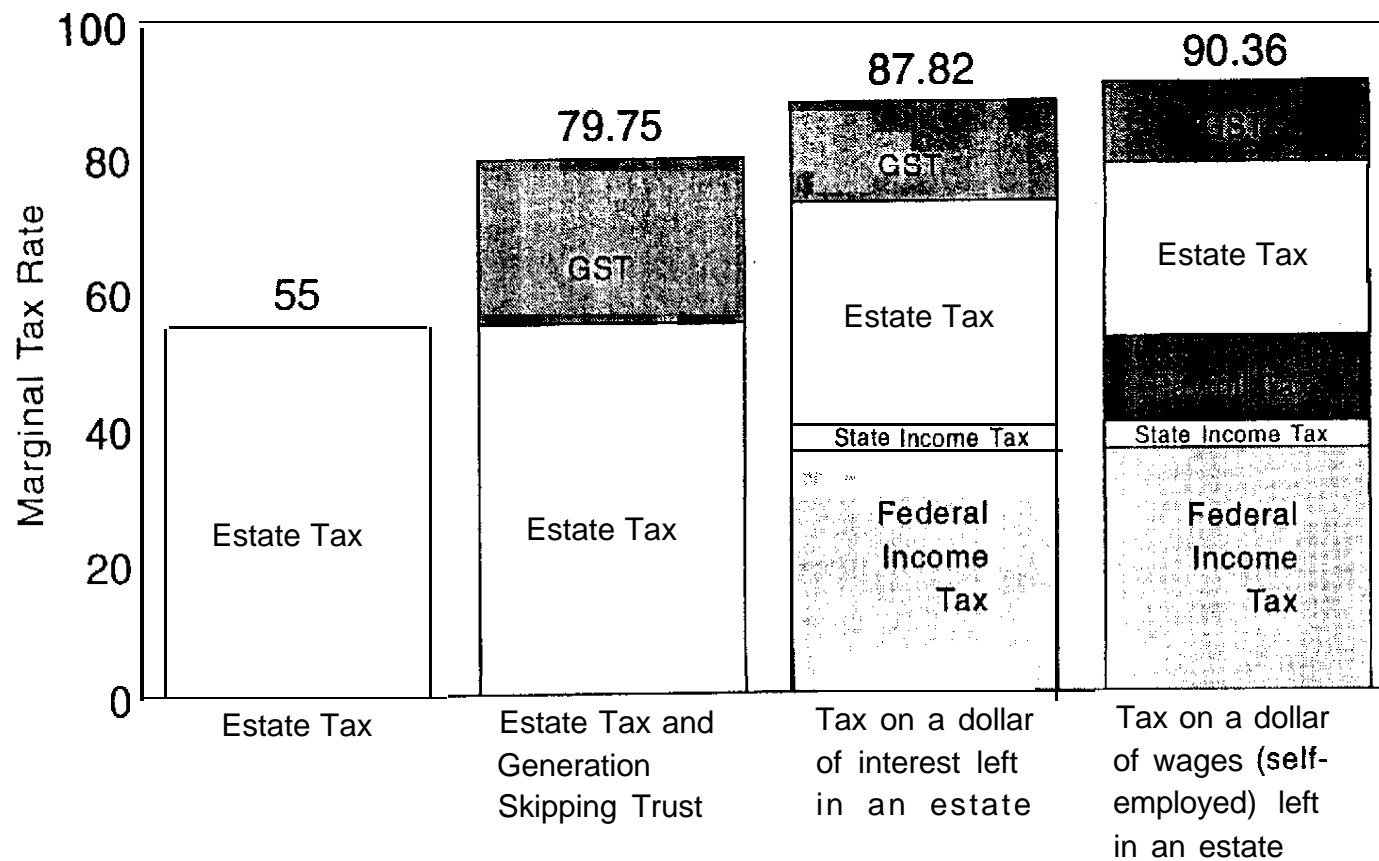
** Assumes self-employed payroll tax, and allows for income-tax deductibility of "employer's" half of payroll tax and effect of deduction on modified adjusted gross income used to determine amount of Social Security benefits subject to income taxation. Figures would be very similar for employee beneficiaries after adding the employee and employer payroll tax rate adjusted for income tax deduction of employer's half at employer's income tax rate.

Chart 10 Multiple Taxation of Corporate Income

	a) Dividend Payout	b) Retained Earnings
1) Corporate income	\$1.00	\$1.00
2) Corporate tax at top rate*	\$0.35	\$0.35
3) After-tax corporate income: (a) paid as dividend; or (b) retained, raising stock price	\$0.65	\$0.65
4) Individual income tax: (a) on dividend at top rate (39.6%); or (b) on after-tax retained earnings taken as a long-term capital gain (20%)*	\$0.2574	\$0.13
5) Total tax	\$0.6074	\$0.48
6) Total tax rate	60.74%	48%
7) Income left to shareholder	\$0.3926	\$0.52

* Top corporate rates exclude corporate surtaxes. Top individual rate excludes effects of phase-outs of itemized deductions and personal exemptions and taxation of Social Security, which may raise effective top tax rates higher than the statutory rates. The top tax rate on short-term capital gains is 28%, which brings the combined tax rate to 53.2%.

Chart 12 Marginal Tax Rates On Estates And Income Contributed, To Estates



Assumes married couple in 36% tax bracket, who are self-employed, with a 6% state income tax as an itemized deduction.

Notes

¹ Derived from data on large company stocks: inflation adjusted total returns, in Ibbotson Associates, Stocks, Bonds, Bills, and Inflation, 1996 Yearbook.

² One of the first economists to propose this policy mix was Robert Mundell, a leading international economist and the recipient of the 1999 Nobel Prize for economics. Then at the University of Chicago, he was searching for a policy mix that would allow stronger real growth without creating inflation and weakening the dollar relative to other currencies. He was joined in advocating this set of policies by Professor Arthur Laffer, then at the University of Chicago Business School.

Another early advocate of sound money, lower tax rates, and reduced government spending, was Norman B. Ture, Washington tax consultant, who had been a staff economist on the Joint Economic Committee, an advisor to Ways and Means Chairman Wilbur Mills, and a former Treasury economist. He developed the earliest comprehensive descriptions of the primary effect of taxes on relative prices, supply, and output, and one of the earliest supply-side models of the economy. Dr. Ture later became the Under Secretary of the Treasury for Tax and Economic Affairs at the start of the Reagan Administration.

³ In 1976, I was attached to the Joint Economic Committee as an aide to Senator Taft. The indexing amendment of 1976 required the preparation of considerable background information because the Members were largely unfamiliar with the concept. I also assisted the other Members and their staffs with the later indexing efforts, and noticed that, as inflation got worse, the Members became much more familiar with the issue. So did the general public. Representative Clarence Brown (R-OH), for whom I later worked on the JEC staff, was about to tell a group of constituents back in Ohio that he was introducing an indexing amendment. He started his talk by pointing out that inflation had raised taxes, whereupon one of the citizens present called out, "Then why don't you index the tax system?" Senator Armstrong finally succeeded in attaching indexing to the Senate version of the 1981 tax bill, even before President Reagan added indexing to the version of the tax proposal he sent to the House.

⁴ For a full account of the maneuvering on this issue, see The Supply Side Revolution, by Paul Craig Roberts, Chapters 1 and 2 (Harvard University Press, Cambridge, Massachusetts, 1984). Also see Reaganomics, by Bruce Bartlett, Chapter 7 (Arlington House Publishers, Westport, Connecticut, 1981).

⁵ Roberts, op. cit.

⁶ Ibid

⁷ See Roberts and Bartlett, op. cit., for a fuller discussion.

⁸ Department of the Treasury, *Integration of the Individual and Corporate Income Tax Systems, Taxing Business Income Once*, Washington, D.C., Jan. 6, 1992. In the introduction, p. 13, the study states: "Integration should distort as little as possible the choice between retaining and distributing earnings. The U.S. corporate system discourages the payment of dividends and encourages corporations to retain earnings..." Also see the section entitled "Bias Against Corporate Dividends Distributions", pp. 116-118.

⁹ Suppose Corporation B owns shares in Corporation A. When Corporation A earns money, it pays tax. Then Corporation B, the recipient, pays tax when it receives a dividend from A or sells its shares in A.