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Priorities in Tax Policy, Testimony before the U.S. Senate Committee on Finance

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This paper discusses the merits of alternatives to the current tax policy: closing "loopholes," reducing taxes for those with low incomes, adjusting the personal income tax structure, and increasing the stimulus for capital formation.

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PRIORITY IN TAX POLICY
By Murray L. Weidenbaum

Testimony before the U. S. Senate Committee on Finance
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Highlights

1. Additional stimulus for capital formation should be placed at the top of the tax policy agenda.

2. Priority should be given to a substantial reduction in the corporate income tax, phased in over three to five years.

3. The progressivity of the existing personal income tax structure should be acknowledged, contrary to the statements of many "tax reformers."
In its action on the current tax bill, the Congress has an important opportunity to set the priorities in tax policy for many years to come. There is no shortage of alternatives to choose from: (1) enhancing the equity of the tax system by closing all those "loopholes," (2) easing the burden on the poor by reducing taxes in the low brackets, (3) protecting the public from the effects of inflation through adjusting the personal income tax structure ("indexing"), and (4) increasing the stimulus for capital formation.

Let us briefly evaluate each of these four alternatives to see which merits greatest priority.

Closing All Those Loopholes

Frankly, it is necessary to go beyond the "horror stories" of the 50 or 30 or 15 millionaires who don't pay any taxes and to focus on the total impact of the revenue system. In passing we should note, however, that at every income level there are people who do not pay any taxes and even larger numbers who do not pay their "fair" share of taxes. But the overall facts of the matter are very clear: the federal individual income tax is progressive, in both practice and theory.

To be sure, that statement runs counter to the popular myth that "the poor pay more, so the rich pay less." That, very frankly, is the big lie in tax reform discussions. On the average, the higher your income, the more federal personal income tax you pay, both absolutely and as a proportion of total income.

NOTE: Mr. Weidenbaum is Director of the Center for the Study of American Business at Washington University in St. Louis and adjunct scholar at the American Enterprise Institute.
proportion of your income. That has been demonstrated in every comprehensive study of the federal individual income tax.

Those writers who focus on the distribution of "tax expenditures" (the revenues lost from special provisions) are looking at the hole instead of the donut. Even after taking full account of tax expenditures, the federal personal tax system is progressive. The most recent corroboration of this fact was provided by Secretary of the Treasury W. Michael Blumenthal in testimony earlier this year. Table 1, taken from the Secretary's statement, shows that the effective personal tax rate rises steadily with the taxpayer's income and at a more rapid rate -- this is the essence of a "progressive" tax.

Table 1

FEDERAL PERSONAL INCOME TAX RATES UNDER PRESENT TAX LAW
(Based on 1976 Levels of Income)

<table>
<thead>
<tr>
<th>Expanded Income Class (in thousands of dollars)</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 5</td>
<td>0.2%</td>
</tr>
<tr>
<td>5 - 10</td>
<td>5.5%</td>
</tr>
<tr>
<td>10 - 15</td>
<td>9.0%</td>
</tr>
<tr>
<td>15 - 20</td>
<td>11.2%</td>
</tr>
<tr>
<td>20 - 30</td>
<td>13.8%</td>
</tr>
<tr>
<td>30 - 50</td>
<td>17.6%</td>
</tr>
<tr>
<td>50 - 100</td>
<td>24.4%</td>
</tr>
<tr>
<td>100 - 200</td>
<td>29.5%</td>
</tr>
<tr>
<td>200 and over</td>
<td>30.0%</td>
</tr>
<tr>
<td>Average</td>
<td>12.4%</td>
</tr>
</tbody>
</table>
There is no need to guess the average citizen's reaction to the equity of the federal income tax. The Advisory Commission on Intergovernmental Relations recently reported its survey of taxpayer attitudes. By a substantial plurality, the American public believes that it gets the most for its money from the federal government. The local property tax receives the "honors" for being considered the most unfair tax (see Table 2).

Table 2
CITIZEN REACTIONS TO GOVERNMENT AND TAXES

"From Which Level of Government Do You Feel You Get the Most for Your Money?"

<table>
<thead>
<tr>
<th>Level of Government</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal</td>
<td>36%</td>
</tr>
<tr>
<td>Local</td>
<td>26%</td>
</tr>
<tr>
<td>State</td>
<td>20%</td>
</tr>
<tr>
<td>Don't Know</td>
<td>18%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>

"Which Do You Think is the Worst Tax -- That Is, the Least Fair?"

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local Property Tax</td>
<td>33%</td>
</tr>
<tr>
<td>Federal Income Tax</td>
<td>28%</td>
</tr>
<tr>
<td>State Sales Tax</td>
<td>17%</td>
</tr>
<tr>
<td>State Income Tax</td>
<td>11%</td>
</tr>
<tr>
<td>Don't Know</td>
<td>11%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Advisory Commission on Intergovernmental Relations

Although the passage of Proposition 13 in California demonstrated the public's general concern with high taxes and big government, it is interesting to note that the proposition focused on the local property tax.
My statement is not an attempt to defend every provision of the Internal Revenue Code. But it does seem clear that tax reform in the sense of closing "loopholes" is not -- and should not be -- at the top of the agenda for tax policy action.

**Reducing the Tax Burden on the Poor**

It is clear from the data in Table 1 that the poor now pay little if any federal income tax. That was not always the case, but it surely is true today. Moreover, the great bulk of the rapid expansion in federal spending over the past decade has been in the form of income-maintenance transfer payments. These federal expenditures are heavily targeted to the lower income groups of the population.

Poverty surely has not been eliminated in the United States. But what remains is not the result of unfair tax policy toward the poor. Lack of jobs is a direct cause of poverty, a point we will take up a little later.

**Protecting the Public Against Inflation**

Inflation surely is a key concern of the American people. The point that we need to note here is that the government cannot protect all of its citizens from the effects of rising prices by merely changing the income tax structure. Surely, "indexing" can reduce or eliminate the added taxes which we pay when inflation forces us into higher tax brackets.

But indexing itself does not cure inflation. We only delude ourselves if we avoid adopting those often painful but necessary measures of monetary and fiscal restraint which can help subdue the inflationary pressures. Reforming needlessly costly government regulations is an important part of any comprehensive anti-inflationary effort.
To those of us who are concerned with the expanding scope of the public sector at the expense of the private sector, reductions in taxes are an important and constructive step in controlling the size of government. But so designing tax reduction that it primarily promotes increases in current consumption -- which appears to be the main strategy of the current tax bill -- surely is not a central part of any anti-inflation effort.

So, quite clearly, we are led to the fourth alternative shift in tax policy -- the encouragement of more capital formation. As we will see, there are many reasons to believe that this is the most desirable of the proposals now under consideration.

Encouraging Capital Formation

There is no need to repeat the many studies which demonstrate the existing bias in the U.S. tax system in favor of consumption and against saving and investment. But it is not surprising that we as a nation devote a far smaller portion of our GNP to investment than the other industrialized nations, who generally use a tax system which taxes saving and investment far less heavily than does our own.

This long-term concern is reinforced by the current outlook for the American economy. Virtually every forecaster is projecting a slower rate of growth for the coming 12 months than was achieved during the past year. A rising minority is forecasting recession sometime in 1979. When we examine the major sectors of the economy, it is clear that capital spending has been lagging far behind what normally would be expected during this stage of the cycle.

Tax changes to encourage investment in economic growth are badly needed to provide needed strength for the economy. By increasing productive
capacity -- the ability to supply goods and services -- the long-term impact of such tax changes would be anti-inflationary. Depending on which specific changes are adopted, a variety of other benefits could be achieved.

Reasonable people may differ over the most desirable tax changes to encourage capital formation. Reducing the high capital gains taxes is one useful approach. In fact, it has been shown that during periods of rapid inflation these taxes can be confiscatory in real terms. Also, expanding the investment tax credit and liberalizing depreciation allowances are other attractive possibilities. For a variety of reasons, however, I support a straight across-the-board reduction in corporate income tax rates.

Of transcending importance, a lower corporate tax rate would reduce the pervasive role of government in day-to-day business decision making. In this period of rising public concern with overregulation of business, we must realize the pervasive interference with business management that occurs as the result of the tax structure. A lower corporate rate would promote more efficient use of resources because fewer business expenses would be incurred merely because they are tax deductible.

A lower corporate tax rate would soften the double taxation of dividends. It is important in this connection to keep in mind that the typical dividend recipient is not the "fat cat" that dominates tax reform folklore. Rather, he or she is a retired worker that ultimately receives corporate dividends via a pension plan, an insurance policy, or a mutual fund.

Increased dividends would be only one result of reduced corporate tax rates. To some extent, consumers also would benefit as a portion of the lower taxes is shifted forward in the form of lower prices, or
at least prices rising less rapidly than otherwise. Also, some part of
the higher after-tax earnings would be shifted backwards to employees
in the form of higher wages and fringe benefits.

I would expect that a substantial portion of the higher net earnings
resulting from cutting the corporate tax rate would be reinvested in the
companies themselves. The resultant increases in new plant and equipment
would provide the basis for higher production, more jobs, and rising
incomes. For all these reasons, I urge that spurs to capital formation
be placed at the top of the agenda for tax policy and that sizable reduc­
tions in the corporate income tax rate be phased in over a period of
three to five years. To get the maximum impact of such long-term action,
the Congress should pass the entire package now. Such action would signal
clearly the specific tax cuts which business can anticipate over the next
several years and which it could count on as it makes its long-term
commitments.

The phased tax reduction would also alter the environment in which
the annual federal budget is prepared. Rather than considering tax cuts
as a residual action to be taken after the appropriations review, the
process would be reversed. The executive branch would be forced to develop
its expenditure programs in the light of a lower anticipated flow of
revenues. Thus, substantial tax cuts, such as those to spur private
capital formation, would simultaneously encourage restraint in public
outlays.