Reagan's Tax Reform

- The President has proposed a striking and historic revision of the income tax laws. His plan would make the system both simpler and fairer.

- The present 14 brackets would be replaced by just three: 15%, 25%, and 35%. The maximum corporate rate would drop to 33% (with graduated rates for small business).

- The plan as a whole would shift the tax burden away from working people and toward businesses that have a lot of income but haven't paid their share of tax. Total taxes paid by individuals would drop 7 percent, while corporate tax payments would rise about 9 percent.

- Distributional Offset. Under the Reagan plan, families with incomes of $10,000 or less would get a 35.5% tax cut; $10,000 to $15,000, a 22.8% tax cut; $15,000 to $20,000, a 13.5% tax cut; $20,000 to $30,000, an 8.7% tax cut; $30,000 to $50,000, a 6.6% tax cut; $50,000 to $100,000, a 4.2% tax cut; $100,000 to $200,000, a 4.1% tax cut; and $200,000 or more, a 10.7% tax cut (the larger-than-average break for the top income group results from the lower top rate of 35% and the lower top capital gain tax rate of 17.5%).

- Return Free System. Under the Reagan plan, only 33% of taxpayers are expected to itemize. In addition, more than half of all taxpayers would be able to get their tax bill or refund without filing a return (if they so choose).

- Protection for Low Income. The plan would remove from the tax rolls virtually all families, married couples, single heads of households, and older Americans at or below the poverty line. This would result from the combination of increasing the personal exemption, zero bracket, earned income credit, and the new consolidated credit for the blind, elderly, and disabled.

- Indexing Protection. The plan retains the indexing protection for rate brackets, the personal exemption, and the zero bracket which we pioneered in 1981. Most plans that claim to do more for middle incomes (like Bradley-Gephardt) do not protect taxpayers against inflation and would do less for them in the long run. President Reagan also expands the indexing concept to the earned income credit, protecting the working poor, to depreciation and to capital gains (in 1991).

- **Business and Growth.** President Reagan proposes a system of business taxation that is more neutral and will reduce tax-motivated distortions that skew economic decisions. Repealing the ITC and revising depreciation schedules mean greater neutrality among different investment categories. Other changes that will limit economic distortions include limiting real estate tax breaks to the amount at risk, and tightening the minimum tax with regard to oil and gas tax breaks (intangible drilling costs).

- **Issues to Watch.** Congress will give the President's plan a very close look, and no doubt many Members will have particular changes they want to propose. In particular, there will be focus on:

  - **Distribution of Tax Burden.** If Treasury's estimates hold up, this is a very fair plan. Some may be concerned about the break for the top income class--but to address that would require changing the rate structure or the capital gains exclusion, both very sensitive issues.

  - **Neutrality/Investment.** Any perceived deviation from "neutral" tax treatment for different industries will bring demands for change from other industries. In addition, those industries most heavily subsidized by the current code--like those which benefit from the ITC because they are capital-intensive--will want to minimize the effect of the plan.

  - **State and Local Taxes.** Secretary Baker has said that eliminating the deduction for State and local taxes is a sort of "acid test" for serious tax reform. This is a $40 billion item over the projected phase-in period, and that amount would be difficult to make up. If high-tax States can fight off this change--even in the context of much lower tax rates and other benefits that ease the tax take on their citizens--progress may be difficult.

ESCALATING DEFICIT

The main threat to continued economic expansion is run-away Federal spending.

- o Since 1940, the Federal Government has run deficits in 37 out of the last 45 years. Since 1960, we've run deficits in 24 out of 25 years.
- o In 1985, the gross Federal debt will total $1,841 trillion, an increase of 533% over 1960, 238% over 1975, and 101% over 1980. The total debt in 1985 now stands at 48% of our GNP.
- o With no changes in Federal spending policy, CBO projects that Federal outlays will rise from $950 billion in 1985 to $1,378 trillion in 1990--an increase of $428 billion in five years.
- o If no changes are made, the budget deficit will increase from $214 billion in FY 85 to $300 billion in 1990 and the National debt will increase to $2,786.

INTEREST ON THE DEBT

This massive increase in debt has itself created one of the largest and fastest growing components of Federal spending--interest on the debt. Constant deficits have put fiscal policy on an endless treadmill of paying for the irresponsibility of previous decades:

- o In 1965, interest on the National debt cost $9 billion and consumed 1.4% of GNP. By 1980, annual interest costs rose to $52 billion--2% of GNP. But the worst was yet to come.
- o In 1985, interest on the National debt will cost taxpayers $130 billion--almost three times the level of five years ago. This represents 3.8% of GNP, 13.5% of the entire 1985 budget, and a 1,450% increase in costs over 1965.
- o $130 billion is equal to the sum total of all Federal spending from 1789--the founding of the Republic--to 1936. It also equals total Federal outlays in 1966, the entire defense budget in 1980, and twice the level of medicare funding today.
- o To put it in even simpler terms, about 40% of all revenue collected by the Federal Government from personal income taxes ($330 billion in 1985) will go to pay interest costs and no Federal services at all.

House Budget

- The House budget doesn't do enough, in a credible way, to keep the economy on an even keel and reassure financial markets.

- First of all, the House plan doesn't even aim as high as the Senate budget. It claims savings of only about $250 billion over three years, as opposed to the nearly $300 billion in the Senate plan. The House would leave the deficit nearly 20% higher in 1988 than the Senate.

- The House budget really undermines the National defense at a time when our defense posture is critical to the success of arms control talks. The Senate plan already freezes defense in 1986, allowing no real increase: there just isn't any room for further cuts without jeopardizing security. The President is absolutely adamant on this point.

- About 50% of total savings in the House budget come from defense even though defense only accounts for 28% of the Federal budget.

- THe House plan avoids major savings in entitlement programs. It also terminates only one program--revenue sharing--where the Senate ends 14 programs and makes significant reforms in many others. That proves the House plan doesn't bite the bullet--it doesn't do anything to ensure the long-term savings that will reassure investors and shore up business and consumer confidence.

- The House budget also is full of smoke and mirrors. $12.2 billion in savings are assumed from reducing spending for contracting out services. But most analysts view contracting out as a cost saving device. $3.7 billion is saved in "offsetting receipts" that will probably not be realized.

KEY POINTS ON SENATE BUDGET

- Through spending cuts alone, the plan would reduce the deficit by $56 billion in FY 1986, and about $295 billion through FY 1988.

- Cuts of this magnitude leave remaining deficits of $171 billion in FY 1986, $145 billion in FY 1987, and $104 billion in FY 1988.

- This plan reaches the goal we set of getting the deficit down to 2% of GNP by 1988, without tax increases.

- Every area of the budget is hit hard: the President's defense request is cut to zero in 1986, 13 programs are terminated, and permanent entitlement savings are achieved by freezing all non-means tested COLAs for one year.

- These are real, meaningful cuts and should have a significant impact on financial markets. Results from a survey of leading Wall Street financial advisers indicates that we should expect interest rates to drop by 1 or 2 percentage points in the near term and by as much as 3 points in 1988 if we follow through this package. Rates have already trended downward--the prime is down 1/2 point to 10%.

- If that happens and keeps the recovery on track, we can expect:

  - almost 7 million new jobs by 1988
  - housing starts back up to the 2 million units/year level
  - inflation staying down at 4% or less
  - national personal income up by $800 billion by 1988
  - potential increase of 18-26% in net income for small business (due to lower interest rates)
  - a potential increase of $2-4 billion in net farm income (due to lower interest rates)