The Economic Recovery Tax Act of 1981: An Experiment in Supply-Side Economics

An Honors Thesis (ID 499)

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Table of Contents

Page

I. An Introduction to Supply-Side Economics 3

II. A Tax Reduction Proven by History. 7

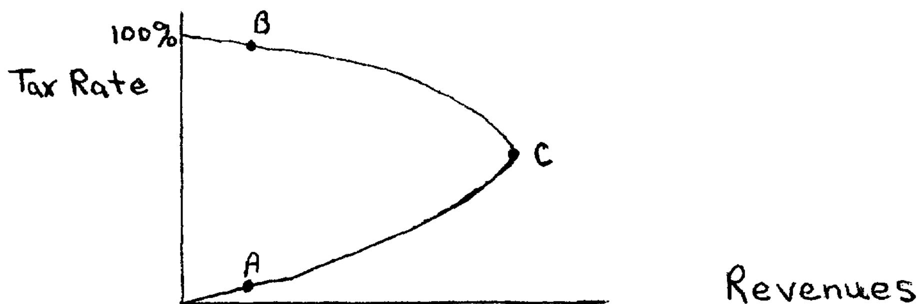
III. Hope For Economic Recovery 10

IV. Changes in the Depreciation Deduction 17

V. Conclusion 22

I. An Introduction To Supply-Side Economics

Supply-side economics is not a new idea. It has only recently, however, been given extensive coverage by the press. The spokesman for supply-side economics is a charismatic gentleman named Arthur Laffer. Laffer, who is a professor of Business Economics at the University of Southern California, developed a graph which explains that "[t]here are always two tax rates that yield the same revenues."[1] The "Laffer curve" is shown below.



This curve appears to be a rather simple diagram at first glance. But through closer examination, one can see the important implications associated with the curve. First of all, we know that the government is trying to maximize revenues. Therefore, the tax rate should be set at point C. The difficult task lies in evaluating the actual tax rate associated with point C. It is not a fixed value for all sit-

uations. It must be analyzed according to the circumstances. In times of war, for example, point C approaches 100 percent.

Let us take a closer look at the Laffer curve and explain what it is saying. First, if the government sets the tax rate at A, many people will want to work. They are allowed to keep nearly all of their wages for personal use. This means output is high. But revenues are low because the government does not procure but a minimal percentage of the total output. On the other hand, the tax rate could be set at point B. Now the government would obtain virtually all of the individual's income. A person would be reluctant to work when he realizes the fact that he will not be rewarded for his efforts. Hence, although the tax percentage is high, total output by the workers will be low. Thus, tax revenues will be low as well.

There is another very important consequence of an excessive tax rate, namely an "underground economy." An "underground economy" is especially prone to exist and prosper in a service-oriented economy such as the one in the United States. It can and does, however, exist in the product market as well. This "underground economy" operates mainly along the lines of a barter system. For example, one person may paint another's house in exchange for vegetables

from the other's garden. Although the Internal Revenue Service requires that the fair market value of the service or product received be considered income, this is difficult to enforce. The person whose house was painted will claim he performed the task himself. The one who received the vegetables will have no evidence of such since the vegetables were consumed. Both parties benefit by not having to pay taxes. Similarly, the "underground economy" can operate when money is exchanged for goods and services as long as the payments are in cash. The seller can offer a reduced price for his product since he will retain the entire amount paid. Again, the seller will benefit from not paying taxes. This time the consumer benefits from the reduced product price. These underground activities cause the government to lose tax revenues which should have been collected on the transactions.

Individuals make an economic decision regarding whether to participate in the "underground economy" or not. Along with the benefits, which were explained above, come the costs of participation. Primarily, the cost is the chance of getting caught. The activity is, in fact, illegal, and many find this to be a tremendous cost. Individuals will choose not to participate unless the benefits exceed the costs.

Consequently, as the tax rates increase, individuals are more likely to choose to participate. The costs have remained stable, but the benefits (forgone taxes) have increased. Laffer and many other market analysts reveal that the participation level in the United States is excessively high. This is evidence that the tax rate in the United States is higher than the optimal level (point C on the Laffer curve).

II. A Tax Reduction Proven by History

The policy implications from this economic thought has not gone untested. John F. Kennedy, during his term of presidency, advocated a massive revamping of the tax structure. His plan called for a significant decrease in both personal and business income taxes. Kennedy argued that the tax reductions would result in a marked upturn of the economy. This would occur for various reasons. First, Kennedy claimed that the tax cut would increase personal consumption. In other words, the demand for consumer products would increase. This, in turn, would cause increased investment by business and an increase in the demand for labor. The end result is an increase in jobs for individuals. Consequently, a general increase in income would result. More individuals would be working thus increasing personal income. In addition, business profits would increase as a result of the increased product demands. So, although the tax rate would be lower, the increase in income would result in an increase in government tax revenues.

Kennedy also contended that these tax measures would protect against recession. Finally, he assured

that they would strengthen the U.S. dollar throughout the world by making investment in America more attractive.[2]

Kennedy's tax reduction bills were not passed before his death. So Lyndon B. Johnson took over where Kennedy left off. Johnson urged that the bills be passed immediately. Finally on February 26, 1964, Johnson signed into law the largest tax cut in the history of the United States. At the signing, Johnson reaffirmed Kennedy's beliefs by stating that the bill would encourage growth and prosperity in the United States. The incomes of millions of individuals and most businesses would immediately begin to increase. Personal federal income taxes, Johnson explained, were cut by nearly 20 percent. Corporate rates decreased from 52 to 48 percent.[3]

An evaluation of the results of this legislation seems to substantiate supply-side economic thought. For its first two years, the tax cut amounted to a 14 billion dollar decrease in taxes. Furthermore, it was accompanied by a 6.5 billion dollar increase in government tax revenues. For the first year some additional statistics were expressed. Gross national product, for instance, increased by 6.6 percent over the 1963 level. Personal income rose by 5.9 percent while corporate profits increased by 12.3 percent.[4]

In addition, the amount spent by businesses for plant and equipment increased by 12 percent in the initial year.[5]

Although Kennedy and Johnson advocated the same type of fiscal policies as are recommended by the supply-siders, they were not, in fact, using supply-side analysis at all. Kennedy's key argument was that the cut in taxes would lead to an increase in consumer demand. He was attempting to fight the recession from the "demand" side of the economy. Supply-siders, on the other hand, view the situation from an entirely different perspective. Supply-siders feel that taxes act as disincentives which stifle production.

III. Hope For Economic Recovery

Recently, several politicians have become converted to the supply-side school of economic thought. Congressman Jack Kemp and Senator William Roth were among these converts. They designed a bill to reduce disincentives to the workers by way of a major tax cut. The Kemp-Roth bill was introduced into the House and the Senate on July 14, 1977. It was met with skepticism,but its supporters did not resign themselves to defeat. They campaigned heavily for the bill by explaining the reasoning behind the proposal.

During this time, President Carter developed a plan supplying some taxpayers with a $50 rebate. Neither Democrats nor Republicans were enthusiastic about the proposal. Many felt that the $50 was not enough impetus to get the economy rolling. Senator Dole also argued that the one-shot tax rebate would be inflationary. It would increase consumer demand while product supply remained constant. The Kemp-Roth proposal, on the other hand, would be strong enough to get the economy moving without the inflationary pressures. This bill would lessen the disincentives for the labor force. In other words, more

people would want to work more hours. In addition, the companies receiving tax breaks would have an incentive to produce more goods which, in turn, results in greater profits. Both individuals and companies would be permitted to keep a larger percentage of "the fruits of their labor". So the Kemp-Roth bill, which increases supply rather than demand, would not be inflationary.[6]

In 1981 Ronald Reagan became President. As governor of California, Reagan had been convinced by supply-side economic thought and advocated the Kemp-Roth bill. He continued his efforts by encouraging a revamp of the tax structure in order to stimulate the economy. At the time, inflation was extremely high. Reagan, consequently, was faced with an economy which was in a recession yet suffering from high inflation. He had to plan a recovery system with great care so as not to feed the inflation. The outcome consisted of tax reductions to fight the recession and tight monetary policy to combat inflation.

Some economists do not agree with the supply-side analysis and Reagan's policies. Economist John Kenneth Galbraith contends that Reagan's two policy tools are, at best, contradictory. Supply-siders feel that a cut in taxes would increase consumer savings and

investment rather than increasing consumption. Galbraith argues that there is no guarantee that this would be true. The tax cuts may, in fact, result in an increase in consumption instead of investment. Furthermore, tight monetary policy is achieved by keeping interest rates high. High interest rates always cause a decrease in investment. So the best possible outcome would be an increase in investment from the tax cuts which would be offset from the decrease due to monetary policy. The worst outcome would be a decrease in investments from both policies.[7]

Other economists feel that in theory the supply-siders may be correct, but in practice the policies will not be effective. It is, perhaps, true that the tax cut will increase investment and savings. But accompanying the increase in private savings comes a decrease in tax revenues. The budget will not be cut sufficiently to offset the lack of revenues. Hence, huge budget deficits will come into existence. The government finances budget deficits through borrowing. The result is known as "crowding out." The tax reduction was supposed to allow individuals to save money thus increasing the source from which business can borrow for plant expansion. However, with large deficits, the government will be competing to borrow the same money. In other words, the government

"crowds" the private sector out of the borrowing market. Consequently, no benefits to the economy would be realized.

Supply-siders and President Reagan, however, have rebuttals for these attacks. The first is to J. Kenneth Galbraith's contention that there is no guarantee that the individuals will save rather than spend the remittance from the tax reduction. Reagan, on the other hand, claims that individuals will make rational economic decisions between saving their extra money and spending it. He says, "After a tax-rate reduction, each dollar spent on current consumption is more expensive in terms of the higher (after tax) future income stream given up by not saving."[8]

In addition to the theoretical argument above that individuals will save rather than spend, empirical data is available to support the idea. Again, one need only look back to the 1960's for substantiating evidence. During the early part of the decade, savings rates in the United States were declining. Following Johnson's tax cuts in 1964, the savings rate rose sharply. Furthermore, it remained high for approximately ten succeeding years. It was finally pushed down by successive increases in the marginal tax rates.[9]

Paul Craig Roberts, Assistant Secretary of the Treasury, feels that a tax reduction today will have an even bigger impact on the savings rate than did the one in the sixties. Currently, inflation has caused bracket creep. The marginal tax rate of a median income family today has suffered an increase of 65 percent over that of the median income family in the 1960's. Roberts asserts that the Keynesians (a traditional school of economic thought) were concerned about disposable income and the ability to consume. Hence they lowered the effective tax rate. They failed to consider, however, the increasing disincentives to produce additional income. If these disincentives are recognized, one can see the need for lowering marginal tax rates.[10]

The second argument against a tax reduction was that it would result in tremendous deficits. Congressman Kemp declares that the tax cut would result in neither inflation nor a huge deficit. He cites four reasons for this. First, it would increase Gross National Product. GNP is the tax base, and hence some or all of the tax revenues will be recovered. Second, it would cause individuals to change their savings from low-yield tax-sheltered investments to high-yield taxable investments. This would further increase the tax base. Third, it would increase the

total amount of savings by making saving more profitable after taxes. Kemp realizes that some of this increase in savings will be required by the government to finance the deficit; however, he still feels there will be a sufficient amount in excess for the private sector. Finally, Kemp states that Federal spending could be reduced because the incentives for employment and output have increased. Thus, unemployment and social welfare payments should conceivably diminish.[11]

The heated campaigns and arguments finally culminated in the passage of the Economic Recovery Tax Act of 1981 on August 4, 1981. This Act instituted significant changes in the taxation of both individuals and businesses. Persons will receive a reduction in the individual tax rate over a four year period. The long-term capital gains tax is also reduced. Several policies were adopted to provide incentives for individuals to save or invest their money. "All-Savers Certificates" were designed for individuals whose marginal tax rates are greater than 30 percent. The interest on these certificates, set at 70 percent of the current yield on a 52-week Treasury bill, is excludable up to $1,000/$2,000 on a joint return. There are several other savings incentives, as well.[12]

One may wonder if this Act will indeed induce individuals to save their money. The U.S. News and World Report conducted a survey across America asking people what they were going to do with their extra money. It was found that most of lower and middle income people realized that their increase in income would be negligible. Most said they would simply use it to pay off debts. This, however, would accomplish the intended purpose. As individuals pay back outstanding loans, the supply of money available for business to borrow from increases. Furthermore, the high income individuals stated that they would use the additional take-home pay to increase their investment portfolios. So it appears that the Act will indeed increase the supply of money which businesses may borrow for plant expansion.[13]

The Economic Recovery Tax Act also provides incentives for businesses to reinvest and expand the company. It extends the carryover period for losses and credits to 15 years. It also increases the corporate charitable contribution deduction limit from 5 percent to 10 percent of its taxable income. Another important provision revises the determination of the depreciation expense allowable for tax purposes.

IV. Changes in the Depreciation Deduction

For many years, businessmen possessed a great deal of freedom in choosing how to charge depreciation. The Treasury professed that a person can only write off an asset once. Therefore, it made no difference as to how or when the depreciation was taken. In 1934, during the Great Depression, Congress needed money and decided to change the rules for the depreciation deduction. They wanted to arbitrarily cut depreciation allowances by 25 percent for three years. The Treasury feared "what that might do to the staggering economy" and "promised to undertake the job of trimming down depreciation allowances by its own methods."[14]

The Treasury developed a detailed schedule (Bulletin F) which estimated useful lives for 5,100 items of plant and equipment. This was an official schedule of estimates, and each company was encouraged to use it as a guideline. The Treasury also came out with a decision which strongly urged businessmen to utilize the straight line method of depreciation. Although this method was not made mandatory, businessmen wisely accepted the suggestion.[15]

In 1954, Congress passed a tax law which only

slightly alleviated the previous restrictions. They explicitly gave approval to two additional methods of depreciation--sum-of-the-years-digits and declining balance. For the declining balance method, Congress authorized a rate equal to double the straight line rate (double declining balance). Congress also approved all other accelerated methods provided that the results do not exceed the results obtained by using the double declining balance method.[16]

The adoption of one of the accelerated depreciation methods was not a decision to be taken lightly. It was necessary to keep in mind that one was not avoiding taxes but merely deferring them. During times of rising tax rates, this may not be desirable. Furthermore, one must examine the impact of the accelerated method in the annual report. Businessmen would like to minimize income on the tax return yet maximize it for the annual report to the stockholders. The company may use an accelerated method for the tax return and straight for reporting purposes. This, however, requires that the company keep two sets of books. Each business would have to separately decide whether or not the tax benefit was worth the added bookkeeping expense.[17]

Many companies in 1954 decided in favor of adopting an accelerated method. These were growing

companies who took advantage of the deferred cash outflow (taxes) and used the money for reinvestment and expansion of the company. In addition, these growing companies would not have to be concerned about "running out" of depreciation in the future because of the continuing outlay for capital expenditures.[18] There was another advantage of choosing the declining balance method rather than straight line or sum-of-the-years-digits as well. If a businessman first chose one of the latter two methods, he could change his election only through negotiations with the IRS. However, if he first chose declining balance, he could later switch to straight line with no problem if he so desired.[19]

The next attempt at liberalizing the depreciation deduction came in 1962. The IRS issued a new booklet called "Depreciation Guidelines and Rules." It contained estimated lives which were approximately 30-40 percent shorter than the ones suggested in Bulletin F. It also simplified the procedure by establsihing about 75 broad classifications of assets instead of the previous detailed list. From 1962 through 1964, a taxpayer was permitted to adopt the new guideline lives without being challenged by the IRS during an audit. Beginning in 1965, however, the IRS could test the taxpayers' replacement policies to see whether

or not the actual useful lives were appropriately shortened.[20]

In 1971, a further liberalizing step was taken by the Treasury Department. The Asset Depreciation Range (ADR) System was established. It retained the idea of asset classes but made two important changes. First, this guideline provided a choice to the tax-payer to elect useful lives of up to 20 percent shorter or longer than those previously established. The second major change stated that the useful life which the taxpayer chose could not be challenged by the IRS during an audit.[21]

The Economic Recovery Tax Act of 1981 brought about a tremendous change in depreciation determination. The amount of the deduction no longer depends on the useful life. No attempt is being made to match the expense of the asset with the income it produces. Instead, the investment is written off according to a fixed schedule over a period of three, five, ten or fifteen years.[22] The system is called the "accelerated cost recovery system"(ACRS). It allows a much faster write-off without regards to estimated life and salvage value.

The purpose of ACRS is to give greater incentives for business to expand their companies. It was designed "to stimulate capital formation, increase pro-

ductivity, improve the nation's competitiveness in international trade and encourage economic expansion."[23] The property which is eligible for ACRS consists of all tangible depreciable property. This includes both real and personal property. The businessman is required to use ACRS on all eligible property. In addition, new and used property are both "recovered" according to the same schedule. No distinction is made between the two.

ACRS permits greater deductions in the first few years. This defers the tax liability. In addition, deferral lowers the present value of the tax payments which increases the after-tax return on investments. The results should be increased plant expansion which leads to more available jobs and an overall increase in the productivity of the country.

V. Conclusion

The Economic Recovery Tax Act of 1981 is a very comprehensive and complicated Act which should be conducive to bringing an end to the current recession. There are many provisions in the Act which were not covered in this paper. Yet those chosen and discussed herein are representative of the thought behind and the purpose of all of the provisions. Incentives have been established for individuals encouraging increased labor output and the savings and investment of the subsequent increase in disposable income. Businesses have been furnished with incentives to increase investments in plant and equipment. Theoretically, the increase in demand for investment funds by businesses will be adequately supplied by the increase in savings by the individuals. Therefore, the Act will not force inflationary pressures upon the economy. The policies set forth in the Act have been previously utilized and tested in the United States and appear to have been quite successful. There is no one who can be certain whether the Economic Recovery Tax Act will succeed in its attempts to adequately stimulate the economy. Supply-side economic theory and all other

economic theories are just that - theories. Only time will tell if policies which appear to be effective on paper are, in fact, successful in the real world.

Endnotes

[1] Cong. Rec., 26 Jan. 1978, pp. 211-213

[2] John F. Kennedy, "As Tax-Cut Drive Heats Up--Kennedy versus Republicans," U.S. News and World Report, 30 Sept. 1963, pp. 84-85.

[3] Lyndon B. Johnson, "The Tax-Reduction Bill: What It Means to You," Vital Speeches of the Day, 15 March 1964, p. 322.

[4] "A Tax Theory That Has Proved Out in Practice," U.S. News and World Report, 26 July 1965, p. 85.

[5] "U.S. Counts Its Gain From Tax Cut," U.S. News and World Report, 17 May 1965, p. 102.

[6] U.S. Senate, Hearings Before the Committee of Finance, by Senator Robert Dole, 96th Cong., 2nd sess., 23 July 1980 (Washington, D.C.: GPO, 1980), pp. 8-11.

[7] John Kenneth Galbraith, "The Market and Mr. Reagan," The New Republic, 23 Sept. 1981, pp. 15-18.

[8] Paul Craig Roberts, "The Tax Cut Will Help Savings," Fortune, 24 Aug. 1981, p. 44.

[9] Ibid.

[10] Ibid., p. 45.

[11] Cong. Rec., 14 July 1977, p. 7157.

[12] Peat, Marwick, Mitchell and Company, The Economic Recovery Tax Act of 1981, (United States: Peat, Marwick, Mitchell and Company, 1981), pp. 1-6.

[13] James M. Hildreth, "What People, Business Will Do With Tax Cuts," U.S. News and World Report, 17 Aug. 1981, pp. 22-23.

[14] "Write-Off Boost for Business," Business Week, 7 Aug. 1954, p. 50.

[15] Ibid.

[16] Ibid.

[17] "It's Not an Automatic Choice," Business Week, 22 Jan. 1955, p. 102.

[18] Ibid. p. 104

[19] Ibid. p. 99.

[20] Raymond F. Gehan, "Depreciation," in Accelerated Cost Recovery System (United States: Deloitte, Haskins and Sells, 1981), pp. 5-6.

[21] Ibid. p. 6.

[22] Emil M. Sunley, "An Economist's Perspective," in Accelerated Cost Recovery System (United States: Deloitte, Haskins and Sells, 1981), p. 115.

[23] Gehan, p. 7.

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