Policy Analysis

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Executive Summary

On September 10, 1984, Walter Mondale unveiled a tax and budget plan to reduce the federal deficit by two-thirds. The plan, which was issued in the form of a news release, offers nothing new or original--simply more of the traditional liberal economic policies of high taxes and increased federal spending. The plan envisages higher spending and dramatically higher taxes. Furthermore, many of the claimed savings and some of the increased revenues are illusory.

The Mondale plan's alleged effect on the FY 1989 budget is set forth in Table 1. An analysis of each of the items listed there will illustrate the dubious nature of much of the plan.

Tax Increases

Mr. Mondale would increase individual taxes by $46 billion in three ways: (1) he would modify tax indexing so that tax brackets over $25,000 would be indexed only to the extent that inflation exceeds 4 percent annually; (2) he would repeal the third year of the tax cuts embodied in the Economic Recovery Tax Act (ERTA) of 1981 for people with incomes over $60,000 (if filing jointly) and $45,000 (for singles); (3) he would impose a 10 percent surcharge on the amount of tax owed on incomes over $100,000 (if filing jointly) and $70,000 (for singles).

Mr. Mondale thus advocates virtually repealing indexing for over half of all taxpayers. This "reform" accounts for the bulk of all revenue that he would raise from individuals.[1] The middle class simply must bear the brunt of any major tax increase because, as Willie Sutton used to say, that is where the money is. It is an unavoidable fact--and Mondale has acknowledged it by the structure of his proposal--that most taxable income in the United States is earned by the middle class.

The wealthy do not benefit appreciably from tax indexing because they cannot be forced by the ravages of inflation into higher and higher tax brackets--they are already as high as they can go. Inflation increases taxpayers' nominal incomes but not their inflation-adjusted (real) purchasing power. As inflation

Table 1	
PROJECTED FY 1989 CBO DEFICIT	($263 billion)
Increased Taxes	
Individual	$46 billion
Business/Upper Income	$25 billion
Compliance/Enforcement	$10 billion

Tax "Freeze" Extension	$4 billion
TOTAL TAX INCREASE	$85 billion
Spending Cuts	
Defense	$25 billion
Health	$12 billion
Agriculture	$4 billion
Miscellaneous	$8 billion
TOTAL SPENDING CUTS	$49 billion
Spending Increases	
TOTAL SPENDING INCREASES	($30 billion)
SUBTOTAL, DEFICIT REDUCTION PACKAGE	$103 billion
Other Assumed Savings	
Higher Growth	$17 billion
Improved Management	$5 billion
Reduced Interest Expense	$51 billion
TOTAL ASSUMED SAVINGS	$73 billion
REMAINING DEFICIT	$86 billion
TOTAL "DEFICIT REDUCTION"	$177 billion

Source: "The Mondale Budget Program," news release, September 10, 1984.

pushes them into higher tax brackets, the government takes an increasing proportion of their incomes. Thus, although their pre-tax real incomes may remain constant, their after-tax real incomes will fall and the government's real tax revenues will rise. To the extent that Mondale inflates the economy and succeeds in pushing middle-income taxpayers into ever higher tax brackets, his modification of indexing would increase tax rates, albeit surreptitiously, and, to a lesser extent, government revenues. Of course, the very fact that Mondale plans to gain so much revenue from repeal of indexing is a strong indication that he does not intend to reduce inflation. As Tom Bethell has said, you can't have bracket creep without the creep--repeal of indexing only "works" to the extent that you keep inflation going.

Mondale would repeal the final 10 percent across-the-board tax cut, which went into effect July 1, 1983, for those earning over $60,000 (if filing jointly) and $45,000 (for singles). This proposal would effect about one taxpayer in 15.

The 10 percent surcharge on taxes incurred on incomes over $100,000 (if filing jointly) and $70,000 (for singles) would raise marginal tax rates on top-rate taxpayers to 55 percent. For example, a taxpayer with $150,000 in taxable income would pay 50 percent of the amount over $109,400 (or $20,300) plus 10 percent of $20,300 (or $2,030). This is precisely the same as if the marginal rate above $109,400 were 55 percent.

The basic impact of the Mondale plan is clear: a rise in the marginal tax rates and a rise in the total tax burden on most Americans. The rate increases would be highest for upper-income families, but the bulk of the government's revenue would come from the middle class.

Such a policy is counterproductive if the point is to reduce the deficit rather than merely to punish those "greedy" souls brazen enough to earn large incomes. Recent Internal Revenue Service statistics persuasively show that the ERTA reduction in top rates from 70 percent to 50 percent for high-income taxpayers has actually raised government tax revenues and increased the proportion of the total tax burden actually borne by the well-to- do. "Supply-side" effects increased the tax base so dramatically that those earning over $500,000 annually paid 39 percent more taxes. Furthermore, their share of the total tax burden increased from 3.1 percent to 4.4 percent. The Mondale tax plan, by implementing tax policies opposite to those embodied in ERTA, would actually reduce government revenue, increase the proportionate burden of middle- and lower-income taxpayers, and slow economic growth.

Details of the effects of the first-year ERTA tax cut are set forth in Table 2.

Table 2 Tax Share under the ERTA 1981-82 Tax Cut					
Net Income Group($)	Tax Revenues Collected (millions of $)		Change(%)	Share of Taxes Paid (%)	
	1981	1982		1981	1982
0-10,000	8,634	7,627	-12	3.0	2.7
10-15,000	17,680	15,873	-10	6.1	5.6
15-20,000	23,385	20,425	-13	8.0	7.2
20-50,000	145,412	140,135	-4	50.0	49.1
50-100,000	52,156	51,732	-1	17.9	18.1
100-500,000	34,613	36,723	+6	11.9	12.9
500-1,000,000	4,118	5,719	+39	1.4	2.0
1,000,000 and up	4,901	6,945	+42	1.7	2.4

Source: Internal Revenue Service

The results of the tax cut are the most dramatic among upper-income groups for two reasons. First, the upper-income taxpayers' entire tax cut came in the first year. The top income tax rate on investment income was reduced from 70 percent to the maximum on employment income, 50 percent. Later tax cuts did not benefit top-bracket taxpayers substantially, since they faced the same tax rate of 50 percent even in later years. Second, because tax rates are higher in our progressive tax system for upper-income taxpayers, tax considerations loom large in their economic decision making. Reduced taxation has its greatest positive effects among those most heavily taxed.

Similarly, Mondale's repeal of both indexing and the third- year tax cut would constitute counterproductive disincentives to work, save, and invest which would reduce economic activity and harm the recovery. The Mondale plan would impose a 15 percent minimum corporate tax on economic income. The plan failed to define "economic income," but in light of proposals put forward by the Democratic Study Group early in the 1984 tax bill deliberations, the Mondale minimum tax and the "limitations on tax shelters, loopholes and accounting abuses" could easily raise the $25 billion claimed for them.

The utter lack of specificity in Mr. Mondale's proposal makes analysis difficult. Presumably, "base-broadening for business" translates into an attack on the Accelerated Cost Recovery System (ACRS), the investment tax credit (ITC), and various expensing provisions in the tax code. ACRS was enacted in 1981 and has exceeded expectations in its positive impact on investment in plant and machinery, which is at a 30-year high.

This boom in investment is critical if we are to sustain the high rates of economic growth that we have witnessed during the recovery. ACRS and the ITC, combined with lower tax rates, represent an important abatement of the tax bias against savings and investment. The markets are reflecting this step toward neutrality by increasing investment (and therefore future growth) by 16.5 percent in the past five quarters.

Mondale's proposal would evidently take us back to the days before ERTA when inadequate depreciation allowances were causing American capital stocks to age and our competitive position to decline at an alarming pace.

Both the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984 contained many new, burdensome compliance and reporting provisions. These are expected to raise only a few billion dollars. Mondale proposes "measures to improve compliance" which would increase the government's tax take by over $10 billion (or over 10 percent of the underground economy). In light of the provisions already implemented by the 1982 and 1984 acts, there is every reason to believe that it would be virtually impossible to raise $10 billion without either imposing crushing administrative burdens on small businesses or violating innocent taxpayers' rights.

The Mondale tax "freeze" which he claims will raise $4 billion consists of repealing or postponing tax reductions which are scheduled to go into effect under present law. For example, the amount of depreciable property that can be expensed rather than depreciated is scheduled to increase from $7,500 to $10,000. Telephone excise taxes are scheduled to expire but would be extended. Top estate and gift tax rates are scheduled to decline from 60 percent to 50 percent but would not under the Mondale proposal.

Proposed Expenditure Reductions

Mondale claims he is going to create "stronger conventional forces" (necessary to make up for reduced nuclear forces) and yet save $25 billion (about 6 percent of the defense budget) in FY 1989. Since strategic nuclear weapons account for only about 20 percent of the defense budget (about $90 billion in FY 1989), Mondale would have to reduce our nuclear forces by over one-third to both save $25 billion and finance a stronger conventional defense. Such a drastic cut in strategic deterrence is highly unlikely. Mondale explains neither the implications of such cuts nor how he would achieve them. (His figures are especially hard to understand when one realizes that he intends to build two new strategic weapons systems, the stealth bomber and the Midgetman ICBM.)

Although his press release is not clear on this point, Mondale evidently would attempt to save the government $12 billion annually through a price-fixing scheme on physician and hospital fees. But history has proven repeatedly that price controls are both counterproductive and ineffective. Either the quality of medical care will decline or market prices will be reflected in other ways. In any case, Mondale's plan to set federal spending limits and leave the states "free to design their own strategies" virtually guarantees that no change will occur.

The agricultural program referred to in Mondale's plan is not really a program; it consists of savings of $4 billion from "prudent management," even "while improving farm incomes." The press release provides no additional details.

Mondale also claims that he would eliminate $5 billion in "waste, fraud, and abuse" that the Reagan administration would leave untouched. This is a dubious claim at best, in light of Mondale's past record as a less-than-ardent foe of profligate government and the failure of the Reagan administration to find and eliminate such readily apparent "waste, fraud, and abuse."

Mondale would increase spending $30 billion in unspecified ways. But $30 billion seems a low figure in view of his many campaign promises, and others have estimated the costs of his programs to be far greater. Wall Street Journal reporter John J. Fialka, for instance, conservatively estimated that as of January 1984 Mondale's promised programs would cost at least $45 billion a year and perhaps as much as twice that.[2] Mondale also claims that he would reduce domestic discretionary spending by $8 billion, without specifying which programs he would ax.

The Real Mondale Program

Table 3 shows what is left of the Mondale program once the bald, unspecified pledges are removed from the calculations. Note that the tax increases are 90 percent of Mondale's actual package. The ratio of tax increases to spending cuts is ten to one.

Mondale's assumptions of higher growth (to which he credits $17 billion of deficit reduction) are curious, given the program he has put forth. His proposal does not reduce either the government's spending or its tax drag on the economy. To the contrary, it increases the tax rates that economic actors must face and would, therefore, likely reduce economic activity and economic growth rates.

His projected interest rate savings are based on the utterly incorrect premise that a massive tax increase, similar to that of 1982, would cut interest rates by 2.5 percent from present levels. The 1982 tax increase did not succeed in reducing interest rates. In fact, programs like it and the proposed Mondale tax increase simply exacerbate the tax bias against savings, reduce the savings pool, and gradually force interest rates to increase.

Table 3	
Increased Taxes	
Individual	$46 billion
Business/Upper Income	$25 billion
Tax 'Freeze' Extension	$4 billion
TOTAL TAX INCREASE	$75 billion
Spending	
Proposed Increases	($30 billion)
Defense Cuts	$25 billion
Health Cuts	$12 billion
TOTAL SPENDING CUTS	$7 billion
TOTAL DEFICIT REDUCTION	$83 billion

In sum, the Mondale plan is based on discredited economic theory backed by unsubstantiated predictions. To the extent that the plan has substance (mostly on the tax side), it would aggravate, rather than solve, our economic difficulties.

FOOTNOTES

[1] The Congressional Budget Office estimates that repealing indexing for all taxpayers would raise $65 billion in FY 1989. See Reducing the Deficit: Spending and Revenue Options, part 3 (February 1984), p. 189.

[2] John J. Fialka, "Pledges by Mondale Add Up to a Big Bill, An Analysis Suggests," Wall Street Journal, January 24, 1984, p. 1.