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INFORMATION

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MEMORANDUM FOR: SECRETARY REGAN

From: Greg Ballentine GB
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Subject:
The Burden of Taxes and the Burden of Government: A Non-political Discussion.

In the ongoing discussion of possible tax increases, we should not accept the conclusion that raising taxes necessarily imposes a direct burden on the private economy. The direct government burden on the private economy is determined by the government's use of real resources. Essentially that burden is measured by the level of government expenditures.

Given any level of government expenditures, debates over raising tax revenues or borrowing more (running a larger deficit) are arguments about how to finance the burden of government and not the magnitude of the burden. A decision, for example, to raise excise tax revenues and borrow less does not impose an additional direct burden on the private economy, it only finances the burden differently.

Indirectly, taxes can impose an additional burden on the economy because they may distort incentives. That is, they can cause the private economy to use resources in an inefficient way, devoting, for example, too much production to consumption goods or too much time to leisure.

But borrowing imposes a special burden also, for it directly lowers private investment. We have acknowledged this when we have argued that even though future deficits may be large, the pool of savings will have increased so much that even after government borrowing, more savings will be available for private investment. This same reasoning also implies that if taxes were raised in a way that does not discourage private saving, then the reduced deficit would allow for still more private investment.

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
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Initials / Date	/	/	/	/	/	dp / 10/30

OS F 10-01.II (2-80) which replaces OS 3129 which may be used until stock is depleted

A carefully selected increase in certain taxes should not be viewed as a rollback of the tax cut. To the extent that the tax cut was simply an accompanyment to a cut in the burden of government, the tax cut was rolled back when we recognized that expenditures will not fall as much as hoped. But the recent tax cut was more than that, it was a cut in marginal rates and in taxes on savings specifically designed to improve incentives. Tax increases can be found which will not reverse that effect of the tax cut and which are superior to borrowing as a means of finance. Except for the corporate speed-up, the six revenue enhancement measures mentioned in the President's speech are examples of such tax increases.

A reasoned approach to the current problems must recognize that all tax increases are not bad policy compared to heavy borrowing. But there is a clear danger that in attempting to raise the right taxes, we may end up with the wrong tax increases and thereby rollback the improved incentive structure obtained under the recent tax bill.

The Effect on Fiscal Year Receipts *
of Selected Revenue Raising Proposals

(Based on Fall Review Economic Assumptions)
($ billions)

	Fiscal Years 1982	1983	1984
Excise taxes: (April 1, 1982):			
Double tobacco tax rates..................	0.7	1.8	1.8
Increase telephone tax rate to 4 percent	0.5	1.4	1.6
Double beer and wine tax rates...........	0.5	1.3	1.3
Double distilled spirits tax rate........	0.7	2.1	2.3
Total..................................	2.4	6.6	7.0
Motor fuels tax options (April 1, 1982):			
Double motor fuels tax..................	1.5	3.2	3.1
Increase motor fuels tax from 4 cents to 7 cents in 1982, 10 cents in 1983, 14 cents in 1984 and thereafter.......	1.1	3.5	6.0
$3 Oil tax options (April 1, 1982):			
$3 Import fee:			
Tax on imports..........................	1.9	5.4	5.4
Net windfall profit tax..............	1.1	2.5	2.1
Total..............................	3.0	7.9	7.5
$3 Excise:			
Tax on imports..........................	1.9	5.4	5.4
Tax on domestic production............	3.0	8.6	8.6
Total..............................	4.9	14.0	14.0
Windfall profit tax on natural gas revenues from accelerated decontrol (April 1, 1982):1/			
With no oil import fee.................	0.9	6.4	11.5
With $3 oil import fee.................	1.0	7.2	13.0

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1/ Based on Midsession Review economic assumptions.

* See the attached note for an explanation of these estimates.

Consequences of Excise Tax Increases on the Economy

Some have suggested that the solution to a perceived deficit problem should consist of further (unspecified) spending cuts coupled with massive--perhaps $45 billion--of excise tax increases in 1984. Putting aside the issue as to whether this is a problem for which tax increases are appropriate or even necessary, it is important to understand the economic effects of excise taxes.

Excise taxes are indirect business taxes which are subtracted from GNP in order to reach the profit and wage shares which comprise the income tax base. Any increase in indirect business taxes must, by definition, widen the gap between GNP and the tax base. If GNP in future years is fixed by overall economic policy then an increase in excise taxes must lower taxable incomes thus decreasing the revenue effect of the rise in excise tax rates.

In other words, any increase in gross excise tax collections will overstate the reduction in the budget deficit because there will be a partially offsetting loss of income tax receipts. The exact size of this loss is equal to the gross excise tax change multiplied by an overall marginal income tax rate of about 27 percent.

Consistent with this view is the conclusion that the overall level of prices (e.g., the CPI) will not increase as the result of an excise tax change. There will be increases in the price of goods directly or indirectly impacted by the excises. For example, an excise on crude oil will directly increase the price of gasoline and heating oil and will indirectly increase the price of oil based products such as plastics and fertilizers. These price increases will, however, be relative price increases only, since predetermined levels of nominal GNP will play a constraining role forcing prices of other goods and services down.

The alternative view, that excise tax increases will somehow raise the general price level by forcing nominal GNP higher than levels considered in the economic scenario, relies ultimately on the notion that monetary authorities will accommodate a tax increase in order to preserve former levels of taxable income. This is an unrealistic expectation. If the Fed wished to reduce a receipts shortfall by increasing the supply of money, that judgment would be independent of a Treasury decision to raise taxes.

The estimated receipt changes resulting from the excise tax proposals shown on this table take into account the income tax loss described above. Thus, these estimates may correctly be added to the level of receipts estimated for the Fall Budget Review without overstating the resulting improvements in the deficit.

Excise Taxes on Telephone Service, Distilled Spirits, Beer and Wine, and Tobacco

Proposals: The excise taxes on distilled spirits, beer and wine, and tobacco would be doubled. The telephone excise tax, which is scheduled to fall from 2 percent to 1 percent on January 1, 1982 and expire on January 1, 1985 would be raised to 4 percent and made permanent.

Pros:

- Such tax increases would restore the previously legislated real burden of these taxes, which have been largely eroded by inflation.
- The increases would compel users of alcohol and tobacco to bear more of the costs of Federal programs for health care and highway safety necessitated by alcohol and tobacco use.

Cons:

- Excise taxes reduce the incentive to work by reducing real after-tax wages.
- Excise taxes distort relative prices and therefore interfere with consumption choices.
- Excise taxes on these items are generally borne disproportionately by low-income families. However, for these particular excises, the effect is likely to be small.

Excise Tax on Gasoline

Proposal: Double the present 4 cent per gallon Federal excise tax on gasoline used as a motor fuel and on other motor fuels.

Pros:

- This proposal would partially restore the effective tax on gasoline as a percent of sales that has been eroded by rising prices. The effective rate would still be only about 10 percent, as compared to 11 percent in 1975 and 23 percent in 1970.
- By raising the price at the pump, the tax would help to reduce gasoline consumption and, thus, reduce dependence on imported fuel.
- Reduced demand for motor fuels would help to hold down prices on heating oil, industrial fuels, other petroleum-based products or close substitutes.
- As a tax on a consumption item, this tax is consistent with a policy to promote saving.

Cons:

- The present Federal gasoline tax is a user charge to help pay for highway construction and maintenance. An additional tax for the general fund has no such rationale.
- Decontrol of petroleum prices has provided appropriate market incentives to conserve gasoline use. An additional tax on gasoline, not tied to highway costs, discriminates unfairly against consumers of this particular commodity. Gasoline use is disproportionately large in Western states and rural areas. (Per capital consumption is three times as high in Wyoming as New York.)
- The tax would be regressive by income class.

Oil Import Fee or Oil Excise Tax

Proposal: Impose a $3 per barrel fee on imported oil, or a $3 per barrrel excise on all oil

Pros:

- o The fee or tax would reduce dependence of U.S. economy on insecure foreign oil sources by reducing imports.
- o The proposal involves direct reliance on the price mechanism to reduce imports, rather than on cumbersome and inefficient regulations and subsidies.
- o The fee or tax would be an appropriate way to finance the Strategic Petroleum Reserve.
- o A small import fee or excise tax would raise considerable revenue without raising prices much above those prevailing earlier in 1981.

Cons:

- o Taxes on consumption reduce incentives to work, by reducing real after-tax wages.
- o Excises discriminate among forms of consumption and therefore represent a direct interference in consumer choice.
- o Taxes on oil consumption impose a disproportionate burden on lower-income families who generally must spend a larger amount of their incomes on oil-based products than higher-income families spend.

Natural Gas Decontrol and Windfall Profit Tax

Proposal: Decontrol natural gas and impose a tax on a portion of the "windfall" profit.

Pros:

- o The combined program would increase profits of natural gas producers, stimulate domestic energy production, and reduce dependence on imported oil.

- o The proposal would make decontrol politically more palatable by softening the impact of income transfer from natural gas consumers to natural gas producers.

- o The tax would raise significant revenues.

Cons:

- o Decontrol alone would increase the price of natural gas to consumers and increase returns to producers. The tax would not affect the price consumers pay, since this price would be determined by world oil prices, but the tax would reduce the return to producers, and therefore remove part of the stimulus to domestic production provided by decontrol.

Comparison of Stockman-type Budget Deficit Resolution
with the Recently Enacted Tax Cuts

(Based on Fall Review Economic Assumptions)
($ billions)

	Fiscal Year 1984
Recently enacted ERTA tax reductions:	
Individual rate reductions and marriage penalty relief....................	$-107
All other provisions........................	- 38
Total ERTA................................	$-145
Possible revenue raising proposals............	$+ 45
As a percent of individual rate reductions and marriage penalty relief................	42%
As a percent of the total Economic Recovery Tax Act of 1981 (ERTA)...........	31%

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In the context of the previous table, it is misleading to separate the individual tax cuts in ERTA from the business tax cuts. Ultimately, all taxes are paid by people, thus the business tax cuts were part of individual tax relief just as much as the cuts in personal income tax rates. The most relevant ratio in that table is the one which shows the possible tax increase as a fraction of total ERTA cuts in 1984.