Drafting In

Volume 4
Number 2 *Draftings in Economics: Major Themes*

Article 5

1989

The Effect of the Economic Recovery Tax Act of 1981 on Saving and Investment

Cori McNeilus
University of Northern Iowa

The Effect of the Economic Recovery Tax Act of 1981 on Saving and Investment

by Cori McNeilus

In 1981, Congress passed the controversial Economic Recovery Tax Act (ERTA). ERTA reduced personal income tax rates and provided a new accelerated depreciation system for business. Supporters of the legislation predicted that the increased after-tax returns produced by these tax reductions would encourage saving and investment. This article examines the political history and economic theory behind the tax cuts and the impact these changes may have had on saving and investment.

Political Background

Prior to 1977, the Republicans advocated balancing the Federal budget by increased taxes and decreased spending. This policy hurt them politically. A change came early in 1977 when the Republican minority in Congress proposed an across-the-board tax cut. Republican Senator Jack Kemp argued that a decrease in taxes would increase savings, capital formation, productivity, real wages, and job opportunities. Democrats, on the other hand, argued that the tax cut would increase the deficit. The following year, some Democrats joined the advocates of tax cuts. In 1978, the Nunn Amendment (sponsored by Senator Sam Nunn, Democrat from Georgia) proposed a decrease in the personal income tax rate and a decrease in federal spending.

Although the Nunn Amendment was defeated during the Carter Administration, there were growing numbers of tax cut advocates in both parties in Congress. These advocates found support for their views from the country's experience with tax cuts in the sixties. President Kennedy's advisers had recommended a decrease in taxes to stimulate consumer spending. Several tax cuts were ennacted between 1962 and 1965, including cuts in personal income tax, and investment tax credits and an accelerated depreciation schedule for business. Following these tax cuts, consumer spending declined (contrary to expectations), but saving and investment rose (Brown, 1988, p. 28).

While Congress debated tax rates, the country suffered a recession in 1978 and inflation rose to 13.3 percent. As wages rose with inflation, people were placed in higher tax brackets that constrained their standard of living. Furthermore, an increase in the labor force and a decrease in capital formation (a declining capital/labor ratio) hurt productivity. Yet another problem was a decline in saving and investment. All these factors were in place when Ronald Reagan became President and urged tax cuts as a part of supply-side economic policies.

Supply-Side Economics and Tax Changes

One of the goals of supply-side economics was to improve the economy by increasing production through incentives to save and invest. The ERTA of 1981 reflected this goal. It implemented across-the-board tax cuts to increase after-tax returns that would give people liquidity and incentives to save and invest. In 1981 individual income taxes were reduced across the board by 5 percent and a 10 percent decrease was planned for both 1982 and 1983 (*Economic Report of the President*, 1982, p. 614).

The ERTA reduced business taxes as well as those of individuals. It was designed to increase business investment by decreasing the effective tax rate (the ratio of tax payments to pre-tax profits) on new investment. To do this ERTA increased the investment tax credit, increased depreciation write-offs, and decreased the average tax rates on profits.

Supply-side economics predicts that beyond a certain point, high tax rates decrease tax revenue. A tax cut would, in theory, increase growth, reduce the use of tax shelters, lessen the incentive for tax evasion and, thereby, increase tax revenue.

Advocates of supply-side policies argued that higher tax rates on the upper income group decreased tax revenue as members of this group reduced saving and investment. ERTA reduced the top tax rate on personal income from 70 to 50 percent, thus placing more of the tax burden on the middle and lower income groups (Peterson, 1988, p. 613). The top five to ten percent of earners, however, do two-thirds of the saving and investment. Accordingly, the best way to have the upper income group pay more taxes was to reduce tax rates to encourage investment. This would keep the economy growing and all would benefit (Brookes, 1982, p. 58).

Supply-side theory notwithstanding, a recession did occur in 1981. As the deficit soared and unemployment increased from 7.1 percent to 10.8 percent, Congress re-examined its tax cut policy and passed the Tax Equity and Fiscal Responsibility Act (TEFRA) in 1982 (McComas, 1984, p. 54). Overall, TEFRA resulted in a 95 billion dollar tax increase. For individuals, personal income taxes were increased. For business, the accelerated cost recovery allowance was cancelled and the basis for depreciation was decreased by one-half.

Changes in Saving and Investment: 1981-84

Statistically, the effects of the 1981-1982 tax changes did not meet expectations. While some proponents of ERTA predicted that savings would increase from 6 percent of disposable income in 1980 to 8 percent in 1984, in actuality savings declined to 4.9% in 1983 and climbed to its original 1980 level of 6% in 1984 (McComas, 1984, p. 54). Also, some economists predicted that these tax changes would increase investment from 11.5 percent of GNP in 1981 to 14.5 percent in 1984. However, investment rose to only 12.3 percent of GNP in 1984 (McComas, 1984, p. 54).

A number of factors may explain why saving and investment did not grow as predicted. First, the recession in the early eighties, influenced by the Federal Reserve's tightening of the money supply, reduced saving and investment. Second, the stock market rally in 1983 also may have decreased the level of saving; as stock values rose, individuals' net worth increased, resulting in more spending. Third, the 1982 tax increase resulting from TEFRA may have partially offset the positive effects on saving and investment expected from ERTA. Finally, uncertainty about taxes may adversely affect saving and investment. When individuals feel uncertain about income tax policies, they are afraid to take risks. As a result, individuals may increase consumption at the expense of saving, and corporations may decrease or delay investment. In addition, tax changes cause the IRS to fall years behind in issuing regulations. Therefore, companies have to interpret the laws themselves and set aside reserves in case their interpretations do not match those of the IRS (Alm, 1988, p. 237).

Studies of Tax Changes and Investment

Martin Feldstein and Lawrence Summers did extensive research on the effect of inflation and taxation on capital formation. They determined that under the tax laws of the late 1970's, the effective tax rates on capital income were greatly increased by inflation and, thereby, offset much of the favorable effects of investment tax credits and shorter depreciation lives on investment. They concluded that the total effective tax rate on capital used in 1977 was 66 percent which increased the amount of taxes paid by the corporate sector by 32 billion dollars. Without inflation, they estimated the tax rate on capital would have been only 41 percent. The higher effective tax rate would tend to lower the rate of capital formation, move investment to areas where the tax rules don't apply, and cause misallocations due to the variation among industries (Feldstein, 1979, p. 468).

There has been controversy, though, over the results of this research. Questions were raised about methodology and validity. According to Jane Gravelle, when errors in methodology and validity were corrected, the data showed that the effective tax rate in 1977 was not 66 percent but 54 percent, less than it had been in 1954 (59.8 percent) (1980, p. 480). She also found that the increase in taxes on corporations was not 32.3 billion dollars, as the Feldstein study estimated, but 21 billion dollars. It would appear that the effect of tax changes on investment remains controversial.

Other studies on the effects of tax cuts on investment examine the user cost of capital. According to Auerbach, the rate of return a firm earns on investment after taxes influences what investment projects will be undertaken (1983, p. 909). Therefore, business will invest as long as the value of returns to investment after taxes is greater than the cost of the asset. An increase in taxes will decrease incentives to invest as the user cost of capital increases.

Slemrod estimated that the tax changes in ERTA decreased the user cost on industrial equipment by only 4 percent from 1980 to 1982, but increased the user cost on office and computing equipment by 2 percent (1986, p. 63). However, this study concluded that if TEFRA had not been enacted in 1982, the user cost of office and computing equipment would have fallen by 10 percent (1986, p. 64). These figures suggest not only that ERTA may not have significantly changed the user cost of some equipment, but also that all equipment was not affected the same way.

Conclusion

The evidence presented illustrates the difficulty in determining the effects of tax changes on saving and investment. This problem is compounded by the many economic variables that coexist with tax changes. As discussed, these variables include inflation, recession, tax uncertainty, and user cost of capital. Thus ERTA was not the only factor influencing investment in the early eighties. Even in hindsight it is often difficult to tell whether tax cuts have a major impact on saving and investment.

References

Alm, James. "Uncertain Tax Policies, Individual Behavior, and Welfare," *American Economic Review,* Mar. 1988, 78, pp. 237-245.

Auerbach, Alan J. "Taxation, Corporate Financial Policy and the Cost of Capital," *Journal of Economic Literature,* Sept. 1983, 21, pp. 905-940.

Brookes, Warren T. *The Economy in Mind.* New York: Universe Books, 1982.

Economic Report of the President. Washington: United States Government Printing Office, 1982.

Feldstein, Martin F. and Summers, Lawrence H. "Inflation and the Taxation of Capital Income in the Corporate Sector," *National Tax Journal,* Dec. 1979, 32, pp. 445-470.

Gravelle, Jane G. "Inflation and the Taxation of Capital Income in the Corporate Sector: A Comment," *National Tax Journal,* Dec. 1980, 33, pp. 473-483.

McComas, Maggie. "Did Supply-Side Incentives Work?" *Fortune,* 26, Nov. 1984, pp. 53-54.

Peterson, Wallace C. *Income, Employment and Economic Growth.* New York: W.W. Norton and Company, 1988.

Slemrod, Joel. *The Impact of the Reagan Program.* Phillip Cagan, ed. Washington, D.C.: American Enterprise Institute, 1986, pp. 45-98.