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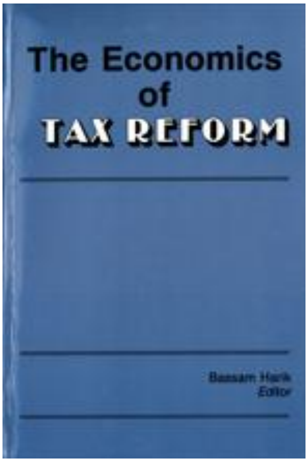
Rating Tax Reform on Growth



Joseph J. Minarik
Urban Institute

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3 Rating Tax Reform on Growth

Joseph J. Minarik
The Urban Institute

Let me begin this lecture with a hypothetical question: suppose that you were confronted with two alternative lottery tickets, one with relatively attractive odds of a small prize and the other with longer odds but a larger prize.

How would you evaluate the alternatives? What would influence you in making your choice?

Would you place a bet only if your preferred alternative were made available, or would you take a chance either way?

I raise these questions because they are much like the choices among alternative investments that many businesses must make. Further, the tax system can make business choices more like either the high-percentage, low-stakes bet or the low-percentage, high-stakes bet.

Of course, the most fundamental elements of the tax system are very much on the bargaining table right now, in a process that has come to be known as tax reform. This process is highly controversial, with conflicting claims of paradise and inferno as the likely result. Nowhere have the claims and counterclaims been more frequent and more strident than in the field of business taxation. Some business spokesmen have seen tax reform as a step toward a more efficient and neutral allocation of investment capital among sectors, leading to faster growth and greater productivity. Advocates of other firms, however, have been particularly adamant that tax reform will choke off investment and lead to stagnation.

Which side is right? Is either side right?

Even in this environment of uncertainty, we can say some things about what a sound tax policy would be, guided by basic principles and by recent economic history. The stakes are high, and so this inquiry is well worth the effort.

I will begin this lecture by setting the scene for the tax reform debate with the tax cuts of 1981. We will see that this law's attempts to stimulate growth caused much of the impetus for tax reform today. We will also see how today's proposals for reform of the individual income tax largely determine the outlines of proposals for business tax reform, and that these outlines lead to much of the opposition on grounds of investment and growth. Finally, we will examine the track record of the current law on investment, and consider the prospects for investment under distinctly different tax rules.

Tax Reform Yesterday

Several years ago, an imaginative pundit wrote a mostly (but not totally) tongue-in-cheek piece called "The Ten Commandments of Tax Reform." Commandment number one (as I recall) was a dictum apparently well known to policymakers, instinctively if not consciously: "Whatever you want to do, call it 'reform.'"*

On this basis, it is not surprising that we have had a lot of tax "reform" in recent years.

It is not a huge logical leap from the nearly universal cries that our tax system today is in desperate need of "reform" to

*(I confess that, with the best of intentions and calling upon the most knowledgeable people in the field, I cannot document this article that is so vividly etched upon my memory. Perhaps someone who hears or reads this lecture will be able to help me along. Or in the best of all possible outcomes, perhaps I only imagined it. Then I would have only nine commandments to go, and I could write the article myself)

a realization that the many recent "reforms" somehow missed their mark. The proof of this idea is no farther away than the last major piece of tax "reform" legislation, and indeed the root of our current budgetary crisis: the Economic Recovery Tax Act of 1981, commonly identified by its acronym of ERTA.

ERTA was motivated, for the most part, by two strongly held beliefs of its early champions: that the level of individual marginal income tax rates was so high as to deter work and saving; and that the tax treatment of business investments in depreciable capital, the carriers of technological progress and the instruments of growth, was so rigorous as to choke off such investments. Obviously, with an agenda such as that, tax reform was quite simple; cutting individual income tax rates is intellectually trivial, and accelerating business growth can be (and was) done in simple ways.

Of course, the political salvation of ERTA was that it did not hurt anyone (with very few exceptions, to be discussed later). ERTA was the tax equivalent of throwing money at problems—roughly $747 billion over five years, to be specific. Roughly two-thirds of this tax cut went to individuals, and about one-third to corporations. With an uplifting theme like "reform," and all that money to go around, who could be opposed?

The problem, as we now see so clearly, is that ERTA both gave away money that we as a nation did not have, and that it did so in an inconsistent manner. On the question of raw dollars, ERTA opened a budget chasm that was to be filled with future unspecified budget cuts. The nation took the cash with a smile, and only recoiled when the spending-cut bills came due. Without the spending cuts that a now-informed nation refuses to make, the tax cuts are unjustifiable.

Equally troublesome for tax policy, however, are the internal inconsistencies that ERTA created. Though allegedly evenhanded because of equal percentage tax rate cuts across the board, ERTA in fact shortchanged the poor and near-poor. The percentage tax rate cut did little for millions of low-income persons whose personal exemptions and zero bracket amounts, badly eroded by five years of rapid inflation, were left to continue to erode over five more years.

A further and more structural inconsistency of the post-1981 tax law was demonstrated by the enactment and heavy use of safe-harbor tax leasing. ERTA, in its zeal to encourage business investment in depreciable capital, including the Accelerated Cost Recovery System (ACRS). ACRS made tax depreciation extraordinarily generous—so generous, in fact, that many firms found that the early-year deductions, in combination with the investment tax credit (ITC), completely wiped out their tax liabilities, with still more deductions left over. These deductions were temporarily wasted unless the investing firm had income from other sources against which the deductions could be offset. This gave an important advantage to large, highly profitable firms, who could use all of the their tax advantages from depreciation; smaller firms, especially new firms with little or no taxable income, would have to raise more cash to undertake investments (because they could not enjoy an immediate tax reduction from depreciation and the ITC), and so such firms might choose to postpone investments until they could use the tax breaks.

The Reagan administration foresaw this problem, and chose to remedy it by allowing safe-harbor leases—paper transactions through which firms that could not use their full depreciation deductions and ITCs could sell their assets to more profitable firms that could use the tax benefits. The public outcry that followed the "buying and selling of tax breaks," however, with the spectacle of banks, insurance companies, and General Electric claiming deductions and credits for other firms' investments and paying no income tax on billions of dollars of profits, caused the Congress to promptly reverse its field and repeal the leasing law. Congress did not, of course, repeal the ACRS and ITC provisions that motivated safe-harbor leasing; so while the symptom has been cured, the disease remains. New symptoms have appeared, including mergers involving firms with unused reservoirs of tax deductions and credits.

Both the internal inconsistencies and the revenue inadequacies of the post-1981 tax law have motivated the current drive for tax reform. The role of the internal inconsistencies is obvious; the President and all other tax reform advocates cite the need for tax relief for the poor and an end to overgenerous depreciation. (In the case of the President, of course, this is quite an about-face from four years ago.) The revenue motivation for tax reform is perhaps less obvious, however; the President insists that any tax reform be revenue neutral, and all other reform proposals claim to follow that line (though some fall short). Nonetheless, many advocates of these proposals acknowledge that a tax increase to narrow the deficit is inevitable. The motivation for reform is that the current tax law, laden as it is with internal inconsistencies, could not provide substantial additional revenues without harmful side effects. If the President stands in the way of a tax increase but would welcome tax reform, it would be wise to get the first half of the job out of the way. Then when the need for revenue becomes even more apparent, possibly in a crisis, the necessary revenue tool will be ready.

Tax Reform Today

The new tax reform proposals are different from the 1981 model in that they cannot give any money away. They are further different in that they address the issue that was the heart of the tax reform debate for decades before the 1981 distraction: the definition of the tax base. In response to complaints from the household sector that the income tax is unfair, the President and others propose to repeal numerous deductions, exclusions, and credits from the tax law, reducing tax rates in compensation. Of course, with no money to give away and major changes in the law, it follows immediately that some taxpayers will win in the process, but others will lose. Nevertheless, by transferring revenues from the corporate sector to finance a household sector tax cut, the President can promise most households tax relief when the dust finally settles.

This kind of tax reform is acceptable to just about everyone (except those who lose deductions, exclusions, or credits that are particularly close to their hearts and wallets). In fact, tax reform is remarkable in uniting the tax field's "old fogies" and the "young turks." Old line tax reformers, of course, would like nothing more than a broader individual income tax base with lower rates. And even the supply-siders, if they really mean what they say about the primary importance of reducing marginal tax rates, have to agree with the wisdom of such tax reform. For them, a tax cut in dollar terms is not a necessary condition for supply-side economics to work. (In fact, from a more conventional point of view, supply-side economics could be successful if the tax base were broadened to recoup the revenue loss, and so no money were given away. In that case, the lower tax rates could encourage more work and saving, without a cash windfall to encourage leisure and spending.) So individual income tax reform à la Reagan 1985 has become part of the conventional wisdom of economic policymaking, even if it is not every interest group's cup of tea.

Business tax reform proposals follow right along with the individual version. Many of the individual income tax preferences that cause the most unfairness and manipulative tax sheltering—ACRS, the ITC, accelerated and exaggerated writeoffs for oil and gas drilling, accounting abuses—also are used in the corporate sector. If they are repealed for households, then they must be repealed for corporations too. Just as marginal tax rates are reduced for households in compensation for the revenue gains from base broadening, so they are reduced for corporations. After all, the corporate income tax is really just a proxy tax on income that is temporarily held outside of the household sector; we tax corporations because, if we did not, households could set up corporations to hold and invest their money and therefore act as tax shelters. The reduction of corporate marginal tax rates keeps the top corporate rate roughly in line with the top individual rate, so that the proxy tax does not encourage the organization of businesses in either incorporated or unincorporated forms.

Thus, the conventional wisdom on individual income tax reform dictates the nature of tax reform on the corporate side; and because it is both conventional and wisdom, with agreement from many ideological adversaries, everything must be hunky dory.

Mustn't it?

Lately there have been two distinct challenges to the corporate branch of tax reform as now preached and practiced. One challenge comes from within the traditional tax reform ranks and some other mainstream economists. This group argues that low-rate, low-subsidy corporate tax reform fails to make a proper distinction between old and new investments in plant and equipment. The argument goes like this: Corporations invested in depreciable capital in the past assuming that they would pay tax on any net income at 46 percent (the highest corporate rate, at which most corporate income is taxed). Under tax reform, however, that tax rate would be cut to anywhere from 30 to 35 percent. That tax cut, the argument goes, is a pure windfall for investment that is already made, so that much of the revenue lost through the rate cut is wasted. The merit of the investment tax credit and accelerated depreciation, the story continues, is that they benefit only new investment. The high corporate tax rate that goes along with these subsidies (of necessity, to make up the revenues loss) then soaks up much of any abnormally high profits (or "rents") of old investments, without discouraging new investment. So this challenge is based on arguments of both economic and cost efficiency. (This argument underlies the Reagan administration's proposed "windfall recapture tax" on the benefits of past accelerated depreciation.) An extension of this argument is that a high corporate tax rate, falling as it most likely does on owners of capital, helps to make the overall tax system more progressive.

The other challenge comes not so much from economists as from the business sector. Some (but by no means all) business leaders argue that any diminution of incentives to invest, either through increases in the corporate tax burden (which the Reagan administration proposes to fund individual income tax cuts) or through cutbacks of targeted investment subsidies, pushes in the wrong direction. The nation needs more investment, this argument goes, because a shortage of investment has been the culprit in our recent economic sluggishness. More investment would increase productivity, because investment is what brings the latest technology into the production process. From this point of view, tax reform's emphasis on the efficient allocation of investment, rather than on the raw amount of investment, is misplaced; we could end up with a better allocation of less capital, and be worse off when the dust settles.

Of course, this business argument is far from universally held; and keeping in mind business' tendency to look at the bottom line, this is not surprising. Remember that under a revenue-neutral business tax reform, some corporations would pay less tax, and some corporations would pay more. Because every business executive probably has a very keen sense of his firm's contribution to society, those executives whose firms would lose cash flow naturally have had negative things to say. Likewise, of course, leaders of firms that would win from tax reform (including primarily those firms most heavily taxed under the current law) have come forward aggressively to favor reform. This is another respect in which 1985 differs most vividly from 1981; four years ago, businesses marched in lockstep for the huge tax cut represented by ACRS; today, because there would be losers as well as winners, the ranks are highly fractionated.

Consequently, economists and business leaders are divided on business tax reform, with the ultimate emphasis on growth. Some policy analysts and businessmen say that tax reform would make our nation leaner and tougher; others counter that business would be smaller and weaker. In the corporate sector, this division is easily explained by self-interest; but similar disagreements among economists prevent us from assuming that the only issue is whose oxen are gored. If we want to make the best possible judgment, we must go beyond the politics of the issue and analyze the economics.

Taking Stock

So what are the merits of these arguments? Will tax reform encourage or inhibit growth? To approach an answer, we must use economic theory, our recent experience, and (because we are contemplating new policy tools) some new thinking. We should certainly start by examining the link between tax policy and investment, but before we finish, we must also reconsider the often-assumed link between investment and growth.

Theory. Unfortunately, as even the most avid theorists and econometricians would admit, our understanding of what causes investment is fuzzy at best. Two theories probably hold the most currency: the cost of capital theory and the accelerator theory.

The cost of capital theory relies on neoclassical economics, putting a heavy emphasis on the supplies of factors of production, and less on the levels of aggregate demand needed to assure that those factors of production are fully employed. The cost of capital model focuses on how much it costs—in interest, depreciation, and taxes, among other expenses—to use a given quantity of capital for a given length of time. Because an equity investor in a unit of capital will want some positive return to justify his investment, there will most likely be some tax liability as part of the cost of capital. This tax liability increases the before-tax return needed to provide the investor with the minimum acceptable after-tax return (the least return that would induce the investor to make the investment). Thus, an increase in taxes on investment would make some previously acceptable investments unacceptable; it would raise the cost of capital for the marginal investment.

The accelerator theory, in contrast, looks more closely at the state of aggregate demand, and less closely at the supply of factors of production. It holds that investment is induced by increases in consumer demand which push on productive capacity, rather than by tax cuts for investment per se. From the point of view of the accelerator theory, a tax cut for investment income while businesses by and large have excess capacity would be wasted; it would be "pushing on a string," to invoke a common analogy. The revenue loss would go largely to businesses that would be investing anyway.

As was suggested not too long ago, neither of these two theories can claim an extreme of predictive accuracy. Empirical studies suggest that business behavior depends on many factors, surely including businessmen's varying perceptions of the conditions in their own varied markets. This diversity of view surely has much to do with the failure of any theoretical model to explain actual behavior.

Of the two models, though, it is the cost of capital model that is the more pertinent to the criticisms of tax reform related above. Economists would argue that incentives should be targeted to new investments, and businessmen would emphasize the level of business taxes, whether through incentives or not. The kind of demand-push fiscal stimulus envisioned in the accelerator model seems to be out of the question at the moment; our demand seems to have been pushed about as far as it would go in 1981.

The Record. It is here that recent history can lend a hand. Surely the 1981 tax law was the quintessential reduction in the tax component of the cost of capital; it cut business taxes significantly through a substantial acceleration of depreciation, targeted on new investment. In fact, its reduction in the tax component of the cost of capital was so great that in many instances, it made that tax component negative. That is, it gave such accelerated deductions for depreciation, coupled with the pre-existing investment tax credit, that the tax deductions and credits wiped out the tax liability of the typical investment in its early years, with more tax benefits left over. If the investor had income from other sources against which he could claim the deductions and credits, those tax savings exceeded (in present value terms) the tax on the investment in question in its later years, after the deductions and credits were used up. Taking into account the tax savings on other income and the time value of money, ACRS and the ITC were so generous as to make many typical investments into tax shelters. If that wouldn't stimulate investment, what would?

But did it stimulate investment? Here opinions differ. Some business advocates argue that the recovery of investment from the 1981-82 recession has been remarkable, and they seem to have the numbers on their side. Business investments in nonresidential structures and in equipment have grown more rapidly after this recession than they have in the typical previous post-World War II recovery. Advocates of generous tax treatment of investment assign this growth to the 1981 tax cuts.

A critical look at the numbers, however, leads to a far different outcome. The most important issue is just where this apparent boom in investment has gone. Barry Bosworth has shown that the increase in investment in equipment is highly concentrated in two types of assets: computers and business automobiles. It happens that the one area where ACRS was not generous was in its treatment of computers, which in fact fell between the cracks and were made subject to longer, not shorter, depreciable lives. The stimulus to investment in computers seems to have come from another direction: their falling prices. This episode just serves as a reminder that tax policy is by no means all of economics, and should not be the first resort for action on any problem that happens along. The boom in investment in business automobiles has an equally ideosyncratic explanation; consumers have become more interested in automobile leasing as an alternative to purchase, and a leased automobile, even if used purely for personal purposes, is considered an investment by the leasing firm—hence the jump in the investment figures.

When he omits computers and business automobiles from the investment statistics, Bosworth finds that the investment recovery from the 1981-82 recession looks much more typical from an historical perspective. In fact, when he measures the investment recovery relative to the previous business cycle peak, rather than the low point of the recession (which in 1981-82 was extraordinarily low), Bosworth finds that the investment recovery has been below average (Barry P. Bosworth, "Taxes and the Investment Recovery," *Brookings Papers on Economic Activity* 1:1985, pp. 1-38).

A further qualification of the strength of the investment recovery comes from an examination of investment in types of structures. Investment in industrial structures—factories—has been virtually flat since 1980. The growth of investment in nonresidential structures has been confined to commercial structures—such as shopping centers and office buildings. Most analysts, certainly including many business advocates, would admit that investment in commercial structures was not a goal of the 1981 tax law, and has little potential impact on U.S. growth and competitiveness.

It is my conclusion from the data as described above that the extreme attempt at investment stimulus through tax policy undertaken in 1981 has failed, thus far, to produce demonstrable results. This is especially true in light of the reinforcing of the "cost of capital" tax cut strategy with an "accelerator" tax cut promising a rush of consumer demand and encouraging firms to build up their productive capacity.

There is certainly an argument that insufficient time has passed to pronounce judgment on the 1981 tax law, and that circumstances since 1981 have been extraordinary and have not allowed a fair test. One point worth considering, however is that the 1981 tax cuts may well have helped to create those extraordinary circumstances. Massive tax cuts, even on the order of ACRS taken alone, will increase the federal government deficit and drive up interest rates. This is especially true because tax inducements to investment invariably are enjoyed by those who would have invested without the incentives, as well as the few who are affected at the margin. If the monetary authorities should fear an inflationary burst of excess demand and restrain the growth of the money supply, that will increase interest rates further. Because interest expense is an element of the cost of capital—again, investment is determined by more than taxes alone—an extreme strategy of investment subsidy through tax cuts can boomerang.

While we do not now have ironclad proof, the track record of tax subsidies for investment appears less than promising. In my judgment, we might well regard advocates of further investment subsidies in the tax code as 19th century physicians leaving a comatose patient to get more leeches.

The Issues

Why have tax incentives for investment had so little effect? In my opinion, despite its logical underpinnings, the cost-of-capital theory has some significant weaknesses as a guide to policy, especially when taken to extremes. I would like to discuss four areas in which I believe this is true.

New, Risky, and Recent-Loss Firms. To encourage investment under the cost-of-capital approach, taxes must be cut on the marginal investment. Significant tax cuts on investments earning only a minimum acceptable rate of return can take on strange forms, however. To stimulate investment in this way, ERTA resorted to such enormous accelerations of depreciation allowances that the tax on many marginal investments became negative. As was explained earlier, investors receive more deductions and credits than they need to wipe out all tax on the income generated by an investment early in its life. The excess deductions and credits can be used to offset tax on the investor's other income.

A problem arises if the investor does not have any other taxable income. In that case, the excess deductions just sit on the firm's accountant's shelf, depreciating with the passage of inflation. A firm in this situation has to raise more money in the credit markets to undertake an additional investment, because it does not have any reserves against taxes to draw down in anticipation of the value of the resulting tax preferences. Such a firm may postpone investments until a later date, when it expects to become profitable; or it may become prey for a takeover by some other firm that does have taxable income. (As was noted earlier, the 1981 tax law included safe-harbor leasing as a safety valve for just such situations, but the public found the results of tax leasing too offensive.)

These problems befall particular kinds of firms: new firms, which typically make large start-up investments and do not earn profits for several years; firms that have recently been unprofitable and are attempting to turn their situations around; and technologically advanced (colloquially, "high tech") firms, which make large investments with long gestation periods and uncertain chances of success. For these firms and for any others that cannot use their investment subsidies immediately, the tax benefits are significantly less valuable; consequently, some portion of the business population is left out of the investment subsidy strategy and disadvantaged by it. This could well make our investment performance under a cost of capital strategy less favorable than we might expect. Furthermore, it is far from clear that it is in our economic interest to favor large, established firms in traditional lines of business.

Tax Shelters. As was noted earlier, even a traditional investment can receive a negative effective tax rate under ACRS. It should not be surprising, then, that tax shelter brokers can achieve new heights of manipulation under the current law. In 1981, for the first time in a quarter century of compiled statistics, the entire partnership sector of the economy (partnerships are the preferred vehicles for tax shelters) showed an aggregate net loss, so great was the boom in tax sheltering. In 1982, this dubious distinction was repeated. The availability of ACRS depreciation deductions effective January 1, 1981, was an important cause of this development. Tax shelters cost the federal government revenue, and they waste capital as well; without the benefits of tax sheltering, there is no doubt that less of the U.S. capital stock would be allocated into investments in the oil and gas industry, and in residential and commercial real estate.

The use of real estate as a tax shelter causes another serious problem of resource misallocation. Commercial and residential real estate makes an effective tax shelter because it is easily resaleable (apartment and office buildings make safe and liquid investments because they almost always have many alternative users), and so it can be highly leveraged. That way, small amounts of cash can generate large amounts of depreciation deductions. In contrast, factories have fewer alternative users, and so they are riskier investments, and less amenable to debt finance. If commercial and industrial structures received depreciation treatment equally generous to that of equipment, this tax sheltering would get completely out of hand. To prevent this, depreciation for shelters is made less generous than that for equipment (measured by the actual reduction in value, i.e., economic depreciation, over time). But this less generous depreciation treatment of structures carries over to disadvantage investments in factories, as opposed to shopping centers and office buildings. The tax bias away from industrial structures can only hinder growth over the long run by encouraging investments in modern equipment to be placed in outmoded structures. It is an inevitable outgrowth of an unbalanced policy with extreme incentives for investments in equipment.

Double Taxation of Corporate Income. Another aspect of the investment incentive strategy is its effect on the double taxation of corporate source income. As was noted earlier, the rich investment incentives in the current law cost revenue, and so for any given revenue target, statutory tax rates must be higher. (Because the same generous depreciation must be made available to individual as to corporate investors, this strategy increases individual tax rates as well as corporate tax rates.) These higher tax rates increase the double tax on corporate source income at the margin, that is, on an additional dollar of fully taxable corporate income that is then distributed.

Sensitivity to Inflation. Another source of distortions because of the high tax rates required to finance large investment incentives is the interaction of the income tax and inflation. With higher tax rates, the mismeasurement of income and of interest expense due to inflation is more serious. (Further, ACRS itself is highly sensitive to inflation; at the low inflation rates that we currently enjoy, ACRS is an even greater net subsidy to investment than was anticipated at its enactment during the high inflation of 1981.)

Summary. A frequently heard argument for investment subsidies is that they encourage risk taking and innovation. As the foregoing analysis suggests, however, this is true in only a limited sense. Rich tax subsidies like ACRS encourage a risk taking and innovation, but mostly by large, established firms; newcomers and revitalized firms get less of a tax advantage. Further, if the incentive to innovate is a function of the after-tax income that the innovation will yield, and if the tax rate is close to 50 percent for either an individual or a corporation, that incentive has to be blunted. A firm or an individual with a new idea has to think twice about the relationship of after-tax reward to risk. What our current tax code seems to foster more than anything, in fact, is ultra-safe investments like real estate.

It was with this tenor of the current tax code in mind that I raised my opening question about a low-risk, low-return lottery compared to a high-risk, high-return one. The current tax law, for all its stated intentions about innovation, seems more directed toward stand-pat investments. Business lobbyists may well argue that the world will end if our rich investment incentives are cut back or repealed. We should not be surprised by this; after all, that is what business lobbyists are (well) paid to do. Business executives, if they do what they are (well) paid to do, will seek out investments where there is profit to be made; and that task will not be changed by the repeal of tax subsidies for investment.

We can only wonder how our economy would perform if the tax code were purged of opportunities for low-risk, tax-shelter arbitrage, and were left with only a substantial reward for truly productive activity. There are some thoughts, however, that might give some idea of the potential benefits of tax reform.

Tax Reform Tomorrow

There is reason to believe that many of the allegations of tax reform harming investment are either unimportant or inaccurate. There are other reasons why tax reform could in fact create a better climate for investment than many observers would anticipate. And there is further reason to expect that in tax reform as currently contemplated, getting there will be half the fun.

Investment and Growth. One possible criticism of tax reform from the cost-of-capital view of the world would be the likely increase in the tax burden on the marginal investment. With ACRS extending negative tax rates to many investments, there is no question that the current law reduces the required rate of return for investment. Tax reform, by repealing these net subsidies, would raise the required rate of return. Is this a serious disadvantage of tax reform? What would its effect be?

From a real world perspective, it is difficult to evaluate just how important it is to drive down the required rate of return to the extent that ACRS does. There is no telling just how often a firm contemplates an investment that it truly believes to be marginal. Some investments wind up earning barely a required rate of return; indeed, some wind up earning only losses. But it is unlikely that those investments were undertaken in anticipation of performing unsatisfactorily, or even marginally.

Further, and more important, the connection between investment and growth is almost certainly exaggerated by many casual commentators; in particular, the value of stretching investment a margin further in a given year is easily overstated. If markets work (and if they do not, I am unsure why you invited an economist to speak to you this evening), then the best investments, the ones that make the greatest contributions to productivity and growth, are the ones that will pass any reasonable market test. The investments that could then be teased out of the economy at the margin are the ones whose value is, well, marginal. As I argued earlier, a good deal of the additional investment stimulated by ACRS was apparently in tax shelters. This suggests that we must examine critically those casual notions about investment being the engine of all progress and growth, and the risks that tax reform, being less generous at the margin, will somehow reduce our well being.

Benefits of Tax Reform. Criticisms of tax reform on the basis of its impact on the tax component of a cost of capital formula ignore its other potentially beneficial effects.

As was noted above, the likely outcome of a low-rate income tax with neutral, nonsubsidized depreciation is a reduction of tax sheltering. This welcome development would redirect billions of dollars from socially unproductive investments in real estate and other tax-favored areas into more traditional investment fields. The additional capital would offset the effect of the elimination of investment subsidies.

Likewise, a reduction in marginal tax rates for individuals has the potential to encourage saving. In all likelihood, the increase in saving would be modest, but it would be welcome; and it would make more funds available for traditional investments. Perhaps even more significant, reduced tax rates and cutbacks of deductibility of interest on consumer loans (including increases in the zero bracket amount, which reduce the number of people who itemize) will decrease borrowing, which is negative saving.

The importance of these developments should not be ignored. Many business advocates seem to take a tunnel view of tax reform and investment, seeing only the repeal of the investment credit or of ACRS. What such observers fail to see is favorable movements of another element of the cost of capital: interest expense. If capital moves from tax shelters into traditional investments, and household saving and borrowing shift modestly but favorably, tax changes in the cost of capital could be offset by reduced borrowing costs, leaving the business sector better off.

Another beneficial effect of tax reform and lower marginal tax rates will be a greater incentive to work. Again, changes will likely be modest, but favorable. When all of these changes occur simultaneously, and all are movements in the right direction, there is at least the potential for a favorable synergism where the whole is greater than the sum of its parts.

The Joy of Transition. In most changes of tax laws, the transition phase is a source of pain and complexity. In many respects, a major tax reform may be no different. But in terms of the incentive to invest, the transition may be a major plus.

President Reagan has proposed a tax cut for individuals to be financed by a tax increase on corporations. Many of the revenue-raising steps under the corporate tax, by their nature, grow into their full effect over several years. This is generally true of changes in depreciation, which affect only investments made after the passage of the law, and so embrace the entire capital stock only as the pre-existing capital stock wears out over a period of years. (This revenue pattern would not hold under the administration's current depreciation proposal which, through newfound generosity, in fact loses revenue in the long run. This is a source of concern regarding the administration's plan.)

Because the revenue gain tends to be less in the early years, revenue neutrality requires that certain steps be taken to raise revenue in the first years after enactment. One such proposal was the administration's windfall recapture tax, which would add into taxable income a fraction of accelerated depreciation allowances claimed since 1980, and would raise revenue for only four years. As was explained above, this provision is intended to recover some of the windfall gain to corporations who invested in anticipation of paying tax at a 46 percent rate, only to be greeted by a tax reform that would impose tax at only 33 percent. Whatever its merits, the windfall recapture tax has met with extreme hostility, largely on grounds of being a retroactive burden. Its chances of enactment are considered to be slim.

The obvious alternative to the recapture tax as a purely temporary revenue raiser is a phasing in of the corporate tax rate reduction. While politically only a second choice to the current administration, the corporate rate cut phase-in is an economic gold mine. Consider these attributes:

First, the rate cut phase-in acts as a short-run investment incentive. A firm that invests early on can claim its depreciation deductions against a higher tax rate, making them more valuable.

And second, the phase-in concentrates the benefits of the ultimate rate reduction on new rather than old capital. In the first years of the phase-in, pre-existing capital is subject to a relatively high rate of tax, reducing the windfall for which some economists criticize tax reform. As the pre-existing capital wears out, however, the statutory tax rates are reduced, giving the relief to a greater extent to capital purchased after the tax reform takes effect. In the long run, the rate reduction rains down more than it otherwise would on new capital, making tax reform more cost effective in terms of stimulating new investment.

Thus, a temporary provision needed to make tax reform revenue-neutral over the short run could defuse much of the criticism of the entire grand undertaking on grounds of its effect on investment.

Summary. Several aspects of tax reform have the potential to improve significantly the economic climate in general, and that for investment in particular. Observers who view tax reform from one particular perspective have a tendency to miss this big picture. We should keep the broad view in mind when we make our decisions on tax reform.

Conclusion

Over the past few years, in our frequent episodes of tax "reform," we have tended to look for tax remedies to too many of our problems—economic and otherwise. By now, it is almost an article of faith to some people that tax policy is the most important determinant of business investment. Perhaps this is only predictable, because a business lobbyist who can wheedle a tax preference from the Congress can deliver to his clients risk-free cash flow, while an engineer or designer can only give his firm a roll of the dice in the free and competitive market.

As difficult as it may be, though, we must question those new preconceptions of taxation as the key to our future. After all, if tax incentives are so important, how did our nation grow so fast before it even had an income tax? Was Christopher Columbus really sailing for Washington to make the case for an exploration tax credit? Did anyone really argue whether the wagon trains were depreciable or not?

As one who has specialized in the economics of taxation, I can only report my opinion: that tax policy is crucial to our economy now only because it has been stretched beyond all reasonable bounds, to interfere in sector after sector. If it were drawn back, the economy would thrive in the short run, after some transition pains, only because it would be freed from the shackles that the current tax law imposes. In the long run, our economic prospects would depend on our ingenuity and energy. No one can guarantee that those qualities will be enough in an ever more competitive world economy, but for myself, I would rather rely on our energy and ingenuity than on some purported incentive in an incomprehensible tax law.