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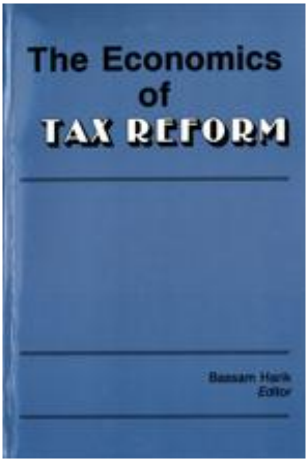

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5 Federal Tax Reform: State and Local Perspective

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*Introduction**

As you know, the nation is now embroiled in a debate concerning the merits of major structural reform of the federal income tax system involving both the broadening of the tax base by elimination of exclusions, exemptions, and deductions, and the reduction of both the number and progressivity of rate brackets. A central element of nearly all such tax reform plans is curtailment or elimination of the itemized deduction for state and local taxes now available to individual taxpayers. Therefore, I will discuss first how federal tax reform might directly affect state and local governments, and second, how those subnational governments might respond to the federal tax changes. The potential pattern of winners and losers among the states will be discussed, and how state and local governments might be able to offset some of the effects of curtailment of federal deductibility and other reform changes by altering their own fiscal structure and behavior will be considered.

Before considering the tax reform proposals specifically, it may be useful to note the opinion of several experts regarding tax reform. In introducing his tax reform proposal to the nation in May of 1985, President Reagan concluded that "The tax system has come to be unAmerican." In contrast, Senator Russell Long, at one time chairman of the Senate Finance

*These comments were first offered as a lecture in January 1986. A postscript has been added to incorporate details of the tax bill adopted by Congress in September 1986.

Committee (the committee which considers tax policy in the U.S. Senate) noted *in 1967* that

> Many businessmen contribute to legislators who have fought against taxes that would have been burdensome to their businesses, whether the tax increase was proposed as a so-called reform, a loophole closer, or just an effort to balance the federal budget.
>
> (*Congregational Record,* April 4, 1967.)

Finally, at an unknown date and regarding an unknown topic, Yogi Berra is reported to have said: "It's *déjà vu* all over again."

Obviously, these views are very different. The President, on the one hand, argues that the tax system, with its myriad exclusions, deductions, and credits, is unAmerican, and perhaps that it is unpatriotic to support the current tax structure and oppose major reform. In response, the President offered what he called "America's tax plan." But Senator Long, with long tax experience in the Congress, had a very different notion. He argued that businessmen will contribute to political officials in an attempt to protect their own economic interest. Rather than being unAmerican, Senator Long suggests that this behavior is typical of and fully expected in American politics. I think we can expand his notion of businessmen to almost everyone. Certainly we have recently observed that state and local government officials and their representatives can be equally as active, and perhaps equally as effective, as businessmen in trying to influence the Congress when it comes to tax reform. And, as Mr. Berra noted, it is *déjà vu* all over again! The tax code which the President characterized as unAmerican developed over many years, not instantly. In addition, most of the ideas included in the current tax reform proposals have been proposed and debated in the past, at least over the last 25 years. And what Senator Long observed in 1967 is equally true today.

What, then, is different about the current tax reform debate? Perhaps it is that in the past, reform proposals have largely come from experts—economists, lawyers, and others—outside of government, while recently those same proposals have been offered first by several Senators and Representatives, then by the U.S. Treasury, and, most recently, by the President.

Review of Recent Proposals

Although a number of different tax reform plans were introduced in Congress in the past three years, let us concentrate here on the developments beginning with the release, in November 1984, of a proposal developed by the U.S. Department of the Treasury at the President's request. That proposal, which came to be called Treasury I, would have increased the personal exemption and standard deduction, generally eliminated the itemized deductions (except in a very few cases), and indexed the tax structure for inflation, not only including indexation of tax rates, the personal exemption and the standard deduction, but also indexation in calculation of depreciation as well as interest and other capital income. Fringe benefits, such as employer-provided health insurance, would have been added to the tax base in a substantial way. Tax rates would have been confined to brackets of 15 percent, 25 percent, and 35 percent. Business deductions would have been reduced or eliminated, the investment tax credit repealed, and the corporate tax rate set at 33 percent. The tax system would certainly have been simpler in what truly would have been significant reform.

In May of 1985, the President moved away from Treasury I, introducing his own tax reform plan, entitled *"The President's*

Tax Proposals to the Congress for Fairness, Growth, and Simplicity," which came to be called Treasury II and referred to here as the President's Plan. This second plan encompassed major tax reform, but was substantially different from the original proposal in several important areas. Some itemized deductions, for example for charitable contributions, found their way back into the tax structure. The broad taxation of fringe benefits which had been proposed in Treasury I was effectively eliminated in Treasury II. The remaining proposed taxation of health insurance, for example, was effectively insignificant. A minimum tax was created to force individuals or firms which would not have liabilities under the general rules to pay some amount of tax. The second plan followed the first in raising personal exemptions and the standard deduction and using three rate classes (15 percent, 25 percent, 35 percent).

With the President's proposal in hand, the Congress went to work. The House considered the issue throughout the summer and into the fall. Negotiations were alternately going forward at full speed and the next day breaking down. Finally, the House Ways and Means Committee reported out a bill, under the direction of chairman Rostenkowski, and in December the House passed a tax reform bill. This plan was substantially different from the proposal which the President had offered in May, and even more substantially different than the original Treasury proposal of the previous November.

First of all, the itemized deduction for state and local taxes was still allowed under the House bill; it would not have been under either of the two Reagan/Treasury proposals. A major issue of confrontation, therefore, was how to treat state and local taxes. There also was substantial difference in the treatment of fringe benefits. While the Reagan proposal would tax fringes less than the original Treasury proposal, the

House proposal does so even less, so much so that, for all practical purposes, fringe benefits are not taxed in the House bill at all. The House proposal added a fourth rate bracket at 38 percent, which would apply to joint returns with adjusted gross income at or about $100,000 a year. The concept of the minimum tax which found its way into President Reagan's proposal was also retained in the House proposal.

In some ways, it is as interesting to consider what these various tax reform proposals do not do. For example, social security income will not be taxed more than it is currently. Apparently, social security income is just politically untouchable. The credit for business research and development activities is maintained. In a national sense, this credit is not very substantial, but it turns out to be very important to firms in Michigan. While the original Treasury proposal adopted more or less complete indexation of the tax code for inflation applying to all of the nominal dollar amounts in the tax code as well as the definition of capital income, the political process has reduced the degree of indexation substantially. Interestingly, despite substantial popular discussion over the last three or four years about flat taxes, none of the proposals is truly a flat tax, that is, with one rate. Some progressivity in the rate structure is maintained.

During the tax reform debate, state and local government officials and their representative interest groups have generally been vocal critics of all the tax reform proposals. They have criticized the notion of ending the deduction for state and local government taxes. They have been vocal critics of changing the definition of the kinds of activities for which state and local governments can sell bonds, the interest from which is not taxed as income in the federal code. In general, states are concerned about the interstate distribution of tax savings from reform and about how the loss of deductibility might affect the ability of state and local governments to raise taxes in the future or continue to provide financing for current services. Each of those concerns is now considered.

First Concern: Interstate Distribution of Tax Savings

Early consideration of the likely effects of tax reform for states focused on the implication for the interstate distribution of federal tax reductions (or interstate increases) caused by reform. Federal tax reform will not be geographically neutral. The residents of some states will benefit more than the residents of others, if for no other reason than federal tax reform treats different income taxpayers differently, and states differ in their income distributions. The U.S. Department of the Treasury estimated that the President's proposal would have reduced personal income taxes by 7 percent in aggregate, with nearly 60 percent of taxpayers receiving some reductions. Thus, the likely concern is the *relative* amount of tax reduction by state, i.e., which states have less than a 7 percent aggregate reduction and which more. To date, the Treasury Department has not released or published any state-by-state analysis of the tax reform plan's effect.

One often gets the impression from state and local government officials that the interstate distribution of personal tax reduction caused by tax reform arises almost entirely from changing the deduction for state and local taxes. They suggest, obviously, that states with both a relatively large fraction of taxpayers who itemize deductions and relatively large amounts of deductible taxes stand to "lose" most from eliminating the deduction. But many, if not all, of the tax features affected by the reform plans have uneven effects on the distribution of taxes among the states. Similarly, those tax features not curtailed (or perhaps even enhanced) by the plan also are significant for any interstate variation in tax burdens.

These features, too, are not expected to be geographically neutral. This fact has been noted by *Business Week:*

> The nondeductibility of state and local taxes is but one factor, and probably not the most important one, determining states' futures. . . . If the tax plan is enacted in its present form there will be substantial variations in its regional impact. But which states and regions emerge as the biggest gainers and losers may be surprising. (June 17, 1985.)

For example, long-term nonresidential capital gain income varies greatly by state. The President's tax reform proposal (Treasury II) would have *decreased* the taxation of capital gains, while the House bill would have *raised* capital gains taxes slightly. In 1981, half of all taxable capital gains income accrued to residents of just six states: California, Colorado, Florida, Illinois, New York, and Texas. That fact understates the concentration, because nearly 35 percent of total capital gains income that year went to residents of only three states: California (16 percent), Texas (10 percent), New York (9 percent). If the deduction for state-local taxes were continued and the revenue loss made up by increasing the tax on capital gains, it is not clear that a state such as New York, whose officials have been prominent in opposing the curtailment of the state-local tax deduction, would be better off. That is, the distribution of any tax change needs to be compared to the distributional effects of the substitute tax provision.

As a second example, Clark and Neubig (1984) report the volume of new, private purpose tax exempt bonds issued in 1983 by state. The President's tax reform plan would eliminate the interest exemption for many of these state-local bonds. But the list of the 10 largest state users of this exemption in 1983 includes Texas (2), Florida (3), Arizona (8), and Virginia

(9), none of which are states usually identified as likely losers from ending the state-local tax deduction.

Finally, while all of the tax reform proposals would end the double personal exemption for senior citizens, both the President's and the House plans would expand the credit for low income taxpayers, including low income elderly taxpayers. Most of the analyses which I have seen suggest that low income elderly taxpayers would be substantially better off under either tax reform plan, while higher income elderly taxpayers would have smaller than average tax reductions. But of all elderly taxpayers with 1981 income less than $10,000, nearly 40 percent lived in just six states: California, Florida, New York, Ohio, Pennsylvania, and Texas. Again, several states often classified as "losers" from elimination of the deduction for state and local taxes apparently stand to "gain" from this change in the treatment of elderly taxpayers.

In other words, it is not easy to determine which states' residents will be winners and which will be losers, on average, from the distribution of federal tax changes. As the tax reform proposals are adjusted, maintaining revenue neutrality, there may certainly be some surprises about the geographic effects of those changes. And to the extent that the tax reform plan would tax currently exempt or excluded activities, state-by-state data may not be available (certainly from tax sources) to estimate the effects.

It may be possible to estimate the interstate distribution of personal tax changes due to reform indirectly, however, if one is willing to assume that all of the changes can be reflected by income. The U.S. Treasury Department estimated, for the President's tax plan, the expected percentage reductions in personal taxes by income class. That information can be combined with income distribution data for each state to estimate the aggregate percentage personal tax reductions for residents of each state.[1] (See Table 1). Those calculations were done by an undergraduate student at Michigan State, Lori Brown, and me, using 1981 data. Essentially, we considered what the effect of the President's tax proposal would have been in 1981.

Table 1
Interstate Distribution of Tax Features

	Federal Tax Change Due to Reform As a Percentage of		Capital Gains Income as % of Total	Percent of Aged & Blind Returns With Income < $10,000
	Disposable Income	Federal Tax		
United States	1.21%	9.04%	—	—
Alabama	1.15%	9.54%	0.9%	0.9%
Alaska	1.51%	7.21%	0.3%	0.1%
Arizona	1.17%	9.01%	1.5%	1.0%
Arkansas	1.10%	10.17%	0.7%	1.1%
California	1.18%	8.82%	15.7%	8.4%
Colorado	1.33%	8.65%	2.6%	1.0%
Connecticut	1.43%	8.46%	1.5%	1.7%
Delaware	1.50%	9.48%	0.2%	0.2%
Dist. Columbia	1.36%	9.11%	0.4%	0.4%
Florida	1.32%	9.32%	7.3%	6.6%
Georgia	1.28%	10.01%	1.7%	1.5%
Hawaii	1.16%	9.27%	0.4%	0.4%
Idaho	1.08%	9.71%	0.4%	0.5%
Illinois	1.30%	8.65%	5.0%	4.7%
Indiana	1.26%	8.78%	1.1%	2.3%
Iowa	1.13%	9.06%	1.3%	2.0%
Kansas	1.23%	8.64%	1.3%	1.1%
Kentucky	1.14%	9.35%	1.5%	1.4%
Louisiana	1.26%	8.38%	1.4%	0.8%
Maine	1.24%	10.75%	0.3%	0.5%
Maryland	1.35%	8.65%	1.3%	1.7%
Massachusetts	1.41%	9.72%	2.0%	3.3%
Michigan	1.14%	8.51%	2.0%	3.7%
Minnesota	1.16%	8.91%	1.6%	2.5%

Table 1
Interstate Distribution of Tax Features—Cont.

	Federal Tax Change Due to Reform As a Percentage of		Capital Gains Income as % of Total	Percent of Aged & Blind Returns With Income < $10,000
	Disposable Income	Federal Tax		
Mississippi	1.15%	9.84%	0.7%	0.9%
Missouri	1.21%	8.76%	1.9%	3.1%
Montana	1.16%	9.60%	0.4%	0.6%
Nebraska	1.16%	9.72%	0.9%	1.0%
Nevada	1.45%	9.37%	0.7%	0.4%
New Hampshire	1.39%	9.57%	0.4%	0.6%
New Jersey	1.32%	8.50%	1.9%	3.4%
New Mexico	1.24%	9.35%	0.7%	0.4%
New York	1.26%	9.07%	9.1%	8.1%
North Carolina	1.17%	9.72%	2.0%	2.3%
North Dakota	1.11%	9.03%	0.3%	0.4%
Ohio	1.31%	9.30%	2.4%	5.7%
Oklahoma	1.30%	8.93%	1.8%	1.2%
Oregon	1.12%	8.91%	1.6%	1.4%
Pennsylvania	1.28%	9.32%	2.4%	5.5%
Rhode Island	1.27%	10.12%	0.3%	0.4%
South Carolina	1.25%	10.31%	0.6%	1.0%
South Dakota	1.03%	9.81%	0.6%	0.6%
Tennessee	1.18%	9.33%	1.2%	1.6%
Texas	1.44%	8.78%	10.0%	5.6%
Utah	1.07%	9.05%	0.7%	0.5%
Vermont	1.22%	9.98%	0.1%	0.3%
Virginia	1.37%	9.38%	1.5%	1.9%
Washington	1.25%	8.43%	2.0%	1.7%
West Virginia	1.19%	9.29%	0.3%	0.7%
Wisconsin	1.20%	9.02%	1.9%	2.8%
Wyoming	1.32%	8.06%	0.6%	0.7%

Source: L. Brown (1986).

We found that adoption of only the personal tax changes in the President's tax plan would have increased disposable personal income an average of 1.21 percent, with a range from 1.03 percent in South Dakota to 1.51 percent in Alaska. Michigan residents, by the way, would have had a 1.14 percent increase in disposable personal income. Measured instead in terms of percentage tax decreases, the results show an average 9 percent decrease in personal taxes, with a range of 8.4 percent in Louisiana to 10.8 percent in Maine. Again, Michigan is slightly below the average at 8.5 percent. Although this is an admittedly rough approximation, the pattern of results is similar to those derived by others who examine the effects of specific details of the tax plan. The results suggest that while federal tax reform will not be neutral between residents of different states, the differences between states are not likely to be very substantial, certainly not to the degree which has been suggested.

There is one important qualification to all of this. The notion of reduced taxes for individuals as a result of federal tax reform is an illusion. Because the proposed tax plans are designed to raise the same amount of revenue as the current structure would have raised, at least by estimation, there will be no reduction of total taxes. In essence, the intent is for increased corporate tax collections to substitute for reduced personal tax collections, with total taxes remaining the same. The tax systems proposed in the various plans are designed to withdraw approximately the same amount of resources from the private economy as the current structure. The myth of individual tax reduction is created by separating personal and corporate tax payments, and then ignoring the corporate payments. For this to make any sense requires that corporations operate as "black holes," where taxes enter, never to reappear. This is nonsense. The tax collected from corporations may cause higher prices or lower wages or lower returns on investment, all of which affect individuals. What tax reform will do is alter the *distribution* of the tax burden among individuals.

Second Concern: Effect on Subnational Government Programs

The second issue about federal tax reform which concerns state and local government officials is whether curtailment of the deduction for state and local taxes will affect the ability of the states to finance services. The marginal price of state and local government services to taxpayers who itemize federal tax deductions is increased if state and local taxes can no longer be deducted. This increase in tax prices could, in some cases, actually bring about reductions from current state or local spending levels or, more likely, would slow the growth of state-local spending by making it harder to further increase state or local tax rates. For instance, the *Wall Street Journal* reported the Alaska revenue commissioner's fear that "residents would resist the need for new or higher revenue collections if the U.S. stops allowing taxpayers to deduct their local tax payments," (June 11, 1985, p. 58). Because the loss of deductibility would particularly raise tax burdens for higher income taxpayers, there is concern that some might want to leave high tax states or cities. Thus, New York Governor Mario Cuomo is quoted as saying "They're pitting state against state. A lot of my people will leave New York so that they can live where their taxes are lower" (*Business Week,* June 17, 1985).

First of all, it is important to emphasize that even if deductibility is retained in a federal tax reform plan, the value of that deduction would be reduced, and thus the subsidy to state and local governments would also be reduced. The value of the state-local tax deduction will be substantially eroded by the other features of reform. A larger standard deduction, cutbacks in other allowed itemized deductions, and the greater personal exemption for nonitemizers which is part of the House plan, would all reduce the number of itemizers, so that fewer taxpayers would be deducting state-local taxes. Even for those taxpayers who would still itemize (and thus deduct state-local taxes) the value of the deduction will be smaller because tax rates will be lower. Some estimates suggest that as much as half of the current value of deductibility would be lost even if deductibility remains in the tax code. Therefore, part of the loss of the state-local government subsidy occurs generally as the result of tax reform (even if that specific deduction is retained) and part because of the curtailment of the deduction.

Will the loss of deductibility or the reduced value of deductibility matter? Evidence is sparse, but seems to show that deductibility has induced states and localities to increase spending slightly and to favor certain revenue sources (deductible taxes, for example) over others. A reduction of deductibility's value, then, might reduce state-local taxes slightly (or more correctly, slow their growth) and induce states to alter their tax structures. I expect that local governments, in many cases, will be affected less by the decreased value of deductibility than state governments because of state tax incentives. Local taxes (mostly property taxes) are deductible against state income taxes in 33 states, while 30 states have state credits for local property taxes (including Michigan). A number obviously have both. These features will become more important and will mitigate the effect on property taxpayers of a reduction in or loss of federal deductibility.

The following example, based on the Michigan property tax credit, illustrates that point. Consider a family of four with a $40,000 income, which pays $2,400 in property taxes and has a total of $5,000 in federal itemized deductions. Such a family receives a Michigan property tax credit of $600 and is in the 25 percent federal income tax rate bracket. As a result, an increase in property taxes of $1 would actually cost this family only $.30, after the federal deduction and the state credit. If the federal income tax is changed so that the personal exemption rises (to $2,000) and tax rates are reduced (this family is now in the 15 percent federal rate class), then the family's cost of a $1 property tax increase rises to $.40 if no deduction for state and local taxes is allowed and to $.34 if the deduction is retained.

First, this family's local tax cost rises due to federal tax reform even if deductibility is retained. Second, the increases in local tax cost due to federal tax reform (with or without deductibility) are small. The loss of federal deductibility increases this family's marginal property tax cost from $.30 to $.40, not from $.75 to $1.00, which would occur without the state credit. Without deductibility, the state credit becomes more important and offsets a larger amount of local taxes.

Exhibit 1
Marginal Property Tax Cost in Michigan:
Deduction/Homestead Credit Illustration

Fiscal Details	$40,000 Income; 4 Exemptions $80,000 House; 60 Mill Tax Rate $5,000 Itemized Deductions Homestead Credit = 60% ($2,400-$1,400) = 600 Marginal Property Tax Cost = .4(1-7), where t = federal marginal tax rate of itemizer
Current Structure	Homestead Credit = $600 Federal Taxable Income = $31,000 Federal Marginal Tax Rate = 25% Marginal Property Tax Cost = $.30
Federal Reform-No Deduction:	Homestead Credit = $600 Federal Taxable Income = $28,000 Federal Marginal Tax Rate = 15% Marginal Property Tax Cost = $.40
Federal Reform-With Deduction:	Homestead Credit = $600 Federal Taxable Income = $27,000 Federal Marginal Tax Rate = 15% Marginal Property Tax Cost = $.34

Summary: Marginal Property Tax Cost

	Tax Structure			
Deductibility	Current	Reform	Current, No Credit	Reform, No Credit
Yes	$.30	$.34	$ .75	$ .85
No	$.40	$.40	$1.00	$1.00

One should also keep in mind that it is possible that the demand for state-local government services would rise because of other effects of federal tax reform. One such factor may be the change in the deduction (and thus subsidy) for other goods and services which may be strong substitutes for or complements to current subnational government services. Two potential cases may be charitable activities, the subsidy for which would be reduced because of lower marginal tax rates and the end of the charitable deduction for nonitemizers, and housing, which would be affected by lower rates and the possible loss of the deductions for property taxes and interest on second homes. These changes are expected to increase the marginal costs of both charitable contributions and housing consumption. One might expect that the activities of many charitable organizations are substitutes for state and local government services and expenditures, and it is known that charitable contributions are substantially more price-sensitive than is the demand for state-local goods. Thus one expects a relatively large decline in individual charitable contributions due to federal tax reform, which could increase the demand for government spending on similar services. The effect of changes in housing demand are more problematic, partly because the base for local property taxes as well as demand for services could be affected.

Finally, because the Treasury Department estimates that personal income taxes would decrease by 7 percent overall under the President's plan, with more than 58 percent of individual taxpayers enjoying some decrease, disposable personal income would increase for some taxpayers. Such an income gain implies an increase in the demand for subnational government spending. Nonitemizers are particularly expected to enjoy net tax decreases (that is, income increases) as a result of the reform plan. So while the desired level of state-local spending might fall for current itemizers because of the increased price, desired state-local spending by nonitemizers would increase. And nationally, only about 35 percent of taxpayers have itemized deductions in recent years.

In a slightly different version of this second concern, Henry Thomassen, an adviser to the Governor of Georgia, has argued that the biggest problem for states from the loss of deductibility is the redistribution of tax burden among different income taxpayers. Mr. Thomassen writes:

> Deductibility provides tax expenditures to individuals rather than governments. Because of progressive income tax systems, the benefits received then differ greatly among individuals . . . if deductibility were suddenly ended, losses would be imposed upon taxpayers in inequitable fashion. Today's itemizers would carry an enlarged share of both the Federal and the State and local taxes. (*National Tax Journal,* September 1985.)

In response to this problem, states can, and I believe will, change their own tax structures. States and localities currently make use of some revenue sources, such as gasoline taxes, license fees, and user charges, which are not deductible. Even among deductible taxes there is wide variation in reliance and structure across states. One avenue of response for states to curtailment of the deduction, then, is change in their revenue structure. But if states or localities do change their revenue mix as a result of federal tax reform, this would also change the equity and efficiency effects of the reform plan. States would want to reduce taxes on those residents who lose because of curtailment of federal deductibility. Some options are less progressive personal income tax rate structures and more reliance on business taxes. The result is to work against the incentives for those taxpayers to move or for those taxpayers to demand less state spending. The burden of the loss of deductibility gets spread over all taxpayers and thus the magnitude of effects is reduced. I firmly believe that if federal tax reform reduces the value of the state and local tax deduction uniformly, the states will use fees and direct business taxes more heavily than in the past and will adopt less progressive personal tax structures. If the state and local tax deduction is reduced for only some state and local taxes (such as the elimination of the deduction for sales taxes which was finally adopted), then states will move away from use of the tax which is no longer deductible.

Conclusions

Most economists believe that federal tax reform would be more efficient and more attractive if the tax base is broadened even more than is currently proposed, and thus tax rates lowered more than currently proposed. Such a plan could be fashioned by combining some features of the President's plan (such as reducing deductions for state and local taxes, consumer interest payments, and some business expenses and ending exemptions for some income from tax exempt bonds and transfer payments) with some features of the House bill (such as increased taxation of capital gains income, an effective minimum tax, and a two-tiered personal exemption).

This evening I have considered some of the ways federal tax reform might affect state and local governments. It appears that tax reform will not be neutral among the states, although the differences in changes in tax liabilities among states will likely be small. The loss of federal deductibility of state and local taxes and tax reform in general will increase the marginal cost of state and local tax increases. The result will likely be a small decrease in state and local taxes, but much of that effect may be offset by changes in state and local governments' tax structure, particularly by moving away from taxes which are no longer deductible or by adopting less progressive state-local tax systems.

In terms of the states' position about tax reform, my point of view is that the potential effects on the states have generally been overblown. State and local government concerns about federal tax reform have also been somewhat misdirected, in focusing almost exclusively on the loss of deductibility. Other aspects of the tax reform plan, particularly the decreased amount of itemizing and the lower rates, will have almost as big an effect for state and local governments as the loss of deductibility *per se*.

Regardless of these effects, no one sector of the economy should dictate the nature or possibility of tax reform. I think it is necessary to move away from thinking about how tax reform will affect Joe, how it will affect Michigan, how it will affect the computer industry, or how it will affect state and local governments. We have to think of what tax reform can do for our economy in an overall sense. It is only in that way that the diffused positive effects of tax reform can outweigh the apparent short-term costs to individual sectors.

The potential promise of tax reform is that taxes become less important in economic decision making, less important at the margin, as economists like to say. That is accomplished largely through the lower tax rates. To maintain revenue neutrality, the base in broadened, which improves fairness and efficiency as well. Perhaps the clearest "winners" from tax reform will be low income workers who will be removed from the tax rolls. And the clearest "losers" are likely to be high income individuals with substantial capital investments, particularly in tax shelters. That support for such a change arose across the political spectrum is remarkable in itself.

Postscript: The Tax Reform Act of 1986 is Adopted

In June 1986, the Senate approved a new tax reform proposal developed by the Senate Finance Committee under the direction of Chairman Packwood. The Senate bill, which in retrospect appears to have been the key to ensuring broad political support for reform, differed from the House proposal in at least five important ways. The Senate plan included only two tax rate classes for personal taxes, 15 and 27 percent. The very low top rate made the package particularly attractive, but required more base broadening to maintain revenue. Therefore, the Senate plan phased out the personal exemption for families with incomes above $145,000, eliminated the deduction for consumer interest (except on mortgages), ended the deduction for state and local sales taxes, and continued deductions for individual retirement accounts only for taxpayers not covered by pension plans. Similarly, the Senate plan proposed lower corporate rates, but a broader base, than in the House bill.

After lengthy and uncertain conference committee sessions during the summer, agreement was reached on a compromise plan in August. A fundamental federal income tax reform bill was approved by the Congress in September. That version maintains two formal personal tax rate classes (15 and 28 percent), phaseout of the personal exemption (which effectively imposes a higher marginal tax rate on high income taxpayers), elimination of the deductions for consumer interest and state and local sales taxes, curtailment of the deduction for IRA accounts and includes taxation of capital gains as ordinary income. Also, losses from most tax shelters, so-called "passive" investments, may not be used to offset income from other sources. On the corporate side, the top rate is 34 percent with the investment tax credit repealed and many deductions reduced or eliminated. Minimum taxes were added for both individuals and corporations.

This proposal which emerged from the conference committee was signed into law by President Reagan on October 22, 1986. The net effect is expected to be a substantial reduction in personal tax collections (perhaps about 6 percent) and a substantial increase in corporate tax collections.

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NOTE

1. This is far from a perfect procedure. In effect, it assumes that a taxpayer with a given income can expect the same percentage reduction in personal taxes regardless of state of residence.