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Alan Greenspan

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# THE NEW TAX LAW: THE FUTURE OF PRIVATE ENTERPRISE AND ENTREPRENEURSHIP*

excerpts from a speech by

ALAN GREENSPAN**

". . . Certainly, if the tax bill which just passed the Congress by an almost unanimous vote were to be presented to a congress in, say, 1955 or even 1965, the near unanimity of the vote would have been exactly reversed. It's just not even remotely credible that a tax bill of the type which has just passed could have gotten through any committee in the Congress as recently as ten years ago. It's even quite dubious that it would have made it within the last five years. It's something whose time had arrived and probably got inserted within a relatively narrow focus so far as political and economic policy is concerned in this country.

What I would like to do in order to give you some context on this whole issue is to try to trace back historically and see how we got where we are and hopefully to look into the future and see whether we can take what history has taught us and project that into potential tax changes in the years, perhaps decades, ahead.

This is an extraordinary tax bill. It's got a lot of good things in it; it's got a lot of bad things in it. It's the type of tax bill which is affecting not only the United States but obviously is creating a great deal of problems for Japan, Canada, and especially the United Kingdom. With the marginal tax rates that now exist on earned income, it's going to be an extraordinary magnet for brains in other countries, and, as you may recall, Britain underwent a major brain-drain to the United States years ago and clearly is concerned that it will do so again and is rethinking its tax system. Japan is already making changes as, indeed, Canada is in the process of doing.

How did we get here? I guess the story starts basically with the extraordinary rise in tax rates which occurred as a consequence of financing World War II and the tremendously high marginal rates which existed for a number of years even after the end of the war. It not only was considered appropriate, it turned out to be . . . a certain income redistribution ethic which emerged out of the 1930s in this country and was formalized in the structure of tax rates which . . . ran up to 91% of marginal incomes. As a consequence, it was inevitable that there would be an emergence of a number of groups, especially economists, who looked at the system as inappropriate, [because it] clearly undercut incentives. . . . [The system] was rife with all sorts of exemptions,

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**Dr. Greenspan has recently been nominated to succeed Paul Volcker as Chairman of the Federal Reserve Board. Dr. Greenspan served as Chairman of the Council of Economic Advisors during the Ford Administration and has worked with the consulting firm Townsend-Greenspan & Co., Inc.



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preferences and the like. Nonetheless, for many years following the end of World War II, the notion that something other than a highly progressive, almost confiscatory tax system in the upper income groups was an essential ethic to the American political system. Those who at the time were initating notions of eliminating exemptions and deductions and going to a flat tax, while they may have been both conservative and liberal in their political affiliations, were nonetheless considered to be on the fringe in any tax policy discussion.

The whole issue of [changing] the marginal tax rates in our tax system struck most of the political commentators for most of the post-World War II period as outside the bounds of legitimate rhetoric. Anytime there was a cut in the tax rates, as we went through the early post-World War II years, it had to have a cap on it. [Either] all or a disproportionately large share of whatever tax cuts occurred had to be in the lower to middle income groups. Usually the upper middle income [groups had] no tax cuts. Even when the investment tax credit was initiated as the first really significant endeavor towards incentives for capital investment, . . . the issue was not productivity or investment profitability, it was [the issue of job-creation].

As a consequence, what we learned through all that period was that there were some very rigid, seemingly invariant approaches to taxation in this country which took on a fundamentally bipartisan set of supports. It began to crumble, or at least the first signs that something in the . . . modified welfare-state concept began to crumble, with Vietnam and with the emergence of inflation in this country. For the first time, a middle-class in the United States had evolved with accumulated wealth, not much, but people had houses and began to have a stake in the system. As inflation began to take hold, albeit relatively low rates of inflation, . . . people began to feel very insecure. They were terribly concerned that the underlying pressures of inflation would so distort the system that their newly found wealth and newly found security were being threatened. There began to be a very significant, very gradual, but definite shift in the politics of the United States. The first sign [of this shift was the rebound of the] conservatives in the Republican party in the [1966 election.]

As we moved into the latter part of the 1960s, we began to observe an extraordinary phenomenon. The Great Society programs which were perceived of as the core of what was right for this society and this economy were not working. They were not doing what they were supposed to do. A number of commentators, essentially those with the Democratic administrations, begin to very seriously question whether the whole thrust of American economic policy, of which tax was a crucial part, was working. . . .

This was the wedge which created, within a very few years, a nation looking for a new way. The old ways were beginning to be undercut by reality: inflation and, in many areas, declining real incomes. Something new politically had to emerge.

The early versions of so-called supply-side economics had started to surface when a number of economists raised serious questions about whether the incentives for capital formation and savings were adequate. The notion began to spill over not only amongst a number of conservative Republicans, but . . . economists of all persuasions were beginning to talk in this manner and it soon began to sprout in the Congress. . . .

Still, as late as 1975, the essential old tax ethic remained fundamentally in place even though it was now being chopped away at the base. The tax cuts initiated by President Ford in early 1975 could not have been presented to Congress unless the tax cuts were capped at $40,000 for a joint return. In effect, all the tax cuts had to be in the lower income groups. Progressivity was considered a term which did not describe the algebra of a distribution of the tax system but a fundamental ethical principle which stipulated that if the tax change was not progressive, meaning creating far greater tax burdens in the upper-income groups, it was almost by definition bad. The reverse, regressivity, was considered a burden on society not only in economic terms but in ethical terms, as well.

As a consequence, what we found was that the process of how we dealt with taxation was a vast, very complex set of philosophical insights into how we viewed our society. As the society was changing and as the values were changing, we began to see our old political structure begin very subtly to shift to the right. Following some versions of tax reform, while essentially holding to the post-World War II tax ethic, President Carter introduced the elimination of the capital gains preference and a tax on the three martini lunch. . . . [However], Congressman Bill Steiger introduced a bill which not only worked against eliminating the capital gains tax preference but actually cut capital gains tax rates significantly. . . . Somebody took a head count and found a majority in the Democratic Ways and Means Committee in favor of the Steiger bill and that was the major turning point in tax history in the post-World War II United States.

The bill passed, obviously, and it was followed by a major shift in tax philosophy. You may recall that Congressman Kemp and Senator Roth introduced the so-called Kemp-Roth Bill which had in it a 10% tax cut per year on individual taxes across the board, without any caps for the next three years. You began now to get a flurry of bills, all of which seemed to be reflecting and evidencing changes in the philosophy of how Americans should be taxed and whether the tax system should be employed to create various forms of incentives for capital investment and economic growth. . . .

The Kemp-Roth bill, however, was conjured up in a way which was basically political, not one which was expected to pass, but it did. In the [aftermath] of Ronald Reagan's 1980 campaign, you may recall that he embodied the Kemp-Roth Bill in a number of other elements and we started in new direc-

tions. The new directions, however, really were a part-way extension of the old. I remember Ronald Reagan used to talk at great length about when he had to pay 91% marginal tax rates. His view of tax reform was getting that marginal rate down. But he never really tried because he expected, as everyone else did, that even with this change in tax philosophy, it was very difficult to approach this issue because it was so deeply embedded as an ethical [principle] . . . in the United States. As a result, we had what was something part-way, namely the tax bill of 1981, which probably went a little bit too far and had to be reversed a bit in 1982. It was a very major change which underscored the notion that incentives to capital investment were crucial to the system and that it was terribly important to create [entrepreneurs] . . . who would be the driving force in creating wealth, productivity, and economic gains.

Nonetheless, through all of this, there was this nagging notion in Ronald Reagan's head that true tax reform required that we lower the marginal tax rates. But everyone told him there was only one way you could do that and that was to eliminate all the various tax preferences and no one, in any way, recommended to the President that that was at all feasible. Nonetheless, there was some generalized work going on in the White House about what packages of tax reform would look like and a lot of [dredging] out of the coffers of research in the Treasury Department, in fact done earlier mainly by Democratic administrations. . . .

It went nowhere until Vice-President Mondale got up in the Democratic Convention in 1984 and made his very famous speech which, in a sense, was 'I will raise your taxes if elected president. So will President Reagan, only he won't tell you!' That short sentence threw the White House staff into a frenzy. They figured that perhaps Mondale had gotten a corner on the issue of candor and was going to ride it right through the President, who kept waffling on the question of the budget deficit and taxes and hoped to continue to do so. What the staff then did was rapidly put together the appropriate response to this, which was, in a political sense very clever. The President announced that he had appointed the Secretary of the Treasury to look at the tax system and would report back to him on any suggested changes in December, which just happened to be after the election. [This] created the ability for the President, when confronted with any press requests about . . . taxes and the budget deficit to say 'it's under study.' A wonderful answer . . . and it worked. But something else also emerged, very quickly as you may recall. Mondale began to fall very rapidly in the polls and eventually lost the election very heavily. A lot of people, in retrospect, think that the tax issue was crucial for that.

Then, of course, we got to December and the bureaucratic system worked. . . . The leaks began to emerge on what we subsequently learned was Treasury I. It got so expanded that then Secretary of the Treasury Regan was in a sense required to issue it and I'm not sure that it really got through the type of analysis it should have. As a consequence, Treasury I created a lot of

static, which led to Treasury II. At this point, James Baker had switched sides with Don Regan and he was now Secretary of the Treasury. As a consequence, what we had was basically a tax bill which largely reflected a consensus that we should go to significantly lower tax rates but not take away all of the preferences.

The bill really was not expected to pass because still deep-seated views remained in the system and it was very difficult to perceive that we were going to be able to get that radical a change. In fact, I remember I used to, with my sort of deep-seated cynicism, get up in front of audiences, talking about the tax bill, and say that the President's tax bill would go into committee, would undergo major amendment, and what would emerge would be the existing revenue code. And I really believed that. In fact, anybody who knew anything about the politics of Washington and how economic policy was put together knew that for certain. And we were wrong! We were wrong because I do not think we fully understood how far the whole issue of tax preferences was beginning to undercut the system and create political problems for a lot of people. Then when President Reagan went before the American people with his new tax bill, he sold it not as a revenue-neutral tax reform, but you may recall he really sold it as a tax cut . . . The speech was so craftily written that it was not incorrect in any specifics. There was no sentence which was inaccurate with respect to the bill that was finally presented to the Congress. But unless you listened very clearly, you would have assumed that everyone was getting a tax cut. It was that process, which the President sold exceptionally well, which created the inability of the Congress to vote against it. What was quite remarkable was it went through Congress basically, grudgingly, haltingly, backing and filling, but ultimately with exceptionally high majorities.

The truth of the matter is, we don't really know what that bill is going to do. . . . There are certain things about the tax bill which are really very good and supported by Congress. Of course, the fundamental part of the tax bill, so far as business is concerned, is the conversion essentially of tax preferences into a corporate rate reduction. The major element in those tax preference changes was the investment tax credit. The investment tax credit has always created a lot of problems for a lot of economists, largely because it's the type of tax preference which, while it creates capital investment, creates investments whose productivity levels can't be very high. A capital investment which is highly productive and can reduce unit labor costs, increase efficiency or increase capacity will have a pre-tax rate of return which will be sufficiently high that it will be accepted by management as a desirable investment with or without the investment tax credit. The only projects which the investment tax credit initiate are those which fail to be sufficiently productive [and will be] employed only if the investment tax credit is available. In short, it means that you're using the tax system to allocate capital to marginal projects. Over the long-run, even though the capital creates jobs, it's not an adequate use of

resources. As a consequence, there have been, and continue to be, strong pressures to convert the tax credit into the equivalent tax cut in the corporate rate and that is essentially what was done.

The trouble, unfortunately, is that doing that [will reallocate capital by] changing the definitions of passive income, which has a very significant effect on real estate operations, [and by] changing a number of things, such as the *General Utilities* doctrine, [which] have been job-creating, investment-creating activities, even if they may not [have been] the most productive type of equipment and plant that we [could have] imagined. In any event, the result of this is that we are at the moment reallocating capital. We are reallocating it presumably in more effective areas, but in the interim, lowering the level of overall capital investment until the full transition takes place. So while we may, in the long-run, see this tax bill as essentially being effective in readjusting capital assets, in the short-run it's effect on economic activity must be clearly negative.

It also obviously has significant impact on the market value of real estate and a lot of other properties. Pulling out preferences reduces the market value of an awful lot of real estate and other types of investments whose effects we have yet to sense. It's not clear how it is all coming out.

In any event, I think that we know for sure that this tax bill is not revenue-neutral and will eventually increase the budget deficit. That will create some additional problems for tax legislation.

Our discussion [raises the issue of whether] . . . pressure will be exerted to prevent the 1988 part of the bill from going into effect. But unless Ronald Reagan is under very severe political pressure, there is just no way that he will not veto tax legislation which changes the timing of the marginal tax cuts of 1988 and there is no possibility of an override of a veto in both houses.

I think we can be reasonably well-certain that the tax bill and all of its ramifications will go into affect as scheduled with the caveat that there is going to be a very large tax corrections bill in 1987 and maybe another tax reform bill in 1988 to come to grips with the problems that exist in this bill. There are ten or twenty major mistakes in the existing tax legislation, and I wish I knew what they were. The trouble is, we are all about to find out and when they are ferretted out, there is going to be an awful lot of new legislation coming on.

The tax debate did not end with the Tax Reform Bill of 1986. On the contrary, if anything, it set into motion a very large, significant change in what's going on in the tax area.

I think the important question, however, when you look beyond the issue of 1988 and where taxation is going to be in the 1990s, is to take a step back and look at the political infrastructure and the political philosophy of our system. We have to ask ourselves, . . . 'Is it going to last?' We certainly know the

Greenspan: Lectureship On Private Enterprise



answers to the question of what is the appropriate tax policy for entrepreneurship, investment and growth. . . . It means zero income tax and zero capital gains tax. That's the optimum in looking at it strictly from the point of view of an economist. The question really is: 'Can we expect lower rates in the future or are we going back to the old philosophies?' We cannot answer that question by looking at tax policy. The answer, in the United States at least, is likely to be signaled by the nature of the political philosophy taught in the universities. . . .

The challenges in the American political system are often foreshadowed in our educational institutions. In the 1930s, for example, following the collapse of the capitalist world and its ideologies, the professors, recruited from an earlier environment, retained their conservatism as the students became more radicalized. A generation later, the students had become the professors and many, if not most, had retained their strong left-wing leanings. But then their students began to exhibit signs of conservatism. This clearly accelerated the onset of inflation and the instabilities of the late 1960s and '70s, following the Vietnam War. So today, two generations from the Great Depression, we find that both students and faculty are remarkably conservative in the United States. Issues of earning a living and making one's way in the existing social and political structure now dominate the curriculum and the attitudes of American students. This is a far cry from the radicalism of the 1930s and some of the anti-establishment excesses of the students in the mid-1960s.

Political and social ideology is a fragile thing. There currently seems to be little evidence of a pending return to leftist inclinations judging from the ideological leanings of today's student body. Nonetheless, a rupture in the overall economic system could create grave doubts about the efficacy of existing institutions as it did in the 1930s. Economic distress could significantly alter the political, social and philosophical mix of the United States and presumably that of our trading partners, as well.

Inclinations towards the welfare state and its tax structure philosophies, as well as government ownership of the means of production and heavy state intervention into the western economies is clearly on the wane. Short of a disruption on economic activity of world dimension, there does not appear to be any indication of a reversal in the shift towards capitalism and towards a tax system which supports it. It would be a mistake, however, to presume that the last two decades' change is deep-seated ideology and irreversible. It is largely pragmatic and subject to reversal should the newly implanted seeds of capitalism fail to clearly enhance the living standards of industrial nations.

Our tax code is a reflection of our political values. Marginal tax rates, exemptions, preferences and enforcement are all tied to and reflect the philosophical glue of our political system. Insight of future changes in our tax laws are more readily gleaned by evaluating the changes in philosophy in the faculty and the students of our universities, such as the University of Akron, than by auditing the committee hearings in Congress."

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