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3-1-1985

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Recommended Citation

Weidenbaum, Murray L., "The Case Against Tax Reform in 1985", Occasional Paper 40, 1985, doi:10.7936/K7MK6B20.

Murray Weidenbaum Publications, https://openscholarship.wustl.edu/mlw_papers/93.

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OP40
March 1985

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Presenting the case against "tax reform" at first seems like making a case against democracy and justice. Nonetheless, there are sound and compelling reasons to oppose the current rush to revise the Internal Revenue Code.

The Treasury's Proposals

The staff of the Treasury Department has proposed a "modified flat tax," an academic economist's dream -- an ideal tax structure for the long run. This new system would lower income tax rates, reduce the number of brackets, and curtail or eliminate many of the special provisions that have been added to the Internal Revenue Code over the years. These changes sound so good that it seems difficult for anyone to quarrel with them. Yet given the serious effects of these proposals, a more cautious approach is warranted.

Upon examining the specific details of the Treasury Department's tax reform proposals, it appears that these changes are tantamount to taking a few steps forward, only to end up taking even more steps backward. The following are four sets of these pluses and minuses:

1. Income tax rates would be lowered. The top bracket would decline from 50 percent to 35 percent, but the plan would eliminate

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preferential treatment of capital gains, and limit the tax deductibility of travel and entertainment.

2. The personal deduction would be raised to \$2,000, but itemized deductions of charitable contributions would be limited to the amount over 2 percent of adjusted gross income. For those taxpayers who do not itemize, there would no longer be a special deduction. Also, the deduction of state and local taxes would be terminated.
3. Depreciation allowances would be protected from inflation, but the faster write-offs authorized in 1981 would be removed altogether. Furthermore, the Treasury would eliminate the investment tax credit.
4. Allowable deductions for worker and spouse IRAs would be raised to \$2500 a year each, but deductions for mortgage interest would be restricted to the taxpayer's principal residence. In addition, only \$5,000 of other personal interest payments would be tax deductible.

Not every special provision in the tax code would be eliminated or even modified. Six key items would not be changed at all. Under the Treasury's plan, the deduction for medical expenses above 5 percent of adjusted gross income, tax deferral of corporate pensions, taxation of Social Security benefits, tax exemption of public-purpose municipal bonds, indexing of personal income tax brackets and personal exemptions, and preferential treatment of capital gains on owner-occupied housing would all be retained.

Some Initial Impacts

In sum, these changes would reduce the overall tax burden on individuals and families by about 7 percent, while increasing corporate tax bills by approximately 30 percent. This result may appear politically attractive, but in terms of elementary economics, the Treasury staff apparently ignored one of

President Reagan's most basic and accurate statements: business doesn't pay taxes; it collects them. Only people pay taxes. Moreover, these changes would transfer after-tax income from business firms who save and invest heavily to consumers with much lower saving tendencies.

Of course, the advocates of the modified flat tax do not formally propose to shift the tax burden from consumption to investment. But reducing tax rates and offsetting the substantial revenue loss by closing "loopholes" will have this effect. Apparently, the tax reformers overlooked the fact that these "loopholes" have helped fuel the current economic expansion. The irony here is rich indeed; the same Treasury Department that urged Congress to enact the Accelerated Capital Recovery System (ACRS) as tax reform in 1981 is now selling the rescission of ACRS as tax reform in 1985. What is less amusing, however, is that such "reform" is likely to reduce investment and economic growth, thereby increasing unemployment.

Another problem area in the ambitious Treasury tax plan is the proposed treatment of small business. Eliminating "progression" in corporate tax brackets may sound like tax simplification, but for a small incorporated business with taxable income of \$50,000 a year, the proposed 33 percent standard rate would double its tax bill. For a corporation with annual taxable income of \$100,000, its federal income tax would increase 28 percent. Perhaps, in his review of the Treasury staff work, the new Secretary, James Baker, will abandon changes with such undesirable results.

The proposal to eliminate the lower tax rate for capital gains would also weaken the prospects for an expanding economy. The record on this tax is clear. When the rate goes up, the pool of venture capital shrinks. Conversely, when the capital gains rate is lowered, the supply of venture capital grows rapidly -- and so does the economy.

In 1969, Congress raised the top capital gains tax rate from 25 to 49 percent. The impact of this hike was devastating; venture capitalists commonly refer to the 1970s as the "Death Valley Days" of this critical source of funds for formative enterprises. In 1978, the rate was cut to 28 percent and the availability of venture capital soared. The further cut in 1981 reinforced this trend. The results are plain to see: the rapid creation of new companies and new jobs.

It is not surprising that new high-tech companies -- which rarely start off with large accumulations of capital -- have been in the vanguard of opposition to changing the current tax treatment of capital gains.

In an administration that has rightly advocated greater reliance on voluntarism and private sector initiatives, the Treasury proposals for a basic reduction in tax incentives for charitable contributions is a serious contradiction. Similarly, the same administration that has consistently (and correctly) urged a shift in federal responsibilities to the state and local level, is now proposing to eliminate the helpful deduction of state and local taxes.

Since the average taxpayer contributes less than two percent of adjusted gross income to charity, the great bulk of gifts to philanthropic institutions would no longer be tax deductible. In addition, the proposal to eliminate the deductions of charitable contributions for those taxpayers who do not itemize would have a similar effect, since two out of three taxpayers do not itemize.

The result would not be the end of voluntary giving. But, at the margin, we would expect taxpayers to make fewer gifts to many types of non-profit organizations. Professor Charles Clotfelter of Duke University projects that charitable giving would decline by 20 percent under the Treasury proposal. He

also estimates that contributions by high-income taxpayers would decline substantially, which would eventually lead to a decrease in charitable endowments, arguably the most valuable type of contribution.

These items are just a sampler; it seems that the Treasury's tax proposals constitute an ill-considered assortment. What is most disconcerting, however, is the myopic vision of the Treasury staff. When you ask the plan's architects how much attention was given to the effects of their ambitious package on growth and investment, the response is, incredibly, that they have not gotten around to it yet.

Apparently, the Treasury reformers were primarily concerned with designing a paragon, a peerless new tax system for the long run. Academics in general, and economists in particular, are often criticized for being wedded to idealized models and notions. This is a valid criticism of the Treasury staff, whose plan is nearly oblivious to so many of the practical problems -- including the arbitrary distribution of windfall gains and losses -- that would arise during the transition from the status quo to their new "ideal."

The Case for Tax Loopholes

Because most of the revenue raised under the Treasury proposal is in the form of closing "loopholes," some attention to the true nature of that pejorative term is warranted.

Contrary to popular belief, most of these special provisions do not result from an ingenious accountant's deft manipulation of the Internal Revenue Code's arcane minutia. Rather, the typical loophole was deliberately placed there by Congress to achieve some important national objective. The really big revenue losses among the special provisions are items which the average taxpayer never thinks of as a loophole; they result from such everyday

activities as working and owning a home. Some of the most highly publicized loopholes, in contrast, involve significant but more modest revenue losses. Examples include tax exemption of interest on state and local bonds and shelters for certain types of real estate income.

The largest "loophole" results from excluding employer-paid fringe benefits from taxable income. Simply not having to declare the value of company-financed pensions, health insurance, and similar benefits costs the federal Treasury \$79 billion a year in lost revenues. Being able to deduct mortgage interest, and property and other state and local taxes, reduces federal revenues by \$66 billion annually. The deductibility of charitable contributions and personal interest payments also results in a substantial revenue loss.

Other important special tax provisions provide incentives for saving and investment. Many corporate "loopholes" have been created to promote economic growth -- notably the investment tax credit and liberalized depreciation allowances. Individual investment is encouraged by lower tax rates on capital gains.

Because tax reformers have ignored the justifications for many of these special provisions, it is appropriate to consider why these "loopholes" are currently in the tax code. In many instances, these tax breaks foster private sector alternatives in areas where the public sector would otherwise attempt to provide services. For example, most of the fringe benefits provided by employers are substitutes for direct government operation of social programs. Private insurance in lieu of national health insurance is perhaps the most obvious case in point.

Similarly, the incentives for home ownership are important factors in enhancing family and neighborhood stability. In contrast, direct federal involvement in housing has been a dismal failure. The deductibility of state and local taxes is, in effect, a basic "revenue sharing" effort by the federal government, where the shares are determined by state rather than federal actions.

The special treatment of capital gains, the investment credit, and liberalized depreciation allowances are strongly justified by the need to promote investment and achieve a growing economy. Arguments for reducing these business "subsidies" would be more compelling if the Treasury were not competing so vigorously with the private sector for the limited supply of savings. Existing investment incentives enhance the ability of capital-intensive enterprises (agricultural and industrial) to finance capital formation out of internal cash flow. Thus, the tax incentives are an important ingredient for economic growth.

There are many reasons for the tax deductibility of charitable contributions. Voluntary, private institutions provide important diversity and choice in a free society. They often take on responsibilities which otherwise would be financed entirely by government revenues. Besides being considerably more expensive, those alternative government-sponsored programs are often less effective since they tend to ignore market forces and individual incentives.

From the viewpoint of determining the desirability of maintaining any specific tax incentive, we should compare the costs and benefits of various ways of achieving public policy objectives. In many cases, tax incentives are a more desirable and more economical alternative than direct federal outlays because they focus on the private sector to achieve national objectives. In

other cases, just letting the market work provides the most attractive approach. There is no need to take a doctrinaire attitude and prohibit public policy from using any of these alternatives. The advantages and disadvantages of each mechanism should be weighed, and the most desirable one used to achieve a specific objective, be it the encouragement of business investment or the discouragement of environmental pollution.

The Initial Business Response

The current discussion about tax reform has succeeded in scaring business executives and investors all over the country. This should come as no surprise. A 1985 overhaul of the federal tax system would represent the fourth major change in five years. This will be destabilizing, especially since, in another year or two, we can expect a fifth tax bill to correct the many technical errors that will invariably result from any hastily enacted revision of the complicated federal tax structure.

Under the circumstances, taxpayers should keep a few basic points in mind. First of all, the established tradition in federal revenue legislation is that the changes are not retroactive. There is no guarantee that this tradition will continue. But, in all likelihood, most tax law changes will be limited to future transactions.

Secondly, if any tax bill is passed, it is not likely to follow the Treasury proposals too closely. To begin with, the President himself has not yet endorsed the Treasury plan and Secretary Baker is currently reviewing the decisions of his predecessor. In fact, a great deal of congressional opposition to any tax bill is developing.

So long as pressure exists for raising ever-increasing amounts of federal revenue to contain the deficit, it will be difficult to introduce significant

improvements in the federal tax system without offsetting them through undesirable revenue-raising changes.

Finally, the question of reforming the Internal Revenue Code is still in the stages of proposal and debate. Thus, the only thing that we can be absolutely sure of is that the Congress will hold many hearings and government printers will be cranking out numerous papers to read.

Conclusion

The rush to enact a fundamental change in the federal revenue system in 1985 is misguided. First of all, in the presence of a \$200 billion budget deficit -- which is likely to linger on through the 1980s -- prudence dictates that deficit reduction should get top priority. Focusing attention on tax reform inevitably means turning away from the more difficult, but far more urgent, task of reducing the overblown budget.

A cynic might conclude that the current interest in tax reform is a political smokescreen whereby legislators of both parties can ignore the tough decisions required to get spending under control. But even for those who believe that the tax system is so bad that it needs to be reformed in 1985, there are many compelling reasons to oppose the package of Treasury Department staff proposals:

1. The Treasury proposals would reduce the incentives for new investment.
2. These changes would also reduce the venture capital available for high-tech and other formative enterprises.
3. They would substantially raise the tax burden on small corporations.
4. These proposals would create uncertainty among business and private investors as to the future tax ground rules for new ventures.

5. In the aggregate, the Treasury plan would reduce economic growth and increase the unemployment rate.
6. These tax changes would weaken the financial position of states and localities, and of private non-profit institutions.

The best advice that can be given to the Treasury tax reformers who have been carried away by their enthusiasm is -- back to the drawingboard! Only this time, pay more attention to the effects of your proposals on the actual economy.