FRBSF Weekly Letter

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Tax Reform

Tax reform took a major step forward in June when the Senate approved a bill with many of the hallmarks of earlier proposals by the Administration and a bill passed by the House of Representatives. Both the House and Senate bills would make significant changes in the federal tax system. This *Letter* discusses the objectives of recent tax reform proposals and their likely economic consequences.

Objectives
Equity (or fairness), economic neutrality, and increased economic growth have emerged as three main objectives of tax reform. An objective such as "equity" clearly can mean very different things to different people. In the current discussions of tax reform, equity has been interpreted to mean that individuals with equal incomes should be treated equally by the tax system, regardless of the source or use of their incomes.

Implementing this concept requires a sizable broadening of the tax base. A wider tax base permits marginal tax rates to be cut while still maintaining the same overall level of federal tax revenues. By carefully choosing the extent to which the tax base is broadened and tax rates cut, tax reform can remain consistent with President Reagan's requirement that any tax bill be "revenue neutral", i.e., leave the total federal deficit unaffected over the next five years.

Economic neutrality means the tax system should not interfere with incentives to channel resources into their most productive economic uses, and not create incentives for investments designed merely to avoid taxes. Thus, economic neutrality means a reduction in the current large variation of effective tax rates across industries.

It has been argued that a "fair" and economically neutral tax system would by itself promote economic growth. By broadening the base and lowering marginal personal tax rates, such a tax system may provide greater incentives to work and save. Moreover, such a system also would reduce nonproductive activities undertaken simply to avoid taxation,and encourage productive investment.

Base broadening
All three tax proposals would broaden the tax base by such means as limiting consumer interest deductions, repealing the two-earner deduction, and allowing only 80 percent of business entertainment expenses to be deducted. Both the House and Senate Finance Committee plans would limit tax-deferred contributions to IRAs and 401(k) plans.

However, both the House and Senate bills would broaden the base less than the Administration's proposal. Both bills would retain major deductions from taxable income now in the tax system. These include the exclusion of pension contributions under employer plans, employer contributions to health insurance, social security benefits, and the continued deductibility from taxable income of mortgage interest on owner-occupied, including second, homes.

The Administration's bill would have taxed some health benefits, allowed mortgage interest deductibility only for an individual's principal residence, and eliminated completely the deductibility of state and local taxes. The House bill would restore full deductibility of state and local taxes; the Senate bill would do the same but place a cap on sales tax deductions.

Personal and corporate taxes
Carried out to its logical conclusion, the principle of making an individual's tax liability independent of his *source* of income requires the integration of the personal and corporate tax systems. Each of the three current plans treat this issue differently. All three remove the current personal dividend exclusion, and the Administration and House plans allow corporations to deduct from income 10 percent of dividends paid.

The taxation of long-term capital gains also receives different treatment in the different plans. Here, the Senate version goes farthest by treating all capital gains as ordinary income. The Administration cuts the current 60 percent exclusion to 50 percent, and the House bill cuts it to 42 percent.

The treatment of capital gains is likely to be a key issue affecting tax simplification since the current law's preferential treatment of such gains has generated much of the industry devoted to tax avoidance. As just noted, the Senate bill, by taxing all realized capital gains as ordinary income and thereby eliminating many tax shelters, is likely to simplify the tax system more than the other proposals.

Two changes contained in all three tax reform proposals that will lead to tax simplification for many individuals are increases in the personal exemption and the standard deduction. As currently proposed, this means that many low-income families will not have to file a tax return. Approximately 6 million working poor would be removed from the tax rolls under the Senate plan. Many other individuals who currently itemize will be able to use the standard deduction.

Long-run growth

Supply-side economists have supported lower marginal tax rates on households as a way to promote economic growth. All three plans would significantly cut marginal personal tax rates. In addition, the maximum corporate tax rate would be reduced to 33 percent by the Senate bill, and 36 percent by the House bill.

Despite this, none of the tax reform proposals is likely to have a major impact on economic growth. In fact, they may slightly *lower* the rate of growth the economy is capable of sustaining over the longer run. This adverse effect on longer run growth is due to the plans' provisions for shifting taxes from the household sector to the corporate sector, which can be expected to reduce investment in plant and equipment.

The chart shows the estimated increase in total direct tax payments by the corporate sector over the next five years under each of the three proposals. Each proposal would lower the maximum corporate tax rate, but each would also offset that drop by removing the investment tax credit, increasing the minimum tax on corporations, and, particularly in the case of the House plan, slowing the schedule for depreciation allowances.

In addition, all three proposals provide more favorable tax treatment for existing plant and equipment than for new acquisitions. The lower corporate tax rate and a 10 percent dividend deduction contained in the Administration and House plans would reduce the tax burden on existing capital as they raise the tax burden on new investment by repealing the investment tax credit and extending depreciation schedules. By discouraging new capital formation, compared to incentives under existing law, the proposed tax plans would adversely affect longer run economic growth.

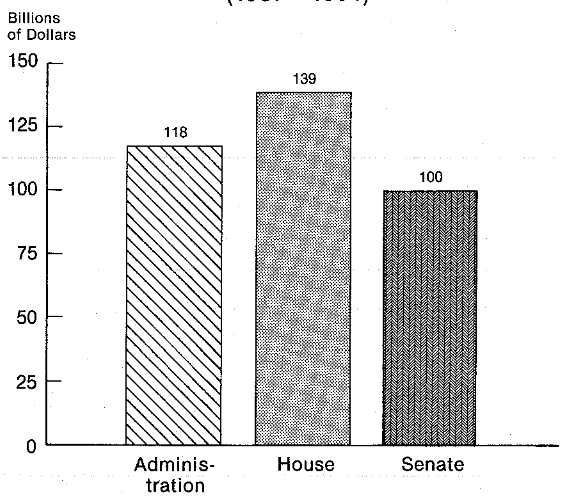
The adverse effect on investment could potentially be offset by a number of factors. First, as discussed in more detail below, tax reform would provide a tax system that treats different types of investment more uniformly. More uniform treatment would tend to reduce the inefficiencies that have been produced by the current tax system. However, empirical evidence suggests that the gains in economic activity from this "uniformity" are likely to be small.

Second, a lower personal tax rate on returns to saving and, in the Senate bill, the elimination of the deductibility of interest on consumer loans, may lift the personal saving rate. A rise in personal saving would provide more funds for investment and thereby reduce the cost of financing for firms. Existing empirical evidence suggests, however, that such an effect would be weak at best. The experience following the 1981 reduction in personal tax rates, for example, is not encouraging in this regard.

Moreover, the Senate bill might actually reduce personal saving by dropping the current deduction for IRA contributions (except for workers not covered by an employer pension plan). Since corporations save a higher fraction of their after-tax income than do households, transferring taxes from households to corporations would lower business retained earnings in the short-run, and thus also may result in a net reduction in total savings by the private sector as a whole, even if household saving rises.

Lower personal tax rates could increase economic growth by raising after-tax wages and

Increase in Corporate Tax Payments Under Various Tax Reform Proposals (1987 - 1991)



thereby induce a greater work effort, although existing empirical evidence suggests this effect is likely to be fairly small. Repeal of the two-earner deduction also would tend to offset this effect somewhat. A variety of estimates suggests that the hours supplied by workers might increase by around 1 percent under any of the plans. Over the next few years, the resulting increase in labor would serve only to offset some of the plans' depressing effect on capital investment. It would have little net effect on the growth of the economy's productive potential.

Economic neutrality

Under current tax law, the effective rates of taxation vary greatly across industries and affect investors differently depending on the types of assets they hold. A neutral tax system would minimize the impact of taxes on private economic decisions. The current depreciation system of Accelerated Cost Recovery (ACRS) together with the investment tax credit (ITC) allow assets to be written off more quickly than would a neutral system that took account of their true rate of economic depreciation.

All three plans would eliminate the ITC. The Administration and House bills both are less generous than ACRS in allowing depreciation deductions. The Senate version retains ACRS, but redefines asset classes and gives more generous depreciation allowances to equipment than to real estate.

In contrast to the Administration and House proposals, the Senate bill retains many of the special treatments current tax law provides to specific industries. It maintains oil percentage depletion allowances and special deductions for reserves held against bad debts at financial institutions. It also keeps the special capital gains rate for corporations in the timber industry.

Tax reform will affect firms' choice of debt and equity financing, as well as the way they divide profits between dividends and retained earnings. A lower corporate tax rate will reduce the value of the interest rate deduction and raise the cost of debt relative to equity financing. The dividend deduction contained in the Administration and House plans, plus the increased tax rate on capital gains, will increase dividend payouts relative to retained earnings.

The tax reform package that seems likely to emerge from Congress later this year will have profound effects on the structure of the American economy. Most of these effects will occur slowly as savings and investment funds are reallocated away from those areas that have benefited from special tax treatment. Because many of the economic forces set into motion by a change in the tax system operate over a long period of time, it will be several years before we can judge the full impact of tax reform.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/18/86	Change from 6/11/86	Change from 6/19/85 Dollar	Change from 6/19/85 Percent[7]
Loans, Leases and Investments[1] [2]	200,024	– 182	7,761	4.0
Loans and Leases[1] [6]	181,714	– 12	7,650	4.3
Commercial and Industrial	51,568	– 318	– 687	– 1.3
Real estate	66,719	– 2	3,235	5.0
Loans to Individuals	38,986	– 21	4,553	13.2
Leases	5,600	– 21	226	4.2
U.S. Treasury and Agency Securities[2]	10,732	– 25	– 492	– 4.3
Other Securities[2]	7,579	– 144	603	8.6
Total Deposits	203,819	– 595	6,512	3.3
Demand Deposits	51,699	159	4,924	10.5
Demand Deposits Adjusted[3]	36,022	– 30	5,602	18.4
Other Transaction Balances[4]	16,261	– 284	2,676	19.6
Total Non-Transaction Balances[6]	135,859	– 470	– 1,087	– 0.7
Money Market Deposit Accounts—Total	46,736	– 87	2,507	5.6
Time Deposits in Amounts of $100,000 or more	35,606	– 115	–2,810	– 7.3
Other Liabilities for Borrowed Money[5]	21,824	–2,247	–2,143	– 8.9

Two Week Averages of Daily Figures	Period ended 6/16/86	Period ended 6/2/86
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	59	127
Borrowings	15	18
Net free reserves (+)/Net borrowed(–)	44	109

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change