Rationale Underlying the Treasury Proposals

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In his 1984 State of the Union message, President Ronald Reagan gave Secretary of the Treasury Donald Regan the following mandate:

> Let us go forward with an historic reform for fairness, simplicity and incentives for growth. I am asking Secretary Don Regan for a plan for action to simplify the entire tax code so all taxpayers, big and small, are treated more fairly. . . . I have asked that specific recommendations, consistent with those objectives, be presented to me by December 1984.

During the following ten months the Office of Tax Policy at the Treasury Department worked to fulfill that mandate, and Regan issued its report to the President, entitled *Tax Reform for Fairness, Simplicity, and Economic Growth* (hereafter Treasury I), in late November.

Academic economists and lawyers specializing in the study of taxation, whether liberal or conservative, were virtually unanimous in their praise of the general contours of the Treasury report; they expressed little doubt that the reforms proposed would go far in satisfying the objectives set out by the President and give the country a much improved tax system. But the outcry that arose from other quarters indicated clearly that the enthusiasm for Treasury I was far from universal. Six more months elapsed before the new Secretary of the Treasury James Baker obtained Reagan's approval of a much watered-down report entitled *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity.*

This paper describes the rationale underlying the tax reform proposals of Treasury I. The first section outlines the need for tax reform and

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the second the basic structure of the reforms proposed in Treasury I. The third section comments briefly on options not followed and the fourth section provides greater detail on the reasoning underlying some of the major reforms and discusses some of the changes made between Treasury I and the President's proposals. The final section provides some concluding observations on the two sets of proposals.

The Need for Tax Reform

Under current law a given amount of income can be taxed very differently, depending on how it is earned and how it is spent. Most cash wages are taxed, but most fringe benefits are not. Interest income on bank accounts is taxed, but that on life insurance policies and state and local bonds is not. Rental income is taxed, but the imputed income on owner-occupied homes is not; even so, interest on mortgage interest is fully deductible by the homeowner. Capital gains are taxed at preferential rates and only when realized—or not at all, when appreciated property is transferred at death. The investment tax credit and accelerated depreciation produce ex ante marginal effective tax rates on income from new investments that vary widely across assets and industries, but are generally far below statutory rates and even negative for some equipment. On the other hand, one particular form of income, that from corporate equity investment, is subject to double taxation, first at the corporate level and again when distributed to shareholders.

Moreover, the U.S. income tax is highly vulnerable to inflation. Fictitious capital gains are taxed, the real value of depreciation allowances depends on the rate of inflation, effective tax rates on real interest income have recently been far above the statutory rate and can easily exceed 100 percent, and the after-tax cost of borrowing can easily be negative. Not only does taxation vary across types of investments, it does so in ways that depend capriciously on the rate of inflation.

These differences in the way various sources and uses of income are taxed create several undesirable effects. Most obviously, it is simply not fair that the income tax paid by families with a given amount of income should vary so greatly, just because of the source and use of the income. Horizontal equity demands that two families with the same income should pay roughly the same amount of income tax.

The current tax system also distorts the allocation of economic resources. Fringe benefits—and consumption that can most easily be taken in the form of fringe benefits—are artificially favored over cash wages. Tax-preferred investment vehicles and investment opportunities are favored over fully taxed ones, resulting in misallocation of funds toward the former and away from the latter. Homeownership is favored

relative to other forms of consumption and investment. The allocation of capital within the business sector is distorted by various tax preferences. Tax preferences, the favorable treatment of capital gains, and the deductibility of interest expense can be combined to create tax shelters that result in allocation of capital to unproductive investments, as well as undermining equity and the perception of fairness. Use of the corporate form—and production that must be undertaken in that form of business organization—is discouraged. The dependence of effective tax rates on the rate of inflation creates uncertainty, as well as encouraging borrowing, discouraging saving, and creating distortions in investment patterns.

Some of the distortions inherent in current law are the result of explicit policy decisions; others are better characterized as accidental. In any event, Treasury I was based on a belief that resource allocation will, by and large, be better if the tax system is neutral in its impact on economic decisions and is not used to implement social and industrial policy.

On balance, much more income escapes the tax collector's net than is caught twice—or once, where no real income exists. As a result, marginal tax rates are substantially higher than would be required if all income were taxed uniformly and consistently. The high rates accentuate any non-neutralities and inequities in the tax system, as well as discouraging work effort, saving, investment, invention, innovation, risk-taking, and so forth.

The current tax system is complex and it causes complexity. To some extent complexity is unavoidable in the income tax law of a complex economy. But to a large degree the tax system is needlessly complex because it is used to further so many nonfiscal objectives. Moreover, it is useful to distinguish between complexity in tax forms, instructions, and recordkeeping, on the one hand, and a more pernicious form of complexity. Tax preferences create complexity in the form of opportunities for tax planning and the distortion of business decisions, and these, in turn, create complexity of the first type. In a world without tax preferences, business decisions could be based on business considerations, without regard for tax considerations, there would be little need for tax planning, and tax compliance and administration could be simpler.

A final concern motivating the proposals of Treasury I was the growing perception that the tax system is unfair. To some extent, this perception is based simply on the recognition that tax burdens at given income levels do vary dramatically and that many high-income individuals are not paying their fair share of taxes. But this perception seems to be manifested often in the seemingly puzzling demand for "tax simplification," rather than "tax reform." In fact, tax simplification may actually just be another name for tax reform, if properly understood. Taxpayers

are not necessarily just saying that *their own* taxes are too complicated when they cry for simplification, though that sentiment is widespread. Rather, they appear to want simplification *for others,* in order to reduce the opportunities *for others* to take advantage of tax-reducing gimmicks.

The perception of unfairness provides an important reason not to implement social and industrial policy through the tax system, even if such policy makes good sense. Since the beginning of the republic governments have spent money in ways that some have questioned. While this may have made many think their tax dollars were being wasted, it did not throw the tax system itself into disrepute. Tax expenditures, the use of tax breaks to achieve nonfiscal objectives, have quite different and more pernicious effects, for they create the kind of horizontal inequities—not to mention vertical ones—that undermine taxpayer morale, a most precious commodity in a system based on voluntary compliance.

In summary, then, the proposals of Treasury I were based on a concern for horizontal equity among similarly situated taxpayers, for neutrality in the allocation of economic resources, for lower tax rates and greater economic incentives, for simplification, especially where opportunities for tax planning are concerned, and for the perception that the tax system is fair. It was expected that a more neutral tax system and lower marginal rates would be more conducive to economic progress. The President's proposals, by comparison, contain a much less comprehensive definition of real economic income and more explicitly favor capital formation and innovation, at some cost in terms of equity, neutrality, and simplification.

The Broad Contours of Treasury I

The overriding objective of Treasury I was to tax, as nearly as possible, *all real economic* income more uniformly and consistently and at lower rates. The discussion of the three italicized words, which are key to the proposals, can be brief, given the discussion of the previous section.

All income must be taxed, if the tax system is to be fair, economically neutral, and simple, in the sense of avoiding opportunities for tax planning. But no income should be taxed twice, as corporate equity income distributed as dividends now is. Nor should fictitious income be taxed, be it nominal capital gains or the inflation premium in interest income. Conversely, deduction should not be allowed for the inflation component of interest expense. Inflation adjustment should also be made in the calculation of depreciation allowances and the cost of goods sold from inventory. Without these adjustments, the income tax will not be based on real income and it will not be fair or neutral.

Finally, economic income should be the basis for taxation that is to

be fair and neutral. This rule has many ramifications. First, fringe benefits should be taxed, as well as cash compensation. Second, income should be recognized for tax purposes when earned, rather than merely when received; if that cannot be fully achieved, the timing of deductions for expenses should at least match that of the income the expenses produce. Third, depreciation, depletion, amortization, and other deductions for expenses associated with wasting assets should, to the extent possible, track the decline in value of such assets.

A further objective of Treasury I was to increase the tax threshold by enough to approximate the official poverty level, and thereby eliminate tax liability on families living in poverty.[1] This was to be done primarily through an increase in the personal exemption; however, the earned income tax credit would be indexed and the zero bracket amount (ZBA) would be increased, especially for heads-of-households, those single persons who support dependent relatives.

A change in the overall progressivity of the tax system was *not* an objective of Treasury I. Raising the tax threshold would, of course, increase the progressivity of the tax system in the very lowest income brackets. But beyond the point at which this effect phases out, the Treasury I proposals would be distributionally neutral.[2] Whereas on average the reduction in individual income tax would be 8.5 percent, the reduction for the brackets above $20,000 would lie in the narrow range of 6.4 to 9.3 percent. Of course, *within* these income brackets there would be substantial redistribution of tax burdens. For example, in all income classes above $15,000 per year, more than 60 percent of all families would experience a tax decrease. But substantial numbers—20 to 36 percent of families in the various income classes—would experience tax increases. Particularly interesting is the fact that in the two income classes above $100,000 per year more than 15 percent of taxpayers would have tax increases in excess of 2 percent of income. By comparison, in those same two income classes, 27 percent (for the $100,000 to $200,000 class) and 49 percent (for those with incomes above $200,000) would have tax decreases in excess of 2 percent of income. This is a clear manifestation of the fundamental proposition underlying Treasury I: under current law different sources and uses of income—and therefore families with similar incomes—are taxed very differently.

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[1]The "25 percent" rate reduction enacted as part of the Economic Recovery Tax Act of 1981 shifted the rate schedule *down;* thus it provided no relief for those at the bottom of the income scale who had been hurt most by the bracket creep of the 1970s that had, in real terms, shifted the rate schedule *to the left*. Treasury I and the President's proposals would shift the schedule *to the right,* thereby removing poverty-level families from the tax rolls.

[2]Figures on distributional effects cited in this paper refer to family economic income, as used in Treasury I and described therein. See U.S. Treasury Department (1984, Volume 1, pp. 57–61).

Treasury I contained a substantial shift of tax burdens from individuals to corporations. To some extent this was the result of a political calculation: if the proposals were revenue neutral for corporations and for individuals, considered separately, there would be about as many losers as winners among individuals, and therefore little popular support for reform. But there was also an important economic reason for the shift: the fear that the gap between a corporate rate of 28 percent and a top personal rate of 37 percent would be great enough to induce taxpayers to use artificial business structures to avoid tax.[3] Of course, the increase in corporate taxes may have done as much to create opposition—especially highly vocal opposition—as was gained by the shift of revenues.

Options Not Followed

An understanding of the rationale for not proposing certain things in Treasury I may be as important as understanding why certain provisions were proposed. This section discusses three of these: the choice of income rather than personal consumption as the tax base; the rejection of a value-added tax; and the tax treatment of housing under the income tax.

Taxing Personal Consumption

Many observers believe that it would be desirable to shift reliance from income taxation toward the taxation of consumption. This can be achieved in at least three more or less distinct ways. The first of these would be to substitute a full-fledged personal cash-flow tax for the income tax. The second would be to impose a value-added tax (VAT) or other form of sales tax, and the third would be to use ad hoc approaches to favor saving and/or investment under the income tax. Unfortunately, the relative advantages of the three approaches seem to lie in inverse order to their likelihood of being employed.

Recent years have seen the development of considerable academic support for a personalized tax based on consumption, rather than income. Many proponents of a tax on consumed income, especially economists, emphasize intertemporal neutrality in the choice of when to consume and equity defined in terms of lifetime endowments. Probably more important than these are the considerable administrative advantages of a consumption tax based on cash flow. Questions of the timing of recognition of income do not arise, because the tax is based on cash flow. Similarly, inflation adjustments are not necessary in the measure-

[3]Simple aesthetics also played a part in the choice; a rate structure for individual taxpayers of 15-25-35 is simply more attractive than 16-28-37!

ment of income (though they are needed for bracket limits and other figures fixed in nominal terms), since cash flow inherently occurs in dollars of the current period.

Despite these manifest advantages—which are highlighted by the complexity of the Treasury I proposals for inflation adjustment and the time value of money—the tax on consumed income was not proposed, in part because the technical experts at the Treasury Department were not convinced that by December 1 they could solve all the problems it might entail. With severely limited staff resources and a tight deadline, it would be impossible to proceed very long on a dual track to develop detailed proposals for both a comprehensive income tax along traditional lines and a novel tax on consumed income. Thus it was necessary to be confident early in the tax-reform process that there were no "showstoppers"—problems that could not be solved—if all staff resources were to be devoted to the tax on consumed income. For better or worse, that confidence did not exist. Among the potential showstoppers were the following: transition, international issues, and the treatment of bequests.[4]

The current income tax involves payment of tax as income is earned, with tax-free consumption or bequest. A tax on consumed income, by comparison, involves no payment of tax as income is earned, as long as income is saved, but taxation at the time of consumption; the treatment of bequests is a controversial issue to be discussed below. The transition problem derives from the fact that it would not be fair—or politically feasible—to levy the personal consumption tax on retirement consumption out of savings accumulated under an income tax. Nor would it be a simple matter to formulate a workable transition provision—which might need to be in effect for several decades—that would exempt consumption from the preexisting after-tax savings of most taxpayers of middle age or older, but without exempting all such wealth, no matter what its size.

International issues take at least two forms: international tax relations and tax evasion. A switch to a tax on consumed income would necessitate renegotiating all foreign tax treaties now in effect. No other country has a tax on consumed income. How to mesh a tax on consumed income with the income taxes of other countries is far from obvious. Nor could the process of renegotiating tax treaties be concluded quickly. It is useful to note that neither Sweden nor the United Kingdom, both of which have been studying the consumed-income tax for roughly a decade, has yet adopted such a tax.

Under an income tax, evasion involves mischaracterization or hid-

[4]For a somewhat more detailed description of the problems posed by constraints on staff and time, see McLure (1985a). See U.S. Treasury Department (1984, Volume 1, Chapter 9) for a more detailed discussion of the potential "showstoppers."

ing of income flows. By comparison, under a tax on consumed income, tax can be evaded if saving can be documented artificially. It appeared that international capital flows provided unacceptable opportunities for this type of fraudulent behavior. (For example, funds borrowed abroad, but not reported, could be brought into the United States as "saving."[5])

One particularly attractive version of a cash-flow tax is based on the desire to tax lifetime income endowments in a way that does not depend on when during the taxpayer's life income is earned and when it is spent.[6] Under this version, bequests would be included in taxable consumption of the decedent as well as being part of the endowment of the heir. Such a tax could easily be as progressive as the current income and transfer taxes, even if levied at relatively low rates.

Under a very different view, the cash-flow tax would not apply to bequests; rather, its base would be only consumption. The existing distribution of taxes by income class could be achieved, if at all, only by levying extremely high marginal rates on consumption—rates that are unlikely to be enacted. Under this approach, the tax liabilities of wealthy families would exceed those of upper middle-income families only to the extent of differences in levels of consumption. Dynasties would be perpetuated and inequalities in the distribution of income would grow. The defects of this second approach and the uncertainty of how bequests might ultimately be treated makes one pause before proposing a tax on cash flow.

One particular form of tax on consumption, that proposed by Hall and Rabushka, merits special attention. Their ingenious proposal suffers from a fundamental political drawback in addition to those just discussed: because of its flat rate, which is essential for administrative reasons, it would involve a massive redistribution of tax burdens from those at the top of the income scale to those in the middle.[7]

Value-Added Tax

A combination of a value-added tax (or retail sales tax) and a comprehensive income tax levied at lower rates could constitute an attractive package. The VAT is relatively neutral, it is generally regarded as being fair, and it avoids the tax bias against saving inherent in the income tax. Moreover, it would take some of the pressure off the income tax, allow-

[5]This problem is over and above the transitional difficulty resulting from the possibility of repatriating wealth previously held offshore.

[6]See Aaron and Galper (1985).

[7]See Hall and Rabushka (1985). Hall and Rabushka (1983) indicate that at a 1979 level of income of about $250,000, taxes would fall by almost one-third. By comparison, at an income level of about $28,000, they would rise by about one-third. For further appraisal of the Hall-Rabushka tax from the perspective of a value-added tax, see Carlson and McLure (1984).

ing lower rates and making remaining distortions and inequities less important. The income tax, on the other hand, could retain conceptual and economic integrity, thereby avoiding the distortions and inequities of current law.

This stands in marked contrast to the use of ad hoc incentives for savings under the income tax. The investment tax credit and accelerated depreciation can easily produce negative tax rates on equity income, and the use of debt financing makes matters worse. Activities that would not be undertaken in the absence of taxation become attractive in such a world. Moreover, the perception of fairness and taxpayer morale suffer.

Even though an entire volume of Treasury I was devoted to the discussion of a value-added tax and other forms of general sales tax, such a tax was never a viable alternative. President Reagan had stated repeatedly, and most prominently during the debates with Walter Mondale, that he would consider a tax increase only as a last resort. Within the context of revenue neutrality imposed by this promise, a value-added tax would be admissible only as a partial replacement for the income tax. Given the substantial administrative and compliance cost of introducing a VAT, not to mention other considerations, this did not seem to be a reasonable policy to propose.[8]

This is not to say that a value-added tax or federal retail sales tax should not have been proposed. My own view is that the continuation of substantial budget deficits endangers the macroeconomic health of the entire world, as well as contributing to the strength of the dollar that hampers the competitiveness of much of American industry. Moreover, I doubt that the will exists to cut enough from the budget to make much of a dent in the currently projected deficits. If we are not willing to make those cuts, then we must reconcile ourselves to paying the taxes necessary to cover our budgetary excesses—and the sooner we start, the better. My preference would be to introduce a sales tax as soon as possible—which may not be for several years, because of the time required to put such a system in place—using a temporary surcharge on a greatly reformed income tax base to buy the time necessary.

The Home Mortgage Deduction

It is unfortunate—if politically inevitable—that President Reagan was forced into removing the home mortgage deduction from the table of tax reform. Because net imputed income on owner-occupied housing is not subject to tax, but property taxes and mortgage interest are deductible, net imputed income is, in effect, subject to a negative rate of tax. Taxing income from other investments at a positive rate therefore

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[8]See also U.S. Treasury Department (1984, Volume 1, Chapter 10, and Volume 3).

results in the misallocation of capital toward housing. The inability to reduce the deduction for mortgage interest means that it is absolutely impossible to achieve a level playing field among alternative investments, except by leveling down to an effective tax rate of zero or below. This is, in a sense, what happened in 1981 when the investment tax credit (ITC) and the accelerated cost recovery system (ACRS) were employed to redress the favoritism previously shown toward housing. (Of course, the abatement of inflation further benefited business investment, relative to owner-occupied housing.) But reducing the taxation of business income in this way, rather than through rate reduction, has further adverse effects. A much more satisfactory approach would be to begin to move toward elimination of the deductibility of mortgage interest, perhaps over a period of 15 to 20 years.[9]

The Proposals

Achieving the objective of taxing all real economic income uniformly and consistently would require changing a large number of provisions of U.S. tax law. This section describes briefly the reasons for some of the more important and more controversial proposals of Treasury I and (where different) the tax reform package submitted by President Reagan.

Fringe Benefits

Treasury I would have taxed many fringe benefits that are currently tax free to the employee, but deductible by the employer. The most important of these was the proposal to tax health benefits in excess of $70 per month for a single person and $175 per month for a family.

Fairness, economic neutrality, and the desire for rate reduction underlie the proposal to tax fringe benefits. It is not fair, for example, that some taxpayers must pay for health care with after-tax dollars, while others receive the same (or better) care as a tax-exempt benefit. Moreover, the tax-free status of most fringe benefits causes them to be overconsumed, relative to other goods and services. There is little question, for example, that much of the growth in health benefits can be traced to their favorable tax status. Finally, of course, there is substantial revenue in the area of fringe benefits. Taxing benefits would allow significant reductions in marginal rates.

In principle, all health benefits should be included in a comprehensive definition of taxable income. There may, however, be important policy reasons for not going so far, as well as persuasive political rea-

[9]For a further discussion of this issue, see McLure (1985b).

sons. There may, for example, be social benefits from employer provision of basic health insurance, and retaining tax incentives for benefits below a ceiling can be justified as a means of forestalling demands for national health insurance.

The Treasury I approach in the health care area represents a compromise between the competing objectives of equity, neutrality, and rate reduction, on the one hand, and the social benefits of employer-provided health insurance on the other. It would hit only the most generous schemes, where the distorting effects of the bias in current law are most obvious, and would, considered by itself, make the income tax more progressive.

The approach to the taxation of fringe benefits adopted in the President's proposals has little attraction beyond a modest amount of rate reduction and the achievement of a small crack in the armor of resistance to the taxation of fringe benefits. Only the *first* $10 per month of health benefits for a single person ($25 for a family) would be taxed, and virtually all other fringe benefits would remain tax-exempt. This approach would improve slightly equity between those taxpayers who do have health coverage, and those who do not, but its distributional effect within the covered group would be perverse. And, of course, being inframarginal for most taxpayers, the approach in the President's proposals has almost no benefit in terms of redressing the incentives for over-utilization of this form of compensation.

State and Local Taxes

State and local taxes are spent largely to provide services that benefit those who pay the taxes. As a result, there is little more reason that they should be deductible than there is that other (private) consumption expenditures should be tax-preferred. The deduction implies that on average for every dollar spent at the state and local level some 15 to 20 cents is, in effect, paid by residents of other states. This, in turn, creates a tendency for the public sector to be over-expanded at the state and local level.

The deduction for state and local taxes also has distributionally perverse effects. Both the likelihood of itemizing and the value per dollar of itemized deductions rise with income. Moreover, though the correlation is far from perfect, the states with the highest amounts of deductible taxes per capita tend to have the highest levels of income.

Defenders of the deduction for state and local taxes commonly argue that many state activities have important spillovers of benefits across jurisdictional boundaries and that much of state and local spending is for redistributional purposes. These arguments are not persuasive. First, the deduction for all state and local taxes is an extremely blunt and

inefficient instrument for the encouragement of the relatively small portion of subnational expenditures that do have important spillovers at the margin. Targeted grants are more appropriate for this purpose. Nor is the distribution argument persuasive. A common tenet of the literature on the assignment of taxes and expenditures in a federal system is that taxes levied at the state and local level should reflect benefits of public services, with redistribution being left to the federal government.

Nor is it compelling to argue that repeal of the deduction for state and local taxes would cause competition among these governments. Economists have long seen competition as the benefactor of the consumer, by ensuring efficiency, cost consciousness, and consumer sovereignty. The same arguments can be made for competition among governments.[10]

The proposal to allow deduction for only some state and local taxes is also not attractive. The federal government should interfere as little as possible in the decisions of state and local governments, absent a compelling reason for interference. Differentiating between state and local taxes would induce artificially excessive reliance on the revenue sources remaining deductible.

Charitable Contributions

The proposals of Treasury I would affect charitable contributions in four important ways. Most important, rate reduction would lessen the incentive for charitable giving. Beyond that, the deduction for non-itemizers would be repealed, itemized deductions would be allowed only for contributions in excess of 2 percent of adjusted gross income, and deductions for gifts of appreciated property would be limited to the taxpayer's (inflation-adjusted) basis in the property. President Reagan proposed only repealing the deduction for non-itemizers, in addition to reducing rates, but would apply the individual minimum tax to the excess of market value over basis in the case of gifts of appreciated property.

Contrary to much of what has been written, the authors of Treasury I did not view charitable contributions as just another tax preference to be eliminated in the name of fairness and neutrality. Rather, they recognized explicitly the social value of allowing tax benefits for philanthropy. There are, however, conflicting objectives in the world of tax reform. Elimination of the deduction for non-itemizers was proposed in the name of fairness, simplicity, and rate reduction; it was also believed that adverse effects on giving by non-itemizers would not be significant. In the case of the floor for itemized deductions the argument was basically

[10]See, for example, Brennan and Buchanan (1983).

simplicity, as well as rate reduction in the context of revenue neutrality. For the taxpayer who could predict at the first of the year that he or she would exceed the floor, the incentive effects would be the same at the margin (except insofar as rates are reduced) as if there were no floor. Incentives would be reduced for those below the floor, but taxpayer compliance would be simplified. Finally, the argument on gifts of appreciated property was one of fairness; taxpayers should not be allowed a deduction for amounts never recognized as income.

Measurement of Capital Income

In the current income tax, measurement of income is based on historical costs of assets and on nominal interest income and expense. As noted earlier, this makes the equity and neutrality of the tax system vulnerable to inflation because effective tax rates depend on the rate of inflation. Moreover, during inflationary times there are political pressures for ad hoc adjustments to income measurement to compensate for the adverse effects of inflation—but not usually for the beneficial ones. This helps explain the liberalization of the taxation of capital gains in 1978 and 1981 and the political appeal of the accelerated cost recovery system (ACRS) and the investment tax credit (ITC) enacted in 1981.[11] Of course, when inflation abates, as it has since 1981, such compensatory provisions can be overly generous and create further inequities and distortions.

Inflation adjustment. Treasury I attempted to cut through this problem by providing explicit inflation adjustment for depreciation allowances, for the cost of goods sold from inventory, for capital gains, and for interest income and expense. With explicit allowance having been made for inflation, there would be no need for ad hoc surrogates for inflation adjustments. Thus Treasury I proposed that depreciation allowances be based on the best available estimates of economic depreciation and that the preferential taxation of capital gains be eliminated. Moreover, like the two major Congressional contenders in the tax reform arena (the Bradley-Gephardt and Kemp-Kasten proposals), it proposed repeal of the investment tax credit, which, in combination with ACRS, produces negative effective tax rates on income from investment in equipment at current levels of inflation. In present value terms the real value of depreciation allowances would be roughly as great for most types of assets under RCRS (the real cost recovery system proposed in Treasury I) as under ACRS (but not as generous as the combination of ACRS and the ITC) at rates of inflation of roughly 5 to 6 percent or higher.

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[11]See McLure (1984).

Inflation adjustment of interest income and expense is arguably the most important of the proposals for dealing explicitly with inflation. The failure to index interest has pervasive and pernicious effects in undermining the equity and neutrality of the tax system. Moreover, current law contains no ad hoc surrogates for the inflation adjustment of interest, as it does for capital gains, depreciation allowances, and cost of goods sold from inventories. Nevertheless, interest indexing was not included in the President's proposals, because it would increase the complexity of taxpayer compliance, cause a loss of revenue,[12] and (as proposed in Treasury I) provide a windfall for financial institutions (by exempting a portion of their "spread" from tax). Unfortunately, few non-economists realized how crucial interest indexing is to the uniform and consistent taxation of all income.[13]

Depreciation allowances. While retaining the provision for inflation adjustment for depreciation, the President's proposals also provided for acceleration of such allowances. But they did so in a way that would be relatively neutral, since the effective tax rate on income from equipment would be uniform across assets—and slightly below that on income from structures.[14]

Aside from the obvious political pressures to do so, there are compelling economic reasons for providing more generous depreciation allowances than under Treasury I. Owner-occupied housing, as noted above, is taxed at negative effective tax rates. Thus resource allocation may actually be made worse by taxing income from all other sources at effective rates approaching the statutory rates. But it is important to recognize that once one retreats from the anchor of economic depreciation, opportunities for tax shelters and tax planning—and the distortions and inequities they entail—reappear.

Capital gains. The Treasury I decision to eliminate the partial exclusion of long-term capital gains was based in substantial part on the desire for simplification. Much of the tax code is devoted to the distinction between long-term capital gains and ordinary income, and much tax planning and tax shelter activity involves the recharacterization of ordinary income as capital gains. Eliminating this distinction would therefore greatly simplify the tax law and reduce the latitude for tax

[12]Some economists realized, however, that by inducing a drop in interest rates, indexing would result in an even greater saving in interest on the national debt.

[13]As proposed, interest indexing did contain a major flaw: it did not extend to interest on mortgages on the principal residence of a taxpayer. Hendershott (1985) has emphasized the misallocation that could result from this omission, particularly at high rates of inflation. In principle—if not in political reality—this defect could easily be remedied. See also McLure (1985b).

[14]This slight preference for investment in equipment, relative to structures, was motivated by the belief that any externalities from investment were likely to be greater for equipment, plus recognition that structures are often debt-financed.

planning based on the distinction between long-term capital gains and ordinary income.

It was recognized from the outset that eliminating the preferential treatment of long-term capital gains could have potentially adverse effects on innovation, entrepreneurship, the supply of venture capital, general capital formation, and economic growth, even if inflation adjustment assured that only real gains were subject to tax. For most "vanilla" investments, those that do not yield extraordinarily high returns, the combination of inflation adjustment and taxation of gains as ordinary income would be as favorable as the current law's exclusion of 60 percent of nominal gains, except at very low rates of inflation. The more compelling case for preferential treatment involves entrepreneurs—and perhaps suppliers of venture capital—who have little basis in an activity that becomes highly profitable. For them, inflation adjustment would not compensate for the loss of the partial exclusion of current law, and some preferential treatment may be justified on externality grounds. In the preparation of the President's proposals, an attempt was made to devise a scheme that would allow preferential treatment only for gains realized on the sale of corporate shares in new ventures, but this was ultimately abandoned as administratively infeasible, in favor of continuation of a general preference for all long-term capital gains.

Dividend Relief

The deduction of one-half of dividends paid, proposed in Treasury I, was intended to reduce the discrimination against income from corporate equities. That, in turn, would reduce the disincentives for equity financing relative to debt financing, increase the attractiveness of new issues of shares relative to retained earnings, and reduce discrimination against products of the corporate sector. The deduction would be available only for dividends paid out of fully taxed income, but under Treasury I that constraint generally would not be a serious one, since most corporate income would be taxable.

The Treasury I proposal broke with common international practice in that it called for a dividend-paid deduction, rather than a shareholder credit, as the vehicle for dividend relief.[15] The shareholder credit or imputation system is commonly preferred because under international convention the credit can be withheld from foreign shareholders with-

[15]In the formulation of Treasury I, considerable attention was devoted to allowing a deduction only for dividends paid on new issues of stock, along the lines of the proposal in the ALI report on subchapter C. (See Andrews, 1984.) Such an approach would have the allocative advantages of allowing relief for all dividends, but at only a fraction of the cost; moreover, it would avoid bestowing windfall gains on owners of existing shares.

out violating tax treaties. By comparison, levying an equivalent withholding tax on dividends paid to foreigners would violate such treaties. In addition, nonprofit organizations would automatically benefit from the dividend-paid deduction, whereas under the shareholder credit approach such organizations would not benefit, in the absence of refunds.

The treatment of dividends under Treasury I (and the President's proposals) was predicated on a desire to extend the benefits of dividend relief to both foreign shareholders and tax-exempt organizations in order to create equality in the tax treatment of debt and equity investments. Given the large number of IRAs, Keogh plans, etc., that are tax-exempt and potential claimants for refunds, the dividend-paid deduction is clearly the simpler approach. There is an expectation that treaty partners who have imputation systems will extend their benefits to U.S. shareholders, not that the United States will impose a withholding tax in order to deny the benefits of dividend relief to foreign shareholders.

Oil and Gas

Under Treasury I the oil and gas and other extractive industries would be taxed on economic income, like other sectors of the economy. This would be done by 1) repealing the option to use percentage depletion and 2) eliminating the provisions that allow immediate expensing of intangible drilling costs (IDCs) by independents. Thus all costs of creating an asset would be capitalized and written off through either depreciation or cost depletion. As with other provisions in Treasury I, these proposals were motivated by a concern for equity, economic neutrality, and simplification, as well as rate reduction. The President's proposals would retain current-law treatment of intangible drilling costs, ostensibly on the grounds of national security, but would tighten the treatment of IDCs under the minimum tax.

The Administration position on IDCs is among the most damaging to the case for tax reform. First, retaining expensing of IDCs has a high cost in terms of both horizontal and vertical equity, neutrality, and simplification (because it would leave intact an important vehicle for tax shelters). Moreover, failure to deal adequately with this highly visible and symbolic issue has caused many to doubt the commitment of the Administration to meaningful tax reform. The appeal to national defense—and, implicitly, to energy independence—is not compelling. One can only wonder how much more nearly independent of foreign suppliers the United States would now be if it had not previously accepted national defense arguments for such misguided policies as import quotas, percentage depletion, and expensing of intangible drilling costs, which are designed to "pump America dry first."

Minimum Tax

The tax base under Treasury I would have approximated economic income closely enough that a minimum tax would not be needed. By comparison, the President's proposals retain many forms of preferential tax treatment: for example, for the oil and gas and other extractive industries; for investment in depreciable assets; and for long-term capital gains. This being the case, it was thought necessary to retain a minimum tax for both corporations and individuals.

The minimum tax is evidence of a schizophrenic view of tax preferences. On the one hand, preferences are retained, presumably because of some overriding social reason not to tax all income uniformly and consistently. But there is strong resistance to allowing any one taxpayer to make too much use of tax preferences, and thereby eliminate (or almost eliminate) tax liability, no matter how justified the individual preferences may appear to be. The policy problem, thus, is to decide how much use of tax preferences is too much.

The minimum tax in the President's proposals would add an important new wrinkle to the existing structure, aside from tightening the tax treatment of intangible drilling costs and subjecting to minimum tax the difference between basis and market value in the case of charitable gifts of appreciated property. This is the proposal to apply the minimum tax to 20 percent of interest expense, to the extent that depreciation is accelerated (as measured by the excess of depreciation allowances over those under RCRS). The idea behind this proposal is that while accelerated depreciation is a legitimate preference designed to stimulate investment, combining it with debt financing goes too far, in the sense of increasing the likelihood of negative effective rates and the ability to pay no tax.

The "Windfall Recapture" Tax

The President's proposals included a novel provision not found in Treasury I or, indeed, in any prior legislative proposal for tax reform, the so-called "windfall recapture" tax. The rationale for the recapture tax is relatively straightforward. Those who have taken advantage of accelerated depreciation under current law have accumulated substantial "deferred tax accounts" which will be reversed or "unwound" once assets pass the "break-even point" at which depreciation for tax purposes no longer exceeds book depreciation. Reduction of statutory tax rates would create a substantial windfall; for example, for a corporation the deferred income would be taxed at 33 percent, rather than 46 percent. The purpose of the windfall recapture tax is simply to prevent this windfall, by subjecting to tax 40 percent of income deferred via accelerated depreciation between January 1, 1980 and the middle of 1986.

This proposal has been criticized as reneging on the investment incentives offered under ACRS and as an unfair capital levy. Both claims are, in principle, unfounded. A properly constructed windfall recapture tax would only prevent the windfall that would otherwise result from the combination of rate reduction and prior acceleration of depreciation allowances. The Administration proposal can be faulted only for using an exceptionally slow measure of depreciation as its benchmark (that employed in calculating earnings and profits), for requiring repayment of the windfall tax over a period shorter than economic depreciation would require, and for applying to depreciation on real estate expected to be "unwound" at capital gains rates.[16]

Concluding Remarks

The proposals of Treasury I were intended to comply with a Presidential mandate to design a tax system that would be fair, economically neutral, simple, and conducive to economic growth.[17] As such, they generally were mutually consistent and had internal integrity. By comparison, current law is a collection of provisions for capriciously preferential and punitive taxation of various sources and uses of income; not surprisingly, it lacks consistency and integrity.[18]

The President's proposals lie somewhere between current law and Treasury I. There are far fewer deviations from uniform and consistent taxation than current law, but more than in Treasury I. Adoption of the President's proposals would represent fundamental reform in several respects—markedly lower rates, elimination of the deduction for state and local taxes, a foot in the door on the taxation of health care, elimination of percentage depletion, and so forth. But the plan would fall quite short of Treasury I in several important respects—a uniform and consis-

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[16]For more on this, see Stretch and Sunley (1985) and Aaron (1985).

[17]Actually, the President did not mention economic neutrality in his 1984 State of the Union Address. But in 1981 he used the following words that are totally consistent with the neutrality objective:

> The taxing power of government must be used to provide revenues for legitimate government purposes. It must not be used to regulate the economy or bring about social change. (President Ronald Reagan, to a Joint Session of Congress on the Program for Economic Recovery, February 18, 1981.)

[18]I sometimes employ the following analogy: Treasury I would have produced a tax law that is basically "round," albeit with a few lumps and bulges (resulting, for example, from retention of preferential treatment of owner-occupied housing and municipal securities). By comparison, current law resembles a bag full of balls, boxes, and sticks; rather than being round, it is nothing but a collection of bumps, lumps, and bulges. Needless to say, converting the current system to the model of Treasury I would require fundamental reform, as the President recognized in issuing his January 1984 mandate to the Treasury Department.

tent definition of income, including especially fringe benefits; comprehensive inflation adjustment; economic depreciation; taxation of capital gains as ordinary income; elimination of expensing for intangible drilling costs; no need for a minimum tax.

There may have never been much hope that Treasury I would be adopted in its entirety. It may have been too comprehensive for the American political system to swallow, even if advocated by a strong and popular president. Whether the President's less ambitious proposals, which were born in political compromise, will fare any better remains to be seen. Early evidence suggests that any change in the tax system that emerges from the political process may bear even less resemblance to fundamental tax reform.

One hopes that Treasury I has changed the nature and level of debate on tax reform, both here and elsewhere, as well as perhaps providing a menu for piecemeal adoption. After the publication of Treasury I, questions such as these were being debated as seldom before: Should we use the tax system to implement social and industrial policy? Can the playing field be truly level so long as owner-occupied housing retains its uniquely favorable tax treatment? Does it make sense to accelerate depreciation allowances without making compensating changes in the tax treatment of interest expense? Should we adopt inflation adjustment, refuse to do so and risk a repeat of the experience of the 1970s, or avoid this choice by moving to a tax system based on cash flow? What will happen in international markets if we tax all income uniformly and consistently? What are the economic effects of moving to a more neutral tax system? Should we move as quickly as proposed, even if the proposals make sense, or should we go more slowly? It is to be hoped that economic research and conferences such as this will help to provide some of the answers to these and similar questions and contribute to the eventual adoption of truly fundamental tax reform.

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Discussion

*Henry J. Aaron**

My comments on Charles McLure's paper are divided into three parts. I begin by underscoring a number of points he makes that are particularly praiseworthy—which in plain language means I agree with him. Then I turn to a few points with which I disagree. Finally, I address the choice Treasury made between trying to move toward a personal income tax or nearer to a cash-flow tax.

Praiseworthy Points

McLure lays great stress on the distinction between two kinds of tax simplification. The first kind makes the tax form short and simple. The second kind results when tax rules are changed to reduce incentives to engage in transactions motivated by the desire to avoid taxes. The first form of simplification makes life easier for the day or so per year most of us spend preparing our taxes. The second form of simplification makes our life easier 365 days a year by freeing us from the need to take taxes into account in making economic decisions. Although most people want their own forms to be simple (the first kind of simplification), many also want other people not to be able to engage in tax avoidance transactions, even socially meritorious ones (the second kind of simplification). McLure stresses that since tax avoidance by others reduces taxpayer morale, the case for the second kind of simplification is enhanced.

Sometimes these two kinds of simplification reinforce one another—elimination of the distinction between long-term and short-term

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capital gains, for example. But sometimes they are in sharp conflict—the Treasury's proposals to index interest, for example. The admitted addition to complexity on the tax form that this provision would have entailed would have been more than offset by the transactional simplification that could have been achieved. The decision to drop this proposal, allegedly because of its complexity, is especially regrettable, ironically because that decision sacrificed one of the great opportunities for simplification.

McLure correctly bewails the untouchability of the mortgage interest deduction. The failure—necessary, perhaps, but no less regrettable for that reason—to include owner-occupied housing in the reform was, as McLure in effect acknowledges, the Achilles' heel of the proposed changes in capital income taxation. The step-by-step dismantling of Treasury I's indexing proposals, first at the hand of Treasury in fashioning the President's proposal; then by Treasury in response to the demands of the Ways and Means Committee that the President's plan should not lose revenue; and now, it would appear, at the hands of the Ways and Means Committee, is the major disappointment in the evolution of the tax reform proposal.

McLure reserves his strongest language for the reversal of Treasury I's proposal to repeal expensing of intangible drilling costs, to which I can only say, "Amen." As obiter dicta he also joins all sane economists in warning of the dangers of the deficit, and he links arms with the overwhelming majority of economists, who doubt that spending cuts will eliminate the deficit, in calling for a tax increase "the sooner the better," as McLure puts it, which I believe is at least a few minutes sooner than "as a last resort."

Finally, McLure says exactly the right things, in my view, about fringe benefits, charitable contributions, capital income taxation, double taxation of dividends, and the windfall tax.

Points Requiring Further Discussion

In a few areas, I believe, McLure has not stated the issues correctly. His criticism of the minimum tax is so muted that it sounds as if the minimum tax is simply Congress's way of never having to say "I'm sorry" for enacting a tax preference—a device for telling taxpayers that it likes them to do certain things that avoid tax, but only if they don't avoid too much tax. McLure does not emphasize what an administrative nightmare a minimum tax is, particularly one that would yield any significant amount of revenue. Moreover, if marginal tax rates really do influence behavior, the minimum tax would vastly complicate private decisions. Effective marginal rates associated with one transaction

would depend not only on the volume of that type of transaction, but also on the volume of other transactions that generate preference income or that influence the limit on preference income before minimum tax triggers in. This way lies *insanity*.

The section on deductibility of state and local taxes is marred, in my opinion, by serious overstatement and imprecision. McLure states: "State and local taxes are spent largely to provide services that benefit those who pay the taxes. As a result, there is little more reason that they should be deductible than there is that other (private) consumption expenditures should be tax-preferred."

This statement is surely false, or it condemns virtually all grants-in-aid. In 1982, 35.6 percent of state and local spending was devoted to education, 9.3 percent to health and hospitals, and 13 percent to public welfare. The preceding quotation from McLure's paper would suggest that the benefits from each of these outlays stop abruptly at the edge of the jurisdiction that pays for them or, alternatively, that the current system of grants correctly compensates for spillovers. Thus, the benefits of education (for which there are virtually no federal grants-in-aid), the preceding quotation would suggest, stop abruptly at the edge of the jurisdiction that pays for them. In Massachusetts, for example, this quotation would suggest that the benefits of education extend for the most part only to the city line, not to other cities in the state, because municipalities bear most of the cost of education in Massachusetts. In Georgia, however, the benefits of education are mostly statewide, because that state pays most of the cost of education. In neither case, however, do any of the benefits of education accrue to people who reside in other states, because they pay nothing for them. Or at least they wouldn't if the deduction of state and local taxes were repealed.

I submit that this way of looking at the interconnectedness of citizens in the contemporary United States is an anachronism, a throwback to a country not linked by jets, televisions, and computers, to a country that had not yet fully achieved nationhood, to a nation in which a citizen might well describe himself first as, say, a Virginian and second as an American. It is a deification of the human instrumentality of state and municipal boundaries to suggest that I am less affected by the education policies of Bethesda, Maryland because I live in Washington, D.C. than I would be if I lived in Baltimore. Is Charles McLure less affected by education policies in the District of Columbia than by those in San Diego? Would citizens of Houston, Texas be less influenced by health policy in El Paso than they are now if Texas exercised its constitutionally guaranteed right to split into five states? Are citizens of Chicago less influenced by education policies in Gary, Indiana, 20 miles away, than they are by what is done in Cairo, Illinois, 370 miles away?

I hope that you will agree that the answer to all of the preceding questions is "no" and that the questions are not even close. I will tell you that I receive no more direct benefits from the District of Columbia Hospital, which mostly serves low-income people and for the support of which I willingly pay income and property taxes, than I receive from Los Angeles County Hospital, which serves a similar clientele and for which I directly pay nothing. The deductibility of state and local taxes is one device for recognizing that commonality of interest, not the best possible one by a long shot, but not one I would willingly abandon completely until the medicaid program or something like it is vastly improved and extended. If these questions have any force, then the rationale for repealing deductibility of state and local taxes cannot be based on McLure's contentions.

There *is* a rationale for viewing deductibility with a good deal of suspicion. But the resulting question *is* close. As McLure later correctly states, "the deduction for state and local taxes is an extremely blunt instrument for [he then adds, incorrectly in my view] the encouragement of the relatively small portion of subnational expenditures that do have important spillovers at the margin." He praises targeted grants as more appropriate in offsetting spillovers.

I couldn't agree more. Had the current Administration succeeded in instituting such a grant system, its case for repeal of deductibility would be overwhelming. Instead, they scaled back the imperfect system we had, notably in the field of education, and they have significantly curtailed the liberality of health grants. The relevant question today is not whether deductibility is inferior to a well-conceived program of matching grants; everyone here would agree that it is. Rather, the question is whether, given the highly flawed and shrinking system of grants we have, deductibility helps marginally in dealing with spillovers. Crude though it is, deductibility is in my judgment better than nothing. Its crudity argues for curtailment, perhaps along the lines of the compromise proposed by the chairman of the Ways and Means Committee.

Deductibility certainly does needlessly encourage citizens in some bedroom communities to have too many or excessively lavish municipal swimming pools. But we insufficiently encourage citizens of Worcester or Wilkes-Barre or Jersey City or rural counties in Arkansas to educate their children well or to provide good health care to the indigent. Repealing deductibility of state and local taxes will solve the swimming pool problem, but, in the absence of a well-developed system of grants, it will make the education and health problems worse. Is that a good trade? In short, whose spillovers are McLure and a good many other economists talking about? Those of a nation in which news and people took days or weeks to get from one place to another? Or those of a nation in which spillovers mock a geographer's boundaries?

Income or Cash-Flow Tax?

McLure describes the way in which Treasury made an early decision to stick with the annual income tax, rather than take the great leap to a cash-flow tax. From a political standpoint I think the Administration made the right decision, despite the growing consensus among economists that a cash-flow tax—either of the consumption type or of the lifetime income type—has important advantages over the annual income tax. The selling job required to win acceptance of a cash-flow tax would have been even more formidable than that needed to pass what was actually proposed. And the burden of that selling job, as we are now observing, may well be more than our political leaders can shoulder.

But the reasons McLure states for rejecting the cash-flow tax are really not very strong. The Treasury seems to have backed away from the cash-flow tax with all the reluctance of an anorexic told to skip dessert. McLure classifies the problems of a cash-flow tax in three categories: transition, international issues, and bequests. In each case, he says, there were apparently unsolvable problems that were sufficiently serious to stop the show. But he doesn't present any.

The principal transitional problem is how to avoid double taxation of old wealth acquired out of taxed income. A simple cash-flow tax would impose yet another tax when, and if, the wealth is spent. McLure states that it would not be a simple matter to formulate a workable transition provision. He is right that it is difficult, but misleading, I think, in suggesting that it is not possible. Harvey Galper and I developed a transitional rule that I believe avoids this problem and requires no more recordkeeping than does the current tax on long-term capital gains. I won't deny that we are clever fellows, but so are McLure's former colleagues at Treasury. Where there's a will. . . .

International problems take two forms, international tax relations and tax evasion. McLure states that adoption of a cash-flow tax would require renegotiation of all tax treaties. Maybe so, but some of the leading tax lawyers in Washington disagree. They suggest that although problems of policy in the United States will be numerous, there would be few treaty obstacles to a new personal and corporate income tax in which income is defined on a cash-flow basis. Before any of us take as gospel the contention that a switch to a cash-flow tax would be a Sisyphean diplomatic labor, we should insist on being shown chapter and verse.

The other international problem is evasion. Proceeds of foreign loans could be deposited as "saving" in the United States. That is a problem, a problem of fraud, and enforcement resources would have to be devoted to minimizing it. But so are fraudulent tax shelters. So, in literal fact, is the deduction of interest expense by anyone who holds

tax-exempt securities. And the diversion of income through tax-haven countries, while often avoidance rather than evasion, reflects the fact that we have responded to many problems under the current income tax by legalizing avoidance, rather than persisting in quixotic attempts to stop it. Thus, we enact provisions to promote saving, such as IRAs and 401ks, and then blink at the current deduction of interest expense on loans while interest on these and other accumulations is exempt. In short, the current tax system, and even the one that would emerge after tax reform, is suffused with what McLure calls showstoppers that are at least as bad as the foreign borrowing problem he cites. Better, it would seem, the showstoppers you know—the practices that you know you can't do anything about and have therefore legalized—than the showstoppers you don't know. My point is a simple one—the current tax system is suffused with provisions that would be regarded, properly, as showstoppers in a proposal for reform.

On the subject of bequests, I have more sympathy with McLure's objections to cash-flow taxes. Most cash-flow taxes are of the consumption variety and would increase the opportunities of taxpayers whose taxes run to dynastic accumulation to indulge their particular form of consumption. McLure expresses concern that if such propensities were unhindered by some tax on unconsumed income, excessive concentrations of wealth would be likely to result. Such concentrations could be limited by a serious attempt to tax gifts and bequests. Not all intergenerational transfers could be subjected to tax, but we would get most of the large ones if we were willing to go to some administrative trouble. The will is conspicuously lacking, and McLure doesn't want to risk losing the tax we now have on unconsumed income. Given that perspective, his support for raising additional revenue from a value-added tax, rather than from higher taxes on personal income, seems a bit inconsistent. His concern should push him in the direction that Harvey Galper and I have taken, support of a cash-flow tax that treats gifts and bequests, like consumption, as a taxable use of resources. As soon as the detached climate of Stanford has permitted him to shed the regrettable Washington habit of abandoning good ideas because they aren't immediately saleable, I hope that he will join us.

Discussion

*John B. Shoven**

Charles McLure is to be congratulated for his role as the chief architect of a truly fundamental tax reform proposal. No previous proposal for comprehensive reform, not even the ambitious *Blueprints For Basic Tax Reform* (1977), has had to come to grips with all of the details which must be dealt with in order for a plan to be realistically considered for implementation. Treasury I has been scrutinized by the press, by lobbyists, and by all sorts of analysts. It is remarkable how far it has gotten, or, perhaps more accurately, what it has started. Clearly this is the proposal that got tax reform moving in this country, and it still is providing the outline for much of the debate. My role as a discussant is to evaluate the paper, which in this case amounts to evaluating the proposal. It is easy to fault the proposal on certain particulars, and I will do so, but let me be clear that I believe it would have been difficult to build a superior comprehensive plan.

The first issue I will mention with respect to Treasury I is the choice of a tax base. The proposal aims to tax a comprehensive measure of real economic income. In making this choice, it is somewhat old-fashioned. The tax base favored by most academic public finance economists today is expenditure. The expenditure tax is touted as having at least three advantages. First, the philosophy of taxing people according to their withdrawals from the social product (i.e., consumption) rather than the value of their contribution to it (income) is attractive. Second, an expenditure-based tax system would not distort the choice between saving and consumption in that it would offer investors the full return on their investments. This may indicate that the economy would allocate resources more efficiently with an expenditure tax than with an income

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tax. The analytical and simulation work in this area tends to support this efficiency advantage of the expenditure tax. Third, a tax based on expenditure can avoid the complicated issues of defining real capital income and adjusting the tax base for inflation. Thus, it holds out the promise of a considerably simpler tax system. These advantages have been asserted in numerous academic articles and were clearly presented in *Blueprints for Basic Tax Reform*.

Treasury I and Charles McLure in his paper state that the transition issues in a switch to an expenditure tax may be such that the whole thing is undesirable. Further, McLure is concerned about the possibility that some "showstopper" would crop up in the implementation of an expenditure tax which would stop tax reform in its tracks. The problems were not presented in detail, and it strikes me that if a proposal that public finance economists have been pushing for the last 10 years suffers from some fatal flaws, then the defects should be fully analyzed.

One can overstate the degree to which Treasury I was pure with respect to the income tax concept. While it attempts to tax real corporate income, it leaves the personal tax base far from true economic income. It makes no attempt to include the imputed income from owner-occupied housing, and it proposes an expansion of Individual Retirement Accounts. These features are consistent with expenditure taxation, not income taxation. Despite this, the direction in which Treasury I tries to go is clear, and it is towards an income tax.

Before going further, I want to register my complaint about the constraints which were imposed on the Treasury Department in the design of its tax reform proposal. First, it was to be revenue neutral. While I cannot claim to be certain of the consequences of running deficits as large as we are, it seems irresponsible to me to rule out a tax increase as a means of reducing the deficit. Even ignoring the connections between our fiscal posture and the dollar's strength and the foreign trade deficit, it should be made clear by our profession that the choice is not between high taxes and low taxes, but between higher taxes now and higher taxes in the future. If we continue to accumulate debt at the current rate, a tax increase will ultimately be necessary just to service our increasingly foreign-held obligations. Second, I thought it was ironic that the same document that pointed out the many tax shelters and legal abuses available to the wealthy would also claim that distributional neutrality was virtue. The current distribution of tax burdens by income class is, after all, partially a product of those very same abuses. Charles McLure, of course, cannot be criticized for playing by the rules, but I hope it is within bounds for me to complain about them.

Treasury I gets mixed marks when it comes to the treatment of capital income. The proposal to partially integrate the corporate and personal income tax systems by allowing corporations to deduct 50 per-

cent of dividends paid should have received loud applause. This is a direction of reform which public finance economists such as Shoup, Musgrave, and Pechman have been advocating for years. Business was slow to endorse this feature of the plan, perhaps because of management fears of pressures to pay out a larger share of earnings, and therefore it has been scrapped in the political compromises of the last year.

The strong point of Treasury I regarding capital formation is that it proposes roughly equal taxation of different types of investment assets. Equipment, plant, land, and inventories would face very similar effective tax rates. This is in sharp contrast to the situation under the current law, where most studies show that equipment is strongly favored. However, neutrality between corporate investments does not imply that Treasury I is completely neutral in the treatment of all investments, or even that it is more neutral than the current law or Treasury II, the President's tax proposals.

One large problem is the failure to tax owner-occupied housing, which constitutes a very significant portion of the nation's capital stock. The point is that treating all corporate investments equally is not necessarily desirable if residential real estate is going to escape taxation altogether. The paper, in my opinion, is wrong in suggesting that removing the deductibility of mortgage interest would have been an improvement. The problem with the treatment of housing, at least from an income tax perspective, is not the deductibility of mortgage interest but the fact that the economic income flow is untaxed. Disallowing mortgage interest deductions would just create a new distortion between people who have large mortgages and those who are able to accumulate a large equity position in their homes. If one can use his own funds to acquire a house, then the implicit interest would still remain free of tax, even in a situation where mortgage interest had been declared not deductible. Only mortgaged homeowners would face a higher cost for housing investments. If it is decided that it is impossible for practical purposes to tax the imputed income of homeowners, then the rest of the design of the tax system should take account of this fact. That might imply that renters should be given tax breaks to put them on a more even footing, and might argue that corporate investments should be lightly taxed so that they can compete on more even terms with housing for funds.

If we look at neutrality in terms of the intertemporal allocation of resources, it is not clear that Treasury I looks good. This, of course, is the natural consequence of judging an income tax proposal on expenditure tax criteria. Using a cost of capital approach in the Hall-Jorgenson tradition, King and Fullerton (1984) found that the total wedge between what an investment earns and what the investor receives amounted to roughly 35 percent in 1980. The methodology includes both the corporate and

personal income taxes, and takes account of the investment tax credit and depreciation and inventory accounting. In two subsequent articles, Fullerton (1985) and Fullerton and Henderson (1984) found that the ERTA bill in 1981 reduced the wedge between investment and investor to 23.6 percent. However, 1982's TEFRA bill increased the wedge to 30 percent and Treasury I would have brought it up to 43 percent. The President's tax proposals of May 1985 would have imposed a tax wedge on investments in the corporate sector of 35 percent, exactly where it was before the Reagan administration took office. The plan currently being considered in Congress probably imposes a wedge somewhere between that of Treasury I and Treasury II. Certainly the Administration and the country seem to have completely changed direction on the taxation of capital income. It might be valuable to note that Shoven and Tachibanaki (1985) used the same methodology and computed the wedge faced by Japanese investors. While the results were different for different years, the figures ranged from 7 to 20 percent, or substantially less than the wedge faced by American investors.

There has been some false advertisement of both the Treasury I and the Treasury II plans. Most blatant are the tables and statements asserting that 75 to 80 percent of households would be better off under the proposed tax plans. These figures are the result of plans that reduce individual taxes and raise corporate taxes and the fact that Treasury did not attribute the taxes that corporations pay to individuals. This ignores the most fundamental rule of tax incidence, namely that someone must bear the burden of all taxes. I also feel that the Treasury should not get credit for the rate reductions that it achieves by making state and local taxes non-deductible. The effect of eliminating the deductibility of state and local taxes is to increase the burden of the state-supplied public goods. The effective marginal tax rate faced by households is not reduced by what amounts to a change in the level of government that is collecting the tax. Finally, in the area of false advertising, the Administration acts as if removing those with below poverty level income from the tax rolls is the ultimate generosity. Of course, in earlier times such programs as negative income taxes and cashable credits have been considered, and they would have done far more than the plans now being considered for the poor.

Let me conclude by evaluating Treasury I on the three standards in its title: fairness, growth, and simplicity. In taxing a broader range of incomes symmetrically and in closing down many unproductive tax shelters, Treasury I greatly improves horizontal equity. It deserves high marks in the area of fairness. In terms of promoting growth, the case that it would improve the situation is not compelling. While different corporate investments would be taxed more similarly, this is achieved at a higher tax rate which puts them at an even greater disadvantage relative

to owner-occupied housing. The whole reform process began with the goal of simplifying the tax system. Here, too, I think less was achieved than claimed. The fact is that taxing real economic income is inherently complicated, and the inflation adjustments that Treasury I makes are not simple. In fact, I think it is largely their complexity which has caused them to gradually disappear from the plans that have followed Treasury I.

Despite those shortcomings, Treasury I was a major accomplishment. It was a detailed proposal to tax real income in a fair manner. It is the only proposal which got serious about adjusting the definition of income for inflation, and it did eliminate the unevenness in the tax treatment of different corporate investments. And, it really went after abusive tax shelters which threaten to undermine the public's confidence in the tax system. These are considerable accomplishments, indeed. Treasury I will long be considered a landmark event in the history of tax reform in the United States.

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Discussion

*Emil M. Sunley**

Charles McLure focuses on the Treasury tax plan submitted to the President in November 1984 (Treasury I) and the President's tax reform proposals announced last May (Treasury II). The broad outlines of the two proposals are similar. Both retain the income tax as the major source of federal tax revenue. Both shift the income tax toward corporations and away from individuals. Both would raise roughly the same amount of revenue as current law. Both include a top marginal rate of 35 percent for individuals and 33 percent for corporations.

Once one gets beyond these major similarities, Treasury II, as McLure concludes, is but a shadow of Treasury I. The original Treasury plan will remain a standard for comparing proposals for comprehensive income tax reform. The profession owes Charlie a debt of gratitude for his critical role in formulating Treasury I.

Let me comment on three issues.

Distributional Neutrality

Treasury I was designed to be roughly distributionally neutral across income classes, except that the lowest income class gets a larger reduction when measured as a percentage reduction in tax. Treasury II provides the largest percentage reductions at both the bottom end and the top end of the income scale.

But is the percentage reduction in tax the best standard for distributional neutrality? One might want to look at the percentage change in after-tax income. Using this standard, one concludes that the tax pro-

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gram tilts dramatically toward families and individuals with higher incomes. However, if one also considers the distributional impact of the increase in corporate taxes, higher income families and individuals do not come out all that well.

Capital Gains

Treasury I would have taxed capital gains in full while permitting the basis of the asset to be adjusted for inflation. Treasury II abandons this approach.[1] Instead, the exclusion for net long-term capital gains would be reduced from 60 percent to 50 percent. Some tax reformers have criticized Treasury II as being only a one-sixth cutback in the preference for capital gains. This is not the appropriate way to judge the capital gains proposal. Under current law, a taxpayer in the 50 percent tax bracket gets to keep at the margin 50 cents of each dollar of ordinary income and 80 cents of each dollar of capital gains. Thus if income is characterized as capital gains instead of ordinary income, the amount of after-tax income is 60 percent greater. Under Treasury II, if the income is characterized as ordinary income the taxpayer keeps 65 cents on the dollar, given the proposed 35 percent top marginal rate. If the income is characterized as capital gains, the taxpayer would keep 82.5 cents, or 27 percent more. The incentive to convert ordinary income into capital gains is cut by more than half, even though the exclusion is cut by only one-sixth.

Indexing for Inflation

Treasury I included proposals for comprehensive indexing of the tax system for inflation. Capital gains, inventories, depreciation and debt would all have been indexed.

Treasury I had a shortcut approach for indexing debt. Instead of indexing each debt instrument, a portion of net interest paid would not be deductible and a portion of net interest received would be excluded from taxable income. The portion depends on the rate of inflation and on an assumption that the real before-tax rate of return is 6 percent. If inflation is 5 percent, then the portion would be 5/11ths (5 divided by six plus five). If the rate of inflation is 7 percent, then the portion is 7/13ths (7 divided by 6 plus 7).

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[1]Treasury II does include a proposal for full taxation of capital gains with an inflation adjustment as an option beginning in 1991.

This shortcut approach for indexing may work on average. But it clearly does not work if a business both borrows and lends. Consider a commercial bank that borrows at 10 and lends at 12, making a spread of 2. If the maturities are matched, the bank is fully protected from inflation. Under Treasury I, however, the bank would be able to exclude a portion of net interest income.

The exact approach for indexing would be to adjust both the interest paid and the interest received. Assuming inflation is 5 percent, then 5/10ths of the interest paid should be deductible and 7/12ths of the interest received should be taxable. The spread would still be 2.

This exact approach probably is too complicated and was rejected by Treasury. Once Treasury realized that the shortcut approach did not work in garden-variety situations, it was forced to drop the indexing of debt.

Many would contend that it is inappropriate to index capital gains or depreciation unless debt is also indexed. Otherwise taxpayers will borrow to buy an asset, gaining a tax advantage from inflation. Interest paid will be fully deductible while only a portion of the gain will be taxed and the depreciation deductions will be magnified by inflation indexing. This would result in an appearance of inequity.

But is it any worse than current law which permits a full deduction for interest paid and provides ad hoc inflation adjustments for depreciation and capital gains? These ad hoc inflation adjustments—accelerated depreciation and exclusion for capital gains—may be right for some level of inflation. They are too generous for lower rates of inflation and not generous enough for higher rates. Indexing depreciation and capital gains would be superior to the ad hoc adjustments even if interest paid remained fully deductible.

Treasury II Compared to Ways and Means Proposal

McLure focuses on Treasury I and Treasury II. These proposals have been partly passed over by events. The Ways and Means Committee has begun marking up a tax reform bill working from a staff option developed by the Joint Committee on Taxation. This option includes many of the proposals put forth by the President, but there are significant differences from Treasury II. Let me describe them.

First, the staff option would improve the distribution of the tax burden. This would be accomplished by reducing the exclusion for net long-term capital gains to 40 percent, making the top tax rate on capital gains 21 percent. Also, the proposed $2,000 personal exemption would be scaled back to $1,500, reducing the tax benefits at the highest income levels. At the same time, the standard deduction would be increased so

that families and individuals with incomes below the poverty line would generally not be taxed, as under Treasury II.

Second, the staff option would not repeal the itemized deduction for state and local taxes. Instead, the staff option proposes to permit deductions for income and real property taxes with the deduction limited to $1,000 or the excess of these taxes over 5 percent of adjusted gross income, if greater. Though this does not sound like simplification, it may represent the kind of compromise necessary if a tax bill is to be enacted.

Third, the staff option adopts the approach of Treasury I and places a per employee cap on the value of employer-provided health benefits. The cap would be $120 per month for individual coverage and $300 per month for family coverage. Though the cap is higher than in Treasury I, McLure would agree that the staff option establishes the correct principle, in contrast to the proposed floor in Treasury II.

Fourth, on the business side, the staff option drops the President's proposal for a windfall recapture tax on excess depreciation and phases in the dividends-paid deduction. The option also drops indexing of depreciation and stretches out the allowable depreciation deductions for new investment. The top corporate tax rate would be 35 percent. The effect of these changes is to lower the tax burden on old capital and increase the tax burden on new capital, compared to Treasury II. Moreover, on an overall basis, the staff option shifts the burden of the corporate tax more toward corporations than Treasury II.