Economic Consequences of Tax Simplification: An Overview

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Tax reform would qualify as a worthy conference topic at any time, but emerged as a particularly important subject in 1985. A Republican President in his 1984 State of the Union message directed the Secretary of the Treasury "to simplify the entire tax code" so that all taxpayers would be "treated more fairly." During the next 10 months the staff of the Treasury's Office of Tax Policy labored to fulfill that mandate, and in November the Secretary presented the President with the Treasury report, entitled *Tax Reform for Fairness, Simplicity, and Economic Growth* (hereafter Treasury I).

The main thrust of the Treasury plan was a substantial broadening of the income tax base combined with reductions in the marginal rates. Hence, a conservative Administration, fundamentally antagonistic to taxation and government spending, had embraced an approach espoused over several decades by liberals, who generally liked the income tax and supported government programs. With the emergence of this coalition, the time seemed ripe for meaningful tax reform.

The Treasury I proposals received wide endorsement from tax experts, but loud outcries were immediately heard from other quarters. In response, the Treasury staff went back to work and after six more months obtained the President's approval for a somewhat diluted report entitled *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (hereafter Treasury II).

To garner support for Treasury II, the President made a television appeal to Americans to support the transformation of an "un-American" income tax system into one that is "clear, simple and fair for all." In an

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expression of bipartisan enthusiasm, the Democratic chairman of the House Ways and Means Committee responded immediately after the President's address and endorsed the tax principles embodied in the Administration's proposals.

In the months following the release of Treasury II and the initial euphoria, support for broad-based tax reform deteriorated. As the time approached to enact legislation, concern emerged on many fronts over the potential adverse economic consequences of including previously untaxed items in the tax base. Some cited the potential deleterious effects on individual saving and labor force activity, some the disruptive effects on financial markets, and some the adverse impact on investment. Others were concerned about the implications for institutions dependent on charitable contributions and the ramifications for the revenue-raising capabilities of state and local governments. These alleged adverse outcomes contributed to a further watering down of the already soggy Treasury II proposals.

The purpose of the Boston Fed's conference was to separate unfounded allegations from reasonable predictions, through a systematic and comprehensive analysis of the potential economic impact on the various sectors of the economy of Treasury I, Treasury II, and some of the other tax reform proposals. The hope was that clarifying the issues would improve future debate on tax reform. Second, even if comprehensive tax reform did involve some adverse consequences, the question was posed whether reform might still be "worth it."

Three major conclusions emerged from the conference. First, most participants viewed the need to raise more revenues as a much higher priority than reforming the tax system. Second, the supply-side effects from major revenue-neutral tax reform were judged, on the whole, to be relatively small. Third, tax reform of the extent proposed in Treasury I was judged to be definitely "worth it," but as the reform proposals became increasingly watered down the participants became more doubtful.

The Rationale for Tax Reform

In the United States, as in other developed countries, a person's income generally has been viewed as the best measure of ability to contribute to the cost of government. Although economic theorists have proposed many definitions of income, most have supported the Haig-Simons concept. This defines income, as an index of taxpaying capacity, as consumption plus an increase in net worth during a given period. Defining income in this broad manner ensures that taxpayers with equal economic resources are assessed equal amounts of taxes and those with

different capabilities are assessed different amounts.

Over time, the definition of income in the U.S. income tax has moved steadily away from the Haig-Simons ideal. Taxation of a given amount of income now varies widely depending on how it is earned and how it is used. As a result, much income escapes taxation and higher marginal rates are required to produce any given amount of revenue. Moreover, the tax system is highly vulnerable to variations in inflation and needlessly complex. These characteristics combine to make a tax system that is not only unfair but also distorts the allocation of economic resources.

The Treasury Proposals

In the introductory paper, Charles McLure, Jr. stated that the Treasury had four main objectives in its tax reform initiative. The first was fairness, particularly with respect to the taxation of individuals with the same total income. This notion of horizontal equity requires that all income be taxed equally regardless of its source or use. With respect to vertical equity, that is, the relative tax treatment of individuals with different levels of economic resources, the Treasury generally accepted the degree of progressivity currently in the system. The only exception was an effort to eliminate taxes assessed on families below the poverty level.

The second objective of the tax reform effort was neutrality, or minimizing interference with economic decisions in relatively efficient markets. Simplification, which was the third objective, consisted of two parts: simplification of factors that plague taxpayers as they prepare their returns, such as forms, instructions, and record-keeping, and simplification of loophole provisions that encourage tax planning and avoidance and distort decisionmaking. The fourth objective, economic growth, was initially thought to emerge naturally as the result of lower rates and a more neutral system.

To achieve these goals, Treasury I proposed to tax all real economic income uniformly and consistently at lower rates. Income rather than consumption was selected as the base primarily because of pragmatic concerns in the face of severe time and resource constraints. Moreover, the difficulties of taxing bequests under a consumption or expenditure tax raised the possibility that individuals might amass large untaxed estates. The taxation of real income was judged necessary to avoid inequities and distortions, such as those created during the 1970s by an income tax based on nominal income in a world of high and variable inflation. Furthermore, *all* real economic income must be taxed in order to have a fair and neutral tax system. Finally, to reduce the double taxation of corporate income, the Treasury proposed to partially integrate

the corporate and personal income tax systems by allowing corporations to deduct from their taxable income 50 percent of dividends paid.

Reform efforts were hampered right from the beginning, since the President was forced to remove the elimination of the home mortgage deduction from the list of possible options. This decision had two significant implications: first, it precluded access to a major source of revenue; and second, it made the goal of neutral tax treatment of all alternative investments unattainable.

Despite this limitation, Treasury I made important strides toward the objective of taxing all real income uniformly and consistently. The most significant changes included the taxation of a portion of health insurance benefits; the elimination of the deduction for state and local taxes; and limitations on the deductions for charitable giving. To make the tax system less subject to distortions from inflation, Treasury I also attempted to improve the measurement of income from capital by proposing explicit inflation adjustment for depreciation allowances, the cost of goods sold from inventory, capital gains, and interest income and expense. Under Treasury I, oil and gas and other extractive industries would also be taxed on the basis of their economic income.

The main change between Treasury I and Treasury II was a movement away from neutrality through the introduction of explicit incentives for growth. Indexing capital income for inflation was replaced by an accelerated depreciation schedule and more favorable treatment of capital gains for assets that appreciate dramatically. Treasury II also fell short of Treasury I in defining income comprehensively, by further limiting the taxation of health insurance benefits and restoring some deductions for charitable contributions. Despite this backtracking, McLure maintained that Treasury II still represented fundamental reform through a reduction of marginal rates, the elimination of deduction for state and local taxes, the beginning of taxation of health care benefits, and an increase in the personal exemption.

Discussion

The three discussants of McLure's paper were unanimous in their praise of his role as the chief architect of a truly fundamental tax reform proposal. Henry Aaron supported his distinction between the two kinds of simplification and noted that sometimes they reinforce one another but sometimes, such as in the case of the Treasury proposal to index interest, they are in sharp conflict. He agreed with McLure that the immunity of mortgage interest to reform efforts was the "Achilles' heel" of the proposed changes in the taxation of capital income and echoed McLure's dismay at the reversal of the Treasury I's proposal to repeal expensing of intangible drilling costs.

Aaron also questioned McLure's justification for his elimination of the deduction of state and local taxes. He acknowledged that deductibility is a blunt instrument for encouraging socially desirable spending and that targeted grants-in-aid are superior, but he was reluctant to sacrifice deductibility in face of the dramatic cutbacks in the grants programs.

John Shoven made two points with respect to the failure to tax owner-occupied housing. First, he questioned whether treating all corporate investments equally is necessarily desirable if residential real estate escapes taxation altogether. Second, he maintained that the problem with the treatment of housing is not the deductibility of mortgage interest, but the failure to include the value of imputed rent in taxable income. Disallowing mortgage interest deductions would just create a new distortion between those who have large mortgages and those who have large equity positions in their homes.

Shoven also questioned the Administration's decision to maintain the existing distribution of tax burden by income class, in that the current distribution was in part the result of the many tax shelters and legal abuses available to the wealthy. He concluded by accusing the Administration of false advertising with regard to tax reduction. The only way that 70 to 80 percent of households could be better off under a revenue-neutral tax reform package was through the failure to attribute the taxes paid by corporations to any individuals. Similarly, effective marginal tax rates are not lowered very much by eliminating the deduction for state and local taxes, since this is roughly equivalent to changing the level of government that collects the taxes.

Emil Sunley picked up on the issue of distribution neutrality and questioned whether the percentage reduction in the tax burden is the best measure. He suggested that one might also want to look at the percentage change in after-tax income which shows that the tax program dramatically favors higher income people. On the other hand, if the distributional impact of the increase in the corporate income tax were included, higher income individuals and families do not fare as well.

Sunley then suggested that critics of the Treasury II proposal for capital gains treatment may be unnecessarily pessimistic. In fact, the incentive to convert ordinary income into capital gains would be cut by more than half, since the differential between ordinary rates and capital gains rates would be narrowed substantially. Finally, Sunley made a plea for indexing depreciation and capital gains even if the indexing of debt may prove to be complex. He acknowledged that partial indexing will allow individuals to profit from inflation by borrowing to buy an asset, but he maintained that the inequity resulting from partial indexing would be superior to the ad hoc adjustments under the current system.

Much of the discussion focused on the issue of owner-occupied housing. Aaron disagreed with Shoven's statement that eliminating the

mortgage interest deduction would not necessarily be an improvement. He argued that since nearly everyone faces liquidity constraints, most people would not be able to buy homes without the favorable tax concessions. Hence, repealing the mortgage interest deductibility would prevent the majority of people from taking advantage of the preferential tax treatment of owner-occupied housing and would reduce the gap between the effective rate on housing and that on the other two-thirds of the capital stock.

Patric Hendershott rejected the equity implications of eliminating the mortgage interest deduction since it would mean that wealthy people would continue to get full benefits from investing in housing while low-income and middle-income people denied the deduction would be squeezed out of the market. Hendershott also reiterated the assertion that to achieve a "level playing field," in the absence of a tax on housing, requires not taxing any other forms of investment.

Towards the end of the session, the discussion moved from housing to the incidence of the corporate tax and the fact that this tax was not allocated among individuals in the distributional tables prepared by the Treasury. Joseph Pechman asserted that if the corporate tax is borne by stockholders (as was assumed by Treasury for classifying people by income class), then the tax reform proposals would appear much less favorable to the rich. Shoven disagreed, making the point that a large share of corporate equities are held by pension funds and the claims to these assets are distributed much farther down the income scale.

The Effect on Individuals

Joel Slemrod's paper shifted the discussion from alternative tax reform strategies to the economic effect of particular proposals—specifically, their direct effect on individuals. To do this, Slemrod assessed how individuals would fare under Treasury II's stated objectives of fairness, simplicity, and economic growth.

Fairness

Slemrod explored three alternative measures of fairness—vertical equity, horizontal equity, and what he called transitional equity. In terms of vertical equity, Slemrod concluded that it was difficult to dispute the Administration's claim of approximate distributional neutrality, even though no attempt was made to trace out the ultimate incidence of taxes paid by corporations.

On the subject of horizontal equity, Slemrod noted that preferential tax treatment in itself need not produce inequities, so long as the tax-

preferred activity is available to everyone and valued equally by all. But many of the preferential provisions in the current law do produce inequities, since they apply to activities not available to and not valued equally by all people. The Treasury I proposals to limit deductions for charitable contributions, tax a portion of fringe benefits, and repeal the deductibility of state and local taxes eliminate some horizontal inequities and move the tax system towards one where taxpayers who are equally well-off pay equal taxes.

Any tax reform creates transitional equity problems by altering returns on long-term commitments made under former law, leading to windfall gains and losses for a period of time. Treasury II addresses these potential inequities by gradually phasing in some provisions, which allows time for adjustment to new rules and reduces the present value of gains and losses. In addition, the proposed excess depreciation recapture rule under Treasury II also serves to limit windfall gains that would otherwise accrue to previously acquired capital.

Simplicity

Slemrod then turned to the second objective of the Administration's tax reform initiative—namely, simplicity. He noted that Treasury II addresses the problem of complexity directly by eliminating numerous special provisions. Similarly, reducing marginal tax rates lessens the incentive to reduce taxable income. On the other hand, collapsing the number of tax brackets from 14 to 3, although characterized by the Administration as a key element in simplification, actually has an insignificant effect on the complexity of the system. Once taxable income is computed, finding tax liability in the tax tables is a trivial operation which would not be simplified by having fewer brackets. Finally, several provisions in the Treasury II proposal, such as the attempt to expand the taxation of fringe benefits received by employees, would actually complicate the filing process. On balance, Slemrod concluded that the Administration's proposal would not significantly reduce the complexity of the system.

Economic Growth

Slemrod noted that the Administration's third objective—economic growth—took a back seat to neutrality in both Treasury I and Treasury II. Also, in the long run, the growth rate of an economy is determined by the rate of technological progress and growth of the labor supply and tax policy was unlikely to have a strong influence on these factors.

In the shorter run, however, growth could be enhanced by increasing the ratio of capital to labor and Treasury II contained several propos-

als aimed at stimulating saving and investment. Expansion of IRAs and the reduction in marginal tax rates could both change the marginal after-tax rate of return to saving. However, IRAs need not create new saving, since an individual can gain a deduction simply by transferring previously accumulated assets or by borrowing funds and, moreover, IRAs will never be effective at the margin for most people since they are subject to relatively low caps. Slemrod concluded that, based on existing estimates of interest elasticity, the reduction in marginal rates could be expected to increase saving by less than 2 percent.

On the investment side, Slemrod argued that the tax incentives to corporate investment would increase slightly, although this conclusion was difficult to reconcile with the projected increase in corporate revenues. Overall, Slemrod concluded that the taxation of investment is probably not changed very much under the Administration proposals, although the relative burden is shifted from nonresidential to residential capital and from corporate structures and inventories to equipment.

Increased labor supply is a major factor that could contribute to growth, but Slemrod's back-of-the-envelope calculations indicated that the reduction in marginal rates proposed in Treasury II would be expected to increase the supply of labor by 3 percent at most. Since true after-tax wage rates would not rise in proportion to the decline in marginal federal rates because of the elimination of the deductibility of state and local taxes, the labor supply response would be even smaller than initially calculated.

Slemrod's overall conclusion was that Treasury II, while not as radical or far-reaching as Treasury I, would represent an improvement over the current system. It would induce more efficient use of resources, and thus improve economic performance, increase equity and reduce tax evasion. On the other hand, Treasury II would not reduce the complexity of the tax system, would not increase incentives to save and invest, would not increase the supply of labor significantly and would, like any major tax reform, introduce some transitional inequities.

Discussion

Slemrod's discussants found themselves in basic agreement with his conclusions. Alan Blinder began by reinforcing the case presented by Slemrod for equal tax rates on different sources of income, since he, like Slemrod, viewed neutrality as the real thrust of Treasury I and II. He noted that although optimal tax theory does not automatically prescribe equal tax rates, it does say that it is always optimal to tax different factor inputs at equal rates. Moreover, if there is equal ignorance about the loss associated with deviating from the optimal, then equal taxation is the best policy. Finally, once unequal tax rates are sanctioned, politics will

ensure that the deviations have more to do with political pressures than with cross-elasticities of demand.

Blinder argued, however, that fairness cannot be achieved by neutrality alone but also requires increasing marginal rates. He applauded the fact that Treasury II awarded disproportionately larger reductions to the poor, but he attributed its generosity to the rich to "an excessive attachment to flatness."

On the simplicity issue, Blinder felt that Slemrod understated the potential contribution of more equal tax rates on different income sources to reducing the complexity of the current law. Equalizing tax rates would reduce significantly the incentive to transform income from one form to another and thereby dramatically simplify the system.

On the subject of growth, Blinder acknowledged Slemrod's point that some short-run growth gains could result from raising the ratio of capital to labor, but questioned whether increasing the saving rate beyond that produced by market forces should be given high priority. Blinder suggested that such a policy objective would be called for only if the income tax seriously distorted choices away from saving, but concluded that the evidence suggested such distortions were relatively small.

Generally, Blinder agreed with Slemrod's overall conclusion that Treasury II, although not as elegant as Treasury I, would make things better rather than worse than the current system and economists should support it enthusiastically.

David Bradford only reluctantly came to the conclusion that Treasury II would represent a clear improvement over the current system. He was concerned about whether the windfall gains and losses arising from such massive tax reform were really compensated for by the improvement in efficiency and apparent equity of the tax system. He cited the examples of the large windfall loss that would be experienced by the owners of timber, which would no longer be treated as an asset eligible for long-term capital gains treatment, and the windfall gains that would accrue to those who have large retirement savings, which will be drawn down at lower tax rates than anticipated. Bradford also questioned the seriousness of many alleged inequities, since he argued that so long as taxpayers have the option of choosing each other's portfolios, differences in their tax liabilities do not imply unfairness.

Bradford's conclusion was that current tax reform efforts should be aimed at replacing the current income tax with consumption-oriented taxation using cash-flow accounting. This approach would produce genuine simplicity as well as equity and efficiency. It would also eliminate the need for indexing capital income, without which inflation will continue to create serious distortions under the current system.

During the general discussion two participants made comments

about the equity effects of comprehensive tax reform. Alan Auerbach questioned the ability to measure windfall gains and losses once the role of expectations is considered. He hypothesized that, with the constant revisions in the tax code, tax provisions represent just one more uncertainty that people take into account when making their decisions. Lawrence Summers focused on the relative reduction in burden afforded the rich under the various tax reform proposals. If the total reduction included not only the reduction in taxes they pay, but also the reduction in efforts to avoid taxes, the gains to the rich would be even greater than those presented in the official calculations.

The Effect on Capital Formation

Moving from the household to the business sector, Richard Kopcke undertook the formidable task of measuring the potential influence on business capital spending of Treasury I, Treasury II and two other reform plans—Bradley-Gephardt and Kemp-Kasten. All four plans would reduce the corporate income tax rate, repeal the investment tax credit, and repeal the dividend exclusion under the personal income tax. Unlike the Treasury proposals, however, neither Bradley-Gephardt nor Kemp-Kasten includes a deduction at the corporate level for dividends paid. The two congressional plans differ from one another primarily in their treatment of depreciation, capital gains and the maximum corporate income tax rate.

Simulations under the Cash-Flow and Neoclassical Models

In analyzing the impact of these four reform proposals, Kopcke employed two different representations of investment behavior: the cash-flow and the neoclassical models. The cash-flow model emphasizes liquidity constraints and uncertainties, while the neoclassical model emphasizes the after-tax rate of return on investment over the life of the project. He simulated the level of investment spending over the period 1981 to 2000 for each of the reform proposals and for the current accelerated cost recovery system (ACRS).

To make the problem tractable, Kopcke made several standardizing assumptions. First, although ACRS was enacted before the alternative proposals were conceived, the simulations introduced all of the plans in 1981 to avoid giving ACRS the benefit of a head start. Since under this scheme businessmen never benefited from the ACRS depreciation schedules, the recapture provisions of Treasury II were not included in the study. Second, in all simulations real GNP grew at 3 percent per year, and inflation, after-tax real interest rates, dividend/price ratios on

common stock, and the relative prices of investment goods were held constant after 1984. Corporate profits before taxes and corporate dividend payments increased at the same rate as nominal GNP. Thus, none of the simulations allowed for feedback or multiplier effects. If one tax plan produced more investment spending than another, this additional investment was prevented from stimulating a more rapid expansion of economic activity by the 3 percent restraint on real GNP growth. Finally, because of the sensitivity of the results to inflation, the simulations were presented for three alternative rates of price increase.

The results using the cash-flow model indicate that only Treasury II would generally increase investment compared to ACRS over the 20-year period. Its lower corporate income tax rate, indexed depreciation allowances, and 10 percent dividend exclusion more than compensated investors for the loss of the investment tax credit and highly accelerated depreciation allowances. Treasury I depressed capital formation at first, but eventually produced rapid investment, once the gradual introduction of the substantial dividend deduction was complete. The Kemp-Kasten proposal produced a greater rate of capital formation than Bradley-Gephardt, but neither matched the two Treasury plans. It should be noted that all reform proposals depressed investment in both durable equipment and nonresidential structures relative to ACRS for the first 10 years of the simulation period.

When the simulations were based on the neoclassical model, Treasury I, Treasury II and Kemp-Kasten all outperformed ACRS in terms of growth in the stock of producer durables and nonresidential structures. In contrast to the cash-flow model, where the postponement of depreciation allowances initially tended to reduce cash flow and investment spending commensurately, under the neoclassical model investors responded immediately to future allowances. Consequently, in the neoclassical simulation, Kemp-Kasten and the two Treasury plans supported more capital formation than ACRS throughout the 20-year period, because investors foresaw from the very beginning the value of future depreciation allowances and dividend deductions.

Discussion

Kopcke's three discussants all disagreed with his conclusion that comprehensive tax reform would stimulate investment; they differed dramatically, however, in the reasons for their disagreement and the vehemence of their concerns.

George Hatsopoulos argued that all four tax reform proposals would, for several years, retard capital formation and accelerate the decline in the U.S. international competitive position. He based his conclusion first on the critical fact that all the proposals increased business

taxes substantially during the next several years. The reduction in tax rates on earnings from existing capital would be more than offset by higher taxes on new capital. Hatsopoulos agreed that eventually three of the four proposals may reduce business taxes and improve capital allocation efficiency, but he concluded that the present value of such benefits was minuscule compared to the short-term damage.

His second line of attack was aimed specifically at Kopcke's simulations. First, he dismissed the cash-flow model as irrelevant to business decisionmaking. Second, he faulted Kopcke's calculation of the cost of capital, a key variable in the neoclassical model. Kopcke departed from the traditional approach of discounting by a single after-tax cost of funds, which combines the cost of equity and the after-tax cost of debt, and used two different discount rates in his calculation. Kopcke employed a high discount rate on real economic returns, due to their comparatively high degree of risk, and a much lower discount rate for tax benefits and interest payments, which he viewed as much more certain. Noting that a firm cannot acquire tax benefits without simultaneously taking on an investment, Hatsopoulos concluded that the use of separate discount rates does not accurately reflect the alternatives and constraints facing business managers. In short, Hatsopoulos implied that by using too low a user cost-of-capital figure, Kopcke failed to discount accurately future investment gains.

Hatsopoulos then focused his remarks on the possible impact of tax-reform-induced changes in capital formation on the ability of the United States to compete successfully in the world economy. According to Hatsopoulos, inadequate incentives in the United States for saving and capital formation, not unfair trade practices, have allowed nations such as Japan to surpass the United States in productivity growth. He suggested that a study which applied the U.S. tax system to the Japanese economy would predict much lower rates of capital formation for that country.

Auerbach stressed that considerable uncertainty necessarily attends any simulated responses to major tax revisions. Although the cash-flow and neoclassical models may have predicted investment better than any other model, they still do not do very well; these models have significantly underpredicted the strength of recent investment spending.

Moreover, Auerbach saw problems in Kopcke's treatment of some of the proposed changes in the tax code. For example, Kopcke ignored the Treasury II windfall tax on excess depreciation, following the logic that his comparisons began in 1981 before any excess depreciation under ACRS would have occurred. This omission, however, made the cash flow under Treasury II look better in the simulations than it does to actual investors who would lose $56.5 billion by 1989 under this provision.

Auerbach concluded his discussion by raising the issue of one of the

costs of transition to a more neutral tax code, namely, the waste of substantial tax revenue on windfall gains to existing capital assets. He encouraged tax reform proponents to consider carefully the construction of suitable transition schemes.

Eisner also raised a number of questions concerning the neoclassical model. Often variables such as interest rates are taken as exogenous, the funds available, regardless of the profitability of the project. While the cash-flow model does predict business investment fairly well, Eisner noted that the typical positive relation between investment and cash flow arises largely because both profits and investment are pro-cyclical.

Eisner also raised a number of questions concerning the neoclassical model. Often variables such as interest rates are taken as exogenous, causing serious forecasting problems if they are in fact endogenous. Eisner illustrated this problem with the prediction by many "neoclassical model devotees" that the introduction of ACRS in 1981 would lower the user cost of capital and spur business investment; here, interest rates were apparently taken as exogenous. However, capital costs rose despite the more favorable tax treatment due to higher market interest rates resulting from monetary and fiscal policy. The absence of an expected capital gains term in the neoclassical model employed by Kopcke also troubled Eisner, for without including and specifying such a term, the effect of corporate tax rate changes on the rental cost of capital is ambiguous. Eisner also argued that dividend deductibility is not likely to encourage as much new investment as Kopcke supposed, since capital gains, not dividends, are the more significant reward to investors providing equity capital.

Eisner concluded that Treasury I would have little effect on aggregate investment, although it would represent a significant step toward neutrality in the tax treatment of different types of investment. Treasury II, on the other hand, would probably eventually be more favorable than ACRS to business investment, because of the combination of inflation adjustments and more rapid depreciation than Treasury I. He questioned, however, whether these new incentives would do much for investment or simply make businesses and their owners richer.

General discussion initially focused on the worth of staying with one tax code for a period of, say, five years, as opposed to making frequent changes. John Makin argued that one reason that capital formation is not at a higher level is that business leaders are cognizant of the recent tendency for the tax code to undergo frequent significant revisions, and therefore discount future benefits at a much higher rate than one might suspect. He went on to propose that a five-year moratorium on changes, whatever the tax code, would tend to stimulate capital formation.

Summers then pointed out that the anticipation of tax reform dis-

torts intertemporal decision-making. If one really expects, say, Treasury II to be passed in the near future, the present becomes a very attractive time to invest, as one can take advantage of the investment tax credit today and of lower corporate tax rates tomorrow.

Summers also referred to the issue of international competition first raised by Hatsopoulos. He noted that, by the national income account identity, the trade deficit is the difference between national investment and national savings. If, as Slemrod claimed, tax reform would not increase national savings, then the effect of reform on investment closely approximates the impact on the trade deficit. Thus, measures which stimulate investment also worsen the trade balance.

The Effect on Financial Markets

Patric Hendershott introduced the next topic with an ambitious paper in which he estimated quantitatively the effects of the four major tax reform proposals—Treasury I, Treasury II, Bradley-Gephardt, and Kemp-Kasten—on interest rates, asset prices, and capital stocks.

Interest Rates

Hendershott began his analysis of interest rate effects by noting that rates are determined jointly by the supply of and demand for funds to finance real capital investments. Changes in some tax reform provisions, such as cuts in marginal corporate and personal tax rates or interest indexation, lower interest rates by shifting downward both the supply and demand curves. Other changes aimed directly at real investment, such as eliminating investment tax credits and revising depreciation allowances, lower the demand curve only. The precise decline in interest rates depends on the amount by which the two curves shift and on the size of the interest-rate elasticity of investment demand, domestic saving and net foreign saving.

Hendershott first calculated the shift in the demand curve by estimating the decline in the pre-tax interest rate that would, under each proposal, hold constant the stocks of real capital desired by individuals and corporations. Turning to the supply side, he estimated on a disaggregated basis the interest rate at which savers would be willing to hold different types of capital. Quantitatively, Hendershott determined that the supply curve would shift down by roughly 3 percentage points under Treasury I and about 1½ percentage points under the other three proposals. For the demand curve, Hendershott estimated that the downward shifts would be roughly 3 points again for Treasury I, 2 points for Bradley-Gephardt, 1 point for Treasury II and no change for Kemp-

Kasten. The larger shifts for Treasury I are attributable to its interest indexation feature, while the smaller or zero demand shifts for Treasury II and Kemp-Kasten are the result of more generous depreciation allowances than under current law. Putting the shifts in the two curves together and allowing for a dampening effect of net foreign saving, the net decline in interest rates under each of the four proposals was 2½ percentage points for Treasury I, 1½ points for Bradley-Gephardt, 1 point for Treasury II and ½ point for Kemp-Kasten.

Financial Flows

Hendershott then turned his attention to how tax reform would affect financial flows. All four proposals would sharply restrict issues of tax-exempt securities for nongovernmental uses, which have accounted for roughly 60 percent of long-term tax-exempts, and all the proposals except Treasury I would modestly reduce home mortgages. The most dramatic change in financial flows, however, would occur under Treasury I in response to the interest indexation provision. Interest rates would decline sharply and, because home mortgage interest would still be fully deductible, the cost of debt financing of owner-occupied housing would also fall substantially. As a result of more housing and a higher loan-to-value ratio, home mortgage issues would increase substantially. In response to this reallocation of real capital towards houses and to a decline in business loan-to-value ratios, the quantity of other taxable issues would fall. This fall would be mitigated, however, by a shift from tax-exempt financing to regular taxable financing for nongovernmental purposes. Finally, the interest indexation provision in Treasury I would favor financial institutions with the greatest excess of interest income over interest expense.

Hendershott concluded with a brief look at the impact of tax reform on capital stocks. He found that the cut in the corporate income tax rate would raise the after-tax cash flows from existing capital and increase stock prices by roughly 5 percent under Kemp-Kasten and by 10 percent under the other three reforms. Under Treasury I, the 50 percent dividend exclusion would raise stock prices by another 15 percent.

Discussion

James Tobin questioned how one evaluates the welfare effects of the large shifts among different types of capital, since the existing allocation and those resulting from the four proposals represent second-best regimes. Treasury I comes closest to eliminating the major sources of inefficiencies, but it is also likely to hinder business investment for many years. Similarly, both Treasury I and Treasury II improve the allocation

within the business sector but accentuate the misallocation of saving between residential and nonresidential investment. How does one balance one effect against another in order to assess and rank the various proposals?

Second, Tobin faulted Hendershott and the rest of the participants for not addressing the effects of tax reform on the risks of capital accumulation. By lowering tax rates, the Treasury assumes a smaller share of the risk associated with capital investment, as well as a smaller share of the returns from such investment. Tobin insisted that the welfare effects of the shift in risk-bearing between investors and the general public are as relevant as those resulting from changes in expected returns.

Third, Tobin lamented the large windfall gains and losses that arise from the various tax reform proposals. He noted the contrast between policymakers in 1962 who tried to stimulate investment through provisions such as the investment tax credit targeted to new investment only and the current Administration which lowers taxes on the entire existing stock of capital. Tobin suggested trying to capture some of the windfalls through a transitional capital gains tax.

Finally, Tobin turned to the prospects for long-run growth. Tax reform has the potential for affecting growth by its effect on the nation's long-run propensity to save. Since the current proposals for reform would reduce the wedge between pre-tax marginal productivity of capital and the after-tax return received by savers, he believed this effect would be positive. He concluded by expressing concern over the explosive growth of public debt relative to GNP and national wealth, due to the budget policies of the current Administration. Tobin saw this as a grave threat to the nation's propensity to accumulate wealth, and lamented the fact that this problem has taken a back seat to the push for tax reform.

In his discussion, Barry Bosworth applauded the analysis of induced changes in interest rates brought about by tax reform as an innovative alternative to the traditional approach of assuming constant after-tax rates of return and calculating the wedge between the return earned on investments and that received by savers. Although he viewed the two approaches as complementary, Bosworth noted that Hendershott's analysis brought out several points not highlighted by the wedge analysis. Bosworth went on to list several issues not addressed in the paper.

First, most analyses of the tax reform plans, including Hendershott's, simply ignore the sensitivity of the tax system to inflation. Treasury I deserves more praise for attempting to make the system relatively neutral with respect to inflation.

Second, the analysis paid inadequate attention to the methods by which investment is financed. The impact of inflation on investment, for example, depends crucially on the extent to which debt finance is used.

Without a model which incorporated endogenous changes in the finance method, Bosworth felt one could not determine what would happen to the tax wedge under different reform plans.

Finally, Bosworth argued that too much emphasis is usually placed on domestic investment, and too little consideration is given to net foreign investment, an alternative productive use of domestic saving. From a welfare perspective, policymakers should be interested in national saving, not domestic investment. National saving should then be allocated between domestic and foreign investment so as to maximize returns to Americans. While the potential impact of tax policy on saving seems very limited based on the experience of the last five years, Bosworth contended that it may be too early to draw conclusions, since higher after-tax returns have different effects on older cohorts who have previously accumulated wealth and on younger ones who are just beginning to save.

In the general discussion, Summers suggested that one other possible explanation for the failure of the private savings rate to respond to increased savings incentives over the last five years would lie in the recent institutional developments which have made it easier for people to borrow. Since borrowing has increased, it is reasonable to suggest that savings would have fallen even more because of easier consumer credit but for the effect of the higher real after-tax returns.

The Effect on the Nonprofit Sector: Educational and Charitable Organizations

In the following session, Charles Clotfelter examined the likely impact of tax reform on charitable giving and thus on the educational and other nonprofit institutions eligible to receive tax-deductible contributions. He focused primarily on individual giving since it constitutes 80 percent of the total.

Individual Giving

The most important way in which the four major tax reform proposals would affect charitable giving is through the sharp reduction in marginal rates, which significantly increases the after-tax cost of giving. In addition, the proposals have some provisions aimed specifically at charitable contributions. Treasury I would repeal the above-the-line charitable deduction for nonitemizers, limit deductions to contributions in excess of 2 percent of adjusted gross income, and limit deductions for appreciated assets to the lesser of inflated basis or market value. Treasury I would affect charitable giving indirectly by reducing the number of item-

izers through the elimination of numerous existing deductions. Treasury II would also repeal the charitable deduction for nonitemizers and reduce the number of taxpayers who itemize. It drops the 2 percent floor, however, and relegates the constructive realization of appreciated gifts to the minimum tax. Bradley-Gephardt would allow all taxpayers to deduct contributions at the basic rate of 14 percent, while Kemp-Kasten would retain full deduction for all taxpayers, though at significantly lower marginal rates.

Clotfelter simulated the impact of these four proposals on charitable giving, using both constant elasticity and variable elasticity assumptions. In both cases, Bradley-Gephardt showed the largest decline (23 percent) and Kemp-Kasten the smallest (13 to 15 percent). Clotfelter then used survey data to calculate the likely impact by type of organization. The data showed that wealthy people tend to give to educational and cultural institutions, while middle and lower income groups favor religious organizations. Due to the large reduction in top marginal rates, the proposals generally produce the largest percentage declines in gifts to higher education and to cultural institutions.

Appreciated Assets

Clotfelter then analyzed the possible effects of the Treasury I and Treasury II proposals to eliminate or reduce the current favorable treatment for gifts of appreciated assets. Under current law, some capital gains escape taxation completely, which reduces the progressivity of the tax code. Furthermore, taxpayers tend to overvalue donated assets, which creates persistent difficulties for tax administrators.

Treasury I addresses the problem by allowing donors to deduct no more than the inflation-adjusted basis of appreciated property, which is equivalent to constructive realization of the capital gain in the Treasury I environment where only real gains are taxed. Treasury II introduces a similar provision into the minimum tax, where unrealized gains on such gifts would be counted as a preference item. This feature offsets the exclusion of capital gains on such assets for taxpayers with preference items in excess of $10,000. Clotfelter's simulation results indicated that these reforms would significantly raise the price of giving appreciated assets.

Clotfelter concluded that the impact of tax reform on charitable giving would be sizable. Reductions in long-run giving of 15 percent and more were predicted for the four major tax reform plans and even larger reductions would be likely for institutions that depend on gifts from high-income taxpayers, such as colleges and universities.

Discussion

Eugene Steuerle made four cautionary comments. First, he reiterated Clotfelter's conclusion that the empirical results in this field should be interpreted with great care. Research to date explains only a little about incentives to give; large unexplained variances in giving across individuals still remain. Moreover, the consensus of elasticities is derived primarily from the results of cross-sectional analysis; time series data and certain survey questionnaires appear not to support the high elasticities found in these studies.

Second, even if the numerical results were totally correct, further analysis would be required to determine what the numbers meant in terms of social costs and benefits.

Third, Steuerle argued that the existing literature generally failed to establish efficiency and/or equity targets. This omission made it difficult to evaluate specific proposals, such as floors on giving or limitations on gifts of appreciated property. Changes in these provisions were often accepted with little thought about what they were trying to achieve.

Finally, Steuerle offered the proposition that whereas broad-based, low-rate tax reform may reduce charitable giving, failure to achieve major tax reform would produce a weaker, not a stronger, charitable sector. Without tax reform, the ongoing erosion of the income tax, in favor of payroll and excise taxes, would be likely to continue. Since these alternative taxes contain no incentive to give, charitable contributions would be hurt significantly.

Gerard Brannon opened the general discussion by suggesting that it would be possible to avoid the predicted declines in charitable giving associated with reductions in marginal rates by allowing an augmented deduction, say $1.15, for each dollar of contribution. In fact, the favorable treatment of appreciated property may be an example of this type of stimulus—albeit extremely inequitable. Brannon argued that the important question was not the form the subsidy should take but rather just how large a subsidy for charitable giving should be incorporated in the tax code.

Summers tossed out the notion that perhaps the favorable treatment of appreciated property was just the natural response to a tax system that did not tax unrealized capital gains at death. If people do not pay tax on capital gains when they leave their assets to their children, why should they have to pay a tax on these gains when they give their assets to charity?

Aaron raised the question of just how sensitive people are to relatively small changes in incentives, and wondered if it were realistic to assume a linear relationship between incentives and behavior. Clotfelter agreed that responses to small changes in incentives would be negligible, but contended that the use of a linear function in the simulations

probably did not distort the results since the aggregate impact came mainly from the large changes that affected the middle and high income taxpayers.

Pechman suggested that a variable price elasticity of giving was probably more realistic than a constant elasticity. He cited as evidence the underprediction of changes in giving among lower and middle income persons in response to the 1981 tax cut, presented in Clotfelter's paper.

The Effect on the Nonprofit Sector: State and Local Governments

Treasury I, Treasury II and Bradley-Gephardt all include repeal of the deduction for state and local taxes as one of the main ways to finance rate reduction in their tax-reform package. Kemp-Kasten proposes repeal of the deductibility of sales and income taxes, but retains the property tax deduction. All four of these plans also severely restrict the possibilities for tax-exempt borrowing by state and local entities. The merit of these proposed changes was one of the more hotly debated issues at the conference.

Elimination of Tax Deductibility

Dick Netzer began his paper by arguing that if all taxes imposed at the state and local level were used to buy ordinary private goods or "club goods," then deductibility would be both horizontally inequitable and inefficient. On the other hand, if state and local taxes were used solely for the provision of pure public goods, then equity would require that individual taxable income be measured net of these involuntary payments and efficiency considerations would argue for deductibility, since these goods would be undersupplied in the absence of a subsidy. According to Netzer, about 10 to 20 percent of state and local tax-financed expenditures produced interstate benefit "spillovers," although these percentages may be somewhat greater at the margin. Netzer concluded that the existence of some spillovers suggests the possibility of a partial deductibility or the deductibility of selective taxes as desirable policy.

Netzer then turned to the question of the effectiveness of deductibility in encouraging aggregate state and local spending and the potential impact of eliminating the deduction. Using a price elasticity of -0.5, a number around which Netzer found an "uneasy" consensus, assuming that the median voter was an itemizer, and calculating that elimination of deductibility would raise the price by about 18 percent, Netzer concluded that revenue from taxes currently deductible would decline by 9

percent. Since deductible taxes account for only 27 percent of total state and local revenues, the expected decline in total state-local spending from all sources would be roughly 2 percent. Hence, Netzer concluded that effects on aggregate revenues do not provide a convincing case for continued deductibility. Netzer, therefore, surmised that the case for deductibility must rest on a national interest, if any, in the composition of state and local taxes or in the disparities among jurisdictions that would be created by ending deductibility.

Netzer investigated the possible shifts in the composition of revenues that might occur in response to eliminating the deduction. On the positive side, a substitution of sensibly designed user charges for currently deductible taxes would probably improve efficiency. On the other hand, greater reliance on selective excise taxes with narrow revenue bases would allow greater substitution of nontaxed for taxed services and thereby create the potential for welfare losses. Similarly, greater use of corporation income and business sales taxes would most likely impair efficiency. A reduction in the use of the property tax would slightly reduce the progressivity of the tax system, while a shift from a tax on housing to one on business-owned assets would lead to some loss of efficiency. On balance, composition considerations led Netzer to favor narrowing, rather than eliminating, deductibility.

Netzer then turned to the effect that ending deductibility would have on different jurisdictions. Removing the current subsidy for high-tax states would be desirable social policy if it simply eliminated spending that produced no interstate benefits. However, Netzer found that financial crises at the state and local level almost inevitably led to cuts in the area of public assistance and social services. Based on this evidence, Netzer feared that the downward pressure on expenditures in higher tax states caused by the end of deductibility would produce a similar pattern of spending reductions.

Netzer also argued that the end of deductibility would increase sharply the differential in tax burdens among jurisdictions. This rise would be likely to cause some locational shifts over time as individuals responded to the incentive for the affluent to move to income-segregated communities. For this reason as well as the likely decrease in redistributive expenditures, Netzer concluded once again that he favored restricting, rather than eliminating, deductibility.

Elimination of Tax-Exempt Borrowing

On the issue of tax-exempt borrowing, Netzer concluded that while a convincing case could be made for eliminating tax exemption entirely, the Treasury I and Treasury II proposals, which eliminate the exemption only on private purpose and advance refunding borrowing, were poorly

designed and most likely ineffectual. Netzer opposed the former because it would be impossible to determine the dividing line between public and private purpose borrowing and because any restrictions imposed would be easily avoided. He noted that some private purpose projects, such as airports, may be more closely tied to the national interest than public projects such as municipal office buildings. He also opposed the recommended limits on advance refunding bonds, calling the proposal a pointless restriction on adept state and local debt management.

Discussion

Edward Gramlich, in his comments on Netzer's paper, agreed with the author's objectives and most of his technical analysis, but came to quite different conclusions on both issues. He favored completely doing away with the deductibility of state and local taxes, and while preferring the complete elimination of the tax preferences for state and local borrowing, would accept the Treasury reforms as a second best. Gramlich emphasized the enormous revenue loss associated with the current tax provisions—$35 billion for deductibility and $20 billion for tax-preferred borrowing—and argued that revenues of this magnitude were sorely needed to offset the large budget deficits.

Gramlich noted that deductibility was one of the provisions in the tax code most favorable to the rich. The fact that many liberals argue for retaining this deduction must mean that they see indirect benefits accruing to the lower-income population. As Gramlich reviewed Netzer's three broad social offsets, however, he came away unpersuaded.

With regard to the aggregate level of state and local spending, Gramlich agreed with Netzer that a small decrease would occur as a result of eliminating deductibility. However, Gramlich noted that in low-income places such as Detroit, where relatively few voters itemize, virtually no reductions at all would occur.

On the subject of the composition of state and local revenues, Gramlich also found no significant social offset. He believed that Netzer overemphasized the potential inefficiencies in any new user charges imposed by states and localities and the likelihood in a highly competitive world that nuisance taxes would be imposed on businesses.

Finally, as far as the effect on interjurisdictional tax disparities, Gramlich agreed with Netzer's contention that tax prices are probably higher for rich people who live in poor areas and these prices would rise if deductibility were eliminated, creating an incentive for them to move. Gramlich contended that the incentive was relatively small, however, since the real quantity of public goods consumed is higher in the rich areas.

Unlike Netzer, Gramlich found merit in the Treasury's proposed limitation on tax-exempt borrowing. He acknowledged the difficulties in defining which issues should be classified as private-purpose bonds, but contended that a partial restriction on borrowing preferences, although difficult to enforce, would be better than doing nothing.

The general discussion began with Auerbach reiterating Netzer's concern that if deductibility were eliminated, many state and local taxes would be simply reclassified as business taxes so as to maintain deductibility. Bradford picked up on this point and advocated that the elimination of deductibility should extend to business taxes as well.

The heart of the discussion, however, was focused on the merits of deductibility. Aaron argued that the externalities produced by a government service will likely have an impact beyond arbitrary divisions such as city or state borders. Summers added that state and local services need to be subsidized, since no theory suggests that voting will necessarily produce the optimum amount. He cited the example of education, where children are the most direct beneficiaries, yet they do not vote. Moreover, it is unlikely that the preferences of the children are fully reflected in the voting of their parents, since so many couples are divorced with spouses living in separate jurisdictions.

Gramlich agreed that state and local spending had substantial externalities and deserved to be subsidized, but argued that deductibility favored primarily high-income communities and was an inefficient tool for encouraging desirable public spending. Instead, Gramlich advocated the use of targeted grants to support these services. Others agreed that grants-in-aid would be a more efficient approach, but were concerned about eliminating even a crude tool such as deductibility in an era when grants programs were being slashed. The practicality of improving the grants programs turned out to be the main area of difference between those who supported and those who opposed the elimination of deductibility.

Richard Musgrave concluded the discussion by suggesting that deductibility might have some merit in its own right as a tool for encouraging state and local spending. He noted that consideration is generally given to state and local effort, as well as need, when deciding the level of federal assistance and grants; in a similar fashion, tax deductibility may be a desirable form of federal assistance based on the fiscal effort of states and localities.

An Overall Assessment of the Tax Reform Effort

This session brought together Richard Musgrave, Joseph Pechman and Lawrence Summers, whom moderator Robert Solow characterized

respectively as "The Silver Fox of Public Finance, The Canny Old Hand of Taxation, and The Young Flash," to evaluate the current tax reform efforts.

Key Features of Reform

Musgrave began by commenting on the key features of this tax reform effort. First, the focus has been on the income tax, which he found not surprising since this levy has been the mainstay of the federal tax system ever since World War II. Musgrave noted that the expenditure tax approach, to which economists have devoted so much time in recent years, had little influence on the proposals.

Second, with regard to the pattern of tax reform, Musgrave noted that the key element has been to broaden the tax base and raise the same level of revenue with lower rates. Musgrave was pleased that, despite the questions raised by optimal tax theory, broad-based taxation remains a desirable goal. The other main feature of the pattern of reform has been to eliminate horizontal inequities in the context of retaining the existing vertical distribution. While Musgrave acknowledged that this approach permits progress toward agreement, he suggested that it does not make much sense to accept as a standard the vertical pattern of tax liabilities that has resulted from massive horizontal inequities. A final element to the pattern of the tax reform has been revenue neutrality, which has separated the reform problem from the need to increase revenues. Musgrave found the need for additional revenues as primary at this time and wondered whether tax reform was not being used by some as a purposeful diversion.

The Individual Income Tax

Musgrave then turned his attention to the specifics of the reform proposals. According to 1985 tax expenditure data, exclusions from the tax base amount to 78 percent of total revenues. As ambitious as it was, the base broadening under Treasury I totaled only 13 percent of actual revenues. The reason that Treasury I fell so far short of full revenue potential was that it left entirely or largely untouched the mortgage interest deduction, pension contributions under employer plans, social security benefits, and employer contributions to health insurance. Despite the limited gains in expanding the base, Musgrave acknowledged that Treasury I made some strides in reducing horizontal inequity.

Similarly, in discussing capital gains, Musgrave characterized Treasury I as being very bold in its attempt to tax realized capital gains in full, but noted that the proposal failed to even discuss the problem of unrealized gains or the question of what happens to the original base of an

asset when it is transferred at death. Musgrave lamented that none of the tax reform proposals even mentioned gift and estate taxes, which he felt should take on greater importance in a situation where the top marginal rates of the income tax are being reduced substantially.

On relieving the tax burden on the poor, Musgrave contended that the Treasury proposals do *not* signal a drastic change in the appropriate treatment of low-income people. Rather, the increase in the exemption and zero bracket amounts merely returns the situation to what it was in 1979.

With regard to marginal rates, Musgrave reiterated the point made earlier that the reduction from 14 to 3 brackets did little to simplify the tax code. He thought that the reduction did have substantial strategic value, however, since it insured that the top bracket, which extends fairly well down the income scale, cannot be too high. On balance, Musgrave found little in the way of simplification in any of the major tax reform proposals. He asserted that the only way to achieve real simplification is through a flat rate consumption tax, but felt that this was too high a price to pay.

The Corporate Income Tax

Turning to the corporate income tax, Musgrave stated that the revision of the depreciation rules might be the major accomplishment of this tax reform effort. He also contended that accelerated depreciation in Treasury II is probably a better mechanism for encouraging investment than the investment tax credit, which would be repealed under all four major reform proposals. He acknowledged that the investment tax credit has the advantage of applying only to new investment and of being very visible, but felt this approach suffered in its favoring of short-term over longer-term investment projects.

Musgrave praised the Treasury I proposal for including a 50 percent dividends paid credit, which moves the tax system toward the traditional goal of integrating the corporate and individual income taxes. At the same time, he voiced the concern that this proposal might have a detrimental effect on the saving rate by reducing the pressure for retention of earnings as a means for avoiding shareholder taxation.

Summing up, Musgrave concluded that the main gains of a tax reform along the lines of Treasury I are the improvements in horizontal equity, which encourage people to feel better about the tax system and perhaps even about the public sector. With regard to the supply effects, he concluded that they would probably be small—an increase of less than 2 percent in the household saving rate, little change in labor force participation and perhaps a 3 percent increase in the supply of durable equipment by the end of the decade. The main problem, however, is

that the tax reform debates divert attention from the much more important problem of increasing revenue.

Discussion

Pechman, as the first discussant of Musgrave's paper, arrived at only a slightly more positive assessment of the current tax reform efforts. He admitted the original principles of reform will have been seriously compromised by the time legislation emerges from Congress, but he nevertheless concluded that the most likely changes would be positive. He particularly supported the increase in the personal exemption and standard deduction to restore tax-free status to persons below the poverty line. He endorsed the redistribution of approximately $25 billion of taxes from individuals to corporations. He also approved of lowering rates from 50 percent to 35 percent with the revenue recovered from eliminating loopholes, but, like Musgrave, found little virtue in the reduction of the number of tax brackets from 14 to 3. Finally, he praised the efforts to improve the equity of the system through limitations on tax-exempt borrowing, pruning personal deductions, repeal of energy tax credits and the like.

On the other hand, Pechman pointed out the major areas where political considerations have already eroded some of the significant improvements originally proposed by the Treasury. For example, pressure from the financial community has resulted in severe retrenchment from the original Treasury I proposal to tax real capital gains at ordinary income tax rates. Another area of retreat from true broad-based taxation was the treatment of depreciable assets. Finally, Pechman criticized the backtracking on personal deductions, such as state and local taxes and charitable contributions.

On balance, Pechman concluded that although serious reform has been badly compromised, the public discussion has been educational and will help some future President and Congress to enact real change. If pressed, he would support, although somewhat reluctantly, the legislation emerging in Congress.

In contrast, Summers concluded that the current tax reform efforts were undesirable. Citing the excessive number of tax bills during the last eight years, Summers made a plea for a 36-month period during which the tax code would be left untouched. He further argued that proposed changes do not represent significant improvement over the current code. Repealing state and local tax deductibility was, in his opinion, undesirable in view of the growing demand for improved public education, the erosion of the nation's infrastructure and marked declines in real AFDC benefits. Summers saw little advantage in cutting rates and broadening the tax base, since often the individual's tax burden remains

unchanged by these offsetting adjustments.

Summers viewed proposed reforms in the area of depreciation as particularly pernicious. The Treasury proposal, argued Summers, reduces the burden on old capital by lowering the corporate tax rate and providing dividend relief and raises the burden on new capital through the elimination of the investment tax credit and lengthening depreciation schedules. He saw this as both unfair and anti-growth. He also challenged the claim that the Treasury proposal is a step toward more neutral treatment of capital, since it was based on the misconception that current law treats capital-intensive industry preferentially. Summers also found it difficult to believe that this proposal improves neutrality when it does little to change the nearly tax-free status of owner-occupied housing, while increasing the effective taxation of business investment.

Summers challenged the notion that the tax system unfairly confers benefits on certain industries and individuals through preferences. As long as people get the tax benefits they originally expected to receive when they purchased an asset whose price and return reflect those tax benefits, then they are not systematically beating the system or receiving unfair rewards; only unexpected changes in the tax treatment of assets create inequities.

Summers summarized his position by calling for another round of TEFRA-like legislation where substantial revenues are raised by closing a laundry list of loopholes. These additional revenues should then be used as part of a sincere effort to attack the budget deficits.

Towards the end of the session, Carl Shoup expressed the view which seemed to be shared by many participants that while Treasury I would have been "worth it," the watered down Treasury II proposals and the even more diluted congressional options would not.

Musgrave then added a few final remarks. He countered Summers' benign neglect argument by suggesting that the present may still have been the right time for tax reform as it brought opponents and advocates of the income tax together. Musgrave disagreed with the suggestion voiced frequently throughout the conference that free choice renders horizontal inequity meaningless, claiming that because individual preferences differ, preferential tax treatment may still be inequitable, even in the presence of identical economic capacity. He concluded by proposing that economists concern themselves solely with first-best solutions, and leave the choice between second, third, and fourth-best solutions to politicians.

Conclusion

Subsequent events have shown that, despite its initial promise, 1985 was not to be the year for major tax reform. Its demise can probably be attributed to the fact that the uneasy coalition for reform consisted of parties with very different motives. Nevertheless, comprehensive restructuring of the nation's tax system reached a level of debate never before realized and the authors of the Treasury proposals deserve enormous credit for this achievement.

The conference clarified numerous issues surrounding the tax reform effort. First, none of the proposals would really simplify the tax system significantly. Particularly, the reduction in the number of tax brackets would have no impact on simplification. Second, economists can say little about neutrality since the existing allocation of resources and those resulting from the alternative tax proposals are all second-best regimes. It is particularly difficult to assess proposals that improve the allocation of resources within the business sector but accentuate the misallocation between residential and nonresidential investment.

Third, economists have limited tools for assessing vertical equity. The basic problem is the lack of a clear standard, so that judgments are necessarily subjective. On the practical side, the uncertainty about the incidence of the corporate income tax makes it impossible to measure the distributional burden of a reform that shifts from personal taxes to corporate taxes. Nevertheless, everyone agreed that relieving the tax burden on low-income individuals and families was a particularly attractive feature of all the proposals.

Fourth, no revenue-neutral tax change will affect economic growth significantly. All four proposals would probably hurt investment initially, but if the tax code were left untouched the level of capital 20 years hence would probably be somewhat greater. None of the proposals would have much of an impact on saving or labor supply decisions.

The main vice of all the proposals is that they entail substantial transitional costs through the creation of large windfall gains and losses. Transitional capital gains taxes can reduce some of the inequities but only at the cost of greater complexity. Moreover, frequent revisions of the tax code create enormous uncertainty that probably inhibits investment and growth.

The main virtue of all the plans would be improvement in the actual and perceived fairness of the system. The closing of obvious tax shelters and the broadening of the base through the elimination of deductions would improve horizontal equity. This is not an inconsequential achievement, since it would reduce evasion, enhance respect for the public sector, and probably make it easier to raise additional income tax revenues in the future to finance federal deficits.