# *An Overall Assessment—Is It Worth It?*

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Is it worth it? This question, which has been posed to me, can hardly be answered without knowing what the congressional outcome will be. Surely, there would be a substantial improvement in the tax structure if Treasury I (the Treasury recommendation to the President) were to be enacted, and there would still be a gain (if substantially less so) under Treasury II (the President's plan). The same can be said for the key features of base broadening under various congressional proposals such as Bradley-Gephardt and Kemp-Kasten.[1] At the same time, a substantial gain will be needed to show a positive balance on the ledger, since there are opportunity costs. For one thing, considerable capital in accumulated goodwill for tax reform will have been expended. For another, concern with the more immediate problem of meeting increased revenue needs will have been diverted.

## *Key Features*

Before entering into specifics, let me note certain key features of the proposed reforms, features which are worked out most clearly in Treasury I but which also characterize Treasury II and the major congressional plans.

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[1]For a convenient summary of the various proposals, see J. Pechman, ed., *A Citizen's Guide to the New Tax Reform*: Rawman and Allenhead, 1985. Note also the flood of tax-reform studies which have appeared recently including the following: H. Aaron and H. Galper, *Addressing Tax Reform*, Brookings, 1985; A. Ando, M.E. Blume, and I. Friend, *The Structure and Reform of the U.S. Tax System*, M.I.T. Press, 1985; J.E. Minarik, *Making Tax Choices*, Urban Institute, 1985; R. Hall and A. Rabushka, *Low Tax, Simple Tax, Flat Tax*, McGraw-Hill, 1983.

## *Focus on the Income Tax*

First of all, note the fact that the current reform focuses exclusively on the income taxes. In a way, this focus is not surprising. The individual income tax, after all, exists and dominates the federal tax structure. Such has been the case ever since the early 1940s, when pressures of war finance transferred the individual income tax from a class tax into a mass tax. Over the last three decades (see table 1), this tax has contributed a

Table 1
Share of Income Taxes in the Federal Tax Structure

| | 1950 | 1960 | 1970 | 1980 | 1984 |
|---|---|---|---|---|---|
| As % of Total Receipts | | | | | |
| 1. Individual Income Tax | 38.2 | 44.0 | 46.7 | 46.2 | 43.7 |
| 2. Corporation Income Tax | 34.1 | 23.2 | 16.9 | 13.0 | 10.0 |
| 3. Payroll Tax | 11.8 | 15.9 | 23.4 | 32.2 | 37.3 |
| 4. Other | 15.9 | 16.9 | 13.0 | 8.6 | 9.0 |
| 5. Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| As % of Total Excluding Payroll Tax | | | | | |
| 6. Individual Income Tax | 43.4 | 52.3 | 60.9 | 68.0 | 69.7 |
| 7. Corporation Income Tax | 38.7 | 27.3 | 22.0 | 19.1 | 14.9 |
| As % of Personal Income | | | | | |
| 8. Individual Income Tax | 8.4 | 10.0 | 11.1 | 11.5 | 10.2 |
| As % of GNP | | | | | |
| 9. Total Receipts | 17.4 | 19.0 | 19.3 | 20.5 | 19.2 |

Source: U.S. Department of Commerce, *The National Income and Product Accounts of the United States, 1929–1965*, August 1966, and *Economic Report of the President*, February 1985.

rather steady 45 percent of federal tax revenue, federal revenue has remained a rather steady 20 percent of GNP, and the income tax has continued to absorb some 10 percent of personal income. This stable pattern, however, was accompanied by a sharp change in the composition of other federal revenue. While the share of payroll tax receipts rose drastically, the corporation income tax and excise shares dropped accordingly. As a result, the weight of the individual income tax in "free receipts" (defined to exclude the payroll tax) rose from 52 percent to 70 percent, thereby increasing its strategic role in federal tax policy.

Over the years, and especially so over the last decade, the structure of the income tax has been weakened increasingly by the growth of loopholes, preferences, or, to use the now common term, tax expenditures. The Treasury estimates revenue loss due to legal tax avoidance to have grown from about 9 percent of revenue in 1973 to 11 percent in

1981.[2] Exclusions, itemized deductions, and credits, which offset about 18 percent of personal income in 1954, by 1982 had risen to 34 percent.[3] Tax shelters in real estate and oil—based on an unholy interaction of investment credit, accelerated depreciation, capital gains preference, loss write-off, and partnership transactions—have mushroomed in recent years, leading to large scale tax avoidance especially in the higher income brackets. Thus, a recent Treasury report for 1983 notes that 11 percent of all returns with personal income over $250,000 paid less than 5 percent, and 53 percent paid below 20 percent. Corresponding ratios for returns above $1,000,000 were 11 percent and 60 percent respectively.[4]

As a result of these developments, the income tax has come to be viewed increasingly as unfair and detrimental to efficient resource use. Referred to by President Carter as a "disgrace to mankind," not to mention President Reagan's more colorful indictments, it has earned bipartisan condemnation. This critique, to be sure, has been voiced not only by friends of income taxation who wish to improve and strengthen its role, but also by opponents of taxation in general and progressive income taxation in particular. This combination gives the current discussion on tax reform a somewhat unusual flavor. As I see it, the critique has been exaggerated. For the bulk of taxpayers and revenue dollars, the income tax has been and still is a pretty good instrument, superior to its likely alternatives. However, there is much scope for improvement, and broad-based concern with income tax reform is all to the good.

At the same time, it is worth noting that the current discussion, with few exceptions, rejects alternative approaches which would tax consumption rather than income, be it via a direct tax on expenditures or an indirect tax on retail sales or value added. Academic interest in and support for an expenditure tax in particular has remained academic. Where *Blueprints*, the Treasury's staff study of 1978, gave equal space to a progressive expenditure tax as a viable and perhaps preferred alternative, Treasury I after a brief analysis decides against it.[5] While such a tax would have the great advantage of avoiding the complexities of capital income taxation, Treasury I concludes that filing requirements would be more complex for most taxpayers, that transition problems would be substantial, and that the equity of taxing consumption only is questionable. Moreover, not all income may be consumed during lifetime, thus raising the question whether gifts and bequests should not be included

[2]U.S. Internal Revenue Service, *Income Tax Compliance Research*: Estimates for 1973–1981, July 1983.

[3]U.S. Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, 1984, vol. 1, p.4. This study is subsequently referred to as Treasury I.

[4]See "Taxes Paid by High-Income Taxpayers and the Growth of Partnerships," Treasury Department, July 31, 1985, as reported in *Tax News*, August 12, 1985, p. 718.

[5]See the recent reissue, D. Bradford, *Blueprints for Basic Tax Reform*, Tax Analysts, Arlington, 1984. Also see Treasury I, vol. 1, p. 191.

in the taxable base, i.e., whether the tax should be on potential or on only actual consumption.

Treasury I gives more detailed consideration to the further option of a possible federal sales tax.[6] It concludes that such a tax, if it were to be introduced, should be broad-based and take value-added tax form rather than be implemented as a tax on retail sales. But no case is made for a federal value-added tax. In the context of a constant-revenue setting, so Treasury I concludes, income tax reform is to be preferred to a partial replacement of its revenue by a value-added tax. As one major reason for this conclusion, Treasury I notes that introduction of a value-added tax might provide easy revenue and thus facilitate further growth of government. This concern, it appears, now provides the key block in the path of a federal value-added tax. Those who in the past might have been proponents thereof (hoping to reduce the progressivity of the federal tax system by replacing income with sales tax revenue) have now become opponents (fearing that such a tax would induce budget growth). The time may come when past opponents of a federal value-added tax (objecting to its lack of progressivity) will become proponents (placing revenue considerations ahead of structural aspects) thus completing the reversal of tax preferences across the political spectrum. Among currently discussed proposals, only one (offered by Hall and Rabushka and entered in Congress by Senator DeConcini) involves a flat-rate consumption tax.

I should add that exclusive concern with income tax reform bypasses the important area of estate and gift taxation. The role of these taxes (and of a potential wealth tax) clearly relates to that of income tax reform, be it via the problem of unrealized gains at death or the overall progressivity of the tax structure. Truly fundamental reform should review the entire tax structure and not only a part thereof, but the constraints of tax politics and timing make this too demanding a task. Prudence suggests that one be satisfied with a comprehensive review of the income tax.

## *Pattern of Income Tax Reform*

Recent plans for income tax reform share a common thrust in pairing base broadening with rate reduction. This was the central message of the comprehensive income tax proposal in *Blueprints,* and remains so in Treasury I and II, as well as in the major congressional plans. This thrust may be seen as a victory, if belated, for academics and income tax students who have urged just such a move. The message was stated clearly in Simons' paper on post-war tax reform circulated in 1943, only two

[6]See Treasury I, vol. 3.

years after the birth of the modern income tax, and was expanded in his 1950 volume on *Federal Tax Reform.*[7] Over the following decades, the case for a comprehensive income base was urged by a generation of tax reformers, including such names as Groves, Shoup, Vickery, Goode, Heller, Pechman, and Surrey. Bradford and McLure, the architects of *Blueprints* and Treasury I, respectively, finally succeeded in giving this doctrine official Treasury status, an accomplishment for which they deserve the thanks of the profession.

The essential point from Simons on (and dating back even further to Schanz and Haig) has been that the income tax should be imposed on a comprehensive base, given by total accretion to the taxpayer's wealth or, putting it differently, equal to consumption plus increase in net worth. The tax base should thus be independent of the source from which income is derived or the uses to which it is put. Conformance with this rule would (1) meet the requirement of horizontal equity, (2) provide a meaningful basis on which to apply standards of vertical equity, and (3) minimize the distorting impact of tax considerations on economic behavior. The younger generation of tax analysts might wish to add that, ironically, the general acceptance of the broad-base rule has been accomplished just at a time when its analytical basis has come to be punctured by the strictures of optimal taxation. But I would rather say, "weakened somewhat." Existing differentials in the treatment of various income sources and uses can hardly be said to meet optimal taxation rules,[8] thus leaving as a pretty good policy rule the presumption that uniform treatment of a comprehensively defined base will be more efficient than arbitrary departures therefrom. Current reform proposals, to be sure, fall far short of this ambitious goal, but the essential spirit of base-broadening is present and there is hope that a good bit will be accomplished.

Given a broadened base, it follows that the needed total revenue can be had at lower rates. Treasury I and II implement this by raising tax-free income to the poverty line and cutting bracket rates by about one-third. Following *Blueprints*, the present set of 14 bracket rates, ranging from 14 to 50 percent, is to be transformed into a three-bracket schedule of 15, 25, and 35 percent. A similar pattern is followed by Bradley-Gephardt, who propose a three-bracket schedule of 12, 26, and 30 percent. Notwithstanding much mention of a flat tax, a single rate is proposed only in the Kemp-Kasten plan (at 25 percent) and the Hall-Rabushka plan (at 19 percent). While we shall find the collapse of 14 into three brackets to be of limited importance, transition to a single or flat-rate system would make a fundamental difference. Even a flat rate, in combi-

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[7]See Henry C. Simons, "Post-War Federal Tax Reform," C.E.D. Memorandum, November 1943, and *Federal Tax Reform*, University of Chicago Press, 1950.

[8]For a similar view, see Joel Slemrod's paper to this conference.

nation with an adequate tax-free amount, can yield a progressive pattern of effective rates over the lower to middle income scale, but multiple rates are needed if progression in the effective rate is to be extended over the upper part of the income scale. We may expect, therefore, that the legislative outcome will involve a multiple schedule of at least three or, more likely, four rates.

Special interests aside, most observers agree that there is a clear gain in a reform which broadens the base and permits the same revenue to be obtained from lower rates. But the adjustment can be made in various ways. One way is to cut bracket rates so as to preserve the pre-reform distribution of liabilities across brackets (defined in terms of economic income). This approach was largely followed by *Blueprints*, except for a substantial cut at the lower end of the scale. It is also retained in Treasury I and II, as well as in the major congressional reforms. Thereby structural reform is to be made distributionally neutral (in the vertical sense), thus bypassing the controversial issue of how progressive the income tax should be. This way of playing the game has merit in that it facilitates political consensus, but it perpetuates the pattern of effective rates which prevailed prior to reform. This pattern came about by imposing a higher level of bracket rates on a highly imperfect base, and thus can hardly be taken to reflect what was an explicit policy intent. This problem arises especially over the upper end of the income scale, where tax preferences have been of particular importance. The issue of vertical burden distribution is thus resolved by fiat, rather than direct attention thereto. Once more, this facilitates consensus, but passes over a key issue in fundamental tax reform.

## *The Role of the Corporation Tax*

The academic tradition of income tax reform, based on the rule that a person's taxable capacity should be measured by accretion, also extended to the treatment of corporate source income. This tradition, shared by the author, has argued that there should be no separate ("classical" or "absolute") tax on corporation profits. The claim to all income rests with individuals, and only they carry taxable capacity. Corporate income, therefore, should be taxed to the shareholder (whether distributed or not), and integrated into the recipient's personal income tax. This approach was taken by *Blueprints* and a first step towards it is repeated by Treasury I. There 50 percent of dividends paid are excluded from corporation tax and the rate is reduced from 47 to 33 percent, close to the top rate of the income tax. However, the case for integration has gained little popular support, even among corporations, and the principle of an absolute corporation tax is retained in most of the current plans. Treasury II does so by reducing the dividend exclusion to 10 per-

cent while matching Treasury I's rate reduction. Various congressional proposals, such as Bradley-Gephardt and Kemp-Kasten, also reduce the corporation tax rate to 30 percent but retain it as a distinct part of the system.

With or without integration, there remains the crucial problem of defining taxable profits correctly. Combined with the investment credit, the depreciation reform of 1981 (still so after adjustment in 1982) resulted in widely differing effective rates of tax, especially after inflation had abated. Treasury I takes a bold step forward in replacing this archaic pattern by dropping the investment credit and adopting a system of inflation-proof economic depreciation which will be neutral across industries. Treasury II also drops the investment credit and approximates a neutral pattern; but it reintroduces an element of acceleration by an across-the-board speed-up in the Treasury I depreciation schedules. More or less similar depreciation reforms are also featured in most of the other plans. Depreciation reform, it appears, may well emerge as the most important gain in the current reform effort.

## *Inflation Adjustment*

A further key feature of the current reform plans is to neutralize the tax system against the impact of inflation. The most important aspect thereof is the just-noted indexing of the depreciation base, but other adjustments are included as well. Though coming somewhat belatedly, this is to be welcomed as an essential part of base revision. Even though the rate of inflation has greatly abated, the current level of unrealized values continues to reflect the rapid inflation of past years. The very accretion concept upon which the case for a broad tax base rests must obviously be understood in real terms, and this requires an inflation adjustment. The 1981 legislation for the indexing of rate brackets and exemptions is followed in Treasury I by inflation adjustments in the treatment of depreciation, inventories, and capital gains. As a further and ambitious stage, both interest received and interest paid were to be inflation adjusted. Treasury II also indexes depreciation, qualifies the capital gains adjustment but drops the indexing of interest. In subsequent action, the Administration further deleted the inventory adjustment, hoping thereby to meet congressional criticism that Treasury II would not be revenue-neutral. However, a move towards inflation-proofing remains an important feature of the current reform plans.

## *Constant Revenue Assumption*

In concluding these general remarks, the condition of constant revenue remains to be noted. This condition appears to be accepted by all

participants in the discussion. If applied to the individual income tax taken by itself, this means that revenue gains from base broadening should be offset by losses from increases in the tax-free limit (exemptions and zero bracket amounts) and from rate reduction. This imposes a nice discipline by forcing focus on structural issues, i.e., on how a given revenue is to be obtained. Combined with the previously noted condition of distributional neutrality, this further narrows the focus to issues of horizontal equity and efficiency, thereby increasing the prospect for agreement. Note, however, that the constant revenue assumption is not applied in this strict fashion. Rather, it is to be applied to the package as a whole, permitting a shortfall under the income tax to be offset by a gain under the corporation tax. Evidently this was done to permit a sharp reduction in the top bracket rate of the income tax.

Critics have questioned whether the Treasury plan will in fact be revenue neutral, but the divergence is minor. The constant revenue assumption is thus a helpful feature of the present exercise, but, as I noted at the outset, it also has its cost. For one thing, structural details may change with changing revenue requirements; for another, focus on the constant revenue frame drives out concern for increased revenue needs, a concern which should be given priority at this time. Given the projected level of defense expenditures, a major deficit reduction cannot (and indeed should not) be met from the expenditure side only. The deficit problem thus cannot be resolved without a substantial contribution from tax increases. Moreover, deficit reduction is essential to permit a change in the monetary-fiscal policy mix, without which we cannot resolve the problem of high interest rates, trade deficits, rising foreign indebtedness, and increased interest burden on the budget. I realize that these issues of macro policy are not on the agenda of this conference, but whether or not the reform is "worth it" can hardly be answered without noting its opportunity cost.[9] Deterring effects on coming to grips with the revenue problem, I fear, will be the major entry on the nay side of the question.

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[9]The major arguments raised against a tax increase are (1) that it would be detrimental to the economy and (2) that it would generate expenditure growth. While (1) would be correct if the tax increase is viewed in isolation, allowance must also be made for the easing in monetary policy permitted thereby. Viewing the combined package, the change in mix could be held aggregate-demand neutral while being favorable (especially if combined with restriction of consumer credit) to capital formation and growth.

Opposition based on (2) reflects the Administration's desire to use the deficit, combined with expansion of the defense budget, as a wedge by which to force reduction in civilian programs. As distinct from a merit-based expenditure review, this hardly seems the way to accomplish fiscal improvement in a democratic process. Nor is it permissible to hold adjustment of macro policy, needed not only at home but also abroad, hostage to an overriding goal of expenditure shrinkage.

## *Income Tax Issues*

In this section, I consider some of the major aspects of income tax reform. Given the large number of specific issues, a selective approach will be required. The next section will consider proposed changes in the corporate income tax and, more generally, the treatment of capital income.

### *Scope of Base Broadening*

As noted before, base broadening is one of the two major features of current reform proposals. Such is the case even though what is being proposed falls short of a fully comprehensive base. How much would these proposals accomplish and how large a shortfall would then remain?

In attempting to answer this question, I shall use the estimates of revenue loss from tax expenditures (pre-1983 concept) as given in the U.S. Budget for 1985.[10] The total revenue losses (1985 level) due to tax expenditures there given aggregate to $260 billion. With actual revenue of $330 billion, it follows that elimination of tax expenditures would raise total revenue to $590 billion, or by 78 percent. Putting it differently, the potential shortfall due to tax expenditures reduces "full revenue" by 44 percent. How does the base broadening under Treasury I compare therewith? Its total revenue loss is estimated at $37 billion, including a loss from rate reduction and exemptions increase of $93 billion and a gain from base broadening of $56 billion. With present-law revenue estimated for 1987 at $407 billion, this amounts to a gain of 14 percent. Using 1990 levels, this ratio rises to 18 percent but remains far below the "full" ratio of 78 percent. I am aware, of course, that this calculus involves its difficulties. Aggregation of losses from various tax expenditures introduces error, since their item-by-item estimation overlooks interdependence. What constitutes tax expenditures is debatable, and certain items (such as unrealized gains and imputed income) are not covered. The scope of revenue loss from omissions from the base depends on the rate structure and so forth. Nevertheless, the above calculation offers at least a rough picture of the limited scope of base broadening, even under Treasury I, and it is a surprisingly disappointing one.

About half the gap is explained by failure to deal with certain major items. Out of the total 1985 loss of $260 billion, $56 billion is accounted for by exclusion of pension contributions under employer plans, $20 billion by remaining exclusion of employer contributions to health insurance, $19 billion by exclusion of social security benefits, and $25 billion

[10] *Special Analyses, Budget of the United States Government for the Fiscal Year 1985,* Special Analysis G, pp. G43–48.

by deductibility of mortgage interest on owner-occupied homes. These items, which are entirely or at least largely untouched by Treasury I, add to $120 billion, or 46 percent of the total revenue loss. Their omission reduces the 1985 loss ratio based on Budget data from 78 to 46 percent of potential (comprehensive base) revenue, still considerably above the 17 percent recoupment ratio of Treasury I.

## *Base Broadening: Implications for Tax Equity*

It would be a mistake, of course, to focus on the aggregative scope of base broadening only. The issue is not merely one of broadening the base so as to permit rate reduction, but also one of improving the structure of the base in equity and efficiency terms. A generally accepted requirement for tax fairness is that of *horizontal equity*: taxation should treat people in equal positions alike, i.e., impose equal burdens upon them. Putting it differently, people in equal positions prior to tax should remain so after tax. It follows that those tax expenditures or preferences are most harmful which are enjoyed in unequal measure by the members of particular income groups, while those which are shared more equally are less offensive in this respect.

Unfortunately, there are few data by which to evaluate the proposed base reforms in these terms. To begin on the income uses side, owners of primary residences retain large advantages over renters, while owners of vacation homes will find their preference cut somewhat. Donors lose part of their advantage as against non-donors due to the restriction of charitable contributions proposed in Treasury I, but not so in Treasury II. Risk-averters (who take out health insurance) lose some of their subsidy. Consumers of durables, purchasing on credit, are to be treated more nearly like their more prudent brethren or sisters who pay cash. In these and other items, there will be some progress in horizontal equity, but gains from the income uses side are bound to be small as long as mortgage interest remains untouched. The fact that no politically realistic proposal can attack this preference not only reflects the power of what usually is referred to as interest-group pressure, but also a generally accepted notion that home ownership is a good (merit-good?) thing which should be encouraged. However, even if this is accepted, a credit may well be superior to the deduction approach.

Gains from reduced preferences on the income sources side should, however, be more important. To be sure, the biggest items of employer contributions to pension funds, social security benefits, and tax-exempts will also remain untouched, but substantial progress can be hoped for in other respects. This includes preferential treatment of upper-income fringe benefits, such as limitations on business meals, travel costs, and seminar cruises. Most important, Treasury I would produce major gains

from provisions making for more equal treatment of salary and capital income over the upper part of the income range, including full taxation of realized gains and a narrowing of escape hatches now offered by a variety of tax shelter investments. This suggests that gains in horizontal equity under Treasury I will be more significant in the middle and upper than in the lower income ranges, but this will be less so for Treasury II.

Base broadening not only matters for horizontal equity, but also bears on vertical equity, i.e., the distribution of the tax burden across income groups. Particular omissions from the base are typically not of equal importance across the income scale. Current proposals stay clear of the social security exclusion at the lower end, of employer contributions over the lower to middle income scale, homeownership in the middle range, and tax-exempts at the upper end. Placing a ceiling on employer contributions to health insurance and full inclusion of employment compensation would tighten at the lower end, but there are only a few such items. The primary emphasis of base broadening appears to be at the upper-middle and high end of the scale. These effects, to be sure, combine with those of rate reduction in setting average effective rates by economic income brackets. Since a substantial cut in top bracket rates is to be applied, a substantial base broadening at the upper end will also be required if the vertical burden distribution is to be left largely unchanged. Such is the case especially since reduction of the top bracket rate to 35 percent or less is in itself a primary goal in the current reform proposals.

### *Base Broadening: Implications for Efficiency*

Efficiency aspects of base broadening are related to those of horizontal equity, but they are not the same. Efficiency costs may arise even in a world in which all taxpayers are identical in their preferences and responses, so that there need be no concern with horizontal equity. Moreover, differential taxation of various products or income uses or sources may be efficient, even though this results in horizontal inequities because preferences differ within income groups. As noted before, considerations of optimal taxation question the broad-base doctrine and complicate horizontal equity implications.[11] However, the goals of hori-

[11]Consider a situation where A's demand for x is elastic while that for y is inelastic, with the opposite holding for B's demand, both having the same pre-tax income. Efficiency then requires that A should be taxed more largely on y while B should be taxed more largely on x. Horizontal equity calls for both to be taxed so as to suffer equal welfare losses. (Some form of utility comparability is inevitably required when dealing with horizontal equity.) But equal welfare losses may well involve different amounts of tax. So far efficiency and equity considerations (properly interpreted in terms of welfare losses) remain compatible. However, this solution may not minimize aggregate welfare loss, so that efficiency thus defined may be incompatible with horizontal equity. Putting it differently, horizontal equity requires equating of total welfare losses across consumers, whereas efficiency requires equating welfare losses at the margin.

zontal equity and efficiency may also coincide, and I suggest will do so for the major omissions from the tax base. Inclusion of mortgage interest and termination of tax-exempts, for instance, would be advantageous on both efficiency and horizontal equity grounds, but neither is provided for. The same holds for the tightening of tax shelters and features now permitting capital income from various sources to be taxed differentially. These aspects of the reform above all should result in substantial efficiency gains and happily most of them will also be matched by improvements in horizontal equity.

## *Base Broadening: Further Issues*

In the following, brief consideration is given to certain items of base broadening which are of particular interest, including the treatment of capital gains, the deductibility of state and local income taxes, and charitable giving.

*Capital Gains.* Preferential treatment of capital gains has been one of the major sources of tax shelter building and tax avoidance by high incomes. Both Treasury I and II provide for a change in the treatment of capital gains. Treasury I calls for full inclusion of realized gains, thus raising the top rate from 20 to 35 percent, while also indexing the base. Treasury II reduces the inclusion rate to 50 percent, which (with the bracket rate cut to 35 percent) reduces the top rate to 17.5 percent. Treasury II also permits an option of full inclusion with indexing beginning in 1991. Bradley-Gephardt and Kemp-Kasten are generally similar to Treasury I but Kemp-Kasten permits the option of 75 percent inclusion without indexing for the first 10 years.

Full taxation of capital gains has long been one of the key items of tax reformers. While there may be some (if dubious) disagreement over whether unrealized gains should be viewed as income, this surely does not hold for realized gains. Preferential treatment of gains, as noted below, has been a key feature in the construct of tax shelters, and the Treasury I proposal for full taxation thereof constitutes a major improvement. So does its proposal to index the base. Accretion should be defined in real terms, since the impact of inflation on nominal capital values needs to be corrected for. Otherwise, even the current practice of a 60 percent exclusion leads to over-taxation once the inflationary component of the nominal gain exceeds 60 percent. Given the backlog of substantial inflation, it is not surprising that the early revenue effect of the proposed change is estimated to be slight, but this may be expected to change over the longer run if the rate of inflation continues to be low.

Treasury II differs sharply from Treasury I. By continuing the option of 50 percent exclusion indefinitely, preferential treatment is retained, at least under the assumption of modest inflation. In seeming contradic-

tion, it is argued first that with adequate incentives provided under CCRS, no special capital gains preference will be needed, but this is followed by a defense of the preference so as to stimulate saving and investment.[12] While the effectiveness of the capital gains preference may be debated, it seems evident that its blanket application to all types of capital gain is inappropriate. To be sure, the magnitude of the preference (with a 50 percent inclusion and a 35 percent maximum rate) would be reduced to 17.5 percentage points, as against 30 under present law, but it would still be substantial.[13] Given the strategic role of the capital gains preference in the tax shelter construct, much of the accomplishment of Treasury I in tax shelter closing may thus be lost by Treasury II.

Among other aspects of the capital gains problem, it may be noted that Treasury I limits tax savings from the donation of appreciated property by requiring use of the smaller of its indexed or market value. Once more, this provision, which is a logical extension of inflation proofing, is not included in Treasury II. Neither Treasury I nor Treasury II addresses the carry-over of basis on unrealized gains to the heir, who is now permitted to use market value at the time of the estate. Appropriate treatment would return to the 1974 provision using the original base, but subject again to indexing for inflation. Finally, this review should note that neither Treasury I nor II, nor for that matter any other plan now under discussion, addresses the problem of unrealized gains and their eventual inclusion in the income tax base, be it periodically or at death. This omission, along with the 1981 cutback in transfer taxes, highlights the changed climate in which tax reform now proceeds, but the underlying problems of wealth distribution and its social as well as economic implications still persist.

*Deductibility of State and Local Taxes.* Both Treasury I and II discontinue the deduction of all state and local taxes. Bradley-Gephardt drops the sales tax deduction only, while Kemp-Kasten discards the deduction of sales and income taxes. Repeal of tax deductions provides the largest single item of revenue gain under the Treasury plan. At $34 billion (1988 level), it accounts for over 40 percent of the total gain from base broadening in Treasury I. No wonder, therefore, that the Administration views this provision as a must item.

Treasury I classifies the deduction of state-local taxes under the heading of "preferred uses of income." The implication is that taxes represent a voluntary use of income, which even to this observer appears as

[12]See *The President's Tax Proposals to the Congress*, referred to as Treasury II, pp. 167–176.

[13]*The Treasury Report on the Capital Gains Tax Reduction of 1978*, which has just appeared, gives a prudent appraisal of the case for preferential treatment. Holding revenue constant, the gain from capital gains reduction in terms of increased consumption is shown to become positive only after several decades, and to be substantially less than that obtained from an across-the-board reduction in the level of capital gains taxation.

a somewhat benevolent view of the fiscal process. Fiscal decisions, after all, are not unanimous but based on majority rule. Treasury I then rejects deductibility for a number of reasons. Deductibility benefits itemizers only, and high-income itemizers in particular; it supports high-tax states at the cost of low-tax states, and high-income states at the cost of low-income states. Benefit leakages to outside the jurisdiction are considered of minor importance, and do not justify a federal subsidy. Past fear that absence of deductibility would raise income tax rates to over 100 percent no longer applies, as rates have come down.

These points are not without merit, but much depends on how one views the role of central government in a federation, and that of Washington in the United States in particular. The approach of Treasury I is well stated in its following dictum: "To the extent that state and local taxes merely reflect the benefits of services provided to the local taxpayer, there is no more reason for a federal subsidy for spending by state and local governments than for private spending."[14] Putting it differently, federal support is considered appropriate only in the case of spill-outs, the benefits from which are not included in the local calculus. As I see it, the role of central government (based on the will of its national constituency) is broader, including protection of certain rights of its "national" citizens, independent of their particular location within the nation. Central responsibility may thus be seen to involve claims to a minimum level of income (or the opportunity to earn it) as well as to a minimum level of essential state and local services. In particular, I continue to view the problem of distribution to be essentially a central responsibility: partly because the basic social contract has to be among citizens of a nation and not only village neighbors; and partly because decentralized redistribution is voided by mobility. There is thus a national interest in state and local budgets, and not only a state-local one. Since the capacity of state and local units to render services differs greatly, central concern is not only with inter-individual but also inter-jurisdictional aspects of distribution. All this of course, is quite compatible with the proposition that certain public services should be rendered at the state and local level; but central concern is not limited to dealing with spill-out situations.

All this establishes a rationale for a capacity-need-effort related system of revenue sharing—a system which, to be sure, would have little resemblance to the ill-designed revenue sharing system which is now being phased out. If such an ideal system were in existence, tax deductibility would not be needed, except for the income tax, where (parallel to

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[14]See Treasury I, vol. 1, p. 78. A rather similar view appears in D. Netzer's paper to this conference, which also bases the rationale for partial retention of tax reduction on the presence of benefit spill-outs.

the treatment of foreign taxes) an allowance (preferably in the form of a partial credit) would remain in order. But this is not the actual setting in which this tax reform proceeds. No ideal system of revenue sharing is in the works, and the trend is towards reduced federal aid of all kinds. In this setting, I hesitate to discard deductibility altogether, especially in view of high-income, high-tax states which must service large low-income populations, and in view of the dependence of school expenditures on the property tax. Whether the deductions should be transformed into a credit approach is a different matter, and certainly one which might be considered to meet the Treasury concern that deductibility accrues to the special benefit of high-income taxpayers.

*Giving*. Treasury I recommends that the deduction for charitable contributions be repealed for non-itemizers, and that itemizers be permitted to deduct contributions in excess of 2 percent only. The quantitative effects of these proposals are significant. As they are explored in detail in another paper,[15] I will here only comment very briefly on their rationale. Disallowance of deductibility to non-itemizers has merit on simplification grounds, but Treasury I, as a further reason, notes that small contributions are not likely to be affected much by removing deductibility. Perhaps not, but there are also equity implications: If preferential treatment of giving is justified, it should not be withheld from small contributors. The provision for a floor to itemized giving makes sense on equity as well as on revenue grounds, since a larger sacrifice (giving as a larger share of adjusted gross income) on the donor's part may be seen to merit a larger preference. However, there is little reason why the subsidy rate should rise with income, a bias which might have been corrected for by substituting a partial credit for the deduction approach.

## *Burden Distribution, Tax-Free Income, and Bracket Rates*

I now turn to the effects of the reform proposals on the distribution of the tax burden among income brackets.

*Burden Distribution*. The distribution of liabilities and the level of average tax rates under present law and Treasury I are compared in table 2. As shown in lines 1 and 2, the percentage distribution of liabilities among family economic income brackets remains largely unchanged. The only major change is a sharp reduction in the share contributed at the low end of the scale. The average rate of tax for the group as a whole is reduced from 8.7 percent to 8.0 percent (involving an 8 percent reduction in yield) and this is reflected in a reduction of average rates throughout the income scale. As shown in line 6, the percentage reduction is

[15] See Charles T. Clotfelter's paper prepared for this conference.

Table 2
Tax Burden Distribution*
(Ratios, with the exception of lines 7 & 8, refer to Treasury I)

| | Family Economic Income in Dollars | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Less than 10,000 | 10,000 to 15,000 | 15,000 to 20,000 | 20,000 to 30,000 | 30,000 to 50,000 | 50,000 to 100,000 | 100,000 to 200,000 | 200,000 and over | Total |
| **Tax Liabilities** | | | | | | | | | |
| Percentage distribution | | | | | | | | | |
| 1. Present Law | .5 | 1.8 | 3.3 | 10.3 | 24.3 | 32.8 | 12.3 | 14.9 | 100.0 |
| 2. Proposed, Treasury I | .3 | 1.6 | 3.1 | 10.2 | 24.1 | 33.1 | 12.6 | 15.0 | 100.0 |
| 3. % change in shares | −40.0 | −11.1 | −6.1 | −0.1 | −0.1 | +0.1 | +0.2 | +0.1 | — |
| **Tax Rates** | | | | | | | | | |
| Average Rates | | | | | | | | | |
| 4. Present Law | 1.4 | 3.2 | 4.6 | 6.3 | 7.8 | 9.4 | 13.2 | 20.1 | 8.7 |
| 5. Proposed, Treasury I | 0.9 | 2.7 | 4.0 | 5.7 | 7.0 | 8.7 | 12.3 | 19.3 | 8.0 |
| 6. % change in tax | −35.7 | −15.6 | −13.0 | −9.5 | −10.3 | −7.4 | −6.8 | −4.0 | −8.0 |
| 7. Proposed, Treasury II | 0.9 | 2.5 | 4.0 | 5.7 | 7.3 | 9.6 | 12.7 | 18.7 | 8.1 |
| 8. % change in tax | −35.5 | −22.8 | −13.5 | −8.7 | −6.6 | −4.2 | −4.1 | −10.7 | −7.0 |
| Marginal Rates | | | | | | | | | |
| 9. Present Law | 4.2 | 9.4 | 12.4 | 16.0 | 20.9 | 27.6 | 37.5 | 46.1 | 23.6 |
| 10. Proposed, Treasury I | 3.7 | 8.5 | 11.0 | 14.0 | 16.5 | 22.1 | 30.5 | 33.2 | 18.9 |

*Treasury I, vol. 1, p. 47, and Treasury II, p. 16.

steepest at the bottom of the scale. Comparable ratios for Treasury II (lines 7 and 8) show a rather similar picture, except for Treasury II's much sharper decline at the very top. The ratios for Treasury I and II, I take it, are based on the assumption that the composition of income remains unchanged. But such changes will occur, leaving me somewhat skeptical on how such comparative estimates can be made without knowing how taxpayers will respond to the various changes in the law.

Lines 9 and 10 show corresponding changes in marginal rates (or, more specifically, average marginal rates) in the various brackets. As may be expected, the decline in marginal rates is relatively slight at the bottom of the scale and increases with income, the estimated drop for the top bracket being from 46 to 33 percent. Corresponding data for Treasury II are not given. In all, the distribution of the burden by bracket shares remains more or less uniform and the percentage reduction in average rates is more or less similar throughout, with a major change only at the bottom of the scale, but marginal rates (especially at the top) decline sharply. One marvels at the Treasury's research staff for having produced so neat a result.

*Tax-Free Income.* This outcome, as noted before, reflects the combined effects of (1) rate reduction, (2) base broadening and (3) raising the tax-free amounts. The latter is accomplished by (a) raising the exemption from $1,000 to $2,000 and (b) increasing the zero bracket amount (or standard deduction) from $2,300 to $2,800 for a single and from $3,660 to $4,000 for a joint return. By giving most of the relief via (a), families with dependents are favored and the marriage penalty is reduced. Bradley-Gephardt raises the personal exemption to $1,600 only, leaves the dependency exemption unchanged, and increases the tax-free amount to $6,000. The proposed change is thus less responsive to family size. Kemp-Kasten follows the Treasury pattern but adds a vanishing exemption beginning with 20 percent of wage and salary income, designed to serve as an offset to the payroll tax.

At the lower end of the scale, the increase in the tax-free amount is *the* decisive factor. We should note, however, that the drastic increase proposed in Treasury I and II does not reflect a new view of how the poor should fare under the income tax. It merely returns the treatment partway to what it was in 1979. At that time, the poverty threshold (using a family of four for illustration) stood at $5,330. With an exemption of $1,000 per person and a zero bracket amount of $3,400, the tax-free total was $6,400, or 120 percent of poverty income. Since then these allowances have not been changed but the threshold for 1986 is estimated at $11,400. Tax-free income has thus declined to 56 percent thereof. This, it appears, has been the most blatant mischief worked by an unindexed income tax during a period of rapid inflation. The proposed increase in exemptions to $2,000 and in the zero bracket rate to $4,600 will

raise the tax-free amount to $12,000. This equals 105 percent of the poverty threshold, so that the current proposal goes most of the way towards restoring the 1978 ratio of 120 percent.

At the same time, the proposed increase in tax-free amount is exceedingly costly in revenue terms. It might well account for close to one-half of the estimated $100 billion revenue loss (1988 level) from raising exemptions and reducing rates. This cost might have been limited greatly, while giving the same benefit to low incomes, by shifting to a vanishing exemption, a device long recommended by tax technicians. Given the goal of maintaining the present level of average rates through the scale, this would not have been a net saving, but it would have permitted middle and upper bracket benefits to be granted more largely by way of reduction in bracket rates. In view of the emphasis placed on the incentive gains from lowering marginal rates, this might well have been the preferred approach.

*Bracket Rates.* Moving up the income scale, the weight of tax-free income declines and bracket rates become increasingly decisive in setting the effective rate of tax. Here the reform provides for two major changes. One is the replacement of the 14-bracket schedule which now applies with a three-bracket set. The other is a substantial reduction in the level of rates.

The reduction to a three-bracket schedule first appeared in *Blueprints* and is now offered by Treasury I and II (with rates of 15, 25, and 35 percent), as well as Bradley-Gephardt (with rates of 14, 26, and 30 percent). Only Kemp-Kasten (25 percent) and Hall-Rabushka (15 percent) offer a flat rate. As noted before, there is a sharp difference between a multiple-rate structure (even with three rates only) and a single rate. Under the latter, effective rate progression cannot be extended over the upper part of the income scale. A shift from 14 to three brackets is much less significant. While it is being pictured widely as a great simplification, this is incorrect. Even with a three (if not a single!) rate schedule, the bulk of taxpayers must use tax tables, in which case the number of brackets becomes irrelevant. Assuming the same result in terms of effective rate, the three-bracket schedule involves fewer points in the income scale at which a step-up in rates occurs, and this may be considered an incentive advantage. But it also involves sharper step-ups where they do occur, and this is a disadvantage. Depending on taxpayer behavior, there may or may not be an incentive gain.

Shift to the three-bracket approach is significant, however, in that it tends to limit the degree of freedom in setting the pattern of effective rates. The top rate under a three-bracket system cannot be too high, as this would have to extend down too far towards the middle income range. What appears as a technical change thus has substantive (and political) importance for policy design in limiting the top rate.

As noted before, one rationale for lowering the top rate from 50 percent to 35 percent is that it "merely conforms" to the pattern of effective rates which already exists. But this is not a convincing rationale, as existing rates reflect the deficient income base. The decline in top bracket rate from 92 percent in the early 1950s (which do not seem so long past to this observer) to 70 percent in the mid-1960s and 50 percent in 1982 is shown in table 3, as is the pattern of changing bracket rates through the

Table 3
Development of Upper Bracket Rates*
(Income levels for 1971–1986 reflect 1952 real term equivalents)

| | 1952 | 1971 | 1982 | Proposed for 1986 |
|---|---|---|---|---|
| 1a. Taxable Income ($) | 20,000 | 31,000 | 74,000 | 90,000 |
| b. Marginal Bracket Rate (%) | 42 | 39 | 42 | 25 |
| 2a. Taxable Income ($) | 50,000 | 78,000 | 185,000 | 224,000 |
| b. Marginal Bracket Rate (%) | 66 | 58 | 50 | 35 |
| 3a. Taxable Income ($) | 110,000 | 125,000 | 370,000 | 449,000 |
| b. Marginal Bracket Rate (%) | 77 | 64 | 50 | 35 |
| 4. Top Rate (%) | 92 | 70 | 50 | 35 |

*For the underlying historical data, see J. Pechman, *Federal Tax Policy*, 4th ed., p. 304.

upper part of the income scale. The general downward trend is interrupted only by a 1971–82 increase in the bracket rate for the middle-upper income group (pictured in lines 1a and 1b), indicative of the impact of non-indexing over that range. Otherwise, the general downward trend persists. Whether this should be viewed as reflecting increased realism regarding the feasibility of enforcing higher rates, as attribution of increasing weight to incentive considerations or as a cultural revolution (retreat from a more egalitarian view of distributive justice) remains an intriguing question for social historians. But the development that has taken place over the last three decades is indeed striking.

My own response, which I should state, is as follows: given that benefits from tax preferences have been especially marked at the upper end of the scale, I question the wisdom of providing this particular group with an especially sharp reduction in effective rates, not to be shared over the broad middle range. As I see it, the proposed cut in the top bracket rate to 35 percent is not imperative on supply-side grounds (more about this below) and I do not find it justified in equity terms as I see them. In my view, a fourth bracket should thus be added. I feel this to be the case especially if a substantial capital gains preference is to be

retained (as proposed in Treasury II) and if allowance is made for the revenue shortfall which sooner or later will have to be met.

## *Simplification*

There are many other aspects of the income tax reform that should be considered, including the treatment of the family unit, the use of floors and ceilings on deductions, including the interesting suggestion by Bradley-Gephardt to permit deduction against the first bracket rate only, as well as the still rather important problem of minimum tax. However, this paper should not be permitted to grow into a book, and I therefore proceed directly to the one remaining issue which must not be overlooked, simplification.

Simplification is featured as a prime target in all the reform proposals, and this is not surprising. Taxpayer compliance costs have been estimated at over $20 billion (1982) and with the costs of the Bureau of Internal Revenue included, the combined cost of income tax administration may exceed $30 billion, or 10 percent of the revenue gained.[16] As Treasury I notes, the proposed reform would simplify matters by reducing the number of taxpayers (due to the increase in tax-free amounts), by eliminating or simplifying 65 provisions of the tax code, and by eliminating 16 forms and 10 lines from the 1040 Return. Also, the number of itemizers would be reduced from 31 to 25 percent, by eliminating various floors and deductions. All this would be of substantial help, but it will hardly provide massive simplification. The 40 percent of all returns now prepared with professional help (60 percent for itemizers and 30 percent for non-itemizers) are still likely to be thus prepared.[17] As Treasury I itself prudently assesses the scope of simplification: "Movement towards a broad-based tax requires that a better measure of income be obtained—in some cases additional calculations would be needed, but on balance a broad-based income tax would reduce the complexity caused by current law."[18] In short, some progress can be made but the scope is limited. This is the case especially with regard to capital income. Here, Treasury I's proposal for full taxation of capital gains would be a (if not *the*) major step towards simplification, as it would curtail tax shelters, but this provision is not followed in Treasury II. Many other measures taken in the reform proposals, such as introducing floors to deductions, should be helpful to broaden the base and to improve the equity of the system, but they will not drastically reduce the task of filing returns. Indeed, some of the proposals in Treasury I (such as indexation

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[16]See J. Slemrod and N. Sorum, "The Compliance Cost of the U.S. Individual Income Tax System," *National Tax Journal*, December 1984.

[17]See Treasury I, p. 16.

[18]See Treasury I, p. 86.

of interest) would add thereto.

A vision of more drastic simplification is offered by the Treasury's plan for a return-free system.[19] Tax liabilities would be withheld as determined on the basis of withholding returns and third-party information. The taxpayer would be shown the calculation and could question it, but no return would have to be filed. Such a system is to be tried first for single taxpayers with wage income only, but a hope is expressed that two-thirds of all returns could be handled in this fashion by 1990. This is indeed an exciting proposal, but it remains to be seen whether such a service could be rendered wage earners without also depriving them of tax options still available at higher levels and to recipients of capital income.

A concluding remark on simplification and the cost of running an income tax might be added. Simplification and cost-saving are obviously desirable where they can be accomplished without interfering with the basic design of an equitable tax. Income tax implementation is a product whose cost should be minimized, just as that of cars. But there are trade-offs. A better income tax costs more, just as does a better car. The finding that the income tax costs $30 billion in itself is not a very meaningful piece of information. There is no obvious reason why a good income tax might not be worth $30 billion, just as there is no obvious reason why automobile purchases should not account for $75 billion. Both, I like to think, are part of the good life. The question, rather, should be how much could be saved without concession to the quality of the income tax or even with gains therein, or what equity losses would have to be accepted for what cost savings.

## *Capital Income*

A major part of the reform effort is directed at the taxation of capital income, the most complex and imperfect part of the system. This includes both revision of the corporation income tax and a tightening of various individual income tax provisions which have permitted the spread of tax shelters.

### *Corporation Tax*

The corporation tax reform proposed in Treasury I includes (1) reduction in the now maximum rate of 46 percent to a flat 33 percent, (2) repeal of the investment credit, (3) replacement of the current system of accelerated depreciation (ACRS) by economic depreciation, and (4) a 50 percent dividend paid credit. Treasury II incorporates (1) and (2), adapts

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[19]See Treasury I, p. 111.

(3) so as to maintain overall acceleration, and reduces (4) to 10 percent. As the result of these and other measures, Treasury I raises corporation tax revenue by $30 billion (1987 level) or 23 percent.

The revenue gain under Treasury II is but slightly less, with the cost of retaining acceleration offset by greatly reduced dividend exclusion and, in the short run, introduction of a recapture provision. A summary of the major reform items and their revenue costs are shown in table 4.

Table 4
Major Changes in Corporation Tax*
(billions of dollars, 1988)

| | Treasury I | Treasury II |
|---|---|---|
| Flat rate of 33% | −38.5 | −35.9 |
| Repeal of Investment Credit | +26.6 | +29.4 |
| Depreciation Reform | +35.6 | +0.2 |
| Recapture Provision | — | +20.4 |
| Indexed FIFO | −6.0 | −4.5 |
| Dividend Relief | −20.7 | −6.2 |
| Multiperiod Construction | +8.8 | +3.6 |
| Energy Subsidies | +6.7 | +0.2 |
| Other | +16.8 | +17.3 |
| Total | +29.3 | +24.3 |

*Source: *Treasury I*, vol. 1, p. 245, and *Treasury II*, p. 453.

*Depreciation Reform.* As Treasury I notes, the combination of ITC and ACRS, operating under moderate rates of inflation, permits investment in depreciable assets to be recovered far more rapidly than under a neutral system. Moreover, the tax rate depends greatly on the length of asset life. With an inflation rate of 5 percent, the effective rate on equity financed equipment under five years is negative, while for structures in the eighteen year class it becomes 40 percent, still below the statutory rate of 46 percent.[20] As a result, the system imposes widely differing effective rates of tax on equity investment in different assets, ranging from 8 percent in the case of motor vehicles to 31 percent in industry and trade. Also, the location of benefits up front discriminates against new enterprise with as yet insufficient income. Repeal of the investment credit and substitution of real economic depreciation—referred to as Real Cost Recovery System (RCRS)—would eliminate these differentials and their distorting effects on resource allocation. These changes, taken by themselves, increase the effective rate of tax, but Treasury I offsets this increase by rate reduction and dividend relief.

[20]See Treasury I, p. 107.

Treasury II follows suit with regard to rate reduction and repeal of the investment credit, but differs in its depreciation reform. Following Treasury I, it proposes to remove the unneutrality of ACRS and accepts the principle of inflation adjusted economic depreciation, but unlike Treasury I, it maintains the general level of investment incentive now provided by ACRS. The proposed Capital Cost Recovery System (CCRS) "would prescribe depreciation schedules and recovery periods which produce systematic investment incentives that are neutral across recovery classes."[21] The proposed close-out periods are thus lower and depreciation rates faster than proposed in Treasury I. While Treasury I shows its proposed effective rates to be uniform across industries, Treasury II does not provide such a table, but its proposed pattern appears to follow that of economic depreciation. Thus similar cross-industry efficiency gains as in Treasury I should be obtained.

Granting the investment incentive via accelerated depreciation (if based on an economic depreciation pattern) is clearly preferable, on neutrality grounds, to a flat investment credit. But Treasury II might have done better to retain the investment credit, adjusted so as to avoid discrimination against long investment, while adopting the Treasury I depreciation plan. This would have avoided granting the incentive to old capital where it is ineffective, would have rendered the incentive more visible, and would have recognized the principle of economic depreciation more clearly. Also, it may be questioned how the investment incentive compares with the dividend paid credit as proposed by Treasury I. Support for the latter, to be sure, does not rest primarily on incentive considerations, but on the normative concept of an integrated corporation. Indeed, it might be argued that the dividend exclusion, by inducing distribution, reduces cash flow available to management for investment. Investment effects thus depend on the level at which investment decisions are made. However, the dividend exclusion also reduces discrimination against equity investment, now resulting from the fact that interest payments can be deducted, whereas return on equity investment is taxed twice.

*Rate Reduction.* The proposed reduction in the top rate from 46 to 33 percent parallels that under the individual income tax. It is thus in line with the integration objective, as is Treasury I's dividend exclusion. For Treasury II, rate reduction provides the major offset to the revenue gain for repeal of the investment credit. In all, both plans provide for some relief in the taxation of old as against new capital, hardly in line with incentive goals.

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[21]See Treasury II, p. 138.

## Shelter Closing

Many of the proposed changes in the corporation and individual income tax law are designed to close or at least reduce the use of tax shelters. The slow-down of depreciation plays a major role in this, but so do other provisions including the full taxation of capital gains and the taxation of large partnerships as corporations, designed to prevent pass-through of losses to partners. To this may be added the tightened treatment of oil and gas, limitation of tax postponement in multi-period production, application of at-risk rules to real estate, and so forth. On the basis of this brave package, Treasury I hopes to secure a substantial cutback in tax shelters.

Unfortunately, the list offered by Treasury II is much less complete. Accelerated depreciation is retained, though modified to check its worst abuses, but preferential treatment of capital gains continues as does carry-through of partnership losses; also, a much milder approach is taken to oil and gas, and to multi-production rules. Treasury II, however, takes a more severe position in two respects. For one thing, it proposes a recapture of tax savings which would result as reduced tax rates are applied to earlier postponement of taxable income under accelerated depreciation. For another, a minimum tax (which Treasury I, rather optimistically, holds no longer necessary) is to be retained and tightened at both the individual and the corporate level. But this is only a second best solution, and one is left with the question of how much shelter closing would in fact be accomplished under Treasury II, and whether an adequate offset to the proposed reduction in the top bracket rate would be provided.

## "Supply-Side" Effects

How much may we expect the reform to contribute to the performance of the U.S. economy? Such contribution may come about through a more efficient use of resources, more rapid technological progress, or through an increase in labor supply, saving, investment and technological advance. As I am approaching the limits of my pages, a brief summary of what was said on this in the earlier papers will have to suffice.

Of the various paths, gains from more productive use of resources, brought about by depreciation reform and reduced distortions through shelter seeking should be the most important. Joel Slemrod reports that the efficiency cost for the tax system as a whole has been estimated at, say, 5 percent of GNP, which burden could be avoided by transition to a lump-sum tax.[22] However, we are not about to undertake such a move.

[22] See Joel Slemrod's paper prepared for this conference.

The gain from complete elimination of differentials in the treatment of capital income has been estimated at 1 percent of GNP, a level which is much above what the proposed reform would accomplish. While the reform does not face up to the larger problem of mortgage interest deduction, elimination of property tax deductibility is estimated to yield an efficiency gain of 0.9 percent of GNP. Potential efficiency gains from the treatment of capital income may thus add to, say, 2 percent of GNP.

Turning to effects on labor supply, Slemrod reports that moving to a completely flat-rate income tax has been estimated to increase labor supply by over 10 percent.[23] Using a compensated labor supply elasticity of 0.2 percent for males and 1.2 percent for females, and an average decrease in marginal rates of 19 percent, an estimated increase in labor supply of 3 percent is obtained.

Using a controversial interest elasticity of 0.4 and holding the level of interest rates constant, the effect of rate reduction on household savings is estimated at less than 2 percent. Little additional gain is expected from liberalized IRA provisions.[24] Effects on corporate savings may be expected to be negative under Treasury I, at least in the short run, given the reduced rate of depreciation and the proposed exclusion of dividend payments. While rate reduction will provide an offset, this will hardly suffice to leave a net gain. With household saving only a small part of the total, the savings rate for the two sectors combined is not likely to show a significant change, in any case not a change anywhere near what might be accomplished by deficit reduction.

This leaves effects on corporate investment demand. While Treasury II claims that the effective tax rate on equity-financed corporate investment would fall from 35 to 26 percent, Slemrod notes that this is not readily reconciled with the projection of a 20 percent revenue gain. He concludes that tax incentives to corporate investment will not be raised substantially.[25] Hendershott estimates interest rates to decline but slightly, except for a more substantial fall under Treasury I due to its interest indexing provision.[26] Kopcke, in his cash-flow model, estimates that there will be little effect on cash flow in the short run, but that the reforms may secure a 9 percent gain by the end of the decade.[27] Under the neoclassical model, the effects on the growth rate in the stock of durable equipment in manufacturing are estimated to be slight or even negative in the short run. By the end of the decade, Treasury I may induce an increase from 3.0 to 3.4 percent, with little change under

[23]Slemrod, p. 23.
[24]Slemrod, p. 21.
[25]Slemrod, p. 22.
[26]See Patric M. Hendershott's paper prepared for this conference, p. 33.
[27]See Richard Kopcke's paper prepared for this conference.

Treasury II. Both the models reflect the state of the art, but leave me somewhat troubled.[28]

Reviewing these results, it appears that "supply side" effects will be modest and that there will be no major impact on the growth rate of the U.S. economy, not only in the proverbial steady-state setting but also over the more relevant period of a decade or so. These estimates, however, may be too pessimistic as they do not account for behavioral shifts which may result in the wake of a truly successful reform. But this is a hope only, a special dividend if it should come about. In the meantime, the major reward should be expected to be in low-income relief and efficiency gains, together with an improvement in horizontal equity and a more favorable image of the income tax. This, to be sure, would be a gain but it leaves unanswered the overriding deficit problem and the needed tax increase without which that issue cannot be resolved. It is unfortunate indeed that reform has come to be viewed in a climate which rules out such an increase and even looks towards future reduction, rather than integrate reform with the more pressing task of providing for increased revenue.

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[28]The cash-flow model, with cash flow as determinant of investment behavior, throws a most uncomplimentary light on the efficiency of the investment process, while the "neoclassical" model bypasses that old friend the impact of loss offset by risk taking. This not only bears on taxation effects on portfolio mix but eventually also on the level of investment. For a recent review of this problem, see Agnar Sandmo, "The Effects of Taxation on Saving and Risk Taking," in A. Auerbach and M. Feldstein, eds., 1985, *Handbook of Public Economics*, Vol. 1, North Holland.

# *Discussion*

*Joseph A. Pechman**

It will come as no surprise to this audience that I agree with practically everything that Richard Musgrave said, and so what I shall have to say is really in the nature of an addendum to his excellent article rather than a criticism. Musgrave concludes that there are some very good things in the original Treasury proposal (Treasury I) and fewer good things in the President's proposals (Treasury II), but he's not so sure about what will emerge after Congress gets through compromising the major issues. However, he doesn't tell us whether it all will be worth it in the end.

Let me try to strike a balance sheet of pluses and minuses to help answer the question. I have the advantage of knowing the options presented by Chairman Rostenkowski to the Ways and Means Committee, so the outlines of what is likely to come out are clearer now than when Musgrave prepared his paper. My conclusion is that the principles of tax reform have already been compromised to a considerable degree and it is hard to see how the final bill, if Congress passes one, will be anything more than a mishmash. But I think that the public discussion of tax reform has been all to the good, and I hope that it will ultimately produce results.

One set of improvements that the bill now being considered is likely to make are the increases in personal exemptions and the standard deduction, and the reduction in the tax rates of individuals and corporations. It is fairly clear that Congress will restore the principle that individuals and families with incomes below the official poverty line should not be subject to income tax. This principle, which was adhered

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to throughout the 1960s and most of the 1970s, was abandoned in 1978 and as a result the burden of income taxation on the poor has been increasing. It is time to rectify this inequity.

The reduction of the top marginal rate from 50 percent to 35 percent would be all to the good, if as now planned the revenue would be recovered by closing major loopholes. However, like Musgrave, I don't think there is much virtue in reducing the number of tax brackets to three. In fact, I think it is worth asking whether it is appropriate in a graduated income tax to tax incomes over the wide ranges now being considered at the same marginal rate. For example, Treasury II would apply the 25-percent individual income tax rate to incomes between $29,000 and $70,000 for joint returns and $18,000 and $42,000 for single persons. I doubt that most people would agree that ability to pay tax on the marginal dollar is the same for joint returns with incomes of $29,000 and $69,999. Why tax simplification was ever associated with reduction in the number of tax brackets is a mystery to me, but I'm prepared to accept three if we get real tax reform and tax simplification in return.

Regrettably, neither the Treasury nor the Congress has taken the opportunity to really simplify the rate structure by replacing the four rate schedules we now have with one. This would rationalize the tax treatment of the family and produce real simplification. All that would be needed would be to retain the deduction for two-earner couples to eliminate the marital penalty and to differentiate the taxpaying ability of one- versus two-earner couples. Unfortunately, given the requirement of revenue neutrality, there is no way to do this without raising the tax burdens of one-earner couples, so we will have to continue to live with four rate schedules even though they make no sense.

Another real gain is that the tax base will be broadened in major respects under every one of the tax reform alternatives now being considered. It is about time that the privilege of issuing tax-exempt securities should be restricted to governmental purposes, that financial institutions should be relieved of their generous loss reserves, that defense contractors should properly account for their income and expenses, that the energy tax credits should be repealed, and that the personal deductions should be pruned. These and other base-broadening reforms would help to improve the image of the income tax, which is not well regarded because the public knows that too many businesses and individuals don't pay their fair share.

I also endorse the redistribution of approximately $25 billion of taxes from individuals to corporations. Those who believe that capital should not be taxed at all will oppose such a move. However, given that we are still taxing income rather than consumption, it seems to me that the yield of the corporate tax has been excessively eroded in the last couple of decades. The corporation tax will account for only about 9

percent of total federal receipts in fiscal year 1986, down from 28 percent 30 years earlier. Treasury I and II and the Rostenkowski option would raise this percentage to about 12½ percent in fiscal 1990. Such a redistribution of tax burdens can hardly be regarded as onerous for owners of capital, particularly since most of the revenue will be coming from corporations that do not pay tax under current law (e.g., financial institutions, real estate, and defense contractors), rather than from the industrial sector, which accounts for a major portion of the nation's productive capital.

Having said all this, it is only fair to point out that political considerations have already diluted some of the major improvements originally proposed by the Treasury, and even Treasury I strayed in some key respects. The most important departures from comprehensive income taxation that will probably endure are the following:

1. Treasury I would have at last taxed real capital gains at ordinary income tax rates, but the financial community saw to it that this vital element of comprehensive income taxation would not be preserved. Treasury II would tax capital gains at half the ordinary rates, thus reducing the maximum rate on long-term gains from 20 percent to 17.5 percent. And, for those who would find that too onerous, Treasury II provided taxation of real capital gains as an option beginning in 1990. Chairman Rostenkowski's alternative would maintain a 42 percent differential between the rates of tax on ordinary income and capital gains. The advantages of eliminating the distinction between capital gains and ordinary income on equity and simplification grounds have been fully documented in the literature. It appears, however, that this step will be postponed once again even if a bill is passed by the 99th Congress.

2. The far-reaching reform of the tax treatment of depreciable assets proposed in Treasury I was watered down by the President and to a greater degree by the Ways and Means Committee. Apparently, the idea of a level playing field for investors in different types of assets and industries is an objective devoutly desired by economists, but not by the business community. The Thatcher government recently adopted this principle and used the revenues to reduce the corporate tax rate from 52 percent to 35 percent. Perhaps the experience in that country will help persuade our Congress that neutrality in taxation *is* worth something.

3. I have always believed that we have overdone the personal deductions in our income tax, and welcomed the initiative in Treasury I to prune them. I suppose it is too much to ask that the deduction for mortgage interest should be included in any limitation of the interest deduction, but the President backtracked on the proposal to put a floor on charitable contributions and it is clear that Congress will not accept elimination of the deduction for state and local taxes. Some restriction of personal deductions is likely to survive, but judging from the compro-

mises now being considered, the result will hardly be a contribution to tax equity or simplification.

4. Treasury I retained deductions for individual retirement accounts even for taxpayers who already receive generous exclusions for contributions to private pension plans; it would also have raised the allowable deductions and increased the spousal IRAs. I see no reason why such deductions should be allowed, let alone be made more generous. If anything has been established pretty conclusively since 1981, it is that people with assets will switch from taxable to nontaxable accounts to take advantage of the offer of a tax cut. Personal saving has not increased since the more generous IRAs were enacted in 1981, while national saving has declined by the increased deficit they have generated (amounting to over $13 billion in fiscal 1986). Instead of increasing the IRAs as Treasury I proposed or retaining present law, which is what the President and Chairman Rostenkowski propose, the deductions should be restricted to those who are not already covered by private pension plans.

5. Treasury I and II would have raised the income tax threshold by almost doubling the personal exemption and increasing the standard deduction somewhat. It's clear that much more revenue will be needed to pay for a significant cut in the marginal rates, so Congress is considering cutting the personal exemption and raising the standard deduction. I believe that some modest differential in the tax burdens of families of different size is warranted, even in the top brackets. The switch in emphasis between a higher personal exemption and a higher standard deduction smacks of a "soak the rich" policy. I believe that distributional issues of this sort should be handled through the rate structure and not by sleight-of-hand. Furthermore, the conversion of the standard deduction from a flat to a per-capita amount would complicate rather than simplify the tax return.

I think I have said enough to demonstrate that the tax reform plans now being seriously considered—i.e., Treasury II or the Rostenkowski option—leave much to be desired. If asked to vote "yea" or "nay," I suppose I would vote yes for either of them. But it is already clear that the compromising has only just begun. Each additional compromise weakens the reform potential of the bill and also makes the law more rather than less complicated. I am, therefore, not optimistic that what will remain in the end will be worth the candle.

I want to make it clear, however, that all has not been for naught. It is amazing that tax reform has reached center stage, after so many years of effort on the part of a relatively few academic lawyers and economists. The proponents of tax reform now include influential congressmen and senators, as well as the President of the United States and the Secretary of the Treasury. Some of the issues have been clarified and major difficulties, both theoretical and practical, have been identified. Even if a tax

reform bill does not see the light of day in 1986, some progress will have been made in enlightening the public and the Congress about the issues. Some future President and Congress will thus be better prepared to fight the good fight if they happen to get religion.

# *Discussion*

*Lawrence H. Summers**

Richard Musgrave's paper provides an excellent summary of the issues at stake in the current tax reform debate without ever providing a definite answer to what is unfortunately a zero dollar question—Is it worth it? I sense Musgrave's ambivalence. He is attracted by the "broader taxes are better taxes" philosophy that he and other academic tax experts have advocated for so very many years. I confess that I cannot agree with Musgrave's conclusion that "the early 1950s do not seem so long past." And he is enthusiastic about the reforms directed at attacking tax shelters. On the other hand, he is not very enthusiastic about the elimination of state and local tax deductibility, which is a linchpin of the Treasury proposals; he recognizes that the proposals attack only a small part of the tax expenditure budget; and he sees the opportunity costs of a major reform effort at this time. This last issue is a tricky one. If the tax reform debate diverts Congress from raising taxes to reduce budget deficits, it will be very harmful. If it distracts Congress and prevents it from starting a trade war, it will have yielded an unexpected dividend.

My assessment is that tax reform along the lines of Treasury I or II is not worth it at present. This is not to deny that these proposals contain many desirable elements, but to suggest that now is not the right time for comprehensive tax reform. To steal a phrase, it may now be time for a period of benign neglect of our tax system following a surfeit of malign attention. We have had three major tax reform bills legislated within the past four years, and five major bills within the last eight years. Treasury I and Treasury II have been put forward, dozens of Congressional proposals have been introduced, and volumes of testimony have been taken

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regarding comprehensive reform, all before the technical corrections to the last tax bill have been adopted. And some of the provisions of the 1982 TEFRA legislation have yet to go into effect. Perhaps it is time to try an experiment in tax policy that we have not tried in many years—living under one tax code for 36 months.

Given this history, the looming budget deficit, and the fact that tax reforms now may preclude other, perhaps better, tax reforms in the future, there would have to be major advantages before comprehensive tax reform would be a good idea. And yet, reading Musgrave's paper, I find it hard to see the compelling benefits of the major aspects of the Treasury's proposals. For example, I share his sense that assistance to the states through tax deductibility is warranted, at least when federal spending aid is being slashed. At a time when the infrastructure is decaying or decayed, when there is a widely acknowledged need to increase spending on education, and when real AFDC benefits have been allowed to decline by a third over the last decade, I find it hard to believe that excessive spending by state and local governments is a major national problem. I agree that bringing the top rate on individuals still further down is not a compelling priority, and I cannot get very worked up about a reduction in the number of tax brackets. Musgrave and I both support efforts to attack tax shelters and to curb abuses involving business entertainment and so forth, but we recognize that these issues do not involve large amounts of revenue.

My major disagreement with Musgrave and the tenor of much of the discussion comes where he writes "Depreciation reform . . . may well emerge as the most important gain in the current reform effort." My view is that proposed reforms in this area represent major errors. In search of some economist's holy grail of neutrality, Treasury's proposals would compromise both economic growth and equity. They are at their root ill-conceived.

Even the most ardent of supply-siders recognizes that tax policies cannot affect the amount of capital already in place. They can, however, have a potent effect on the rate of new investment. It was this recognition that, I think, led a number of those in this room to advocate the investment tax credit in 1962 as an alternative to corporate rate reductions. The investment tax credit and accelerated depreciation are devices for reducing the tax burden on new capital without conferring a windfall gain on old capital. The Treasury proposal goes in exactly the wrong direction. It reduces the tax burden on old capital by lowering the corporate rate and offering dividend relief, while at the same time raising the tax burden on new capital by abolishing the investment tax credit and stretching out depreciation schedules.

Much discussion has focused on the alleged nonneutralities created by ACRS and the ITC, which Treasury argues that the President's pro-

posal will eliminate. In fact current reform proposals are likely to create as many distortions as they eliminate. The concept of economic depreciation on which the Treasury proposal is based is extremely slippery. For example, the major nonneutrality alleged by Treasury, in its discussion of investment incentives, is that between equipment and structures. Treasury claims that the effective tax rate on structures is currently substantially greater than that on equipment. Yet much of the tax-shelter industry relies on structures rather than equipment, making this claim unlikely.

Neutrality calculations on which the Treasury plan is based involve actual data on only five or six types of assets. The assumed depreciation rates for other assets are based on speculative extrapolations. Assertions that the present system is highly nonneutral and the proposed system is neutral are premised on the assumptions that all investments are able to carry the same amount of debt, that properties are never resold and depreciated more than once, and that asset price changes are completely predictable. Without these (patently false) assumptions there is no basis for any claims that the Treasury proposal is somehow neutral. The bankruptcy of the calculations on which the Treasury proposal is based is evidenced by Barry Bosworth's recent finding that changes in the composition of investment have recently had no correlation with measured effective tax rates.

It is commonly suggested that current law somehow favors capital-intensive industries. This is a fundamental misconception. Investments in intangibles—research and development, advertising, or goodwill—all receive the ultimate in accelerated depreciation, first-year write-offs. For example, the large expenditure incurred by Coca-Cola in developing and marketing new Coke can all be expensed. In contrast, outlays on physical capital are necessarily amortized over time. If anything they are penalized, not helped, under ACRS. The nonneutrality between tangible and intangible investment would be greatly exacerbated by current proposals which do not address intangible capital at all but do substantially increase the effective taxation of physical capital.

Finally, the President's proposal does little to address the nontaxation of owner-occupied housing, which represents close to half of physical capital in the United States. By increasing the effective taxation of business investment, the Treasury exacerbates the nonneutrality already present between business and housing investment. On balance, the Treasury's proposed depreciation reforms are not likely to increase the neutrality of our tax system.

Reforms in the name of neutrality are advocated despite the fact that ACRS was put into place less than four years ago, with the stated objective of increasing capital formation, and has been extremely successful in achieving this goal. We are now living through a period of record high

real interest rates, large federal budget deficits, and increasing foreign competition. Despite this adverse environment, the share of gross business fixed investment in GNP actually reached a postwar high within the last year. Investment in producers' durable equipment increased by 42 percent during the first two years of the current recovery compared with an average of 20 percent during the first two years of previous recoveries. While it is impossible to conclusively identify the reasons for the substantial strength of investment, many experts concur with the econometric evaluation of DRI some months ago that "business and fixed investment would now be dismal were it not for the 1981 ERTA legislation."

Perhaps the clearest way to demonstrate the importance of increased investment to productivity growth is through international comparisons. Between 1970 and 1980 the rate of net investment in the United States averaged only 6.6 percent of GNP, while productivity rose at a rate of 2.5 percent. France invested 12.2 percent of GNP and Germany invested 11.8 percent, about twice as much as the United States. Correspondingly, productivity grew about twice as rapidly—at a rate of 4.8 percent in France and 4.9 percent in Germany. Japan invested almost three times as much as we did—19.5 percent of GNP. It enjoyed productivity growth at a 7.4 percent rate, almost three times as great as ours.

Many factors determine the overall level of capital investment. No matter what tax incentives are in place, investments will fall dramatically in recessions when there is excess capacity and will rise sharply in periods of economic expansion. The prescription that we eliminate recessions to stimulate investment is not one we know how to carry out. We must therefore rely on other means. The weight of the evidence suggests strongly that increases in tax burdens along the lines proposed by the President will substantially increase the cost of capital and therefore will reduce investment.

Treasury's own calculations demonstrate that the President's plan would increase the effective tax rate on equipment, which accounts for a lion's share of business investment, by more than 20 percentage points. Alternative calculations using realistic discount rates for depreciation allowances suggest a much greater increase. The abolition of the investment tax credit alone would increase the effective purchase price of new equipment by more than 15 percent. These reforms would more than undo the substantial contribution the 1981 reforms made to the current strength of business investment. Economic science has not progressed to the point where precise estimates are possible, but it is clear that enactment of major reforms like those called for in the Treasury proposal would significantly retard capital formation. Estimates prepared by leading econometric forecasters suggest that net business investment might fall by as much as 15 percent, if the President's plan were enacted. These

reductions in investment will reduce our productivity growth in the years to come. It seems inconceivable that the questionable gains in neutrality that the Treasury proposal might achieve could begin to have as large an effect.

A final distressing element in the Treasury's corporate tax reform proposal is indexation of the basis in capital assets for the purpose of determining depreciation allowances. Inevitably the task of finding the replacement cost of each asset in each year will complicate the tax system. But there is a more important objection to indexation. After the tremendous sacrifice of the last recession, inflation is now running at very low levels. The President and the Federal Reserve appear committed to keeping it at very low levels. If we expect this commitment to be honored, there is little reason to favor indexation of the tax system. Indexation is a clear sign of a lack of confidence in our ability to prevent inflationary fires from re-igniting. Such evidence that we lack confidence in our ability to fight inflation must inevitably affect inflationary expectations, and ultimately the inflation process itself.

Where should we go from here? The two major base broadeners in the current proposal—eliminating state and local deductibility and abolition of the investment tax credit—both seem like mistakes. With huge deficits the case for reductions is weak. Yet the sense that the tax system is a disgrace remains strong. I would propose that consideration be given to a TEFRA-style bill that attacks "loopholes," defined as all the minor items in the current Treasury proposal, and at the same time keeps rates constant. Such a bill would improve equity in the tax system, raise revenue and reduce the deficit. It would encounter less opposition than comprehensive reform, and unlike comprehensive reform, it would leave scope for future changes.