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The Economics of Tax Reform  
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Each year, as April 15 approaches, we are forced to spend some moments thinking about our income tax system. There is, and has been, a great deal of dissatisfaction with our system. There is a general consensus that others are paying less than their fair share.

Popular concern has focused on the inequities and complexities of the system. Economists’ concerns have been centered not only on these matters, but also on the inefficiencies to which our tax system allegedly gives rise.

The dissatisfaction has been so great that President Reagan made tax reform one of the highest priority items in his agenda for his second term. In spite of the importance he attached to it, there has not yet been a tax reform bill as of this writing. But by now, the outlines of what is likely to pass—and there is a consensus that a bill will pass—has emerged. It is not the tax reform bill that President Reagan had hoped would lead to the Second American Revolution. It is certainly not the tax reform bill about which economists had dreamed.

Why and to what extent do I think the bill which is likely to emerge will represent a failure of the movement to reform our income tax system? What lessons can we learn from this seeming failure of reform? What implications does it have for how the government should raise the revenues required to finance its operations? These are the questions which I shall address this evening. First, however, I should like to review
some of the economists’ traditional principles concerning tax design and some facts concerning the consequence of a tax system.

Some Basic Propositions Concerning the Effects of Taxation

There are five basic facts concerning the consequences of a tax system I should like to mention.

First, the inefficiencies associated with a tax system—what economists call the dead weight loss of the tax system—are associated with the marginal tax rates, the extra tax an individual pays for the extra dollar of income. This determines the extent to which the tax system distorts the decision of whether to work more, to retire later, to stay in school longer, or to save more. Our tax system has been criticized for its high marginal tax rates, though the levels today are far lower than they were some years ago.

Second, any tax system that taxes different incomes—whether income to different individuals or income received in different forms—opens itself to the possibility of what we call tax arbitrage, the attempt to change the form in which transactions occur, or to engage in transactions the purpose of which is to reduce total tax liabilities. Let me illustrate.

Because capital gains are taxed at a lower rate than ordinary income, there is an incentive for individuals to attempt to reap their returns in the form of capital gains. In an inflationary period, real estate values are often much higher than the depreciated basis of an asset. If an individual who is at a low income tax bracket sells his real estate to a high bracket individual, the former will have to pay a tax on his capital gain; but this is more than offset by the advantages arising from the higher depreciation allowances accruing to
the high tax individual. In these circumstances, the tax system thus gives rise to an incentive to churn assets.

Perhaps the most notorious tax arbitrage activities growing out of the 1981 Tax Bill were those associated with Safe Harbor Leasing. Firms that did not have the income against which to offset their accelerated depreciation allowances and investment tax credits arranged for other firms with surplus income—in quite different lines of business—nominally to purchase machines for them; they would then lease the machines back. Thus Chrysler might arrange to have its machines purchased by, say, Exxon. But it was a pure paper charade. Chrysler would have purchased the machine by borrowing, say, 80 percent from a bank, and putting up 20 percent of its own capital. Chrysler might now pay Exxon 20 percent as the first lease payment, and Exxon would borrow the remaining 80 percent from the same bank. Exxon has done nothing but sign some papers. In fact, the tremendous tax advantages which would accrue to Exxon mean that it would be willing to pay a considerable amount, perhaps enough to relieve Chrysler of most of its earlier payments. Notice that it is the difference in tax bracket between Chrysler and Exxon which provides the motivation for these transactions.

These tax arbitrage activities have several consequences. First, they make it difficult to ascertain the true incidence of the tax structure—who really pays the taxes. Thus, there has been considerable publicity given to the failure of several of the major American corporations to pay any taxes in recent years, largely because of these leasing arrangements. But in most cases, the companies, like Exxon and GE, who “buy” the machine and lease it—nominally taking the tax advantages—are not the true beneficiaries: rather it is the companies in dire straits (Chrysler, for example) to whom more than 85 percent of the benefits accrue. The result is little different from
what it would be if the government made the investment tax credit cashable (that is, a company with zero income would receive a check from the government); or if the government allowed individuals to defer taking advantage of the tax credit until the firm had a positive income, but credited the firm with interest for the deferment (as most economists believe should be done).

(Similar issues arise in interpreting who gets the benefits from the provisions of tax exemption of interest on state and local bonds. A significant fraction of those benefits accrue to the municipalities, not to the individuals, who earn lower returns on those bonds than they would on taxable bonds.)

Furthermore, tax arbitrage activities *undo* some of the distortions which would otherwise be associated with the tax system. In the example given above, in the absence of leasing, the marginal cost of investment for a firm with no income against which to offset its investment tax credit and its accelerated depreciation allowances (Chrysler) is greater than for a company with a high income (Exxon). It is questionable whether, as a matter of national policy, we would wish to introduce discriminatory legislation of that form. Leasing undoes this distortion.

At the same time, tax arbitrage often does lead to distortions in economic activities. While *pure* tax arbitrage has no effect other than to induce certain paper transactions, that is, the only dead weight loss is the transaction costs, much of the activity which I loosely refer to as tax arbitrage is not *pure*. To take advantage of the special provisions for capital gains, individuals may be induced to purchase real estate (because it is easier to obtain loans against property, and thus take advantage of the differential treatment between the full deductibility of interest and the 40 percent taxation of long-term capital gains).\(^5\)
Finally, these tax arbitrage activities probably imply that the true degree of progressivity of the tax system is less than the nominal degree of progressivity. Wealthier individuals are in a position to take advantage of these tax avoidance activities (and have a greater motive to do so). This is, in fact, one of the reasons for the widespread dissatisfaction with our current tax system.

The third basic fact concerning the effects of taxation is a simple and seemingly obvious one, but one which has been obfuscated in the current debate: it is individuals who bear all taxes. Corporations may pay taxes, but ultimately, the burden of all taxation must rest upon individuals—the managers or workers of the corporation, the shareholders, or the customers.

The fourth basic fact concerning the assessment of the effects of taxation is that the effects of any tax cannot be assessed in isolation: it is the impact of the whole tax structure which is relevant. This is true with respect to an evaluation of both the efficiency and equity consequences. Thus, the marginal tax rate which is relevant for distorting individual behavior is not just the rate imposed by the federal income tax, but the total marginal rate, taking into account social security taxes (and benefits), state income taxes, and sales taxes.

The final basic fact that is particularly important in assessing the consequences of tax changes is that taxes on capital assets are capitalized; that is, the price of existing assets reflects future anticipated tax changes. Thus, if there are particular assets which are taxed at higher (or lower) rates than other assets, it is not the current owners who bear the burden of the tax (or receive the benefits), but the owners of the asset at the time the tax was imposed (or the favorable treatment granted). As a consequence, changes in the tax
treatment of particular capital assets may have enormous effects on current owners of assets. Moreover, removing the favorable treatment accorded some class of assets does not necessarily remove the inequity created when the favorable treatment was granted, but may compound the inequities: for the current owner, who is hurt by the removal of the favorable treatment, may well not be the same individual who owned it at the time the favorable treatment was granted. Conversely, removing the discriminatory treatment on some class of assets may not provide compensation for those who incurred losses at the time the discriminatory treatment was imposed. 7

**Principles of Taxation**

In evaluating the desirability of a tax system, economists have traditionally invoked five principles:

A good tax system should be equitable, first vis-a-vis its treatment of individuals in roughly similar economic straits (the *principle of horizontal equity*), and second, vis-a-vis its treatment of individuals in different economic circumstances (the *principle of vertical equity*). There is one aspect of these principles of fairness to which I would like to call attention: the difficulty of ascertaining what an individual's fair contribution is, and of devising ways of implementing whatever principle one adopts within a legal code. There is a widespread belief that income is the appropriate basis of taxation, a good surrogate for ability to pay. Yet virtually all economists—and most noneconomists—would agree that income should not be measured on a daily, or weekly basis. Most economists would argue that the appropriate time unit is the individual's lifetime income; that is, the government should not penalize those individuals whose incomes have fluctuated over their life time, as our progressive tax structure does. But a lifetime income tax is, in fact, equivalent to a consumption tax (with appro-
appropriate treatment of bequests and inheritances). Thus, if one believes in a lifetime income tax, one should exempt interest income, which can be viewed as a discriminatory tax on those who prefer to consume goods later on in their lives.

Third, a good tax system should "minimize" the distortions it introduces (the principle of efficiency).

A fourth principle is that a good tax system should not impose undue administrative costs, either directly, or indirectly, on the parties being taxed.

This leads me to the fifth principle of a good tax system, one about which there is not universal agreement: a good tax system is one in which individuals know what they are paying. I sometimes refer to this as the principle of political responsibility. Just as we believe it is only fair that lenders tell their potential borrowers what the interest rate they charge is, and that manufacturers of food tell their potential customers what ingredients are contained in the packages they sell, so too it is only right that the government should tell its citizens what each, individually, is contributing to the support of public services. The reason that I say there is not universal agreement on this principle is that just as lenders often argue that the truth-in-lending law just confuses potential borrowers, scaring them off from doing what they intuitively know is in their own best interests, so, too, some politicians are concerned that truth-in-government legislation would simply confuse tax payers and induce them to vote for smaller budgets than they otherwise would, leading to a cutback in important public services.

There are, of course, important trade-offs among these principles. A more progressive ("vertically equitable") tax system is likely to have a greater dead weight loss.

Some of the distinctions we introduce into our tax system, e.g., concerning the deductibility of medical expenses are there
because we believe that they increase the *equity* of the tax system; those who have had to pay large medical expenses have a lower ability to pay than those who have not. But at the same time, they introduce further inequities. There are two types of error in any tax system: some individuals (of a given income) who should have had their taxes reduced (because of their special circumstances) do not get a tax reduction; and some individuals who should not have had their taxes reduced do get a tax reduction. If we tighten rules for medical deductibility, more individuals who should get a tax reduction do not; but fewer individuals who should not have gotten a tax reduction do. There is a trade-off in the two types of error.

There is, moreover, a trade-off between simplicity and equity. To make fine distinctions (e.g., between those who do or do not get a medical deduction) requires a complex law; to simply disallow deductions is simple, but may be unfair.

**An Assessment of the Current Reforms**

With these principles and facts in mind, let us review the direction that tax reform appears to be taking in order to ascertain the extent to which it conforms with these basic principles.

The major hallmark of the tax reform is the reduction in the top tax brackets from 50 percent, to 33 percent. ¹⁸

The tax reform bill has not gone as far in base broadening as the advocates of reform would have liked. While only medical expenses in excess of 7.5 percent will be deductible, the far more important area of employer-provided health benefits has been left untouched. While state sales taxes will not be deductible, the more significant state income and local property taxes remain deductible.
In retaining the provisions for the deductibility of mortgage interest, the government probably has undone much of its effort to reduce the tax deductibility of interest; individuals will simply substitute home equity loans for car loans—as they were already doing before the new tax law. Again, the provision will have some impact, for example, on those individuals who itemize, but do not own a home; how significant a group this is, and whether this is a particular group which should be penalized, are questions we should ask ourselves.

Capital gains will be taxed at full rates. This has one distinct advantage; it eliminates one of the most important sources of tax arbitrage. But the raising of the tax rate on capital gains by more than half, from the current effective maximum rate of 20 percent to 33 percent, may have serious consequences for economic efficiency. Moreover, most economists would argue that it is real capital gains, not nominal capital gains, which should be taxed.

The major effort of the government in simplifying the tax system has been to replace the system of many tax brackets with three tax brackets. This, I think, is an inconsequential simplification. There is little work associated with looking up one’s tax in the tax tables. In other respects, the new tax law may actually make life more complicated.

One of the more popular proposals for dealing with the inequities which will remain within our tax system, given the seeming inability to redesign the tax structure to eliminate the major “loopholes,” is to impose a minimum tax. There is, again, less to this than meets the eye. As we have noted, many of the prosperous firms who pay little tax do so because of leasing provisions. Forcing these firms to pay a minimum tax will not seriously disadvantage them because most of the benefits of the leasing provisions accrue to the less well-off
firms. Thus, the minimum tax may actually work more to the disadvantage of the less well off, and will increase the distortions associated with our tax system.

Most of the currently discussed tax reform proposals entail shifting the burden of taxation from the individual to the corporation; this violates the principle of political responsibility. The proponents of this either simply ignore the fact that it is individuals who must bear the burden of taxation, or are engaged in a political swindle: precisely because it is not easy to recognize who bears the burden makes such taxes politically desirable. (There is a third reason for the corporation tax, to which I shall return later: the belief that it is shareholders and managers who bear the burden, but direct income taxation is an ineffective way of getting revenue from these individuals.)

This list of criticisms is not meant to be exhaustive, but merely to be indicative of the extent to which current proposals ignore some of the basic principles of taxation.

**The Reasons for the Failure of Tax Reform**

Indeed, though it may be too soon to make a final pronouncement, I am willing to venture that—at least from the perspective of most economists—the tax bill which finally emerges from Congress will be a failure; it will fall short of a major reform dreamed of a little more than two years ago. What are the reasons for this failure? I want to suggest three contributing factors.

First, economists have failed to convince the public and those involved in political decision making of the appropriateness of their models. This is partly because some of the models are, in fact, inappropriate, and it is hard for the nonspecialist to distinguish among those which are and those
which are not. This has left the politician in the position of selectively using economists' arguments: when they wish to reduce tax rates (to reduce the degree of progressivity), they refer to supply-side effects and economic efficiency; when they wish to subsidize smokestack America, they ignore the economists' advice concerning the desirability of investment neutrality.

Let me give some examples of where the models that are predominately in use among economists seem, at best, questionable. Perhaps nowhere is there more evidence than in their analysis of the capital market and corporation taxation. Most economists' models assume that firms can borrow freely at the market rate of interest, and this assumption has lead economists to focus on the effect of taxation on the marginal cost of capital. This effect is undoubtedly important. But many firms face credit rationing and are unable to raise funds on equity markets (or it is prohibitively expensive for them to do so). They are thus concerned with their after-tax resources, i.e., their average rate of taxation.

Equalizing marginal tax rates and equalizing average tax rates are two quite different matters, when investment patterns differ. One kind of neutrality does not imply the other kind of neutrality.

The economists' traditional tirade against IRAs misses the point that most individuals do not have easy access to borrowing, and may be induced to increase their savings by this kind of "gimmick." The evidence to date is mixed: wealthier individuals are more likely to take advantage of IRAs, but there is little evidence of the widespread tax arbitrage that economic theory would predict.

Indeed, even economists have been somewhat schizophrenic in their analyses of the effects of taxation within their tradi-
tional neoclassical models. Their models, when strictly applied, simply fail to explain important aspects of individual and firm behavior. At crucial junctures, they have resorted to ad hoc assumptions in order to "resolve" what would appear to be, within the confines of their model, inexplicable paradoxes. Let me mention a few instances. In some earlier work (Stiglitz 1983, 1985), I took the economists' standard models of the tax system and of the capital market (perfect capital markets) and showed that there were tax arbitrage activities which could completely eliminate all taxes on capital, and indeed, if carried far enough, all taxes on earned income as well. I also showed that the optimal behavior of the corporation entailed it never paying dividends (this has come to be called the dividend paradox); there are tax preferred ways of distributing funds from the corporate to the unincorporated sector (Stiglitz 1973). (I also showed that there were no efficiency losses from the corporation income tax for a firm, facing no uncertainty provided the firm pursues an optimal financial policy.) (Stiglitz 1973, 1976.) I do not necessarily believe the conclusions of these studies; I do not believe that the corporation tax is nondistortionary. I certainly do not believe that individuals have eliminated all taxes through tax arbitrage. But what these models show is how woefully inadequate the traditional economists' models are for analyzing the consequences of taxes. This is not to say that some of the effects, which they have emphasized are not important. But I suspect that many politicians, not thoroughly indoctrinated into the economists' way of thinking, smell, if not a rat, at least a little mouse; they suspect something is wrong with the model, but are obviously not in a position to determine what it is.

Political decision makers may also be somewhat confused by the seeming vagaries of the profession. A quarter century ago, economists like Nicky Kaldor and Milton Friedman
could write, quite convincingly, of the desirability of the consumption tax based on considerations of economic efficiency, because it reduced the number of distortions. Then economists, following a rediscovery of Frank Ramsey’s classic paper of the late 1920s (Ramsey 1927), realized that two small distortions might be better than one large distortion (one could not simply count distortions), and derived conditions under which an interest income tax would be economically efficient. But Ramsey had conducted his analysis on the assumption that there was no progressive income tax. When this was recognized, the presumption in favor of no interest income tax was restored.\textsuperscript{10}

Following this confusion, economists have switched their arguments for a consumption tax from a focus on economic efficiency to one on administrative simplicity: much of the complexity of the tax code, and most of the tax avoidance activities, are centered around the taxation of capital. (See Bradford 1986.)

There are further, quite convincing arguments for the abolition of the taxation of the return to capital. We alluded to one of these earlier: the belief that the appropriate time period for taxation is the individual’s life time.

Moreover, much of the lost revenue from the abolition of the taxation of capital is income which, under an ideal tax system, would not be taxed anyway: nominal (as opposed to real) returns, including nominal capital gains. With real interest rates traditionally at less than 1 or 2 percent, the loss of revenue from the taxation of the real return to capital may be negligible (although the returns to risk-taking may not be insignificant).

On the one hand, one might contend that the abolition of the capital tax hardly constitutes a “solution” to the admin-
istrative problem of taxing capital; on the other hand, if the revenues lost are not too great, if one believes that it is lifetime income which is the appropriate basis of taxation, and if much of the complexity and most tax avoidance activity are indeed associated with capital taxation, elimination of capital taxation becomes an attractive possibility. Yet this is not the route that the current tax reform has taken, largely because of the belief, whether mistaken or not, that it would be, or would appear to be, inequitable.

This brings me to the second explanation for the failure of tax reform. Our tax system is an important forum within which our national values become stated. In other words, what is at issue is more than just economics. We have seen this repeatedly.

The Jeffersonian ideal of a country of small farmers may be inappropriate for a modern industrial society, but we still believe that individuals should have the right to own their own house, to have an equity claim, so to speak, in America. I am not unsympathetic with this view, as contrary as it may seem to economists' traditional obsession with the neutrality between rental and owner-occupied housing. (As an aside, economists' modelling of the differences between these economic arrangements leaves much to be desired; the central issues of moral hazard, the incentive effects of maintenance of one's own house, are, in this work, completely ignored.) House ownership has, I suspect, important effects on individuals' views of themselves and their relationship to their society; and it may have positively beneficial effects on voting behavior, and hence on the nature of local communities. (See Stiglitz 1986.)

The positive encouragement of ESOP plans (by which individuals obtain an equity share in the firms for whom they work) and IRAs can be justified on similar terms.
Charity has always played an important role in the American ideal and the decentralized provision of public goods encouraged by the charitable contributions has had, overall, a tremendously positive influence on our society. Without its privately supported medical foundations and educational institutions, America would not be what it is today. Thus it is not surprising that the charitable deduction has been defended with such vehemence, and retained.

But once one recognizes the desirability of retaining the charitable deductions, it is hard to eliminate completely the deduction for local and state taxes, part of which perform functions not dissimilar to charity: the compulsory contribution of an elderly individual to support a local public school system in similar in many ways to his voluntary gift to support a local private university.11

The third reason for the failure of tax reform is related to simple political economy considerations: there are vested interests who are willing to fight quite hard to retain the special provisions which benefit them. Some of this may be put down to simple greed. But I have increasingly become convinced that there is frequently more to it than that: we live in a complex world, where the consequences of various policies are hard to ascertain. Those who are in an industry know the industry better than anyone else, except perhaps the economists who have made a study of them; but for reasons I have already alluded to, the economists’ model often appears to be suspect. Thus, economists might argue that risk markets work almost perfectly, but the lobbyist for the oil and gas industry may make a convincing case that this is not true, and that unless special tax provisions are given, the tax structure will adversely affect this important industry.

Moreover, as I have also argued, there is more at stake than just efficiency considerations: there are values. The housing
industry may concede that mortgage deductibility is not neutral, but argue that is precisely why it is good.

The problem is to distinguish between legitimate arguments, and those that are self-serving.

The political economy problems associated with taxation should not come as a surprise. Indeed, one can interpret the restrictions imposed on taxation within the Constitution as a recognition of them. The writers of the Constitution were well aware that certain forms of taxation could be used to discriminate against different groups, and to favor other groups. The South, afraid that the more populous North would impose export taxes, to the South's disadvantage, succeeded in making such taxes unconstitutional. But they failed to recognize that in a general equilibrium model, export taxes and import duties are equivalent, and the North was successful in imposing these taxes with differential burdens on the South.

The writers of the Constitution also imposed a uniformity clause, though the recent decision of the Supreme Court in upholding the constitutionality of the exemption of North Slope oil from the windfall profits tax decimated what little force was left in this important provision.

As most of you may be aware, the Constitution also originally prohibited direct taxes (such as an income tax) on a basis other than per head. Whether they intuited the kinds of problems that we now face may be debated. But certainly the writers of the amendment allowing the income tax seem, at least in retrospect, to have been insufficiently aware of the abuses to which the power to impose that form of taxation is subject.

Where Do We Go From Here?

What lessons are there to be learned from this failure of tax reform? Where do we go from here?
First, it appears to me that we have asked too much of our tax system. By asking more, we may have gotten less. We have been overly ambitious in our attempts to redistribute income through the tax system, and as a result, we have provided incentives for massive tax avoidance. We have attempted to address the energy crisis and other social ills with our tax system; from an administrative perspective, this may not be unreasonable. It may be cheaper, for example, to subsidize the rehabilitation of our inner cities through the tax system than to set up a grants program. But the overall loss in faith in the equity of our system of financing public services may not be worth the savings in administrative costs.

Second, I think one can safely conclude that a major revamping of our income tax system appears unlikely for the foreseeable future. It should be borne in mind that there are significant costs associated with continually revising our tax system; individuals find it difficult to plan for the future, and this, in itself, may be a discouragement to investment. Given that a general tax reform appears unlikely, the only way to reduce the inefficiencies and inequities associated with the tax system is to reduce the amounts of revenue that we seek to collect from it. Moreover, reducing the tax rates reduces incentives to engage in tax avoidance activities.12

This leads me to a qualified support for the introduction of a value added (consumption-based) tax. Most economists have been suspicious of such a tax because it is equivalent to a proportional income (or consumption) tax (depending on the specific rules of the tax); thus the introduction of such a tax, in effect, serves to reduce the overall progressivity to the tax system. Moreover, it introduces an additional administrative apparatus. Why, economists have asked, have two administrative systems, when one can do just as well with one?
What this argument ignores is the fact that there are also administrative costs associated with tax avoidance activities. Thus, while it might pay an individual to attempt to avoid a 20 percent income tax, it might not pay him to engage in activities to avoid a ten percent income tax, and a separate set of activities to avoid a 10 percent value added tax. Moreover, the way these taxes are collected, in fact, means that there are different tax avoidance possibilities in each. Thus, the principle of multiple nets suggests that one might obtain a more equitable tax system, with indeed lower overall administrative costs per dollar raised, by having two separate systems. This principle of multiple nets can be used to justify two other aspects of our tax code. If we had a well-functioning estate and gift tax system, then a consumption tax, combined with such an estate and gift tax, might well be desirable. But our gift and estate taxes are far from perfect. We can think of our present tax system, which exempts much of life cycle savings (housing, IRAs, pensions, etc.) as an attempt to capture the returns to some of the capital which escape the estate gift tax net. The corporation tax may be justified on similar grounds.

I qualify my support for these proposals for a value added tax for two reasons. First, there will be pressures to have a nonuniform value added tax. The more differentiated the tax, the greater the administrative problems, and the more likely we are to wind up in the same quagmire that we now find ourselves in with respect to the income tax. Second, there is concern that political leaders will take advantage of consumer ignorance, of their inability to ascertain their true tax liabilities, and that the imposition of the value added tax will provide a mechanism for an expansion of the scale of the public sector.

The growing recognition of what I call the “political economy problems,” what the popular press refers to as the
lack of restraint on government expenditures and government's propensity to dispense favors to special interest groups, and what economists might loosely describe as the lack of optimality of political equilibrium\(^{13}\) (see Atkinson and Stiglitz 1980 or Stiglitz 1986), has given rise to a movement for constitutional restrictions on the level of government expenditures and the size of the deficit.

Note that the change in the constitutional restrictions on the set of admissible taxes may be closely tied to concerns about the size of the public sector. Popular support for government expenditure programs may be much greater if one believes that someone else (or no one) pays for it. With a progressive income tax, or a corporation tax, one can be mislead into believing that it is the "rich" or "corporations" which pay. Many of our current programs might not be supported if we had to finance them out of a head tax.\(^{14}\)

That is one of the reasons I have emphasized earlier the importance of the principle of political responsibility in tax systems.

I have mixed feelings about these proposals for a constitutional amendment. The dangers of the loss of flexibility from a constitutional amendment must be balanced against the possible advantages in ameliorating the problems with which we have been concerned here. Moreover, I am not convinced that the proposals I have seen will deal adequately with the problem. Restrictions in deficits, in the absences of an adequate capital budget, give rise to incentives to sell government assets such as the sale of offshore oil and gas leases during the past few years merely to balance the books, regardless of long-term costs to the American taxpayer. Restrictions on government expenditures give rise to the use of tax expenditures, loan guarantees, and other devices, regardless of their merits relative to direct expenditures. Nor do the standard
proposals do anything to address directly the abuses of our tax system, i.e., the structure problems which are the center of concern of the tax reform movement.

There are no easy solutions. As an educator, I have a strong belief in the value of information. That is why I think it important to have some truth-in-government legislation, where the government details the tax burden imposed on each individual. I also think this kind of forum you have been holding here this year on taxation, the objective of which is to increase the general understanding of the effects of our tax system, is vital. I am pleased and honored to have been invited to address you this evening, and to participate with you in these endeavors.

REFERENCES


NOTES

1. The marginal tax rate determines the magnitude of the substitution effect (at a given level of welfare, which is related to how the individual trades off consumption and leisure, or present consumption and future consumption), the average tax rate determines the magnitude of the income effect. The total effect is the sum of the two. The inefficiency associated with the tax system is associated with the substitution effect. The absence of a significant total effect (with substitution and income effects offsetting each other) has often been confused with the absence of any distortionary effect.

2. And there may possibly be a tax at ordinary rates on the recapture of his depreciation.

4. This description oversimplifies by ignoring the important risks which Exxon might face in the presence of a default on the part of Chrysler. One of the main consequences of the Safe Harbor Provisions were to reduce those risks.

5. In addition, the “at risk” provisions are more favorable in real estate.

6. Or more accurately, at the time that it became believed that such a tax would be imposed (or such a favorable treatment would be granted).

7. Or more accurately, at the time that it became believed that such a tax would be imposed (or such a favorable treatment would be granted).

8. The legislated top rate is 28 percent, but as individuals’ incomes increase, there is a reduction in their exemptions (and standard deductions) so that the effective rate is 33 percent.


10. See Atkinson and Stiglitz (1976). More accurately, there are conditions under which there should be an interest income tax, and other conditions under which there should be an interest income subsidy. It appears difficult to ascertain empirically which of these conditions actually prevail.

11. The minimum tax may similarly be viewed as desirable, not because it actually increases equity, or because it increases efficiency, but because it represents a statement of values, that is, the principle that every one above a certain income level should pay at least 20 percent of his income to the government, and it should be transparent that he does so.

12. Though much of the cost of those activities may be the fixed costs associated with learning about how to avoid taxes. If that is the case, then a reduction in tax rates may not reduce tax avoidance activities substantially.

13. Or, indeed, the absence of an equilibrium (see Arrow 1951).

14. Similarly, the scope for redistribution at the local and state level is much different than at the national level. The extent of distribution which well emerges if responsibility for welfare is placed at the state and local level differs from that which will emerge if the locus of responsibility is at the national level.

15. There are obvious difficulties, because not even economists can agree on who pays the corporation tax. But these ambiguities can be noted in the “information” sheet sent to each individual.