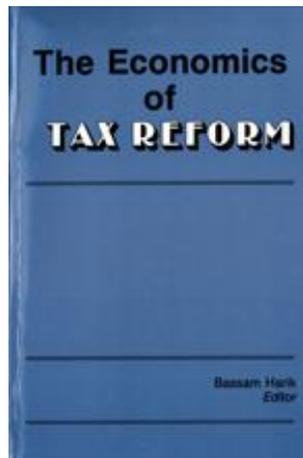


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Introduction

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Introduction

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The Tax Reform Act of 1986 has been called, among other superlatives, a “legislative miracle” and an “historic achievement.” The Tax Act is certainly the most sweeping tax legislation since the inception of the tax code in 1913. Even though it received overwhelming support in Congress, the Tax Act is not without its critics inside and outside Congress. Some members of Congress felt that they had been railroaded into voting under pressure on a bill that was negotiated behind closed doors. Some of the other criticisms came from the business sector, especially those businesses that, perceived themselves to be adversely affected by the Tax Act.

One provision that threatened to undermine the tax bill compromise was the cutback in deductions for individual retirement accounts (IRAs): families with income exceeding \$50,000 and who are covered by employers’ pension plans are no longer eligible for deductions of contributions to IRAs. Individuals not covered by employers’ pension plans and those whose income is less than \$40,000 would still be able to retain the full \$2,000 deduction in contributions to IRAs. Nonworking spouse deduction remains at \$250. Reduced deductions will be allowed for those with incomes between \$40,000 and \$50,000. Nondeductible contributions up to \$2,000 with the deferred taxes on earnings still can be made by those who are not allowed deductible IRAs. The tax conferees resisted all attempts to introduce amendments dealing with IRAs because they were afraid of opening the floodgates for other amendments.

Another controversial provision was that dealing with capital gains. Long-term capital gains are no longer given

preferential tax treatment, but are to be taxed at the same rate as other income, i.e., a top rate of 33 percent. Supporters of the provision say that maintaining a preferential rate would unfairly benefit the rich who have already benefited from the reduction of the top rate on income. Furthermore, this simplifies the tax law and reduces the inefficiency which occurs when individuals try to protect ordinary income by transforming it into long-term capital gains. Opponents of the provision have argued that eliminating the historical preference will discourage investment.

Unlike earlier versions that had dealt a sweeping blow to most deductions, the bill that emerged retained most of the popular deductions. Some of the major retained deductions are mortgage interest payments on first and second homes, and state and local income and property taxes. Business and medical expenses are allowable if they exceed 2 percent and 7.5 percent respectively of a taxpayer's adjusted gross income. Interest on consumer loans gradually will become nondeductible by 1991.

Tax shelters are to be eliminated. Taxpayers are no longer able to offset ordinary income with passive paper losses. Rather, they have to be active participants in partnerships in order to claim any losses, and even then there is a limit on the losses to be claimed. This provision made the reduction of the top rate on income from 50 percent to 33 percent more acceptable. Investment in oil and gas drilling operations, however, has been exempted. The new rules will be completely phased in by 1991.

With respect to businesses, the Act includes some major changes, the ultimate impact of which is far from certain. At first blush, it seems that businesses such as heavy industries that rely heavily on the investment tax credit will be losers, as will commercial real estate developers. Businesses in the

service sector and those that have been paying high effective tax rates would be beneficiaries under the Tax Reform Act. The preferential treatment currently given to oil and gas producers was left almost intact.

Here are some of the provisions dealing with businesses. As with individuals, there is a significant change in tax rates for businesses. The top corporate tax rate has been dropped from 46 percent to 34 percent. There are two more brackets, 15 percent for income up to \$50,000 and 25 percent for income between \$50,000 and \$75,000. Here again, there is a 5 percent tax surcharge for income between \$75,000 and \$100,000 and the 34 percent rate will apply to all income when income exceeds \$100,000. The rate on corporate net capital gains has been raised from 28 percent to 34 percent. This provision benefits those businesses that have not been taking advantage of the various tax breaks and are currently paying high effective tax rates. These changes were completely phased in by mid-1987.

The investment tax credit is to be repealed, and depreciation allowances are to be reduced. These two provisions will have an adverse effect on businesses investing heavily in plant and equipment and on real estate developers. This is a far cry from the 1981 tax breaks designed to favor these businesses.

Oil and gas producers have retained most of their tax allowances under the bill. The cause of this industry was helped by some influential key members of Congress, and by the fact that the industry is in a depressed condition. It would have been more difficult to plead the industry's case in the late 1970s when windfall profit taxes on oil companies were popular.

In response to the public outcry over the fact that some large and profitable corporations have sometimes paid little or

no taxes at all, the Act includes a new minimum tax on businesses. The alternative minimum tax of 20 percent is computed after adding back many of the tax breaks to taxable income. The alternative minimum tax must be paid if it exceeds the ordinary tax. This is similar to the alternative minimum tax on individual earnings.

In other business-related areas, the Act extends the targeted-job credit for three years, and the research and development tax credit is also extended for three years. Tax credits allowed for rehabilitation of old buildings were reduced. The tax incentive for construction of low-income housing has been replaced by a generous new tax credit. Some changes in allowable accounting practices are expected to raise tax revenue. The Act also includes changes in the use of tax-exempt bonds and foreign tax credits.

When President Reagan directed Treasury to study tax overhaul in early 1984, the stated objectives were to achieve simplicity, fairness, efficiency, and revenue-neutrality. Simplicity was given low priority soon after the overhaul process started because it was judged incompatible with the other objectives, although one could argue that having three tax brackets for individuals instead of fourteen is simpler. In chapter 2 of this volume, Joseph Stiglitz points out, however, that looking up one's tax in the tax tables involves little work.

The Tax Reform Act rates higher on fairness. According to Sheldon Danziger (chapter 6), the Act promotes horizontal equity because of the expanded tax base and reduced number of brackets. Even though it is estimated that about six million poor and near-poor taxpayers will be removed from the tax rolls, however, Danziger believes that this is not enough to offset the large increases in poverty and inequality that have taken place since 1973. In order to insure that high-income individuals and corporations will pay some tax regardless of

allowed deductions, the Act includes an alternative minimum tax. Stiglitz argues, however, that the prosperous firms will not be greatly affected by the minimum tax because of leasing provisions. Stiglitz also points out that shifting the tax burden from individuals to corporations ignores the fact that it is individuals who must bear the burden of taxation, and that it violates the *principle of political responsibility*.

Lowering the top tax rates is expected to promote efficiency and economic growth and to result in stronger incentives for increased labor market participation. Eliminating the tax avoidance schemes means that investments will be undertaken for their own merit and not for their tax implications. One should add that eliminating many of the investment tax incentives might have a negative short-term effect on capital formation. Joseph Minarik argues in chapter 3 that the reduction of tax sheltering would redirect funds from unproductive investments in tax-favored areas into more traditional investment fields. Furthermore, Minarik states that reduced tax rates and cutbacks of deductibility of interest on consumer loans will decrease borrowing and modestly increase saving, making more funds available for traditional investments. Laurence Kotlikoff (chapter 4) argues that a reduction in investment incentives results in a capital gain to owners of old capital, which means that older generations will benefit and young and middle-aged generations will be worse off because they must pay higher prices to acquire capital stock. Taxing capital gains at full rates will remove the most important form of tax arbitrage. Stiglitz cautions, however, that raising the maximum tax rate on capital gains from 20 percent to 33 percent may have serious consequences for efficiency.

Revenue-neutrality is supposed to have been achieved by lowering the tax rates and expanding the tax base, and by raising business tax revenues while lowering tax revenues from

individuals. Estimating changes in revenue as a result of tax changes generally involves a great deal of guesswork. There are uncertainties regarding the impact of lowering marginal tax rates for individuals, boosting corporate profit taxes, and eliminating preferential treatment for capital gains, to name a few specific examples.

The five economists in this volume discuss the issues of taxation and tax reform from different points of reference.

Stiglitz provides a general theoretical background for the principles of taxation and the assessment of the impact of taxation. He discusses at length how various tax policies lead to tax arbitrage activities. He also points out that taxes on capital assets are capitalized, and that individuals bear all taxes. Among the principles of taxation, Stiglitz discusses the principle that taxpayers should know what they are paying—“truth-in-government.” Using the principles of taxation for guidance, Stiglitz assesses the various tax reform proposals. He concludes that the proposals ignore many of the principles of taxation. Stiglitz gives his qualified support to the introduction of a value added tax, discussing both the merits and drawbacks of such a tax. One can use the standards employed by Stiglitz to evaluate the advantages and the shortcomings of the new tax provisions.

Minarik looks at the impact of tax reform on investment and growth. He points out that the roots of the recent tax reform drive were in the Economic Recovery Tax Act (ERTA) passed in 1981. Minarik argues that ERTA, with its Accelerated Cost Recovery System (ACRS) and the Investment Tax Credit (ITC) provisions, has resulted in inconsistencies and revenue reductions to the government, giving the impetus to tax reform. Minarik further argues that, contrary to common wisdom, ERTA was not instrumental in stimulating investment. Investment subsidies, he contends, do not always

stimulate risk-taking and innovation. On the contrary, the recent subsidies have encouraged low-risk tax shelters. Minarik also argues that the elimination of tax subsidies would have no negative impact on investment in the long run.

In his paper, Kotlikoff discusses the impact of fiscal policy on intergenerational redistribution of income. He discusses the redistribution effects of income taxes, as well as the social security tax system and government borrowing. He argues that some of our current accounting definitions lead to “fiscal illusion” in the way we view the budget deficit and the national debt. Kotlikoff proposes redefining social security “taxes” as “loans” since the contributors are lending money to the government during their working years and receiving benefit payments during retirement. He would also have the government raise funds by levying a “head tax” with the promise to repay the tax plus interest as a tax credit in the future, instead of the present practice of selling bonds. Redefinitions such as these, according to Kotlikoff, would lead to more relevant estimates of the budget deficit and the national debt. Consequently, one could concentrate on the impact of fiscal policy on intergenerational redistribution of income and its effect on saving, growth and economic efficiency.

Ronald Fisher (chapter 5) examines tax reform from the perspective of state and local governments. Since the paper was presented before the passage of the new tax law, it contained an analysis of the impact of the loss of deductibility of state and local taxes on those governments. Even though this is no longer an issue, the analysis itself stands of its own and the conclusions are very interesting from a theoretical point of view. Fisher concludes that any tax plan should be judged on its aggregate impact rather than its impact on specific sectors of the economy.

Danziger concentrates on the impact of tax reform on poverty and income distribution. He argues that the policy of

helping the poor via economic growth has not been successful. Policies such as ERTA have not had the desired effect on income distribution or on alleviating poverty. He stresses that tax reform should be and can be effectively used to aid the poor. Danziger introduces some statistics showing a shift towards greater poverty and inequality since the late seventies, and explores possible explanations of these phenomena. He then discusses the impact of the new tax law on the poor. In order to correct the recent trend, Danziger proposes the expansion of the current Earned Income Tax Credit and Per Capita Refundable Credit that would replace the present personal exemption. In discussing the merits of these proposals, he argues that they offer efficient options for helping the poor.

Like many tax changes in the past, the real impact of the Tax Reform Act cannot be fully predicted. There will be some unforeseen side effects; there will be pressures to rework some of the provisions. Some urgent problems will be addressed by tax revisions, but the bias will always be there. It is easier to effect a policy through tax incentives and disincentives than through appropriation or disappropriation. After all, this is how our tax system got to be the monster that it is today. There are still some unanswered questions with respect to the impact of the Act on the foreign sector and on the value of the dollar. The revenue-neutrality of the Act is based on estimates and projections that are far from perfect. The issue of the budget deficit has not been addressed by this Act.

It is hoped that this volume will provide some insight into the complexity of the world of tax reform. History has shown us that tax reform is an ongoing process and it does not end with the signing of this specific legislation.