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ONE CHEER FOR THE TREASURY TAX PLAN

INTRODUCTION

Secretary of the Treasury Donald Regan has released the first draft of his recommendations for the comprehensive reform of personal and corporate income taxes. Says he: "The present U.S. tax system desperately needs simplification and reform. It is too complicated, it is unfair, and it retards savings, investment and economic growth."

The fact that the proposal was released and given a high profile--though not a full endorsement--by the Administration represents the first major decision by the second Reagan Administration. By releasing a modified flat tax plan that reduces marginal tax rates and raises the same revenue as present law (using a static model of the economy), the Administration signals that it intends to tackle the federal deficit challenge through a policy of economic growth and spending restraint--and not by raising taxes. The Administration is correctly interpreting its re-election mandate as an endorsement of economic growth policies and a rejection of high taxes.

Both Ronald Reagan and Treasury Secretary Regan have asked for comments and criticisms of the proposal. Both have stated that they are ready to compromise with Congress and have cited warmly such "flat" tax alternatives as "Kemp-Kasten" and "Bradley-Gephardt." Reagan has insisted only that tax reform never be used to mask a tax increase. Exactly where the President stands will not be made public until his State of the Union Address in January 1985.

The Treasury proposal, however, is a good first start. It deserves one good cheer. It reduces marginal tax rates and it rejects tax increases. It also pushes the Administration into the debate on how best to reform the federal income tax to reduce

its present disincentives to savings, investment, and work faced by both individuals and businesses. Secretary Regan has said that he is willing to revise his first draft. This is as encouraging as it is important, for this draft encourages economic growth less than do some alternatives already before Congress. It does not lower individual tax rates as far as it should; and in broadening the tax base for individuals and businesses it may actually increase taxation on capital investment, perhaps inhibiting the economic growth it seeks to stimulate.

THE CAMPAIGN FOR A FLAT TAX

The consensus in Congress, in the economic profession, and among the general public for some form of a flat tax has been building for some time. When the income tax was established in 1913, and expanded to cover corporations as well as individuals, it soon became the object of political tampering as various industries and classes of income earners successfully lobbied Congress for special deductions, exemptions or credits.

As these "loopholes" slipped into the tax code, marginal tax rates were raised to maintain revenue levels. Higher marginal tax rates made deductions and exemptions more valuable to those who enjoyed them already and more attractive to those individuals, corporations, and industries whose "unsheltered" incomes faced a climbing tax burden. Said Secretary Regan: "Under the current progressive tax system, all taxpayers face higher marginal tax rates in order to make up for the revenue lost by numerous special preferences, exceptions and tax shelters used by a relatively small number of taxpayers."

The present patchwork quilt of high marginal tax rates and deductions, exemptions and credits, has survived intact for several reasons. First, those protected by deductions fear any change that may eliminate their shelter without sufficiently reducing tax rates to make up for the loss of the deductions. As such, they have lobbied hard against tax simplification. Second, politicians wield tremendous political power in granting deductions and credits and, conversely, in threatening classes of individuals and whole industries with the loss of such protection. Seats on the Senate and House committees dispensing such "tax expenditures" have become as desirable as those which hand out pork barrel spending programs.

This institutional bias against reducing marginal tax rates and eliminating deductions, credits and exemptions has now come under attack as a result of three changes.

1) Effects of High Rates

There is now widespread recognition of the tremendous disincentive effects of high marginal tax rates. This education process began with the doubling of the capital gains tax in 1969

which almost immediately crippled the venture capital market and seriously damaged the chances for new businesses to enter the marketplace. Investments contracted so much that the higher new tax actually brought in less revenue than the lower previous capital gains tax. When a tax rate could double and still lose revenue, Congress began to do some serious thinking about the importance of marginal tax rates.

To roll back these excessive tax rates, Congress in 1978 enacted the Steiger Amendment, sponsored by the late Representative William Steiger (R-WI), over the objections of the Carter Administration. This reduced the top marginal tax rate on capital gains from 48 percent to 28 percent. As predicted by Steiger and his colleagues, and in contrast to the dire warnings of the Carter Administration, new business incorporations, new stock offerings, and the amount of venture capital available skyrocketed; revenue from the tax increased dramatically.

When Ronald Reagan moved into the White House, he made reduction of taxes his No. 1 priority. The Economic Recovery Act of 1981 (ERTA) cut marginal personal rates by 25 percent across the board and allowed businesses more rapidly to recover the cost of capital in plant, equipment, and vehicles through the new Accelerated Cost Recovery System (ACRS). The aim of the corporate tax changes, said officials and congressional supporters, was to reduce the bias of the tax code against capital and thus encourage increased investment in the economy.

By 1983, the premises for the Reagan tax cut were confirmed. Investment exploded and four million new jobs were created in 1983 alone. Real, after-tax incomes were increasing and inflation remained low, signifying that this recovery, created by lower marginal tax rates, was not built on the precarious easy money of previous inflationary "booms."

The success of the 1978 capital gains tax cut and the 1981 cut in personal and corporate income taxes has convinced a generation of Congressman and Senators that lower tax rates do matter and that the present high tax rates are inhibiting economic growth.

2) <u>Distortions</u>

There is a growing recognition that the complicated deductions and credits of the present tax code distort economic decisions, impede economic growth, and destroy fair burden-sharing of tax.

3) <u>The "Reagan Effect"</u>

Reagan himself has changed tax reform dynamics. Attempts at comprehensive tax reform have failed in the past in part because the American taxpayer feared that Congress and the Executive Branch would use such reform as a cover for massive tax increases.

The American people today, by contrast, have good reason to trust Reagan's pledge that tax reform will not be used to increase revenues, but to encourage economic growth.

THE TREASURY PROPOSAL

Under existing law, corporate income taxes would total $87.9 billion in 1986. Under Treasury's new proposal, this would jump to $110 billion. Four years later, the present law would yield $122 billion from corporate income tax, while the Treasury proposal would collect $167 billion. At the same time, the Treasury's proposal would drop the individual tax burden by $22 billion in 1986 and by $37 billion in 1990. This decrease is offset by the extra $22 billion in corporate taxes raised in 1986 and the $44.7 billion in 1990.

The proposal includes changes in the tax code that would have significant implications for both individual and corporate taxpayers.

1) Individual Taxes

Fewer tax brackets, lower marginal tax rates

While the present tax code has 14 brackets ranging from 11 to 50 percent, the Treasury proposal has three brackets set at 15, 25 and 35 percent. The zero-bracket, or income on which no tax is paid, would be $2,800 for individuals, $3,500 for head of household returns, and $3,800 for joint returns. The top bracket of 35 percent is reached at $38,100 for individuals, $48,000 for heads of households, and $63,800 for joint returns.

The Treasury bill, therefore, both drops the top marginal rate from 50 percent to 35 percent and reduces the steepness of the present graduated income tax. The Treasury Department claims that this will "reduce individual tax liabilities for all income classes by an average of 8.5 percent and reduce marginal tax rates by an average of nearly 20 percent."

Economists looking at the incentive effects of the bill will focus on the 20 percent drop in marginal tax rates. Individuals looking at the bill from the rather static analysis of, "how much will it change my tax liability last year or this year," no doubt will focus on the 8.5 percent figure. The size of the reduction in marginal tax rates is a key factor in determining how "pro-growth" is the Treasury tax plan, but the change in average tax liabilities may determine how much political support the final legislation will garner.

Changes in deductions, credits and exemptions

The good news for taxpayers is that the Treasury proposal increases the personal exemption for all taxpayers and their

dependents to $2,000, from the current $1,000. With the important exception of expanding IRAs, other changes are mainly base-broadening--that is, they take previously untaxed income and make it taxable. Examples:

> Charitable Contributions: Itemized deductions for charitable contributions henceforth would only be allowed for contributions in excess of 2 percent of adjusted gross income. There would no longer be a special deduction for those who do not itemize.
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> Interest Deduction: The home mortgage deduction would remain for a taxpayer's principal residence. Interest payments on a second home could be deducted only to the extent that they did not add up to more than $5,000 more than the taxpayer's investment income. All interest deductions (other than for mortgages) would be limited to $5,000 above one's interest income. And in an effort to remove the effects of inflation from tax policy, only the real interest--interest rates minus the inflation rate--would be taxed as income or deductible as an expense.
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> Capital Gains Tax: Capital gains would be taxed at the same marginal tax rates as ordinary income. Thus, the top rate would increase from the present 20 percent to 35 percent. To avoid taxing purely inflationary gains, the Treasury proposal indexes the basis to inflation.
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> Health Insurance Benefits: The present exclusion of health insurance benefits from taxation would be limited to $70 a month for singles and $175 per month for families. Treasury estimates that this will affect 30 percent of all employees.
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> Unemployment Compensation: Unemployment compensation, now untaxed up to $18,000 for a joint return, would be fully taxed under the plan.
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> State and Local Taxes: State and local taxes would no longer be deducted from income. This would eliminate the present situation which, in effect, forces taxpayers of low tax states to "subsidize" high tax states. This change would pressure governors and state legislatures in high tax states to trim back their own tax and spending policies.

The Treasury plan maintains or expands certain deductions. Examples:

> Individual Retirement Accounts: Working men and women would be able to make maximum annual contributions to their IRAs of $2,500 instead of the present $2,000, while their spouses could make a maximum annual contribution of $2,500 instead of the present $250. Thus, the total a married couple could put into an IRA in any given year would increase to $5,000.

<u>Other changes</u>: The earned income tax credit would be indexed for inflation, while the child care credit would become a deduction. The present Social Security benefit exclusions would continue. Employer-provided pension and profit sharing plans that currently are excluded from income would remain untaxed. This includes a number of "hard to value" fringe benefits such as free parking spaces.

2) <u>Corporate Income Taxes</u>

All corporations would be taxed at a flat 33 percent, down from the present top marginal tax rate for corporations of 46 percent. Yet corporations would sacrifice the Investment Tax Credit and the Accelerated Cost Recovery System (ACRS). These two features of the tax code were enacted in 1981 specifically to reduce the tax bias against real investment. They would be replaced with much longer depreciation schedules under which property now fully depreciated in 3 years would be only 85 percent depreciated in 5 to 12 years. Schedules for much equipment currently depreciated over 5 years would be stretched to between 17 and 25 years. And depreciation of building structures would be stretched to as long as 63 years. To compensate somewhat for these longer depreciation schedules, and to keep inflation from reducing the value of the depreciation allowance, the Treasury proposes to index the basis or original cost of the investments for the effects of inflation.

The Treasury proposal also reduces, but does not eliminate, the double taxation of dividend income. Under the proposal, half of all dividends paid out to stockholders would be exempt from the corporate income tax. This change would reduce corporate tax liabilities by $38 billion in 1990. For a tax reform proposal that recognizes the economic disincentives caused by the double taxation of dividend income, it is surprising and disappointing that the proposal only halves this anti-savings bias, rather than eliminating it.

A host of industry-specific deductions, credits, and exemptions are targetted for elimination under the Treasury plan--the energy industry and financial institutions would be particularly affected. The Treasury Department insists that the present tax policy is a <u>de facto</u> industrial policy that favors one industry over another. Treasury officials claim to be correcting this by restoring tax neutrality between industries. They point to such studies as the Joint Committee on Taxation's analysis of industry tax burdens, which shows that aerospace firms paid a 1980-1982 average of 7.7 percent of their income in taxes, contrasted with 40.3 percent for trucking, 25 percent for beverages, 2.7 percent for financial institutions, and 2 percent for airlines.

ANALYSIS OF THE TREASURY PROPOSAL

<u>The Individual Income Tax Changes</u>

The reduction in marginal tax rates will reduce the progressivity of the tax brackets and provide better incentives to work

and save. The expansion of the Individual Retirement Accounts and the inclusion of non-working spouses will be a tremendous benefit to American families and will increase total savings.

Yet boosting the tax rate on capital gains to 35 percent ignores the lesson of the 1969 capital gains tax and its tremendous disincentive on investment. Ignored too is the explosion of venture investment after the capital gains tax cut.

Capping the deduction for group health insurance may make employers and employees more cost conscious and thus stimulate a more competitive health care industry. The severe limitations on the deductibility of charitable contributions appear to contradict the Administration's support for the privatization of federal activities through greater reliance on charitable organizations. The Treasury proposals would discourage contributions to charitable groups that take the pressure off government.

Eliminating the deductibility of state and local taxes will pressure high tax states to bring down their income and property taxes. But it also may prompt state and local politicians to oppose the transfer of federal programs to the state and local level--a key strategy for reducing federal spending (and thus the need for federal taxes).

<u>The Corporate Income Tax Changes</u>

The Treasury Department is likely to find its most strenuous opponents in the business community, which argues that this proposal will increase drastically the real cost of investment, leading to a slowdown in the economy. Proponents of the current Accelerated Cost Recovery System depreciation schedule credit it with creating the investment boom that led the 1983 recovery. They point out that investment increased more than twice as rapidly during this recent economic surge than the average of the previous five recoveries. Thanks to the investment boom, total GNP grew more rapidly than consumption in this recovery--something that has befuddled Keynesian economists who believe that consumers always lead recoveries.

The Treasury proposal substantially shifts the tax burden onto businesses. This creates two problems:

1) Because businesses do not pay taxes but merely collect taxes from consumers (in the form of higher prices) or from stockholders, and then transfer these taxes to Washington, the proposed business tax increase on Americans would be hidden. Hidden taxes invariably are easier to increase than direct, visible taxes.

2) The way in which the business taxes are increased undermines Treasury's stated goal of crafting a "pro-growth" tax bill. By increasing the capital gains tax and by eliminating the ACRS and Investment Tax Credit, the proposal would increase greatly the cost of capital investment. The Treasury thus should reassess

its tax treatment of capital gains and investment, recognizing that the present recovery has been led by investment and largely due to the ACRS provisions.

On the other hand, of course, the reduction of the corporate income tax rates, from 46 percent to 33 percent, and the exclusion from tax of half of all dividends paid are an important step forward. But it is shortsighted to combine this with other measures which shift the bias of the code even further against investment, and hence job creation.

ALTERNATIVE PROPOSALS

The Treasury proposal must be examined and judged not only as an alternative to present tax law but in contrast with flat tax proposals before Congress.

The "Fair and Simple Tax" (FAST) introduced by Congressman Jack Kemp (R-NY) and Senator Robert Kasten (R-WI) would establish a single tax rate of 25 percent, maintain the indexation of tax brackets, increase the personal exemption to $2,000 and double the dependent allowance. On the corporate side, it would maintain the Accelerated Capital Recovery System (ACRS) and drop the top tax rate to 30 percent.

The "Fair Tax" introduced by Senator William Bradley (D-NJ) and Representative Richard Gephardt (D-MO), would reduce the top individual tax rate to 30 percent, but repeal indexing. It would increase the personal exemption to $1,600, but leave the dependent allowance at $1,000. On the business side, it would eliminate ACRS and the Investment Tax Credit and replace them with much less rapid depreciation schedules.

Representative Mark Siljander (R-MI) has introduced a 10 percent flat rate tax. Under the Siljander plan, a 10 percent rate would apply to all personal earnings, and numerous deductions, including medical expenses, the capital gains exclusion, and the two-earner deduction would be ended. On the other hand, other breaks, such as the deductions for mortgage interest, charitable donations, and consumer interest would not be altered. The corporate tax structure would not be affected by the plan.

The Broad Based Enhanced Savings Tax Act (BEST), introduced by Senator William Roth (R-DE) and Representative Henson Moore (R-LA), would establish a "super-IRA" which would allow individuals to deposit up to $20,000 annually in an IRA, thus sheltering that sum from taxation. Regular income tax, but no penalties would be paid on the funds when withdrawn. On the business side, the bill allows plant and equipment to be "expensed," that is, fully deducted from taxable income immediately as they are acquired.

Representative Cecil Heftel (D-HI) has introduced the "Cash Flow Income Tax," a tax only on income actually spent--that is,

it would exempt net saving from taxable income. It would allow expensing of all capital investment and permit individuals and businesses to deduct all savings. It would establish a top marginal rate of 30 percent.

CONCLUSION

The Treasury proposal is a good first step--but only a first step. It deserves one cheer--not two or three. The proposal keeps Ronald Reagan's campaign promise not to chase the deficit with tax increases and it brings the White House into the tax reform debate firmly on the side of a modified flat tax.

Disappointing, however, is its failure to reduce marginal tax rates as much as most alternative bills before Congress. Moreover, its reliance on shifting the tax burden onto businesses and, in particular, capital investment by businesses is likely to undermine the growth incentives the package is intended to provide.

Still, the debate has been framed correctly as a search for a pro-growth tax bill, not tax simplification or reform for its own sake. Given the support of the Administration, and the growing support in Congress and among the general public for some form of "flat tax," the Treasury plan is a significant political development. With suitable modifications it could form the basis of a major reform of the tax code.

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