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FEDERAL INCOME TAX REFORM: RESUMING THE BATTLE

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INTRODUCTION

With the ink on the 1986 tax reform law barely dry, fresh discussion of reforming taxes may seem inappropriate. Yet supporters of tax reform should not rest on their laurels. For one thing, the job is far from complete. While great progress was made toward improving the equity and efficiency of the tax code during the first phase of tax reform completed this year, the nation is still far away from an ideal tax system. The new code is neither as simple nor as fair as was advertised. In fact, the code still contains many unnecessary disincentives, inefficiencies, and biases, which discourage productive activity and encourage waste. Tax reformers should not rest as long as there are improvements that need to be made.

For another thing, the fact that a major tax reform bill has been enacted improves the political environment for achieving further reforms. A major barrier to reform always has been a fear of attacking "sacred cow" deductions, such as mortgage interest relief. Yet by reducing marginal tax rates substantially, tax reform has eroded much of the deductions' remaining value--and thus erodes the political resistance to further streamlining of deductions needed for even lower tax rates. For example, a homeowner in the highest bracket will have seen the top tax relief for \$1 of mortgage interest fall from 70 cents in 1980 to 28 cents by 1988. Reduction in rates thus cuts the value of mortgage interest and other deductions by more than half. Consequently, taxpayers now are likely to be far less concerned about abolishing such a deduction than they would have been in 1980, and it is likely that far more would support a reform proposal that

promises a true flat-rate tax or other benefits in return for the loss of additional deductions.

There is another compelling reason why tax reformers cannot afford complacency: Those interests who stuffed all of the deductions, credits, exemptions, and exclusions into the tax code in the first place are still around, and they will press Congress to restore lost deductions and to add new ones to the tax code. The best way to preserve gains already made is to take the offensive by proposing new reforms.

As Congress and the Administration get down to business next year, therefore, tax reform needs to be high on the agenda. With the balance of political forces still favoring tax reform, lawmakers can achieve the fair and simple system promised to Americans in 1986. To do this, Congress must move closer to a genuine flat tax at much lower rates. This can be achieved by eliminating the deductions for all state and local taxes and for mortgage interest and by making Social Security benefits fully taxable.

If this is done, American will benefit from a greater incentive to work, save, and invest; the tax code will create fewer distortions of people's economic decision making; and there will be a more dynamic economy, faster economic growth, more jobs, and a rising standard of living for all Americans.

ENACT A TRUE FLAT-RATE INCOME TAX

Progressivity in the tax code punishes success by taking more than a proportional share of any gain derived from work, saving, or investment. By taxing away ever larger amounts of each extra dollar earned, such a tax discourages work, saving, and investment to a greater degree than a flat-rate tax raising the same revenue. Economists call this cost the "excess burden of taxation," and research indicates that even a mild degree of progressivity imposes a heavy drag on the economy.¹

1. For recent estimates of the welfare cost of the U.S. tax system and the gains from tax reform, see Alan J. Auerbach, Laurence J. Kotlikoff, and Jonathan Skinner, "The Efficiency Gains from Dynamic Tax Reform," International Economic Review, February 1983, pp. 81-100; Charles Stuart, "Welfare Costs per Dollar of Additional Tax Revenue in the United States," American Economic Review, June 1984, pp. 352-362; Charles L. Ballard, John B. Shoven, and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," American Economic Review, March 1985, pp. 128-138; and idem, "The Total Welfare Cost of the United States Tax System: A General Equilibrium Approach," National Tax Journal, June 1985, pp. 125-140.

Progressivity also imposes an enormous compliance cost on the economy. The mere fact of progressivity, for instance, creates enormous complications and distortions in the administration of the tax law, which would disappear under a pure flat rate. Law professors Walter J. Blum and Harry Kalven, Jr., explained a quarter century ago: "It is remarkable how much of the day to day work of the lawyer in the income tax field derives from the simple fact that the tax is progressive."²

A flat tax would eliminate many compliance problems. Example: there no longer would be any need to differentiate between different forms of income, to be concerned about the timing of income receipts or about splitting income between parent and child or husband and wife. Since the tax rate would be the same in every case, nothing would be gained from such differentiation.

Progressivity also prevents equity among taxpayers. Although progressivity exists mainly to impose what is called "vertical" equity (that between taxpayers of different incomes), it makes "horizontal" equity (that between taxpayers with the same income) virtually impossible to achieve. Example: a taxpayer who receives several years' worth of income in a lump sum, such as a writer receiving an advance for a book, pays more taxes than another taxpayer receiving the same income over the same period of time, who received his income regularly in the form of wages. While this was partly mitigated for a while by income averaging, the 1986 tax bill abolished this provision. Most economists believe that Americans with the same lifetime incomes ought to pay the same taxes over their lifetimes. Progressivity makes this virtually impossible.

A true flat-rate tax would be a bulwark against future tax increases. The reason: to raise taxes it would be necessary to raise taxes on everyone. One of the greatest evils of progressivity is that it creates the illusion that revenue can be raised by "soaking the rich." The fact is, however, that not much revenue can be raised from the rich. Confiscating 100 percent of the income of all millionaires would provide only enough revenue to run the federal government for a few days. For example, prior to the 1981 tax cut, the Tax Foundation estimated that, if all the income in the tax brackets from 50 percent to 70 percent were taxed at 100 percent, it would raise only enough revenue to run the federal government for six days. Thus imposing higher taxes on the "rich" cannot raise enough revenue to relieve the

2. Walter J. Blum and Harry Kalven, Jr., The Uneasy Case for Progressive Taxation (Chicago: University of Chicago Press, 1953), p. 15.

poor. By contrast, tax-rate reductions almost always raise revenue from the wealthy.³ The highest 10 percent of all taxpayers, ranked by adjusted gross income, already pay 51 percent of all federal income taxes, according to the Tax Foundation.

Ironically, the ultimate effect of high progressive tax rates has not been lower taxes on the poor, but higher taxes. As Nobel Laureate economist F. A. Hayek points out, under the illusion that the burden of taxation has been shifted to the wealthy, less wealthy citizens are often willing to accept a much heavier burden than they would otherwise have been willing to bear.⁴

There also is a constitutional argument against tax-rate progressivity. University of Chicago Law School professor Richard Epstein argues that only a flat-rate tax is consistent with the Constitution. This is because government benefits do not increase with incomes. Thus progressive tax rates violate the takings clause of the Fifth Amendment, which says that people may not be deprived of their property without just compensation.⁵

ELIMINATE THE DEDUCTION FOR STATE AND LOCAL TAXES

A long litany of arguments exists against the deduction for state and local taxes. The most powerful is that, in effect, it subsidizes spending by state and local governments, by allowing them to raise a dollar's worth of revenue at substantially less than a dollar of cost to their taxpayers. Naturally, governments raise more revenue, under these circumstances, than taxpayers would be willing to pay without federal deductibility. Indeed, the state and local tax deduction has been called a form of state-initiated revenue sharing.

3. For evidence on the Reagan tax cut, see Lawrence B. Lindsey, Taxpayer Behavior and the Distribution of the 1982 Tax Cut, Working Paper No. 1760 (Cambridge, Massachusetts: National Bureau of Economic Research, October 1985); *idem*, Establishing the Revenue Maximizing Top Personal Tax Rate, Working Paper No. 1761 (Cambridge, Massachusetts: National Bureau of Economic Research, October 1985). For evidence on earlier tax cuts, see James Gwartney and Richard Stroup, "Tax Cuts: Who Shoulders the Burden?" Federal Reserve Bank of Atlanta Economic Review, March 1982, pp. 19-27.

4. F. A. Hayek, The Constitution of Liberty (Chicago: University of Chicago Press, 1960), p. 311.

5. Richard Epstein, Takings: Private Property and the Power of Eminent Domain (Cambridge, Massachusetts: Harvard University Press, 1985), pp. 295-302.

According to Congressional Research Service calculations, thanks to deductibility, state and local government spending is over 20 percent higher than it would be without deductibility.⁶ The Advisory Council on Intergovernmental Relations estimates that spending is 7 percent higher as a result of deductibility, while research by economists Roger Gordon and Joel Slemrod indicates that state and local government spending would fall 13.6 percent without deductibility.⁷ The elimination of deductibility, writes Professor Helen Ladd of Harvard, would reduce the demand for state and local government services by about 14 percent.⁸ And University of Michigan economics professor Edward Gramlich estimates that state and local government spending in Michigan would fall 10 percent in the absence of deductibility.⁹

In short, the federal government is providing an enormous subsidy to state and local governments in the form of deductibility for state and local taxes. The corresponding loss of federal revenue is estimated by the Treasury at over \$30 billion in fiscal year 1986.

Not only does deductibility encourage states and localities to raise more revenue than their citizens otherwise would tolerate, it encourages them to raise such revenue in the form of progressive income taxes. This is because the advantages of deductibility increase with a higher marginal tax bracket. The result: progressive state and local taxes meet less voter resistance when superimposed on

6. Nonna A. Noto and Dennis Zimmerman, Limiting State-Local Tax Deductibility in Exchange for Increased General Revenue-Sharing: An Analysis of the Economic Effects, Committee Print, Senate Committee on Governmental Affairs, 98th Congress, 1st Session (Washington, D.C.: U.S. Government Printing Office, 1983), p. 11. See also Dennis Zimmerman, "Resource Misallocation From Interstate Tax Exportation: Estimates of Excess Spending and Welfare Loss in a Median Voter Framework," National Tax Journal, June 1983, pp. 183-201.

7. Strengthening the Federal Revenue System: Implications for State and Local Taxing and Borrowing (Washington, D.C.: Advisory Commission on Intergovernmental Relations, 1984), p. 48; Roger H. Gordon and Joel Slemrod, "A General Equilibrium Simulation Study of Subsidies to Municipal Expenditures," Journal of Finance, May 1983, pp. 585-594.

8. Helen F. Ladd, "Federal Aid to State and Local Governments," in Gregory B. Mills and John L. Palmer, eds., Federal Budget Policy in the 1980s (Washington, D.C.: The Urban Institute, 1984), p. 195.

9. Edward M. Gramlich, "The Deductibility of State and Local Taxes," National Tax Journal, December 1985, pp. 447-465.

a progressive federal tax. The higher state tax rates paid by the wealthy are offset in great part by increased federal tax savings.¹⁰

The benefits of deductibility vary widely among states. Those states with the highest taxes and the highest tax rates enjoy the greatest benefits from federal deductibility. As a result, Americans in states with low taxes are penalized by paying part of their federal taxes to offset lost federal revenues caused by deductibility in states with high taxes.¹¹ In essence, deductibility redistributes income from low-tax to high-tax states.

By forcing all federal taxpayers to carry part of the burden of state and local taxes, deductibility inhibits tax reduction efforts at the state and local level.¹² It also inhibits privatization efforts at the state and local level. This is because deductibility often means that governments can provide services at a lower after-tax cost than can the private sector, even though the private services are actually less expensive.¹³ Similarly, deductibility discourages governments from charging user fees for services, since fees are not deductible, while taxes are.¹⁴

The main argument usually voiced against eliminating deductibility is that states would simply shift their tax burden onto corporations, which would be able to deduct such taxes as business expenses.¹⁵ If this were to happen, however, it would lead to an exodus of businesses from high-tax states. Research indicates that businesses, especially small firms that provide the bulk of new jobs,

10. Edward Moscovitch, "State Graduated Income Taxes--A State-Initiated Form of Federal Revenue Sharing," National Tax Journal, March 1972, pp. 53-64. See also Robert I. Keller, "The Case for Highly Graduated Rates in State Income Taxes," Maryland Law Review, 1976, pp. 617-650.

11. This point was emphasized by the Treasury Department. See Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President (Washington, D.C.: U.S. Government Printing Office, November 1984), p. 64.

12. "Deductibility Hurts Local Tax Cut Efforts," Dollars & Sense, July-August 1985, p. 7.

13. E. S. Savas, "Tax Plan's Boost to Privatizing Services," The Wall Street Journal, July 10, 1985, p. 28.

14. Harry P. Hatry, A Review of Private Approaches for Delivery of Public Services (Washington, D.C.: The Urban Institute, 1983), p. 90.

15. Martin Feldstein, "A Tax-Reform Mirage," The Wall Street Journal, November 20, 1985. See also Martin Feldstein and Gilbert Metcalf, The Effect of Federal Tax Deductibility on State and Local Taxes and Spending, Working Paper No. 1791 (Cambridge, Massachusetts: National Bureau of Economic Research, January 1986).

are highly sensitive to state and local taxes. They will move or expand elsewhere if taxes are excessive.¹⁶ The fear of such an exodus would constrain states from shifting the tax burden from individuals to businesses. If it were easy to tax business, moreover, liberals already would have raised state business taxes above their current levels to finance additional welfare and other government spending. The reason they have not done so is precisely because they fear that, in states like New York, businesses will flee to lower-taxed jurisdictions or expand their operations outside New York.

The other main argument against eliminating deductibility is that it would constitute a "tax on a tax," the idea being that the amount of taxes paid to state and local governments should not, in effect, be considered federal taxable income. Were this the case, however, Congress would have to make all taxes deductible, including federal taxes. But it explicitly rejected this rationale some time ago when it ended the deductibility of federal excise and gasoline taxes.¹⁷ This rationale similarly would require states to allow deductibility of federal taxes from state taxable income. Yet only 16 states allow such a deduction.¹⁸ Ironically, New York Governor Mario Cuomo, who led the fight against the elimination of deductibility and heavily used the "tax on a tax" argument, refused to allow New York City residents to deduct their city taxes on their state tax returns.

Eliminating the deductibility of state and local property and income taxes would have desirable effects even if it did not lead to further reductions in tax rates. In fact, it would raise substantial revenues that could be applied to further rate reductions.

TAX SOCIAL SECURITY BENEFITS

Until 1983 Social Security benefits were completely exempted from federal income tax. This tax-free status was based on a 1941 Internal Revenue Service ruling. Private and other government pensions, however, always have been fully taxable to the extent that benefits exceed contributions. Today's elderly are one of America's more wealthy groups. A recent Conference Board study finds that, while Americans over age 50 account for just 35 percent of the adult

16. See, for example, Ronald E. Grieson et al., "The Effect of Business Taxation on the Location of Industry," Journal of Urban Economics, April 1977, pp. 170-185.

17. Richard Goode, The Individual Income Tax, revised ed. (Washington, D.C.: The Brookings Institution, 1976), pp. 169-170.

18. Significant Features of Fiscal Federalism, 1985-86 Edition (Washington, D.C.: Advisory Commission on Intergovernmental Relations, February 1986), p. 78.

population, they receive 42 percent of the nation's after-tax income. An astounding 77 percent of the nation's household financial wealth--stocks, bonds, and cash--is in the hands of this generation. In short, the image of the elderly as a poor group is just not true.¹⁹

Those retired Americans who are poor, moreover, would not pay federal income taxes anyway. And since effective tax rates rise with income, those most in need would be unaffected by the proposal, and the de facto reduction in benefits would affect only those with upper incomes. For this reason, taxing Social Security benefits often has been proposed even by liberals. In 1982, for example, Democratic Governor Bruce Babbitt of Arizona strongly endorsed taxation of Social Security benefits. "Subjecting Social Security benefits to income taxation," he said, "would spread any given amount of cuts more equitably: Lower-income recipients would pay little or no tax while upper-income recipients would be subject to the progressive structure of the income tax."²⁰ Editorialized The Washington Post in 1980: "Of all the ways to trim Social Security, some version of taxation is the most sensible. It is least damaging to those who rely on the system for the bulk of their income...[and] the fiscal stability of the system would be improved substantially."²¹

Others who have supported taxing benefits include former Commissioner of Social Security Robert M. Ball and economists Alicia Munnell of the Federal Reserve Bank of Boston, Sylvester J. Schieber of the Employee Benefit Research Institute, Mickey D. Levy of the American Enterprise Institute, Henry Aaron of the Brookings

19. "The New Old": Where the Economic Action Is," Business Week, November 25, 1985, pp. 138-140; Spencer Rich, "Many Elderly Can Afford Luxuries, Study Says," The Washington Post, December 17, 1985, p. A3; Thomas E. Ricks, "People's Perception of the Elderly as Being Poor Is Starting to Fade," The Wall Street Journal, December 19, 1985. See also Samuel H. Preston, "Children and the Elderly in the U.S.," Scientific American, December 1984, pp. 44-49; Alvin Rabushka and Bruce Jacobs, Old Folks at Home (New York: The Free Press, 1980); Henry J. Aaron, Economic Effects of Social Security (Washington, D.C.: The Brookings Institution, 1982), pp. 68-72; Michael Hurd and John B. Shoven, "Real Income and Wealth of the Elderly," American Economic Review, May 1982, pp. 314-318; and Economic Report of the President (Washington, D.C.: U.S. Government Printing Office, 1985), pp. 159-186.

20. Bruce Babbitt, "For Taxes On Benefits," The New York Times, December 22, 1982.

21. "...And on Social Security," The Washington Post, May 19, 1980, p. A16.

Institution, and Rudolph Penner, outgoing director of the Congressional Budget Office.²² In short, it is an idea with considerable intellectual and political support.

Two principal arguments against taxing benefits are made. The first is that the taxation of current retirees' benefits would break faith with those who made their retirement plans assuming that their Social Security benefits would not be taxed. This view regards the Social Security system as a private pension, in which there is a contractual right to benefits. In fact, as University of Missouri law professor Christopher Hoyt explains: "Despite the appearance of a contractual or proprietary right, one is not automatically entitled to Social Security benefits by virtue of paying Social Security taxes."²³ Or, one might add, to any specific level of benefits. Congress has frequently denied benefits to those who have paid substantial Social Security taxes and altered benefits formulas up and down. For example, the so-called earnings test reduces an individual's Social Security benefits if he or she has earned income over a certain level and is under the age of 70.²⁴ In any event, the Social Security legislation of 1983 began taxing part of the benefits

22. Robert M. Ball, Social Security: Today and Tomorrow (New York: Columbia University Press, 1978), pp. 478-479; Alicia H. Munnell, The Future of Social Security (Washington, D.C.: The Brookings Institution, 1977), pp. 29-30; *idem*, "Is It Time to Start Taxing Social Security Benefits?" New England Economic Review, May/June 1982, pp. 18-27; Sylvester J. Schieber, "Thinking the Unthinkable: A Tax on Social Security," The Washington Post, December 26, 1982; Mickey D. Levy, The Tax Treatment of Social Security: Should the Exclusion of Benefits Be Eliminated? (Washington, D.C.: American Enterprise Institute, 1980); and U.S. Congress, Senate, Committee on Finance, Social Security Financing and Options for the Future, 97th Congress, 1st Session (Washington, D.C.: U.S. Government Printing Office, 1981), part 1, pp. 74, 82.

23. Christopher Hoyt, "Income Taxation of Social Security Benefits: Balancing Social Policy with Tax Policy," UMKC Law Review, Spring 1986, p. 415.

24. The earnings test imposes severe marginal tax rates on the working elderly, strongly contributing to the low labor force participation rates by the elderly. Indeed, the disincentive effects are so strong that even the Social Security Administration admits that elimination of the earnings test might raise revenues more than benefits are increased. See Josephine G. Gordon and Robert N. Schoepfle, "Tax Impact From Elimination of the Retirement Test," Social Security Bulletin, September 1979, pp. 22-32. For further discussion, see Marshall Colberg, The Social Security Retirement Test: Right or Wrong? (Washington, D.C.: American Enterprise Institute, 1978); Anthony J. Pellechio, The Social Security Earnings Test, Labor Supply Distortions, and Foregone Payroll Tax Revenue, Working Paper No. 272 (Cambridge, Massachusetts: National Bureau of Economic Research, August 1978); and U.S. Congress, Senate, Committee on Finance, Social Security Retirement Test, 96th Congress, 2nd Session (Washington, D.C.: U.S. Government Printing Office, 1980).

of those retirees with taxable income above \$20,000 for single persons, and above \$25,000 for couples.

The second argument raised against taxing Social Security benefits is that it would take money away from those living on limited fixed incomes. But those with low incomes, in effect, would be exempt from the provision, for they would pay almost no taxes anyway. This applies to even more retirees since the 1986 tax law raised the personal exemption and lowered tax rates.

ELIMINATE THE DEDUCTION FOR MORTGAGE INTEREST

Many provisions that favor home ownership remain in the federal tax code. Property taxes are fully deductible, for example, while capital gains on home sales are not taxed at all if they are reinvested in another primary residence. Taxpayers over age 55, moreover, can pocket tax free up to \$125,000 of capital gains on home sales. The fattest homeowner benefit is the deductibility of mortgage interest,²⁵ which costs the Treasury an estimated \$27 billion in fiscal year 1986.

There are good reasons for eliminating the deduction for mortgage interest apart from the need to raise revenue to permit tax-rate reductions. It encourages, for example, what probably is excessive homeownership at the expense of using capital for business investment, thereby reducing U.S. productivity and international competitiveness.²⁶ This misallocation is enormous. According to the Commerce Department, the gross stock of U.S., owner-occupied, nonfarm residential capital in 1985 totaled \$3.6 trillion.²⁷ Various estimates put the excess investment in home ownership, caused by the tax treatment of housing, at between 4 and 5 percentage points.²⁸ This suggests that as much as \$180 billion of capital has been

25. See Congressional Budget Office, The Tax Treatment of Homeownership: Issues and Options (Washington, D.C.: U.S. Government Printing Office, 1981), pp. 6-17.

26. Patric H. Hendershott, "Government Policy and the Allocation of Capital Between Residential and Industrial Uses," Financial Analysts Journal, July-August 1983, pp. 37-42.

27. "Fixed Reproducible Tangible Wealth in the United States, 1982-85," Survey of Current Business, August 1986, p. 38.

28. Congressional Budget Office, Tax Treatment of Homeownership, p. 27. See also Harvey S. Rosen, "Housing Subsidies: Effects on Housing Decisions, Efficiency, and Equity," in Alan J. Auerbach and Martin Feldstein, eds., Handbook of Public Economics, 2 vols. (New York: North-Holland, 1985), vol. I, pp. 395-400.

misallocated--equivalent to almost half of all nonresidential fixed investment in the U.S. in 1985. U.S. productivity surely would be much higher if this capital had been invested in new factories and equipment instead of housing.

Another argument for eliminating the mortgage interest deduction is that by favoring housing it allows special interest groups to argue that fairness and consistency require that they too be allowed tax breaks. Charles McClure, former Deputy Assistant Secretary of the Treasury for Tax Analysis, explains: "Defenders of tax breaks for both rental housing and business investment can argue with some justification that tax reform is unacceptable, even by the standards of its advocates, who speak in terms of a level playing field, as long as owner-occupied housing continues to enjoy a uniquely favorable status."²⁹ Mortgage interest deductibility also is unfair because the benefits accrue only to homeowners and not to renters and because the tax savings rise with the taxpayer's marginal tax rate, and therefore, with income.

The 1986 tax law, with its dramatic reduction in marginal tax rates, already has eroded the benefit of the mortgage deduction. This is the principal reason why the complete elimination of the deduction no longer is as politically unrealistic as it once was. The possibility that the loss of the deduction would lead to a further drop in marginal tax rates could convince many homeowners that the trade-off is worth making. In 1981, the Congressional Budget Office estimated that, under the tax code at that time, eliminating all special tax breaks for homeownership would allow for a 10 percent reduction in all marginal tax rates across the board with no loss of revenue.³⁰ And because only 37 percent of households itemize, while 65 percent of all households are owner-occupiers,³¹ the vast majority of taxpayers would not suffer from loss of the mortgage interest deduction. Instead, they would benefit from lower tax rates.

While there will be stiff resistance to eliminating the mortgage deduction from some groups, the potential of this resistance has been weakened because of the marginal tax-rate reductions since Ronald Reagan became President.

29. Charles E. McClure, Jr., "The Tax Treatment of Owner-Occupied Housing: The Achilles' Heel of Tax Reform?" in James R. Follain, ed., Tax Reform and Real Estate (Washington, D.C.: The Urban Institute, 1986), p. 226.

30. Congressional Budget Office, Tax Treatment of Homeownership, p. 40.

31. Joel B. Slemrod, "The Effect of Tax Simplification on Individuals," in Economic Consequences of Tax Simplification (Boston: Federal Reserve Bank of Boston, 1985), p. 82.

CONCLUSION

The battle over tax reform is about to resume. Those who benefit from special tax breaks can be expected to try to turn next year's legislation, designed to make technical corrections in the 1986 tax bill, into a major bill that restores some of the benefits lost in 1986 tax reform legislation. Since tax legislation will continue to be considered and enacted, it is vital that supporters of genuine reform press their case by offering new initiatives consistent with the principles embodied in Reagan's original tax reform proposal. They should continue efforts to broaden the tax base and reduce marginal tax rates, aiming at a low flat rate. They should strive to treat taxpayers with similar incomes in the same way, to remove disincentives to work, saving, and investment, and to achieve greater fairness and equity in taxation.

Historically, a major barrier to the enactment of meaningful reforms has been a fear of attacking the "sacred cows" in the tax code. The fear has been that the perceived losses suffered by those benefiting from specific provisions of the tax code would cause them to block reform proposals. The experience of 1986, however, suggests that American taxpayers are willing to give up loopholes in return for lower rates.

To "pay" for lower rates, a number of steps can be taken. They include:

- 1) Eliminate the deduction for state and local nonbusiness taxes. This would have raised \$33.3 billion in fiscal year 1986, according to the Office of Management and Budget.
- 2) Tax Social Security benefits. This would have raised \$13.5 billion in 1986.
- 3) Eliminate the deduction for mortgage interest. This would have raised \$26.9 billion in 1986.³²

Enough revenue could be left over to raise the personal exemption further and make other desirable reforms, such as expanding Individual Retirement Accounts.

Some will say that with the reforms already enacted there is no longer political support for further reforms. In fact, the opposite is true. The changes enacted make it possible for the first time to legislate reforms that would indeed have been politically impossible

32. These figures will, of course, be substantially altered by the 1986 tax law.

to contemplate a few years ago. The reduction in rates enacted in 1981 and 1986 have eroded significantly the value of all remaining deductions and exclusions.

There still are considerable economic and political benefits to be derived from tax reform. Those supporting such reforms should prepare so that, when the inevitable tax bill comes along, they are ready to make their case, lest the effort once again be dominated by the special interests.