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Tax Reform: Theory and Practice

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The Tax Reform Act of 1986 is the most significant piece of tax legislation enacted since the income tax was converted to a mass tax during World War II. After decades of erosion, the individual and corporate income tax bases were broadened and the revenues were used to reduce tax rates. Loopholes and preferences that were formerly considered sacrosanct were eliminated or moderated despite the determined opposition of powerful pressure groups. Comprehensive income taxation, which had earlier been regarded as an impossible dream, carried the day with strong bipartisan support. I will trace the origins of the tax reform movement and speculate about why it was successful in 1986 after repeated failures in earlier years. I also explain what the 1986 act accomplished and what more needs to be done to achieve the objectives of comprehensive income taxation.

Henry Simons and the Concept of a Comprehensive Tax Base

The idea of comprehensive income taxation goes back at least 50 years to Henry Simons, who argued in his classic *Personal Income Taxation* that the personal tax in a modern tax system should be based on an economic definition of income. According to Simons, income is the sum of an individual's consumption and change in net worth during a particular time period. George Schanz in Germany, David Davidson in Sweden, and Robert Murray Haig in the United States had previously arrived at the same definition of income, but Simons was the first to put together an agenda for reform based on this definition.

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The Simons concept of income includes all sources. He recognized that capital gains should be taxed as ordinary income on an accrual basis, but for practical reasons he accepted the use of the realization principle (assuming accrued gains on assets transferred by gift or at death are treated as realized for tax purposes). All gratuitous receipts—including transfer payments and gifts and inheritances—are counted as income under this definition because they provide the basis for consumption or accumulation.

In 1943, Simons was commissioned by the Committee for Economic Development to develop a tax reform program for the post–World War II period. His proposals were published seven years later in a small book entitled *Federal Tax Reform*, in which he tried to implement the ideas he had developed in *Personal Income Taxation*. Although Simons clearly intended the tax base to be comprehensive, he paid no attention to personal deductions, which were already eroding the U.S. personal income tax. His major proposals were to tax realized capital gains in full and allow full deductions for realized capital losses, repeal the tax exemption for interest on state-local securities, eliminate percentage depletion, and include imputed rent on owner-occupied homes in the tax base. He was a strong supporter of income averaging for tax purposes and an equally strong opponent of a separate corporate tax. He relied on full taxation of capital gains, including gains transferred by gift or at death, to prevent use of the corporate form of doing business to avoid the personal income tax. Many of the Simons proposals were incorporated by CED in its 1944 policy statement, *A Postwar Federal Tax Plan for High Employment*, still the most advanced tax policy statement ever issued by a business organization.

Following World War II, a relatively small group of political leaders, tax lawyers, and economists repeatedly called attention to the erosion of the income tax and to the need for reform. Senators Hubert Humphrey and Paul Douglas in the 1950s and 1960s, and Ted Kennedy and Bill Bradley in the 1970s and 1980s stand out among politicians as staunch advocates of tax reform, while Walter J. Blum, Walter W. Heller, Richard Goode, Richard A. Musgrave, Randolph Paul, Carl S. Shoup, Stanley S. Surrey, and William Vickrey were leaders among the academics and tax practitioners. They were supported by a succession of reform-minded Commissioners of Internal Revenue and Assistant Treasury Secretaries for Tax Policy of both political parties.[1]

Although he was not a strong advocate of comprehensive taxation, Wilbur D. Mills, the chairman of the House Ways and Means Committee, gave the tax reform movement a boost in 1959 by inviting a large group of tax experts to prepare papers and to testify on tax revision. These papers were collected in three volumes entitled the *Tax Revision Compendium*, which had a considerable influence on tax policy in

[1]These included Donald C. Alexander, Mortimer Caplin, John E. Chapoton, Sheldon S. Cohen, Frederick W. Hickman, Jerome Kurtz, Donald C. Lubick, Ronald A. Pearlman, Stanley S. Surrey, and Laurence N. Woodworth.

succeeding years. The papers and the hearings were forerunners of the later literature that emphasized the horizontal inequities and distortions created by tax loopholes and "unintended benefits," as well as the advantages of such provisions to the upper income groups and large corporations.[2]

A major contribution to the tax reform movement was the development by Stanley Surrey and his associates of the concept of "tax expenditures," which emphasizes the similarity between tax subsidies and direct government outlays.[3] The term was first used in a speech by Surrey in late 1967. The Congressional Budget Act of 1974 gave it official sanction by requiring a listing of tax expenditures in the federal budget and directed all congressional committees to identify any changes made in those expenditures by new legislation. The act defines tax expenditures as revenue losses attributable to special provisions that deviate from the "normal tax structure" —similar but by no means identical to the Haig-Simons definition. Although criticized as vague and unscientific, the term is now widely used inside and outside Congress and in many foreign countries and has undoubtedly dramatized the erosion of the tax base, the inequities in the tax law, and the need for reform (OECD, 1984; McDaniel and Surrey, 1985).

My own contribution to comprehensive tax reform was to estimate the personal income tax base under the Haig-Simons definition of income and the rate reductions that might be possible if such a base were adopted. I published the first of these estimates in 1955 and updated them periodically in various professional publications, congressional testimony, and magazine articles. The early estimates were "back-of-the-envelope" calculations for all taxpayers in the aggregate; later, with the advent of the computer, my associates and I prepared detailed estimates by income classes (Pechman, 1955; Pechman and Okner, 1972; and Pechman and Scholz, 1982). The message of these calculations was that, with a tax base broadened along the lines of the Simons definition of income, it would be possible to reduce the tax rates substantially and still maintain approximately the same degree of progression and raise the same amount of revenue as that produced by the narrower tax base.

In recent years, another group of tax reformers joined the critics of income tax erosion from an entirely different vantage point. This group consisted of economists and lawyers who believe that the income tax should be replaced by a consumption expenditure tax. The idea of a consumption tax goes back to Thomas Hobbes and John Stuart Mill. It was promoted without success in this country by Irving Fisher in the 1930s and in Britain by Nicholas Kaldor in the 1950s. Prominent among the more recent converts are William D. Andrews, Michael J. Boskin, David Bradford, Martin S. Feldstein, Robert E. Hall, Peter Mieszkowski, and Alvin Rabushka in the United States, John A. Kay and Mervyn K. King in the United Kingdom, and Sven-Olof

[2]For a debate on the usefulness of the concept of comprehensive income as a basis for income tax reform, see Bittker *et al.* (1968).

[3]Especially Henry J. Aaron, Gerard M. Brannon, William F. Hellmuth, Jerome Kurz, Paul R. McDaniel, Gabriel Rudney, and Thomas A. Troyer.

Lodin in Sweden. This group was joined by some income tax advocates like Henry J. Aaron, Harvey Galper, and Charles E. McLure, Jr., who embraced the consumption tax provided gifts and bequests were included in the base. With this modification and certain simplifying assumptions, the consumption tax turns out to be equivalent to a lifetime income tax. Whatever their rationale, the advocates of the consumption tax approach agreed on the need for a comprehensive base whether the tax is an income tax or a consumption tax. The influential 1977 report by the Treasury Department (prepared under Bradford's direction), *Blueprints for Tax Reform*, emphasized this point. In the end, some (but by no means all) of the consumption tax proponents opposed the 1986 act on the ground that it increased the tax on income from capital. However, their support helped establish the original case for the comprehensive approach.

Practically every president since World War II has recommended tax reforms to close loopholes, but only John F. Kennedy, Jimmy Carter, and Ronald Reagan supported reform along the lines of a comprehensive income tax. Kennedy called for a number of major changes, but the most important of his recommendations fell by the wayside in the legislative process. Carter, who called the tax system a disgrace, would have gone even further, but his proposals were not considered seriously by Congress. Ronald Reagan never endorsed comprehensive income taxation as such, but he always spoke approvingly of the idea of "tax simplification and rate reduction." Even though he must have had considerable reservations about base-broadening, he supported the Treasury's 1984 version of comprehensive reform (prepared under McLure's direction and coordinated by Eugene V. Steuerle), *Tax Reform for Simplicity, Fairness and Economic Growth*, with several significant modifications, and put his considerable political influence behind the tax bill as it made its way through Congress.

The Shrinking of the Tax Base

Despite the efforts of the tax reformers, the trend of U.S. tax policy since the end of World War II had been to expand old preferences and to introduce new ones to achieve various economic and social objectives. The list is long. It includes provisions that were intended to promote investment in general—accelerated depreciation and the investment tax credit—as well as tax favors to particular industries and firms, such as the extension of percentage depletion to sand, gravel, oyster shells, and salt, taxation at preferential capital gains rates of livestock held for more than six months, unharvested crops sold along with land, and coal royalties, and extension of immediate expensing of development and exploration costs to minerals as well as oil and gas. Many of these provisions, combined with the deduction for interest expense, permitted wealthy people and large corporations to avoid payment of any tax.

Some relief provisions were even tailored to fit specific individuals, the most famous of which was the "Mayer amendment," enacted in 1951. This amendment provided capital gains treatment for a lump sum distribution to Louis B. Mayer on his retirement from the movie industry. To avoid identifying him by name, the amendment was worded to apply to a movie executive who (1) had been employed for more than 20 years, (2) had held his rights to future profits for 12 years, and (3) had the right to receive a percentage of profits for life or for a period of at least five years after the termination of his employment.

The situation became so bad that in 1976 the House approved an amendment submitted by Congressman James Burke of Massachusetts, perhaps tongue-in-cheek, to provide a 7 percent tax credit for the purchase of garden tools "to encourage the private production of food." Sanity prevailed, however, and the amendment was removed by the Senate and not restored in conference. Louis Mayer and garden tools are only two examples. There were others.

The proliferation of tax preferences was interrupted in 1969, partly in response to the revelation by Treasury Secretary Joseph A. Barr of the outgoing Johnson administration that 154 persons with adjusted gross incomes of more than $200,000 had not paid tax in 1966. The reform spirit lasted until 1975, when percentage depletion was denied to large corporations. Congress then reverted to its old habits in 1978, when the exclusion for long-term capital gains was raised from 50 percent to 60 percent, homeowners over 55 years of age were given a lifetime exemption of $100,000 for capital gains realized on the sale of a principle residence, the limits on tax-exempt industrial development bonds were liberalized, and the investment tax credit was extended to outlays for rehabilitation of old buildings. In 1981, President Reagan easily persuaded Congress to enact his across-the-board individual income tax rate reductions and the excessively generous accelerated cost recovery system (ACRS) for depreciation, which were major features of his election campaign platform in the previous year. Congress got into the spirit of the occasion by adding to the bill a raft of unnecessary and costly deductions of its own, including an annual deduction of up to $2,000 for amounts set aside in individual retirement accounts (even by employees already covered by private pension plans), an exclusion of $750 ($1,500 on joint returns) for reinvested dividends paid by public utilities from 1982 through 1985, an exclusion of $1,000 ($2,000 on joint returns) for interest on savings certificates purchased in 1981 and 1982 (to help bail out the savings and loan industry), an increase to $125,000 in the lifetime capital gain exemption for homeowners, and a new deduction for charitable contributions of nonitemizers.[4] In the same bill, Congress gutted the estate and gift taxes by tripling the exemption and lowering the top rate from 75 percent to 50 percent.

Gathering the Forces for Reform

In the light of this dismal history, particularly of the last several years, the passage of the Tax Reform Act of 1986 is indeed a remarkable event. Political scientists will be trying for years to come to explain why it happened in 1986. I offer the following observations in full recognition of my amateur status as a political analyst.

[4] The deduction was phased in from 25 percent of the first $100 of annual contributions in 1982 and 1983 to 100 percent of contributions in 1986.

First, the large tax cuts and new preferences enacted in recent years undermined the confidence of the people in the tax system. The growing use of tax shelters by wealthy people to reduce or eliminate their tax liabilities was well-known. So were the names of giant corporations (General Dynamics, General Electric, etc.) which had not been paying any taxes. Low- and middle-income taxpayers resented paying higher effective tax rates on their incomes than many wealthy individuals and large profitable corporations. Furthermore, the tax system has become so complicated that millions of people were paying someone else to prepare their returns. Tax reformers were promising greater equity, efficiency, and simplicity in taxation and this message struck a responsive chord.

Second, the old tax reformers were joined by the new breed of supply-siders in promoting lower tax rates (for example, see Meyer, 1981). The original idea of comprehensive reform was to maintain a system of graduated rates, but at a reduced level. The supply-siders added a new wrinkle: instead of a multiple-rate system, they proposed the use of a single flat rate, and were willing to sacrifice many tax preferences to get it. The flat tax movement collapsed when it was shown in congressional hearings that a flat rate meant that people with very high incomes (those with incomes of about $50,000) would pay lower taxes, while those with lower incomes would pay higher taxes. But to their credit, many of the flat taxers continued to support tax reform at mildly graduated rates, but a low top rate. As it turned out, the coalition of liberals and conservatives favoring comprehensive reform and rate reduction prevailed in Congress.

Third, the Treasury and its supporters stressed the importance of allocating resources on the basis of economic, rather than tax, considerations from the very beginning. Although businessmen were split on the merits of tax reform, many influential corporate executives found the idea of a "level playing field" appealing and threw their support behind the tax bill. Even the financial community, which traditionally fought any increase in the capital gains tax, muted its opposition this time because of the attractiveness of the low top rate on other income.

Fourth, the support for tax reform by the President of the United States was crucial in the legislative history of the bill. Like other supply-siders, he was interested mainly in reducing tax rates and was willing to accept a considerable amount of base-broadening to achieve them. He had earlier said that he opposed the corporate income tax, yet he accepted a large increase in corporate tax liabilities, which was needed to provide a cut in effective individual income tax rates at all income levels. At one stage in the legislative process, he persuaded the Republican minority in the House of Representatives to support a rule to permit debate on the bill to proceed. He also supported a radically altered version of the administration's plan in the Senate, and later in conference, in the interest of expediting passage of a bill. Without his support at these stages, the bill would never have emerged from Congress.

Fifth, influential members of the House and Senate from both political parties supported the ideas of broadening the tax base and reducing rates. Senator Bill Bradley was an early advocate of tax reform; his persistence in urging a comprehensive approach is widely acknowledged to have been a major contributing factor to its success. The bill he and Congressman Richard Gephardt introduced in 1983 became a model for responsible discussion of tax reform in recent years.[5] A somewhat similar bill followed from Congressman Jack Kemp and Senator Bob Kasten.[6] Other members of Congress followed suit, recognizing that Bradley-Gephardt and Kemp-Kasten has stolen a march on them.[7] Like the president, many of these legislators were more interested in rate reduction than in base-broadening, but they were willing to join forces with the tax reformers to achieve their objective. The bipartisan support for base-broadening kept the bill from foundering as it made its way through the legislative process.

Credit should also be given to the chairmen of the two tax-writing committees, who guided the tax bill through their committees and the two houses of Congress. Ways and Means Committee Chairman Dan Rostenkowski was particularly skillful in judging how far he could push his colleagues without losing their support. After a false start, Senator Bob Packwood was able to persuade the Senate Finance Committee, which he chairs, and the Senate to pass a real tax reform.

Finally, members of the staffs of the Treasury Department, the Joint Committee on Taxation, the Ways and Means and Finance Committees were strong supporters of tax reform and seemed always to be prepared with modifications to satisfy political realities without fatally weakening the bill. When the Senate Finance Committee had emasculated the bill and practically everybody was predicting its demise, William M. Diefenderfer, Chief of the Finance Committee staff, and David H. Brockway, Chief of the Joint Taxation Committee staff, persuaded Senator Packwood that it would be possible to reduce the maximum individual income tax rate to as low as 25 percent with sufficient broadening of the tax base and higher corporate taxes. That rate was increased almost immediately to 27 percent to retain the homeowner preferences, but the principle that significant rate reduction could be achieved was established. At that rate, the objections of the opponents of tax reform faded and the bill ultimately sailed through Congress with a top effective rate of 28 percent.

What the Reform Accomplished

The Tax Reform Act of 1986 is a major step toward comprehensive tax reform. I believe it will greatly improve the fairness of the tax system and remove major distortions from the economy. The many more improvements remaining to be made in the tax system do not detract from what has been achieved. The major accomplishments of the act are as follows:

[5] S. 1472 and H.R. 3271, 98th Congress.

[6] S. 2600 and H.R. 5533, 98th Congress.

[7] Some examples are S. 557 introduced by Senator Dennis DeConcini, S. 1040 introduced by Senator Dan Quale, H.R. 5432 introduced by Representative Mark Siljander, and H. R. 5811 introduced by Representative Cecil Heftel, all in the 98th Congress.

1. By doubling the personal exemptions and increasing the standard deduction, the act removes 4,800,000 poor people from the tax rolls.[8] This step restores the principle (abandoned by Congress in 1978) that people who are officially defined as "poor" should not be required to pay income tax. The principle will be perpetuated by the resumption in 1989 of the automatic annual adjustment for inflation of the personal exemptions.

2. Significant increases were made in the earned income credit for wage earners with families.[9] These increases eliminated almost the entire social security tax (including the employer's share) for those eligible for the full credit and reduced the tax burden for many other low income workers, thus increasing the progressivity of the tax system.

3. Two tax rates—15 percent and 28 percent—were substituted for the earlier 14 rates, which rose to a maximum of 50 percent. However, counting the 33 percent rate created by phasing out the lowest tax rate and personal exemptions for high income taxpayers, the new rate structure will have four brackets, with rates of 15, 28, 33, and 28 percent. These lower marginal rates will reduce the attractiveness of tax shelters and the return to tax cheating and increase work and saving incentives. Some estimates of the supply response to changes in tax rates have been excessive, but the more responsible estimates suggest that there will be a modest improvement in work effort; the saving response is unclear (Bosworth, 1984, chapters 3 and 5; Hausman and Poterba in this journal).

4. The taxation of realized capital gains as ordinary income—the keystone of comprehensive tax reform—has finally been realized. This change will reduce the incentive to disguise ordinary income as capital gains, and thus make the tax code less complicated and simplify financial planning. Without this change, the act would have cut the taxes of the wealthy by large amounts and would have been grossly unfair. However, the continued exemption from the regular tax of accrued capital gains on assets transferred by gift or at death will increase the incentive of taxpayers to defer realizing gains until the assets are transferred to their heirs.

5. A good start was made on reversing the erosion of the individual income tax base. Unemployment benefits, which were previously taxable only if a married taxpayer's income exceeded $18,000 ($12,000 for single people), were made taxable regardless of the size of income. Deductions for state and local sales taxes and consumer interest were eliminated. Deductions for unreimbursed business expenses, costs incurred in earning investment income, and other miscellaneous costs were allowed only to the extent that they exceed a floor of two percent of income. The floor for the deduction of medical expenses was raised from 5 percent to 7.5 percent of income. The exclusions for prizes or awards for scientific and other achievements and

[8]The personal exemption is increased from $1,080 in 1986 to $1,900 in 1987, $1,950 in 1988, and $2,000 beginning in 1989. For married couples, the standard deduction is increased from $3,670 in 1986 to $3,760 in 1987 and $5,000 beginning in 1988; for single persons, it is increased from $2,480 in 1986 to $2,540 in 1987 and $3,000 beginning in 1988.

[9]The earned income credit is increased from 11 percent to 14 percent of earnings, the maximum credit is raised from $550 to $800, and the phase-out range is lifted from $6,500–$11,000 to $9,000–$17,000. The maximum credit and the phase-out starting point will be adjusted for inflation.

for scholarships and fellowships exceeding university tuition, books, and supplies, were eliminated. Perhaps most important, the deduction for investment interest of noncorporate taxpayers was limited to investment income. These changes and others will enlarge the tax base, reduce horizontal inequities, and simplify compliance by reducing the number of people who itemize their deductions.

6. The act makes a frontal assault on major loopholes and special benefits. Many tax shelters will no longer be profitable because of a new limitation on the deductibility of losses from passive investments,[10] tax subsidies for borrowing (other than for mortgages) will be eliminated by the limitation on the deduction for investment interest expense, the deduction for contributions to individual retirement accounts by persons already covered by private pension plans will be allowed only for taxpayers with incomes below $50,000 if married and $35,000 if single,[11] deductible business expense accounts for meals, travel and entertainment will be limited to 80 percent of outlays, tax preferences benefiting defense contractors, banks, and other industries will be eliminated or narrowed,[12] and the minimum tax for both individuals and businesses will be strengthened.

7. Contrary to Henry Simons' views about the corporate tax, the U.S. Congress believes that a separate, unintegrated corporate tax is essential for effective income taxation. A separate corporate tax prevents individuals from avoiding income tax by accumulating earnings in corporations, although some might question whether it is appropriate to tax corporations at a higher tax rate than the top bracket individual rate. Simons disregarded the tremendous value of tax deferral, which is possible when capital gains are taxed only when realized. The 1986 act reduced the general corporate tax rate from 46 percent to 34 percent, thus reducing the maximum tax on dividends at the margin by over a quarter (from 73 percent to 52.5 percent) in the top brackets. Nevertheless, the reform act increased corporate tax liabilities about 20 percent overall by eliminating the investment credit, reducing depreciation allowances for structures, and eliminating loopholes.

How the New Tax Burden is Distributed

The distributional effect of the act is distinctly progressive, especially if the increases in corporate income tax liabilities are taken into account. I have calculated the change in average effective tax rates on the basis of the most recent distribution of tax burdens estimated from the Brookings MERGE file (Table 1). The combined

[10] Losses from passive activities will be deducted only against passive income. A passive activity is a trade or business in which the taxpayer (or spouse) does not materially participate. All rental activities are regarded as passive.

[11] The IRA deduction is phased out between $40,000 and $50,000 of adjusted gross income for married couples and between $25,000 and $35,000 for single people.

[12] For example, defense contractors are required to pay tax on at least 40 percent of income from long-term contracts, banks will be required to deduct actual losses on loans rather than set up loss reserves and will not be allowed to deduct interest incurred to purchase tax-exempt securities, and oil and mining firms will be required to amortize 30 percent of intangible drilling costs and exploration and development outlays (instead of 20 percent under the old law).

Table 1
Change in individual and corporation income tax liabilities under the tax reform act of 1986, by income decile

	Percent Change in	
Income Decile[a]	*Federal individual and corporate income taxes*[b]	*Total federal taxes*
Lowest	−44	−16
Second	−32	−11
Third	−24	−10
Fourth	−16	−7
Fifth	−12	−6
Sixth	−8	−4
Seventh	−7	−4
Eighth	−6	−3
Ninth	−6	−4
Highest	+3	+2
Top 5%	+4	+3
Top 1%	+5	+5

Source: Author's estimates based on the 1985 Brookings MERGE file.
[a]The classification is by a comprehensive definition of income, including imputed rent and corporate earnings allocated to stockholders, whether distributed or not.
[b]Assumes the corporate tax is a tax on capital in general.

federal corporate and individual income tax burden is increased for the top 10 percent of the income distribution, but reduced for the lower 90 percent. Total federal tax burdens also decline in the lower nine deciles and then rise in the top decile. The tax reductions in the lower deciles are the result of the increases in the personal exemptions, standard deduction, and earned income credit under the individual income tax. The increases at the top reflect the increase in corporation tax liabilities, which are assumed to fall on owners of capital in these calculations.

The major complaint against the reform is that corporations will be paying higher taxes than before, which will increase the cost of capital and reduce investment. The fact is that the corporate rate reductions will be almost as large as the revenues raised by the elimination of the investment credit, reductions in depreciation allowances, and other changes in the capital cost allowances. Practically all the *additional* tax to be paid by corporations will come from eliminating loopholes and other structural changes. These reforms will increase average, but not marginal, tax rates and are less likely to affect investment incentives.

Critics of the increase in corporate tax liabilities neglect to mention that many corporations will actually be paying lower taxes than before. These are the corporations which have been paying taxes on most of their economic income. By eliminating preferences, the act will improve the allocation of investment and increase economic efficiency. Higher taxes will be paid by capital-intensive firms such as steel, aluminum, and utility companies, but they are the nation's sluggish industries. The less capital-intensive but more innovative industries—computers, electronics, biomedicine, and so on—will pay lower taxes and will have higher after-tax profits to invest. This redistribution of the corporate tax burden should have a favorable effect on growth.[13]

Mistakes and Missed Opportunities

Notwithstanding the accomplishments just enumerated, much remains to be done to reach the comprehensive reform target. In legislation as far-reaching and as complicated as the Tax Reform Act of 1986, some mistakes were inevitable and some real opportunities for improvement in the tax structure were ignored. Moreover, the bill contains the earmarks of numerous political bargains and compromises that make little economic or administrative sense.

Perhaps the most unsatisfactory feature of the act is the way it handles owner-occupied housing. Since the tax advantages of homeowners are regarded by politicians as untouchable, the act kept intact the exclusion of the rental value of owned homes from income, the deduction for interest on home mortgages, and the deduction for property taxes. At the same time, the deduction for consumer interest was eliminated and the deduction for investment interest was limited to the amount of reported net investment income. The public is already being bombarded by newspaper and magazine articles by so-called experts who advise taxpayers to increase their home mortgages as a device to generate deductible interest payments. The tax bill limits the extent to which this can be done, but the efforts to circumvent the law will be difficult to police.[14]

Even if the exemption of imputed rent and a deduction for mortgage interest are sacrosanct, it is possible to limit the borrowing subsidy without encouraging rearrangements of debt for tax purposes. The solution was first proposed by my colleague, Richard Goode, more than twenty years ago and the new law applies it to investment interest (Goode, 1976, p. 152). The idea is to allow deductions for interest payments up to the amount of investment income reported on an individual's return. To accommodate the political requirement that mortgage interest be deductible, the limit can be raised to new investment income plus an arbitrary amount, say $10,000 or $15,000. At a 10 percent interest rate, such generous limits would permit deductions for interest on mortgages of up to $100,000 or $150,000–more than enough to take care of the vast majority of home owners. The limits would also remove the discrimination against borrowing for other purposes and the temptation to refinance home mortgages for the purpose of financing other consumption or investments.

A second unsatisfactory feature of the new law is the treatment of deductions other than interest. I interpret the Simons definition of income to include all sources of

[13] For an evaluation of the economic effects of the 1986 tax reform, see Pechman, ed. (1987).

[14] Mortgage interest is deductible only on first and second homes and is limited to interest on mortgages up to the purchase price of the property plus the cost of any improvements and loans to pay educational or medical expenses.

income, without any deductions for the uses of that income. For equity reasons, I believe it is appropriate to permit a deduction for unusual expenses which reduce the taxpayer's ability to pay, but they should be kept to a minimum. The law already contains deductions for unusual medical expenses, which are defined as medical payments in excess of 7.5 percent of income (up from 5 percent under the old law), and casualty losses, which are allowable to the extent they exceed 10 percent of income. The remaining deductions for state and local taxes and charitable contributions subsidize public services provided by state and local governments and provide an incentive for private charitable giving.

The Treasury I plan in 1984 recommended the complete elimination of the state-local tax deduction and the restriction of the charitable contribution deduction to amounts in excess of two percent of income. Congress retained the deduction for charitable contributions and eliminated the deduction for state and local sales taxes, but retained the deduction for income and property taxes. I do not believe that our federal system of government depends on the deductibility of state and local taxes, as some allege, and I agree with the Treasury that charitable giving would not be impaired if the deduction were limited to amounts given above a small floor. The revenue gained from restructuring all deductions as the Treasury proposed would be large (on the order of $40 billion in 1988) and could be used to finance further reductions in marginal tax rates or to reduce the federal deficit. In addition, further pruning of the personal deductions would reduce the record-keeping needed to prepare tax returns and simplify tax compliance and administration.

I find another feature of the new tax law bizarre. This is the telescoping of the schedule of fourteen rates into two, while concealing two additional brackets. The reduction in the number of rates is a response to the flat tax proposals which were being promoted when the tax reform bill began its journey through Congress. The simplifications from a single or double rate system are negligible, but the allure of the flat rate survived the legislative process, even though it was necessary to conceal two brackets to moderate the loss of revenue.

More important, I have serious reservations about the elimination of graduation at the top of the income scale. Surely there is a difference in ability to pay out of a marginal dollar at $30,000 than at $300,000 of taxable income, yet the 1986 act makes no distinction between the rates at these levels. Moreover, the 5 percent marginal rate increase in the phase-out range is an anachronism that should not be allowed to survive. I do not recommend going back to fourteen brackets, but I certainly believe that there is room for graduation beyond four brackets, especially when one of the brackets introduces an unsightly bulge into the rate structure.

The four-bracket structure led to two additional changes that I find objectionable. The first is the elimination of the deduction for two-earner couples and the second is the elimination of the privilege of averaging. Since graduation was reduced, Congress felt that the remaining penalties on marriage and on fluctuating incomes were tolerable. These penalties were reduced, but they were not eliminated entirely. The annual marriage penalty can be as large as 13 percent and the penalty on fluctuating income can be as high as 40 percent over a period of five years. Moreover, omitting these provisions will act as a deterrent to the introduction of more graduation. Consequently, I hope that the two-earner deduction and averaging will be restored.

Another major neglected problem was the erosion of the tax base from the exclusion of employee fringe benefits. Congress has treated fringe benefits leniently because they benefit workers with moderate income, but in fact the largest per capita subsidy goes to the highest paid employees because of graduated tax rates. Moreover, loopholes for moderate income recipients are no more defensible than those for the rich. The Reagan administration proposed to limit the exclusion from the tax base for health insurance premiums paid by employers to a rather generous amount, but even this proposal was rejected by the Congress. The so-called "cafeteria plans," which give employees a choice between taking cash compensation or nontaxable benefits (for such things as medical and dental expenses, accident and health insurance, group term life insurance, and child care), were left untouched. The revenue leakage from these provisions has been growing rapidly and it is time to stop it.

Finally, the act continued the earlier practice of adjusting the personal exemptions, standard deduction, and rate bracket limits for inflation, but avoided adjusting the value of taxable assets. Economists agree that, of the two types of adjustment, the adjustment of asset values is by far the more important. Perhaps the major reason why the tax system was in such disrepute a few years ago was the discrimination against capital incomes inherent in a nominal tax system. Now that capital gains will be subject to full taxation and depreciation has been put on a more realistic basis, an inflation adjustment of the purchase price of assets to compute real gains and losses and real depreciation allowances is essential to avoid pressure to reinstate the ad hoc adjustments that did so much damage to the tax system.

The major inhibition against indexing the base is the difficulty of adjusting interest receipts and expenses for inflation. In 1984, the Treasury I report proposed an approximate plan. It assumed (incorrectly) that the inflation element in all interest payments was the same. Furthermore, the plan was defective when applied to banks and other financial institutions. The Treasury avoided calling for direct adjustments for inflation in each transaction for fear that many taxpayers would not be able to cope. I am not persuaded, however, that the problem is insuperable. Most interest payments are made by financial institutions which can easily calculate the necessary inflation adjustments. Individuals and small businesses might have a difficult problem in adjusting their interest payments, but it would be better to address these problems directly than to refrain from indexing altogether.

Completing the Task of Tax Reform

In making these criticisms, I am not suggesting that Congress should reopen the tax law for revision any time soon. Economists and the economy need time to digest the enormous changes already made in the tax structure. However, it is not too early to begin thinking about next steps in tax reform when the opportunity arises. To help this process, I offer still another of my periodic estimates of the rate changes that could be made if the tax base were moved as closely as possible to a Simons definition of income.

Imagine a comprehensive personal income tax constructed along these lines. In addition to the items now taxed, adjusted gross income would include accrued capital gains on gifts transferred at death, interest on life insurance savings, employer contributions to health and life insurance plans, interest on newly issued state and local government securities, workers' compensation, and veterans' benefits. Half of all social security retirement and disability benefits would be included in the taxable income of all taxpayers rather than only those with other incomes of $32,000 if married and $25,000 if single. Deductions for IRAs would be available only to those not covered by private pension plans. Deductions for all state and local taxes would be eliminated, and there would be floors on all the remaining deductions (10 percent for medical expenses and casualty losses and 2 percent for charitable contributions and miscellaneous expenses). The personal exemption would be raised from $1,950 to $2,000 in 1988 rather than waiting until 1989, the standard deduction would be set at

Table 2

Adjusted gross income and taxable income under the Tax Reform Act of 1986 and under a comprehensive income tax, 1988

	Billions of dollars	
Item	*Adjusted gross income*	*Taxable income*
Tax Reform Act of 1986	2,941	1,973
Plus:		
Personal exemptions[a]	—	−8
Personal deductions[b]	—	101
Transfer payments[c]	80	75
Fringe benefits[d]	129	118
Two-earner deduction[a]	−40	−40
Other[f]	6	40
Equals: Comprehensive Tax	3,171	2,259

Source: Brookings 1983 tax file projected to 1988.
[a] Exemption increased from $1,950 to $2,000.
[b] Includes flat standard deduction of $4,000; investment interest limited to net investment income; no deduction for state-local taxes; 10% floor on deductions for medical expenses and casualty losses; 2% floors on deductions for charitable contributions and miscellaneous expenses; and no standard deduction for the elderly and the blind.
[c] Includes half of social security retirement and disability benefits for all taxpayers, workers' compensation, and veterans' benefits.
[d] Includes premiums paid by employers for health and life insurance; interest on life insurance policies; and IRAs of persons covered by employer pension plans.
[e] 10 percent of earnings of spouses with lower earnings up to a maximum of $3,000.
[f] Including unrealized capital gains transferred by gift or at death, interest on newly-issued state and local securities, and all preference items now subject to the minimum tax. Eliminates the child care credit.

Table 3

Comparison of tax rates under the Tax Reform Act of 1986 and under a comprehensive income tax, 1988

Tax Reform Act of 1986[a]		*Comprehensive income tax*[b]	
Taxable income	*Rate (percent)*	*Taxable income*	*Rate (percent)*
\$0–\$29,750	15	\$0–\$5,000	6
29,750– 71,900	28	5,000–10,000	12
71,900–192,930[c]	33	10,000–20,000	17
192,930 and over	28	20,000–50,000	21
		50,000–70,000	24
		70,000 and over	26

[a] For a married couple with two dependents. Separate rate schedules apply to single persons and heads of household.
[b] Applies to all taxpayers, regardless of marital and family status.
[c] Range within which the 13-percentage point reduction in the first bracket and the personal exemptions are phased out. Top limit of the range increases or decreases by \$10,920 for each exemption.

a uniform \$4,000 for all taxpayers, and the special \$600 standard deduction for the elderly and the blind and the child care credit would be eliminated. As Table 2 shows, at 1988 income levels, this tax base would be 14 percent larger than the base under the 1986 act and thus permit further reductions in tax rates.

In designing the tax rates, I thought it was time to move away from the multiple rate structure that was developed as a compromise to moderate the impact of income splitting on heads of households and single people. It is simpler and more appropriate to use a single rate schedule and rely on the personal exemptions to differentiate tax liabilities among different types of families. To avoid a marriage penalty, the deduction for two-earner couples (10 percent of the earnings of the spouse with the lower earnings up to \$30,000) would be restored. To raise the revenue produced by the new law and to introduce somewhat more graduation, a six-bracket schedule ranging from 6 percent at the bottom to 26 percent at the top could be substituted for the current four brackets. Table 3 spells out this revised rate schedule. Needless to say, it does not contain a concealed rate.

Table 4 compares the average effective rates under this tax and the law that will apply to incomes in 1988 (when the 1986 act becomes fully effective) for various income classes. The average effective rates, which are fairly close in both cases, rise to about 24.5 percent for persons with incomes of \$1,000,000 or more, a modest degree of progression by any standard.

I recognize that few people would go as far as I would in broadening the tax base. However, I submit that the tax system just outlined would be fairer, more efficient, and much simpler than the 1986 law.

Finally, I should like to add a word about progression in the tax system. Some people have criticized the 1986 act on the grounds that it has not increased

Table 4
Effective individual income tax rates under current law and a comprehensive tax, both measured at 1988 income levels

Adjusted gross income[a]	*Percent current law*	*Comprehensive tax*
0–5,000	−1.0	−0.9
5,000–10,000	0.4	0.3
10,000–15,000	3.5	2.8
15,000–20,000	6.1	4.9
20,000–25,000	7.7	7.0
25,000–35,000	9.1	9.1
35,000–50,000	10.9	11.9
50,000–100,000	14.9	15.0
100,000–500,000	21.6	20.2
500,000–1,000,000	23.6	23.7
1,000,000 and over	24.5	24.7
Total[b]	12.0	12.0

Source: Brookings 1983 tax file projected to 1988.
[a]Under the comprehensive tax defined in tables 3 and 4.
[b]Includes negative incomes not shown separately.

progression enough, and would probably criticize the comprehensive income tax I have just described for the same reason. I agree with this criticism. However, it would have been foolhardy to try to revise the tax base and increase progression much more. I have learned the hard way that, if taxed at excessively high rates, the rich will seek out loopholes explicitly or implicitly designed for their benefit. It is a far better strategy to eliminate the loopholes first and expose the real effective tax rates applying to the top incomes. Only then does a battle over the rate of progression become possible. I cannot predict the outcome of that battle, but it is certain that more progression will not be won merely by proposing high tax rates.

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