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Treasury I and the Tax Reform Act of 1986: The Economics and Politics of Tax Reform

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During President Reagan's State of the Union Address in January 1984, he requested that Treasury Secretary Donald Regan prepare "a plan for action to simplify the entire tax code so that all taxpayers, big and small, are treated more fairly." In response, the Department of the Treasury spent ten months preparing a report to the President that has come to be called Treasury I (U.S. Department of the Treasury, 1984). This three-volume study explained the need for tax reform and the general directions such reform should take, provided a comprehensive set of proposals for reform of the income tax, and analyzed the feasibility and desirability of an American value-added tax. Following almost two years of public debate, the Tax Reform Act of 1986 (hereafter the 1986 Act) became law on October 22, 1986. Though widely hailed as the most far-reaching reform of the nation's tax system since the 1940s, if not since the introduction of the income tax in 1913, the 1986 Act falls far short of the promise of Treasury I.

It is useful to devote attention to Treasury I, even though much of it failed to survive the legislative process. First, because Treasury I represented an attempt to formulate a workable tax system that closely approximates the economist's view of an ideal income tax, it is likely to condition future deliberations on tax reform both in the United States and in other countries. Second, the conceptually coherent proposals of Treasury I provide a standard against which to measure the hodge-podge of proposals

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that became law in the 1986 Act. Finally, a discussion of the decisions underlying Treasury I should prove informative to economists and political scientists interested in the process and substance of tax reform.

Before proceeding, a brief description of the process by which Treasury I was formulated may be of interest. The White House had no involvement in preparing Treasury I. Instead, the staff economists and lawyers in the Office of Tax Policy, under the direction of the Deputy Assistant Secretary for Tax Analysis (Charles McLure, a public finance economist), prepared proposals for consideration by the Assistant Secretary for Tax Policy (Ronald Pearlman, a tax attorney). Proposals approved by Pearlman were forwarded to Treasury Secretary Donald Regan and discussed in highly confidential meetings attended by Regan, his Deputy Secretary, the Undersecretary for Monetary Affairs (Beryl Sprinkel), the Commissioner of Internal Revenue (Roscoe Egger), the assistant secretaries for Economic Policy (Manuel Johnson), Legislative Affairs, Business and Consumer Affairs, and Press Relations, as well as Pearlman and McLure. Of the nine individuals advising the Secretary at these meetings, only three were tax experts; two (Sprinkel and Johnson) were economists without particular expertise in tax matters, but the other four were neither tax experts nor economists. However, in most cases Secretary Regan did accept the advice of his two chief tax policy advisers.

Critical Decisions on Tax Reform

Literally hundreds of decisions were made during the formulation of Treasury I, and many of these affected the final contours of tax reform. The seven most critical decisions were: (1) to reform the basic structure of the income tax rather than relying on "add-on" or "back-stop" indirect measures; (2) to use income rather than consumption as the tax base; (3) to have a revenue neutral reform; (4) to have a distributionally neutral reform; (5) to strive for investment neutrality and thus eliminate opportunities for tax shelters; (6) to shift some of the burden of taxation from individuals to corporations; and (7) to implement reform quickly.

Reforming the Basic Structure of the Income Tax

The reform strategy chosen in Treasury I was a frontal attack on nearly all current law deviations of taxable income from real economic income. Efforts were made to match the timing of recognition of income and the deduction of related expenses, and to eliminate industry-specific tax preferences. Comprehensive inflation adjustment would have been applied to capital gains, interest income and expense, depreciation allowances, and the cost of goods sold from inventories. On the individual side, most tax credits and most exclusions, exemptions, and deductions not necessary for the accurate measurement of real economic income would have been eliminated or sharply curtailed, while personal exemptions and the zero-bracket amount would have been raised.

Achieving the overriding objective of taxing all real economic income consistently would reduce horizontal inequities (substantial differences in tax payments by families with equal real economic incomes), allow lower tax rates, reduce interference of the tax system in private market decision-making, reduce the importance of tax planning, simplify tax compliance, and improve both the actual and the perceived fairness of the tax system.[1]

Two alternative approaches were rejected in Treasury I. The first would have left the existing income tax more or less intact and concentrated on devising an alternative minimum tax that tracked economic income much more closely. Once the minimum tax was in place, its rates could be raised gradually, and those of the existing tax lowered, until the minimum tax superceded the existing system. But such an approach would require millions of taxpayers to calculate tax liability under two tax codes during a lengthy transition period. It was deemed to be politically unacceptable and too complex.

The second alternative was to set tougher limitations on deductions for artificial losses. Many tax preferences would be left intact under this approach, but taxpayers would be prohibited from using artificial accounting losses (resulting, for instance, from accelerated depreciation allowances coupled with interest deductions) to offset (or shelter) income from other sources. This approach was rejected both because it is more complicated than direct structural reform and because the arbitrary line-drawing it requires—distinguishing, for instance, "tax shelter" losses from "real economic" losses—is unfair and distortionary.

The 1986 Act is commonly portrayed as being similar in spirit to Treasury I, but actually the two differ in spirit and substance. Instead of fundamental reform, the 1986 Act is better characterized as using the revenues from elimination of most tax shelters, the investment tax credit, sales tax deductibility, and other politically vulnerable provisions to reduce tax rates dramatically. Reflecting political compromise that was almost totally absent in the development of Treasury I, the 1986 Act allows many sources and uses of income to remain tax-preferred. To eliminate or sharply curtail tax shelters, the 1986 Act combines the minimum tax and the limitation on artificial loss approaches, with all the complexity those approaches imply. For example, in attempting to limit artificial losses, the 1986 Act creates a new distinction between passive and active investment income and new restrictions on which types of interest expense are deductible. Distinctions like these lead to complexity, expensive compliance and enforcement procedures, and a multitude of traps for the unwary; furthermore, they generate an endless cycle of administratively cumbersome regulations, taxpayer schemes to recharacterize income and expenses, and use of mergers or "bundling" arrangements through financial intermediaries to circumvent the limitations. Finally, such distinctions distort economic decision-making; for example, some taxpayers will simply avoid many transactions that would subject them to

[1]For further elaboration on this objective and its reflection in the proposals of Treasury I, see U.S. Treasury Department (1984) and McLure (1986b). The political importance of the objective of "perceived" fairness is particularly apparent in the minimum tax provision of the 1986 Act which assesses tax on corporations on the basis of their reported book income.

these complex rules, including some of those that would otherwise make economic sense.

As a result, the 1986 Act provides little simplification, except for those removed entirely from the tax rolls or those who will no longer itemize deductions. For many taxpayers with upper-middle or high incomes or with substantial wealth, the effect of the tax system on economic decision-making will become more complicated, rather than less.

Choosing Income as the Tax Base

The most fundamental decision made in formulating Treasury I—and for many, the most disappointing—was to propose a comprehensive tax on real economic income, rather than a tax on personal consumption or consumed income. The simplicity, equity, and efficiency advantages of consumption taxes have been detailed in the literature, and various consumption-based taxes have attracted broad support in both the academic and business communities (for an excellent recent exposition, see Bradford, 1986). However, the income tax has the obvious advantage of familiarity.[2] A great deal of experience has been acquired over the years with all practical aspects of income taxation, while no industrialized country has ever implemented a personal tax on consumption.[3]

But the choice of the income tax model reflected much more than familiarity; implementation of a consumption tax is more problematic than it may seem. For example, some consumption tax advocates would exempt from tax gifts and bequests transferred between individuals until such transfers are consumed by the recipient. Others argue that a consumption tax would be acceptable only if gifts and bequests were included in the tax base of the donor or decedent (that is, treated as consumption of the transferor), and then taxed again when consumed by the recipient. Under such an approach the tax base would be the individual's lifetime endowment (see Aaron and Galper, 1985). Given the amounts of wealth held by high income families that passes from generation to generation, the treatment of gifts and bequests assumes major importance.

In this context, it is important to note that gift and estate taxes have been drastically reduced recently and that there is apparently an unwillingness to curb gift and estate tax loopholes that are now so generous that one expert has categorized gift and estate taxes as "voluntary" (see Cooper, 1979). Moreover, during the formulation of Treasury I, it was impossible to gain agreement for even extremely limited taxation of capital gains on assets transferred at death. Accordingly, if consumption had been

[2]Most of the following discussion is relevant primarily for a cash-flow tax on consumed income modeled after that outlined in *Blueprints for Basic Tax Reform* (U.S. Department of the Treasury, 1977), the approach that received most consideration by the Treasury Department. Some are equally applicable to a tax patterned after the so-called "Plan X" described in Bradford (1986), a multi-rate version of the flat tax reform proposal described in Hall and Rabushka (1983, 1985). The flat rate tax plan advocated by Hall and Rabushka would seriously violate distributional neutrality.

[3]For further discussion of the choice of an income-based tax and the role time constraints and staffing problems played in that choice, see McLure (1985, 1986b). Other determinants of that choice are discussed in U.S. Department of the Treasury (1984), Vol. 1, chapter 3.

chosen as the tax base, gifts and bequests would probably have been excluded on political grounds. At least some of those responsible for the formulation of Treasury I, agreeing with the "individual lifetime endowment" school of consumption tax advocates, thought such an outcome would be highly inequitable.

International considerations raised additional problems with moving to a consumption tax. First, bogus international transactions might be used to evade or defer indefinitely a tax on consumed income. For example, funds might be "invested" in a sham foreign subsidiary of a privately owned domestic corporation and then channeled back into the United States covertly to reappear as deductible saving. Stopping this form of abuse might require pervasive exchange controls. Second, all foreign tax treaties (since they are based on the income tax model) would have to be renegotiated, and provisions for unilateral relief of double taxation of foreign source income via the foreign tax credit would need to be revised. Such treaty negotiations could take years to complete, during which time the tax treatment of income from international investment would likely be under a cloud of uncertainty and controversy.

Also, a consumption tax might be difficult to sell to the American public. Shifting to a tax which imposes relatively greater burdens than current law during the high-debt years of relative youth and during retirement, when consumption is financed by drawing on previously accumulated assets, might be perceived as fundamentally unfair. This perception may reflect an implicit recognition that capital markets are not perfect, as assumed in most theoretical demonstrations of the superiority of consumption-based taxation.

Finally, numerous difficult transitional issues arise in moving to a consumption tax. In particular, many taxpayers nearing retirement would consider it unfair that earnings on which they had already paid tax would now be subject to a second consumption-based tax when spent.[4] It would not be simple to devise a scheme which would exempt consumption of a minimal amount of wealth accumulated from after-tax income, without exempting all consumption of existing assets.[5]

Of course, Treasury I was not a conceptually pure income tax. In particular, the tax-preferred status of pension plans was retained and opportunities to save in tax-advantaged individual retirement accounts (IRAs) were substantially increased. These provisions defer taxes on some savings, as would a tax on consumed income, without moving to a pure consumption tax. This break with income tax principles was

[4] Some consumption tax schemes have relatively low tax rates or can be shown (under certain assumptions) to increase the welfare of all future generations because they effectively impose a one-time wealth tax on current capital owners. This effect is questionable on equity grounds and, if widely recognized, would likely prompt a firestorm of political opposition.

[5] For example, the transition rules proposed by Aaron and Galper (1985) are fairly complex, as they involve a one-time establishment of basis of all assets, to be indexed by a factor related to market interest rates. These rules effectively grant consumption tax treatment immediately to existing assets, since they provide for immediate expensing (in present value terms) of all remaining basis. As a result, the Aaron-Galper transition proposal could be viewed as overly generous to owners of existing wealth; moreover, this problem would be magnified if their recommendation to deny all interest deductions on existing loans were not followed—a prospect which seems rather likely from a political perspective. For further discussion, see Zodrow (1986).

not without cost, since these preferences distort portfolio choices and create opportunities for blatant tax arbitrage—for example, borrowing with tax-deductible interest (subject to the limitations proposed in Treasury I) to invest in a tax-advantaged IRA. Moreover, critics of IRAs argue that they provide ineffective saving incentives; since much of the saving in such accounts would have occurred anyway, the subsidy is largely inframarginal.[6]

Revenue Neutrality

During his debates with Walter Mondale, President Reagan left no doubt that he would not tolerate a tax increase masquerading as tax reform. On the other hand, most Treasury Department economists agreed that tax reform should not reduce revenues, given the size of the federal budget deficit. Thus, tax reform would have to be revenue neutral. Unfortunately, it is no simple matter to predict revenues or define revenue neutrality; moreover, revenue neutrality need not imply zero impact on the budget deficit. There are at least three major problems.

"Static" Revenue Estimation. Treasury Department economists have been severely criticized for employing "static revenue estimates," instead of estimates that reflect behavioral responses of individuals, firms, and all levels of government.[7] Supply-side economists argue that revenues are understated since more rapid growth induced by lower tax rates is not considered; others believe that revenues are overstated because new tax avoidance techniques cannot be predicted. The fact is that available economic models cannot accurately estimate all of the reactions to a reform package as comprehensive as Treasury I.

Static estimates are almost certainly wrong, but they are less subject to manipulation than are "dynamic" estimates. While the economists in the Office of Tax Analysis have traditionally been quite free from effective pressure to "shade" revenue estimates up or down for political purposes, they might be less successful in resisting such pressure in a world of widespread dynamic revenue estimation, which would inevitably entail making controversial assumptions concerning the dynamic responses of the economy to tax reform.

[6] These arguments have been used to justify the limitations on IRAs for higher income taxpayers contained in the 1986 Act. Inconsistent with these limitations, however, is the new law's decision to allow contributions of up to $7,000 (down from $30,000 under current law) to so-called 401(k) deferral plans, which Treasury I would have eliminated. The continued availability of 401(k) plans will put considerable pressure on all firms to set up such plans, distort firm compensation choices, add complexity, waste legal and accounting resources, and extend the benefits of consumption tax treatment of saving to only a relatively small (and commonly wealthy) subset of the population. Such a result is incompatible with true tax reform; the treatment of saving in deferral accounts should be simple and equally available to all taxpayers.

[7] In many cases this criticism is simply incorrect; some microeconomic adjustments are considered even though macroeconomic forecasts are not changed (see Nester, 1986). It should also be noted that virtually all of the revenue estimates presented in Treasury I and quoted here generally overstate the revenue consequences of individual provisions, because they are based on existing rates before the effect of lowering rates is calculated. If the proposed rates were adopted, the revenue gain or loss from not adopting the provision in question would ordinarily be substantially less.

Appropriate Time Horizon. A reform package was defined to be revenue neutral if it produced substantially the same revenues as current law over the five-year budget period following enactment.[8] Clearly, this criterion could result in greater or smaller tax receipts than under current law in the long run. For example, the proposal by U.S. Representative Jack Kemp (R-New York) and Senator Robert Kasten (R-Wisconsin) to allow multi-year depreciation deductions equal in present value to "expensing" (immediate write-off of investment) would have been revenue neutral in the short run but would have involved large long run revenue losses due to much greater deductions for depreciation just beyond the five-year budget horizon. In the 1986 Act, a significant fraction of the increase in corporate taxes represents accounting changes that move tax revenues forward in time; this fact suggests that the increase in corporate tax revenues may be significantly less in the long run than suggested by the five-year estimates and that the tax reform adopted would not satisfy a longer run definition of revenue neutrality.

Indirect Budgetary Impacts. Treasury Department revenue estimates generally ignore indirect effects that tax reform would have on the budget deficit. These could either decrease or increase the deficit while not violating the specified standard of revenue neutrality.[9] For example, if Treasury I led to lower interest rates (as was widely predicted), it would reduce the deficit due to lower interest payments on the national debt. On the other hand, reducing some "tax expenditures" might lead to increased federal spending for the same purposes.

Distributional Neutrality

Although not mandated by President Reagan, distributional neutrality was adopted as a reasonable "first-cut" objective of tax reform to divorce the technical issues of redefining the income tax base from the controversial political issue of the proper distribution of tax burdens across income classes (U.S. Department of the Treasury, 1984, p. I:15). However, when the tax burden shifts from individuals to corporations, as in Treasury I and all subsequent reform proposals, defining distributional neutrality becomes quite complicated for at least two reasons.

First, in order to answer questions about distribution, the increase in the corporate income tax must be attributed to individuals; but, as is well known, the incidence

[8] Though Treasury I did provide a few estimates of revenue effects of tax reform when "fully phased in" (and all estimates of distributional effects were made on this basis), it is fair to say that little attention was paid to the long run revenue implications of tax reform. In the debate on Treasury I opponents of reform (and the press) focused on the 37 percent increase in corporate taxes during the five-year budget period, rather than on the much smaller 24 percent increase when all proposals were fully phased in.

[9] To the extent that the Treasury I reforms would increase the base for Social Security contributions (for example, by including certain fringe benefits in taxable income), Social Security tax revenues would be increased, unless compensating changes were made in tax rates applied to the Social Security base or in the base itself. No account was taken of these increases in revenues because, strictly speaking, modification of the Social Security base would require separate legislation; it would not result automatically from reform of the income tax base. No recommendations were made to assure such conformity because Social Security reform had recently been the subject of a major bipartisan agreement.

of the corporate income tax is very controversial. To make the question even more complex, much American capital is owned by pension funds and financial institutions on behalf of low and middle income individuals, by others in the nonprofit sector, and by foreigners. Those responsible for the Treasury Department proposals felt that they could not include in their analysis of proposals for tax reform either a long discourse on the incidence of the corporate income tax or distributional analyses based on alternative estimates of incidence. Nevertheless, it is important to note that, to the extent that the burden of corporate income taxes is more (less) progressive than the burden of individual income taxes, all proposed tax reforms would be more (less) progressive than suggested by the calculation using only individual income taxes.

Second, Treasury I and all subsequent reform packages defined distributional neutrality in the reform of the individual income tax as equal percentage reductions in tax liabilities at all income levels. A reasonable alternative is an equal percentage increase in after-tax incomes at all income levels (see Musgrave and Tun Thin, 1948). The implications of these two definitions differ substantially, as the definition of distributional neutrality adopted by the Treasury Department results in far greater tax reductions for high-income taxpayers than does adoption of the second alternative. In retrospect, it appears that the definition of distribution neutrality was chosen without full appreciation of the political importance of that decision.

Investment Neutrality and the Elimination of Tax Shelters

An evenhanded policy of neutrality toward economic decisions is likely to be a significant improvement over politically determined tax subsidies, even if some socially beneficial activities are denied preferential tax treatment. Thus preferential treatment of an investment activity was recommended in Treasury I only when dictated by compelling economic, administrative, or political arguments. The decision to design a neutral tax system had profound implications. Measures to assure economic neutrality toward investment decisions included indexed economic depreciation allowances, taxation of indexed capital gains at ordinary income tax rates, and inflation adjustment for interest income and expense.[10] Tax reform that would produce investment neutrality would also severely curtail, if not eliminate, opportunities for tax shelters. Given the popular perception of abuses associated with tax shelters, as well as the distortions of investment decisions they cause, greater neutrality was viewed as imperative. The magnitude of the horizontal inequities created by tax shelters is revealed by some simple statistics. About 11 percent of returns with total positive income (TPI, defined as the sum of positive income flows before subtraction of negative income items such as partnership losses) in excess of $250,000 (or even in excess of $1 million) paid income taxes of less than 5 percent of TPI. By comparison, 47 percent of those with incomes in excess of $250,000 paid at least 20 percent of TPI in tax, and even returns with TPI of $30,000 to $75,000 paid an average of 13 percent of TPI in tax (U.S. Department of the Treasury, 1985, pp. 717–18). Clearly, the tax

[10]These proposals would have reversed many of the changes made just five years earlier in the 1981 Economic Recovery Tax Act.

code offers some high income individuals a chance to avoid tax liability. Treasury I would have rectified this situation by taxing all real economic income uniformly and consistently. Whereas 27 percent of those with incomes between $100,000 and $200,000 and 49 percent of those with incomes in excess of $200,000 would have experienced decreases in taxes of at least 2 percent of economic income, about 15 percent of households in these income classes would have experienced tax increases of this magnitude (Department of Treasury, 1984, p. I:54).

Several prominent arguments for preferential treatment of investment deserve comment. Some argue that preferential tax treatment of equipment purchases is appropriate because most technological improvement is embodied in equipment and such technology creates external benefits. Even if these propositions were agreed to be valid, the appropriate tax treatment would be an incentive limited to investments especially likely to show such external benefits. The existing research and development tax credit was retained with modifications in both Treasury I and the 1986 Act partly on these grounds.

Others note that the combination of the investment tax credit and the accelerated cost recovery system of current law is a surrogate for expensing, which they assert is the appropriate way to treat depreciable assets for tax purposes. The problem with this view is that expensing generally makes sense only in a full-fledged consumption tax system; if grafted onto an income tax system in which interest expense is deductible, expensing results in low or negative marginal effective tax rates, misallocation of resources, inequity, and complexity. Once the tax on consumed income was rejected, it made no sense to consider expensing, and even accelerated depreciation was inconsistent with the principle of taxing real economic income.

Some observers view the acceleration of depreciation allowances as an ad hoc surrogate for explicit indexation of depreciation allowances. But a given pattern of accelerated depreciation makes sense only for a particular rate of inflation; at any other inflation rate depreciation allowances are either too generous or not generous enough. Treasury I reflected the judgement that the risks and costs of instability in the rate of inflation justify the introduction of an explicit system of indexation for depreciation allowances. Accordingly, Treasury I proposed to eliminate the investment tax credit, base depreciation allowances for tax purposes on the best available estimates of economic depreciation, and index those depreciation allowances for inflation.

The decision to tax all real economic income generated by depreciable assets did not extend to owner-occupied housing. The decision to maintain preferential treatment of housing provides an interesting example of how a seemingly simple political decision can have far-reaching economic implications. On February 18, 1981, President Ronald Reagan said: "The taxing power of government must be used to provide revenues for legitimate government purposes. It must not be used to regulate the economy or bring about social change."[11] Yet on May 10, 1984, in response to

[11] President Ronald Reagan, to a joint session of Congress on the program for economic recovery, February 18, 1981.

pressure from the National Association of Realtors, President Reagan promised not to eliminate the deduction for home mortgage interest. This promise guaranteed that the so-called "playing field" would not be level. While lower tax rates make all deductions less important, the distortion in favor of owner-occupied housing actually would have been accentuated by the subsequent decision that interest indexing could not be applied to interest on home mortgages.[12]

The sanctity of the home mortgage interest deduction posed a difficult question for tax reform. Given that the mortgage interest deduction could not be curtailed and that income from owner-occupied housing could not be taxed, did it make sense to subject all other real economic income from capital to full taxation? The importance of such second-best considerations is indicated by calculations suggesting that the President's Proposals (1985), a watered-down version of Treasury I that did not go nearly as far in taxing real economic income, may have generated greater welfare gains than Treasury I (see, for example, the estimate in Fullerton, 1987). It was decided that these considerations did not overwhelm the case for a "nearly pure" comprehensive income tax. But critics who question the desirability of fully taxing non-housing capital while subsidizing capital investment in owner-occupied housing raise a valid and troublesome point.

Unfortunately, the 1986 Act may have accentuated the already overly favorable tax treatment of owner-occupied housing. Home mortgage debt will become relatively more attractive since interest on such debt (within certain limits) remains fully deductible, while consumer interest becomes non-deductible and deductions for interest incurred to finance most investments not yielding current income will be curtailed. Of course, these restrictions on consumer interest deductions will encourage individuals to finance consumption purchases with home equity loans and favor individuals who can substitute "business" borrowing for "consumption" borrowing.[13]

Moreover, the 1986 Act accentuates the favorable treatment of owner-occupied housing because of changes in capital gains taxation. While capital gains on virtually all assets will be taxed as ordinary income, those on owner-occupied housing will continue to qualify for extended rollover as long as the proceeds from a sale of one home are reinvested in another, and gains on sales of such homes by taxpayers over 55

[12]Treasury I proposed that part of nominal interest expense would be nondeductible, but an exception was made for home mortgage interest, which would have remained fully deductible. The failure to index interest on home mortgages would have created substantial incentives for tax arbitrage, in the form of borrowing via unindexed mortgage debt for investment in indexed debt. For further discussion of the impact of the sanctity of the home mortgage deduction on the possibility of achieving the goals of tax reform, including a level playing field, see McLure (1986a).

[13]Initially, it appeared that residents of states that prohibit home equity loans would be disadvantaged by this treatment. However, a last minute provision inserted in the 1986 Act by Texas Senator Lloyd Bentsen creates yet another type of fully deductible debt to be known as a "non-enforceable second mortgage." For tax purposes this new type of loan is similar to a home equity loan in that the 1986 Act allows home owners to borrow an amount equal to the purchase price of their home plus the cost of improvements less outstanding mortgages; however, it is a home mortgage loan in name only—and in its characteristic of full deductibility—since it cannot be secured by the residence. Such measures illustrate the arbitrary and complex treatment of interest under the 1986 Act.

years of age will continue to be largely tax-exempt. If inflation should again enter the double-digit range, the strong incentives that existed during the 1970s for excessive investment in owner-occupied housing will emerge again.

Shifting the Tax Burden from Individuals to Corporations

One of the hallmarks of Treasury I and its successors, including the 1986 Act, is a substantial shift of tax liabilities from individuals to corporations. The shift in Treasury I reflected several considerations.

A decision had already been made on neutrality grounds to eliminate or sharply curtail most tax preferences, including those of benefit primarily to the corporate sector, whether they benefited mainly single industries (defense contractors, insurance companies, banks and other financial institutions, the oil and gas industry, timber companies, etc.) or the entire corporate sector (the investment tax credit and the Accelerated Cost Recovery System). Eliminating these tax breaks without a shift from individual to corporate taxes could have produced a tax system with a lower corporate rate (28 rather than 33 percent), and higher individual rates (16, 28, and 37 percent rather than 15, 25, and 35 percent). This outcome was thought to be unacceptable for three reasons.

First, the gap between the corporate rate and the top individual rate had to be kept small to limit incentives for using the corporate form to avoid tax. A nine percentage point difference between corporate and individual rates was thought to be unacceptable. Second, a political judgement was made that a net tax reduction for individuals was necessary to create many more individual "winners" than "losers." Otherwise, since the losses would be more concentrated than the gains, the outcry from losers might have swamped any positive reactions from winners and tax reform would have been politically impossible. This strategy almost backfired when the increase in corporate taxes generated a firestorm of opposition.

Finally, aesthetics played at least a minor role in the choice of tax rates, and therefore in the shift of tax liabilities from individuals to corporations. Recalling the effectiveness of "10-5-3" as a rallying call during the 1981 quest for accelerated depreciation, it was felt that rates of 15, 25, and 35 percent had more aesthetic and political appeal than 16, 28, 37—which one wag likened to signals called by a quarterback in a football game.

Reform Should Be Implemented Quickly

The existing tax system creates vested interests that stand to lose enormous amounts if the system is changed suddenly. More generally, any tax reform is likely to result in marked changes in the value of various assets. For instance, the repeal of the investment tax credit can be expected to benefit owners of old equipment, but to harm producers and purchasers of new equipment. Similarly, lowering tax rates confers windfall gains on owners of both physical and human capital, but for owners of capital specific to industries that lose tax preferences these may be offset by windfall losses.

If adequate provisions are not made for a fair and orderly transition to the post-reform tax system, political opposition to reform is likely to be formidable, and perhaps overwhelming. Transition provisions focus on ameliorating the reductions in wealth that accompany an unexpected change in the tax structure through measures such as grandfathering, phasing-in, and delaying the enactment of reform.[14] Such provisions should balance the benefits of reducing such losses against the costs of delaying the gains in efficiency, equity and simplicity which result from implementing reform (see Feldstein, 1976; Zodrow, 1981, 1985).

The Treasury I proposals attempted a fair and orderly transition, but generally erred in the direction of implementing reform too rapidly. There were two primary reasons for proposing a quick transition, in addition to the desire to capture the gains from reform quickly and the fear that postponements would provide time for opponents of reform to repeal various provisions. First, in some cases where special tax preferences were highly visible and had frequently been discussed as potential targets for reform, markets had presumably already adjusted to the possibility that these provisions would be repealed so that transitional relief was unnecessary. Second, a "tough" initial stance was deemed appropriate to provide a strong bargaining position for the negotiating which would surely follow the introduction of Treasury I.

In retrospect, the transition proposed in Treasury I may have been too rapid from a political point of view, since it resulted in unnecessary controversy by focusing attention on the speed of implementation rather than the need for reform. For example, the proposed introduction of interest indexing was delayed for only two years. The rationale was that the interest rate reduction induced by enactment of Treasury I would result in the refinancing of most large existing loans and that investors in existing debt-financed business assets would receive an offsetting benefit from the taxation of the asset's income at a lower rate. The business community found this rationale to be inadequate and protested fiercely; in response, a modified ten-year phase-in transition rule was quickly announced.

However, the 1986 Act, in many respects, provides for an even more rapid transition than proposed in Treasury I. For example, the investment tax credit is repealed retroactively to January 1, 1986 (Treasury I called for only prospective repeal) and the deduction for state and local sales taxes is repealed immediately (rather than phased in over two years as was repeal of all state and local tax deductibility under Treasury I). Moreover, the four-year phase-in period for the new limits on the deduction of passive investment losses strikes some as being inappropriately short.

Major Proposals of Treasury I and How They Fared

This section discusses important individual provisions of Treasury I and how they were changed and amended in producing the Tax Reform Act of 1986. The discussion

[14]Concern is hardly ever shown for tax-induced increases in wealth; the windfall recapture tax recommended in the President's Tax Proposals (1985) was a notable exception.

is separated into those topics dealing primarily with the measurement of business and capital income and those provisions affecting individuals.

Business and Capital Income Provisions

The Treasury I proposals for the taxation of income from business and capital were an integrated and largely consistent attempt, based on the principles outlined above, to make the tax base resemble real economic income. Since the tax breaks that are the building blocks of tax shelters (acceleration of deductions and postponement of recognition of income, partial exclusion of long-term capital gains, and full deduction of nominal interest expense) would have been sharply curtailed, a minimum tax would have been unnecessary. Unfortunately, the 1986 Act did not follow this integrated and consistent approach.

Depreciable Assets. For the reasons described earlier, the Treasury I proposals focused on taxing real economic income. In contrast, the 1986 Act provides for accelerated depreciation allowances not indexed for inflation. Such treatment will result in distortions due to differential taxation of assets and industries, problems that will worsen if inflation increases or varies dramatically.[15]

The 1986 Act also lengthens depreciation lives and requires straight line depreciation for real estate. Moreover, the Act will eliminate capital gains treatment and limit interest deductions for real estate (although not as severely as for other passive income), reducing these offsets to relatively slow depreciation allowances. The net result will be to change commercial real estate (including rental housing) from a tax-advantaged to a tax-disadvantaged asset. This will imply a long period of economic transition for the real estate industry, which is already suffering from overbuilding (probably produced in part by anticipation that favorable treatment under the 1981 bill would be temporary).

Other Issues of Time Value. Depreciation is only the most widely discussed case of the general problem of accounting for expenditures incurred in one year that give rise to income over several subsequent years. Examples include the costs of developing oil and gas wells, mines, timber, vineyards, and so on. The common tax policy question is the appropriate time pattern for allowing such expenditures to be deducted. Current tax law allows immediate expensing of many of these expenditures. Treasury I proposed to bring tax accounting more nearly into line with economic reality—and with generally accepted accounting principles, which require that many such costs be capitalized and amortized over the life of the resulting asset.

The 1986 Act took a similar approach in that it requires that many expenses of this type be capitalized, including costs of production for additions to inventories. But the most notorious of all, intangible drilling costs in the oil and gas industry, will continue to be expensed if incurred by independent drillers. (Integrated producers must amortize 30 percent of intangible drilling costs over a five-year period, compared

[15] For further elaboration of this argument and estimates of marginal effective tax rates for several inflation rates, see U.S. Department of the Treasury (1984, Vol. 2, chapter 8).

to 20 percent over three years under current law.) This tax subsidy is generally agreed to be a poor response to the "national security" problem of assuring an adequate energy supply; its continuation reflects a compromise with members of Congress from the "oil patch."

The other side of the coin is the question of when to recognize income that is earned through a process that lasts several years. The most apparent example of such "multi-period production" involves the income reporting of defense contractors, but the same problem arises for any construction activity extending over several years and for sales made on an installment basis. Under the completed contract method of accounting, taxpayers can defer tax on income from such contracts until they are completed. Although Treasury I did not eliminate the completed contract method, the 1986 Act will significantly curtail its benefits by requiring that taxpayers use the percentage completion method, under which income is recognized as the project proceeds, to calculate at least 40 percent of income from such contracts. These "timing" issues account for at least half of the $120 billion five-year net increase in revenues from corporations.

Capital Gains. Under pre-1987 law, 60 percent of long-term capital gains (gains on assets held for more than six months) are excluded from tax. Efforts to take advantage of this exclusion by recharacterizing ordinary income as long-term capital gain—and the corresponding attempts of the Internal Revenue Service to thwart such efforts—account for a substantial portion of the complexity of the U.S. tax system.

The two primary justifications commonly given for the exclusion are that it is an ad hoc adjustment for inflation and that it provides an incentive for entrepreneurship and risk taking. Treasury I dealt explicitly with the first problem by indexing the basis of capital assets, to eliminate the taxation of fictitious inflationary capital gains. The increase in complexity due to indexing would have been offset by the benefits of an improved measure of economic income and the elimination of incentives to recharacterize ordinary income as capital gains.

The effect of capital gains taxation on risk taking is a more complex issue. The arguments of Domar and Musgrave (1944) and the subsequent literature have made it clear that a proportional income tax with full loss offsets is likely to encourage risk taking. Since loss offsets are far from complete and the tax system is progressive, the net effect is not clear, either under the old law or the new. Although it was recognized that raising the capital gains rate might have an adverse effect on risk taking, those responsible for Treasury I decided that the known benefits of simplification and lower tax rates justified taking that risk.

However, Treasury I did not attempt to tax capital gains on an accrual basis rather than when recognized, as is required under a pure income tax. Taxation only upon realization creates inequities and encourages taxpayers to hold existing assets, rather than realize gains and reinvest proceeds in assets paying higher yields; these tendencies are aggravated by the failure to tax gains on assets transferred at death. (No tax is collected on such gains and the basis of the asset is "stepped up" to the value at death.) During the formulation of Treasury I several ways of dealing with

those problems, including constructive (deemed) realization at death, were considered and rejected.[16]

In light of the outcry prompted by the Treasury I proposal to index capital gains against inflation and tax them at a maximum rate of 35 percent, the agreement under the 1986 Act to tax gains at a 33 percent maximum rate without indexing for inflation is quite amazing. From an economic standpoint, the failure to index against inflation can be justified only as an ad hoc method of offsetting the advantage of deferral of tax payments until a capital gain is realized. But this approach means that the effective tax rate paid on real capital gains will continue to depend on the rate of inflation. Full taxation of nominal gains, combined with the more stringent provisions for treatment of losses, implies that there will be major inequities and distortions in the pattern of investment, and that risk taking will be reduced. It would not be surprising—particularly if inflation accelerates—to see reintroduction of a capital gains exclusion.

In addition, the failure to adopt constructive realization of capital gains at death renders questionable the taxation of gains on gifts of appreciated property given to charity under both Treasury I and the alternative minimum tax in the 1986 Act. It is justifiable on income measurement grounds not to allow a deduction if the associated income is never realized, and such a rule reduces the benefits of overvaluing donated property to evade taxes. But since gains are taxed when donated to charity during an individual's lifetime, but not when passed on to heirs at death, there will be incentives to delay or avoid charitable contributions.

Interest Income and Expense. The ad hoc adjustments for inflation provided by accelerated depreciation allowances and the partial exclusion of long term capital gains are quite imperfect, but at least they exist. In contrast, the inflationary component of nominal interest income receives no such adjustment; similarly, the entire amount of nominal interest expense is allowed as a deduction, with no adjustment for inflation. The result is substantial inequity and misallocation of resources. Tax shelters become especially attractive in times of high inflation, since borrowers can deduct the full amount of nominal interest expense and then benefit from accelerated deductions for depreciation (and similar expenses of multi-year production) and the partial exclusion of capital gains.

Treasury I proposed that both interest income and expense should be adjusted for inflation. This combination would sharply reduce the inequities, distortions, and opportunities for tax shelters that exist in current law. Moreover, since capital gains were to be indexed, indexation of interest was critical to remove the opportunity for arbitrage.

However, Treasury I did not follow the conceptually correct approach of excluding from income or disallowing deduction of an amount of interest equal to the

[16]Accrual taxation of only securities listed on major exchanges—using "mark-to-market" techniques—would create an undesirable bias against investment in such securities, relative to investment in assets where accrual-based taxation is not administratively feasible. It should be noted that existing mark-to-market rules (in futures markets) are designed primarily to limit abuses rather than to meet the requirements for a consistent measure of annual economic income.

product of the inflation rate and the outstanding principal of debt. This procedure was viewed as inordinately cumbersome from an administrative standpoint, since in principle it would involve applying an inflation adjustment factor to the principal (calculated on the annualized basis) of every credit arrangement in the economy; compliance would have been difficult except on loans involving financial institutions or other sophisticated borrowers or lenders. In practice it would likely have resulted in "indexed" and "unindexed" classes of loans which would have been somewhat arbitrary, difficult to monitor, and subject to abuse.

Instead, Treasury I proposed to disallow a fraction of all interest expense (and exclude the same fraction of interest income) equal to the rate of inflation divided by the sum of that rate plus 6 percent. This partial exclusion approach is only a rough approximation to accurate indexing of interest, and was chosen for simplicity.[17] The formula's use of 6 percent—a rate that is high relative to historical real interest rates —was chosen to err on the side of a smaller than appropriate disallowance of interest deductions (although this decision also implied a relatively small interest income exclusion).

The proposal for interest indexing was strongly opposed by those in the real estate and tax shelter industries. Moreover, the short transition period stirred opposition from firms with large outstanding indebtedness, especially public utilities. A surprising but frequently cited objection to interest indexing and all the other Treasury I inflation indexing proposals was that indexing creates uncertainty in the nominal amount of deductions available. The final blow to interest indexing was its cost. Because Treasury Department economists estimated that the inflation adjustment of interest income and expense would cost roughly $43 billion over the five-year period 1986–90, interest indexing was quite vulnerable.[18] It did not survive the initial process of political compromise leading to the President's Proposals (1985) and was not reinstated in the 1986 Act.

Dividend Relief. Income from equity investment in the corporate sector is taxed twice, once when earned by the corporation, and again when distributed to shareholders. This "double taxation of dividends" creates a well-known set of inequities and distortions in resource allocation and the financial decisions of corporations (see

[17]The Treasury I proposal would clearly be inappropriate for financial institutions, which would benefit from partial exclusion of the spread in interest rates on funds borrowed and then loaned, even though the effects of inflation cancel in such a transaction. (The gain from the reduction in the real value of the principal amount borrowed is exactly offset by the loss from the reduction in the real value of the principal amount loaned.) This point was made abundantly clear by the fact that financial institutions did not oppose Treasury I despite various other proposals eliminating tax treatment benefitting them. Nevertheless, the imperfect partial exclusion approach, especially if modified so that only the equity investments of financial institutions (amounts loaned or invested net of amounts deposited in the institution) were indexed, would have been an improvement over current law which implicitly assumes that no inflation exists.

[18]U.S. Department of the Treasury (1984, p. I:247). In actuality, this revenue loss would occur entirely in fiscal years 1988–90, because implementation of interest indexing was not to occur until 1988. During both 1989 and 1990 revenue loss was estimated to be roughly $18 billion to $19 billion per year. This revenue loss may have been more than offset by savings on the cost of servicing the national debt.

McLure, 1979). To ameliorate these effects, Treasury I proposed a 50 percent corporate deduction for dividends paid.[19]

Dividend relief is enormously expensive; the proposal would reduce annual revenues by $31 billion in fiscal 1990, and still not be fully phased in. Moreover, much of this revenue loss would represent windfall gains to present owners of corporate shares; it would be an extremely inefficient way of achieving the benefits of increased equity finance or improved resource allocation associated with *de novo* enactment of an integrated corporate-personal income tax.

Those responsible for Treasury I seriously considered the possibility of allowing dividend relief only for newly issued shares, but rejected the idea, in part because of feared complexity and the potential for abuse through using nonprofit conduits to convert old shares that would not benefit from the deduction to new ones that would benefit.[20] Little attention was devoted to the possibility of fully integrating the corporate and personal income taxes, a conceptually correct approach that is generally agreed to be administratively infeasible for large publicly held corporations (see McLure, 1979, Chapter 5).

On a related topic, the authors of Treasury I recognized that many large limited partnerships resemble corporations, even to the point that shares are traded on major stock exchanges. Accordingly, it was proposed that such entities be subject to the corporation income tax, rather than being allowed the "conduit" treatment accorded partnerships under current law. Under "conduit" treatment, partnership income and losses are attributed directly to the partners, thereby avoiding the corporate tax on income while getting immediate deductions for losses. Such an approach would have severely restricted the use of the partnership form in tax shelter schemes.

The 1986 Act alters dramatically the incentives involved in choosing between corporate and non-corporate forms of business organization. Most obviously, tax shelter partnerships will be discouraged. But for other purposes, non-corporate forms of business organization may come to dominate corporate forms. The 1986 Act provides no relief from double taxation of dividends. Under current law most income retained by corporations is taxed at a 46 percent rate, whereas that earned by a partnership is taxed to individuals at rates as high as 50 percent. Under the new law these rates are changed to 34 percent and 28 or 33 percent, respectively. This shift in relative rates may lead to disincorporation in some cases, but this response will be limited by another 1986 reform (the repeal of the General Utilities doctrine) which provides for corporate taxation of gains on assets distributed to shareholders in

[19]A 100 percent deduction was avoided partly to reduce the revenue loss and partly to keep the rules simpler—since preference income would be presumed to be paid out last under rules governing the order of payout of dividends, these rules would come into play infrequently under a 50 percent deduction, but would affect many corporations under a 100 percent deduction. For further discussion of the difficulties caused by tax preferences, see McLure (1979, Chapter 4).

[20]A high tax on non-dividend distributions would forestall simply reorganizing to convert old shares to new. However, large nonprofit institutions could buy a controlling interest in a corporation, pay out all retained profits as untaxed dividends, and then reorganize.

liquidation. However, new business ventures may use such forms as master limited partnerships to take advantage of conduit treatment and lower individual rates. The long run economic consequences of this change in organizational form are not obvious.

Tax Exempt Bonds. One of the few major deviations of Treasury I from the principles of uniform taxation of real economic income was in the area of state and local bond interest. Repeal of the exemption of interest on state and local bonds issued for "governmental" or "public" purposes was not recommended, despite the strong economic case for doing so; the rational was that the exemption appeared "to be an accepted part of the fiscal landscape" (U.S. Department of the Treasury, 1984, p. I:135). But Treasury I recommended that the exclusion be repealed for "non-governmental" or "private purpose" bonds, defined as those where more than one percent of the proceeds were used directly or indirectly by any person other than a state or local government. The 1986 Act follows this general approach, but is more liberal in its threshold test of private purpose; moreover, a long list of exemptions are provided, for example, for tax-exempt organizations, rental housing, mass commuting facilities, airports, local utilities, water plants, and sewage and water treatment facilities.

The Treasury I decision to eliminate the exclusion for "private purpose" bonds was probably a mistake. Subsidized debt issued to support many activities which generate little or no external benefit (such as industrial development bonds and home mortgage subsidy bonds) would justifiably have been eliminated. However, some "private purpose" bonds are related to services characterized by substantial "publicness" that render them similar to services financed with general obligation bonds.[21] Though one might quarrel with a few of the choices of activities that will continue to benefit from the exclusion under the 1986 Act, it appears that in most cases the Congressional decision to continue the exclusion for private purpose bonds is not unreasonable—given the reluctance to eliminate the exclusion for general obligation bonds.

Provisions Affecting Individuals

Treasury I would have made substantial changes in the tax treatment of individuals by repealing or eliminating many exclusions, exemptions, deductions, and credits. The following discussion focuses on three base-broadening issues: fringe benefits, especially employer-provided health insurance, state and local taxes, and charitable contributions. It concludes with comments on the "hump-backed" rate structure of the 1986 Act.

Fringe Benefits. Many types of compensation are currently untaxed, with the largest category being employer-provided health insurance and group life insurance. As a result, there are substantial horizontal inequities between those who are paid in

[21]A convincing case can be made for the continuation of a federal subsidy only for activities generating substantial national benefit spillovers. But if the subsidy is to be continued for general obligation bonds, it seems sensible to judge the availability of the subsidy for "private purpose" bonds by the same standard as that used for general obligation bonds.

taxable and tax-exempt forms, and consumer choices are distorted in favor of goods and services that can be provided as untaxed fringe benefits.[22] Also, the exclusion of employer-provided fringes has regressive distributional consequences, since the value of the exclusion increases with the marginal tax bracket of the taxpayer. Treasury I proposed to eliminate the preferential treatment of many fringe benefits and curtail others. The net increase in annual revenues from these proposals would have been $24 billion in 1990.

The most important proposal was to tax health benefits in excess of $175 per month for a family ($70 for an individual). This approach was a compromise between the objective of taxing all income uniformly and consistently and the objection that doing so in the case of health insurance would lead to less reliance on employer-provided health benefits and to greater pressure for government-funded health insurance.

One of the most glaring deficiencies of the 1986 Act is that it makes no attempt to tax fringe benefits more fully. Particularly unfortunate is the refusal to curtail the tax advantages of so-called "cafeteria plans" which allow employees a choice between taxable cash and a wide variety of non-taxable fringe benefits. This decision is likely to lead to rapidly increasing erosion of the income tax (and Social Security tax) base as more and more forms of compensation are accorded tax exemption.

State and Local Taxes. The itemized deduction for state and local taxes reduces the effective price individuals who itemize pay for services provided by state and local governments; as a result, it acts a federal subsidy for the activities of those governments. If such services do not provide significant national spillovers, the subsidy provided through the itemized deduction for these taxes is likely to induce excessive allocation of resources to the state and local public sectors. Even if such national benefit spillovers exist, the itemized deduction is a peculiar means of compensating for them; the subsidy depends on the marginal tax rate of individuals, is nonexistent in the case of taxpayers who do not itemize deductions, and does not differentiate between activities deemed to have significant national externalities and purely "local" public goods (or even private ones provided by state and local governments).

Treasury I proposed that the deduction be eliminated on the grounds that most state and local expenditures do not have strong national benefit spillovers and those that do should be subsidized with direct Federal outlays. No distinction was made between types of taxes, because to do so would interject the federal government into the fiscal decisions of state and local governments and have capricious effects across states. The predicted increase in annual revenue by 1990 was $39 billion.

The 1986 Act repeals the deduction for state and local sales taxes, while leaving fully intact those for income and property taxes. This is a mistake, for the reasons given above. It would have been preferable to eliminate a given fraction of the itemized deduction (or provide a partial tax credit) for all state and local taxes.

[22] Recent arguments that such horizontal inequities are unimportant because taxpayers are free to choose among jobs with or without generous fringe benefit packages (see Feldstein, 1976) are of questionable relevance since they rest on the assumption that all individuals have the same tastes, abilities, and access to fringe benefits.

Charitable Contributions. The itemized deduction for charitable contributions is commonly justified as a reflection of the external benefits associated with the activities of nonprofit organizations receiving the donations; it allows an element of personal control over altruistic activities absent in governmental programs with similar objectives. Treasury I proposed continuation of the deduction, in one of the few cases in which use of the tax system to encourage a particular economic activity was recommended. A conceptually more attractive approach would be to convert the deduction into a tax credit; this was rejected because of the desire to eliminate all credits (except that for foreign taxes) in order to remove at least this part of the camel's nose of tax subsidies from the tent of tax reform.

However, Treasury I would have limited the deduction in three ways, reflecting a compromise between the objectives of fairness and lower rates and the encouragement of nonprofit organizations. The deduction would not have been available to non-itemizers, itemizers would have been allowed to deduct only contributions in excess of two percent of adjusted gross income, and deductions for appreciated property would have been limited to the inflation-adjusted basis (usually the cost) of the asset. Only the repeal of the deduction for non-itemizers (and taxation of gifts of appreciated property under the individual alternative minimum tax) survived in the 1986 Act. Aside from the problems with taxing gifts of appreciated property mentioned above, such treatment does not seem to be an inappropriate resolution of a difficult tax policy problem with no obvious solution.

The Individual Rate Structure. The marginal tax rate structure of the 1986 Act—rates of 15, 28, 33 and 28 percent, with the 33 percent rate due to phasing out of the benefits of the 15 percent rate and personal exemptions for high income taxpayers—is extremely peculiar.[23] It began as a cosmetic ploy designed to make the package salable as a "two-rate" structure with a so-called "maximum" rate of 28 percent. This illusory maximum marginal rate seems to have been particularly important (and particularly deceiving) in the debate regarding raising the maximum tax rate on capital gains from its existing level of 20 percent; many apparently believed that the decision to tax capital gains as ordinary income—and perhaps tax reform itself—would unravel if this rate rose much above 28 percent. The equity implications of a lower marginal tax rate at the very highest income levels are troubling, especially since individuals in the income class of $100,000 and above receive larger percentage individual income tax cuts than taxpayers in the upper middle income classes.[24]

[23] Though the theory of optimal taxation suggests that a regressive rate structure may be appropriate at the top of the income distribution, it seems doubtful that this line of reasoning provided any part of the rationale for the decision. Even if such results had been considered, it is not clear that a regressive marginal rate structure would be implied for the U.S. income tax.

[24] Particularly anomalous is the fact that the regressive pattern of marginal rates produces an incentive for upper-middle income taxpayers to bunch into "28 percent years" capital gains and other income over which they can exercise discretion in timing, rather than allowing such income to be spread more evenly and taxed at the 33 percent rate.

Concluding Remarks

The Tax Reform Act of 1986 has been characterized as a political miracle; in this view, it is amazing that Congress decided to pay attention to the general interest in tax neutrality and equity, rather than (for the most part) to the representatives of special interests. But it is also amazing that a better reform package could not be passed. Congress clearly wanted to eliminate the specter of wealthy individuals and profitable corporations paying little or no tax, yet it was unwilling to eliminate some forms of preferential treatment (such as depreciation allowances more rapid than economic depreciation) or to provide explicit indexing for interest income and expense. As a result, it was forced to adopt "backstop" provisions such as the beefed-up alternative minimum tax and the limitations on deductions for so-called passive losses and various types of interest expense—features that will add considerable complexity to the tax law. If, as some have said, the 1986 Act was an opportunity that occurs only once in each generation, it is hard to know whether to rejoice that the glass of tax reform is half full or bemoan the fact that it remains half empty.

For an economist it is troublesome to see how little influence economic arguments exerted once Treasury I went to the White House and considerations of politics and cosmetics became dominant.[25] On the other hand, it is gratifying that economists were influential within the Treasury Department, especially in making the case for consistent application of income tax principles that set the terms for the ensuing debate.

The Treasury I decision to follow the income tax pattern is the decision that will be debated the longest. It may be that it is simply too difficult to implement a reasonably consistent tax on annual real economic income. Certainly, more research needs to be devoted to the hard issues involved in the choice between income and consumption as bases for personal taxation, including transition issues, the consequences of alternative ways of treating gifts and bequests, and international issues.[26] But if Treasury I showed conclusively just how complex a relatively pure income tax can be, the Tax Reform Act of 1986 makes strikingly clear that a tax that is less pure is sure to be even more complicated.

[25] Unfortunately, economic arguments sometimes affected the tax reform process in a negative way. A few weeks after the release of the Treasury I proposals, several macroeconomic forecasting firms issued forecasts warning of the undesirable economic effects of tax reform. However, macroeconomic models generally cannot adequately capture the economic benefits of tax reform, especially because such models do not distinguish between investments of differing marginal productivity or consumption of differing marginal benefits to consumers. Although also subject to limitations, general equilibrium models of the types constructed by Shoven, Whalley, Fullerton, Henderson and others that capture the benefits of improvements in resource allocation are much better suited to the task of evaluating tax reform (see Shoven and Whalley, 1984, and the references cited there). Nevertheless, because macroeconomic forecasting models are more familiar and more quickly available, they were far more influential in the early debates following the release of Treasury I.

[26] For a survey of these issues which compares alternative approaches to progressive consumption taxation, see Zodrow (1986).

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