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Murray L. Weidenbaum
Washington University in St Louis

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by Murray L. Weidenbaum, Director
Center for the Study of American Business
Washington University in St. Louis

Testimony prepared for the Senate Finance Committee
Washington, D.C., January 30, 1986

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CSAB WASHINGTON UNIVERSITY BOX 1208 ST. LOUIS, MISSOURI 63130

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My position here today is a clear case of role reversal. In analyzing Treasury I, Treasury II and the House tax bill, I find the government taking too academic a position and this professor urging more attention to reality. Specifically, when I rank the most serious problems facing our country right now, tax reform doesn't even make the list.

We can all readily agree that the current tax structure is full of well-known shortcomings. But, by and large, producers, consumers, and investors have adjusted to those shortcomings. Debating tax reform has introduced considerable uncertainty over the treatment of saving and investment. This uncertainty has a chilling effect on investment planning. Far more important than tax reform is dealing with the budget deficit, the trade deficit, and the pervasive debt problems -- rural and urban, foreign and domestic.

Back in the classroom, it is challenging and useful to identify a more equitable and efficient tax structure for the long run. We can hope that such analyses will help to improve tax policy over the years. But in the context of today's pressing concerns, focusing on tax reform is not only irrelevant; it is

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Note: Dr. Weidenbaum is Mallinckrodt Distinguished University Professor and Director of the Center for the Study of American Business at Washington University in St. Louis. The views he expresses are strictly personal.

counterproductive. Debating tax reform now shifts attention away from the hard but compelling challenge of controlling federal spending.

Each of the recent versions of tax reform, including the House bill, would dampen saving and investment and, thus, economic growth -- just as the economy is slowing down. A smaller GNP means less revenue into the Treasury. It also means more federal spending for unemployment compensation, food stamps, and welfare. All of this adds up to bigger budget deficits.

The House bill would make it more difficult for American firms to compete, even as international competition is becoming more fierce. The numerous blows to saving, investment and R&D would slow down the modernization of American plants.

Corporate taxes would be raised by about $140 billion over the next four years, further straining our ability to compete. Many of the companies hardest hit by imports -- those in capital-intensive heavy industry -- would have their tax burdens increased most substantially. This is an unusual switch from the old proposition that you don't kick a man when he's down.

The proposed changes in bank taxation would come at a time when those institutions are wrestling with the difficult debt problems of the private sector. For example, deductions for bad-debt reserves are eliminated, except for relatively small banks. Finally, the claim of tax simplification violates any truth-in-labeling law.

Here is some support for these statements:

I. **The claim that the House bill is revenue neutral does not hold up.** Projections of future federal revenues are based on overly optimistic estimates of economic growth. For example, the assumed 4 percent growth rate in 1986 compares with the prevailing private-sector forecast of 3 percent. In a $4 trillion economy, a 1 percent difference implies a substantially smaller tax base and lower revenue collections.

II. **That shortfall in revenue is compounded by the proposed shift of the tax burden from consumption to investment.** Many provisions of the House tax bill would discourage saving and investment:

1. The dividend exclusion is eliminated.

2. The top capital gains rate for individuals is raised from 20 percent to 22 percent.

3. The cap on annual contributions to 401K contractual employee retirement plans is reduced from $30,000 to $7,000 -- and the employee in effect is also prevented from making an IRA contribution.

4. The incremental R & D credit is reduced from 25 percent to 20 percent and extended for only three years -- when analyses show that the temporary nature of the credit reduces its effectiveness.

My colleagues Laurence Meyer, Joel Prakken and Chris Varvares have estimated that, by 1991, the House tax bill would result in a level of GNP 2.3 percentage points lower than under present law and unemployment 1.1 percentage points higher.

In the process, we see a political perpetual motion machine at work. That is, the institution of the investment tax credit and of liberalized depreciation were originally hailed as tax reform. Reversing policy on these investment incentives is now justified as tax reform.

III. **The claim of tax simplification is a bad joke.** The proposed distinctions between different categories of individual taxpayers and also between different categories of corporate taxpayers surely make it likely that tax returns will be more complicated in the future.

Whatever its other merits, requiring expanded use of accrual accounting cannot be viewed as simplification, not by anyone who has been exposed to at least a semester of undergraduate accounting. Of course, this is only forced upon certain businesses, not others -- a further complication. And the host of transition rules, albeit an inevitable accompaniment to a package of far-reaching tax changes, make for further complexity.

IV. **The claim of fairness is overblown.** I fail to see the equity in eliminating income averaging. Why should people with fluctuating incomes pay more taxes than people with stable incomes? Why should the capital gains tax on timber sales depend on whether your business is incorporated? Why is the tax exemption of the college professors retirement fund rescinded, but not those of unions, companies, and fraternal organizations? Why does the effort to toughen the tax treatment of three-martini lunches and lavish entertainment also expand to the most modest non-alcoholic business breakfast meeting? Why should corporations who want to establish and expand markets overseas be forced to pay an additional tax on their overseas earnings? Why should tax credits for political contributions be deleted -- except for Congressional elections?

V. **The label of tax reform is misleading.** The driving force in the House bill -- as in Treasury I and Treasury II -- is another round of income tax rate reductions. Given the goal of revenue neutrality, this means identifying the most politically vulnerable provisions of the Internal Revenue Code so that they can be changed to yield offsetting revenues.

True tax reform would move in the opposite direction. It would start with the desired changes in the tax structure, and then adjust the rate tables -- in whichever direction is necessary -- to maintain revenue neutrality.

What Should Congress Do Now?

Tax reform and deficit reduction are both important and desirable objectives. The choice in 1986 is a matter of putting first things first. As the most elementary analysis of national priorities shows, that means elevating budgetary control to the top of Congress' policy agenda. That is not a task for just the budget and appropriations committees. Virtually every committee of the Congress has jurisdiction over federal spending programs. That certainly is true of the Senate Finance Committee, with its broad jurisdiction in the key area of entitlements.

I suggest that Congress think in terms of a two-track approach. While the budget-cutting drive is accelerating, more moderately paced tax reform studies should be getting under way. Specifically, committee and Treasury staffs should undertake a careful review of the structure of the Internal Revenue Code. Drawing on the good work that they have done in the last several years in identifying special tax provisions, they should now evaluate each of them by weighing the cost (in terms of revenue foregone) and benefits (in terms of public policy objectives achieved).

Where the studies reveal that the revenue loss exceeds the funds going into the end activity -- such as in many shelters that finance housing -- the conclusion would be clear: change or even eliminate the provision. But, in other cases, where the benefits (say, in terms of more capital investment and hence enhanced international competitiveness) are greater than the revenue loss, the provision would be continued.

These tax choices would be based primarily on effectiveness rather than ideology. To state categorically that all "tax expenditures" are undesirable is foolish. Some may be a more effective and less expensive substitute for direct federal spending.

The time-consuming and comprehensive tax review I am proposing should take place while Congress and the President concentrate on the many difficult problems involved in cutting expenditures. In that manner, they can get on the path that leads to achieving the deficit reduction targets in Gramm-Rudman-Hollings prior to making basic changes in the tax system.

The result would be an effective one-two punch strategy -- instead of two wild and unsatisfactory swings that seem to be in store for us under the current procedure. The first punch at the nation's economic problems would be spending cuts and deficit reduction. That would set up the economy for the second punch -- tax reform. To state the matter a little differently, it is up to the Senate to put the horse of spending control before the cart of tax reform.