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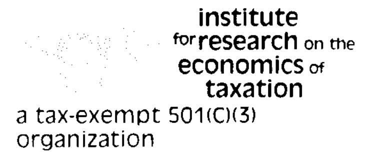

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THE ECONOMIC FALLOUT OF THE TAX REFORM ACT OF 1986[1]

Introduction

The Tax Reform Act of 1986 (TRA-86) has been touted as the most far reaching and important income tax legislation since the income tax was added to the federal government's revenue arsenal more than seven decades ago. This characterization may be a tad hyperbolic, but there can be little doubt that in terms of its reach, the number of provisions in the Internal Revenue Code that are changed, the magnitude of the changes in tax burdens, the number of individuals and corporations directly affected, and so on, the TRA-86 is surely among the very biggest tax events in our nation's fiscal history. It is more than passing strange, therefore, that so little of policy makers' attention was focused on how the major provisions of the legislation and how the Act taken as a whole would affect the composition and magnitude of economic activity in the United States. One must wonder about a policy-making process that leads to questions about the effects of the tax changes on, say, the competitive position of U.S. businesses in world markets, the composition and amount of capital formation, or the growth rate of the Nation's total output and income, only after the tax changes have become law.

In all fairness, it must be acknowledged that a detailed, definitive enumeration of the economic consequences of the TRA-86 very likely lies beyond the present capacity of quantitative economic analysis. One reason for this is that the TRA-86 is so large, so varied, and so complex a set of changes in the tax law as to defy easy conclusions about what specifically and precisely it will do to the U.S. economy, other things being equal. Another reason is that in an economy as large, as diverse, and as dynamic as that of the United States, other things are never equal. The problems of delineating the interaction of this enormous set of tax changes with this ever-changing and enormous economy are so severe that conclusions about the economic consequences of tax reform must be surrounded with substantial qualifications.

It is well, moreover, to remember that although taxes, indeed all public policies, influence the economy's performance, they do not uniquely or ultimately determine that

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.

performance. The U.S. economy is not a marionette dangling at the end of government policy strings, predictably reacting to each tug and twist. Changes in the tax structure alter the price signals confronting household and business decision makers and influence their decisions. So do a very large number of other factors, many of which originate in the private sector, not in public policy. To focus only on tax policy, or on any other public policy, in assessing economic developments is to run a substantial risk of overlooking other very important and diverse influences on economic outcomes.

One might have thought, nevertheless, that the initial legislative effort surely should have been to delineate the economic effects to be sought and those to be avoided. With a consensus about goals, the process should then have turned to determination of the changes in the tax law believed to be needed to achieve these goals. In fact, as it must be widely recognized, the process was driven by an initial decision about some specified tax changes, principally rate reductions, constrained by the dicta of revenue neutrality and no new revenue sources, followed by efforts to rationalize these changes in terms of the announced policy objectives of simplicity, equity, and economic neutrality, the substantive content of which was never spelled out.

Our concerns about the fallout from the TRA-86 might have been muted had these goals, given operational meaning, been attained. As a tax policy goal, simplification should not be construed principally, if at all, as relieving several million taxpayers of the need for filing a tax return and of income tax liability. Nor is it meaningfully sought by inducing millions of additional taxpayers to claim the standard deduction -- a deduction for expenses they *don't* incur. Still less is this goal served by having the Internal Revenue Service prepare your tax return for you, reserving for you the right to prove that you've been assessed with too much tax. Simplification, as a tax policy goal, surely should seek to make income tax concepts and rules easily understood and readily agreed to, at least by most taxpayers. These concepts and rules should minimize uncertainty about the tax treatment and tax consequences of most of the day-to-day economic behavior of household and business participants. If *this* sort of simplification had been perceived to be the goal of tax reform and had been effectively pursued by that reform, costs of compliance and of administration would have been reduced, with obvious economic benefit to the Nation. The relevant measure of tax simplification is the extent to which it results in shrinking the Internal Revenue Service. In no relevant respect has the simplification goal been achieved by the TRA-86. On the contrary, the tax law has been made substantially more complex.

Equity is certainly the most elusive goal of tax reform. The conventional articulation of this objective -- equal tax treatment of equally situated persons -- is vaporous, finessing the problem of determining those attributes of individuals, their economic status and behavior the similarities of which are relevant for measuring equality or inequality of their taxpaying capacity. The goal of tax equity surely is not meaningfully sought by assertions that corporations must pay their "fair share" or that the fairness standards -- hazy and flimsy at best -- applied to individual taxpayers are equally applicable to corporations. It is difficult to discern in the TRA-86 anything that represents a significant equity advance. There are, on the contrary, numerous changes in the Act that make the income tax more unfair.

Economic neutrality as a tax reform goal is certainly much more precisely and meaningfully specified than either simplicity or equity, but its attainment is not less difficult. In summary terms, neutrality means that the tax system and its various provisions do not distort the relative prices and costs that would prevail in a no-tax

world. Perfect tax neutrality is not attainable; every tax has an excise effect, raising the relative cost or price of something or other compared to what it would be in the absence of the tax. But tax policy should seek to minimize these excise effects. Doing so, of course, requires first identifying the relative price effects of the tax or of specific tax provisions; you're not likely to hit a target you don't see. No such effort was apparent as the TRA-86 went from drawing board to final enactment. Failure to formulate a meaningful neutrality goal to guide the reform process resulted in tax changes that exacerbate rather than moderate many of the most damaging excise effects of the income tax.

A tax reform act that can lay no claim to achieving greater simplicity or fairness or contributing to greater neutrality, hence to greater economic efficiency, leaves us with our concern about economic effects undiminished. Let's examine these under two headings, effects on the growth of the economy as a whole and effects on the composition of economic activity.

Effects on Economic Growth

The TRA-86 has received highly mixed reviews for its impact on the economy's growth. Some observers believe that the substantial reduction in individual income tax liabilities, estimated at $122 billion over the five fiscal years 1987-1991, will fuel a substantial increase in consumption outlays, sufficient to overcome, and then some, any decline in capital outlays, in the short run or over a more extended period of time. Others believe the rate reductions, particularly in the individual income tax, will spur major increases in saving and investment, in the supply of labor, and in innovative entrepreneurial activity; these results, if they materialize, surely would mean higher levels of economic activity, and at least for a while, more rapid rates of increase in total output and income. Still others regard the changes in the tax base as major steps toward leveling out the economic playing field. In this view, the greater efficiency in the use of production capability will more than offset any reduction in the aggregate amount of capital resulting from these base changes. The net effect, it is believed by those holding this view, will be a somewhat higher growth path for the economy. Finally, there is a strongly held view that the repeal of the investment tax credit, along with the stretch-out of cost recovery periods and numerous other changes in the tax base, will so slow growth in industrial capacity as to erode the total economy's growth performance and lower its growth path.

The Consumption Spree View

The least tenable view about the economic growth consequences of the TRA-86 is that it will generate a significant increase in consumption outlays that will sustain, if not accelerate, the economy's momentum. This is, in fact, a trivial notion, resting on a highly naive view of how the economy works.

The view is the familiar one that the substantial reduction in individual income tax liabilities will provide households with more disposable income, a large share of the increase in which will go into additional consumption spending. Of course, the mere fact of a tax reduction for households does not, in and of itself, increase the economy's total output and income. Unless the public sector's take out of that initially unchanged total output is also reduced, the output available for private consumption can be increased initially only at the expense of reduced capital formation and/or a smaller trade surplus (or greater trade deficit). If consumption is to grow without

offsetting reductions in other components of GNP, total output, hence income, must first increase. But this will result from the tax changes only if they induce an increase in the amount of production inputs people are willing to supply at prevailing supply prices. One must look to the incentive effects of the TRA-86, not to its effects on households' disposable incomes, to determine whether a consumption outlay increase is likely to result.

Even if one chooses to disregard the TRA-86's incentive effects and insists on disposable income effects, one confronts the allegation that the tax reform legislation is "revenue neutral". The reductions in individual tax liabilities are offset by increases in corporate income tax liabilities and excises. Unless one believes in a fiscal fantasy land in which corporate tax liabilities are paid out of nobody's pocket, the TRA-86 involves no disposable income effect for households, again accepting the revenue estimates. It is a truism that corporations don't pay taxes; only real, live human beings do. Who pays how much of corporate tax liabilities need not detain us; real people pay them, and if they are increased by essentially the same amount as individual tax liabilities are cut, the result, so far as real persons' disposable incomes is concerned, is a wash.

One should not look to a consumption boom, induced by the TRA-86, to sustain, let alone expand, economic growth.

The Incentive Effects of Rate Cuts

A more realistic view of the growth consequences of the TRA-86 focuses on the beneficial incentive effects of its rate reductions. Reducing the level of individual tax rates reduces the differentially higher cost that an income tax imposes on saving compared with consumption and on the use of one's time, energies, and talents in jobs with taxable rewards compared with "leisure" uses. Graduation of statutory rates is equivalent to imposing increasing excises on saving, investment, and productive effort on all activities that increase one's income productivity. Reducing graduation, therefore, moderates this adverse excise effect. The corporate income tax is usefully identified as a differential excise on saving committed to equity capital used by corporate businesses, adding to the basic income tax bias against saving and capital formation and distorting the allocation of production resources between incorporated and unincorporated enterprises. Reducing corporate tax rates contributes to better resource allocation and moderates the adverse excise effects of income taxation.

On these scores, the rate reductions are major improvements in the income tax structure. Taken by themselves, if that were indeed the case, they would surely lead to larger supplies and employment of labor and capital services, to more innovation, risk taking and entrepreneurial activity, to a higher growth path of total output and income, and, in the near term, to a higher rate of economic growth than would otherwise prevail.

The rate cuts, unhappily, cannot be taken by themselves. Their beneficial effects are offset to an extent that has not yet been appropriately estimated by changes in the individual and corporate income tax bases. For the most part, these changes in the tax base, impelled by the perceived need to offset the revenue loss from the rate reductions, have severely adverse incentive effects regarding saving, investment, and risk-taking. Taken by themselves, the repeal of the investment tax credit and of the net-long term capital gains deduction, the expansion of the reach and the stiffening of

the alternative minimum tax, the new severe limits imposed on Individual Retirement Arrangements and on so-called 401(k) plans, and the unprecedented and outrageous limitations on the deductibility of so-called passive investment losses, among many other provisions, must increase the relative costs of saving and of investment and of risky ventures.

It is extremely difficult to generalize about the weight of the effects of the rate cuts as opposed to those of the base changes on the level and pace of advance of economic activity. Both sets of effects will vary from household to household and business to business, depending on a large number of circumstances that differ widely among the household and business populations. For example, companies that have peaked, at least temporarily, in their capital expansion programs are likely to benefit more from the rate reductions than they suffer from the ITC repeal, or in some cases from the new Alternative Minimum Tax. On the other hand, businesses that are highly capital intensive and are expanding production facilities rapidly are likely to find their effective tax rates significantly increased, not merely by virtue of the ITC repeal but also because the Alternative Minimum Tax will accelerate their tax liabilities, hence increase their present value, with respect to the income produced by their new capital facilities.

Changes in tax liabilities in a short -- e.g., five-year -- time frame are highly unreliable as a measure of changes in the burden of the tax. Notwithstanding this reservation, it is drearily instructive to note that the gross revenue gains attributable to changes in the tax base that increase the tax burden on saving, capital formation, and production costs in industry after industry amount to an astonishing $360 billion plus in the five years, 1987-1991.[2] The adverse relative price effects associated with these revenue gains are not readily deduced, but it is virtually certain that they involve substantial increases in real, as opposed to statutory, marginal tax rates, hence increases in the relative costs of the affected activities. Whether these rate increases are offset by the statutory rate reductions is difficult to estimate. For this reason, it is difficult to estimate the extent to which they are likely to be offset by the rate reductions.

A sobering thought is that the net $120 billion increase in corporate tax liabilities is virtually certain to reduce corporate saving by at least that amount. Most observers would agree that it is highly unlikely that household saving will increase by at least an equal amount. The likely reduction in private sector saving will show up in a reduction in total capital formation, unless a compensatory increase in net capital inflow from the rest of the world occurs. Let's not count on it.

The Level Playing Field

Administration spokesmen, joined by some members of Congress and staff, sought to counter the concern about the anti-capital formation complexion of the TRA-86 by asserting that the new law would place differing kinds of investments and their returns on a more nearly equal tax basis than prior law. This, it was claimed, would reduce tax intrusions in decisions about the composition of investment. The resulting more nearly market-determined composition of capital would be so much more efficient than

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[2] This is measured on a static revenue basis, before taking account of the revenue losses from rate reductions.

otherwise as to overcome any reduction in the amount of capital that might occur, relative to the amounts under prior law.

There is much to be said in favor of seeking a more nearly neutral tax system, even if one consequence of doing so is a somewhat smaller stock of capital than would otherwise be accumulated. Regrettably, the TRA-86 moves away from, rather than closer to, tax neutrality. With respect to saving and investment, neutrality requires that the present value of capital recovery allowances must be just equal to the amount of the saving or capital outlay. The simplest way of assuring satisfaction of that neutrality requirement is to provide for expensing of the saving or capital outlay for tax purposes, but the requirement can obviously be met by extended period writeoffs as well, so long as the aggregate amount of writeoffs is not limited to the amount of the outlay.

Such treatment of saving and investment would assure both first-level neutrality -- that between saving-investment, on the one hand, and consumption on the other -- and second-level neutrality -- that among different forms of saving and investment. Administration policy makers rejected first-level neutrality out of hand, justifying doing so on the peculiar notion that such neutrality was incompatible with income as opposed to so-called consumption taxation. Even so, second-level neutrality might have been attained by capital-recovery provisions affording allowances the present values of which were the same per dollar of capital outlays for all kinds of capital. Instead of this, however, the Treasury proposed a new capital recovery system that systematically imposed higher effective tax rates the longer the recovery period of the property. Congress followed suit, finding in repeal of the investment tax credit and the stretching out of recovery periods the major devices for raising the revenues needed to offset the losses from tax rate reductions, personal exemption increases, and the standard deduction giveaway. To be sure, the rate reductions for individuals combined with those for corporations significantly moderated the distorting effects of the changes in the capital recovery provisions. Nonetheless, the net effect was to create a greater dispersion in effective tax rates on the income produced by different kinds of capital.

By taking a giant step away from expensing of depreciable property, the TRA-86 augments the income tax bias against investment in durable capital, and it enhances rather than diminishes the differentials in effective tax rates among differing types of such capital. This adverse differential excise effect is moderated significantly by rate reductions, but its thrust is blunted, not removed. The playing field has not been leveled so much as it has been pock marked.

It is difficult to determine whether the overall effect of the TRA-86 will be to accelerate or to retard total capital formation. One should not look to the TRA-86 to provide efficiency gains in the composition of capital as effective offsets to any retardation that may occur.

The TRA-86, aka The Deindustrialization Act of 1986

Understandably, spokesmen for the industrial sectors of the economy perceive the overall thrust of the TRA-86 as a severe depressant of industrial capital formation, hence strongly anti-economic growth. One may certainly take issue with them regarding the net effect of the TRA-86 on the cost of capital confronting industrial businesses. They are on much more solid ground in identifying the growth in the economy as a whole as depending largely on the growth in the industrial sector.

It has been noted frequently in the past decade and longer that the share of GNP originating in manufacturing has remained remarkably constant despite the steady decline of manufacturing employment relative to the aggregate. This necessarily means that labor productivity has grown more rapidly in manufacturing than in other sectors, and, unless one believes in magic or that the laws of production have been repealed, this must mean that other inputs in manufacturing have increased more rapidly relative to labor inputs than elsewhere. Those other inputs have included capital. If the TRA-86 increases the cost of capital in manufacturing and other industrial activities compared with capital costs in other kinds of economic activity, capital will shift from industrial to other uses. The growth in capital relative to labor in the industrial sectors will slow. This suggests both less industrial output and, because of a narrower gap between productivity gains in industrial business and in other business, still less labor in the industrial sector and more in the nonindustrial parts of the economy. Simple arithmetic urges that shifting resources from more to less productive uses must result in a lower growth path for the economy.

The Allocational Effects of the TRA-86

However uncertain may be the effects of the TRA-86 on the economy's growth, there can be little doubt that it will have a substantial effect on the composition of economic activity. The TRA-86 provisions will fall with differing weights on various groups in the household and business populations. It is hard to believe that these groups will all react in the same ways to these differing tax impacts.

Changes in the cost of capital will differ among broad types of capital and within each such category, depending on numerous other tax attributes of the taxpayer. For this reason, changes in the composition of capital formation and in the companies undertaking the investment should be expected. On the whole, it seems likely that additions to the stocks of capital in the industrial sectors will slow compared with the pace in other sectors of the economy. The deindustrialization forecast may well be the right one, although the rate of this change may be quite slow. This may be accompanied by a relocation of industrial expansion by U.S. firms from domestic to foreign sites, a reversal of the shift that seems to have occurred in response to the Economic Recovery Tax Act of 1981.

A collateral allocational effect that may fall out of the TRA-86 is a shift from production for export to production for the domestic market. Much of our exports are the products of capital-intensive businesses. Insofar as the net effect of the TRA-86 is to raise the relative cost of capital to such businesses, the resulting shrinkage in profit margins in the face of world market prices over which U.S. producers have little influence is likely to induce them to shift the market focus and to reduce the aggregate amount of their operations.

The effects of this erosion of U.S. businesses' competitiveness in the world market on the U.S. trade balance is by no means certain. Many factors influence the volume and value of both our imports and exports. The response of the industrial sectors to the increase in the relative cost of capital in industrial uses may exert a substantial downward drag on the economy; the resulting slowdown of economic expansion would certainly tend to depress imports, perhaps to a greater extent than the growth in exports would decrease because of higher production costs. Moreover, if the adverse effects on the cost of capital of the TRA-86's base broadeners are perceived by

foreigners as exceeding the beneficial effects of the tax rate reductions, the volume of net capital inflows may well shrink, exerting additional downward pressure on the dollar exchange rate. This development would tend to inhibit imports and bolster U.S. exports.

Even were these developments to improve the trade balance, however, it would be the outcome of a weakening of the U.S. economy. An erosion of the growth of productivity and of advance in living standards surely must be seen as too high a price to pay for shrinking the trade deficit.

Significant changes should also be anticipated with respect to the composition of household saving and investment. The repeal of the net long-term capital gains deduction increases the marginal rate of individual income tax on such gains, from a top of 20 percent to 28 percent. It places assets the return to which is largely in the form of appreciation much more nearly on the same plane as assets with higher current yields, if indeed it does not make them less attractive, given their relatively greater riskiness. In view of the fact that much of the reward for undertaking a new enterprise takes the form of increase in the value of the equity in the enterprise, this tax change clearly is at odds with the claim that the 1986 TRA will give new life to risk-taking, innovative entrepreneurial activity. For the same reason, venture capitalists are likely to confront a smaller market than in the pre-TRA-86 years.

The lower level of tax rates erodes the advantage of the tax-exemption of municipal bonds, and will give them a lower priority in household and business portfolios. This will exert upward pressure on their yields relative to those of taxable bonds. The Alternative Minimum Tax will further reduce the attractiveness of private purpose municipals. Commercial banks are likely to take only minimal amounts of new issues of municipals, if they take any at all, leaving a very thin market in which municipalities can obtain capital financing. State and local governments will find it necessary to rely more than in the past on tax revenues to finance capital projects; even those states whose income taxes are modeled after the federal government's and which obtain a tax windfall from the TRA-86's base broadeners will find themselves less and less in the bond market and more and more digging into their constituent's pockets for additional tax revenues. The passive loss deduction limit will tend to dry up interest in real estate development. All of those changes are also likely to impact corporate financing.

Conclusions

No simple generalization about the economic fallout of the TRA-86 is feasible. One can identify the direction of effect of this, that, or another provision or set of provisions, but in view of the very large number of such provisions and the fact that they act in conjunction with many other provisions, the net outcome is highly ambiguous. This is true for many companies, industries, and sectors of the economy, as well as for the economy as a whole. Nor is this ambiguity surprising in view of the lack of a coherent, well-conceived and implemented tax revision strategy focused on attaining specified economic results.

One thing can be definitely asserted about the TRA-86. What saves it from being an economic catastrophe are its rate reductions. Without them, the base changes would so increase the tax burdens on growth-generating activity that it would take tremendous stimuli from other economic developments to avert a major lowering of the Nation's economic growth path. By the same token, any extension of 1987's so-called blended

rates would impose a serious threat to the economy. So, too, would an income tax surcharge. The developing budget situation for fiscal 1988 is generating mounting pressures in the Congress for one or another or some combination of these tax increases. Any of them would impose burdens on the economy far greater than the increase in tax liabilities might suggest.

Income tax rate increases, no matter the form they might take, would certainly be a breach of faith by Congressional policy makers. Public support for the TRA-86 was based on the conviction that the sharply reduced tax rates it provides were real and would at least offset the punishing effects of the base broadeners. Preventing those rate cuts from taking effect would make the TRA-86 a public policy sting.

Just as bad, reneging on the TRA-86's rate cuts might open the legislative door to swift escalation of marginal tax rates. Congressional policy makers may not yet appreciate the increase in the revenue potential from even quite small tax rate increases that is provided by the base-broadening provisions of the Act. Once they do, it is difficult to identify any effective constraints on their efforts to shrink the budget deficits by a succession of seemingly modest tax rate hikes, while increasing government spending.

Also damaging to the economy, although through different sets of responses, would be any of the various increases in selective excises and oil import fees that have been proposed.

Policy makers must be persuaded that budget balancing requires expenditure reduction, not tax increases. They must also be dissuaded from snatching defeat from the jaws of victory by cancelling the one true tax reform in the TRA-86 --- the reduction in tax rates.

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President