IRET Institute For Research On The Economics Of Taxation

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

Norman Ture sent a copy of "ACRS, ITC, And Tax Neutrality" (Norman B. Ture and Carlos E. Bonilla, *IRET Economic Report*, No. 25, January 4, 1985, available at http://iret.org/pub/REPT-25.PDF) to Ronald A. Pearlman. Pearlman was then Acting Assistant Treasury Secretary (Tax Policy).

Secretary Pearlman wrote back with comments. Norman Ture quickly responded to Secretary Pearlman's thoughts. Ture's letter follows on the next page.

Tax Notes published both letters several days later (*Tax Notes*, March 4, 1985, pp. 864-865).

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Letter from Norman B. Ture to Ronald A. Pearlman

Dear Ron:

It was good to get your letter of February 6, 1985, commenting on IRET's Economic Report "ACRS, ITC and Tax Neutrality." Your reaffirmation of the Treasury Department's receptivity of thoughtful analysis of tax issues was heartening; I regret that we had not had the opportunity during the period in which your office was developing the Treasury's tax reform proposals to exchange views about the critical issues of tax policy addressed in our Economic Report and in the RCRS proposal. I do hope that continuing discussion of those issues is not foreclosed, and with this hope, I'd like to discuss some of the points you raise in your letter.

To begin with, I do, indeed, believe that tax reform should seek tax neutrality across types of saving and capital. I do not believe that the proposed RCRS serves that goal; in fact, against the concept of tax neutrality which I believe to be correct, RCRS moves away from the neutrality objective.

The concept of tax neutrality upon which I rely is quite precise: a tax system is neutral if it does not change relative prices compared to those which would prevail in the absence of taxes. Against this definition (which I believe is widely agreed to though often not explicitly stated), an income tax is biased against saving and capital formation in the aggregate and in favor of consumption; this is the first-level anti-saving bias. It is also likely to be biased against some uses of saving -- some kinds of capital -- compared with others; this is the second-level bias. There is nothing pejorative in this designation of first- and second-level bias; the first-level bias, referring to that against saving in the aggregate, obviously is more severe than the second- level.

The income tax is also biased against effort generating taxable rewards compared with that producing nontaxable returns. The income tax bias against work is severe; it is also highly resistant to correction in the framework of an income tax. For the most part, the best that can be done is to limit the second-level bias against productivity-advancing activities by imposing the tax at a flat rate at the lowest possible level. We have dealt at length with the labor- leisure choice issues in Mike Schuyler's Consumption Taxes: Promises and Problems, which I commend to you as one of the best and most readable books on the subject of consumption taxes. You will find in it, incidentally, a rigorous proof that a consumed income tax does not require a higher marginal rate than a broad-based income tax for any given revenue level; it does not, therefore,

distort the work- leisure choice more than the income tax (see pp. 14-16 in the enclosed copy). In terms of overall neutrality, a consumed income tax is unequivocally superior to a broad-based income tax.

Our Economic Report focuses on the particular subject of the contribution of ACRS and ITC to more nearly neutral tax treatment of the saving-consumption choice. In this context, we show that the goal of tax neutrality across types of saving and capital means that the tax does not alter the relative prices of the various assets into which saving is directed. Achieving this highly desirable policy objective with respect to depreciable property requires true expensing or its equivalent, i.e., if extended over time, capital recovery deductions the present value of which equals the price of the asset. ACRS and ITC, as enacted in ERTA, represented a major advance with respect to this second-level neutrality objective; TEFRA was a significant retreat therefrom. Although our Economic Report did not treat the Treasury's RCRS proposal, it must be clear that RCRS violates the standard of neutrality across types of capital. Tables 4 through 7 presented in volume 2 of the Treasury's Report show that the present values of the RCRS deductions decrease sharply with the recovery period; RCRS, therefore, results in differentially heavier income tax burdens on longer, compared with shorter, recovery period property.

I do agree, Ron, that complete expensing would result in a reduction in business income tax revenues at the onset and so long as the stock of business property eligible for expensing continues to grow. These revenue considerations are perceived, obviously, as an important barrier to the kind of tax reform which the neutrality criterion calls for. But as we've pointed out, expensing is not the only way to pursue the tax neutrality goal; extended-period capital recovery can be designed to meet the neutrality criterion by assuring that the present value of the deductions equals the price of the asset. Congressman Kemp and Senator Kasten, as you know, have adopted this treatment in the current version of their FAST bill, as a means of increasing the revenues their bill would provide. I hope the Treasury will give serious consideration to this approach as an alternative to the highly saving-and-capital-punitive and distorting RCRS proposal.

One final comment is called for. The Treasury proposes indexing of the basis of depreciable assets as an alternative to the ACRS-ITC capital recovery provision's mitigation of the adverse effects of inflation. To be sure, ACRS and liberalized ITC provisions were thought to reduce the erosion of real capital recovery by inflation, but this was not the primary purpose to be served by these provisions. You are certainly correct in pointing out that the present system is not inflation proof. To address that problem does not call for repeal of ACRS-ITC but for the addition of indexing to this system.

I hope we'll have additional opportunities for discussion of the important features of the Treasury proposal, many of which are highly constructive.

Cordially,
Norman B. Ture