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TAX REFORM, TAX REVENUE, AND THE DEFICIT

Walter W. Heller*

Prologue

Need someone to help crack a hard nut on inflation economics? Call Otto. Need someone to provide aid and comfort in writing on "what's right with economics" (when the far more popular indoor sport is to write on "what's wrong with economics)? Call Otto. Need some astute insight into what's going on in the economy and where it's going from here? Call Otto -- or listen to him at a **Time** Board of Economists meeting. Need a colleague on the Council of Economic Advisers who can run with the ball in the White House economic policy orbit, one who combines logical reasoning, true savvy on policy matters and rapid-fire, yet lucid, writing? By all means, call Otto. Need an old hand at the inflation game to contribute a key analysis of disinflation for a Center for National Policy Monograph? Call Otto. Need an unfailing source of sunshine in a "science" that, at times, does get pretty dismal (at least, for economists)? Call Otto.

Otto himself and Otto's economics had so many sparkling facets that one could not hope to have experienced all of them. Where his path and mine intersected and joined most often was, not surprisingly, on the macroeconomic policy front. Especially on fiscal policy -- on budget and tax matters -- on stagflation, on incomes policy, and on monetary policy, he was so often not just an enlightening economic analyst but a comrade-in-arms in political economy, doing battle for sensible activist policy.

Oh, how he would have been "in there pitching" this year on tax reform, tax revenue, deficit reduction, on balanced and responsible fiscal-monetary policy -- at Congressional hearings, in DRI publications, at **Time** Board of Economists meetings, and in myriad other forums. And in the process of plugging hard for what he believed in, he would not -- never did, so far as I know -- lose friends or alienate people. He was one of those people of whom it is said that he made a friend every time he went around the block -- and never lost any along the way.

At a time when the U.S. economy is riding high, yet, in the absence of courageous and responsible fiscal policy, is riding for a fall, the loss of Otto Eckstein's sharp mind, effective voice and pen, and persuasive personality is irreparable. Were he still among us he would surely address the issues of the monstrous federal deficit and long overdue tax reform, first hand.¹ So it seems appropriate to dedicate this tract for the times to Otto Eckstein's memory.

As we move into the second half of the eighties on a wave of economic optimism generated by sustained cyclical expansion and moderating inflation, the fiscal storm clouds are gathering. An unprecedented structural deficit -- one that is rising to 5% of

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¹For an analogous inquiry, see my earlier monograph, **Tax Policy: New Directions and Possibilities**, Center for National Policy (Washington, D.C., November 1984).

GNP in a prospering economy -- has turned from a welcome stimulus to recovery into an increasingly malignant threat to our future economic health. Coupled with the imperative of major action to trim the budget and increase taxes to meet the deficit crisis is a rising clamor for tax reform to avert a crisis of confidence in our present income tax structure.

In this article, I review the major contenders in the tax reform battle -- the comprehensive income tax, a modified flat income tax, the expenditure or consumed-income or cash-flow tax, and the VAT or national sales tax. As a result of the combined support of the Treasury and White House and the Bradley-Gephardt and Kemp-Kasten bills in Congress, the modified flat income tax now occupies center stage in the tax reform drama. But over the longer pull, the proponents of the comprehensive income tax and of consumer taxes, like the expenditure tax or the VAT, will also be heard from. In a basic sense, all four approaches to tax reform also have to be viewed as means of bearing the burden of deficit-cutting. Never has there been such combined pressure for deficit-cutting and tax reform.

Yet, quite apart from political pledges of "no, no, a thousand times no" on tax increases, tax reform may be an inappropriate vehicle for achieving the early tax increases needed to help narrow the deficit gap to manageable proportions. Full-fledged tax reform involves such deep-rooted values, such an exhaustive job of rebuilding the income tax or building a new tax, such intense political pressures from groups whose sacred cows are to be slaughtered that reform will probably take a back seat to revenue in 1985. At least temporarily, then, the needed revenues will have to be derived from sources largely outside the major battlegrounds of tax reform. Yet it will be important to raise those revenues in ways that facilitate or at least do not impede reform. So the thrust of this article is not just to review the major contenders for tax reform but to face the immediate revenue problem.

The Deficit: Rhetoric versus Reality

With the presidential election safely behind us, it is high time to put error and ideology aside and face economic fact and logic. That means, in other words, recognizing that (1) we can't "grow our way out" of the deficit; (2) we can't rely on state-local surpluses to "solve" much of the federal deficit problem; (3) we can't indulge ourselves in the fantasy that deficits don't affect interest rates; (4) we can't afford to downplay the damage deficits do and act as if little has to be done about them; (5) we can't bring the deficit under control without major tax increases; (6) we can't go on substituting pieties about a balanced-budget amendment for the hard, grinding reality of the budget cuts and tax boosts required to bring the deficit under control; and (7) we can't dawdle on deficits while joining battle on tax reform.

First, "growing our way out" is not a credible option. Even though there is much presidential talk of economic growth as the most promising way of overcoming budget deficits, the president's budget for fiscal 1986 hardly bears this out. Using rosy assumptions of unbroken expansion averaging about 4% real GNP growth per year, the Reagan budget projections show deficits (prior to any 1985 action) staying stubbornly above \$220 billion a year for the rest of this decade. Using somewhat more realistic assumptions, the Congressional Budget Office (CBO) projections show the unified budget deficit rising steadily from \$215 billion in fiscal year 1986 to \$296 billion in 1990. Even the structural deficit (ie. deficit that would prevail at 6% unemployment) rises from \$171 billion in 1985 to \$282 billion in 1990. That is, it remains above 5% of GNP throughout the period. So much for the notion that we can grow our way out of the federal deficit.

Second, what about rising state-local surpluses as an offset to federal deficits and

as a cushion to absorb the force of sharp additional cuts in the flow of federal funds to state-local government? On closer inspection, one finds that the great bulk of the state-local surplus has a "hands-off" sign on it. It consists of monies collected from state-local employees to finance their pensions and is distinctly not available as operating money to pay for local services. The bitter fact is that even after putting through painful tax increases and sharp budget cuts in recent years, the state-local **operating** surplus is running at less than \$5 billion a year as of 1985.

But what of the argument that the additions to pension fund reserves are available as a savings pool to finance the federal deficit? Studies show that, for the most part, these funds are regarded as a substitute for personal saving by state and local employees, so even this argument fades away.

Third, consider the assertion that huge structural deficits have no connection with high interest rates. The White House, the Treasury, and a small band of supply-siders were virtually alone in believing that the clash between \$200 billion-a-year federal credit claims and burgeoning credit needs of business, consumers, and the housing industry won't raise interest rates. Their reasoning -- based largely on experience during recessions, which force deficits up and interest rates down -- simply failed to recognize the pressure of sharply rising credit demand on a limited supply of saving in a buoyant economy (not to mention the fear that big deficits might lead to inflation).

Fourth, the damage deficits do starts but hardly ends with high interest rates. The CBO projects that under its baseline assumptions, federal debt held by the public will grow from \$1.3 trillion at the end of fiscal year 1984 to \$2.8 trillion by the end of 1990. This would raise the debt held by the public as a percentage of GNP from less than 30% during the 1970s to almost 50% by 1990, while the Treasury's annual interest costs would more than double, to \$230 billion by fiscal 1990. Simply keeping pace with these surging interest bills would preempt much of our political capacity for tax increases and budget cuts.

Further, the interlocking budget and trade deficits, together with \$100 billion a year of IOUs that foreign suppliers of capital are now building up against us, will cheat tomorrow's generations to fatten today's. Our spending and deficit spree is handing them a legacy of diminished capital assets and slower economic growth on one hand and huge foreign debts to service on the other.

Fifth, we cannot control the deficit by budget cuts alone. Searching studies by both Brookings and the Urban Institute estimate that \$100 billion or more of the job will be left for taxes to do even after all defensible and politically feasible budget cuts have been made. The Committee for Economic Development (CED), in its September 1984 report, **Fighting Federal Deficits**, after portraying the deficits that loom ahead of us as "the single most important obstacle to sustained non-inflationary growth of the U.S. -- and, in fact, the world - economy," concludes that "measures to increase tax revenues will have to be an integral part" of the attack on the deficit and goes on to spell out a major tax offensive as part of its deficit-cutting program. The case for a major tax increase is not simply one of political feasibility, compelling as that case is. The point is also that the burden of a major defense buildup should not be borne simply by social programs and public infrastructure. It should be shared broadly by both the private and the public sectors.

Sixth, to seek refuge in advocacy of a constitutional amendment requiring a balanced budget is political escapism. A presidential program (as in Mr. Reagan's February 1985 budget) that would leave deficits at over \$140 billion a year by the end of

the decade is an open contradiction of a balanced budget requirement. A mandatory balanced budget would not only violate sound economic policy but as a former Republican minority leader of the House asserted, even with a variety of qualifying phrases, "It would be so easy to end-run it."

Finally, the drive for tax reform must not thwart the drive for tax revenue. However, basic tax reform can be made a vehicle for a major contribution to deficit-cutting: by broadening the income tax base toward the objective of a comprehensive income tax; by scaling up the rates of the modified flat tax; by doing the same to the expenditure tax; and by flanking the income tax with a value-added tax.

There are those who believe that the urgent need for revenue can be an important propellant to tax reform. And it is true that recapture of some of the excessive tax cuts and reversal of some of the economically damaging tax preferences introduced by the 1981 act are an important cause for action on the tax reform front. But, when there are not net tax cuts to compensate the losers in tax reform, it seems hard to believe that the pressing need for revenue will make the road to reform easier. Hence, after reviewing some of the issues involved in tax reform, I return to the subject of revenue-raising and suggest an interim program for 1985 tax increases to "hold the fort" until basic tax reform can be enacted.

Issues in Tax Reform

Before coming down on one side or the other of the income-versus-consumption-tax approaches to tax reform, one should be aware of the common threads that run through them as to the cause for action and the nature of the solution. The inequities, complexities, and adverse economic effects of the present income tax system provide us with a common destination, namely, a major broadening of the federal tax base and reduction of its high marginal income tax rates.

Also common to both the income and consumption tax approaches are the objectives of fairness, simplicity, greater efficiency of resource allocation, and an increase in the rate of savings, capital formation, and economic growth.

The biggest bone of contention is the treatment of saving, that is, whether (1) to tax all income, consumed or saved, (2) to broaden the income tax base but retain substantial preferences for saving, or (3) to exempt all saving--or at least, saving out of capital income. The issue is critical to the choice among tax reform options. First, though, it is useful to review briefly the major tax reform options in terms of the goals of simplification, fairness, and economic efficiency.

Simplification

Although the argument for simplification of tax compliance and administration is both valid and appealing, one should be careful to distinguish between political rhetoric and administrative reality.

Yes, the income tax law has become vastly complicated, and lampooning it is a favorite indoor sport. Yet, the two-thirds of the taxpaying public who do not itemize (that is, who use the standard deduction, or "zero bracket amount" as it is now called) don't encounter most of the law's complexities. Among the one-third who do itemize, those who cannot afford tax advisers may well find themselves bewitched and bewildered by those complexities.

Yes, a comprehensive income tax or modified flat tax would be an important move

toward simpler compliance and administration. But one should recognize that it is the elimination of tax differentials, deductions, and exclusions rather than a simpler rate structure that brings about the bulk of the simplification.

Yes, junking the income tax in favor of a spending tax could, in principle, eliminate an enormous amount of complexity. But as one sees what complexities would be added--for example, keeping track of all assets as well as income transactions, shielding the elderly from unfair burdens as they spend their previously taxed income, differentiating between the investment and consumption components of housing and other durable goods purchases, and embracing bequests as part of the tax base--the vaunted simplification begins to fade. Then add the various sources and uses of funds that the White House and Congress will want to shelter in full or in part, and simplification becomes still more elusive.

Yes, the value-added tax, on its face, appears relatively easy to administer and comply with. Yet, probing a bit more deeply, one finds that the countries using the VAT typically exempt such items as food, shelter, and medicine, or at least give them preferential treatment. The greater the exclusions, the more the simplicity of the VAT goes down the drain.

Fairness

The issue of fairness has both a vertical and horizontal dimension. Vertically, the objective is to maintain progression or at least to shelter the lowest income groups from the impact of the tax. This can readily be done by exemptions and standard deductions under both the income and spending taxes, with further reinforcement from graduated rates. We need a combination of exemptions and rates that would approximately maintain the present rather modest degree of progression in the tax system.

We would also need relief for low income groups, under the VAT, not through exemption of food or other necessities--which would not do the job--but rather through a refundable income tax credit. For those not filing income tax returns, the credit would be built into one or another federal assistance program. Merely to state this type of relief is to recognize its difficulty and complexity.

When it comes to horizontal equity--even-handed treatment of taxpayers in similar circumstances--all of the tax reform plans claim major gains. Almost by definition, the broadening of the income tax base would validate this claim.

But as to the expenditure tax and the VAT, let the buyers of these tax reform options beware. Is it plausible to assume that the White House and Congress, having long responded to public pressures to riddle the income tax base with special tax preferences or "tax expenditures" aggregating about \$400 billion, would enact a spending tax or a VAT unblemished by such special exclusions, deductions, and preferences? The danger here is that a very imperfect income tax forged in a highly political crucible will be compared with a virtually perfect consumption tax forged in the minds of economists.

With respect to the spending tax, take just one example: the inclusion of gifts and bequests in the tax base is vital to the fairness of the tax since their exclusion would result in a measure of ability to pay which is basically flawed, and invite an ever-greater concentration of wealth. Yet, the 1981 tax act left the estate and gift tax a skeleton of its former self (which, at that, was none too robust).

Economic Efficiency

As it stands today, the income tax is replete with open invitations to misallocation of resources. Its exclusions, deductions, and tax credits serve as powerful magnets, pulling resources out of the uses to which the market mechanism would allocate them. Instead, they are diverted into tax-favored channels. A larger and larger proportion of our total resource flow is directed by tax advantage rather than market advantage.

To put some meat on the bones of this point, let's look at the distortion in the flow of resources that arises from anomalies in the way we tax income from capital. Under the Accelerated Cost Recovery System (ACRS), coupled with the long-standing investment tax credit, the tax on many items of business equipment is zero or negative. Structures are now written off in unrealistically short periods. Others have referred to the "wildly different" effective tax rates on profits that result from existing tax preferences.

There are also anomalies in the current taxation of income from capital, such as the lopsided depreciation system, the vagaries of capital gains taxes and the severe "tax arbitrage" problems that arise from the deductibility of interest paid on loans to finance tax-preferred and tax-exempt investments. Money borrowed at, say, 12 percent by an individual taxed at 50 percent or a corporation taxed at 46 percent costs only about six percent after taxes. Yet it can be invested in IRAs that yield large immediate write-offs. Such borrowers are clearly subsidized by the tax system and thus strongly favored over lenders.

The comprehensive income tax and Bradley-Gephardt "Fair Tax" reforms would solve these problems by eliminating the preferential treatment of capital gains, repealing the investment tax credit, replacing ACRS with a system providing for actual cost recovery, and essentially limiting interest deductions to the amount of the taxpayer's investment income, thus denying interest deductions on loans incurred for tax-sheltered investments.

The expenditure tax would remove the distortions by, in effect, "expensing" asset purchases, that is, deducting the cost of assets when acquired and taxing all proceeds from assets as they are consumed. Given a pure expenditure tax, the solution is an elegant one. But once again, one must recognize that the political process, like the rest of the world, is peopled not by saints but by sinners who would very likely replace a flawed income tax with a flawed expenditure tax.

Now let us turn from the issue of inefficient resource use to the issue of inadequate savings.

The Savings-Investment Issue

The impact of taxes on saving is perhaps the most widely misunderstood issue in the current debate on tax policy and tax reform. The conviction that sharp cuts in marginal rates, special savings credits under the income tax, and shifts from income to consumption taxes will foster large increases in private saving has played an important role in recent tax action and tax proposals. It helped gain acceptance of the excessive tax cuts in 1981. It spawned income tax credits for IRAs and Keoghs. It is a key peg on which many advocates of the shift to consumption taxes hang their case. And it has led to widespread neglect of the adverse impact of deficits on the nation's saving and capital information.

We need to seek added saving and investment, and some tax structures serve this

end better than others. The single most effective action to spur national saving in the foreseeable future would be to cut government dissaving by shrinking the deficit. True, there would be some offset in the form of reduced private saving, but empirical analysis indicates that the offset would be modest. So a dollar of deficit reduction should yield nearly a dollar of increased national saving. Here again, the interplay between revenue-raising and tax reform comes to the fore: any reform that fails to cut the deficit is missing the savings boat.

What about the impact of tax structure on saving? One of the battle cries in the tax reform campaign is: increase the incentives to save! That will increase saving, which will in turn increase investment, which, bottom line, will increase the rate of U.S. economic growth. But the links in this chain are weaker than usually assumed. The evidence that untaxing of savings will unerringly increase private saving and investment is anything but persuasive.

The misguided mini-reform intended to increase savings through extended use of IRAs is a case in point. As a generator of net saving, IRAs suffer from a double fault:

- Studies show that for the most part, taxpayers simply switch funds from other sources or from borrowing into their IRAs. Clearly, the dog can get the bone, not by sitting up, but simply by barking.
- IRAs now result in a \$9 billion annual loss of revenue and a corresponding increase in the federal deficit, or dissaving. The result: a net reduction of saving. In spite of special savings stimulants, saving has declined, not risen, as a percent of GNP.

Even at a higher level of generality, namely, the savings impact of cuts in marginal income tax rates or shifts from income to consumption taxes, superficial thinking is often mistaken. First, as just noted, if the result increases the deficit, the public sector dissaving will swamp the higher private saving. Second, there is also a clash between the price effect and the income effect of lower taxes on saving. The higher return on saving pulls income away from consumption and thus increases saving. But the higher return also enables taxpayers to fund future consumption with less saving, thus lowering saving. Recent empirical research indicates that the price effect may be stronger but that the net stimulus to saving is modest.

That brings us to the second link of the chain, namely, the conversion of savings into investment. That conversion is by no means a one-to-one proposition. In an underemployed economy, one need not increase annual saving (that is, forego current consumption) to provide the resources for investment--one can draw on idle resources. At full employment, on the other hand, policies to boost saving have to be carefully coordinated with (monetary) policies to increase investment and maintain aggregate demand. Beyond this, in a world of open capital markets, increased domestic saving can flow overseas to finance foreign investment. At present, of course, the flow is just the opposite. And one must again underscore that tax cuts that increase government dissaving in the form of budget deficits--that is, tax cuts not matched by budget cuts--won't raise national saving; indeed, they are more likely to reduce it.

As to the third link, the conversion of investment into growth, two points are worth noting. First, tax incentives focused on investment will provide more bang for the buck than savings incentives. Unlike the latter, where the price or substitution effect, as noted above, clashes with the income effect, the two effects work in harmony when tax breaks lower the effective cost of capital. Second, simply stimulating savings is just as

likely--perhaps more likely--to boost investment in housing and consumer durables as in plant and equipment and research. It follows that if tax revenue is to be foregone in the pursuit of growth, the tax subsidy should be focused sharply on business investment decisions.

In short, there are many slips twixt cup and lip in the pursuit of growth through tax spurs to saving. Any tax reform measure should be based on economic reality rather than on self-serving rhetoric.

The Choice Among Tax Reform Options

The Value-Added Tax

The VAT is to be judged not as a substitute for, but as a supplement to, the income tax. True, the revenues generated by the VAT would avoid magnifying the anomalies of the income tax and could provide a budgetary cushion to help in restructuring it.

But it is not hard to see why the VAT, or sales tax, is losing support as a federal revenue source:

- It would add a whole new range of administrative and compliance problems to the federal revenue system.
- The great difficulty of protecting the low-income taxpayers from the VAT's impact raises the fear that it would push the federal tax system even farther towards regressivity. The relentless rise of regressive payroll taxes, the erosion of the corporate income tax (the effective rate of which dropped from over 40 percent in the early 1950s to 13 percent in 1982), and the adverse impact of the 1981 tax cuts on the lowest income groups have already undermined the progressivity of the federal tax system.
- The introduction of the VAT would cause a one-time jump in the inflation rate and might become imbedded in wage and price increases.
- Though there is room for side-by-side state and federal consumption taxes, the states would not take kindly to this "invasion" of their tax domain.
- The potential of the VAT as a money machine brings it into disrepute with many conservatives.

The Expenditure Tax

The expenditure tax is in many ways an economist's dream, but it is all too likely in the political process to turn into a practical nightmare. Its fairness, its favorable impact on resource allocation, and any simplicity it achieves depend critically on the inclusion of gifts and bequests in the tax net, on the appropriate treatment of investment outlays for housing and the like, on complex transition provisions to shield spending out of previously taxed income, and on avoiding the exclusions, deductions, and credits that pockmark our present income tax.

Even at best, substituting it for the income tax boosts taxes on the young and old and cuts those of middle-aged taxpayers who save more. Workers who would be drawing down their savings because of unemployment or disability would also pay tax when they had no income. Over the long run, or life-time--with appropriate treatment of gifts and inheritances--the tax would conform with the ability-to-pay principle. But in the long run....

Once again, one has to stress that, given the apparent will of the White House and Congress to crank down rather than gear up estate and gift taxes, the tax-free flow of savings under the expenditure tax would lead to untaxed and undue concentrations of wealth.

Broad-Based Income Taxes

That leaves the comprehensive or modified flat tax as the most promising route for tax reform. I find myself in sympathy with the bold Treasury program to broaden the base, cut the rates, and simplify the rate structure of the income tax.

The Treasury plan as originally proposed in November 1984 went well beyond the Bradley-Gephardt, Kemp-Kasten, and similar "bumpy" flat taxes in offering a dramatic improvement in fairness, in economic impact, and in simplicity. Even if the proposal is modified in the White House, and even if the legislative assault on "tax expenditures" falls short of its objectives, the erosion of the income tax base might be stopped and reversed.

A surprising feature of the Treasury plan is the reversal of the role of the corporate income tax. Not only would it be retained, but by drastic base-broadening measures, its yield would be increased 37% while reducing its rates to a high of 35%. Again going beyond Bradley-Gephardt, the Treasury would give the corporate income tax much the same treatment as the individual income tax: a cleansing and a broadening of the base coupled with a sharp reduction in the rate. After warmly endorsing the general principle, President Reagan seemed to balk at the sharp increase in corporate tax liabilities and the cutback in accelerated depreciation. The issue hangs very much in the balance.

The Rocky Road to Reform

A bit of perspective on the tough job that lies ahead may be gleaned from some episodes in the history of tax reform.

One lesson of history seems to be that nothing is terribly new under the sun--and what is new faces tough sledding in Congress. In 1942, a group of Treasury economists and tax experts spent several months devising a progressive net expenditure tax, right down to the drafting of sample tax returns. The purpose was to quell the waves of purchasing power beating against World War II wage price, and rationing controls. But the Congress wasn't buying. A Treasury presentation to the Senate Finance Committee convinced only five of the then 19 members that such a tax, requiring "balance sheet control," should be superimposed on an income tax that was expanding from a "class tax" of some four million taxpayers in the late-1930s to a "mass tax" of some 44 million taxpayers in the early 1940s.

As to income tax reform, four previous experiences are worth bearing in mind. First, in the late 1950s, Chairman Wilbur Mills of the Ways and Means Committee conducted lengthy hearings on methods of broadening the base and reducing the marginal rates of the income tax. But the hearings themselves led to such strong opposition--the very idea of hearing testimony on curbing mortgage and property tax deductions was denounced as heresy, perfidy, and an invasion of the sanctity of the American home--that the concept of a major tradeoff between base-broadening and lower rates died aborning.

Second, in the 1960s, the occasion of a major tax cut was considered a superb opportunity for tax reform. Large tax cuts would be the lubricant for such reform. The Treasury persuaded the White House that opposition of pressure groups and lobbyists

could be defused by a generalized provision limiting total deductions to the amounts exceeding five percent of adjusted gross income. Instead of muting criticism, this threshold proposal elicited a cascade of protest and anxiety from all groups of taxpayers whose deductions were being curbed, in the interests of getting on with the urgently needed tax cut. President Kennedy jettisoned the five percent threshold provision within weeks after it was presented early in 1963.

Third, the experience of President Carter is also instructive. He came into office a veritable tiger for reform of our income tax system, which he called "a disgrace to the human race." But in the Congress, his reform proposal was transformed into new benefits for capital gains and the like.

Fourth, even the 1984 experience is not particularly encouraging. The so-called "downpayment" legislation to cut the deficit took one step back for every two steps forward on the base-broadening front. Senator Howard Metzenbaum counted 22 new tax "giveaways" in the Senate version of the bill. Even such juicy tax preferences as the 15-year depreciation period for buildings and tax-free industrial revenue bonds were gingerly narrowed rather than boldly closed. Looking ahead to further efforts in 1985, Senator Robert Packwood of Oregon said, "There'll be anguish and screaming and tugging and howling."

All this is not to say that the battle for reform is lost before it is fought. Perhaps the tax reform iron is hot enough to strike now for a big breakthrough. Those of us who have labored in the tax reform vineyards for decades surely have to hope so. But history suggests that the road to basic, broad-scale tax reform is all uphill and strewn with rocks.

Yet, if President Reagan's strong endorsement of the Treasury's tax reform program in principle prevails over his expressed doubts in practice, and if he mounts a major offensive on behalf of the plan, the odds on real tax reform would surely improve. For decades, the dream of tax reformers has been to rebuild the integrity of the income tax, not through trench warfare, moving yard-by-yard, but rather through a blitzkrieg that would overwhelm the special-interest opposition. One lives in hope.

A Tax Program for the Short Term

Tax reform and deficit-cutting may be equally important, but the latter is more urgent. Any delay in taming the deficit will be extremely costly. For example, assume (as CBO does) that Congress were to adopt a program of budget cuts and tax increases of \$30 billion in the first year, \$55 billion in the second, and \$90 billion in the third. Putting the program into effect starting in 1986 would save \$25 billion a year in interest costs on the debt by 1989 and would hold the ratio of debt to GNP to 41.7%. But delay the program for only one year, and interest costs would be \$11 billion higher by 1989, and the debt/GNP ratio would rise to 44.1%. The previously cited damage done by our huge deficits in an expanding economy is cumulative. So the penalties we pay for delay are enormous.

But what if the economy is softening or, worse, what if recession looms? Can we cut budgets and boost taxes in the teeth of a slowdown or turndown in the economy? The answer is yes, provided that

the Federal Reserve keeps its end of the implicit bargain by easing money and lowering interest rates, thus maintaining demand in the short run and tilting the fiscal-monetary mix towards increased investment and growth in the longer run;

if severe recession threatens, Federal Reserve easing is coupled with postponement of the effective date of new tax increases until the economy can stand them. This is the standby or contingency or triggered tax approach proposed (though later abandoned) by President Reagan in 1983 in recognition of the necessity of tax increases if the deficit failed to shrink.

In short, economic urgency and political reality combine to call for prompt interim tax action coupled with budget cutbacks in 1985. It will be important to formulate a tax program that facilitates or at least does not interfere with tax reform. That would mean making permanent only those provisions that contribute to an improved tax system, while making strictly temporary those tax measures that would serve as revenue-raisers but do not fit into basic tax reform.

In the best of all worlds, tax increases to eliminate the deficit should come from tax reform. Congress would "simplify taxes upwards," and quickly at that. Representative Richard A. Gephardt, Democrat of Missouri, for one, feels that deficit reduction would be the "sweet coating" for tax reform. But this might be a classic case of the best being the enemy of the good. A Congress caught in the controversial coils of tax reform might well bog down on the critical job of raising more revenue.

The much safer course is to move ahead promptly on a hold-the-fort program of interim tax increases. In doing so, the major reliance should be on actions that facilitate or at least do not thwart tax reform. Only those provisions that contribute to a better tax system would be made permanent. Those measure that would serve as revenue-raisers but do not fit into basic tax reform would be made strictly temporary. It is useful, therefore, to classify tax measures into those that would facilitate reform, those that are neutral, and those that run counter to reform.

In light of the widening Congressional support for the Bradley-Gephardt modified flat tax and the endorsement of this approach by the Treasury, it seems reasonable to put base-broadening measures at the head of the list for 1985 action. The menu of proposals for cutting back income tax preferences is lengthy. One hopes that the White House and Congress could agree on general priorities and select several of the least distasteful items for action in 1985 with a view to folding them into an eventual broad-gauged income tax overhaul. By way of illustration, one might put the following on a 1985 agenda:

- . Repeal deductions for interest paid on non-mortgage consumer credit. This would yield \$11 billion in 1986.
- . Start cutting back accelerated depreciation and the investment credit, which now cost us about \$60 billion a year.
- . Tax employees on part of employer contributions to health plans, as President Reagan has proposed. This would raise about \$10 billion in fiscal year 1986.

Rather than taking the foregoing selective approach, one could pave the way for later tax reform by interim across-the-board measures. One approach would erect a hurdle or threshold for allowable deductions. That is, the type of threshold now used for medical expenses and casualty losses might be applied to deductions as a whole: Only the excess of total deductions above, say, 5 to 10 percent of adjusted gross income would be deductible. That would be a powerful revenue-raiser. An alternative would be to simply clip 10 to 20 percent off a wide range of designated deductions and exclusions.

Another measure that might well fit into a modified flat tax reform would be to eliminate, curb, or postpone income tax indexing. Given that the revenue loss from indexing zooms from \$6 billion in the fiscal year 1985 to \$65 billion in 1989 and given the crying need for revenue, one could limit indexing to inflation minus two percentage points and thereby raise \$26 billion by 1989.

One revenue-costly but vital reform measure that should not be delayed would be to shield the lowest income groups from the growing tax burdens they have suffered through failure of the 1981 Reagan tax cut to adjust the personal exemption and the standard deduction. Both human decency and fiscal logic call for zero income taxes for those living in poverty. This would involve a revenue loss that would have to be offset by other provisions of a revenue-raising measure.

Turning to the reform-neutral category, one could draw sizable revenues from excise taxes--primarily those on liquor, tobacco, gasoline, energy and telephone service--as well as user fees. A package that would double the excise taxes on alcohol, keep cigarette taxes at 16 cents a pack and extend the current telephone excise tax would produce \$7 billion of revenue in 1986 and \$8.5 billion by 1989. User fees to cover general aviation costs, Coast Guard protection, and other services, could produce another \$3 billion a year.

Energy taxes are often mentioned as candidates for revenue-raising and conservation purposes. Broad-based energy taxes are highly regressive and are not likely to produce the national security and conservation advantages often claimed for them. Still, they could be powerful revenue-raisers. Total energy demand in 1983 had an end-use value of over \$400 billion. At a tax rate of 5%, this would produce gross revenues of \$20 billion a year. If the political battle were to boil down to "least-evils" choice between a bigger deficit and an energy tax, the macroeconomic pluses of such a tax might outweigh its microeconomic minuses.

If the foregoing tax measures do not yield sufficient revenue, one would have to turn to measures that conflict with tax reform. A strictly temporary set of surtaxes for deficit-cutting purposes might be justified on a least-evils basis. A 5 percent surtax on individual income would raise \$16 billion in the fiscal year 1985, rising to \$20 billion by the fiscal year 1987. A 5 percent corporate tax surcharge would add \$4 billion and \$5 billion, respectively.

It is easy to view a variety of tax increase measures like the foregoing as one more example of "patchwork" or "piecemeal" legislation. Yet, it is entirely feasible to put together a program that can be justified in terms of the urgent need to cut the huge Federal deficit.

A combination of base-broadening measures, a curb on tax indexing, and the excise tax steps reviewed above could make an increasing inroad on the deficit, to the tune of some \$60 billion by 1989. For a faster start, the strictly temporary surtaxes and perhaps an energy tax could also be defended as preferable to letting the structural deficits continue on their dangerous course.

Conclusion

At this writing, prospects for bold tax initiatives -- whether for reform or for revenue, or both -- are clouded. Yet, one cannot rule out the possibility that White House and congressional leaders might be able to negotiate a compromise agreement on a major base-broadening and rate-reducing plan to fuse the Treasury, Bradley-Gephardt,

Kemp-Kasten, and similar initiatives and defuse the inevitable divide-and-conquer onslaught of special-interest groups.

Were such a move to materialize and succeed, it would upset the conventional wisdom growing out of half a century of frustration in trying to protect, restore, and broaden the income tax base. It would represent a major victory of the general over the special interests.

Yet, in expressing this hope for victory against heavy odds, one should bear in mind three important caveats. First, as the Treasury's proposal recognizes, any tax reform plan must avoid imposing further burdens on the poorest taxpayers, indeed, must ease their burdens by raising personal exemptions and the zero bracket amount (minimum standard deduction). Second, any modified flat tax must not be so flat as to provide still greater net tax benefits for the top income groups who were more-than-generously treated by the 1981 tax cut. Again, to its credit, the Treasury proposal satisfies this requirement. Finally, action on bold tax reform must not be allowed to thwart prompt action on the tax increases and budget cuts so urgently needed to cut the dangerous federal deficit.