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Symposium on Tax Reform

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The debate on the Tax Reform Act of 1986 was marked by the enthusiastic participation of economists. Years of accumulated research was dusted off and applied to various proposals. New research was undertaken and completed. The results revealed both strengths and weaknesses in the capacity of economics and of economists to enlighten public debate.

The most conspicuous strength was the relentless insistence by economists that arguments should be supported by sound theory and accurate statistics. Despite this fact, three circumstances led to the frustrating situation where on almost all important issues noted economists could be found on two or more sides. First, economists frequently disagree on the weights to be attached to considerations of equity and efficiency. These disagreements led to conflicting positions on policy even when the likely effects of a particular proposal were not in dispute. Second, economists disagreed about the importance of administrative considerations relative to improvements in efficiency or equity. Third, the tax debate highlighted a number of areas where major analytical puzzles remain unsolved or where the data necessary to apply available theory are hopelessly inadequate.

The conflict over whether marginal tax rates should be lowered illustrates the first source of disagreement. Virtually all economists agree that lowering marginal tax rates reduces excess burdens associated with taxing labor income, and many economists defended the proposed rate cuts for this reason. Others held that the rate cuts were undesirable because they ratified a previous erosion of progressivity. Still others worried that reduced rates would facilitate subsequent tax increases that would enlarge a public sector they regarded as already too big.

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The second source of disagreement is illustrated by the debate over indexing the measurement of capital income. Some applauded the Treasury Department for presenting proposals to index capital gains, depreciation, interest income and expense, and the cost of goods withdrawn from inventories. They deplored the failure of Congress to adopt these or similar measures. Others found indexing too complex and unimportant at low inflation rates. And some feared the possibility that it would signal relaxed vigilance against renewed inflation.

The tax reform debate also highlighted gaps in economic knowledge that will almost certainly influence future research. Perhaps the most important gap concerns the failure of most current theory and empirical work on the incidence and effects of taxes to take into account the effects of world economic interdependence. Many standard propositions about the incidence and effects of taxes developed in closed-economy models are called into question if one allows for the effects of tax-induced international movements of capital and of shifts in exchange rates and the current account balance. For example, most closed economy analysis suggests that capital income taxes fall predominantly on some or all owners of capital. When international trade and factor movements are taken into account, taxes on capital income may fall predominantly on labor, rather than on capital, even in the short run. As a second example, investment incentives may for many years hurt the firms they are intended to help if the firms depend significantly on foreign sales and if the investment incentives induce currency appreciation. Furthermore, tax changes that have one effect in the short run may have quite opposite effects in the long run.

This aspect of tax research is in its infancy. Progress will depend on the cooperation of several branches of economics: public finance, international trade, and finance, to name only the most obvious.

A related gap in current knowledge concerns the interaction between finance and tax provisions. Whether the corporation income tax imposes burdens only on shareholders, on all owners of capital, on entrepreneurs, or on no one at all remains unsettled. Such disarray makes it hard for economists to speak with one voice on how the corporation income tax should be modified, if at all, and what the effects of any change would be. Work by many economists has documented the coexistence of widely disparate rates of tax depending on how various investments are financed. The central question is why the least-taxed method of finance is not invariably chosen. Some combination of risk, ignorance, and institutional barriers determines what form of finance appears to investors as the least cost form of finance. But what that combination is remains uncharted territory. Accordingly, the full effects of changes in tax rates and the tax base on the cost of capital, the preferred method of finance, investment, saving, and the distribution of tax burdens remains obscure.

These three sources of disagreement are all involved in the split among economists favoring consumption taxation, annual income taxation, or lifetime income taxation. The Tax Reform Act of 1986 moves the tax system toward annual income taxation.

Advocates of consumption taxes traditionally view with suspicion any measure that would increase effective rates of tax on any type of capital income, since such income would be wholly exempt under a consumption tax. They objected to a number of provisions in the Tax Reform Act of 1986 that were designed to equalize, but in the process raised, average effective tax rates of tax on capital income.

Advocates of lifetime income taxation hold that all income should be taxed once in each recipient's lifetime, a goal that is reached by taxing consumption plus all gifts and bequests by the taxpayer to others. One of the rationales for both consumption and lifetime income taxation is the practical difficulty of taxing capital income annually in an equitable and efficient manner. While the consumption tax would exclude from tax all unconsumed income, even large estates transferred across generations, the lifetime income tax would fall on such transfers.

Advocates of annual income taxes tend to support measures that would raise effective tax rates on categories of capital income that are taxed at lower than average rates. They do so because they emphasize annual, rather than lifetime, measures of ability to pay and because they discount the intertemporal distortions that advocates of consumption and lifetime income taxation allege result from the taxation of capital income.

Many of the changes in the Tax Reform Act of 1986 were designed to curb capital transactions that were used to shelter not just capital income, but labor income as well. These opportunities for tax avoidance arose from the coexistence of tax rules appropriate to income taxation with other rules appropriate to consumption taxation. The opportunity to deduct interest and to claim depreciation deductions is appropriate to an income tax. The nontaxation of accrued capital gains and of many forms of tax-sheltered interest income are appropriate to a consumption tax. Thus, permitting deduction of interest on loans (an income tax rule) used for deposit in tax-sheltered savings accounts (treated as they would be under a consumption tax) meant that taxpayers could reduce liabilities without doing any saving at all. In more complicated transactions, taxpayers could link up-front deductions for interest and depreciation to the accrual of capital gains on which tax was deferred. The exclusion of 60 percent of long-term capital gains enlarged the opportunities for avoidance.

Many aspects of the 1986 act were designed to reduce these opportunities for tax avoidance. But a side effect was some increase in taxes on capital income—good news for annual income tax advocates, but bad news for supporters of consumption taxation.

The split among advocates of annual income, lifetime income, and consumption taxes rests on disagreements concerning the equity and efficiency effects of taxing capital income and the capacity to do so consistently and at reasonable administrative cost. Do people, in fact, make long-term consumption plans based on expectations regarding lifetime income? Do they have sufficient liquid assets or access to credit markets to free themselves from the constraints imposed by periodic paychecks? How great is the disposition to substitute consumption in one period for consumption in another when the net return to saving changes? Are the gains in efficiency from reducing differences among tax rates on different types of assets more or less important than the loss of efficiency from increasing average rates? Which of these effects dominates depends on empirical information on the nature of production and utility functions. The debate between income and consumption taxes persists in large part because the economics profession does not have answers to these questions that are persuasive to its own members or to others.

The papers in this symposium are a representative sample of the diverse views economists hold on the political and economic advantages and disadvantages of the Tax Reform Act of 1986. They indicate some of what positive economics has to say about the effects of the new law on labor supply, corporate finance, investment, and state and local governments. They reflect varying political perspectives on the desirability of reducing marginal tax rates. Both the diversity of the conclusions and the areas that are omitted provide a revealing guide to what economic research about taxation has accomplished and what remains to be done.