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WHERE TAX REFORM WENT ASTRAY

CHARLES E. McLURE, JR.†

AUTHOR'S PREFACE

MUCH has happened between the time this paper was written in February 1986 and the time final revisions for publication were begun in late June, shortly after Senate passage of tax reform by a vote of ninety-seven to three. In particular, tax reform was taken to the very brink of disaster by Senatorial kowtowing to special interests, before being salvaged by a bold proposal to eliminate most tax shelters and reduce tax rates substantially, ostensibly to 15% and 27%.1 (The phase-out of the benefits of the 15% rate and personal exemptions as adjusted gross income rises above $75,000 produces a top marginal rate of 32% over most of the phase-out range.) As a result, some may think that the title of the paper should be changed (at least by inserting the word “almost”), and much of the text, as originally written, may seem dated.

Even so, I have not found it necessary to substantially rewrite the paper to take account of Senate action on tax reform, or to even change its title. To do so would produce an inaccurate record of the conference proceedings, as well as require an inordinate amount of time. More important, even if tax reform follows the general contours of the House and Senate bills, in some combination, truly fundamental tax reform will have gone astray in important respects. I have added a postscript in which I reflect briefly on events of the past few months.

I. INTRODUCTION

In late November of 1984, the United States Treasury Department submitted proposals for fundamental tax reform to

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President Reagan (the proposals are hereinafter called Treasury I). Just over a year later, the House of Representatives passed H.R. 3838, the Tax Reform Act of 1985. Although H.R. 3838 contains a large number of proposed reforms which are worth enacting, it does not constitute fundamental tax reform. Rather, it is more accurately characterized as a lineal descendent of the Democratic base-broadening efforts enshrined in the tax reform acts of 1969 and 1976, with enough of the kind of rate reductions—at least for individuals—found in the 1964 and 1981 acts to make the package politically palatable, if not popular. Because the current reform effort is constrained to be revenue neutral, the reduction in taxes for individuals is financed by substantial increases in taxes imposed on corporations. Much of this corporate increase comes from sectors which have historically used preferential tax treatment designed specifically to allow them to pay little or no taxes. A substantial portion of the increase in corporate liabilities results from the reduction of investment incentives (via accelerated depreciation and the investment tax credit) enacted in 1981.

Legislative action now moves to the Senate, where the majority hopes to modify the House bill. Republicans will attempt to increase incentives for investment, reduce the shift of tax burden from individuals to corporations, and increase to $2,000 the personal exemptions for taxpayers who itemize, as well as for those who do not itemize. There are indications that President Reagan assured House Republicans that he would veto any bill coming


4. See id. It should be noted that all references to H.R. 3838 are to the bill passed by the House of Representatives in December 1985, not to the Tax Reform Act of 1986.

5. For example, of the $139 billion proposed net increase in corporate taxes over the 1986-1990 period, $80 billion comes from “accounting provisions,” $7 billion results from increases in taxes on financial institutions, insurance products and companies provide an additional $10 billion, and changes in “corporate provisions” produce another $11 billion, for a total of $88 billion. By comparison, “capital income provisions” account for an increase in corporate taxes of $119 billion. Of this amount, repeal of the investment tax credit, by itself, accounts for $98 billion. If the benefits of corporate provisions that reduce liabilities by $86 billion are added to the net increase of $139 billion, the gross increase is $225 billion. The $88 billion increase in the four categories listed in the first sentence above represents almost 40% of this gross increase in corporate tax liabilities. See H.R. Rep. No. 426, 99th Cong., 1st Sess., 62-77 (1985).
out of a House-Senate conference that is not more favorable to investment than is H.R. 3838. However, many informed observers believe that the President will sign any tax reform bill that comes to his desk, as long as the top marginal rate is no higher than approximately 35% to 38%.

It appears quite unlikely that a conference bill will differ substantially from H.R. 3838. This is because the only way to avoid the shift in liabilities from individuals to corporations and restore a $2,000 personal exemption for all taxpayers would be to eliminate the deduction for state and local taxes or find a new source of revenue, such as a value-added tax. While both of these options have been discussed, neither seems likely to have substantial support in the Senate. It thus seems safe to believe that the United States may soon enact a tax law patterned after H.R. 3838.

Several models exist for idealized systems of direct taxation. Like most tax reform proposals, H.R. 3838 differs substantially from all of these. The purpose of this paper is to describe and discuss these deviations. Section II describes briefly several idealized systems with which H.R. 3838 and other tax reform proposals can be compared. It notes that Treasury I, the Treasury Department's November 1984 proposals to President Reagan, had already deviated from these conceptual ideals in several important respects. Even so, the Treasury I proposals are generally recognized as a far-reaching attempt to introduce a truly comprehensive income tax that would have provided fundamental tax reform.

Section III discusses the question of the best strategy to use in attempting to gain fundamental tax reform. Some observers of the legislative process argue that fundamental tax reform is impossible, or at best, can be achieved only incrementally. By comparison, Treasury I and its derivatives were based on the view that fundamental reform was possible, but could only be achieved if presented as an all-or-nothing proposition. Thus, Treasury I reflected a strategic decision that fundamental tax reform would be feasible only if virtually all forms of preferential treatment were eliminated simultaneously in order to achieve substantial and visible benefits of rate reduction, fairness, neutrality, and simplification. Also discussed in Section III are the difficulties of

6. This paper deals only with direct taxation, that is, taxes levied on the income or consumption of individuals and the profits of business. It does not consider indirect taxes, such as retail sales taxes, value-added taxes, and other forms of transaction-based taxes on consumption. For an analysis of such taxes, see McLure, The Value-Added Tax: Key To Deficit Reduction? (forthcoming).
formulating proposals for fundamental tax reform in the politically-charged environment of an election year, the role of transition rules in facilitating acceptance of tax reform, the importance of revenue neutrality and distributional neutrality in the formulation of Treasury I, and the political importance of where one starts in determining the acceptable contours of tax reform.

Section IV describes in greater detail the outline and defects (both real and imagined) of the Treasury I proposals. The outline provides a benchmark against which the President's proposals and H.R. 3838 can be examined. A major defect of Treasury I was its failure to eliminate the preferential treatment of owner-occupied housing. Treasury I also exhibited a few technical defects that rendered it vulnerable to political attack. Probably more important, Treasury I suffered from innumerable cosmetic difficulties which hurt it politically.

Whereas the Treasury I proposals took the "high road," in the sense of reflecting few political compromises with the goals of fundamental tax reform, the road of the President's proposals and H.R. 3838 was decidedly downhill. Section V describes how the relatively pure system proposed in Treasury I was dismembered and distorted as it moved through the political process. Section VI identifies the components of Treasury I that make it truly fundamental tax reform. The bottom line is that while H.R. 3838 may be an improvement over current law, it is certainly not fundamental tax reform.

II. IDEALS OF TAX REFORM

Three primary objectives are commonly attributed to tax reform: fairness or equity, economic neutrality and simplification. Some treat encouragement of economic growth as an additional objective. However, others believe that economic growth will be adequate, and perhaps faster, if only tax policy did not distort economic decision-making and therefore the allocation of economic resources. Similarly, various observers place different importance on "international competitiveness" as a goal of tax policy. Finally, tax policy can contribute to macro-economic stability by assuring that the difference between government spending and tax revenues falls within acceptable bounds.

This section has two objectives. First, it describes three idealized bases for taxation: annual income, annual consumption and lifetime income. Then it notes that annual income, the tax base underlying Treasury I and the proposals and legislation de-
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rived from it, is inherently inferior to lifetime income as a basis for taxation. Whether it is also inferior to a tax based on annual consumption depends on one's view of the importance of basing taxation on income, rather than consumption.

A. Goals of Tax Reform

Virtually everyone agrees—at least in principle—that taxation should be fair, economically neutral, and simple. Therefore, the principal task of tax reform is to design a tax system that meets these various objectives. Of course, where these objectives conflict, disagreements may exist as to the relative importance of the various objectives. Additionally, many will suggest that economic growth or international competitiveness should also be listed as explicit goals of tax policy.

An important criterion of fairness is that of horizontal equity, the notion that taxpayers in similar circumstances should pay similar amounts of tax. In other words, if income (consumption) is chosen as the proper measure of tax-paying ability, those with equal incomes (amounts of consumption) should pay taxes that are quite similar, if not exactly equal. By virtually any standard, the current United States income tax does not score well on the standard of horizontal equity. Those who receive income from particular sources or in particular forms pay little or no tax on the income. By comparison, when received as dividends, income resulting from equity investment in corporations is taxed twice. Inflation results in effective tax rates that are higher than statutory rates for many investments and allows overstatement of interest deductions. In addition, certain uses of income are subsidized by the tax system. These subsidies act to lower the tax liability of those who are able to take advantage of them.

The extent of horizontal inequity resulting from the use of tax shelters is indicated by the following two sets of calculations. First, about 11% of returns with total positive income ("TPI" or income before subtraction of various items of negative income that reduce taxable income) in excess of $250,000—or even $1 million—paid less than 5% of TPI in taxes. By comparison, nearly half (47%) of those with incomes in excess of $250,000

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7. For example, income from interest on state and local securities, most employee fringe benefits, and income in kind from owner-occupied housing are not taxed, and for the most part little tax is paid on income from oil and gas.

8. For example, homeowners benefit from the mortgage interest deduction, whereas those who rent do not have any similar deduction.
owed at least 20% of TPI in tax, and even middle-income returns with TPI of between $30,000 and $75,000 paid an average of about 13% of TPI in taxes.  

Second, the proposals of Treasury I, by eliminating most opportunities to shelter income, would have resulted in increases in tax liabilities in excess of 2% of economic income for more than 15% of families with incomes in excess of $100,000, even though more than 27% (for incomes of $100,000 to $200,000) and 49% (for those with incomes in excess of $200,000) of families in those income classes would have experienced tax decreases in excess of 2% of income.  

Vertical equity—the relationship between tax liabilities at various points in the scale measuring ability to pay (e.g., income or consumption)—is a matter of social conscience and therefore somewhat more elusive. In the formulation of Treasury I an attempt was made to sidestep this politically sensitive issue by proposing tax reforms that were (by at least one standard) distributionally neutral. This same basic approach was followed in the formulation of the President’s proposals and H.R. 3838.

This issue is further addressed in Part D of Section III.

A tax is economically neutral if it does not affect economic decisions (except by reducing real income or wealth).

\[\text{9. U.S. Dep't of the Treasury, Taxes Paid by High-Income Taxpayers and the Growth of Partnerships, 28 Tax Notes 717, 718 (1985). For further documentation of the ability of high-income individual taxpayers to pay little or not tax, see id. at 717-21.}\]

\[\text{10. See Treasury I, supra note 2, vol. 1, at 54. These figures also indicate clearly that horizontal inequities are substantially greater for upper-income groups (those with economic income in excess of $100,000 per year) than for those with lower incomes, reflecting the fact that both incentives and opportunities for tax sheltering are greater at high income levels. Id.}\]

\[\text{11. Treasury I would have reduced tax liabilities in economic income classes as follows: over $200,000 by 8%; $100,000-200,000 by 6.4%; $50,000-100,000 by 7.4%; $30,000-50,000 by 9.3% and all income classes by an average of 8.5%. See Treasury I, supra note 2, vol. 1, at 47.}\]

\[\text{12. The President's Proposals did, however, reduce taxes paid by those with incomes in excess of $200,000 by 10.7%, compared to a reduction of 7.0% for all households and barely 4% for those with incomes of $50,000-200,000. See The President’s Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985) [hereinafter cited as President’s Proposals]. The greater cuts at the top of the income scale are the inevitable consequence of the decisions to maintain many tax preferences of special benefit to high-income taxpayers and limit the top marginal rate to 35%.}\]

\[\text{13. Economists will recognize that the parenthetical qualification in the text is intended to indicate that neutrality involves only substitution effects, that is, effects on the allocation of resources induced by changes in relative prices; changes in resource allocation that result from changes in real income or wealth are not considered in appraising the neutrality of taxation. A tax system that is}\]
types of decisions that can be—and are—distorted by taxation are legion. They include the decision whether to save or consume;\(^{14}\) whether to work; the choices of types of investments; decisions on risk taking, invention and innovation; decisions on business form (i.e., whether to use the corporate or non-corporate form of business organization); decisions on means of business finance (especially debt versus equity finance and dividend payout ratios); decisions on the composition of employee compensation (e.g., taxable wages versus tax-exempt fringe benefits) and consumption choices (among various differentially taxed goods and services). Taxation will be economically neutral only if two or more alternatives facing a given decision maker are subject to the same effective marginal tax rate.

Underlying the attempt to make the tax system more neutral is President Reagan's view that, generally, the tax system should not be employed to implement social or economic policies.\(^{15}\) In this sense Treasury I was a free-market manifesto. Of course, that view, especially in recent years, runs directly counter to the historical development of the United States tax system.

Complexity takes at least two distinct forms. The first, and perhaps more important, is the difficulty and burden experienced neutral is not necessarily optimal, since it may not minimize loss of welfare resulting from taxation. Moreover, a neutral tax system would not steer economic decision makers away from pollution and other socially harmful activities. For a technical explanation of the theory of optimal taxation, see A. ATKINSON & J. STIGLITZ, LECTURES ON PUBLIC ECONOMICS (1980).

\(^{14}\) Strictly speaking, it is the choice between present and future consumption that is distorted by taxation. This choice can be distorted even if there is no tax-induced change in the allocation of funds between saving and current consumption. For elaboration of this point, see Feldstein, The Welfare Cost of Capital Income Taxation, 86 J. POL ECON. S29-S51 (April 1978) or, for a more elementary exposition, McLure, Taxes, Savings, and Welfare: Theory and Evidence, 33 NAT'L TAX J. 311-20 (1980). Despite the technical inaccuracy of such a reference, this article shall refer to tax-induced distortions of the saving-consumption choice.

\(^{15}\) In speaking to a joint Session of Congress on the Program for Economic Recovery, February 18, 1981, President Ronald Reagan gave the following assessment of the proper role of taxation: "The taxing power of government must be used to provide revenues for legitimate government purposes. It must not be used to regulate the economy or bring about social change." Address before a Joint Session of the Congress, 17 WEEKLY COMP. PRES. Doc. 130, 137 (Feb. 18, 1981). Such exceptions to strict neutrality as deductions for charitable contributions, and expensing and credits for research and experimentation can be justified on the basis of external social benefits. Turnier, Personal Deductions and Tax Reform: The High Road and the Low Road, 32 VILL. L. REV. 1701, 1726-27 (1986). Others, such as the home mortgage deduction and the exclusion of interest on state and local taxes, have little economic justification; they were kept almost entirely for political reasons. Brannon, Tax Loopholes as Original Sin: Lessons from Tax History, 32 VILL. L. REV. 1763, 1767-69, 1774-75 (1986).
in reading and understanding instructions, keeping records, and completing tax returns. This is the form of complexity that is probably most familiar to taxpayers.

The second, which may be of equal importance, is the complication of economic life that results from non-neutral taxation. Under a truly neutral tax system, taxpayers can simply respond to economic incentives, without the necessity of considering the tax consequences of their decisions. Thus, production managers can worry about production, dentists can concentrate on dentistry and investors can consider the economic advantages of alternative investments without being concerned about the tax consequences of their decisions or about how to minimize taxes. By comparison, if the tax system is not neutral, economic decision-makers are faced with the additional complication of considering tax consequences as well as economic results in making their decisions. For many businessmen and investors, this second form of complexity may be every bit as important as the first. It might be noted that many view simplification and tax reform as one and the same thing. They see others benefit from provisions of the tax code that they do not use and wish that the tax code could be "simplified" to eliminate these provisions. Thus, they desire simplification (reform) for others, as well as for themselves.

As noted earlier, some observers believe that tax policy should be employed to stimulate economic growth or the international competitiveness of the United States economy. The Treasury I view denies that the tax system needs to be used for either of these purposes. It agrees that taxation should not unduly hinder either economic growth or international competitiveness, but believes that both growth and competitiveness would be adequate if only the tax system were more neutral and did not impede growth or our ability to compete internationally.

B. Income and Consumption Taxes

Income has traditionally been accepted as the proper measure of taxpaying ability. However, this view has not been universally accepted, and in recent years, leading tax authorities have expressed an especially strong interest in consumption-based taxation. For a review of arguments for and against income and consumption as measures of tax-paying ability, see, for example, Goode, THE INDIVIDUAL INCOME TAX (1976); id. (1980); Bradford, The Case for a Personal Consumption Tax, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? 75-113 (J. Pechman, ed. 1980). For additional arguments in favor of the personal expenditure or consumed income tax, see infra references in note 17.
personal taxation.\textsuperscript{17} However, many who understand and appreciate the manifest advantages of a personal tax on consumption, which would be measured by cash flow, are concerned by the distributional implications of switching from income to consumption as the measure of taxpaying ability.\textsuperscript{18} A third alternative, based on taxation of lifetime income rather than annual income, has recently been put forward as a means of realizing the primary advantages of both income and consumption taxes.\textsuperscript{19} However, its feasibility depends on the politically vulnerable proposal to include gifts and bequests in the tax base of donors and decedents.

Despite the substantial advantages of a system of taxation based on cash flow, be it of the consumption or lifetime income variety, \textit{Treasury I} (like the President's proposals and H.R. 3838) follows the more traditional approach of an annual income tax. This section describes briefly the major difficulties of an annual income tax, the economic and administrative advantages of the systems based on cash flow, and some of the reasons for rejecting the latter in favor of the traditional annual income tax approach.

\section{The Tax on Annual Income}

For reasons to be indicated below, \textit{Treasury I} adopted annual income as its tax base, rather than either consumption or lifetime income. In order to meet the basic objectives of horizontal equity, economic neutrality and simplicity, it adopted as its proximate objective the uniform and consistent taxation of all real economic income, regardless of the source or use of income.\textsuperscript{20} In many respects, the base broadening required to implement a comprehensive tax on annual income is no different from that required under a comprehensive tax on consumed income or life-

\begin{itemize}
  \item \textsuperscript{18} A tax based on consumption is, under certain conditions, equivalent to either a zero tax on capital income or a tax on labor earnings. Thus, substituting it for the income tax would shift the tax burden to consumers or wage earners and away from wealthy taxpayers. See D. Bradford, \textit{supra note} 17, at 122-23.
  \item \textsuperscript{19} See H. Aaron \& H. Galper, \textit{Assessing Tax Reform} 66 (1985).
  \item \textsuperscript{20} For an attempt to implement a definition of real economic income in assessing the distributional implications of tax reform, see \textit{Treasury I}, \textit{supra note} 2, vol. 1, at 57-59.
\end{itemize}
time income. These issues are not discussed at this point. Rather, the remainder of this subsection is devoted to a brief discussion of inflation and the time value of money, two problems of income measurement that are inherent in the tax on annual income, as well as the double taxation of corporate income, a problem that can be handled more easily under a cash-flow tax than under a tax on annual income.21 Significantly, H.R. 3838 takes virtually no steps to deal with two of these problems. The distortion of the saving-consumption choice inherent in an annual tax on income is discussed in subsection 2 below.

a. Inflation Adjustment

Perhaps the most fundamental proposal contained in Treasury I was that which called for inflation adjustment—of depreciation allowances, cost of goods sold from inventory, capital gains and interest income and expense.22 Unless inflation has been abolished, in the absence of an inflation adjustment in the calculation of income from business and investment, it is meaningless to speak of uniform and consistent taxation of all income. Income from wages and salaries that is paid currently is measured accurately (if it is included in the tax base), regardless of the rate of inflation. However, in an inflationary period, nominal capital gains exceed real economic gains, real interest income and expense are both overstated, costs of goods sold calculated using first-in, first-out (FIFO) inventory accounting are understated, and depreciation allowances are understated, unless they are deliberately accelerated (relative to economic depreciation) as an ad hoc adjustment for inflation. While ad hoc measures such as the exclusion of part of long term capital gains, the acceleration of depreciation allowances, and the use of last-in, first-out (LIFO) inventory accounting can compensate for inflation, they do so inadequately, because the accuracy of the particular adjustment depends on the actual rate of inflation experienced.23 Mis-

21. Distortions caused by inflation would disappear under a consumption tax based on cash flow because all outlays for savings or investments would be fully deductible when made. See H. AARON & H. GALPER, supra note 19, at 87. A consumption-based tax would eliminate the need to consider the time value of money because only cash flow would be considered in determining tax liability. Id. The cash flow tax on corporations would be fully integrated with individual taxes. Id. For a further discussion of the problems of inflation and the time value of money under a tax on annual income, see H. AARON & H. GALPER, supra note 19, at 55-63.


23. Many would argue that LIFO produces a more accurate measure of in-
measurement of income results from the failure to accurately adjust for inflation in the measurement of business and investment income. This, in turn, creates horizontal inequities, economic distortions and complexities. Moreover, it can hinder capital formation, growth and international competitiveness.

The only way to avoid these problems in the context of an annual income tax is to allow for inflation in the measurement of income from business and investment. *Treasury I* contained a far-reaching, if imperfect, attempt at inflation adjustment. The proposals for inflation adjustment for depreciation allowances, inventories and capital gains were generally satisfactory and require little comment. On the other hand, though better than current law, the inflation adjustment for interest income and expense were known to be imperfect and would create at least two technical problems if enacted.

Conceptually, the correct way to allow for inflation in the case of debt instruments is either to reduce both reported interest income and deductible interest expense by the product of the inflation rate and the amount of outstanding debt or to adjust the basis of the debt by that amount. Because this pure approach was thought to be administratively infeasible, *Treasury I* followed the latter approach rather than FIFO and not that it is an ad hoc offset to inflation. Others would counter that LIFO improperly takes account of shifts in relative prices, as well as changes in price levels.

24. See *Treasury I*, supra note 2, vol. 2, at 151-92. The proposal for indexed depreciation allowances, which were based on the inflation adjustment of the best available estimates of economic depreciation, were generally subject to attack on two technical grounds. The first argument, that economic depreciation cannot be measured accurately, has nothing to do with the accuracy of the inflation adjustment per se. However, it may raise doubts about the wisdom of relying entirely on inflation adjustment to compensate for the effects of inflation. The second objection, that replacement costs in some industries do not closely track changes in the consumer price index (the index proposed by the Treasury Department for use in inflation adjustment) reflects a misunderstanding of the purpose of inflation adjustment. The objective is to measure real income accurately, not to assure that capital can be replaced tax free, without regard to movements in relative prices. For this purpose, use of a general price index is appropriate.

25. See *Treasury I*, supra note 2, vol. 2, at 197-200. In addition to the two technical defects described below, there was the basic defect that interest indexing would not apply to mortgage interest on the principal residence of the taxpayer. Indeed, *Treasury I* would not have even required that mortgage income be offset against mortgage interest expense, with only net interest income being indexed. C. McLure, *The Tax Treatment of Owner-Occupied Housing: The Achilles Heel of Tax Reform?* in *Tax Reform and Real Estate* 219-32 (J. Follain ed. 1986).

26. These two approaches involve an important issue of timing. Adjusting current interest income and expense to allow for inflation involves current recognition of changes in the purchasing power of outstanding debt, whereas adjustment of basis postpones recognition until debt is repaid.
an alternative ad hoc approach. A percentage of interest income
and expense would be disregarded depending on the rate of infla-
tion experienced during the year. 27

Though superior to the implicit assumption in current law
that inflation does not exist, the Treasury I approach to interest
indexing suffers from two obvious flaws. First, it clearly produces
the wrong results in virtually all cases. Second, it results in partial
exclusion of the "spread" of financial institutions. 28

b. Time-Value Of Money

In order to be totally fair and neutral, taxation must apply as
income accrues, rather than merely as it is realized. However, the
United States tax system has historically been based almost en-
tirely on realization; the use of depreciation allowances is a long-
standing notable exception. A tax based solely on realization ac-
cords preferential treatment to industries in which recognition of
expenses normally precedes recognition of the income they cre-
ate. Such "natural deferral industries" include oil and gas, min-
ing, timber, and orchards and vineyards. Analogous problems
can occur in the case of multi-year construction of assets if in-
come is recognized under the completed contract method of ac-
counting. Related problems occur in the case of bonds purchased
at a discount and the expense of decommissioning nuclear power
plants and reclaiming strip mines. In all of these areas, and

27. See Treasury I, supra note 2, vol. 2, at 194-200. The exclusion rate was
to be calculated by dividing the rate of inflation by the sum of that rate plus 6%.
Implicit in this procedure is an assumption that the real rate of interest is 6%. See
H. Aaron & H. Galper, supra note 19, at 62. This overly high estimate of the
real rate of interest was chosen deliberately in order to avoid overstating the
inflation adjustment.

28. Suppose, for example, that a bank borrows at 8% and lends at 10% at a
time when the inflation rate is 4%. Under an ideal system of indexing, taxable
interest income and allowable interest deduction would, in effect, both be re-
duced by four percentage points, leaving unchanged the two percentage points
spread between borrowing and lending rates. The Treasury I proposal, however,
in effect applied a fractional exclusion to net interest income or expenses. Thus,
it would reduce the spread representing the taxable interest income of the bank
by 40%. This illustration also shows that the proposed technique of interest
indexing would be defective for most net borrowers or lenders who are active as
both creditors and debtors. By coincidence, the 40% exclusion rate in the ex-
ample is exactly correct for the debtor paying an interest rate of 10% to the
bank. Under the Treasury I proposal, if the inflation rates were 4%, the 40%
exclusion rate would apply to all borrowers and lenders, including those that
had entered into contracts for interest rates well above or below 10%. For ex-
ample, the recipient of interest income at a rate of 8% from the bank would
exclude only 40% of net interest, even though inflation would, by assumption,
offset 50% of nominal interest income.
others, important issues of the “time value of money” arise because the timing of accrual of income and expense differs from that of cash flow.

Treasury I contains an astonishing array of complicated provisions intended to deal with issues resulting from the unwillingness to adopt either a strict cash flow or a pure accrual approach to taxation.\textsuperscript{29} Among these are requirements for capitalization of expenses in the case of multi-period production, recognition of income in the event of the pledge of installment obligations, restrictions on eligibility for the use of the cash method of accounting, elimination of deductions for reserves for bad debts and elimination of ensuing intangible drilling costs in the oil and gas industry.

c. \textit{Integration of Corporate and Individual Income Taxes}

The United States is almost alone among major developed countries in not allowing meaningful relief from double taxation of dividends. The existence of a separate unintegrated tax on corporate income results in double taxation of corporate equity income distributed as dividends. This produces horizontal inequities, encourages undue reliance on debt finance, discourages payment of dividends and discriminates against investment in the corporate sector.\textsuperscript{30} This problem cannot be solved in the context of an annual income tax by simply eliminating the corporate income tax, without freeing all retained earnings of corporations from tax. However, relief can be provided for double taxation of dividends by such techniques as shareholder credits for corporate taxes, corporate deductions for dividends paid and application of split-rate systems to amounts that are distributed and retained. But complete integration, for retained earnings as well as dividends, is generally deemed to be infeasible for administrative reasons.\textsuperscript{31}

2. \textit{The Tax On Consumed Income}

Recent years have seen substantial academic interest in a personal tax on expenditures or consumed income. In common par-

\textsuperscript{29} See \textit{Treasury I, supra} note 2, vol. 1, ch. 7; \textit{id.} vol. 2, ch. 10. Provisions dealing with the time value of money are also found in the discussions of the taxation of energy and natural resources and the taxation of financial institutions. See \textit{Treasury I, supra} note 2, vol. 1, ch. 11, 12.

\textsuperscript{30} See \textit{id.} at 134-35.

\textsuperscript{31} See \textit{C. McLure, Must Corporate Income Be Taxed Twice?} 146-84 (1979).
lance this may be expressed as a preference for basing taxes on consumption, rather than on income. Unlike indirect taxes on consumption, such as retail sales taxes and value-added taxes which are levied on transactions and do not allow for the personal circumstances of the taxpayer, the tax on consumed income is implemented through tax returns that closely resemble income tax returns. Therefore, a tax on consumed income can be personalized to take account of various taxpayer’s circumstances. Under one proposal the taxpayer receives a deduction for amounts deposited in “qualified accounts” and is taxed on amounts withdrawn from such accounts. Investments in capital goods are expensed, but the proceeds of borrowing are included in taxable income. As a result, only income that is consumed is subject to this tax on cash flow, hence the name “consumed income tax.”

Economists tend to stress the inter-temporal neutrality and fairness of the consumed income tax compared to the conventional annual income tax. Whereas the annual income tax discriminates against saving for future consumption, the consumed income tax is neutral with respect to the saving-consumption choice. Moreover, the present value of a proportionate tax on

32. Under this type of a consumed income tax, almost all financial transactions would be conducted through IRA-type qualified accounts held at banks or other financial institutions. See Treasury I, supra note 2, at 194. Any amounts put into a qualified account would be deductible. Id. Income earned on the account would not be taxed until withdrawn. Id. For further exposition of the mechanics of the use of qualified accounts to implement a tax on consumed income, see D. BRADFORD, supra note 17, at 110-14; Mieszkowski, supra note 17, at 193.

33. A form of consumption tax that resembles a peculiar form of a value-added tax but is implemented in a way that resembles the income tax has been proposed. See R. HALL & A. RABUSHKA, THE FLAT TAX (1985); R. HALL & A. RABUSHKA, LOW TAX, SIMPLE TAX, FLAT TAX (1983). Because the Hall-Rabushka Tax can provide personal exemptions, Treasury I describes it as a personal exemption value-added tax. See Treasury I, supra note 2, vol. 3, at 44, 103. For a further discussion of the Hall-Rabushka approach in the context of value-added taxes, see generally Carlson & McLure, Pros and Cons of Alternative Approaches to the Taxation of Consumption, Proceedings of the 77th Annual Conference on Taxation of the National Tax Association (1984).

34. See A. ATKINSON & J. STIGLITZ, supra note 13, at 62-63, 95, 563-66; D. BRADFORD, supra note 17, at 102-09.

35. Suppose that the interest rate is 10%; this implies that in the absence of taxation, 100 units of consumption today can be exchanged for 110 units of consumption tomorrow. A consumption tax that applies equally to consumption in both periods will not affect this rate of trade-off between present and future consumption. By comparison, an income tax that applies to interest income will modify the rate at which present consumption can be exchanged for future consumption. For example, if the income tax rate is 50%, a taxpayer who forgoes consumption of 100 units today will be able to consume only 105 units tomorrow. Thus, the income tax distorts preferences in favor of present consump-
consumed income is independent of the point in time in a person’s life when income is earned and when it is consumed. The conventional income tax, by comparison, is more generous towards early consumption and late receipt of income.

These economic benefits are not the most important reasons for adopting a tax based on cash flow. Probably more important is avoiding the administrative difficulties of implementing a tax on annual income. Under a cash flow tax, the two types of inherent difficulties with the annual income tax, previously identified, simply vanish. In a cash flow tax system, there is no need for an inflation adjustment because all income flows automatically occur in current dollars. In addition, there are no issues as to the time value of money because recognition of taxable consumption is determined simply by current cash flow. Finally, integrating personal and corporate taxes based on cash flow is a relatively simple matter.

3. Tax On Lifetime Income

Many who recognize the economic and administrative benefits of cash flow taxation are concerned about the failure of the consumed income tax to apply to income devoted to gifts and bequests. Failure to tax gifts and bequests would produce substantial disparities in the amount of taxes paid by taxpayers with equal lifetime resources who make different bequests. Moreover, total exclusion of gifts and bequests would facilitate growth in large family fortunes and accentuate inequality in the distribution of income.

Henry Aaron and Harvey Galper have proposed dealing with this problem in the context of a tax based on cash flow by including gifts and bequests in the tax base of the donor or decedent. The taxpayer’s total lifetime tax base would thus equal consumption plus gifts and bequests, or the total amount of resources available for consumption during the lifetime. For this reason
Aaron and Galper refer to this tax as a tax on lifetime income. Like the tax on consumed income, the lifetime income tax is based on cash flow and avoids the aforementioned problems of inflation adjustment and the time value of money. Similarly, integration of the personal and corporation income taxes is straightforward under this approach.

4. Choosing The Annual Income Tax

Despite the manifest advantages of taxation based on cash flow, Treasury I chose annual income as the basis of taxation. A number of factors lie behind this choice. First, there was serious concern about whether certain fundamental problems could be handled satisfactorily under the timetable set for the preparation of Treasury I. If a tax based on cash flow was proposed, it was feared that insuperable problems might be encountered in the following areas: transition, prevention of evasion and taxation of international investment and income flows, including the need to renegotiate all double taxation agreements with foreign governments. Concern that “show-stoppers” might be found in one or more of these areas (or others) precluded devoting all resources to development of a tax based on cash flow to the exclusion of work on the annual income tax. Moreover, the very novelty of the tax on consumed income also militated against its proposal.

A further reason for choosing the tax on annual income was purely political. The distributional implications of the two variants of a cash flow tax previously described above are quite different, for a given pattern of rates, depending on how gifts and bequests are treated. Advocates of a cash flow tax that included gifts and bequests in the base of the donor or decedent might be quite unwilling to support a similar tax that excluded such transfers. Similarly, advocates of a pure tax on consumed income might have little interest in a cash flow tax that included gifts and bequests in the base.

39. Id. at 66.
40. Work on Treasury I began in February, 1984. The deadline for submission of fundamental tax reform to the President was December, 1984. It should be noted that this discussion of why Treasury I chose annual income as the tax basis is not intended to be exhaustive. For a discussion of reasons for not proposing a tax based on cash flow, see Treasury I, supra note 2, vol. 1, at 200-12. For more on the practical problems of deciding whether a consumption-based tax is feasible, see C. McLure, Reflections on Recent Proposals to Rationalize the United States Income Tax (forthcoming in the Proceedings of the Annual Congress of the International Institute of Public Finance (Madrid, August 26, 1985)).
41. Id.
bequests in its base. If a cash flow tax had been proposed, the likely political outcome might have been either a legislative impasse resulting from inability to agree on the tax treatment of transfers or an unacceptable resolution of that issue. Given this prospect, a proposal for a tax on annual income, with all its defects, appeared preferable to a proposal for a conceptually superior tax based on cash flow.

III. Strategy of Tax Reform

History shows clearly that the achievement of fundamental tax reform is no simple task. Even under ideal circumstances it is difficult for the general interest—represented by a tax system that is more equitable, less distortionary, and simpler—to triumph over the special interests who defend the multitude of particular provisions of the tax code that undermine fairness, neutrality and simplicity. 42 This section discusses briefly several aspects of the politics and strategy of tax reform: the choice between "incrementalism" and the "up or down" approach of Treasury I, the advantages and difficulties created by the unusual way in which Treasury I was formulated, the political and economic importance of rules for fair and orderly transition to a reformed system, the role of distributional neutrality in the debate on tax reform, President Reagan's determination that tax reform must occur in a revenue neutral context and the importance of the starting point for tax reform.

A. Incrementalism or Up and Down?

In commenting on President Reagan's call for a plan for fundamental tax reform, many seasoned observers of the Washington scene have suggested that producing and proposing such a plan would be an exercise in futility.43 According to this way of thinking, the American political process simply could not absorb far-reaching and fundamental tax reform. If the tax system were

42. In his letter submitting Treasury I to President Reagan, Treasury Secretary Regan wrote the following,

Those who benefit from the current tax preferences that distort the use of our nation's resources, that complicate paying taxes for all of us, and that create inequities and undermine taxpayer morale will complain loudly and seek support from every quarter. But a far greater number of Americans will benefit from the suggested rate reduction and simplification.

Treasury I, supra note 2, vol. 1, at iv-v.

43. This is the assessment of Barber Conable, a former member of the House Ways and Means Committee, who calls himself a "raging incrementalist."
to be reformed, observers said, it must be through incremental changes over time, provision by provision.

_Treasury I_ did not adopt this pessimistic viewpoint. First, under an incremental approach, it was thought to be impossible to rally popular support for elimination of any but the most egregiously offensive provisions. Granted, reform of individual provisions might add to the fairness of the tax system, and perhaps even increase its neutrality and reduce its complexity, but the visible gains from reform of any one provision would probably be so small that popular support would be virtually nonexistent. The experience of history suggests that most of those interested in preserving particular provisions would have no difficulty in continuing to prevail over the general interest in such a case.

Second, it would be virtually impossible under the incrementalist approach to achieve a tax system that had internal consistency and logic. (Could we be sure, for example, that the provisions for dealing with inflation in the calculation of depreciation allowances, capital gains and interest income and expense were mutually consistent and consistent with other provisions?) More important, even if such a system might ultimately be achieved under the incrementalist approach, years would probably pass before the system achieved consistency and made sense. During that time taxes would continue to be unfair and distortionary. Moreover, even if the incremental approach to fundamental tax reform were successful, it would leave in its wake an absolute swamp of transition rules that would greatly complicate administration and compliance for years to come. Eventually, the repeated cries of taxpayers to "quit changing the system" are likely to be heeded.44 This would prevent fundamental tax reform from being fully achieved, and there is no reason to believe that a partially reformed system in place at such a time would be markedly better than the current one. Certainly, it would be inferior to the product of fundamental reform.

_Treasury I_ was based on the proposition that fundamental tax reform was most likely to occur if enacted in one comprehensive act. Fundamental reform would make possible substantial reductions in horizontal inequities and distortions of resource allocation. If carefully explained, these advantages of reform might

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44. This theme, leaving the tax system unchanged for a while, was among the most commonly heard during the series of eight hearings held throughout the country by the Treasury Department during the spring and summer of 1985 to elicit public views on the need and desirable contours of tax reform.
appeal to the general public. Elimination of all preferential treatment would create important reductions in marginal tax rates, a benefit that is far more understandable to the public than economists' esoteric arguments about reduced distortions and horizontal inequities. Moreover, fundamental reform could simplify economic decision-making, as well as administration and compliance, producing benefits which the public could readily appreciate. In short, it might be possible to rally the public behind fundamental tax reform in a way that would be impossible if tax reform were to take an incremental approach.

To be politically viable, the “all-or-nothing” approach would need to be just that: it would be necessary to propose the repeal of virtually all important and highly visible tax preferences. This would seem to be required by politics as well as economic integrity. As long as no important interest had been allowed to escape tax reform, it would be relatively easy for members of Congress to resist special pleading on behalf of any one industry or taxpayer group. But once Congress begins to make important concessions, tax reform would unravel politically, as well as economically. Even those who would be willing to give up their own pet provisions in the context of a fundamental reform that eliminated all preferences, would be unwilling to do so if others were let “off the hook.”

An important difficulty with the all-or-nothing approach is that many provisions for preferential treatment that economists decry are quite popular with the public. Notable examples include the itemized deductions for home mortgage interest, state and local taxes, and charitable contributions. Even many of those who would benefit from a combination of rate reductions and curtailment of such preferences fail to support such a policy, presumably because they fail to understand fully the opportunity costs (in terms of rate reduction) of the provisions. If enough of these important provisions were to survive tax reform, substantial rate reduction would be impossible in the context of revenue neutrality.

A further political difficulty of tax reform results from the existence of a multitude of less important provisions that make no

45. Throughout this paper, the term “tax preference” is used in the generic sense to describe deviations from uniform and consistent taxation of real economic income, rather than as the term of art employed, for example, in provisions dealing with the minimum tax.

46. See generally Brannon, supra note 15; Turnier, supra note 15.
sense and yet carry significant emotional appeal. These include the special exemptions for the aged and the blind, the exclusion of unemployment insurance and worker's compensation and the tax-free status of all veterans benefits. Proposals to curtail such provisions produce storms of righteous indignation that jeopardize the cause of tax reform, despite the reality that the truly needy would be protected from reductions in benefits. Any attempt to replace these provisions with explicit but less generous spending programs or with more properly structured (and hence less generous) provisions for preferential tax treatment generates opposition that would undermine the political feasibility of tax reform.

B. The Formulation of Treasury I

Treasury I was produced under conditions that were, for a variety of different reasons, difficult. First, the time frame of only ten months from announcement to due date meant that there was relatively little time for original thinking or innovative proposals. Instead, the distillation of the conventional wisdom among tax experts was the order of the day. Moreover, given this timetable and the need for confidentiality, it was difficult to employ outside experts as consultants. This reduced the likelihood of novel proposals such as a tax based on cash flow. It also meant including some proposals that could not be fully developed in the allotted time period, and resulted in a few technical errors. Finally it meant that adequate staff time was not available for full development of the economic analysis necessary to sell the tax reform proposals—or even to defend them effectively against their critics.

Second, Treasury I was produced during an election year. Rather than surviving intact as a proposal for fundamental tax reform, it could easily have been nibbled away as the Reagan Administration promised to preserve particular provisions in order to gain the support of various special interest groups. As it turned out, the home mortgage deduction was the only provision removed from the table of tax reform in this way.

48. For further discussion of the difficulties of formulating proposals for fundamental tax reform, see McLure, supra note 40 (forthcoming).
49. President Reagan also indicated publicly that fairness toward the American family would be an important objective of tax reform. The provisions in Treasury I and the President's proposals to increase the personal exemption to
The relationship between the Treasury Department and the White House (and other agencies of the executive branch) during the formulation of Treasury I deserves special attention. Secretary of the Treasury Donald Regan was forced to walk a tightrope as, for political reasons, it was convenient for President Reagan to be able to say truthfully during the campaign that he did not know what the Treasury Department would be recommending. Moreover, if the White House had been involved in the formulation of Treasury I, leaks would almost certainly have occurred. Once provisions became public, political compromises would have been made and fundamental tax reform would have been lost. Thus, as the tax reform package was being developed, the White House knew very little about the likely contents of Treasury I. On the negative side, this meant that Treasury I could not realistically be described as an Administration proposal. While tax reform proposals bearing the imprimatur of the Secretary of the Treasury carry far more weight than proposals from other sources, without a Presidential endorsement, such proposals would not immediately be of more than academic interest.

Since the White House had no prior knowledge of the contents of Treasury I, it is hardly surprising that President Reagan did not immediately adopt the proposals in their entirety. But the hands-off approach of the White House, perhaps expressed most graphically in Secretary Regan’s statement that the proposals were written on a word processor, indicated clearly that changes would be made and provided the signal for special interests to come forward and make their cases. Of course, the prospect of $2000 and eliminate the deduction for second earners have sometimes been interpreted as a response to conservative demands that tax reform favor the traditional family, in which both parents are present and only the father is employed outside the home. Such is not the case. Conservatives were well aware of research by a member of the Treasury Department’s Office of Tax Analysis documenting the deterioration of the real value of the tax threshold. Steuerle, The Tax Treatment of Households of Different Size, in TAXING THE FAMILY 73 (R. Penner ed. 1983). However, their insistence on an increase in the tax threshold was no more than incidental in the formulation of the Treasury Department’s proposal to increase the personal exemption and zero bracket amount (ZBA) enough to raise tax thresholds to the poverty level. It is also notable that the largest increase in the ZBA was for heads of households, hardly the typical traditional family. Finally, concern for so-called traditional values played absolutely no part in the decision to propose elimination of the deduction for second earners. That decision was based on recognition that the deduction in current law is not structured properly to achieve its intended effect and the belief that a provision such as the second earner deduction would be substantially less essential with a rate structure of the type being proposed in Treasury I. See Treasury I, supra note 2, vol. 2, at 13-14.
eliminating important reform proposals from the package the President would be submitting to the Congress, as well as being undesirable in its own right, threatened the political viability of fundamental tax reform. From the time Treasury I was unveiled, the all or nothing approach was in jeopardy.

Treasury I seems to have caught many of those who would have been most adversely affected by tax reform off-guard and unprepared. Few seemed to have expected the Treasury Department to propose such far-reaching reforms. Had the White House moved quickly to determine what modifications it wanted to make in Treasury I and then submitted the revised package to Congress, passage of a more comprehensive tax reform package might have been possible. The unfortunate lapse of six months between the release of Treasury I and submission of the President’s proposals—explained, in part, by the Regan-Baker job switch 50—allowed special interests to regroup and gear up for battle and thus undermined the cause of tax reform.

C. Transition Provisions

The “all-or-nothing” approach to tax reform underlying Treasury I does not imply that all reforms of current law should be implemented immediately or simultaneously. As the discussion of fair and orderly transition in Treasury I indicates, 51 it is neither fair nor economically sensible to suddenly make drastic changes in the fiscal landscape. The windfall gains and losses and the economic disruptions caused by sudden change are simply too great to be tolerated.

Moreover, it may not be politically feasible to make sudden changes. Certainly, it would be easier from a political point of view to make changes that reach full effectiveness only over time than to change the tax law immediately, without any provisions for transition relief. Changes can be made gradually by using future effective dates, by phasing them in, or by grandfathering existing assets. If given a chance to adjust to the future tax law, businesses and individuals are less likely to resist changes than if faced with economic hardships caused by sudden changes in the law. In other words, from a political point of view, as well as from the viewpoint of economic good sense, there is much to be said

50. James Baker was sworn in as Secretary of the Treasury on February 3, 1985, succeeding Donald Regan, who resigned to become Chief of Staff at the White House.
for gradually implementing fundamental tax reform. After all, there is no compelling reason for quickly changing the fundamental structure of a tax system that has been in place for seventy years. Moreover, the necessity of implementing reform gradually need not be a deterrent to enacting fundamental tax reform. Even though the President wants to be identified with fundamental reform, there is nothing preventing reform enacted during his term of office from becoming effective at a later date.

Unfortunately, all political considerations do not fortuitously point in this direction. Rather, politicians naturally want to take credit immediately for provisions that, considered by themselves, reduce revenues. Most notable among these are provisions that increase personal exemptions and reduce rates. Moreover, there may be concern that any provision for tax reduction that does not become effective immediately might be repealed before its implementation in order to reduce the deficit or to change the distribution of tax burdens across income classes.\footnote{At the time formulation of Treasury I was nearing completion, Democrats in the Congress were proposing that benefits from the third year of the 1981 rate reductions be capped, and therefore largely denied to upper income individuals.} But if the benefits of these revenue-losing provisions are to be granted immediately, the requirement of revenue neutrality implies that the reforms that raise revenue must also take effect on the same timetable.

The timetable for implementing the reforms proposed in Treasury I was, unfortunately, dictated by such short-run political considerations, rather than economic good sense. For example, because of the desire to reduce individual income tax rates and to raise personal exemptions quickly, the investment tax credit would be eliminated on January 1, 1986, the deduction for state and local taxes would be eliminated within two years, and beginning in 1988, interest indexing would apply to outstanding debt.\footnote{Effective January 1, 1986, personal exemptions would have been raised to $2000. In order to meet the goal of revenue neutrality during the first year, the reduction in tax rates for individuals was delayed until July 1, 1986. For a full list of transition provisions in Treasury I, see Treasury I supra note 2, vol. 1, at 233-43.} It is hardly surprising that those who would be adversely affected by these precipitous changes protested vigorously. One can only speculate whether the prospects for fundamental tax reform would have been better or worse if more reasonable transition rules had been proposed in Treasury I.
D. Distributional Neutrality

Tax reform has historically been a liberal cause motivated by the desire to increase the overall progressivity of the tax system by reducing or eliminating provisions that are especially advantageous to upper-income individuals and corporations.\textsuperscript{54} Treasury I took a quite different approach. It concentrated on horizontal inequities, economic neutrality and simplification. It sidestepped vertical equity by aiming for equal percentage reductions in tax liabilities at all income levels except for the very bottom, where percentage reductions would be much larger. The objective of distributional neutrality, defined in this way, characterized the 1985 debate on tax reform.\textsuperscript{55}

Many observers presumed that revenue neutrality would be applied separately to corporations and to individuals, rather than being interpreted as simply requiring that the sum of individual and corporate tax liabilities remains unchanged after tax reform. Treasury I, however, contained a substantial increase in corporate taxes and a corresponding reduction of individual taxes.\textsuperscript{56} Several factors explained this choice. First, the definition of taxable income was determined on technical grounds. The objective was to tax all real economic income uniformly and consistently. Thus, the shift of tax liabilities should be attributed to the choice of tax rates, not the definition of the base. Under Treasury I, it was deemed undesirable to have a substantial difference between the corporate rate and the top individual rate.\textsuperscript{57} This was especially true because taxable income would reflect economic income much more closely than it does under current law. A 37% top

\textsuperscript{54} Fred Harris, a former member of the Senate Finance Committee, and former Chairman of the Tax Action Campaign, has been quoted as saying that every poll showed that people felt the rich and corporations didn't pay their fair share. Pierson, \textit{Tax Reform in the 70's: Tilting at Windmills, Oil Rigs, and the Middle Class}, 28 Tax Notes 1229, 1231 (1985). The targets of reform remained mostly the rich and corporations. \textit{Id.} at 1294.

\textsuperscript{55} This is, of course, only one of several ways (and not necessarily the best one) in which distributional neutrality might be defined. An alternative would have been to define distributional neutrality as an equal percentage increase in after-tax incomes. This would have produced a substantially more progressive pattern of post-reform average tax rates. \textit{See also} Musgrave & Tun Thin, \textit{Income Tax Progression}, 56 J. Pol. Econ. 498-514 (1948).

\textsuperscript{56} For the amount of the increase in corporate taxes and decrease in individual taxes, see \textit{TREASURY DEP'T REP.}, \textit{supra} note 2, vol. 1, at 45.

\textsuperscript{57} If the corporate tax rate is significantly lower than the top rate for individuals, many high-income individuals could incorporate to avoid the higher individual rate. For a critical discussion of this objective, see Ballentine, \textit{Where Is the Income Tax Rationale for The Shift to Higher Corporate Taxes?}, 90 Tax Notes 443 (1986).
marginal rate for individuals would have produced both revenue
neutrality and distributional neutrality for individual taxpayers. However, the 37% rate was deemed to be too far above the 28% corporate rate that would have produced revenue neutrality for corporate taxpayers.

Second, the shift of liabilities from individuals to corpora-
tions was judged to be necessary for political reasons. That is, it was deemed necessary to propose both a substantial reduction in individual income tax liabilities (not just reductions in marginal tax rates) as well as a more rational system that exhibited greater equity, neutrality and simplicity. Without a shift of liabilities from individuals to corporations, there would only be a slight increase in the number of individuals who would experience tax cuts rather than tax increases. (The fact that those with tax reductions outnumbered those with tax increases indicates that the relatively few who make the greatest use of tax preferences are taking advantage of the more numerous taxpayers who make less use of preferences.)

Third, there was some concern that the reductions in corpo-
rates tax liabilities resulting from the 1981 tax act might have been overly generous. Finally, much of the increase in corporate liabilities would result from curtailment of provisions that, being of particular benefit to specific industries, are particularly inappropriate, rather than a generalized increase in corporate taxes.

The acceptance of a shift of liabilities from individuals to corpora-
ations in *Treasury I*, which was included in the President’s proposals at an attenuated level, conditioned the debate on tax reform in the Congress. Having proposed such a shift, it would be difficult for the administration to object to H.R. 3838, which included a similar shift of liabilities. Of course, as in *Treasury I*, much of the proposed increase in corporate taxes contained in H.R. 3838 came from sectors that have historically used preferential provisions to pay little or no taxes.

E. *The Constraint of Revenue Neutrality*

In response to prodding from Walter Mondale during the presidential debates, President Reagan promised that he would

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59. For a discussion of the sources of increased corporate tax liabilities, see supra note 5. See also Treasury I, supra note 2, vol. 1, at 245-54.
not tolerate a tax increase as part of fundamental tax reform. Since this promise has frequently been reiterated by Regan and other administration officials, revenue neutrality has been an essential element in Treasury I, the President’s proposals, H.R. 3838 and the ensuing debate in the Senate.

The constraint of revenue neutrality has a potentially important positive effect on the tax reform debate. First, in the context of truly fundamental tax reform, revenue neutrality helps assure that advocates of special provisions recognize the opportunity cost of such provisions; if a given preference is to be retained, it is necessary to make up the revenue. Conversely, advocates of tax reforms can be relatively confident that revenue raised through base broadening will be reflected in rate reductions, rather than finding its way into deficit reduction or increased spending. Of course, once compromises are made to retain some preferences, this line of reasoning loses much of its force.

The promise of revenue neutrality has had another fundamental effect. Treasury I devoted an entire volume to examination of general sales taxation, including a value-added tax (VAT). It concluded, however, that it would be senseless to introduce a VAT if revenues generated from it were only employed to offset revenue reductions caused by lower-income tax rates. In the absence of the revenue neutrality constraint, a VAT or some other form of general sales tax might have been chosen as a means of both reducing the deficit and replacing part of the income tax.

Having the VAT revenues available for this purpose might have both helped and hindered the tax reform process. Target rate reductions and increases in personal exemptions could have been reached more easily without taking such a hard line toward base broadening. But if this approach is carried to the extreme, the existing defective income tax might have been left in place, with a VAT, lower rates and increased exemptions in the income tax being the only lasting legacy. With VAT revenues available to finance these two forms of reductions in individual taxes, the corporate-individual shift that has so incensed business groups and many members of Congress would not have been necessary. Of

60. See generally Treasury I, supra note 2, vol. 3.
61. Preliminary cost estimates by the IRS indicate that implementation of a VAT would cost $700 million per year once the tax is fully implemented. See Treasury I, supra note 2, vol. 3, at 124, 128. In addition, enforcing the tax system would require an additional 20,000 employees. See id., vol. 3, at 128.
course, those who are concerned about the regressivity of a VAT would have attempted to block such a development.

F. The Tyranny of the Starting Point

The process of legislating (or even proposing) tax reform exhibits considerable resistance to change. Those who benefit from preferential treatment under current law fight hard to protect their privileges by wrapping them with whatever arguments and protective devices they can muster. Industries that would never have come into existence in the absence of preferential tax treatment send lobbyists to plead their cases. Provisions that make little sense, and which may not have even had strong advocates before enactment, suddenly become sanctified and are protected by the special interest groups they have spawned.

The tyranny of the starting point is worth particular notice in two cases, that of the deduction for state and local taxes and the investment incentives enacted as part of the Economic Recovery Tax Act of 1981 (ERTA). 62

Suppose that someone were to propose a federal program to subsidize the expenditures of state and local governments. One might reasonably question why public expenditures should be subsidized, relative to private expenditures, but that is only the first problem. Suppose further that it was suggested that the subsidy rate should depend on the income level of individual taxpayers living in each state or local jurisdiction and that contrary to expectations, the subsidy rate would rise with income, rather than decline. Moreover, in the case of jurisdictions with heavy concentrations of taxpayers who do not itemize deductions—generally lower-income families—there would be little or no subsidy at all. We might all agree that the characteristics of the subsidy scheme just described do not constitute good public policy and would presume that no such program would be enacted. 63


63. Aaron and Galper employ the same type of argument in demonstrating the defects of the current tax treatment of owner-occupied housing. See H. Aaron & H. Galper, supra note 19, at 17. Their description of this “home ownership assistance” program follows:

Most members of both houses of Congress today embraced a new homeownership assistance program. Under this program homeowners will be entitled to rebates based on the amount of their mortgages and the interest rate on those mortgages.

Unlike many assistance programs, however, the amount of aid will rise with income, and there will be no limit on the maximum payment. Four-person families with incomes of less than $7,400 will be entirely
Yet, those are precisely the characteristics of the deduction for state and local taxes, one of the most staunchly defended of all tax expenditures. Representatives of states with the highest levels of income and/or taxation fight hard to retain this deduction, because it benefits their constituents the most. Once enacted, provisions such as these that make little or no sense are difficult to repeal, especially if repeal is to occur rapidly.

Consider now the outcry that was heard against replacing the accelerated cost recovery system (ACRS) enacted under ERTA with the Treasury I proposal for a real cost recovery system (RCRS). RCRS is a system of indexed depreciation allowances designed to reflect economic depreciation. Had RCRS been proposed in 1981, the business community would probably have hastened to support it. The United States had just gone through an extended period of high inflation that eroded the value of depreciation allowances based on historical costs. RCRS would have protected future depreciation allowances from inflation and would have been substantially more advantageous than the depreciation allowances under the then-current law. Of course, by ineligible for aid. So will any family whose housing payments for mortgage interest plus certain other payments are less than $3,400.

The payments will begin at as little as 11% of qualifying expenditures by single persons with incomes of less than $3,300, and four-person families with incomes of less than $7,400. The maximum subsidy of 50% of qualifying expenditures will be available only to single persons with incomes of more than $85,000 and to four-person families with incomes of more than $166,400.

The new program will be administered in a novel way. Instead of processing applications for assistance, the government will pay funds automatically to anyone who fills out a simple form. The government intends to audit only about 2% of all such forms for accuracy and honesty. "It sure keeps down the size of the bureaucracy," one skeptical critic quipped.

When asked whether it was true that some upper income families might receive $10,000 per year or more under the program, while some lower income families receive nothing, the bill's sponsors acknowledged that such an outcome was anticipated. Despite a study by the Congressional Budget Office showing that more than half of the subsidies under this homeownership-promotion program would accrue to households with incomes of $50,000 per year or more and virtually none to households with incomes of $10,000 per year or less, no one in Congress, the current administration, or in any previous administration could be found to criticize the plan on the record.

Id.

64. For a discussion of RCRS and its effects, see Treasury I, supra note 2, vol. 2, at 157-72.

the time Treasury I was proposed, the business community had already gained adoption of ACRS and saw no reason to give it up once inflation had subsided. While at high rates of inflation RCRS is more generous than ACRS, it would be less generous if inflation is below a rate of about five percent.66

Treasury I has been attacked as inimical to economic growth and the competitive position of American industry in international trade. Again, had Treasury I been proposed in 1981, the arguments would have been just the opposite. Treasury I would have stimulated economic growth by preventing the adverse effects on investment stemming from the combination of inflation and an unindexed tax system. Moreover, this would have been seen as helping the competitive position of American industry. Of course, by the time Treasury I was proposed, American industry was reeling from the adverse effects of an overvalued dollar induced by capital inflows resulting from the budget deficit and high interest rates.67

IV. Treasury I: The High Road

Being relatively isolated from demands for political compromise, the authors of Treasury I had the opportunity to formulate a set of proposals for fundamental tax reform that would closely approximate the ideal of a comprehensive annual income tax. Because Treasury I took this high road, its advocates could speak with fervor of its advantages in achieving horizontal equity, economic neutrality and simplification. Although Treasury I was not without defects, it was not as flawed as the advocates for special interests claimed. This section describes in broad outline the most fundamental provisions of Treasury I and (where not already given) their justification. It then describes several real defects and even more imagined problems.

66. See Treasury I, supra note 2, vol. 2, at 166-72. At a 5% rate of inflation, the present value of depreciation allowances under RCRS exceeds that of ACRS for assets in classes 1-3. Id. at 166-68. At the same rate of inflation, the allowance for assets in classes 4-7 is less under RCRS than under ACRS. Id. at 169-72.

67. Those who argued for investment incentives on grounds of international competitiveness apparently overlooked a simple identity from the national income accounts. The excess of national investment over national saving equals the inflow of capital, that is, the excess of imports over exports. Stimulating investment without increasing saving inevitably implies a deterioration in the current account in international transactions.
A. The Outlines of Treasury I

As noted earlier, Treasury I proposed introduction of a comprehensive system of inflation adjustments. The indexation of interest income and expense would have increased incentives to save and reduced incentives to borrow. It would also have taken much of the wind out of tax shelters by reducing the interest expense passed on to investors. Thus, a system of inflation adjustments would have helped tax reform achieve the goals of economic neutrality, horizontal equity and simplicity.

With both depreciation allowances and the calculation of capital gains indexed for inflation, it was not thought necessary to provide accelerated depreciation allowances or to exclude a portion of long-term capital gains from the tax base. As a result, the RCRS proposed in Treasury I would have allowed deductions for the real value of depreciation as indicated by the best available estimates of economic depreciation. Similarly, taxing real capital gains as ordinary income would have had important benefits in simplifying the administration of and compliance with the tax system, since a substantial amount of the Internal Revenue Code is devoted to preventing the conversion of ordinary income into preferentially-taxed capital gains.

Treasury I contained numerous proposals to reduce or eliminate preferential treatment now accorded various industries and sources of income. Those included elimination of percentage depreciation and expensing of intangible drilling costs in the oil and gas industry, extension of at-risk rules to real estate, capitalization of many expenditures incurred in multi-year production that are now expensed, taxing large limited partnerships as corporations and tightening the rules for interest limitations for individual taxpayers. Together with the deceleration of depreciation al-

68. Time and space do not allow comprehensive examination of all the provisions in Treasury I. Only the most fundamental reforms are outlined here. Many others, while important in the aggregate, are probably better seen as traditional base broadening, rather than as fundamental reform. For a list of provisions of current law not affected by Treasury I, see Treasury I, supra note 2, vol. 2, at 147.
69. For a discussion of the Treasury I proposals in this area, see supra notes 22-28 and accompanying text.
71. For a discussion of the elimination of percentage depletion and expensing of intangible drilling costs, see Treasury I, supra note 2, vol. 2, at 229-33. For a discussion of the extension of at-risk sales to real estate, see id. vol. 2 at
lowances, elimination of the investment tax credit, the taxation of real capital gains as ordinary income and interest indexing, these (and similar) provisions would have virtually eliminated opportunities for profitable corporations to pay little or no tax and for high-income individuals to shelter income.\(^\text{72}\) As a result, *Treasury I* suggested that if the changes it proposed were enacted, both the corporate and individual minimum taxes should be eliminated.\(^\text{73}\)

In order to prevent double taxation of corporate source equity income and the problems it produces, *Treasury I* proposed that corporations should receive a deduction for one-half of dividends paid.\(^\text{74}\) Together with the indexing of interest income and expense, the deduction for dividends paid would help to redress the preference given by current law for the use of debt finance, rather than equity.

*Treasury I* also proposed that many sources and uses of personal income that are now accorded preferential treatment be taxed more fully. Most notable among these are the proposals to eliminate the exclusion for most employee fringe benefits and the deduction for state and local taxes.\(^\text{75}\) Reduction of the tax advantages of employee fringe benefits is required for both horizontal
fairness and economic neutrality.\textsuperscript{76} The existing exclusion of most fringe benefits provides an unfair advantage to those who are paid this form of compensation. Moreover, it encourages over-consumption of goods and services that can be provided as tax-exempt fringe benefits, relative to goods and services that cannot be provided as tax-exempt fringe benefits. Similar concerns motivated the proposal to eliminate the deduction for state and local taxes.\textsuperscript{77} The deduction encourages over-expansion of state and local services. Furthermore, taxpayers in high-tax states benefit relatively more than those in low-tax states.

\textit{Treasury I} also proposed substantial reductions in marginal tax rates of individuals—on average roughly 20\%.\textsuperscript{78} High-income taxpayers would receive the largest reduction because they benefit the most from preferential provisions in the current law.

Tax liabilities for families with incomes above $20,000 would be cut by a relatively uniform fraction. Whereas the average cut for all families would be 8.5\%, the reductions for various income categories above $30,000 fell within the relatively narrow range of 6.4\% to 9.3\%.\textsuperscript{79} As indicated earlier, these reductions in individual taxes were to be financed by increases in taxes on corporations.

Since 1979, when the personal exemptions and zero-bracket amounts (ZBA’s) were last changed, there has been a substantial amount of inflation. As a result, the tax-free amounts represented by exemptions and the ZBA have deteriorated substantially in real terms. The 1981 tax cuts did not reverse this trend, although the indexing enacted in 1981, to become effective in 1985, will prevent its continuation.\textsuperscript{80} In order to restore approximate equality between the threshold level at which income tax liability begins and the official poverty level, \textit{Treasury I} contained a

\textsuperscript{76} See \textit{Treasury I}, supra note 2, vol. 1, at 73-74; id. vol. 2, at 20-50.

\textsuperscript{77} See id. vol. 1, at 78-81; id. vol. 2, at 62-68.

\textsuperscript{78} See id. vol. 1, at 47.

\textsuperscript{79} Id.

\textsuperscript{80} Inflation had, in effect, shifted the curve relating marginal tax rates (on the vertical axis) to levels of real income (on the horizontal axis) to the left. The 1981 act, by shifting the curve downward, compensated (or more than compensated) taxpayers with incomes above the poverty level for the effect of inflation. However, it did not provide any benefit to those low-income households that had been forced by inflation to pay income tax on poverty level incomes. Both \textit{Treasury I} and the President’s proposals would shift the rate schedule back to the right. It is ironic that Congressman Jack Kemp, one of the most outspoken advocates of increasing the personal exemption in the recent debate, had been one of the authors of the 1981 rate reductions that failed to deal with the problem of inflation-induced erosion of the personal exemption.
substantial increase in the personal exemption and moderate increases in the ZBA's.\textsuperscript{81}

B. Economic Defects of Treasury I

*Treasury I* contained one major economic defect and several less important ones. These defects are discussed in this subsection. Alleged defects of *Treasury I* are discussed in subsection C below.

The single most important defect of *Treasury I* was dictated by political reality. President Reagan, in the aftermath of a question and answer session with members of the National Association of Realtors, was forced to declare the deduction for home mortgage interest "off limits" for tax reform.\textsuperscript{82} This prohibition was ultimately interpreted to mean that the inflation adjustment would not be applied to the home mortgage deduction.\textsuperscript{83} Besides meaning that the resulting proposals for tax reform could not be totally fair, this artificial constraint meant that the tax system proposed in *Treasury I* might actually be less neutral than current law.\textsuperscript{84} The unfairness of making the home-mortgage deduction a sacred cow is easily seen. Those with home mortgages would pay less tax than others with the same amount of real economic income. Moreover, there would be a tremendous incentive for all homeowners to borrow the equity on homes in order to benefit from tax arbitrage: investing the proceeds from higher mortgages in debt obligations in order to benefit from the asymmetric tax treatment of deductions for interest on mortgage debt (not indexed) and income from interest bearing securities (indexed). The tax advantages of home ownership could easily induce such over-investment in owner-occupied housing that it would totally offset the benefits from achieving a more level playing field in other dimensions.

Another inappropriate provision in *Treasury I* was retention of the exclusion of interest income on state and local securities. Though this exclusion creates well-known inequities and inefficiencies...
ciencies, for political reasons its elimination was not proposed.\textsuperscript{85} Given the proposal to eliminate the deduction for state and local taxes and the exclusion for interest on state and local securities issued for non-governmental purposes, it did not seem worthwhile also to propose repeal of the exclusion for interest on securities issued for governmental purposes.

C. Alleged Defects of Treasury I\textsuperscript{86}

The proposal to decelerate depreciation allowances and eliminate the investment tax credit ("ITC") created a split among the business community. Most capital-intensive industries fought hard against the elimination of these investment incentives by forecasting the imminent "deindustrialization" of America and the loss of international competitiveness. Because these industries use investment incentives and other provisions to substantially reduce their tax liability, if not to eliminate it altogether, they would have gladly accepted higher statutory tax rates in exchange for retention of the ITC and accelerated depreciation. On the other hand, there are many firms and entire industries, including some that make heavy capital investments, that pay relatively high effective tax rates. These corporations were willing to give up the investment incentives in order to achieve the substantial rate reductions proposed in Treasury I.

Many academic economists sided with advocates of investment incentives; some would clearly accept higher statutory rates to finance more generous investment incentives. This reflects several interesting shifts in viewpoint over the past several decades. After all, economists, like others, have traditionally decried the imposition of high marginal tax rates because of the distortions of economic decision-making and the disincentives they create.

Academic support for investment incentives can probably be traced to two sources. The first is the relatively recent development of a methodology for assessing how combinations of tax provisions affect the "cost of capital" and so-called ex ante marginal effective tax rates. Interest in this approach has "crowded out" concern over other types of distortions, including those that

\textsuperscript{85} For a standard description of the inequities and distortions caused by the exclusion of interest on state and local securities, see Ackerman & Ott, An Analysis of the Revenue Effects of Proposed Substitutes for Tax Exemption of State and Local Bonds, 23 Nat'l Tax. J. 397 (1970).

\textsuperscript{86} This section concentrates on specious attacks mounted against the most fundamental provisions for reform proposed in Treasury I.
result from high statutory tax rates. Second, as mentioned above, academic interest in consumption-based taxation has been growing. There may be a tendency to believe that any provision that reduces the taxation of investment would represent a desirable move toward a consumption-based system.

There are at least two problems with this rather naive viewpoint. First, one cannot simply "mix and match" expensing (or even rapidly accelerated depreciation) from the tax on consumed income with the interest deductions from the income tax. Any such attempt cannot be made without creating negative effective tax rates on debt-financed investments, economic distortions that would not exist in either pure system, opportunities for tax shelters and substantial complexity. To achieve neutrality, equity and simplicity, one must choose either the income or consumption system and adopt it in full. Second, as noted above, the primary advantage of a tax on consumed income is its simplicity of compliance and administration, particularly the elimination of problems involving inflation-adjustment and the time value of money. Simply including investment incentives—whether indexed or not—in a tax system based on nominal income would not achieve simplification; it creates complexity.

The Treasury I proposals for indexing and the related provisions for economic depreciation and taxation of real capital gains as ordinary income were also attacked on a number of other grounds, most of which were fallacious. First, there was a tendency to focus on revenue effects during the 1986-1990 period. This put the proposal to switch from ACRS to RCRS in quite a negative light. ACRS can reasonably be seen as an ad hoc attempt to compensate for inflation by allowing depreciation to be taken more rapidly than assets actually lose value. RCRS, on the other hand, explicitly allows for inflation, so that depreciation allowances track economic depreciation more accurately. In present value terms, RCRS is actually as generous as ACRS for most types of investment unless the inflation rate lies below 5%.

The deceleration of depreciation allowances during the period of transition from the "front-loaded" ACRS to RCRS would have produced a temporary bulge in corporate tax revenues during the 1986-1990 period. Business opponents of the shift from ACRS

87. For further discussion of RCRS and ACRS, see supra note 66.
88. See Treasury I, supra note 2, vol. 1, at 44-45. Thus, corporate receipts in 1990 would be 36.5% higher than under current law. By comparison, if the Treasury I proposals were fully phased in, corporate receipts would be only about 24% higher. See id.
to RCRS concentrated on these five-year revenue figures rather than long-run revenue estimates or on the present value of real depreciation allowances.

The argument that the real present value of depreciation allowances would be as great under RCRS as under ACRS carried less weight with many business executives than might have been expected. This can probably be traced to a variety of sources. First, some simply did not understand the purpose of indexing, which was to prevent the measurement of real income from being distorted by inflation. Second, even those who clearly understood the economics of RCRS did not necessarily prefer it to ACRS. This suggests that economists' models that focus attention on real present values and exclude consideration of up-front cash flow may fail to capture real-world decision making.

If business was concerned about the increase in its tax liabilities during 1986-1990 period, others were equally concerned that indexing of depreciation allowances would create a revenue "time bomb" that would explode sometime beyond 1990. That is, they feared that if inflation accelerated, depreciation allowances would increase accordingly and revenues would be lower than under an unindexed system. This attribute of an indexed system is undoubtedly correct. But it should be seen as an advantage of indexing rather than a disadvantage, since the mirror image of lower government revenues is less improper taxation of fictitious business income.

As indicated above, the Treasury I proposal for interest indexing was known to be imperfect. Even so, it was thought to be a substantial improvement over current law. The inadequacies of Treasury I concerning the treatment of financial institutions could

89. In private conversations with the author, several business representatives have complained that the provisions for inflation adjustment increase uncertainty about the nominal value of deductions for interest expense. Of course, the basic purpose of these proposals was to reduce the uncertainty of effective marginal tax rates, calculated on the basis of real economic income.

90. Prospects for long-run budgetary balance were even worse under the system of "present value expensing" proposed in one of the later versions of the Kemp-Kasten proposal. See H.R. 777, 99th Cong., 2d Sess., 131 Cong. Rec. E288-91 (daily ed. Jan. 31, 1985). Rather than including a proposal for expensing, which clearly would have entailed an enormous and unacceptable loss of revenues in the early years, Kemp and Kasten proposed a "back-loaded" system of indexed depreciation allowances that would equal expensing in present value but involve relatively minor revenue cost in early years. (This was achieved by allowing deductions for more than the cost of assets.) As structured, the Kemp-Kasten proposal would entail an explosion of depreciation allowances just after the 1986-90 period, regardless of the rate of inflation.
have been repaired, with some resulting complications.\footnote{More problematical was the failure of the proposal for indexing to apply to home mortgage interest, or even to require netting of mortgage deductions against interest income. While it might have been possible to provide for netting, thereby eliminating the most egregious cases of tax arbitrage, the over-allocation of capital to owner occupied housing could not have been eliminated without directly facing the political necessity to eliminate (or at least substantially reduce) the deduction for home mortgage interest.} However, the real opposition to interest indexing came from three other directions. First, because indexing would apply to the interest on the national debt, for which there is no offset on the deduction side, a loss in tax revenues would result. Nonetheless, indexing probably would have reduced interest rates significantly—by as much as two percentage points.\footnote{The amount by which interest rates would drop would depend on the degree of international mobility of capital, an issue about which economists are divided.} The savings on interest on the national debt resulting from this reduction could easily have exceeded the reduction in tax revenues caused by indexing. However, this was not factored into the calculation of revenue neutrality.

Second, interest indexing would have taken much of the attraction out of investment in real estate, which is generally heavily reliant on debt finance. Moreover, investments in tax shelters, which are based on the tax advantages of debt finance, would be less attractive to high income taxpayers who take advantage of shelters to reduce or eliminate their tax liability.

Third, under the transition rules of Treasury I, indexing would become effective in 1988 and would be applied to loans outstanding at that time. This unreasonable transition provision would have hit public utilities especially hard because they rely heavily on debt financing and had recently undertaken large capital investments.

The proposal in Treasury I to tax real capital gains as ordinary income was attacked from two directions.\footnote{For a discussion of the proposal to tax real capital gains, as ordinary income, see Treasury I, \textit{supra} note 2, vol. 2, at 178-88.} One line of attack focused upon the 75\% increase in statutory tax rates applied to taxable gains. Whether through ignorance or subterfuge, critics of the proposal denied the substantial benefits of indexing. At inflation rates approximating those experienced in recent years, taxation of real capital gains as ordinary income is actually more generous than taxation of only 40\% of nominal gains, except in the case of truly spectacular gains.\footnote{See \textit{id.} vol. 1, at 101-05.}
Those concerned with entrepreneurship and venture capital investment took little solace from this argument. They expressed concern that the proposed provisions would not be generous enough to provide adequate incentives for invention, innovation, and the investment of venture capital that brings such activities to fruition. Essentially, the argument was that many entrepreneurs who begin successful new ventures have little basis in their companies. They also argued that venture capitalists have relatively little basis in investments that are highly successful. Thus, compared with the substantial increase in the maximum statutory rate from the current 20% to the proposed 35%, inflation adjustment is of little benefit to either of these groups. Those who were concerned about this problem took little comfort from the fact that the portfolios of most venture capital investors are sufficiently diversified that historical rates of return on them vary little from those of more mundane investment portfolios. Nor could these fears be allayed by suggestions that provisions for deduction of losses could be liberalized. The conventional wisdom among advocates of preferential tax treatment of capital gains (though not among economists) is that both entrepreneurs and venture capital investors are driven by the attraction of truly spectacular gains and would take little notice of provisions for more complete loss offset.

The proposal to tax most employee fringe benefits is arguably one of the most important provisions of Treasury I. Yet, it was attacked as undermining the foundation for private health care in America. The argument was that if employer-provided health insurance did not remain entirely tax free, a system of national health insurance would result. Of course, the reality was that Treasury I would have only taxed health benefits to the extent that they exceeded a quite generous amount. Substantial tax incentives for private health care would have remained intact.

The proposal to end the deduction for state and local taxes precipitated a split along state lines. Public figures from high-tax states protested vigorously against the proposal. Arguments employed included extraordinary redistributational activities of high-
tax states and spillovers between jurisdictions, as well as a variety of less compelling but emotional arguments. Those from low-tax states, which on average would have benefitted from the repeal of this deduction in a revenue-neutral context, were generally not vocal in their support for the provision. Indeed, there were some representatives of low-tax states who actively opposed it.98

The proposal for a deduction of 50% of dividends paid would have eliminated an important source of inequity and distortion from the tax code. However, this provision would result in a substantial loss of revenue. Thus, the proposal for dividend relief was vulnerable from the start. Many corporations would have gladly traded it for retention of the ITC provided by the investment tax credit and ACRS. The proposal for dividend relief received only lukewarm support from those in the corporate community who would have benefitted the most from it.

V. DOWNHILL TO H.R. 3838

Concerns and complaints such as those described in the previous sections had a devastating effect on tax reform as the process moved to the formulation of the President’s proposals and passage of H.R. 3838. This brief section summarizes and evaluates some of the most important changes made between Treasury I and H.R. 3838. For convenience, the discussion proceeds in two stages: the “slippage” in the President’s proposals and the further compromise in reaching H.R. 3838. As before, we concentrate on the proposals for truly fundamental changes in the tax code.

A. The President’s Proposals

Indexing of interest income and expense was dropped from the President’s proposals. Although inventory indexing was originally retained, it was soon sacrificed on the altar of revenue neutrality. The dividend deduction was reduced from 50% to 10% for the same reason.99 Indexing was retained for depreciation al-

98. One cannot escape the impression that many public officials from low-tax jurisdictions, whose constituents would benefit from repeal of the deduction, opposed repeal because their own jobs would be made more difficult if taxpayers in their jurisdictions could not claim the deduction. Of course, employees of state and local governments predictably opposed repeal, arguing that repeal would lead to various types of disaster. For a recent analysis of the “tax competition” argument for retaining the deductions for state and local taxes, see McLure, Tax Competition: Is What’s Good for the Private Goose Also Good for the Public Gander? 34 Nat’l Tax J. 341 (1986).

99. See President’s Tax Proposals, supra note 12, at 122-23.
allowances, but these allowances were accelerated in the interest of stimulating capital formation. The current-law approach to the taxation of capital gains was retained in response to the pleas of those concerned about entrepreneurship and venture capital. The expensing of intangible drilling costs in the oil and gas industry was retained for political reasons, though ostensibly on the grounds of national security.

The President proposed eliminating the deduction for state and local taxes. Without this reform, there would not have been enough revenue to meet the targets for rate reduction. On the other hand, the taxation of most employee fringe benefits was excluded from the President's proposal, presumably because of a deal with Bob Packwood, Chairman of the Senate Finance Committee, who thinks fringe benefits should not be taxed. The quid pro quo in such a deal has never been clearly identified. It may have been merely Packwood's general support for tax reform.

The President's proposals would have been an improvement over current law. But since the three primary components of tax shelters (acceleration of deductions, preferential treatment of capital gains, and full deduction of nominal interest expenses) survived, it was necessary to include a minimum tax on corporations and individuals in the President's proposals. In short, the tax reform proposals officially sanctioned by President Reagan were only a dim shadow of those submitted to him by the Treasury Department six months earlier; compared to Treasury I they

100. Id. at 138-51. The problem of tax shelters would have been substantially greater had advocates of expensing been more successful in their attempts to substitute it for RCRS.

101. The President proposed that the Treasury I approach to the taxation of capital gains be allowed as an option, beginning in 1991. See id. at 169. For practical purposes this meant that a policy of taxing real capital gains as ordinary income had been shelved.

102. It should be noted, however, that the minimum tax was strengthened in important ways, particularly by reducing the "net income offset" allowed in calculating the preference for intangible drilling and development costs. See id. at 231-33. Under current law this offset virtually eliminates this item of preference.

103. See id. at 62-69.

104. Whereas Treasury I would have taxed employee health benefits to the extent that they exceeded a fairly generous cap, the President's proposal contained a ludicrous provision to tax only the first few dollars of such benefits. See id. at 24-29. Such an approach has neither the equity nor the allocative advantages (in terms of reduced incentives for excessive expenditures on health care) of the Treasury I approach.
would be less equitable and less neutral, and would achieve less simplification.

The approaches used by the White House in early efforts to sell the President’s proposals to the American public were decidedly different from those that had been used in the initial efforts to popularize Treasury I. Advocates of Treasury I emphasized the horizontal inequities of current law, the allocational advantages of a tax system that applied uniformly and consistently to all sources and uses of income and the simplification that would occur both in taxpayer compliance and in economic decision-making.

Rather than taking this high road and arguing for tax reform on the basis of sound principles, the White House speech writers chose to make an emotive appeal to greed and a presumed widespread dislike for the Internal Revenue Service. The implied suggestion that virtually everyone would get a tax cut played directly into the hands of those who could point out numerous examples of sympathetic taxpayers who would pay more taxes under the President’s proposals than under current law. With so many sources and uses of income remaining tax-preferred under the President’s proposals, it was difficult to argue persuasively that economic neutrality was an important objective. The retention of a minimum tax on both individuals and corporations belied the claims that simplicity would be achieved. The transparency of the political compromises in the President’s proposals, in such areas as fringe benefits and the tax treatment of oil and gas, made it clear that this was to be political business as usual, rather than a legitimate attempt to rationalize the United States tax system.

B. H.R. 3838

The House bill reflects further departures from the ideal system of Treasury I. Indexing remains only for depreciation—and only for one-half of inflation in excess of 5%. A deduction for 10% of dividends paid would be phased in over ten years. Fringe benefits would remain virtually exempt from tax, and state and local taxes would remain fully deductible. Despite substantial

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105. These themes can be seen clearly in President Reagan’s May 29, 1985 message in which he submitted his tax reform proposals to the Congress. President’s Message to the Congress Transmitting Proposed Legislation, 21 WEEKLY COMP. PRES. DOC. 707 (May 29, 1985). These themes have been repeated in many other speeches on tax reform.

106. See H.R. REP. No. 426, supra note 5, at 154-55.

107. Id. at 234-42.
In short, while H.R. 3838 contains many worthwhile provisions, it achieves few of the objectives of Treasury I. Substantial distortions and inequities will remain and little significant simplification will have been achieved. Indeed, H.R. 3838 would add to complexity in several areas. The rate structure of H.R. 3838 appears at first glance to resemble that of Treasury I and the President's proposals with the addition of 38% rate for taxable income in excess of $100,000. In fact, H.R. 3838 contains substantially less of a rate reduction because the 25% and 35% rates begin at substantially lower levels of taxable income.  

VI. Assessment

Treasury I contained 408 pages of general explanations, the detailed descriptions of current law, reasons for change, proposed changes and analysis. Some of these proposals involved fundamental changes in the structure of the United States income tax. Inflation adjustment of interest income and expense—with concomitant changes in depreciation allowances and the tax treatment of real capital gains—clearly falls in this category, as does the proposal for deduction of 50% of dividends paid by corporations. The proposals to end itemized deductions for all state and local taxes and to tax most forms of employee fringe benefits are also fundamental. The reductions in marginal tax rates of individuals and corporations to levels not seen for many years also constituted a fundamental change. By comparison, the increase in the personal exemption and ZBA merely continued a tradition made necessary by the prior failure to index those amounts for inflation. Taken individually, few of the other provisions constituted fundamental reform. But taken together, these provisions—in combination with those for RCRS, taxation of real capital gains as ordinary income, interest indexing, etc.—would have constituted truly fundamental reform, as indicated by the Treasury I proposal to eliminate the minimum taxes.

108. On the other hand, the definition of income in H.R. 3838 is substantially less inclusive than under Treasury I and the President's proposals. For a comparison of marginal tax rates under current law and H.R. 3838, see Sunley, Reduction in Marginal Tax Rates for Individuals, 30 TAX NOTES 447 (1986). For a comparison of marginal tax rates under current law and the Senate Finance Committee proposal, see MAKIN, ORNSTEIN & STEUERLE, THE ECONOMICS AND POLITICS OF TAX REFORM (1986).

Virtually all of the fundamental reforms proposed in *Treasury I* are absent from H.R. 3838 or present only in much attenuated forms. For example, H.R. 3838 contains a slow phase-in of a small deduction for dividends paid and limits the inflation adjustment of depreciation allowances to one-half of the excess of inflation over 5%. Thus, H.R. 3838 is appropriately characterized as Democratic base broadening in the 1969 and 1976 tradition and is more accurately described as “tax overhaul” than as tax reform. Some of the reforms of *Treasury I* may be salvaged in the Senate in order to finance liberalization of depreciation allowances. Some state and local taxes and fringe benefits have been mentioned in this regard. But no matter what happens, the result will not approach the comprehensiveness or the economic integrity of *Treasury I*. Nor will it deliver the equity, neutrality and simplification of that proposal.

**Postscript: The Senate Bill**

In the early hours of the morning of May 7, 1986, the Senate Finance Committee voted unanimously in favor of a radical tax reform bill that would virtually eliminate tax shelters and lower marginal tax rates.\(^\text{110}\) Seven weeks later, the full Senate voted ninety-seven to three for a bill that did not differ significantly from the Finance Committee bill. Even though differences between the House and Senate bills must be resolved in conference before being presented to President Reagan for his signature, most observers agree that such resolution will occur and that by the end of the year the United States will have a vastly improved income tax.

This turn of events is widely hailed as a miracle, in light of the way special interests had so recently been able to subvert the tax reform process in the Senate Finance Committee. In a speech on May 2, less than a week before the Finance Committee’s “conversion,” the present author had the following to say:

> The Senate Finance Committee seems to be hell-bent on proving that democracy does not work. True tax reform would entail eliminating or curtailing egregious tax preferences that benefit the few, in order to lower marginal tax rates on the many, and thereby improve the fairness, neutrality, and simplicity of the system. But in response to pressure from representatives of

special interests, the Senate Finance Committee has voted to preserve tax preferences that are unfair, that distort economic decision-making, and that complicate the tax system for everyone. They have reduced marginal income tax rates, but would use highly regressive and horizontally inequitable excise taxes to offset much of the revenue loss.

Two natural questions to ask about the Senate bill are: 1) is this really fundamental tax reform and 2) why and how did the miraculous change occur? Though these questions (and others) cannot be answered in detail, this postscript does offer brief comments on both.

A. Is it Fundamental Tax Reform?

The various provisions of the Senate bill were "cobbled together" in an attempt to gain some objectives of tax reform, while preserving politically sensitive preferences. As a result, the bill lacks the coherence of Treasury I, and falls short of realizing the full potential of tax reform for fairness, neutrality and simplicity.

The Senate bill is characterized by two basic features: substantial rate reduction and sharp curtailment of opportunities for tax shelters. In and of themselves, these are important improvements. Curtailment of tax shelters will increase the horizontal equity and neutrality of the tax system and reduce its complexity and the perception of unfairness by reducing the ability to avoid taxes by investing in tax-favored activities. Lower rates will reduce incentives for tax-motivated behavior of all kinds, as well as reducing disincentives and horizontal inequities. The Senate bill improves the tax system in few other fundamental ways.

That this is true can be seen by considering briefly the most important Treasury I reforms, described in Section IV above. Under the Senate bill, inflation should continue to erode the value of depreciation allowances based on the historical nominal cost of assets and overstate real interest income and expense. Even worse, nominal capital gains would be taxed as ordinary income, without the benefit of inflation adjustment, and dividends would continue to be taxed twice. While tax shelters would be considerably curtailed, many of the preferences that constitute the basic ingredients of shelters would be continued. Indeed, oil and gas is explicitly excluded from the anti-shelter provisions.

Little is done to rationalize the tax treatment of individuals.
All mortgage interest on as many as two homes would be deductible, as would most state and local taxes. Contributions to individual retirement accounts (IRAs) would no longer be deductible for all taxpayers, but employee health benefits provided by employers would continue to be tax exempt. In short, the Senate has passed a tax shelter-rate reduction bill, not fundamental tax reform.

B. How Did It Happen?

In gaining the unanimous approval of the Senate Finance Committee bill (and the nearly unanimous vote of the Senate) Senator Packwood used exactly the tactic envisaged in the preparation of Treasury I. That is, he presented for an “up or down” vote a package that was sufficiently attractive to be acceptable to all (or almost all) members, even though it contained many provisions that individual senators disliked. In the Senate, virtually all amendments to the Finance Committee bill were rejected on the grounds that acceptance of any one might open the floodgates for others.

The process in the Finance Committee differed from that hoped for in the preparation of Treasury I in one important way. Favors were granted to some Senators in order to gain their support for the tax reform package. These included preferential treatment for oil and gas, for timber and for health benefits, as well as continuation of such popular provisions as the deduction for most state and local taxes. As a result, there are obvious and unfortunate holes in the fabric of tax reform as it has emerged from the Senate, as well as in the House bill.