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SPECIAL REPORT: THE ECONOMIC RECOVERY TAX ACT OF 1981

It is very difficult to describe the Economic Recovery Tax Act of 1981 without recourse to the grandiose. Press reports have been replete with references to the "revolutionary," "dramatic," "massive tax bill." The "biggest tax cut in history"* is a common lead.

The dollar figures are certainly impressive with the annual cut rising from $38 billion in fiscal 1982 to $268 billion by five years out in 1986 (initial impact basis). The cumulative reduction for those years is estimated at $749 billion -- about $145 billion more than total federal receipts this fiscal year and roughly equivalent to the total gross national product in 1966. The tax cut in relation to today's economy -- and that projected through 1986 -- appears much smaller, though still very significant, especially compared to other major tax reductions in the postwar period.

Tax Cuts and the Economy

Economic Recovery Act of 1981	FY82	FY83	FY84	FY85	FY86
Estimated Total Revenue Reduction ($bils.)	37.6	92.7	150.0	199.3	267.6
Reduction as % of GNP 1/	1.2	2.6	3.8	4.5	5.6

Other Major Tax Reductions as % of GNP 2/	
1962 Revenue Act	0.2
1964 Revenue Act	1.8
1971 Revenue Act	0.7
1975 Tax Reduction Act	1.4
1977 Tax Reduction & Simplification Act	0.5
1978 Revenue Act	1.4

1/ According to Administration budget assumptions as of 7/15/81.
2/ Generally for first full year of impact, excluding extensions of existing tax cuts.

Sources: OMB, Joint Committee on Taxation.

*In absolute dollars, this is obviously true, but the 1981 bill is still small potatoes in proportion to the cuts in federal revenues in the 1920s and after the Civil War. In the mid-1920s under then Secretary of the Treasury Andrew Mellon's prodding, income tax rates were reduced up to 83% in the lower brackets, by 40% in the middle brackets and

Because of the gradual phase-in of several important provisions of the current bill and uncertainties as to both the actual revenue cost and future GNP level, the dollar impact/GNP ratio is only an approximation. Also, the ratios for past bills are probably understated somewhat because extensions of existing tax cuts, an important factor in a number of major Acts in the 1970s in particular, are excluded from the calculations. Nevertheless, the overall implication is clear. If the major provisions of P. L. 97-34 are implemented on schedule, the reach of the public sector over private sector resources should stabilize measurably below the present level. The following table illustrates:

Federal Tax Receipts as % of GNP
1950 - 1986

Actual			Under P. L. 97-34[1/]	Without P. L. 97-34[1/]
1950	17.5	1982	20.7	22.0
1955	18.2	1983	19.6	22.3
1960	18.6	1984	19.0	22.8
1965	17.8	1985	19.1	23.3
1970	20.2	1986	19.2	23.9
1975	19.3			
1978	19.5			
1979	20.1			
1980	20.3			
1981(E)	21.1			

1/ According to Administration budget assumptions as of 7/15/81.
Source: OMB, Economic Report of the President, January 1981.

The Administration is certainly very pleased with the outcome, having achieved at least 90% of its initial objectives -- across the board rate reductions and depreciation reform -- and being favorably inclined to many of the add-on provisions, particularly inflation indexing. The business community is generally quite satisfied with the bill, too, but at this point not exuberant. In fact, since the loud cheer from the Republican side as the crucial July 27th House vote on the Hance-Conable substitute bill passed the required majority of 217, there has been little tub-thumping. In part, this reflects the sobering thought that the onus is now on the program's supporters. If future economic performance does not respond favorably as projected, if sufficient further budget cuts cannot be implemented and the deficit balloons in the next fiscal years, if interest rates stay in the stratosphere, if almost any number of quite conceivable bad scenarios happen, the Republican program will be blamed and public reaction turn negative.

Obviously, the sweep of the President's Congressional victory has not silenced the program's detractors. Adoption of the tax bill has been called "Christmas in July," "a great day for the aristocracy," and an act that

over 50% in the highest brackets. Going further back, the Republicans in power in the post Civil War decade set about energetically to dismantle the income tax. Total federal tax receipts were chopped by two-thirds from a peak of $309 million in 1866 to a paltry $110 million in 1873, following the total demise of the income tax.

"monstrously complicates an already complicated Code." The reception from the financial markets has been positively frigid with continuing worries about future deficits, high interest rates and crowding out of private section financing. There is speculation that if the deficit in fiscal 1983 cannot be brought down sharply, the Administration may be forced to ask for a delay in the effective dates of some of the phased-in tax cuts or raise taxes elsewhere.

Regardless of the near-term economic fall-out from the Economic Recovery Act of 1981 and its pointed political implications, the movement to reduce the burden of income taxes has a lot of momentum. It will be very hard to reverse that momentum at any time in the foreseeable future, absent a critical national emergency. The progressive income tax structure has been under strain for many years, strain greatly exacerbated by inflation, by deterioration in compliance and then by growing disillusionment with many of the public programs it was designed to support. The problems of high rates of income taxation in terms of equity, compliance, effect on investment and work incentives, etc. became more and more intolerable as the public wearied of big spending programs that did not produce the desired results. This doesn't mean that the U.S. electorate wants to dismantle government, but that it wants a lower profile of government without the most destructive aspects of income taxation. And this could have a lot of staying power whatever future political grades are assigned to the Economic Recovery Act of 1981.

Demise of the Clean Bill

There has been much comment, usually negative, as to how overloaded the tax bill became in part because of the open "bidding" war between the Administration and House Democrats for the support of consecutive Democrat votes. The contrast between simple 10-10-10 rate reduction and depreciation reform, as proposed in February, and what actually emerged is very marked, of course. There are 66 separate provisions in P. L. 97-34, at least 42 of which have a measurable revenue effect.

The Administration readily admits that many provisions were taken on board at the last minute to cement the victory in the House. As Secretary of the Treasury Regan told a group of supporters, these provisions were the "impedimenta" of the battle -- the baggage that had to be brought to the front.

The table below shows the extent to which provisions added by Congress exceed the estimated dollar impact of the original Administration program in the later 1980s.

Estimated Revenue Impact of P. L. 97-34 in Excess of Administration's February 1981 Proposals

Fiscal Years	$Bils.	% of Total Impact
1982	- 16.2	N.A.
1983	- 7.3	N.A.
1984	1.9	1.3
1985	13.6	6.8
1986	45.9	17.2

Source: Joint Committee on Taxation.

As indicated, in fiscal 1982-83 the impact of the added provisions is more than offset by the smaller first year rate reduction, but then gets progressively larger as the 1980s wear on. Most observers felt right along that the tax bill would end up looking much more like the Senate Finance Committee measure of last summer than the squeaky clean proposals of last winter. Our tax legislative process just doesn't lend itself to unsullied bills.

Nevertheless, there is some genuine simplification in the measure. In particular, of course, the new depreciation system should prove much easier for record keeping and compliance purposes for most businesses. The liberalized treatment of LIFO accounting and new treatment of foreign earned income likewise will make tax compliance simpler for small business and overseas workers, respectively. Not to mention that substantially lower rates can make all tax problems easier to live with.

Two Critical Factors

How the President and his supporters orchestrated the tax battle of 1981 and won such a sweeping victory at mid-year has been well chronicled. We should take note, however, of two critical factors in the development of P. L. 97-34, which have received less attention.

One was an important change in strategy, reemphasizing the pain of existing tax burdens and deemphasizing the rosier supply-side projections of how much good these tax cuts would do. Regardless of the extent to which the President believed in, and felt comfortable with, the supply-side scenario, he saw early on that the communication job would be very formidable. Hence the first round of super-optimistic projections from OMB consultants was shelved; the need for extensive budget cuts was brought up front; the Treasury began trotting out reams of tables showing just how high tax rates had gotten, and where they would go if there were no tax cut or a limited tax cut.

This strategy fit in well with the temper of the times. It built on the many studies and assessments of recent years showing how unsatisfactory our savings and investment performance had been, but shied away from specific future predictions on the economy (other than to insist right along that a very significant part of the marginal rate cuts would be saved). The public was certainly aware of high and rising tax burdens and at the same time increasingly suspicious of any economic forecasts, supply-side or otherwise.

On the individual side, the Administration was effective in communicating the story of marginal rates and how, even with hoped for improvement in economic conditions and lower inflation, a big tax cut would be necessary to keep people relatively even, to avoid real increases in future tax burdens. The table on the next page shows the estimated effect of the rate changes under the tax cut program on top marginal rates for three "typical" income classes compared to the recent past.

Marginal rates should drift downward because of the tax cut and this will help generate additional savings at all levels. Note that even under the Administration's relatively optimistic projections of declining inflation, the marginal rate for each of the three typical income classes in 1984

Marginal Tax Rates for Four-Person Families[1/]
1965-1984

Year	One-Half Median Income $	Tax Rate	Median Income $	Tax Rate	Twice Median Income $	Tax Rate
1965	$3,900	14%	$7,800	17%	$15,600	22%
1970	5,582	15	11,165	20	22,330	26
1975	7,924	17	15,848	22	31,696	32
1977	9,162	16	18,723	22	37,446	36
1978	10,214	19	20,428	25	40,856	39
1979	11,211	18	22,422	24	44,844	43
1980	12,722	18	25,443	24	50,886	43
			Under P. L. 97-34[2/]			
1981	14,100	18	28,100	28	56,200	43
1982	15,100	16	30,100	25	60,300	44
1983	16,000	17	31,900	23	63,900	40
1984	16,800	16	33,600	24	67,200	38

1/ Assumes itemized deductions equal to 23% of income.
2/ Rate changes only, assumes inflation of 8.7% in fiscal 1982 trending down to 5.0% in fiscal 1986 and same increases in median income.

Source: Office of Tax Analysis, Department of the Treasury.

is the same or nearly the same as back in 1977-1978. Without the tax cut, of course, marginal rates were projected to keep rising to the point where the median income family of four with about $33,600 in 1984 would face a 32% marginal rate and the twice median income family with $67,200, a 49% marginal rate. Thus, even while the actual reductions in tax burdens for most taxpayers could hardly be termed revolutionary, the contrast between future burdens under the Administration program, and future burdens under no bill or a considerably lesser bill, was quite significant. The opposition was never able to get over this hurdle. The Democratic alternative--essentially a one and one-half year cut-- clearly afforded less in the way of an offset to bracket creep at almost all levels of income.

Oddly, the inflation indexing provision was never a significant issue in the formative stage of the tax debate. Presumably, if implemented on schedule in the mid-1980's, indexing will eliminate the problem of inflation induced bracket creep, as well as the erosion in value of the major flat allowances. But indexing was thrown in on the Senate floor well after the arraying of forces for a three-year versus a smaller tax cut.

Another critical factor facilitating quick action to adopt P. L. 97-34 was the budget process at least as it evolved in 1981. This helped in two ways. First, it forced an early commitment to make a very substantial cutback in the trend of public spending which legitimized a large tax cut. Secondly, it set forth target levels of revenues, tax reductions and deficits for both fiscal 1982 and later years that were compatible with the Reagan tax program. While the out year targets of the Budget Resolution are not binding, they put a further stamp of approval

on the multi-year tax cut. Whatever doubts individual Congressmen had about locking in tax reduction that was far, far bigger than the budget savings under the current reconciliation bill, the process itself served as an authority to go ahead.

Some in Congress thought the main result of the Budget Control and Impoundment Act of 1974 would be to greatly weaken the Executive Branch's ability to bottle up spending programs approved by Congress. They must be shaking their heads still.

Distribution

Equity of distribution of tax cuts was an oft-raised but never really dominant issue in the development of the 1981 tax program. The ground was preempted largely by the President in his insistence early on that tax relief should be apportioned in proportion to tax liabilities paid. That is just about where it came out, despite the emergence of numerous additional provisions affecting individual taxpayers. True, the House Democrats fashioned a bill that would skew more relief to the lower income groups. But the actual differences in distribution between the original Administration proposal, the Ways and Means Committee measure, and P. L. 97-34 as enacted, were far less pronounced than the political rhetoric.*

For one thing, the House Democrats quickly decided that there had to be some rate relief for everyone and even led the charge on reducing the top marginal rate from 70% to 50%. The provisions in the Ways and Means bill aimed specifically at the lowest income groups still paying taxes, such as expanding the earned income and child care credits, were comparatively modest. Easing the marriage tax penalty, which was picked up in P. L. 97-34, is of benefit primarily to middle income taxpayers. The resulting mix of tax reductions under either the Ways and Means or the Administration proposal, were spread in a reasonably even manner according to actual tax burdens, a decided contrast to the redistributionist tax bills of the 1969-1976 era. The tables on pages 7 and 8 illustrate.

A number of quite significant provisions of P. L. 97-34 are difficult to distribute precisely according to income class. In general, the new savings incentives, as well as the liberalization of foreign earned income treatment and the expanded exclusion on gain at sale of residences, primarily will benefit upper income groups; the charitable contributions deduction for non-itemizers and the expanded child care credit will benefit low-middle and middle income groups the most. Probably on balance, the major changes under P. L. 97-34 affecting individuals other than the rate changes and the marriage tax penalty relief will weaken the progressivity of the tax structure somewhat, but not enough to change our assessment of the overall bill as basically a proportional tax reduction.

One interesting twist here. What's left of the estate and gift tax under P. L. 97-34 actually is somewhat more progressive, at least below the $2,500,000 level. As a result of raising the estate tax exemption equivalent to $600,000 by 1987, more than tripling the gift tax exemption to $10,000 per donee per year, and allowing an unlimited marital deduction,

*A quixotic demonstration of the real parallelism of the two major bills was provided b Chairman Dan Rostenkowski's repeated calls to direct more tax relief to the "working classes of $20,000 to $50,000." In 1980, the median income for four person families with one or more earners was $25,400.

Comparison of Tax Liabilities - Prior Law vs P. L. 97-34, 1981-1986[1/]
Constant 1980 Dollars, One Earner Family of Four

Income Class	1981 Prior Law	1981 P. L. 97-34	1981 Tax Reduction	1982 Prior Law	1982 P. L. 97-34	1982 Tax Reduction	1983 Prior Law	1983 P. L. 97-34	1983 Tax Reduction
$10,000	$ 484	478	6	$ 559	485	74	$ 626	505	121
20,000	2,132	2,104	28	2,233	1,993	240	2,312	1,873	439
30,000	4,153	4,101	52	4,363	3,195	448	4,527	3,674	853
50,000	9,972	9,848	124	10,400	9,364	1,036	10,800	8,777	2,023
100,000	28,831	28,487	334	29,460	27,563	1,897	29,948	25,609	4,339

Income Class	1984 Prior Law	1984 P. L. 97-34	1984 Tax Reduction	1985 2/ Prior Law	1985 2/ P. L. 97-34	1985 2/ Tax Reduction	1986 2/ Prior Law	1986 2/ P. L. 97-34	1986 2/ Tax Reduction
$ 10,000	$ 686	527	157	$ 733	521	212	$ 776	517	259
20,000	2,381	1,818	563	2,446	1,811	635	2,521	1,806	715
30,000	4,669	3,606	1,063	4,827	3,589	1,238	4,977	3,579	1,398
50,000	11,201	8,616	2,585	11,536	8,569	2,967	11,832	8,542	3,290
100,000	30,373	24,802	5,571	30,728	24,725	6,003	31,042	24,681	6,361

% Change in Real Tax Liabilities

Income Class	1981-1984	1981-1986
$ 10,000	15.2%	21.5%
20,000	14.0%	18.7%
30,000	13.6%	18.4%
50,000	13.6%	18.3%
100,000	10.2%	13.6%[3/]

1/ For each year, incomes are calculated using increases in the consumer price index since 1980 according to Administration budget assumptions. Tax calculations assume itemized deductions equal to 23% of income. Changes in tax liability reflect only changes in the marginal income tax rate schedule.

2/ Tax brackets, zero bracket amount and personal exemption are increased 5.43% in 1985 and 4.65% in 1986 - reflecting the indexing feature of P. L. 97-34.

3/ The $100,000 income class realizes a smaller percentage reduction because the entire income is considered wage income taxed at a maximum 50% under prior law.

Source: fice of the Secretary of Treasury and Office of T Analysis, Department of the Treasury. August 17, 1981.

Percentage Distribution of Individual Income Tax Reductions Over Income Classes

Expanded Income ($000)	Average of Major Cuts 1969-1977 1/	Revenue Act of 1978	1981 Ways & Means Committee Bill 1984 Impact	Conable-Hance Substitute 1984 Impact	Prior Law Distribution Total Tax Liability 1981 Income Levels
0-3	8.6%	1.6% (0-5)	0.5% (0-5)	0.2% (0-5)	0% (0-5)
3-5	14.6				
5-10	32.6	11.6	4.8	2.4	2.2
10-15	24.5	7.8	7.3	5.4	5.7
15-20	12.2	11.6	8.7	7.8	8.0
20-30	9.0 (20-50)	23.2	22.3	20.7	20.4
30-50		20.0	31.5	31.3	29.9
50-100	0.8	12.3	14.8	18.5	18.0
100-200	-2.4 (100+)	4.8	5.0	7.5	8.4
200+		7.2	5.1	6.1	7.4

1/ Includes reductions in 1969, 1971, 1975, and 1977. Weighted averages of constant dollar distribution by AGI (not expanded income).

Source: Joint Committee on Taxation; Office of Tax Analysis, Department of the Treasury; Tax Foundation calculations.

he structure almost literally has been transformed into a millionaire's tax. The two lowest marginal rates will be dropped, however, and by 1986 the first estate tax slice will cut in at 37%.

To assuage the pain of being included in the select group of estates that will be subject to tax, the top rate applying above $2,500,000 has been dropped from 70% to 50%. Maybe not a great day for the aristocracy but certainly a much better one.

Capital Formation

ACRS

P. L. 97-34 does a lot for capital formation, particularly through the adoption of the Accelerated Cost Recovery System, and associated liberalization of the investment credit. The changes here are truly dramatic. In one swoop, hundreds of asset classifications are done away with as are all but a small vestige of useful life determination. The sharp acceleration of recovery periods for many assets will make U.S. depreciation policy much more competitive with respect to other industrial nations.

If the initial impact revenue estimates attached to ACRS are even any indication of its magnitude, almost regardless of their accuracy, the program should have a major effect on business investment. According to the Joint Committee on Taxation, that revenue impact will rise steadily from $9.6 billion in fiscal 1982, to about $50 billion by fiscal 1986. Cash and credit constrained, but still profitable, companies desiring to expand their capital spending programs cannot help but be encouraged by the cash flow contribution of the new tax treatment. More marginal firms may be induced to invest through the liberalized leasing provisions allowing them, in effect, to swap tax deductions and credits with more profitable lessors who can take more advantage of the tax savings.*

It is true, of course, that the direct benefits of ACRS will be heavily concentrated in capital intensive industries such as primary metals, public utilities, communications and non-auto transportation and also concentrated in businesses with relatively long lived assets. There was some debate over the distribution of tax savings under ACRS and the potential for treatment even more generous than expensing of many machinery and equipment assets (see Federal Tax Policy Memo of 7/1/81). Some business interests would have preferred a more balanced program bringing in corporate rate reduction. The Ways and Means Committee attempted to respond here with its plan for phased-in expensing of equipment assets and future corporate tax rate cuts. But the latter were too uncertain and it was too late in the game. The momentum was all with ACRS, tied snugly into the Administration's program.

Those who have claimed right along that depreciation reform should have

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*The leasing provisions could prove to be controversial as well as attractive for ailing industries. Mass marketing of tax deductions and credits would raise more than a few eyebrows. The question of public subsidy here is more diffused than with the refundable investment credit, which the leasing provisions headed off, but still a potentially difficult policy area.

the first priority do have some convincing points. The biggest problem with inflation in the area of business taxation clearly has been the resulting underdepreciation of our capital base and the distortion of investment decisions adversely affecting the building of new plant and equipment. The combination of accelerated deductions under ACRS and the investment credit is a pretty good proxy for expensing in many cases. Barring the emergence of hyper-inflation, the inflation penalty factor should be greatly diminished or removed entirely from investment decisions, at least with regard to new equipment assets.

It is said that a more competitive and up-to-date capital base will transmit productivity gains and other benefits throughout the whole economy. These arguments, plus some very good footwork on the part of the business organizations over the last two years, carried the day for ACRS.

R&D

The research and development provisions of P. L. 97-34 are quite significant. While the estimated revenue impact of the new R&D incentives is quite modest -- less than $1 billion by 1984 -- they reflect a consensus that private sector R&D effort is critical enough to our national productivity to warrant some very special tax treatment. Not so incidentally, the R&D provisions provide new tax savings to firms that typically would get relatively little or no direct benefit from ACRS.

Total private sector R&D spending actually has held up fairly well in recent years, but the more basic research component involving long lead times for fruition has been stagnant, hurt by inflation and the high hurdle rates for marginal investment. The 25% incremental tax credit for R&D work should be high enough to make a difference here.

Of particular interest to multi-national firms with large domestic R&D programs is the two-year suspension of Section 861 regarding allocation of domestically performed R&D between U.S. and foreign source income. It is said that the effect of the existing regulations under Section 861 is to discourage expansion of U.S.-based R&D because of problems in getting foreign governments to accept the allocated deductions and/or loss of foreign tax credits. In the meantime, the Treasury is required to study the issue and report back to Congress within six months - a very short time table for such a complicated issue.

Personal Savings Incentives

P. L. 97-34 contains a covey of new incentives for savings in response to both the perceived need to lighten the income tax's bias against savings and some heavy lobbying by affected institutions. There is a significant liberalization of the treatment of IRAs, Keogh plans, ESOPs and stock options; there is a new deferral provision for dividends reinvested in public utility stock, and there is the most controversial initiative, the tax exempt savings certificates.

How the latter came about would make an interesting chapter in the recent history of the tax legislative process. Virtually every tax policy spokesperson outside of the thrift institutions thought tax exempt certificate were a bad idea. The business press panned it. A major part of the business financial community was opposed. The Administration itself initially

was against it. But there just happened to be savings and loan associations, mutual savings banks, or credit unions in just about every Congressional district in the country. Many of these institutions have been in deep trouble. When the dust settled, there it was embedded in P. L. 97-34 -- tax exemption for up to $1,000 ($2,000 on a joint return) in interest on one year savings certificates issued by qualified depository institutions between October 1, 1981 and December 31, 1982. Interest rates on these certificates will be set at 70% of the most recently issued one year Treasury bills and most of the proceeds must be used for housing or agricultural loans.

Not that these certificates won't be appealing to many individuals. Even stacked up against the highest yielding money market funds, about 17½% at this writing, it could pay a joint return couple with a marginal tax rate as low as 33% in 1982 to put a few thousand into these certificates. As for overall net savings, it is hard to see any gain. More likely is a considerable churning of short-term investments. One unintended result may be further withdrawals from regular passbook savings, paying much lower interest, from the very institutions the measure was designed to help.

If the program is a bust, tax policy can take some comfort in the fact that it is of quite limited duration, and, presumably, like the late unlamented credit for new home purchases, expire on schedule at the end of 1982. In the mid-1980's, a new net interest provision is set to come into play, allowing a 15% deduction of the excess of interest received over interest paid, excluding home mortgage and business interest paid. This is designed as a replacement for the savings certificate scheme and because after 1982 the present $200/400 flat exclusion on interest and dividends will revert to prior law, allowing only a $100/$200 dividend exclusion. The net interest deduction would be a genuine though limited savings incentive and represents another step away from income taxation.

It is difficult to assess what specific effect the other new provisions will have on net savings and capital formation. Extending the IRA privilege to pension plan participants and liberalizing Keogh plans should be helpful as more funds directed to retirement purposes tend to stay in the savings stream and not be withdrawn for consumption purposes. The same would apply to the new dividend reinvestment provision, although this is a quite limited program for new issue utility stock only.

The tables on page 12 indicate the approximate extent and proportion of capital formation oriented provisions in P. L. 97 -34 by 1984, compared to past bills. Obviously, the marginal rate cuts for individuals that loom so large in the overall program have a large capital formation function -- to increase personal savings -- as well as the provisions more specifically directed at capital formation. Since marginal rates were not cut across the board since 1964, this comparison does understate the true capital formation proportion of P. L. 97-34.

Indexing

The most far reaching change from the Administration's February proposals was the adoption of inflation indexing of the personal income tax scheduled to go into effect in 1985 after the statutory rate reductions are completed. Rate brackets, including the zero bracket amount, and personal exemptions

Extent of Specific Capital Formation Provisions in P. L. 97-34, Third Year Out

Provision		Estimated Tax Savings in Fiscal 1984 ($bils.)
Business Tax Cuts		$ 27.1
ACRS	26.2	
R&D credit	.8	
Other cuts	1.2	
Increased corp. tax payments 1/	- 1.2	
Energy provisions		2.2
Savings incentives		4.2
Estate and gift tax provisions		3.2
Total Capital Formation		36.8

1/ The only "anti-capital formation" provision of P. L. 97-34 of significant dollar impact.

Source: Joint Committee on Taxation.

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Specific Capital Formation Provisions of Major Tax Reductions as % Total Reduction, 1964-1981 1/

	Capital Formation Share
Revenue Act of 1964	21%
Revenue Act of 1971	46%
Tax Reduction Act of 1975	21%
Tax Reduction & Simplification Act of 1977	12%
Revenue Act of 1978	29%
Economic Recovery Act of 1981	25%

1/ First full year of impact including extensions of existing cuts except for 1981 Act which is third year of impact (1984).

Source: Joint Committee on Taxation, Tax Foundation calculations.

will be adjusted annually according to the consumer price index. If the Administration's inflation assumptions for 1985 and 1986 are close to the mark, indexing still will have a major impact on revenues estimated at more than $20 billion by fiscal 1986. If the inflation rate doesn't go down significantly as forecast, the dollar impact will be much greater, of course. This is one of the things bothering the securities markets right now.

Indexing has been debated for a number of years and had gathered substantial support in Congress. Still it was somewhat surprising to see it slide through so easily on top of other major reductions. Fears have been expressed that indexing the tax system will help institutionalize and lower resistance to inflation just as it apparently has done with respect to Government transfer programs. But there is a fundamental difference between indexing taxes and indexing public expenditures. The latter came about because of deliberate decisions to shelter beneficiaries of various transfer programs from the direct effects of inflation. Bracket creep, on the other hand, is the unintended result of the interaction between a progressive rate structure and inflation. The by-product of bracket creep is to allow Congress to pass on the burden of increased spending programs to the taxpayers without having to vote on it. Indexing will make it much harder for Congress -- and the Executive Branch -- to do this without open political decisions, at least with respect to the income tax. Indexing's chief virtue may well be the enforcement of better public accountability.

LOOKING AHEAD -- TOWARD CONSUMPTION TAXATION

Two years ago Al Ullman, then Chairman of the House Ways and Means Committee, was speaking out forcefully for a value-added tax as a replacement for part of the individual and corporate income taxes. He didn't have much company. In fact, advocacy of a value-added tax didn't help him at all during the 1980 elections. Nevertheless, a good part of the message that Al Ullman was trying to convey -- that the income tax was overburdened, that we needed to move away from income taxation -- seems to be taking hold. Under P. L. 97-34 we now have the effective exemption of capital investment from the corporate income tax, a series of still small but potentially quite significant exemptions of personal savings from the personal income tax as well as a general lowering of the rate structure. In the future we may well keep moving away from income taxation and toward a de facto consumption base even if nobody whispers about a value added or national sales tax.

There are, of course, unfinished items on the agenda for reducing tax obstacles to capital formation even after the big tax cuts of P. L. 97-34. The top corporate tax rate remains at 46% and double taxation of corporate earnings persists. This still constitutes a heavy penalty on corporate enterprise in general. Individual rates will still be progressive even after the three-year rate reduction program is completed, particularly when considered in conjunction with state and local income taxes. Future inflation indexing may mask the effect of the progressive rate structure on individuals, but with gains in real income, taxpayers will continue to move up the tax brackets.

Looking at present and potential budget woes the question quickly arises as to how much can be done with respect to future income tax cuts without replacement revenues. Some, in fact, already are saying it will be very hard to hold onto and implement provisions of P. L. 97-34 on schedule let alone consider new tax cuts. The history of major enacted tax reductions over the last two decades shows that they generally came through with the exception only of some selected excise tax cuts delayed during the Vietnam war period. But the time span for phase-ins was much shorter in the past than under P. L. 97-34.

Another possibility, already raised, is to look again at the bottom of the barrel to see what nuisance taxes or user charges can be dredged up or what "tax expenditures" now seem less sacred. We haven't gotten very far in this direction to date but there has been some chipping away at the non-capital formation part of the tax expenditure list. We now do tax part of unemployment compensation and there has been lots of talk, at least, about taxing employer provided health insurance benefits and other fringe benefits and limiting deductions for consumer loan interest. But it is probably impossible to make significant changes here without allowing much of the benefit of these exemptions and deductions to continue for lower and middle income groups. It's doubtful that really significant new revenues can be raised from including such items partially in the tax base.

At some point we may again consider a broad-based consumption tax at the Federal level. Otherwise, the only real defense against big deficits will have to be unrelenting budget restraint.

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