Executive Memorandum

The Heritage Foundation

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TWO CHEERS FOR THE REAGAN TAX REVOLUTION

Ronald Reagan's revised tax reform plan is a clear improvement over the Treasury's November 1984 proposal, popularly called Treasury I. It also is a better tax system than that currently saddling the American public. On the individual side, the proposal is a clear plus. On the business side there are pluses and minuses. On balance, it gives a fairer more neutral tax code. In the long run, it should stimulate growth. In the short run, however, the cost may be high in terms of lost investment and jobs in certain industries.

The tax "revolution" unveiled last night explicitly recognizes the importance of capital formation--especially risk capital--to the health of the economy. Accordingly, the tax treatment of business depreciation and capital gains are greatly improved over Treasury I. The revised proposal also recognizes better than Treasury I that people are the greatest natural resource by doubling the personal exemption, reducing the top rate and raising the standard deduction, thereby virtually relieving poor families from paying any taxes at all.

Yet, the revised proposal unwisely perpetuates the idea that taxes on business are not paid by individuals. In essence, the revised proposal like Treasury I, would greatly increase business taxes to obtain the revenue that allows tax cuts for individuals. In truth as the President himself has noted, taxes paid by businesses are ultimately paid by individuals. As such, the Reagan proposal is not a tax cut at all, but merely a rearrangement of the tax burden so that some people and some businesses will pay less and others will pay more.

The real question is whether the President's proposal will increase economic efficiency, by giving the U.S. a cleaner, more economically rational tax code. On this score, it is hard to say. Companies which invest heavily in capital equipment and structures will clearly be more heavily burdened than they are at present, while service industries will clearly benefit. Although such service industries as retailing, information processing and finance are important engines of future economic growth, the economy will still need substantial capital investment in the manufacturing sector. This is no time, indeed, to allow heavy industry to deteriorate further by raising taxes on it.

There is, of course, much to be said for ending tax code bias in favor of or against any particular investment. To the extent that such "tax neutrality" is the goal, and to the extent that this will encourage capital to flow to where the highest economic and social return can be achieved--rather than where the tax code pushes it--the Reagan tax reform proposal is a big step toward this goal.

Welcome too is Reagan's proposal to eliminate the deduction for state and local taxes. This provision only encourages excessive spending by state and local governments and is, in effect, an income transfer from low-tax (generally poorer) states to high-tax (generally wealthier) states. Its elimination will help curtail excessive spending by state and local governments, probably spur state and local tax cuts, and more fairly spread the federal tax burden between states.

What makes less sense is the President's retreat from Treasury I's plan to tax employer-provided health insurance. This provision is partially responsible for the enormous jump in medical costs in recent years. Nor is there much economic reason for the Administration's decision to seek a higher and more comprehensive minimum tax on corporations and individuals. It is a bad way to make tax policy. It raises taxes arbitrarily, by restricting the use of tax incentives, without addressing the fundamental value of those incentives.

The elimination of tax-exempt status for industrial revenue bonds is a plus. Such bonds merely have encouraged excessive off-budget government spending. Also a plus is the proposal that corporations can deduct from their taxable profits 10 percent of what they pay in dividends; this recognizes that corporate profits ought not be taxed at the corporate level, but at the shareholder level. This at least is a tiny step to remedy the basic inefficiencies and unfairness of the corporate tax.

In sum, the Reagan tax "revolution" is an improvement over Treasury I. It is also an improvement over the existing tax code. Yet, it still needs improvement, especially in its treatment of business investment. It provides a good starting point for congressional and public debate over a tax bill that Congress can now improve.

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For further information:

<u>The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity</u>, The White House, May 1985.

Grover Norquist, "One Cheer for the Treasury Tax Plan," Heritage Foundation <u>Backgrounder</u> No. 397, December 17, 1984.

Bruce Bartlett, "The Minimum Tax Could Impale Investment," <u>The Wall Street Journal</u>, May 21, 1985, p. 30.

Paul Craig Roberts, "A Wasted Opportunity for Real Tax Reform," <u>Business Week</u>, June 3, 1985, p. 24.