

A Conversation with Joseph A. Pechman

EEJ: Most economists are thoroughly disenchanted with the federal income tax. Whether they are traditionalists who would substitute a progressive expenditure tax for the income tax or supply siders who view the progressive income tax as compromising economic incentive, most economists are unequivocal in their attack. Thus, your ongoing support of federal income taxation coupled with tax reform, sets you apart from most of your fellow economists. Why do you think they are wrong?

Pechman: In my view there is no good reason for their disenchantment with the income tax. The consumption expenditure tax—the main rival of the income tax—is distinctly inferior on theoretical as well as practical grounds. Not only is the endowment or lifetime perspective of the expenditure tax indefensible in a world of financial, political, and family instability, but the transition problems inherent in shifting from an income tax to an expenditure tax are horrendous. We also cannot overlook that the substitution of an expenditure tax for the income tax would greatly increase the concentration of wealth. Even more relevant though, is that the public regards *income*, not expenditure, as the best index of ability to pay. In my view it would be most unwise to abandon this familiar and widely-approved basis for taxation.

EEJ: You have been estimating federal, state and local tax burdens by income classes for the last two decades on the basis of the Brookings MERGE files. How do these estimates relate to your view that further tax reform is needed?

Pechman: As your readers undoubtedly are aware, the tax burden of the bottom 90 percent of the income distribution did not change very much from 1966 to 1985. By contrast, there was a fall in the tax burden of the top ten percent of income recipients which was especially enjoyed by those in the top 5 percent and 1 percent. The tax burden of the highest income recipients fell because top federal individual tax rates were reduced throughout this period, from 70 percent in 1966 to 50 percent in 1985. Further, the federal corporate income tax dwindled to relative obscurity, while personal deductions, such as state and local taxes, interest payments, and IRAs proliferated. Tax-exempt bonds, and tax shelters were also major factors in the reduction of the tax burden at the top part of the income distribution. The distribution of tax burdens has changed since 1985 largely because of the enactment of the landmark Tax Reform Act of 1986. This act increased the progressivity of the tax system, most notably by raising personal exemptions, standard deductions, and the earned income credit, and by shifting about \$20 billion in taxes annually from individuals to corporations. However, this change in tax policy restored only a small fraction of the progressivity lost in the preceding two decades. The 1986 federal tax reform restored about half the reduction in effective tax rates at the very top of the income distribution, that took place between 1980 and 1985, but left them far below 1966 levels: the top 1 percent paid only 26.8 percent in taxes in 1988 as compared with 39 percent in 1970.

EEJ: The concept of “tax expenditures” seems to have been critical to the way in which the tax reform movement has evolved. What exactly are tax expenditures?

Pechman: The tax expenditure concept has, indeed, been central to tax reform. The term was first used by Stanley Surrey in late 1967, but it was not until the Congressional Budget Act of 1974 that it was given official sanction. That act required a listing of tax expenditures in the federal budget and directed all congressional committees to identify any changes made in those expenditures by new legislation. The act defines tax expenditures as revenue losses attributable to special provisions that deviate from the “normal tax structure.” As the readers of this Journal undoubtedly know,

the trend of U.S. tax policy after World War II had been to expand old preferences and introduce new ones to achieve various economic and social objectives. The list was long. It included such items as accelerated depreciation, investment tax credits, and tax favors to particular industries and firms; in particular, the percentage depletion was extended to sand, gravel, oyster shells, and salt. There were also preferential capital gains taxation rates on livestock held for more than six months and unharvested crops sold along with land, and coal royalties. Immediate expensing of development and exploration costs for minerals, oil and gas was also introduced. These provisions, along with the deduction of interest expenses, permitted wealthy persons and large corporations to substantially avoid payment of any taxes. Probably the most famous (or infamous) was the "Mayer amendment," enacted in 1951. Though it never mentioned Louis B. Mayer by name, this amendment provided capital gains treatment for a lump sum distribution of moneys to him on his retirement from the movie industry.

EEJ: How did this incredible list of preferences ever become reversed?

Pechman: The proliferation of tax preferences was finally interrupted in 1969, partly in response to the revelation by Treasury Secretary Joseph A. Barr (of the outgoing Johnson administration) that 154 persons with adjusted gross incomes of more than \$200,000 had not paid any taxes in 1966. But, despite the public hue and cry and condemnation by every sitting President from Eisenhower to Reagan, tax reform was not achievable without a variety of powerful factors, not the least of which was the incredible personal popularity of Ronald Reagan. One of these was the stress the Treasury and its supporters gave to the principle of allocating resources on the basis of economic, rather than tax considerations. Many influential corporate executives also found the idea of a "level playing field" appealing and threw their support behind the tax bill. The financial community, which traditionally fought any increase in the capital gains tax, held down its opposition because the proposed low top rate on other income was attractive.

EEJ: Was Congress fired up about reform in the direction of tax broadening?

Pechman: It is probably fair to say that legislators were more interested in rate reduction than in base-broadening, but they were willing to go along with the tax reformers to achieve their objectives. Credit for tax reform must, of course, also be given to the chairmen of the two tax-writing committees. Dan Rostenkowski was particularly skillful in judging how far he could push his colleagues without losing their support. Senator Bob Packwood was able to persuade the Senate Finance Committee, which he chaired, and the Senate to pass a real tax reform.

EEJ: Has the Tax Reform Act of 1986 really improved fairness and reduced distortions?

Pechman: There are at least four or five specifics I can give you with the respect to the fairness objective.

First, 4,800,000 poor persons have been removed from the tax rolls as a result of the doubling of personal exemptions and the increased standard deduction. The resumption, in 1989, of the automatic annual adjustment of personal exemptions for inflation further advances the principle that persons defined as "poor" are to be exempt from taxation.

Second, there were significant increases in earned income credits for wage earners with families. These eliminated almost the entire social security tax (including the employer's share) for those eligible for the full credit and reduced the tax burden for many other low income workers. These changes enhanced the progressivity of the whole tax system.

Third, marginal tax rates have been lowered; the new rate structure has four brackets, specifically, 15, 28, 33 and 28 percent. These will reduce the attractiveness of tax shelters and reduce the return to tax cheating and increase work and savings incentives.

Finally, the taxation of realized capital gains as ordinary income—which I view as the keystone to comprehensive income tax reform, has finally been realized. If left intact this change will reduce the incentive to disguise ordinary income as capital gains, and thus make the tax code less complicated and simplify financial planning. Without this change, the act would have cut the taxes of the wealthy by large amounts and thus have been grossly unfair. Of course, the

continued exemption of accrued capital gains on assets transferred by gift at death from the regular tax will increase the incentive of taxpayers to defer realizing gains until the assets are transferred to their heirs.

EEJ: The system of transfer payments or negative taxes is the other major element of government policy affecting the distribution of income. Can we evaluate the impact of the tax-transfer system on income distribution?

Pechman: It is relevant to note, first, that the transfer system includes not only public assistance programs intended to address the poverty problem but also other payments, specifically retirement and unemployment benefits that are unrelated to public assistance. To evaluate the impact of the tax-transfer system on income distribution, cash and in-kind transfers must be added to market incomes and taxes deducted. I cannot precisely separate the effects of transfer payments and taxes on the after-tax distribution of income because the income distribution used in the Brookings MERGE file for 1966 were prepared on the basis of incomes *including* transfer payments. After so many years, it is impractical to reclassify the income and tax data for 1966 by income excluding transfer payments.

EEJ: Can you at least give us some perspective as to how redistributive transfers appear to be altering the after-tax income distribution?

Pechman: On balance, I think we can say that families in the lowest three deciles received more in transfers than they paid in taxes, while those in the top seven deciles paid more in taxes than they received in transfers. It is mainly because of transfers, not taxes, that the tax-transfer system is progressive. What we are doing in the United States is financing redistributive transfers with taxes that are roughly proportional to incomes. The tax system has been getting less progressive in the last two decades, while the ratio of transfers to income has been increasing. In other words, the recent increases in transfer payments in the United States have been financed by the low and middle income groups, while the rich have been getting tax cuts.

EEJ: In effect, then, the income tax has not substantially reduced the unequal distribution of income. Isn't this an outcome many economists would applaud if for no other reason than the possible effects of a progressive income tax on incentives to work and save?

Pechman: In that matter we have to be very careful for, as is well known, the substitution and income effects of taxation work against each other, and the net result cannot be predicted. What we can say is that historical trends in U.S. labor supply are not consistent with the finding that taxes have reduced work effort. Adult males have been reducing their labor supply over the last forty years, but this reflects the trend toward earlier retirement, little of which is the effect of tax rates. The labor force participation of women has risen sharply in recent years, despite high marginal rates resulting from the requirement that married couples must file joint returns to benefit from income splitting. Studies in other countries are not reliable enough to support conclusions about the relationship between taxes and labor supply.

EEJ: What about the effect of taxation on the incentive to save?

Pechman: The effect of taxes on saving is even more ambiguous. The reduction in the personal saving rate in the United States in the 1980's confounded most economists. In view of the reductions in marginal tax rates, the incentive provided by individual retirement accounts (IRAs), and high real interest rates, the incentive to save should have increased. The strongest conclusion one can draw from the available evidence is that the incentive effects of taxation have been relatively small.

EEJ: What, in your view, remains as the unfinished agenda of tax reform?

Pechman: In a sentence, the fact that the federal income tax is still considerably short of the comprehensive income tax I consider ideal. There is a great deal more that can be done to broaden the tax base for equity, efficiency and revenue. Incorporating an inflation adjustment is but one item.

Personal exemptions, standard deductions, and rate bracket limits are adjusted annually for inflation, but the tax base is not. Of the two types of adjustment, adjustment of the tax base would be by far the more important. An inflation adjustment of asset prices should be incorporated into the tax law to compute real capital gains and losses, real interest and expenses, and real inventory and depreciation allowances. The adjustment of interest is admittedly difficult, but the widespread use of computers should ease the administrative and compliance problems that are involved.

EEJ: Does the tax treatment of home-owner interest seem a loophole that is likely to become changed?

Pechman: The tax treatment of owner-occupied housing clearly reflects political bargaining that left the tax advantages of homeowners intact. While the law does limit the extent to which homeowners can generate deductible interest payments via mortgage secured loans, it is going to be difficult to police this tax practice.

EEJ: Are there deductions other than interest payments that merit attention?

Pechman: The treatment of deductions other than interest payments are, in my view, an unsatisfactory feature of the present law. The Treasury plan for tax reform recommended elimination of the state-local tax deduction and the restriction of the charitable contribution deduction to amounts in excess of two percent of income. Congress proceeded to retain the deduction for charitable contributions and eliminated the deduction for state and local sales taxes, but retained the deduction for income and property taxes. I do not believe that our federal system of government depends on the deductibility of state and local taxes, as some allege, and I agree with the Treasury that charitable giving would not be impaired if the deduction were limited to amounts given above a small floor.

EEJ: Restoration of differential tax treatment between capital gains and ordinary income is a matter of recurring controversy. Do you still hold firm on your view against differential treatment for capital gains?

Pechman: Absolutely! Restoration of a lower rate on capital gains should be resisted at all costs. Equalization of the tax rates eliminates the incentive to convert other income into capital gains; it simplifies business and financial decisions, and reduces income tax complexity. Aside from the correction for inflation, the one additional reform needed in the capital gains tax is to include unrealized capital gains transferred by gift or at death into the tax base. Taxing such gains would reduce the lock-in effect of the tax on transfers of assets and eliminate a source of horizontal inequity.

EEJ: What about favorable treatment of social security benefits and the exclusion of fringe benefits from taxation?

Pechman: Under a fully comprehensive tax system both of these would have to be reassessed and both raise intense political issues, on the one hand for workers, and on the other from retired persons. Continued exclusion of fringe benefits has wide support among workers in spite of the fact that the largest subsidies go to the highest paid employees. Loopholes for union members and other workers are no more defensible than those for the rich. Taxation of fringe benefits would encourage their conversion into cash compensation, thus giving employees more control over the disposition of their income and the choice of the providers of their services. Australia and New Zealand have shown the way to reform in this area by taxing fringe benefits (other than contributions to pension plans) at the corporate tax rate. This method of handling the problem is simple and effective.

Even though the elderly can no longer be regarded as a disadvantaged group, Social Security benefits continue to receive favorable treatment. The medical insurance subsidies they receive are not subject to tax, and less than half of retirement and disability benefits is taxable to married couples with income above \$32,000 (\$25,000 if single). In my view the value of the medical insurance subsidies should be subject to tax in full. Retirement and disability benefits

should be treated like private pensions without any income thresholds, which would mean that roughly 85 percent of the benefits would be currently taxable.

EEJ: With your great concern about the erosion of the revenue raising potential of the tax law you are, no doubt, quite negative about the reduction of the older tax schedule of fourteen rates into two.

Pechman: I mostly assuredly am critical of that feature, although there are two additional "concealed" brackets. This telescoping was, of course, a surrender to proponents of the flat rate. My chief reservation relates to eliminating tax rate graduation at the top of the income scale. Surely there is difference in ability to pay out of a marginal dollar at \$300,000 of taxable income, as opposed to \$30,000. The 1986 Act makes no distinction between the rates at these levels. On the other hand, I don't recommend a return to as many as fourteen brackets.

EEJ: What about the return of the so called "marriage penalty" and the elimination of income averaging?

Pechman: I find both of these changes objectionable, although Congress apparently regarded them as tolerable. I suspect that unless these provisions are reversed, the prospect of more tax brackets is less likely. So, of course, I would urge that both the two earner deduction and averaging be restored.

A comprehensive income tax along these lines is compatible with further rate reductions throughout the income scale if the degree of progression enacted in 1986 is retained. On the other hand, I am critical of the loss of progressivity in the federal tax system since the mid-1970s. As a result, the distribution of before-tax income, which was growing more unequal in the 1980s, has become even more unequal on an after tax basis. I have suggested that the goal of tax policy should be to restore the progressivity of the income tax at least to its level in the mid-1970s. I estimate that this can be accomplished with a rate schedule ranging from 4 percent at the bottom to 48 percent at the top of the taxable income scale—a moderate schedule of rates by any standard.

EEJ: Is there not another important consideration when it comes to taxes—namely their revenue producing potential? Would not a value added tax be attractive and practical either in addition or even as a substitute for the income tax?

Pechman: Apart from the positive arguments I've already made for retaining the income tax, it is, in my view, inappropriate to introduce a value added tax because it is regressive and imposes unnecessarily heavy burdens on the lower income classes. With tax rates as low as they are today, more revenues should come from the income taxes, the tax paid by those who have the ability to pay. Especially in view of the recent reductions in the progressivity of the federal tax system, would it be unconscionable to enact the distinctly inferior alternative of a value-added tax. Besides, it is also clear that the revenue potential of the income tax has not been exhausted in this country. Even if the base is not broadened, the income tax can be used to raise considerable additional revenues in order to eliminate the recurring federal deficits. Each percentage-point increase in the individual and corporate income tax rates would bring in about \$30 billion in 1994, so that three points would come close to balancing the overall budget in that year. A top individual income tax rate of 31 percent and a corporate rate of 37 percent cannot be regarded as punitive or harmful to economic incentives.

EEJ: Thank you on behalf of our readers. Hopefully, yours will continue to be a persuasive voice in the decade ahead as it has been during your thirty years at the Brookings Institution.

This Conversation is based on several talks in person and on the telephone with Joe Pechman, the last just a few days before his untimely death. His offer to me of the opportunity to read an advance copy of the Presidential address he was scheduled to present in Atlanta on December 29, 1989 "as soon as it is typed," was graciously accommodated by his long time friend and colleague at the Brookings Institution, Dr. Henry J. Aaron. Dr. Aaron offered to share the personal tribute which preceded his reading of the Presidential address on Joe's behalf with our readers. His interest in the Eastern Economic Association and its Journal is gratefully remembered.

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