NBER WORKING PAPER SERIES

TAX POLICY IN THE 1980S: A PERSONAL VIEW

Martin Feldstein

Working Paper No. 4323

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
April 1993

The Andrew W. Mellon foundation is gratefully acknowledged for financial support. This paper is part of NBER's research program in Public Economics. Any opinions expressed are those of the author and not those of the National Bureau of Economic Research.

NBER Working Paper #4323
April 1993

TAX POLICY IN THE 1980S: A PERSONAL VIEW

ABSTRACT

The tax reforms of the 1980s were the most substantial tax changes since the dramatic expansion of personal taxation during World War II. This paper, which was written as part of the NBER project on American economic policy in the 1980s, examines the nature of these changes and discusses the reasons why tax policies evolved as they did in the 1980s. Particular attention is given to the role of economic analysis in shaping the tax reforms.

Martin Feldstein
NBER
1050 Massachusetts Avenue
Cambridge, MA 02138
and Harvard University

Tax Policy in the 1980s: A Personal View

Martin Feldstein[1]

This paper is part of a longer essay on American economic policy in the 1980s. The other parts of that essay appear as three NBER working papers that deal with: monetary policy; government spending and budget deficits; and the dollar and international trade.

These essays are not intended as a detailed history of economic policy during the decade. Excellent analytic histories have been written as part of the NBER project on American Economic Policy in the 1980s. The study of tax policy for that forthcoming book was written by Donald Fullerton and has been distributed as NBER Working Paper No. 3507.

My own essays, which will be combined in the first chapter of that book, are an attempt to analyze some of the reasons for the policy changes that occurred in the decade and to offer my judgements about some of those changes. I have, therefore, not commented on the paper by Fullerton or on other published discussions of tax policy during this period. I do provide some bibliographic references to my own publications, particularly nontechnical ones, in order to incorporate their content into this paper.

****

The reforms of the personal income tax in the 1980s were the most substantial tax changes since the dramatic expansion of personal taxation during World War II. The top marginal tax rate for individuals was reduced from 70 percent in 1980 to less than 35 percent a decade later, median income taxpayers saw their marginal tax rates reduced by a third, and millions of low

[1] Professor of Economics at Harvard University, and President of the National Bureau of Economic Research

income individuals no longer paid any individual income tax. At the same time, the opportunity for middle and upper income individuals to reduce taxable income through a variety of special provisions was substantially reduced. Indexing of tax brackets meant that inflation would no longer increase effective tax rates.

The effective tax rate on investment income at both the personal and corporate levels was also substantially reduced by the 1981 tax legislation. But unlike the general reduction of personal tax rates, those changes in the taxation of investment income were reversed during the next five years.

These remarkable developments were driven by an unusual convergence of intellectual and political forces and shaped by the preferences of President Reagan and a few key Administration officials. This paper begins by examining these general determinants of the tax reforms in the 1980s and then turns to a more detailed analysis of the sequence of specific tax legislation. Because Don Fullerton has provided an excellent analytic history of these tax changes, my comments focus on my own interpretation of the causes of those changes and a personal perspective on the changes themselves. I provide only enough description of the legislative changes themselves to permit the reader to understand my comments.

1. The Determinants of Tax Reform in the 1980s

1.1 The Conceptual Foundations of Tax Reform

The tax reforms of the 1980s reflected ideas about taxation that public finance economists had been discussing for many years: combining base broadening with lower tax rates, substituting a "flat tax" for the finely graduated "progressive" rate structure, indexing tax brackets for inflation, using a "vanishing exemption" to increase the average tax rate of the

highest income taxpayers without raising their marginal rate, and restructuring depreciation rules to improve the efficiency of capital allocation. The "academic scribblers" who had written about these issues during previous decades may not have been in Washington when the changes occurred, but the influence of their ideas was very much present in the design of the tax legislation of the 1980s.

The intellectual roots of the tax reform went beyond the technical concepts of public finance specialists. They reflected a very fundamental retreat from the general Keynesian economic philosophy that had shaped economic policy throughout the postwar period. There were four interrelated aspects of this shift in thinking: attention to the effects of incentives on behavior; a concern with capital formation; an emphasis on the efficiency of resource use; and a negative attitude about budget deficits. None of these represented new ideas in economics, but were in fact a return to the earlier views that had dominated economics from the time of Adam Smith until the depression of the 1930s ushered in the Keynesian revolution.[2]

1.1.1 Effects of Incentives on Behavior

The massive unemployment of the Great Depression had focused the economic profession's attention on the lack of demand as the cause of low output and employment. The Keynesian economics that was developed in the 1930s emphasized that an increase in demand through monetary or fiscal policy would raise national income. With one third of the labor force out of work, there was no need to worry about the willingness of workers to supply labor.

The simple Keynesian models that shaped most economists' view of the world over the

[2] On the retreat from Keynesian economics, see Feldstein (1981). On the ways in which the policies of the 1980s reflected a return to older ideas, see Feldstein (1986a)

next several decades generally ignored incentives: labor supply was assumed to be a fixed given quantity; household savings were assumed to depend only on income (and not on the rate of return to the saver); and business investment was assumed to depend on sales and capacity utilization rather than profitability. This was a dramatic reversal of the views that had been held by economists before the 1930s and the introduction of Keynesian economics. While sophisticated economists recognized that all of the Keynesian assumptions were just analytic simplifications, this "demand-determined" world view conditioned much of the economic thinking about practical policy problems in the 1950s, 1960s and 1970s.

In the design of personal taxation, this emphasis on demand and disregard of supply incentives led to high marginal tax rates; at the end of the 1970s, marginal tax rates reached 49 percent for an individual with $25,000 of taxable income and exceeded 65 percent for taxpayers with incomes of $90,000 and above (although a maximum tax rate of 50 percent applied to personal services income). The interaction of inflation with tax rules that did not distinguish between real and nominal interest income or between real and nominal capital gains meant that many taxpayers faced marginal tax rates over 100 percent on real interest income and real capital gains.

The procedure of revenue estimating by the staffs of the Treasury and the Congress were symbolic of the disregard of the behavioral response of taxpayers to changes in tax rates. The revenue effect of any proposed tax change was always calculated on the assumption that it would have no effect on the behavior of taxpayers and therefore that an induced change in behavior could have no feedback effect on total tax revenue. Although the economists who managed these revenue estimating calculations knew that the assumption of "no behavioral response" was not

literally true, they regarded it as a good enough approximation on which to base policy decisions.

All this began to change in the 1970s. Academic economists began to focus research on the way in which tax rules and government transfers affected economic behavior. There were studies of the effects of taxation on labor supply, of the effects of social security on retirement behavior, and of the impact of unemployment insurance on the behavior of the unemployed. The common theme in all of this research was that labor supply is responsive to incentives.

But it was the Congressional consideration of changes in the tax treatment of capital gains that made Congress recognize the importance of taking the behavioral response of taxpayers into account in the analysis of tax reforms. In the context of the 1978 reduction of the capital gains tax rate, the members of the House Ways and Means Committee and the Senate Finance Committee focused on the fact that lower capital gains tax rates would cause taxpayers to realize more capital gains as they accrue. They recognized that this behavioral response would reduce and possibly eliminate the revenue loss that would otherwise result from lowering the tax rate on capital gains.

The logic of the capital gains response and the research on labor supply led some economists to note that cutting personal tax rates in general would also cause less revenue loss than the nonbehavioral (or "static," to use the somewhat misleading label that became popular in Washington tax policy discussions) calculations implied. This idea, that tax cuts were not as expensive as they seemed because of taxpayers' positive supply response, was of course the basis for what came to be called supply side economics. Economists like Art Laffer dramatized the importance of the supply side response by claiming that it is so strong that a substantial

across-the-board reduction in personal income tax rates would actually increase tax revenue.

I will return below to the experience with the capital gains tax reduction and to the claims of supply side economists. But first I want to turn to another aspect of the retreat from Keynesian economics: the renewed interest in capital accumulation.

1.1.2 Capital Formation

The 1970s saw a renewed interest in capital formation as an engine of economic growth. This, too, was a reversion from Keynesian economics to an idea that had been stressed by pre-Keynesian economists.

The accumulation of capital was understandably irrelevant in the economic conditions of the depression years that shaped Keynesian economics. With vast amounts of unused capacity, additional investment was not needed to increase output. Increasing the propensity to save was even less important since the Keynesian "multiplier" analysis implied that an increased desire to invest in plant and equipment would automatically increase national saving by an equal amount. Indeed, textbook Keynesian theory stressed that an increase in the desire to save would actually reduce national income by decreasing the demand for output.

Although these ideas were developed for the economic conditions of the 1930s, they continued to have a powerful effect on economic thinking and policy in later decades. Various policies were adopted that would favor an increase in consumer spending rather than in saving: banking rules that limited interest paid to depositors and reduced the cost of mortgage borrowing, tax rules that reduced the return to saving and lowered the net cost of borrowing, a Social Security system that made private saving for retirement virtually unnecessary for a majority of households, and an acceptance of budget deficits as a useful tool of demand stimulus.

Ironically, the economic profession's development of "growth theory" in the 1960s did little to reverse the attitude that capital accumulation was unimportant. One reason is that the theory emphasized that a higher national saving rate does not increase the rate of economic growth in the very long-run. This conclusion was reinforced by the implied calculation that a one percent increase in the saving rate would only increase the rate of GNP growth in the short run by about one tenth of one percent. Even when an investment tax credit was adopted in the early 1960s, it was conceived as a Keynesian cyclical stimulus rather than as a way of expanding productive capacity. The aversion to encouraging saving remained, reinforced perhaps by the fact that any plan that is likely to encourage substantial personal saving is likely to favor those with higher incomes or assets.

Nevertheless, the decline in unemployment throughout the 1960s turned attention from the Keynesian problem of increasing demand to the pre-Keynesian problem of raising output per worker. Economists in the 1970s began to focus again on the desirability of increasing national saving and investment in plant and equipment. Although growth theory implied that increased capital accumulation would have only a modest effect on per capita GNP, it was the only determinant of growth that seemed susceptible to changes in economic policy.

The emphasis on saving and investment played an important part in the tax reforms of 1981: strengthened incentives for business fixed investment through more rapid depreciation allowances, increased incentives to save through universal eligibility for individual retirement accounts, and an increased return on individual equity investments through lower rates of tax on capital gains. The reasons that these increased incentives were largely withdrawn later in the decade are discussed below.

1.1.3 Efficiency of Resource Use

Even before Adam Smith, economists like William Petty were concerned with making the best use of scarce resources. Much of the subsequent academic work in public finance -- including the writings of David Ricardo, A. C. Pigou, Frank Ramsey and Irving Fisher -- was specifically concerned with levying taxes in a way that would raise the revenue required by the government with the least distortion to economic efficiency.

Once again, it was the experience of the depression that diverted attention from this traditional economic concern with the efficiency of resource use. National income could be raised much more easily by putting unemployed resources to work than by increasing the efficiency with which already employed resources were used. During the early postwar decades, the attention of most economists who were concerned with economic policy was on policies to achieve and maintain full employment.

The pre-Keynesian tradition nevertheless continued within public finance with economists like Richard Musgrave and Arnold Harberger emphasizing the design of tax policies to reduce economic distortions. With the return to full employment in the postwar period, a wider group of economists eventually came to see the fundamental importance of these efficiency issues. The public finance economists of the 1960s and 1970s were concerned with efficiency questions rather than with the macroeconomic questions of achieving full employment. A substantial academic literature on the design of efficient capital income tax rules played a significant role in shaping the depreciation reforms in the Tax Reform Act of 1986. (See, for example, the NBER studies included in Feldstein (1983a, 1987a and 1987b).

1.1.4 Adverse Effects of Budget Deficits

Yet another of the Keynesian propositions that was rejected in the 1970s was the idea that an increased national debt would have no adverse effects because "we only owe it to ourselves." Analyses by James Meade, Franco Modigliani and James Buchanan pointed out that, even when all of the government debt is intranational, it is harmful to the extent that it substitutes for real capital formation and that it requires future interest payments that have to be financed by higher taxes that themselves involve distortions and therefore a loss of economic efficiency.

Ironically, it was Ronald Reagan who was both a longtime outspoken critic of budget deficits and also the President during whose years the United States amassed the largest increase in the national debt. But despite this, as I emphasize in what follows, it was President Reagan's aversion to budget deficits that caused him to accept tax increases in 1982, 1983 and 1984.

1.2 Political Motivations for Tax Reform

The retreat from Keynesian economics in the 1970s and the growing influence of the technical ideas of public finance economists resulted in new tax legislation in the 1980s because they coincided with political forces that supported similar reforms.

1.2.1 Inflation and Tax Burdens

The inflation of the 1970s -- a decade in which the level of consumer prices doubled -- was in my judgement the primary political force driving the tax reforms of the 1980s.

The interaction of inflation and an unindexed tax system pushed middle income individuals into sharply higher tax brackets. Between 1965 and 1980, a typical median income family saw its marginal personal income tax rate double (from 22 percent to 43 percent) while a family at twice the median saw its tax rate jump from 38 percent to 54 percent.

The combined employer-employee Social Security tax also rose in these years from 7.25 percent in 1965 to 12.3 percent in 1980 and many states either introduced or increased their state income tax rates. A middle-class couple with about $40,000 of income in 1980 was shocked to find itself facing a combined marginal tax rate over 50 percent.

Average effective tax rates also rose sharply. A median income family paid about 8 percent of its total income in federal income tax in 1965, but half again as much (12 percent) in 1980. And a family with income equal to twice the median saw its effective individual income tax rate rise from 13 percent to 21 percent over the same 15 years.

While taxpayers always prefer lower taxes, the sharp rise in real tax burdens caused by inflationary bracket creep without any explicit legislation created a sense that the higher taxes were unfair, unjustified, and unnecessary.

Inflation also caused a sharp rise in the effective tax rates on the investment incomes of individuals and in the effective corporate tax rate.[3] The rise in inflation from 4 percent in the second half of the 1960s to 8 percent in the second half of the 1970s raised the short-term interest rates available to savers from 7 percent in 1969 to nearly 10 percent in 1979. Thus the real interest rate declined by once percentage point. This decline in the real interest rate (from 3 percent to 2 percent) was magnified by the fact that taxes are levied on nominal rather than real interest income. Even a taxpayer whose marginal tax rate remained unchanged at 40 percent would have seen his net real return decline from essentially zero (i.e., the 40 percent tax on the 7 percent nominal interest rate implies an after-tax return of 4.2 percent or only 0.2

---

[3] Several of my own papers on the interaction of inflation and tax rules that were written in the late 1970s and early 1980s are collected in Feldstein (1983b).

percent above inflation) to minus 2 percent (i.e., the 10 percent nominal interest rate implied an after-tax return of 6.0 percent or two percent less than the rate of inflation).

In practice, the rise in the tax burden on interest income was compounded by the increase in marginal tax rates. Thus, for a median income family whose marginal tax rate increased from 22 percent to 43 percent, the real after tax return fell from about 1.5 percent to minus 2.3 percent, a decline of nearly four percentage points. For a family at twice the median income, the real after tax rate fell from zero to minus 3.4 percent. Individuals resented this capital levy and felt justified in their demand for lower tax rates.

A similar distortion applied to the taxation of capital gains. An individual who had purchased a portfolio equivalent to the Standard and Poors 500 in 1965 for $10,000 and sold it in 1980 would have realized a nominal gain of $3,520. But the rise in prices over that 15 year period meant that the individual needed $26,160 to buy the same volume of goods and services in 1980 that $10,000 bought in 1965. Thus the taxpayer would pay a tax on $3,520 of gain even though he had incurred a real loss of nearly 50 percent of his initial investment (the $13,520 was only 52 percent of the $26,160 needed to maintain the purchasing power of the initial investment). Not surprisingly, individuals who invested in common stock felt that a dramatic cut in the capital gains tax rate was justified and they found a sympathetic hearing among many members of Congress. That political pressure supported the capital gains tax reduction of 1978 and the subsequent reduction in 1981.

Finally, inflation grossly distorted the taxation of corporate income. Because the depreciation of plant and equipment for tax purposes is based on original cost with no adjustment for inflation, the rise in interest rates caused by inflation substantially reduced the present value

of the depreciation deduction. Between 1965 and 1980, the rise in corporate bond rates reduced the present value of 15 year straight-line depreciation by more than 40 percent, a reduction equivalent to an increase of 20 percent in the initial cost of the investment.

Inflation also caused a sharp rise in artificial accounting profits for firms that used the first-in first-out method of accounting. Such artificial profits rose from a negligible $1 billion in 1965 to more than $40 billion in 1980.

These extra corporate taxes were partly offset by the deductibility of nominal net interest costs. Nevertheless, when Larry Summers and I (Feldstein and Summers, 1979) put all of the pieces together, we concluded that effect of inflation with the existing tax laws was to raise the 1977 tax burden on the capital income of the nonfinancial corporate sector by an amount equal to 69 percent of the real after-tax income of that sector (including retained earnings, dividends and the real interest receipts of the corporations' creditors). Stated differently, the effect of inflation was to raise the effective tax rate on capital income of the nonfinancial corporate sector from 41 percent to 66 percent.

The greatly increased tax burden caused by inflation was a major engine of the tax reduction movement in the late 1970s that led to the 1981 tax cuts. It also helps to explain why once the idea of indexing tax brackets for inflation was explained to the public it was politically unstoppable.

1.2.2 Personal Incomes and Public Spending

The pressure for tax cuts reflected not only the increasing tax burden, but also the combination of the stagnant pretax incomes of working families and increased government spending on transfer programs. Middle income individuals felt that their own situations were

deteriorating while the government taxed them more heavily in order to give money to an increasing number of transfer recipients.

Between 1970 and 1980 median family income in constant dollars rose by less than one percent. A full time year-round male worker earned $21,511 (in 1981 dollars) in 1970 and $21,162 in 1980 (in the same 1981 dollars). The corresponding figures for female workers showed a rise of $50 over the entire ten year period. If per capita incomes rose, it was only because of the substantial rise in female labor force participation (from 43 percent in 1970 to 52 percent in 1980).

During the same decade, government nondefense spending rose rapidly. Nondefense outlays of the federal government increased from 11.2 percent of GDP in 1970 to 16.7 percent in 1980. Transfer payments and non-defense discretionary outlays rose 93 percent in real terms during the decade, jumping from 55 percent of total government outlays to 70 percent. Even when Social Security and Medicare outlays are set aside, nondefense spending rose by 82 percent in real terms between 1970 and 1980.

It is not surprising that voters were very receptive to the message that taxes and government spending should be sharply reduced to redress the distribution of income between wage earners and welfare recipients.

1.2.3 Political Competition in 1981

Although the inflation-induced tax increases of the 1970s and the public's dissatisfaction with the shift of income to welfare recipients and other transfer beneficiaries provided the political impetus for a program to cut taxes and spending, the actual tax legislation in 1981 was shaped by a competition between Republicans and Democrats to get credit for tax cutting.

Ronald Reagan's presidential campaign had promised that he would seek ten percent tax cuts for three successive years, a cumulative 27 percent reduction in marginal and average tax rates. When he presented this proposal to the Congress, the Democratic leadership responded with its own package of tax cuts that included such things as a tax credit for second earners and an expanded program of Individual Retirement Accounts. A bipartisan coalition lead by Republican Congressman Barber Conable and Democratic Congressman Jim Jones also supported sharp reductions in corporate tax liabilities though accelerated depreciation schedules; this Conable-Jones bill was known as 10-5-3 because structures would be depreciated for tax purposes in 10 years, equipment in 5 years and vehicles in 3 years. The final "compromise" legislation included virtually all of these pieces (although the personal rate reductions were reduced from 10-10-10 to 5-10-10, or a cumulative 23 percent) plus an agreement to index tax brackets starting in 1985.

1.2.4 The Political Origins of the 1986 Tax Reform Act

The radical changes in tax rules and tax rates in the 1981 legislation would have been enough to characterize the 1980s as a decade of major tax reform. While it is perhaps not surprising that the 1981 legislation was followed by several small tax bills in succeeding years to reduce the budget deficit, it is quite remarkable that Congress enacted another change in tax rules in the Tax Reform Act of 1986 and did so as a piece of tax reform without any expected net revenue impact.

The specific features of the 1986 legislation reflected several of the intellectual developments that I have already discussed. It can be seen as a shift in emphasis from increasing the rate of investment to using the available investment dollars more efficiently. But

the 1986 legislation owes its existence to neither the tax specialists' desire to increase allocative efficiency nor to strong public support for another round of tax changes.

Administration interest in a second round of tax reform originated in the White House as a political response to the initiative developed by Senator Bill Bradley and Congressman Dick Gephardt. The Bradley-Gephardt proposals called for a combination of lower rates and base broadening, appealing to traditional tax reform sentiments of fairness and more technical concerns about the efficiency of resource use. The influence of academic public finance economics in this design was very clear.

Jim Baker, then President Reagan's chief of staff, was concerned in early 1984 that the Democrats could seize the tax reform issue from the Republicans in the upcoming presidential election by building on the Bradley-Gephardt proposal. The President's 1984 State of the Union address, therefore, called for a new major tax reform which would reduce tax rates without increasing the deficit and ordered the Treasury to carry out the study and report after the election. What started as an attempt to preempt a political move became the most wide-ranging tax reform since the introduction of the income tax.

1.3 Presidential Preferences

It would be wrong to regard the tax reform of the 1980s as the product of intellectual fashions and political forces alone. President Reagan had strong convictions about tax policy that shaped the tax changes throughout his eight years as president.

President Reagan strongly opposed high rates of personal income taxation and particularly the very high level of the top marginal tax rate. He spoke privately of the personal disincentive and of the sense of frustration and unfairness created by tax rates of nearly 100 percent that he

had experienced himself. Until the 1963 tax reductions, the maximum marginal rate was 91 percent and the tax rate was 89 percent for income over $100,000. He had a visceral dislike of high maximum tax rates and wanted tax changes that would reduce them.

The President clearly believed on the basis of his own experience and that of his friends that lower tax rates would increase work effort and reduce the use of accounting arrangements to shelter taxable income. This explains his enthusiasm not only for the initial 1981 rate cuts, but also for the 1986 plan to combine even lower rates with a broader tax base. Although the President believed in the supply side effect of lower taxes, I never thought that he accepted the extreme supply side position that lower tax rates would actually increase tax revenue. He did make such statements in public announcements and press conferences[4], but I never recall him saying that in private discussions with senior administration officials; perhaps even if he once believed it, he no longer did by mid-1982 when I joined the Administration.

When it came to deficit reduction, the President disliked any kind of tax increase but was less opposed to higher business taxes, especially when they took the form of "eliminating undeserved breaks and closing tax loopholes," a characterization that could be applied to the tax increases of 1982, 1983 and 1984 since the statutory tax rates were not increased. He strongly resisted the rise in the Social Security payroll tax that was proposed as part of the Social Security rescue package in 1983, but reconciled himself to this change by noting that it only

---

[4] See, for example, his comments in a July 7, 1981 speech: "It's true, that I believe, as President Kennedy did, that our kind of tax cut will so stimulate our economy that we will actually increase government revenues, but the gross national product will be increased by even more so that government's excessive percentage will decline."

represented advances in the dates of the increases that had been proposed and legislated by the Carter administration.

Although President Reagan's rhetoric always emphasized his opposition to increased taxes, he agreed grudgingly to the need for tax increases in 1982, 1983 and 1984 because he did not like the looming budget deficits. While projecting the image of a fierce opponent of taxes, he was always careful in his prepared remarks and his press conferences to avoid an outright promise that he would not raise taxes. Instead, he would say things like (my words) "I will not hurt the American economy by raising taxes" or "I will not raise taxes that penalize hard-working American men and women." It may have sounded like a promise not to raise taxes, but it was in fact a statement about the kinds of tax increases that he would accept. When pressed explicitly in a press conference, his favorite reply was of the form, "A president should never say never."

The following excerpt from a December 23, 1981, press interview provides a good example of the Presidents's ability to stress his opposition to higher taxes while keeping open all options for future tax increases. At that time there was already talk about the need for a tax increase that ultimately led to the enactment of the 1982 tax bill that raised a projected $100 billion over three years. When the President was asked about raising taxes, he replied as follows:

> "Well, there certainly will be no change in taxes in 1982, I guarantee you. We have put a program in place that I believe will increase government's revenue simply by broadening the base of the economy, stimulating an increase in productivity, offering incentives that the program does offer.

"I learned a long time ago that putting your feet in concrete was dangerous, because I have among my mementos a round cement block with a pair of shoes imbedded in it that was given me by the Capital Press Corps in Sacramento after I had put my feet in concrete and then, one day, had to stand before them and say the sound you hear is the sound of concrete breaking around my feet. So, they gave me that but I would like to see what happens with this program.

"Of course there is one thing with regard to taxes that from the very first I did always speak of, and that was we continue to review where there are places where people are getting undeserved tax breaks, the so-called closing of loopholes. Now in that I do not include as loopholes the legitimate deductions that -- without which the whole program would have failed a long time ago -- but actual loopholes where, as I say, there is an unjust break. This we continue to review and I am not opposed to that."

A press interviewer then asked, "At what point will you make a decision?" and the President replied "After I see what happens."

A subsequent questioner asked whether, even if there would be no tax increase in 1982 except for loophole closing, there might be a tax increase in 1983. The President replied that he would not "look kindly on anything that is contrary to the stimulative part of our tax program," but that "what I was trying to say with my story about the concrete block was that with the unexpected things that can happen I just feel that I'm in no position to comment on suggestions for a 1983 tax increase."

Later in the interview, the President was asked about excise taxes and replied that "I don't think that consumption taxes are in direct opposition to the tax program that we instituted.

"It is clear from these remarks that the President was very eager to emphasize his opposition to higher taxes and in fact to resist increases in marginal tax rates as such, but would not rule out any future tax increase if he felt it necessary and was more inclined to accept excise taxes than other forms of tax increase. This was not empty rhetoric since the President proposed and Congress enacted tax increases (by "closing loopholes") in 1982, 1983 and 1984 and a higher excise tax on gasoline in 1982.

2. The Sequence of Tax Changes in the 1980s

With these comments as a general background on the reasons -- intellectual, political and presidential -- for the tax changes of the 1980s, I turn to some personal observations on the major tax changes.

2.1 Reducing Capital Gains Taxes

The capital gains tax cut of 1978 is important as a precursor of the individual and corporate rate cuts enacted in 1981. By the late 1970s, the combination of inflation-induced increases in tax brackets and new additional taxes on capital gains (the add-on minimum tax and the reduced ability of taxpayers with capital gains to use the maximum tax on earned income) had raised the maximum tax rate on capital gains to more than 45 percent.

In 1978, the Ways and Means Committee was considering legislation to reduce capital gains tax rates that would bring the top rate down to 28 percent. The staff at the Treasury and at the Congressional Joint Tax Committee estimated the revenue consequences of the proposed changes on the assumption that the lower capital gains tax rates would have no effect on taxpayer decisions to realize gains. The opponents of reducing the capital gains tax rate, including the Carter administration, charged that the projected revenue loss was too large to be

acceptable. The supporters of lower capita gains taxes, who were generally unaware of the "no behavioral response" assumption used by the revenue estimators, argued that the projected loss of revenue was worth accepting because a lower capital gains tax would encourage venture capital and other activities that would contribute to economic growth.

Research that I was doing on the effect of capital gains taxation on shareholder behavior implied that the Treasury and Congressional staff calculations were fundamentally wrong.[5] Since capital gains taxes are only levied when the individual actually sells an asset, the capital gains tax can be postponed indefinitely and thereby substantially reduced in present value. Moreover, the tax on accrued gains need never be paid if the asset is held until death and bequeathed to the taxpayer's heirs; their base for future capital gains taxation is the value of the property at the time that it is bequeathed. And since, under the tax rules of the 1970s, an individual could borrow against the appreciated asset to finance current consumption and deduct the interest paid in calculating taxable income, it was unnecessary to sell the asset in order to consume the value of the appreciation.

With these rules, capital gains realizations would be expected to be very sensitive to tax rates. The statistical analysis that I was doing of a very large random sample of individual tax returns appeared to confirm that. Indeed taxpayers appeared to be so sensitive in their decision to realize capital gains that a reduction in the capital gains tax would actually raise revenue.

The ink was hardly dry on my NBER working paper reporting these research findings when I was asked to testify about them to the Senate Finance committee. Several Senators made

[5] This research, done with Joel Slemrod and Shlomo Yitzhaki, appeared in several papers that are reprinted in Feldstein (1983c).

it clear that they had not previously understood the "static" nature of the staff's revenue estimates (i.e., the assumption that there would be no behavioral response to a cut in the capital gain tax rate) and that they did not believe that such static estimates were useful for evaluating the proposed tax changes. I had a receptive audience for my estimates of substantial feedback effects of taxpayer behavior on the revenue consequences of lower tax rates on capital gains.

The capital gains tax rules were changed in the 1978 legislation, reducing the effective tax on capital gains. The subsequent experience confirmed the conclusion that taxpayers are quite sensitive to the capital gains tax rate. The revenue estimating procedure of the Treasury and Joint Tax Committee staffs was subsequently modified to take the behavioral effects of changes in capital gains tax rates into account in estimating revenue consequences.

2.2 Supply Side Extremists and the 1981 Tax Reduction[6]

My advocacy of a capital gains tax cut and my emphasis on the favorable revenue effect of the induced increase in the tax base made me an early "supply sider," probably before the term had been coined by former CEA chairman Herb Stein and certainly before I had heard the term.

I believed (and continue to believe) that the favorable feedback effects of tax cuts on revenue would not be limited to capital gains tax cuts, but was also convinced that other kinds of economic behavior would be much less sensitive to taxes than capital gains realizations. I objected, therefore, to those supply siders like Arthur Laffer who argued that a 30 percent across

[6] Don Fullerton's chapter in American Economic Policy in the 1980s provides an excellent detailed survey of the evolution of the 1981 tax cuts. Since I was not then a member of the Administration, I limit my remarks here to a recollection of my own views at that time.

the board tax cut would also be self financing because of the resulting increase in incentives to work. While lowering the very highest marginal tax rates might actually raise revenue, for most taxpayers a cut in the tax on wages and salaries would increase tax revenue only if the resulting increase in labor supply was much greater than either logic or previous experience suggested was at all likely.

I was not opposed to a substantial across the board rate reduction when the idea was debated in the late 1970s although I thought that the combination of a smaller rate cut and immediate bracket indexing was safer at a time when future inflation was uncertain. I recall discussing this with Senator Bill Roth, an early advocate of the 10-10-10 personal rate cut. He recognized the logic of the argument that indexing might be better, but argued that it would be harder to enact than a pure rate cut because it was more difficult for the public to understand.

While reasonable people could differ about just how big a tax cut was desirable, I had no doubt that a combination of a sizable tax cut and a reduction in spending would improve efficiency and was justified after a decade of increases in taxes and spending. I was convinced that there would be some favorable offsetting feedback effects of the lower tax rates on total revenue, but that it would definitely not be self-financing.[7]

I was convinced moreover that the supply side hyperbole about self-financing tax cuts was undesirable because it was discrediting what I thought was a good case for reducing tax rates. Critics of the tax cut could rightly argue that it was unlikely to be self-financing as its most

[7] The actual size of the tax cut and the reasons for the increase of the budget deficit are discussed in my essay, "Government Spending and Budget Deficits in the 1980s: A Personal View."

ardent supporters were claiming and then jump to the wrong conclusion that such a tax cut would therefore be a mistake.

The rhetoric of self-financing tax cuts nevertheless continued during the 1980 presidential campaign and was later part of the Administration's effort to sell the tax package to Congress and the nation. The implausibility of the claim that the tax cut would be self-financing clearly did not hamper the ability of the new Reagan Administration to enact its package, but it did complicate my subsequent job as CEA chairman in defending the tax package as good economics despite its obvious failure to raise revenue. And just when an increasing number of mainstream economists were accepting the traditional "supply side" view that incentives are important and that high tax rates do not raise correspondingly high revenues, the supply side extremists gave supply side arguments in general a bad name.

Within a few years, the surge in the budget deficit caused many of the original supply side extremists to say that they had never claimed that the tax cut would raise revenue. For example, Martin Anderson, President Reagan's first domestic adviser, claimed in his 1988 book Revolution and in subsequent newspaper articles that the supply siders had never said that the tax cut would be self-financing.[8] The record clearly points to the opposite conclusion. Arthur Laffer, the leading supply-sider, writing about the proposed series of three 10 percent tax rate cuts, was quite explicit in saying that "each of the 10 percent reductions in tax rates would, in terms of overall tax revenues, be self-financing in less than two years. Thereafter each

[8] I tried to be polite in my remarks on this subject to the 1985 meeting of the American Economic Association (Feldstein, 1986a) by not identifying anyone by name when I said that the supply siders had claimed that the tax cut would be self-financing, only to be accused by Anderson in his book of attributing views that the supply siders never had.

installment would provide a positive contribution to overall tax receipts" ("Government Exactions and Revenue Deficiencies," in Supply Side Economics, 1981, p. 201). This was not an isolated statement, but part of a general line of argument that distinguished the self styled "supply siders" from the rest of the economics profession.

2.3 Shrinking the Deficit: Tax Changes in 1982 through 1984

It became clear almost immediately after their enactment that the 1981 tax reductions would lead to deficit increases despite the Administration's success in cutting many domestic spending programs. This led to a series of small tax increases in 1982, 1983 and 1984. Although President Reagan strongly opposed any increase in personal or corporate income tax rates, he accepted the increases in revenue that resulted from a variety of technical changes in business tax rules.[9]

2.3.1 The 1982 Deficit Reduction Legislation

The 1982 tax legislation was projected to raise $100 billion over three years by reducing the value of business depreciation allowances and by eliminating the "safe harbor leasing" provisions. The "safe harbor" rules allowed companies that had no taxable profits to take advantage of favorable depreciation rules and the investment tax credit when they made investments by transferring the tax benefits to companies that did have taxable profits.

The politics and economics of safe harbor leasing contains an interesting lesson about the importance of the appearance of fairness in tax policy, even in an aspect as arcane as business depreciation rules. Safe harbor leasing looked bad because it permitted companies with

[9] The paper "Government Spending and Budget Deficits in the 1980s: A Personal View" discusses the policies and politics of deficit-reduction in more detail. The current section focuses on the specific tax proposals in each year's budget.

substantial taxable profits to pay little or no tax by buying the tax benefits from companies that had made investments. In reality, the transferable tax benefits were priced in such a way that almost all of the value went to the firms that made the investments rather than to the firm that bought the resulting tax benefits. The safe harbor leasing rules thus had the desirable effect of encouraging investment for new firms that lacked taxable profits and for established firms that were temporarily losing money as well as for established firms with taxable profits.

Although I was not in the Administration at that time, my judgement, both then and in retrospect, is that the 1982 reversal of the favorable tax treatment of investment was a mistake. A generous tax treatment of business investment is needed to balance the relatively favorable treatment of owner occupied housing if a disproportionate share of national saving is not to flow into residential investment. Safe harbor leasing was needed to allow all types of firms to face the same cost of investing. But the perception of firms buying the right to pay no tax made the safe-harbor approach politically unsustainable.

A further adverse effect of the 1982 tax legislation was that it was the first time that depreciation rules were changed retroactively on equipment that was already in use. This meant that businesses would no longer be able to count on the prevailing depreciation rules when they made investment decisions, a factor that would make future investments riskier and would reduce the potency of changes in depreciation rules. I found that it also made it impossible in 1983 to interest businessmen in the idea of accepting indexed depreciation in exchange for a further lengthening of depreciation lives.

2.3.2 *The 1983 Contingent Tax Plan*

The debate about taxes in the budget to be submitted in February 1983 (i.e., the fiscal year 1984 budget) provided a good lesson about both the difference between economic and political priorities and about the way that an internally divided administration worked in practice.

The preliminary estimates for that budget (the first that I participated in preparing as CEA chairman) implied that, without substantial changes in taxes or spending, there would be large deficits in each of the next five years. The sharp decline in inflation and the deep recession together meant that tax receipts would be low in 1983 and 1984 while the indexing of brackets scheduled to begin in 1985 meant that future revenue increases would be very modest. Even with the spending cuts that could be proposed (but not enacted), the projected deficits would remain unacceptably large. At an informal dinner soon after Christmas 1982, Secretary of State George Schultz suggested that an energy tax on domestic and imported oil would be a good way to raise revenue. The combination of that energy tax and the proposed spending cuts would, on realistic economic projections, lead to substantial deficit reductions over the five year budget horizon. The "supply siders" in the Treasury, the Congress and elsewhere objected to any tax increase as economically counterproductive and argued that once the recovery began the revenue gains from the tax cuts enacted in 1981 would be so great that no further tax changes would be needed to eliminate the deficit. The White House political strategists, led by Chief of Staff Jim Baker, were concerned about the adverse political effects of any proposal to increase taxes. Baker was also aware that his leadership in achieving the 1982 tax increase may have weakened his relationship with the President and definitely had hurt his relations with those

Republicans who were more concerned about keeping taxes low than about preventing large budget deficits.

In the White House budget discussion that followed, Ed Harper (the Domestic Policy Adviser) and I suggested as a compromise that the energy tax could be legislated in 1983, but would only take effect in 1985 and then only if the deficit remained above some threshold level. Budget Director Dave Stockman, who was also skeptical of the supply-siders' claims and eager for a plan that would actually reduce the outyear deficits, supported the idea of a contingent tax.

Treasury Secretary Donald Regan responding both to the advice of the Treasury supply-siders and the White House political staff, opposed the idea of a tax increase and favored assuming that future economic growth would be fast enough to shrink the budget deficit. CEA was responsible for the forecast and my refusal to go along with the Treasury projections of five years of rapid growth made a tax increase necessary to achieve an acceptable projection of declining deficits.

Despite the opposition of Regan and others, the combination of spending cuts and the "conditional" energy tax increase was accepted by the President as part of the February 1983 budget plan for fiscal year 1984 and beyond. But getting Presidential approval for a budget that combined a reasonable economic forecast and good policies for deficit reduction was far from getting those policies legislated.

The White House political strategists and Treasury Secretary Don Regan couldn't stop the President's adoption of a proposal for a contingent tax increase because they recognized the need to project declining deficits and an eventual budget balance. But they could make sure that it would not be enacted by asserting that the contingent tax increase would be acceptable to the

President only if all of the President's proposed spending cuts were also accepted by the Congress. Since the proposed spending cuts are at best only the first bid in a negotiation between the President and the Congress, it was easy for the White House staff and the Treasury to sink the entire budget by adopting a very tough no-compromise strategy and blaming Congress for the continued deficits that the President had proposed to reduce. In the end, none of the Administration budget was enacted that year.

2.3.3 Taxes for Social Security Solvency

The tax changes that were actually enacted in 1983 were the result of a plan to protect the long-run solvency of the Social Security system. A bipartisan commission, headed by former CEA chairman Alan Greenspan (who was then a private citizen), had been established in 1982 to find a way to deal with the projected gap between future Social Security benefits and taxes.[10] The report of the Committee, released in 1983, called for raising the payroll tax and including half of the benefits of higher income individuals in income subject to personal taxation. The income level at which this inclusion began was fixed in nominal terms, permitting the tax to fall only on relatively high income individuals in the near term, but gradually extending future taxation to all beneficiaries without the political pain of enacting additional legislation to increase taxes. The resulting rise in tax revenue made a substantial contribution to shrinking projected deficits over the next five years and beyond.

When the proposed Social Security changes were initially described to the President (before they were made public by the commission), he objected vehemently to the plan to close

---

[10] The 1983 decisions about social security are discussed more fully in the paper dealing with budget and government spending.

the Social Security funding gap by higher taxes alone with virtually no reductions in future benefits. He eventually reconciled himself to the higher payroll taxes on the grounds that this was essentially just advancing the date of changes that had already been proposed and enacted by President Carter. He accepted the inclusion of benefits in taxable income with the rationale that it was essentially equivalent to a reduction in the benefits paid to high income beneficiaries. But the reality was that the Social Security financial crisis had been resolved without any fundamental changes in benefits, a subject to which I return in the paper on government spending and the budget.

2.3.4 Raising Taxes in 1984

When the forecasts were prepared for the budget to be enacted in 1984, the economy had already been in recovery for more than a year. Despite the relatively strong growth in the first year of the recovery, plausible estimates of the future path of expansion (estimates that subsequently proved to be essentially correct) left unacceptably high budget deficits for the indefinite future.

The spending cuts that could be proposed in an election year were not large enough to make a significant dent in the projected deficits. Once again, the Treasury supply siders and their allies outside the Administration argued that no tax increase was needed because growth would continue at a fast enough pace to provide the additional revenue. Some conservatives who didn't accept the supply siders' optimism argued that it would nevertheless be better to hold out for further spending cuts since a tax rise would just lead to additional spending without shrinking the deficit. Not surprisingly, the White House political strategists were opposed to any tax increase in an election year.

David Stockman and I were convinced that the five-year deficit could be reduced significantly only with the help of a tax increase and that such an increase would achieve a net deficit reduction. I continued to favor some type of contingency tax increase. My preferred solution was a modification of indexing in which Social Security and other retirement benefits and personal tax brackets would be adjusted by three percent less than the inflation rate instead of by the full inflation rate. Such a modified indexing rule would still protect individuals completely against any unexpected rise in inflation. Although there would not literally be any tax increase (just a slowdown in future tax cuts) or any reduction of benefits (just a slowdown of future benefit increases), the modified indexing would raise a substantial amount of additional tax revenue and save roughly an equal amount in Social Security outlays.

In the end, such a rise in personal taxes and fall in personal benefits was politically too costly to be acceptable as part of the President's budget. Instead, the Treasury developed a series of technical changes in business tax rules that would over time raise a moderate amount of additional revenue. The President accepted that these were not real "tax increases," but just the closing of business loopholes, allowing the Treasury to collect the taxes that "should be paid."

I left the Administration in the summer of 1984 hoping that, once the election was over, a political compromise could emerge that would combine a significant tax increase with reductions in entitlements and other spending (Feldstein (1984a) and (1984b)). But that was not to be. In the second Reagan term, there were no voices in the Administration to support higher taxes as part of an overall budget compromise. Instead, budget deficit action shifted to the

Gramm-Rudman initiative while tax legislation turned from deficit reduction to revenue neutral tax reform.

2.4 The Tax Reform Act of 1986

The primary focus of the Tax Reform Act of 1986 was a dramatic reduction of personal income tax rates. The marginal tax rate on the highest incomes fell from 50 percent to 28 percent and other rates were reduced to 15 percent. The challenge was to pay for these rate reductions with changes in tax rules that would be acceptable to voters as a trade-off for the rate cuts and to do all of this in a way that appeared distributionally neutral, i.e., that gave low and middle income taxpayers at least as large a percentage reduction in tax liabilities as the reduction given to high income taxpayers.

The biggest distributional challenge was to limit the overall tax reduction of the highest income taxpayers whose statutory rate had been cut nearly in half. An early proposal to eliminate the personal deduction for state income taxes died because of the opposition of large states like New York with high state income taxes.[11] Raising the lower tax rate on long term capital gains was then seized upon as the way to show a substantial offsetting increase in taxes paid by high income taxpayers. Although raising the capital gains rate for high income taxpayers from the existing 20 percent maximum to 28 percent would substantially reduce realizations and therefore produce less revenue from these taxpayers than the "static" calculations implied, the reality was less important than the perception. What mattered was to show that taxing long-term gains like other income would offset the reduction in the top rate of personal

[11] Eliminating the personal tax deduction might only have encouraged states to rely more heavily on corporate taxes with a resulting larger revenue loss to the federal Treasury: see Feldstein (1985) and Feldstein and Metcalf (1987)

income tax. The Treasury and Congressional staff therefore ignored the behavioral effects of the proposed higher capital gains tax rate in their projections of tax changes by income bracket. Remarkably, they nevertheless took the reduced realizations into account when calculating the aggregate revenue effects of the proposed tax change!

A number of technical changes were also made in tax rules to discourage the use of tax shelter investments, particularly eliminating the use of so-called "passive losses" to reduce taxable income. As a practical matter, these changes were less important in discouraging the use of tax shelters than the publicity given them suggested. They were less important in practice because the other changes in tax rules -- reducing the maximum personal rate to 28 percent, raising the capital gains rate to the same level as ordinary income, and cutting depreciation allowances -- were sufficient by themselves to eliminate the advantage of tax shelter investments.

The primary effect of eliminating the use of passive losses reflected the Treasury's decision to phase out these accounting losses on already existing tax shelter investments. This raised revenue from high income taxpayers and did so quickly. However, just as with the 1982 retroactive changes in depreciation rules, it sent the message that depreciation tax rules could not be relied on in the future. It also encouraged tax-motivated investors in real estate to sell their properties immediately, exacerbating the collapse of real estate values and the problems of the banking system in the late 1980s.

Another change designed to limit the tax cut for the highest income taxpayers was eliminating the personal exemptions and the use of the low bracket rates (the zero bracket and the 15 percent bracket) for high income individuals. This feature, which had long been advocated by liberal tax reformers as a way of increasing the overall progressivity of the tax

schedule, had the effect of creating a range in which the marginal tax rate exceeded 28 percent for taxpayers with moderately high incomes before dropping back to 28 percent. Although the average tax rate increased continuously with income, this "hump" or "bubble" in the marginal tax rate schedule was seen by many taxpayers as unfair. But, in practice, the pressure to remove the "bubble" led in the 1990 tax legislation to a modification of the rate schedule that raised tax rates at the top to 32 percent and that pushed the "bubble" to higher income levels.

But even with all of these changes, the high income group appeared in 1986 to receive a proportionally larger tax cut than those at lower income levels. The designers of the tax reform, therefore, introduced a substantial increase in the personal exemption as a way of cutting taxes for lower income taxpayers. An increase in the personal exemption leaves almost all marginal tax rates unchanged (except among those who no longer owed any tax as a result of the higher exemptions) and, therefore, has no favorable supply side effect. Indeed by increasing the after-tax income while leaving marginal tax rates unchanged, the increase in the personal exemption could be expected to increase the demand for leisure and reduce labor supply. Its justification was that it focuses tax cuts not only on those with lower incomes, but also on large families who had been disproportionately hurt by the inflation-induced erosion of personal exemptions over the past decade.

The increased personal exemption was however very expensive, adding about $25 billion a year to cost of the overall reform. To balance this, the Administration and Congress agreed to increase corporate tax revenue by $25 billion a year. This was achieved despite a reduction of the corporate tax rate from 46 percent to 34 percent by lengthening depreciation lives and eliminating the investment tax credit.

The revenue estimators conveniently chose not to take the increased corporate tax revenue into account in calculating the effect of the overall reform on the taxes paid at each income level. This produced the politically convenient result of an apparent tax cut for each income class despite the aggregate estimate that the tax reform as a whole was revenue neutral.

A more accurate analysis might impute the additional corporate tax on the basis of the ownership of capital and would, therefore, indicate that the extra $25 billion of corporate tax was paid primarily by higher income taxpayers.[12] If the corporate tax collections had been correctly imputed, it would not have been necessary to raise the capital gains tax rate in order to show that higher income individuals were not receiving a disproportionately large tax cut.

Indeed, since little or no additional revenue would result from raising the tax rate on capital gains from 20 to 28 percent, that change was also unnecessary to make the tax package revenue neutral. The top rate on capital gains was raised by 40 percent to create an impression rather than to raise revenue or balance the distribution of tax changes. Once again, the content of tax reform was shaped by the desire for a perception of fairness rather than by the actual likely effects of the proposed changes on the distribution of taxes and the performance of the economy.

The Treasury staff took the tax reform legislation as an opportunity to redesign depreciation rules in a way that they thought would increase the efficiency of the allocation of the corporate capital stock. In order to achieve what was popularly described as a "level playing field," the Treasury staff carefully calculated the depreciation schedules for equipment and

[12] See Feldstein, (1988), for an analysis of the distribution of the corporate tax increase by income class.

structures that they believed would achieve equal effective tax rates on investments in equipment, structures and inventories.[13] In my judgement this attempt to achieve a "level playing field" for different types of investments was misguided in three ways.

First, the overall increase in the effective tax rate on the return to corporate capital as a whole increases the distortion between owner occupied housing and business capital.

Second, the higher effective tax rates on investments in plant and equipment and in inventories increase the distortion within business investment between these forms of tangible investment that must be depreciated over time and intangible investments in such things as advertising, marketing, and price discounting that enjoy immediate expensing.

Finally, the Treasury calculations of equal effective tax rates as a standard of tax neutrality made no allowance for differences in the way that different types of investments are financed. Inventories can be financed by relatively low cost short-term loans and real estate investments by somewhat more expensive mortgages and bonds while equipment and research must rely more heavily on equity capital.

It is perhaps ironic that a Republican administration should have passed such an anti-business tax reform bill. In part, this reflected the President's primary interest in personal rather than business taxes and his great desire to reduce the top tax rate. Increasing the corporate tax by $25 billion a year or approximately 25 percent was of course opposed by those businesses that would expect to pay higher taxes. The Administration was very clever in defusing this opposition by seeking endorsements from those businesses that were not capital intensive and

---

[13] See the chapter in American Economic Policy in the 1980s by Fullerton for a discussion of the evolution of the tax changes proposed by the Treasury staff as part of the TRA86 legislative process.

that would, therefore, gain more from the reduction in the corporate tax rate than they would lose from the less favorable treatment of capital investments. In addition, the Administration promised a variety of corporations that had particular tax concerns that the Treasury would try to help them if they would publicly support the overall legislation. As a result, the business community as a whole did not offer a unified opposition to these tax changes. Since the total of the Treasury's promises was more than could be accommodated within the overall revenue target, the Treasury jettisoned some of these supporters during the final round of Congressional negotiations when it was too late for them to reverse their support.

The general effect of the business tax changes was to reduce the reward to investment and therefore to saving, exacerbating the problem of a low national saving rate. The incentive to save was also reduced in the 1986 Tax Reform Act by narrowing the eligibility for IRAs, by reducing the allowable level of pension benefits, and by increasing the tax rate on capital gains.[14]

The decade ended with personal income tax rates much lower than they were when the decade began and with fewer opportunities for individuals to reduce tax liabilities by creative accounting or by investments that have large tax advantages, but few economic profits. Although the lower rates should have supply side advantages, the decline in the top marginal tax rate from 50 percent to 28 percent (now 32 percent) exaggerates the favorable change since many of those who had faced a marginal tax rate of 50 percent had previously used tax shelters to reduce the effective marginal tax rate on a substantial portion of their incomes. Whether the sharply reduced personal income tax rates of the 1980s will remain in the 1990s is now uncertain.

[14] For further comments that I made at the time, see Feldstein, (1986b) and (1986c).

Bibliography

Feldstein, Martin. 1981. "The Retreat from Keynesian Economics," The Public Interest. No. 64, Summer 1981.

Feldstein, Martin. 1983a. "Behavioral Simulation Methods in Tax Policy Analysis," (Introduction and editor). NBER Conference Volume, 1983.

Feldstein, Martin. 1983b. Inflation, Tax Rules and Capital Formation, Chicago: University of Chicago Press, 1983.

Feldstein, Martin. 1983c. Capital Taxation, Cambridge: Harvard University Press, 1983.

Feldstein, Martin. 1985. "A Tax Reform Mirage," Wall Street Journal. November 20, 1985.

Feldstein, Martin. 1986a. "Supply Side Economics: Old Truths and New Claims." American Economic Review. May 1986.

Feldstein, Martin. 1986b. "Tax Reform: Harmful if Passed," Wall Street Journal. February 14, 1986.

Feldstein, Martin. 1986c. "A Gamble with Capital Formation," Wall Street Journal. May 19, 1986.

Feldstein, Martin. 1987a. The Effects of Taxation on Capital Accumulation, (ed.) University of Chicago Press, 1987.

Feldstein, Martin. 1987b. Taxes and Capital Formation, (ed.) University of Chicago Press, 1987.

Feldstein, Martin. 1988. "Imputing Corporate Tax Liabilities to Individual Taxpayers," The National Tax Journal. March 1988.

Feldstein, Martin and Gilbert Metcalf. 1987. "The Effect of Federal Tax Deductibility on State and Local Taxes and Spending," Journal of Political Economy. 1987.

Feldstein, Martin and Lawrence Summers. 1979. "Inflation and the Taxation of Capital Income in the Corporate Sector," National Tax Journal. Vol. 32, No. 4., 1979.