This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Tax Policy and the Economy, Volume 5

Volume Author/Editor: David Bradford, editor

Volume Publisher: The MIT Press

Volume ISBN: 0-262-02295-8

Volume URL: http://www.nber.org/books/brad91-1

Conference Date: November 13, 1990

Publication Date: January 1991

Chapter Title: Introduction, acknowledgments

Chapter Author: David F. Bradford

Chapter URL: http://www.nber.org/chapters/c11266

Chapter pages in book: (p. -7 - 0)

INTRODUCTION

David Bradford
Princeton University and NBER

The 1980s were a time of substantial change for tax policy in the United States. Although it represented continuation of a trend that began at least as early as 1978, the 1981 Tax Act was notable for sharp reductions in the effective rate of tax on certain forms of investment. In particular, accelerated depreciation and investment tax credits favored investment in structures and equipment, and the exclusion from the base of 60% of capital gains encouraged corporate investment supporting equity claims ("equity-financed" investment). The Tax Reform Act of 1986 apparently balanced less accelerated depreciation, the elimination of the investment tax credit, and the removal of the capital gains exclusion with reduced tax rates at both the corporate and individual level. The objective of the 1986 law was to even the investment playing field, to subject all forms of investment to lower but more uniform levels of taxation. In the process, windfall gains were generated for many taxpayers (for example, those on the verge of retirement, who paid lower than anticipated taxes on pension benefits), whereas others (notably investors in real estate) experienced windfall losses. In addition, both the 1981 and the 1986 Acts brought about some strong incentive side-effects that were poorly anticipated.

In their paper, "The Role of Tax Rules in the Recent Restructuring of U.S. Corporations," Myron S. Scholes and Mark A. Wolfson take up some important issues. They emphasize the unintended consequences, especially for the choice of business form and financial structure, of the shifts in the taxation of corporate equity, *relative* to debt or noncorporate capital, between the 1981 and the 1986 laws. Indeed, in 1986 for the first time the rate of tax on corporations was set above the rate applicable to

high-income individuals. The combination of this change and the reduction in the tax advantage of capital gains resulted in significant shifts in incentives. Scholes and Wolfson argue that whereas the 1981 Act encouraged mergers and acquisitions among U.S. corporations, the 1986 Act discouraged them. Furthermore, the opposite incentives were set up with respect to takeovers of U.S. companies by foreign corporations. Recognizing that it is difficult to demonstrate causal relationships in a world that is changing in many respects at the same time, they show that their analysis offers an explanation of the historical record of merger and acquisition activity, of both domestic and foreign firms.

Considerable political attention and a large body of law have been directed toward the regulation of phenomena such as mergers and acquisitions and the issue of junk bonds. Currently, concerns about the takeover of U.S. businesses by foreign firms is a subject of political concern. The lessons that Scholes and Wolfson have to teach about the fundamentals that underlie these oftentime puzzling economic effects are well worth our close attention and may help us avoid imposing rules that unnecessarily address symptoms rather than causes.

Hans-Werner Sinn's contribution to this volume represents something of a departure from the usual pattern in that his focus is on a conceptual rather than an empirical issue. The subject of his paper, "Taxation and the Cost of Capital: The "Old" View, the "New" View, and Another View," is the effect of tax rules on the pretax rate of return required on corporate investment. This is a topic on which Bureau researchers have contributed frequently over the past decade and more. Although no one will be surprised that there is much that remains to be learned of an empirical nature about the influence of taxes on corporate behavior, it may be less obvious that the conceptual framework for the analysis is incomplete. This is exactly Sinn's argument, however.

The key point at issue is the well-known "double taxation" of corporate equity, once at the level of the corporation and again at the level of the shareholder, either on distribution in the form of dividends or on realization of capital gains generated by the corporate-level investment. At the heart of the matter is the fact that we do not yet have a fully convincing theory of corporate financial structure. Putting the matter simply, under existing rules it seems clear that corporations should be financed essentially entirely from debt. To the extent that equity financing does occur (for example, because of the historically inherited corporate financial structure or because a debt-finance project pays off more than can be distributed as interest) the associated distributions to shareholders should certainly not (at least in the United States) be in the form of dividends. Instead, funds should be distributed out of the corporate

sector through share repurchase or its functional equivalent, cash acquisition of other corporations.

There are many explanations for the observed facts that contradict these (oversimply stated) predictions of economic theory, but none of the explanations has yet proven fully satisfactory. Yet predictions about the effect of, say, dividend taxation depend on the determinants of corporations' use of equity finance. In the absence of a unifying theory, tax analysts resort to assumptions, for example, a fixed ratio of debt and equity. In the course of a broad overview of the conceptual issues, Sinn argues in his paper that our view of the effect of tax rules has been marked by a too-restrictive set of assumptions about corporate financial behavior. Enlarging the set in a very plausible way reveals the likelihood that mature companies can greatly moderate the distorting effects that would be implied by very rigid financial behavior, but that the discouragement of new firms is probably greater than has been generally recognized.

In a series of papers, Laurence Kotlikoff has asserted that the budgetary accounting tools currently employed to express the government's economic choices are flawed to the point of being useless. In particular, he has argued that the budgetary concepts of taxes and transfers are based on arbitrary conventions and have no economically meaningful foundation. The economic content of "budget deficit" refers to the degree to which fiscal policy shifts burdens toward future generations. Current budgetary conventions carry no reliable indication of this incidence effect. Consequently, current budgetary measures of deficit or surplus are poor indicators of economic policy, and they may even give the wrong sign to the directions of policy change.

Although Kotlikoff's critique has attracted some support, until now we have lacked more than the most rudimentary quantitative version of accounts that are economically meaningful in the terms he has set out. The paper, "Generational Accounts: A Meaningful Alternative to Deficit Accounting," by Alan J. Auerbach, Jagadeesh Gokhale, and Laurence J. Kotlikoff, in this volume presents the first attempt at a comprehensive accounting for the intergenerational effect of fiscal policy of the entire U.S. governmental sector (federal, state, and local). The results are revealing in a great many respects. One is naturally attracted first to their quantitative conclusion that the present path of fiscal policy implies a burden on future generations that is 10 to 17% larger than that facing those born today. More important is the fleshing out of a framework within which to debate and evaluate the myriad assumptions about the economy and about the future that are necessary to an economically meaningful assessment of fiscal policy. A nice example is provided by

the alternative consequences calculated by the authors of the federal budget agreement reached in the fall of 1990. Depending on the degree of permanence of the tax and spending changes embodied in the agreement, the estimated reduction from a baseline 17% excess burden on future generations ranges from 1 to 13%.

The measurements developed by Auerbach, Gokhale, and Kotlikoff are erected on a structure of assumptions that will certainly be subject to challenge and controversy. In my view, however, their contribution to advancing the cause of meaningful accounting for government will be a lasting one.

The last two papers in the volume contain empirical analyses with clear connections to ongoing policy concerns.

The paper by Jonathan Gruber and Alan B. Krueger deals with another area of policy that is much influenced by the weaknesses in our system of accounting for government. One of the ways that government may influence the distribution of benefits and the allocation of resources is through the simple mandating of certain programs. Generally, a mandated program is economically equivalent to a combination of tax and spending rules, but it does not appear in a government budget. Thus, a requirement that schools provide adequate access for the physically handicapped is economically equivalent to a government grant to schools to cover the cost of constructing the required facilities combined with a tax on schools in the same account.

Mandating employer provision of health insurance benefits has attracted increasing attention as a policy option. In "The Incidence of Mandated Employer-Provided Insurance: Lessons from Workers' Compensation Insurance," Gruber and Krueger assess the incidence of a similar program that has existed for some time. They take advantage of the considerable variation across time and across states in the costs of providing workers' compensation insurance to identify the degree to which the cost of the program is shifted to employees through wage adjustments. They interpret the weight of the evidence as suggesting that changes in employers' costs of workers' compensation insurance are largely shifted to employees.

The federal budget package enacted in 1990 incorporated a small increase in the per gallon tax on gasoline. If the current strong interest in matters of energy conservation is sustained, this and similar tax instruments are likely to receive continuing consideration. James Poterba's paper, "Is the Gasoline Tax Regressive?" takes up an important dimension of this tax policy issue, the distribution of burdens it implies between rich and poor.

Poterba points out that frequently encountered claims of regressivity

of gasoline taxes rely for evidence on annual surveys of consumer income and expenditures. These surveys show that gasoline expenditures are a larger fraction of income for very low-income households than for middle- or high-income households. His paper argues that annual *expenditure* provides a more reliable indicator of household well-being than annual income.

This point is a general one, and would apply to any incidence analysis (for example, of the income tax). Poterba focuses on the particular case of the gasoline tax. Using data from the Consumer Expenditure Survey, he reassesses the claim that gasoline taxes are regressive by computing the share of total expenditures that high-spending and low-spending households devote to retail gasoline purchases. This alternative approach shows that low-expenditure households devote a smaller share of their budget to gasoline than do their counterparts in the middle of the expenditure distribution. Although households in the top 5% of the total spending distribution spend less on gasoline (as a fraction of spending) than those who are less well off, the share of expenditure devoted to gasoline is much more stable across the population than the ratio of gasoline outlays to current income. The conclusion, which appears to be typical when a consumption basis for analysis is used, is that the gasoline tax is far less regressive than conventional analyses suggest.

ACKNOWLEDGMENTS

The authors and I are indebted to the people who made this volume and the conference on which it is based possible. Since the conference's inception five years ago, NBER President Martin Feldstein and Executive Director Geoffrey Carliner have wholeheartedly supported this effort to communicate widely the results of economic policy research. Candace Morrissey assisted in every stage of this project. Kirsten Foss Davis and Ilana Hardesty did their efficient job of handling the conference logistics as usual. I am especially grateful to the authors of the papers presented here for their responsiveness to my editorial requests.

David Bradford