INTRODUCTION

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While the 1986 Tax Reform Act was as sweeping as any in the history of the American income tax, it did not put an end to discussions of tax reform. The combined pressure of continuing budget deficits and increasing concern about the ability of the United States to compete in an increasingly open world economy has led to continuing discussion of further tax reforms. Tax policy debates continue to occupy the attention of public officials, the business community, tax attorneys, and the general public. Capital gains tax reform was one of the most contentious issues considered by the Congress in 1989, and is likely to be debated further in the near future.

Economic research can make an important contribution to tax policy debates by providing quantitative information on both the distribution of the burdens associated with various tax changes, and on the likely effects of various proposals on economic efficiency. Tax changes are often credited or blamed for a host of changes in the American economy ranging from increases in corporate leverage to declines in personal saving. Economic research makes an important indirect contribution to tax policy when it evaluates the veracity of these claims.

This volume, like its three predecessors, collects a number of economic studies of issues of immediate relevance to ongoing studies of tax reform. Each of the studies is at the forefront of modern work in public economics. But the conclusions are presented in a way that is intended to be accessible to non-economists who are concerned with the development of tax policy. In the remainder of this introduction, I shall summarize the five papers included in the present volume.

Daniel Feenberg’s and my paper, "Who Benefits from Capital Gains Tax Reductions?" examines the distribution of capital gains benefits along several dimensions. Examining the distribution of benefits across income classes, we find that, contrary to some recent claims, the lion’s
share of the benefits of any capital gains reductions go to high income taxpayers. By a variety of measures, the richest 2 percent of Americans receive more than 50 percent of all capital gains. Capital gains on corporate stocks are even more concentrated among high income taxpayers. Because moderate income taxpayers typically hold their assets longer, and enjoy smaller capital gains than their higher income counterparts, it turns out that indexing the basis of capital assets is considerably more progressive than reducing capital gains tax rates.

Because some assets such as new equipment may yield more external benefits than others and because the current tax system probably favors some types of investments, it is of interest to know what types of assets would benefit from a capital gains tax reduction. Feenberg and I find for a variety of capital gains tax reduction options that less than half of the benefits go to corporate assets, and that in most cases real estate is the principal beneficiary of capital gains tax reductions. This bias is especially strong in the case of indexation proposals. We also find that most capital gains are realized on assets that have been held for 10 or more years. This implies that over a five year period, close to 80 percent of the benefits of capital gains tax reductions are likely to accrue to assets that were already in place when the tax cut was enacted. Since relatively few short-term capital gains are realized, it is unlikely that graduating tax rates by holding period for taxable investors would have much impact on the turnover of financial assets.

The paper "Treatment of Capital Income in Recent Tax Reforms and the Cost of Capital in Industrialized Countries" by Eytan Sheshinski contrasts the 1986 U.S. Tax Reform Act with recent reforms in other countries. While top marginal tax rates have fallen sharply and the tax base has been broadened almost everywhere, Sheshinski finds no similar uniformity in the treatment of capital income. The United States is alone in having embraced the concept of uniformity in the taxation of capital income. In most other countries, interest, capital gains, and to a lesser extent dividends continue to be heavily tax favored. Traditionally, other countries have been less generous than the United States in permitting individuals to deduct interest in computing their taxes, but the gap has narrowed with the U.S. decision to phase out consumer interest deductions.

Mark Gertler and R. Glenn Hubbard’s paper "Taxation, Corporate Capital Structure, and Financial Distress" offers some reflections on the role of taxation in corporate leverage decisions. During the 1980s, corporate leverage has increased sharply. In the last year or so, a number of highly leveraged firms have encountered severe financial distress, lead-
ing some observers to worry that current tax rules endanger financial stability. Gertler and Hubbard review recent developments in economic theory which highlight the potential benefits and costs of debt finance. They argue that firms would choose optimal capital structures, trading off the benefits and costs of debt finance, if there were no tax bias in favor of debt. They then argue that present tax rules induce firms to accept more risk of cyclical distress and so endanger financial stability. Gertler and Hubbard conclude their paper by suggesting a number of reforms that have the potential to reduce the tax bias in favor of debt finance.

Alan Auerbach and Laurence Kotlikoff's paper "Demographics, Fiscal Policy, and U.S. Saving in the 1980s and Beyond" explores the implications of demographic changes for U.S. saving behavior. Given the large changes in the age structure of the U.S. population that are likely over the next 40 years, this topic is of considerable importance for budget policy generally and Social Security policy in particular. Auerbach and Kotlikoff use data on the savings of persons in different age groups in an effort to forecast the likely effects of demographic change on the American saving rate. They find that for about the next 30 years, demographic factors are likely to push the American saving rate upward. They suggest that this may lead the U.S. current account to move into surplus by the year 2000.

Auerbach and Kotlikoff observe that demographic factors cannot account for the decline in personal and private saving during the 1980s. They therefore examine a number of other factors, including the strong stock market, increased consumer borrowing, and reductions in the precautionary demand for saving. In the end, however, they are unable to fully resolve the question of why saving declined in the 1980s. They suggest that the decline in saving during the 1970s reflects non-demographic factors and so does not call into question their conclusion that demographic factors will push the American saving rate upward in the years to come.

Lawrence Goulder's paper "Implications of Introducing U.S. Withholding Taxes on Foreigners' Interest Income" addresses an issue that has attracted increasing attention as the magnitude of foreign investment in the U.S. has increased during the 1980s. Using a computable general equilibrium model of the U.S. as an open economy that he developed in an earlier work, Goulder concludes that the introduction of a statutory 30 percent U.S. withholding tax on foreigners' interest income would make Americans better off if foreign governments do not retaliate. He also finds that it would reduce the American trade balance
in the short run, but would exacerbate it in the long run. On the other hand, he finds that if foreigners retaliated, the introduction of a withholding tax on interest income paid to foreigners would make Americans worse off. In addition to those efficiency arguments, Goulder also considers a number of equity arguments made for and against proposals to introduce a withholding tax.
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