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12 The Impact of Fundamental Tax Reform on the Allocation of Resources

Don Fullerton and Yolanda Kodrzycki Henderson

Recent discussions of tax reform have emphasized the importance of defining the tax base as economic income and of taxing that base at lower rates. Specific proposals have differed with respect to the particular means of implementing these goals. Our paper (see Martin Feldstein, ed., *The Effects of Taxation on Capital Accumulation* [Chicago: University of Chicago Press, 1987]) examines the Treasury tax plan of November 1984 and the president's proposal of May 1985 as they would amend taxation of income from capital. We find that these reforms would differ in their relative emphases on alleviating interasset, intersectoral, interindustry, and intertemporal distortions.

Our approach in this paper is to measure the net effects of proposed changes in statutory rates, credits, depreciation allowances, and other features of the tax code such as the indexation of interest and capital gains. We compare costs of capital for individual assets, sectors, and industries and weight these together to evaluate the impact on total investment incentives under the administration's plans. Then, using a general equilibrium model, we simulate alternative resource allocations and associated changes in welfare.

The results of our study depend in part on the assumed role of dividend taxes. We initially consider the "new view" that dividend taxes have only a small effect on investment incentives. Under this assumption, current law and the president's plan provide the highest incentives for investment as a whole. The costs of capital (and, equivalently, the effective tax rates on income from capital) are similar under these two regimes. The Treasury plan would raise the cost of capital

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almost 7% from its current level and would therefore tend to deter capital formation. On the other hand, both administration plans would tend to allocate capital more efficiently across its uses. The Treasury plan is most effective in narrowing the disparities in the cost of capital across assets (within each sector). For example, within the corporate sector, we find that the effective rates for investments in different types of equipment, structures, inventories, and land would all lie between 39% and 52%, compared with a range of -4% to +50% under current law. The rates across assets would become more similar because of the abolition of the investment tax credit (which is currently available only for equipment) and because of adoption of depreciation allowances closely adhering to economic depreciation. Remaining differences are primarily the result of differential local property taxes. The president's plan would tax corporate assets at rates ranging from 24% to 45%. This range is larger than under the Treasury plan because of the adoption of accelerated depreciation provisions that confer preferential taxation on depreciable assets relative to inventories and land.

We find, however, that the president's plan would be more effective in narrowing the disparities in capital costs and effective tax rates across industries and sectors than would the Treasury plan. This stems largely from the treatment of corporate investments relative to owner-occupied housing. As a result of elimination of deductibility of local property taxes, both plans would raise somewhat the effective tax rate on owner-occupied housing. The president's plan would not change the overall tax rate in the corporate sector, so the preexisting disparity between corporations and housing is diminished. The Treasury plan would produce a sizable increase in the cost of corporate investments. This increase would lead to a greater difference in the relative treatment of heavily corporate industries such as manufacturing and other industries such as agriculture and housing, where the corporate form of organization is not predominant.

These findings are somewhat changed under the "old view" of dividend taxes. Under this view, dividend taxes are a significant component of capital costs. Corporations would be provided a deduction for 50% of dividends under the Treasury plan and 10% under the president's plan. These features have a more substantial impact on reducing the corporate costs of capital when the old view is considered. Under this theory, we conclude that both plans cause a slight reduction in the overall cost of capital and both would lower intersectoral distortions.

We then turn to a simulation of these reforms over a fifty-year horizon using a general equilibrium model. This model is able to evaluate efficiency gains or losses from the various features of revised taxes on capital incomes. The effect of interasset tax distortions is captured by firms' substitution among different types of equipment, structures, in-

ventories, and land in production in response to their relative capital costs. Intersectoral distortions are captured because of the model's endogenous allocation of capital among corporations, noncorporate business, and owner-occupied housing. Finally, the effect of taxes on intertemporal allocation of resources is captured in that households decide how much to save in response to the after-tax rate of return. This saving determines the accumulation of capital over time.

Under the "new view" of dividend taxes, in most of our simulations, we find that both reforms generate net welfare gains even with slight declines in the capital stock. That is, in terms of output, a more efficient allocation of capital more than makes up for a lower capital stock. Under the "old view" that dividend taxes have a significant effect on investment, both plans reduce intertemporal distortions as well as differences among assets. Under this view, the Treasury plan no longer worsens intertemporal distortions. Even for the least favorable set of parameters in this case, these reforms raise both the capital stock (by 0.5%–0.7%) and the real value of output (by 0.3%–0.4%).

Finally, our paper shows alternative allocations of capital across assets, sectors, and industries. We expect firms to make relatively less use of equipment as a result of the reforms, but the industrial mix of output will depend on the particular assumptions about dividend taxes. Under the Treasury proposal with the new view of dividend taxes, the only industries that would experience a long-run increase in output would be agriculture and housing. Under the president's plan with the new view, more industries would experience increases in output, but housing would decline. Simulation under the old view produces the largest increases in output for the heavily corporate manufacturing and mining industries and declines for real estate.

To summarize, our paper contains a comprehensive model of investment incentives and estimates of the efficiency effects of tax reform. It is important to realize, however, that it does not provide information about the effects of tax reform on equity, simplicity, or other criteria essential to final policy judgments.

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