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THE THRUST TOWARD GENUINE TAX REFORM

By Robert M. Bleiberg

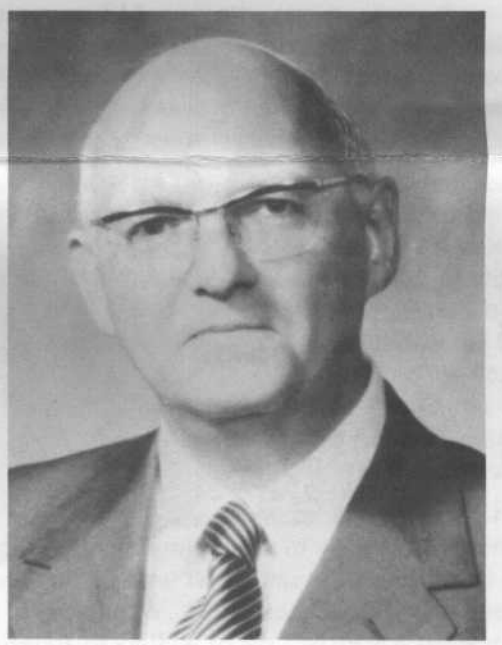
Robert Bleiberg has been Editor of Barron's National Business and Financial Weekly *for more than 25 years. Under his editorial direction,* Barron's *has won a number of awards for its reporting, the circulation of* Barron's *has grown from 50,000 to over 265,000, and Mr. Bleiberg's weekly editorials have been influential in business and political circles.*

He earned a B.A. with honors in economics from Columbia College. In 1950 he received an M.B.A. from the New York University Graduate School of Business Administration. In 1977 he received an honorary Doctor of Commercial Science from Hillsdale College.

Mr. Bleiberg joined Barron's *in 1946 as associate editor. He was named Editor in 1954 and in January 1980 was named Vice President of the Magazine Group, a new position created when Dow Jones was reorganized into seven principal operating groups.*

He is listed in Who's Who in America *and is a member of the New York Security Analysts, New York Financial Writers Association, Phi Beta Kappa Associates and The Economic Club of New York.*

Mr. Bleiberg delivered this presentation recently at Hillsdale as part of the Ludwig von Mises Lecture Series.



In spite of the great academic honor bestowed on me by Hillsdale, which I have come to regard as a second alma mater, I remain a journalist rather than a scholar. And it's in the capacity of journalist that I presume to address you this evening. In my profession, timing is important—after all, yesterday's newspaper, as the old saying goes, is only good for wrapping fish in. Hence on April 23, 1974, when I gave my first von Mises lecture on wage and price controls, the nation's one and only peacetime fling with these disastrous expedients was scheduled within a few days to come to an ignominious end. Twelve months later, under the same auspices, I offered a critical appraisal of federal regulation, which I believed was destined to make headlines for years to come.

My topic tonight is, "The Thrust Toward Genuine Tax Reform." Coming as it does within a week of April 15, that inevitable day of reckoning and annual orgy of financial blood-letting, it aims to carry on the journalistic tradition of good timing. Perhaps it may also convey to you some sense of where we've been in the murky realm of tax policy, as well as where we're going.

Let me sum up the points I hope to make this evening. One: as practiced by our elected representatives in Congress, tax legislation from the late Sixties through the late Seventies was neither an art nor a science, but a game almost anyone—the less skilled the better—could play. To get down to cases, Congress, so an overwhelming weight of evidence suggests, time and again passed measures which it neither understood, weighed nor even necessarily had a chance to read. As a consequence, it had to spend an incredible amount of time clarifying, rewriting and, more often than not, wholly undoing its own handiwork.

im•pri•mis (im-pri-mis) adv. In the first place. Middle English, from Latin in primis, among the first (things).

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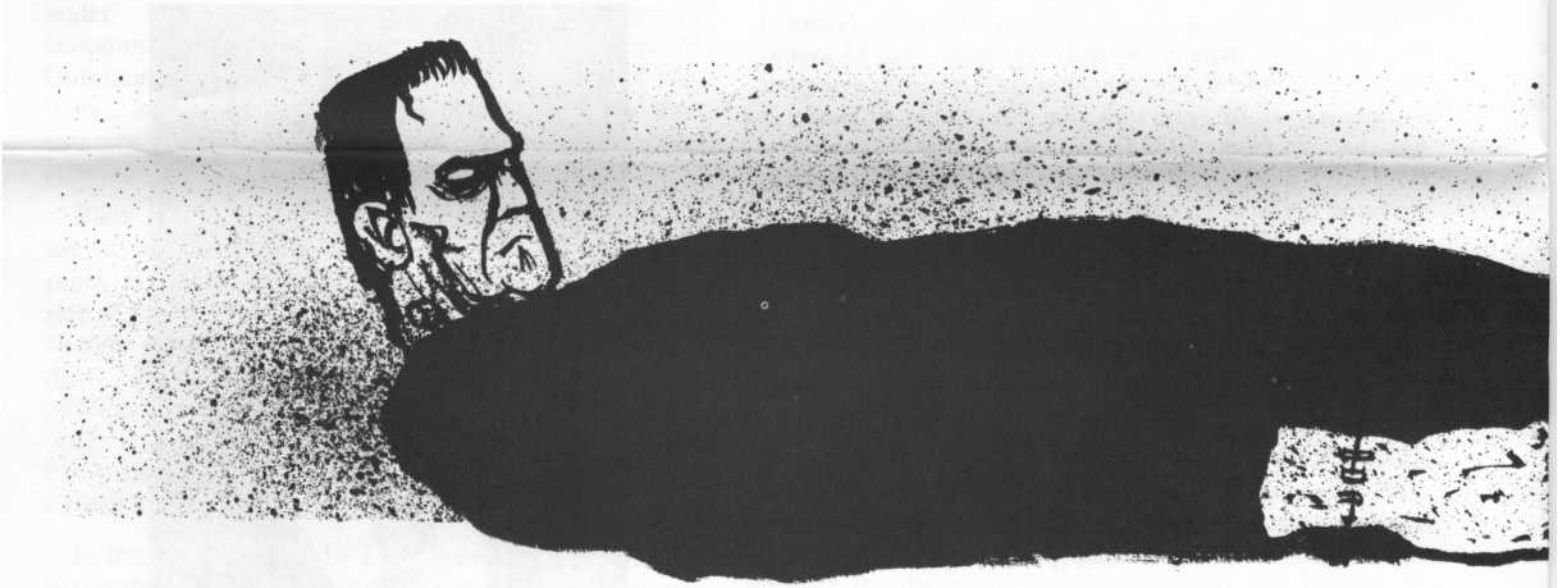
Two: not surprisingly, U.S. tax laws, instead of being farsighted and wise, as one would hope, for more than a decade proved to be a succession of financial and economic disasters. They inevitably wound up favoring consumption over saving and investment, undermining incentive and discouraging growth. Finally, three: for the first time in many years, a shift in national thinking is clearly afoot. Principles and premises once embraced unquestioningly have come under heavy attack. Contrariwise, notions like the desirability of capital formation suddenly seem to be ideas whose time has come.

To grasp fully the significance of where the U.S. is heading, we must first understand clearly where it's been. Here a bit of history seems in order. Though lurking in the background throughout most of the Sixties, if not before, so-called tax reform got its first great impetus in January of 1969, when then-Secretary of the Treasury Joseph Barr, in a sort of farewell address, disclosed that 750 people with incomes of more than $100,000 per year, and 154 making $200,000, had paid no federal income tax in 1966-67. In consequence, he warned the Joint Economic Committee of Congress, the U.S. was facing a taxpayers' revolt, not because taxes were so high, but because the rich were evading their fair share of the burden.

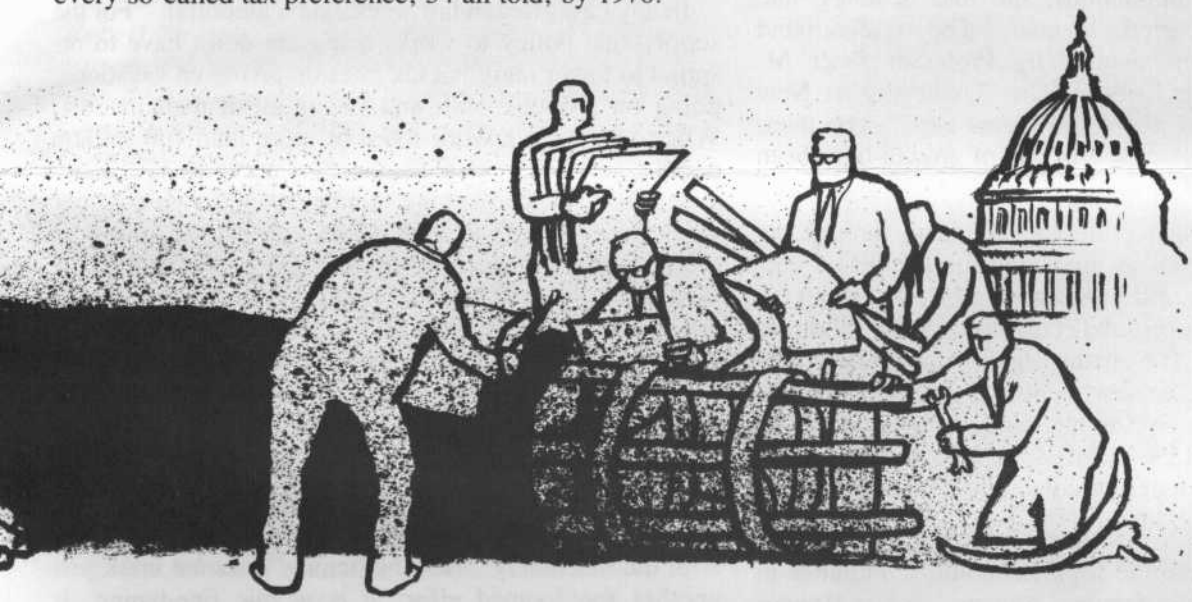
In a fascinating volume called *Tax Loopholes, the Legend and the Reality,* Roger A. Freeman, of the Hoover Institution on War, Revolution and Peace, made the following observations: "Mr. Barr's statement—delivered without an explanation of why or how recipients of huge gross incomes could escape paying taxes—was prominently featured in news media throughout the country and aroused public sentiment to a high pitch. The result was a situation not too different from what he had predicted. Some members of Congress who had viewed tax reform with detachment early in the session came back from Easter recess with a mandate from their constituents and a personal determination to 'make the rich pay.'" The result was the 225-page Tax Reform Act of 1969, a measure which made hundreds of changes in the tax law and constituted—up till that time, at any rate—the greatest and most complex addition to the Internal Revenue Code in history.

Let's take a harder look at that landmark measure, which ostensibly was aimed straight at all those allegedly tax-delinquent millionaires. Despite its passage, the millionaires got off lightly, but others were hit harder. Among a host of other things, the legislation repealed the Investment Tax Credit (subsequently reinstated); limited accelerated depreciation in real estate; lowered mineral depletion allowances, notably for oil and natural gas—just in time, by the way, for the Arab oil embargo; increased levies on capital gains and pension profit-sharing plans; and, in a thrust at those odious tax avoiders, imposed for the first time a minimum tax on otherwise sheltered income.



Here is how Raymond Saulnier, who headed the Council of Economic Advisers under President Eisenhower, viewed the measure just prior to its passage: "The bill would impair the nation's capability for achieving vigorous economic growth by a number of provisions that would reduce incentives to save and invest, including the proposed treatment of capital gains and the reduction of incentives to invest in real estate and in mineral resources. It would further inhibit growth by reducing—in some cases eliminating altogether—ways in which business concerns reward management achievement. And the balance of its revenue effect... would favor consumption at the expense of investment, thereby weakening government efforts to overcome inflation as well as impeding economic growth.... One is impressed again and again that what we have here is a massive example of throwing out the baby with the bath water—in this case, a whole family of babies, with a few cups of bath water."

That great tax reform of 1969 was just for openers. Along came 1972 and a Presidential election year, in which Senator George McGovern, the Democratic standard-bearer, introduced his own Tax Reform Act of 1972, a revolutionary set of proposals aimed, in the Senator's view, at "closing $28 billion in tax loopholes which now benefit the rich and the big corporations." Not long afterward, Congressman Wilbur Mills, who at the time still headed the powerful House Ways and Means Committee, jumped on the bandwagon with his so-called Tax Policy Review Act, which, unless Congress took affirmative action, would have phased out every so-called tax preference, 54 all told, by 1976.



Finally, take the Tax Reform Act of 1976. This monstrosity of the legislative process changed virtually everyone's bottom line for good or ill. For example, it gave tax breaks to cigar makers, amateur athletic organizations, private foundations and a number of others, including those with estates of up to half a million dollars. While allegedly closing loopholes, in short, it briskly opened up new ones.

However, its main thrust was anti-capital. Among other things, the '76 law raised from 10% to 15% the rate on "preference" items, on which taxpayers pay at lower than full rate, including the untaxed portion of capital gains. Moreover, the exemption on preference items was slashed from $30,000, plus part of one's tax bill, to $10,000. Americans who work abroad were faced with heavier levies, to the pleasure and profit of the foreign competition, an inequity, by the way, which remains on the books to this day. Similarly, the length of time which securities and other property must be held to qualify for capital gains treatment was boosted from six to nine months in 1977 and to twelve months in 1978. And most tax shelters—with the significant exception of low income housing—had their advantages severely curtailed. It's also worth noting in passing that this legislation, in one of its less publicized but far-reaching provisions, quietly imposed fairly severe strictures on those who professionally prepare tax returns.

In a scathing commentary on the whole affair, a leading business daily wrote as follows: "Democratic liberals will, of course, argue that their bill only increases taxes on upper income Americans, closing loopholes, tightening treatment of capital gains, increasing the bite of the minimum tax, and expanding business taxation on foreign investment. But as usual, this mindless egalitarianism is unaccompanied by an assessment of its impact on the total economy—output, employment, the tax base and revenues from other sources...." Summed up the publication: "It's a massive volume of tax law that rivals Tolstoy in complexity and Dostoevski in gloom."

And what about those untaxed millionaires? Somehow the IRS never laid a glove on them. In 1970, despite passage of the 1969 legislation, nearly 500 taxpayers in the same two tax brackets also got off scot-free. Every year since, thanks to the array of so-called tax preferences and deductions, some have always succeeded in slipping through the net.

Such results should really come as no surprise. The fact is that until recently, tax legislation was not written so much as put together with Scotch tape and paper clips. For example, in the case of the 1969 measure, despite extensive hearings, which filled 15 large volumes with testimony, the legislative procedure was slipshod. On the day before the bill was scheduled to come up for a vote on the floor, the Chairman of the House Ways and Means Committee called an extraordinary session of the group at noon to ponder the fate of seven million middle-income taxpayers who had somehow gotten lost in the shuffle.

In a dissenting report on the Tax Reform Act of 1969, Rep. Sam M. Gibbons (D., Fla.) was severely critical of the proceedings. He pointed out that not until July 28, 1969, six days before the report was written, did the

Committee get a chance to view "any of the more than 360 pages of this very complicated legislation.... On that day, just six days ago, we first saw and took under consideration a tentative draft of a part of this bill. On that day, we approved some 83 pages. This same rapid pace without any opportunity for the Committee to examine the language in advance was carried on for the rest of the week.... In my opinion, all of these matters are far too important for this type of deliberation and decision-making." Small wonder that the measure swiftly became known as the Lawyers' and Accountants' Relief Act.

The so-called Tax Reform Act of 1976 evoked a similar response. In the midst of the debate, Rep. Brock Adams (D., Wash.), then chairman of the House Budget Committee, called the Senate version of the pending tax bill "a Frankenstein monster that ought to be killed if it can't be changed." Chimed in Lowell Weicker (R., Conn.): "The bill we have now before us just totally defies human understanding, never mind Senatorial understanding." By the same token, in a discussion of efforts by the House Ways and Means Committee to prevent recipients of Social Security from enjoying a "double-dip" (which referred to two tax rebates of $50 each), Congressman Ed Jenkins (D., Ga.) remarked: "In the past two days, we've been dipped and double-dipped until I'm totally confused." He added for posterity: "Before we're done, I'm afraid the average taxpayer is going to be skinny-dipped."

Congressman Jenkins swiftly proved to be a prophet in his own country. For the ink had scarcely dried on the Tax Reform Act of 1976—which, by the way, with a cost of thousands had been three years in the making—than the lawmakers hurriedly started to dismantle their handiwork.

Indeed, despite three years of deliberation, the evidence is compelling that the lawmakers literally did not know what they were doing. On that score, consider the critical comments of Sen. Harry F. Byrd, Jr. (Indep., Va.) on the Estate and Gift Tax provisions of the 1976 law.

According to Senator Byrd, the chief purpose of that measure in this realm was to reduce the tax burden upon small and medium-size estates and to help meet the needs of farmers and small businessmen who wanted to pass on their property to the next generation. Quite a laudable goal, but things didn't work out the way the framers of the legislation intended. On the contrary, it soon grew clear that the estate and gift tax provisions were doing precisely the opposite of what they were meant to do. To make matters worse, the 1976 estate and gift tax provisions created an administrative nightmare that added to the complexity and cost of handling the affairs of the deceased: "The law as it now stands will have a disastrous effect over a period of years on small businesses and will aggravate the problem of the ever-increasing concentration of economic wealth and power in a few large corporations."

In the 1976 legislation—three years in the making, let me remind you again—the estate and gift tax provisions weren't the only ones to go awry. In several cases, involving: (a) deductions and the exclusions of income earned abroad by Americans; (b) substitution of a credit for the child care deduction; and (c) substitution of a credit for the elderly for the retirement income credit, the effect was made retroactive to various dates. The shift naturally imposed a burden upon taxpayers who had already made their plans for the fiscal year. To compound the confusion, when the deadlines were extended by law, as they swiftly were, taxpayers were compelled to go through the cumbersome process of seeking refunds.

Though widely condemned by tax experts, lawyers, accountants and others, by the way, retroactive tax legislation has become all-too-popular. On this score, the Tax Reform Act of 1969 took effect according to 84 different time schedules, employing more than 40 different effective dates. Similarly, the so-called Tax Reform Act of 1974, if it had passed as originally drafted by the Ways and Means Committee, would have had over 50 retroactive provisions.

Which brings us to 1978 and the Carter Administration tax proposals. As outlined before the House Ways and Means Committee on January 30, 1978, by W. Michael Blumenthal, Secretary of the Treasury, this program called for more and more of the same. Specifically, the White House proposed broadening and extending the assault on tax shelters. It urged eliminating the special federal deduction for general sales taxes, personal property taxes, gasoline taxes and miscellaneous taxes paid at the state and local levels. Finally (and worst of all), the White House sought to eliminate what was left of the 25% alternative tax for capital gains. And in a thrust that seemed aimed straight at me, it would have outlawed the notorious "three-martini lunch."

But on the way to the forum, a funny thing happened. Thanks to the outbreak of the nationwide tax revolt, the lawmakers that autumn actually approved the first cut in the capital gains tax—from nearly 50% to an effective rate of 28%—since it was put on the books nearly half a century ago. Thus, the Revenue Act of 1978 was a landmark. It signified the overwhelming bipartisan rejection of policies best described not as soak-the-rich but as soak the productive middle class and the beginnings of genuine tax reform, which aims to stimulate investment, production and productivity.

Similarly, during the 96th Congress a spate of forward-looking legislation was dropped in the hopper. Thus, Congressman Richard T. Schulze (R., Pa.) introduced a bill, The Individual Investors Incentive Act of 1980, that would offer the individual taxpayer a credit of up to $1,000 ($2,000 in case of joint return) against his income tax if he invests up to $10,000 in industrial stocks or bonds.

Other pending measures would have encouraged the

reinvestment of dividends, granted tax incentives for research and development, and fostered employee stock ownership plans. And a highly innovative piece of legislation, introduced last July by the Senate Majority whip, Alan Cranston of California, one of the few liberals to survive the Reagan sweep, would have established an investment rollover account, whereby an investor could defer the tax liability on long-term gains in securities if he reinvested the proceeds in another security (much like the tax break currently employed by homeowners).

Since the 97th Congress convened in January, the trend, if anything, has grown stronger. President Reagan, of course, has now thrown the full weight of his office behind the Kemp-Roth proposals, which would cut tax brackets virtually across-the-board by 10% per year over the next three years, and speed up the write-off of plant and equipment. Moreover, in his State of the Union message, the Chief Executive spoke of a second, or follow-on, tax bill which may prove equally fruitful. Surely the possibilities are almost endless.

Thus, Congressman Schulze has reintroduced his Individual Investors Incentive Act, as well as the Small Business Tax Relief Act of 1981, which, among other provisions, would permit a small businessman to sell his company and reinvest the proceeds within 18 months in another venture without being subject to tax. With fine bipartisanship, both Republicans and Democrats have dropped into the hopper measures that propose to lower the levy on capital gains from 28% to 18%. One imaginative bigwig on Wall Street is lining up support for a proposal to cut the capital gains levy to zero—but only on new commitments. Here is how he recently outlined his scheme to the House Budget Committee: "If the capital gains tax were reduced to zero on new investments, anyone expecting future gains would have a powerful incentive to sell immediately and reinvest the proceeds.... As a result, there is good reason to believe that such a tax change would unleash a large volume of selling and reinvestment of assets. Thanks to the unlocking of existing capital gains through the surge in trading activity, the Treasury would get a substantial windfall in the form of increased tax revenues from a capital gains tax."

"Looking further ahead, general tax revenues should increase by a large amount under this proposal because of its stimulative impact on business activity. We have run this proposal through the DRI econometric model, comparing what would happen after its adoption with a baseline solution that assumes no tax changes. Under those assumptions, the model shows that economic growth would accelerate significantly so that the budget position would show a $122.6 billion surplus by 1985 with an accommodating monetary policy and an $89.3 billion surplus with a non-accommodating monetary policy. Although one may quibble about the assumptions or the precise magnitudes involved, such a tax change seems likely to result in a major increase in revenues to the Treasury. In other words, this is a tax cut that would boost tax revenues in both the short and long run. The large expansion of future revenues would result from an acceleration in business activity, a sharp increase in employment, and an accompanying reduction in unemployment."

And just consider what has happened since the capital gains tax was slashed. As the Securities Industry Association has taken pains to point out, the cost to the Treasury has turned out to be gratifyingly low. Instead of the $2.2 billion per year in lost revenues officially forecast at the time of enactment, the Treasury last summer conceded that thanks to unexpectedly heavy realized gains, the figures would run to only $1.3 billion, or 40% less. (Moreover, SIA cogently argues, even these estimates, based as they are on effective tax rates of only 11% for 1979-80, instead of the 14.2% that prevailed during a comparable period in the late Sixties, continued to overstate the impact on revenues.)

A few weeks ago, new official estimates surfaced. From tax returns filed in 1979, preliminary data now suggest that at worst, the net loss in revenues came to only $100 million. In fact, some studies of the data indicate that far from losing any revenue whatsoever, the Treasury collected over $1 billion more at the lower 1979 rates than at higher rates in the previous year. On the basis of costs to benefits, including a surge in new incorporations and new jobs, the cut in the capital gains tax clearly winds up on the right side of the ledger.

Yet believe it or not, there are those who still fail to understand the significance of what has happened. A year or so ago *The New York Times* ran an editorial so off-base that it led the W. R. Grace Company to spend tens of thousands of dollars to set the record straight. What the *Times* was saying, briefly, was that the cut in the capital gains tax had achieved virtually nothing. How wrong can you get? Let me share with you the numbers.

The Revenue Act of 1978 was passed in October of that year. In 1978, 45 companies made public offerings of common stock, thereby raising $250 million. In 1979, 81 companies went public, raising $506 million. Last year, 237 companies went public and raised $1.4 billion. To bring the figures up to date, since the turn of the year, 96 companies have gone public, compared to 22 in the like period of 1980. In the process, they have already raised $684.6 million, more than four times as much as was raised in the like period of 1980.

Moreover, there's very little doubt that much of the strength in the stock market as a whole, which has seen a number of leading stock market indices rise to all-time highs, has come from the improved tax climate, especially the cut in the capital gains tax. In a special analysis a year or so ago, the leading stock brokerage firm of Merrill Lynch estimated that without the cut in the capital gains tax, prices on the New York Stock Exchange would be nearly 10% below current levels. It went on to add: if the further cuts in the capital gains tax approved last year

by the Senate Finance Committee, and increasingly likely in the light of the new political climate, (a maximum rate for individuals of 20%, and a called-for alternative tax of 20%) should be adopted, the U.S. would enjoy a significant advance in spending on plants and equipment, and a greater rate of growth in productivity. In such circumstances, if one can believe the folks at Merrill Lynch, between now and 1985, the Standard & Poor's 500 would rise from its current level of 130 or so to over 200.

Will the same be true of Kemp-Roth or the other proposed reforms? Nobody can be sure, but there is reason to think so. That's particularly true in the light of the vast explosion of cash transactions, sub rosa dealings, and under- and unreported income. The underground economy, as it was dubbed by Professor Peter M. Gutmann of Baruch College, City University of New York, first surfaced just a few years ago. Since then, estimates of its size, scope and rate of growth have been continuously revised upward.

Back in 1977, when Professor Gutmann, through the use of such techniques as analyzing the amount of currency in circulation, did his pioneering work, he put the size of the U.S. underground economy at $176 billion, or slightly more than 10% of the legal gross national product, a figure which a subsequent IRS study did much to confirm. More recently, he has revised upward his estimates to closer to 15% of GNP (at current levels, over $2.7 trillion), a staggering total which other scholars nonetheless deem too low.

In testimony before the Joint Economic Committee in November, 1979, Professor Gutmann probed deeper: "What is the theoretical...tax loss involved in the subterranean economy? The upper IRS estimate is $26 billion for 1976. However, the IRS study team left out a number of categories and may have underestimated others. Once these omitted categories are added, the tax loss for 1976 will be more than $35 billion, corresponding to the higher 13 to 14 percent estimate of the subterranean income as a percentage of legal GNP. For 1979, the tax loss corresponding to the higher 13 to 14 percent estimate of the subterranean income as a percentage of legal GNP would be over $50 billion."

In Professor Gutmann's view, reducing taxes would shift production and trade from the underground to the legal economy, thereby, so to speak, surfacing the scratch. In combination with the Laffer curve, which projects an increase in economic activity at lower tax rates, the result could be an increase in the Treasury's take. "Politicians," presciently writes the economist, "may yet be able to advocate tax reduction and a balanced budget at one and the same time." Long before supply side economics works its long-range miracles, then, the fiscal results may loom large. After all, it's easier to render unto Caesar at reasonable rates.

Let me conclude by quoting some of the observations made last week at a Financial Writers dinner by Secretary of the Treasury Donald T. Regan. (By the way, unlike his two predecessors, G. William Miller and W. Michael Blumenthal, Don Regan puts his first name up front. That may not make him the greatest Secretary of the Treasury since Andrew Mellon, but it strikes me as a pretty good start.)

In any case, Regan last week said a mouthful: "For the supply-side policy to work, taxpayers don't have to respond to lower marginal tax rates by giving up vacations, going on a double-shift and saving all of their income. When you have a work force of more than 100 million people, small individual responses result in a large aggregate effect. If the average number of hours worked per week rises from 35 to 35.5, GNP rises by $42 billion. If the absentee rate declines by one-half percentage point, GNP rises by $10 billion. If the personal savings rate rises from about 5.5% to about 7.5%, private savings increase by $42 billion annually at current income levels. The increased savings, together with the revenue 'reflows' and the budget cuts, more than pay for the tax cuts, thus making possible increased capital formation."

Regan then told the financial writers: "What this Administration proposes and intends is not a mere tinkering with the machinery. 'New beginning' does not mask just another foredoomed effort at economic fine-tuning. It does not describe a mere nibbling at the edges, or the latest short-term reaction to a long-term problem, or another spasm of counter-cyclical tax cuts. In its scope, capacity for results, daring, and comprehension of the dynamics of our people and the underlying strength of our economic system, it can only be compared with the economic ferment that produced the Federal Reserve System in 1913, or the first hundred days of 1933."

"But I believe that even these comparisons fall short of the real nature of this 'new beginning.' For what is really involved is what our scientific brethren call a new 'paradigm'—a fresh way of looking at a universe. We are proposing nothing less than a new understanding of the mechanics of the economic universe."

April 15, 1981, has come and gone. Before Tax Day rolls around again next year, there's reason to hope and to believe that the whole world of finance will be a different and better place.

Editor, Ronald L. Trowbridge.