Federal Tax Policy

JOSEPH A. PECHMAN

FOURTH EDITION



Studies of Government Finance
THE BROOKINGS INSTITUTION
WASHINGTON, D.C.

Contents

1.	Introduction	1
	Features of the U.S. Tax System 1	
	Goals of Taxation 5	
2.	Taxes and Economic Policy Stabilization Policy 9 Fiscal Policy 9 Built-in Stabilizers 12 The High-Employment Surplus or Deficit 15	8
	Expenditure versus Tax Adjustments to Promote Stability 20 Automatic Budget Rules 23 Monetary Policy 24 Rational Expectations 26	
	Policies to Promote Economic Growth 27 Achieving Full Employment and Stable Prices 28 Raising the Growth Rate 30 The "Debt Burden" 32	
	Summary 35	
3.	The Tax Legislative Process	37
	Executive Preparation of a Tax Bill 39	
	The Bill in Congress 43 The Ways and Means Committee 43 House Approval 46 The Senate Finance Committee 47 The Senate Debate 48 The Bill in Conference 49	
	Presidential Action 50	
	Improving the Process 52 Simplifying the Tax Law 52 Representation of the Public Interest 53 Reforming the Tax Structure 55 Consideration of Overall Fiscal Policies 56	
	Summary 58	

60

4. The Individual Income Tax

The Structure of the Federal Income Tax 61

Adjusted Gross Income and Taxable Income 61

Tax Rates 64

Reporting Requirements 66

Methods of Tax Payment 66

Final Tax Reconciliation 68

Possible Modification of the Current Payment System 69

Economic Effects 70

Role as Stabilizer 70

Work Incentives 72

Effect on Saving 73

Structural Problems 74

Personal Exemptions 75

The Negative Income Tax 81

Personal Deductions 86

Transfer Payments and Wage Supplements 94

The Family 96

The Aged 101

Earned Income 103

Indexing for Inflation 107

Capital Gains and Losses 109

Saving Incentives 116

State and Local Government Bond Interest 117

Income Averaging 121

Minimum Tax 122

Tax Shelters 124

Tax Simplification 125

Summary 128

5. The Corporation Income Tax

Characteristics of the Tax 131

The Tax Base 131

Tax Rates 134

Tax Payment 134

Shifting and Incidence of the Tax 135

The Shifting Mechanism 136

The Evidence 138

Economic Issues 141

Investment and Saving 142

Equity and Debt Finance 145

Resource Allocation 145

Built-in Flexibility 147

Balance of Payments 148

Structural Features 149

Capital-Consumption Allowances 150

Allowances for the Mineral Industries 158

129

CONTENTS		xiii
Financial Institutions	160	

CO	ONTENTS	xiii
	Financial Institutions 160 Tax-Exempt Organizations 162 Corporate Acquisition, Reorganization, and Liquidation 164 Foreign and Export Income 165	
	Inflation Accounting 166 Depreciation 167 Inventories 168 Net Financial Assets and Liabilities 169 Choice of Adjustments 170	
	Integration of the Corporation and Individual Income Taxes 171 The Additional Burden on Dividends 173 Methods of Integration 174	
	Summary 181	
6.	Consumption Taxes	183
	Types of Consumption Taxes 183	
	Issues in Excise Taxation 185 Economic Effects of Excise Taxes 185 Equity Considerations 191	
	A General Consumption Tax? 193 The General Sales Tax 194 The Value-Added Tax 197 Sales or Value-Added Taxes versus Income Taxes 199 The Expenditure Tax 201 Summary 204	
7.	Payroll Taxes	206
	The Development of Payroll Taxes 206	
	The Insurance Analogy 210	
	Features of Payroll Taxes 211 Regressivity 211 Built-in Flexibility 213 Effect on Prices, Employment, and Wages 215 Effect on Personal and Public Saving 217 Taxation of Benefits 218	
	Financing Social Security 218 The Contributory System 219 Proposals for Reform 220	
	Financing Unemployment Insurance 222	
Q	Summary 224 Estate and Gift Taxes	225
υ.	Listate and Ott Lakes	223

The Role of Wealth Transfer Taxes 225 Characteristics of the Taxes 227

The Estate Tax 228

	٠	
x	1	v

NTS

xiv	,	CONTENTS
	The Gift Tax 229 The Tax Base 230	
	Structural Problems 230 Transfers by Husbands and Wives 231 Imperfect Unification of Estates and Gifts 233 Generation Skipping through Trusts 235 Generation Skipping through Outright Transfers 240 Charitable Contributions 241 Small Business and Farm Property 242	
	Other Methods of Taxing Wealth 243 Inheritance or Accessions Taxes 244 The Annual Wealth Tax 245	
	Summary 246	
9.	State and Local Taxes	247
	The State and Local Structure 248 State Taxes 250 Local Taxes 252 State and Local Fiscal Performance, Capacity, and Effort 254	
	Major Issues 254 Income Taxes versus Sales Taxes 255 Deductibility 257 The Property Tax 260 Tax Coordination 269 State and Local Fiscal Relations 276 Federal Aid 279 The Plight of the Cities 286	
	Summary 288	
	Appendixes Historical Summary of the Major Federal Taxes 290	
	Tax Bases of the Major Federal Taxes 324	
	Tax Expenditures 341	
D.	Statistical Tables 349	
E.	Bibliographical Notes 384	
	Index	403