OVERVIEW AND ASSESSMENT OF CHANGING TAX POLICY

Eric J. Toder
Congressional Budget Office

The past four years have seen major changes in federal tax policy. The Economic Recovery Tax Act of 1981 was motivated by concerns that federal tax burdens had become too large and were impeding work effort, capital formation, and economic growth. For individual taxpayers, the act lowered the top marginal rate from 70 percent to 50 percent; lowered other marginal tax rates by 23 percent over a three year period; provided for indexing of personal exemptions, the zero bracket amount (ZBA), and tax rate brackets to increases in the consumer price index beginning in 1985; provided a new deduction for two earner households equal to 10 percent of the second earner's earnings, up to a maximum deduction of $3,000; and provided increased incentives for individual savings, including the availability of tax-deferred individual retirement accounts (IRAs) to taxpayers with other pension arrangements. For business, the act significantly accelerated depreciation deductions; included a "safe-harbor" leasing provision that enabled the benefits of the accelerated cost recovery by the accelerated cost recovery system (ACRS) and the investment tax credit to be available to corporations with no current tax liability; and provided a number of more narrowly targeted investment incentives, including a new credit for increased expenditures on research and experimentation.

The provisions of the 1981 act were partially reversed in the Tax Equity and Fiscal Responsibility Act of 1982. The purpose of the 1982 act was to reduce the federal budget deficit by scaling back excessive and unintended investment incentives, improving compliance and eliminating tax abuses, and raising selected excise taxes. Major provisions of the act included the repeal of safe harbor leasing; elimination of the further acceleration of depreciation deductions scheduled to go into effect in 1985 and 1986; reduction of the basis for depreciable property by 50 percent of the investment credit; and scaling back of some corporate tax preferences; compliance measures, including withholding on interest and dividends (repealed in 1983) and other measures for improved reporting of income; temporary increases in excise taxes on telephone and telecommunications services and cigarettes; and increases in airport and airway user taxes. The 1982 act, however, preserved the marginal tax rate reductions, the scheduled indexing of exemptions, the ZBA and rate brackets, and the major investment incentives enacted in 1981.

The Tax Reform Act of 1984, enacted as part of a larger deficit reduction effort, was also meant to reduce unintended incentives and abuses and to raise additional revenue by selected tax increases. The 1984 act repealed a provision enacted in 1981 that would have excluded a portion of net interest received from tax, beginning in 1985; extended the telephone excise tax and increased excise taxes on distilled spirits; and delayed scheduled reductions in estate and gift taxes and the windfall profit tax. Tax reform provisions in the act included limits on depreciation benefits on property leased to tax-exempt entities; restrictions on private purpose tax-exempt bonds; accounting changes to measure better the time value of money; extension of restrictions on tax straddles enacted in 1981 and 1982; an increase in the depreciation life for structures from 15 to 18 years combined with limits on installment sale benefits; and many other reforms.

In addition to these broader changes in tax policies, there were more narrowly focused tax bills that also increased revenues and restructured taxes. These included the Highway Revenue Act of 1982, which increased the excise tax on gasoline and diesel fuel by 5 cents per gallon and restructured other taxes dedicated to the Highway Trust Fund, and legislation enacted in 1983, which accelerated scheduled increases in payroll taxes and provided that 50 percent of social security benefits be included in taxable income for taxpayers with income in excess of base amounts.

Major Problems with Current Tax System

In spite of these major tax policy changes, there remains considerable discontent with the federal tax system. Many people consider the tax system to be unfair because people with equal income often pay vastly different amounts of tax. Particular concerns have been expressed about the expanded use of tax shelters by high income taxpayers to defer or eliminate most of their tax liability. The ability to shelter otherwise taxable income is a consequence of provisions that allow income from many assets to be deferred or taxed at preferential rates, while interest on funds borrowed to finance the assets is fully deductible. The growing use of tax shelters reinforces the belief that the tax system is unfair and too complex and may erode voluntary compliance.

Economists have raised concerns about the effects of the federal income tax on economic efficiency because market prices that influence decisions on how to earn or spend income are often distorted by special tax provisions. In particular, concerns have been raised about the unequal taxation of returns to different kinds of investments. The federal income tax generally favors noncorporate over corporate investments; machinery and equipment over structures and inventories; investments that produce returns in the form of capital gain rather than ordinary income; owner-occupied housing and consumer durables rather than business sector investments; and investments in some industries that receive special tax advantages. The attempt to reduce disparities in effective tax rates among assets and industries is a major component of both the administration's tax reform proposals and alternatives introduced in the Congress.

One result of the many special tax preferences in the federal income tax is that the tax system is not only a means for raising revenue, but also a major instrument for setting social priorities. In many functional areas of the federal budget, including energy, housing, health care (excluding Medicare), and general purpose fiscal assistance, the revenue loss from special tax provisions exceeds direct budgetary outlays. Tax incentives promote many activities deemed to be worthwhile, including state and local public services, services provided by private charitable institutions, home ownership, energy conservation, oil and gas drilling, and historic preservation, among others. On the other hand, many tax incentives may be either unjustified, in the sense that the market would provide the appropriate level of activity without a federal subsidy, or excessively costly. Moreover, the proliferation of special preferences erodes the tax base, requiring higher rates to raise the same revenue and thereby exacerbating the adverse effects of the income tax on incentives to work, save, and invest.

Finally, many are disturbed by the complexity of the tax system, not only because of the time spent in filling out returns, but also because of the need to consider taxes when making investment decisions. Moreover, even those with relatively simple returns may resent the fact that others use complex provisions to reduce their taxes. Complexity results in part from the use of the tax system to favor certain activities and groups of taxpayers and would be reduced by eliminating special deductions, exemptions, and credits and by flattening the rate structure. At the same time, some complexity is an inevitable consequence of attempts to measure income for tax purposes and could be increased by some reform provisions intended to promote equity and economic efficiency by improving the measurement of taxable income. For example, proposals to adjust for the effects of inflation in measuring depreciation and gains from the sale of assets and to include more noncash fringe benefits in taxable income could increase complexity.

Broad Issues in Tax Reform

While discontent with the current tax system is widespread, there are great differences of opinion on how the tax system should be restructured. Major issues include the choice between a tax system based on income and one based on consumption, and the choice between a flat rate and graduated rates. Moreover, a consumption base can be achieved either by a tax collected from business, such as a retail sales tax or value added tax, or by modifying the present income tax to remove all saving from the tax base and tax all borrowing and dissaving.

Many economists have advocated shifting the tax base from income to consumption. Tax reform plans based on the consumption tax model (also referred to as a "cash flow" or "lifetime income" tax) have been developed in reports by the United States Department of the Treasury [6] and the Meade Commission [4] in the United Kingdom and in books and articles by a number of academic economists, including Aaron and Galper [1] and Hall and Rabushka [3]. The Hall and Rabushka proposal is for a flat rate tax, while others favor graduated rates applied to a base that excludes net saving. Some plans include special taxes upon bequest or inheritance to tax income not consumed during an individual's lifetime. Supporters of a consumption tax argue that it would eliminate the bias in an income tax that favors current or future consumption, and might thereby increase savings and capital formation. It would also reduce complexity by eliminating the need for special rules to tax annual changes in net worth. Because all purchases of capital goods and financial assets would be immediately deductible, there would be no need for depreciation rules, maintenance of records of the basis of assets to compute future capital gains, and adjustments to avoid taxation of inflationary gains. In addition, under some consumption tax plans, the corporation income tax would be eliminated as superfluous, while under others it would be converted to a "cash flow" tax that essentially exempts the return on new investments.

The current federal income tax includes many elements of a consumption tax. In particular, savings accumulated in an employer-funded pension plan, an individual retirement account (IRA), a Keogh plan, or qualified employer-provided cash and deferral arrangements (CODAs) are taxed as under a consumption tax; contributions and interest earnings are untaxed, while withdrawals of both principal and earnings are taxed at the time of withdrawal. Capital recovery rules also approximate consumption tax treatment for many investments. For example, at a 10 percent discount rate, the present value of tax savings from the combination of the investment credit and depreciation deductions on five year ACRS property is approximately equal to the present value of tax benefits from expensing.

Other economists favor reforming the current tax to resemble more closely a comprehensive income tax: see, for example Minarik [5]. Both groups of tax reform advocates would broaden the tax base by including all forms of employee compensation and by eliminating provisions that allow credits or deductions for personal consumption expenditures. Unlike consumption tax supporters, however, income tax advocates also favor more comprehensive taxation of income from capital.

This can be achieved by broadening eliminating provisions that allow exclusion and deferral of income from capital and by basing timing of deductions for capital recovery on estimates of economic depreciation. Some income tax advocates also favor integrating the corporation and individual income taxes, so that corporate income is attributable to individual shareholders and taxed only once, and indexing the basis of capital assets to remove the inflationary component of capital gains and to allow depreciations based on current, rather than historical, price levels.

Advocates of broadening the income tax base believe that annual income, including both consumption and increases in net worth, is the best measure of ability to pay. Some income tax advocates contend that accumulation of wealth itself gives an individual power and status and therefore should be taxed even if not consumed; others believe that taxation of capital income is justified because government spending enhances the security of property and thereby protects the accumulation of capital. In addition, special concerns have been raised about the transition from the current income tax to a consumption tax; the major problem would be how to tax consumption from wealth accumulated under the income tax. Equitable transition rules that would protect the aged from double taxation of their savings, while at the same time preventing windfall gains to wealthy individuals, could be extremely complex.

Advocates of tax reform also differ on whether to maintain a graduated rate structure or move towards a single, flat rate tax. A flat rate tax would involve a number of simplifications. If there were one tax rate, there would be no need for income averaging, no marriage penalty or bonus, and less concern about transactions undertaken to shift the tax base among taxpayers (for example, between individuals and corporations or between high bracket and low bracket individuals). On the other hand, there would still be a need to define the tax base; this results in most of the complexity under current law and proposed alternatives. The major objection to a flat rate tax is that it would redistribute the tax burden from upper income to lower or middle income groups. The lowest income groups could be held harmless if taxpayer exemptions were large enough, but this would shift more tax payments to the middle class.

A flat rate tax could be collected from business in the form of a value-added or retail sales tax. Such a tax could replace only a portion of the current income tax, or could be used to raise additional revenues. Some of the regressivity of a federal sales tax could be offset by changes in the income tax rate structure or by exemption of items consumed by low income groups. These offsets would be imperfect, however. Income tax relief would not help low income people who do not file tax returns and exemptions could not be precisely targeted to the lowest income groups and would add complexity to the tax. Concerns about a federal sales tax have also been expressed by those who fear that it might, in the long run, facilitate higher levels of federal spending.

Administration Tax Reform Proposal

The administration tax reform proposal essentially maintains a graduated income tax with a separate tax on corporate income, but with lower rates on individuals and corporations and a broader tax base. Some of the consumption tax elements of the current tax system, such as the deferral of tax on retirement savings, are maintained, but capital recovery provisions are altered in the direction of taxing economic income. The proposal attempts to maintain approximately the distribution by income group of individual income tax burdens as under current law, but reduces relative tax shares to some degree for both the lowest and highest income groups. The House Ways and Means Committee has begun consideration of a similar proposal, drafted by the committee staff, that imposes somewhat larger tax burdens on corporations and upper income individuals, but essentially also lowers the tax rates and broadens the base of a graduated income tax.

The administration proposal substantially lowers individual and corporate tax rates. The rates applied to individual income, which currently range from 11 percent to 50 percent, are replaced with a three bracket structure with rates of 15, 25 and 35 percent. The amount of tax-free income available to individual filers is increased by raising the personal exemption from $1,080 to $2,000, raising the zero bracket amount (ZBA) for single and joint filers and heads of household, and expanding the earned income credit. At the same time, the administration proposal eliminates the second earner deduction and repeals income averaging. These provisions are regarded to be unnecessary with the lower and flatter rates in the administration's proposal.

The maximum corporate tax rate is reduced from 46 percent to 33 percent and a structure of preferential rates for corporations with less than $100,000 of taxable income is maintained. The administration proposal also allows corporations to deduct 10 percent of dividends paid, a very modest step in the direction of integrating the corporate and personal income taxes.

The revenue loss from lower tax rates and the increase in personal exemptions and the ZBA is paid for by broadening the tax base. For individual taxpayers, the base is broadened by eliminating and restricting some exclusions and itemized deductions. The administration proposal includes a portion of employer-paid health insurance premiums in taxable income and repeals exclusions of employer-provided death benefits, employee awards, unemployment compensation, workers' compensation and black lung benefits, scholarships and fellowships, prizes and awards, and employer contributions to group legal plans and for educational assistance. The deduction for state and local taxes (other than taxes that represent a cost of business) is repealed, deductions for employee business expenses and miscellaneous deductions are combined and limited to the amount in excess of 1 percent of adjusted gross income (AGI), and the deduction for nonbusiness interest (other than for mortgages on a principal residence) is limited to net investment income plus $5,000.

At the same time, a number of important exclusions and deductions are retained. The itemized deductions for home mortgage interest, medical expenses, casualty losses, and charitable contributions are continued in their present form, although the "above-the-line" charitable deduction is eliminated one year earlier than scheduled under current law. The exclusion of $50,000 of employer-provided life insurance under current law is retained, and employer-provided health insurance in excess of $10 per month for individual coverage and $30 per month for family coverage remains tax-exempt.

The proposal significantly alters taxation of income from capital. The investment tax credit is eliminated, capital recovery rules are altered to approximate a better measure of economic depreciation, and depreciation deductions are indexed to changes in the price level. Depreciation deductions, however, continue to be more accelerated than indicated by available estimates of economic depreciation of capital assets, thereby maintaining a tax preference for investments in depreciable assets. The capital gains exclusion is also maintained, although reduced from 60 percent to 50 percent. (The combination of the 50 percent exclusion and the top rate of 35 percent results in a lowering of the maximum rate on capital gains from 20 percent to 17.5 percent.) Depreciable assets, however, are not eligible for capital gains treatment. Other major provisions in the administration proposal that move in the direction of taxing real income from capital include the repeal of the $100 dividend exclusion and provisions that require the matching of income and expense from multiperiod production, allow the use of indexed FIFO accounting for inventories, and restrict the use of the cash accounting method.

The administration also proposes a special transitional tax, labeled a "windfall recapture tax," on the accelerated depreciation deductions on corporate investments placed in service between 1980 and 1985. The tax is intended to capture a "windfall" that results because accelerated deductions were taken at a 46 percent rate to produce income that will be taxed at 33 percent under the proposal.

Many narrowly-targeted investment incentives are eliminated or reduced. Provisions that restrict subsidies for particular industries and assets include: repeal of business energy credits and phase out of the exemption of gasohol from the gasoline excise tax; phase out of most percentage depletion; repeal of capital gains treatment of timber and certain royalty income; elimination or limiting of many tax preferences for financial institutions, including bad debt deductions, deductibility of interest to hold tax-exempt securities, tax-exemption of credit unions, and special deductions and exemptions utilized by insurance companies; taxation of the inside buildup of life insurance reserves; repeal of tax-exemption for "private purpose" state and local bonds and tightening of arbitrage rules; and repeal of rehabilitation tax credits. Some industry incentives are maintained, however. The proposal continues expensing of intangible drilling costs for oil and gas and extends the tax credit for research and experimentation.

The proposal continues to allow deferral of retirement savings through pensions plans and individual retirement accounts (IRAs), but includes some revisions in incentives for retirement saving. The spousal IRA limit is increased from $250 to $2,000, but limits are placed on the use of employer-provided cash and deferred arrangements (CODAs). (A subsequent modification proposed by the administration to result in revenue neutrality eliminates all tax benefits for CODAs.) The administration proposal also repeals the three-year basis-recovery rule for contributory plans and modifies top-heavy rules, rules for preretirement distributions, rules for averaging of lump-sum distributions, and other provisions.

The administration proposal includes a number of provisions to restrict tax abuses and the use of tax shelters including limits on deductions for business meals and entertainment, extension of the at-risk rules to real estate, and the tighter restriction on interest deductions in excess of net investment income mentioned above. There are also simplification provisions including a proposal to implement a return-free system, repeal of the political contributions credit and the presidential campaign checkoff, and simplification of information return penalties. Finally, there are several important revisions of international tax provisions, including use of a per country limit for calculating the foreign tax credit and modification of rules concerning sources of foreign income and the allocation of deductions.

Evaluation and Prospects for Enactment

Any tax reform proposal that lowers tax rates and broadens the tax base can be regarded as a whole series of proposals that effectively reduce federal tax subsidies for particular activities. Thus, the details of any tax reform proposal have broad implications for changes in social priorities. In addition, changes in the federal tax rate structure, as well as changes in deductions, credits, and exemptions, have implications for current and future revenues; the distribution of the tax burden among income groups and family types; the choice between current consumption and saving; the allocation of the capital stock among industries and assets; and the level of tax shelter activity, among other consequences. In the remainder of my comments, I will discuss these and other aspects of the administration's tax proposal and then briefly assess its current chance of enactment.

The administration tax reform proposal, as noted above, maintains a graduated income tax system with a separate corporate income tax, but lowers both individual and corporate tax rates and broadens the tax base. The proposal is intended to be revenue neutral. The Joint Tax Committee estimated that the original administration proposal would lose about $25 billion over the period 1986–1990. While this shortfall is well within the range of estimating error, the administration subsequently modified its proposal to eliminate any estimated revenue loss over the five-year period. There still may be a long-run revenue loss after 1990, however. The depreciation provisions accelerate revenue collections, but give rise to less revenue after 1990 because depreciation deductions are indexed for changes in the price level. In addition, the "windfall recapture tax," which raises almost $60 billion over the five-year period, will have expired by 1990.

While there are many separate base broadening provisions in the administration proposal, a relatively small number of provisions provide most of the revenue needed to offset the individual and corporate rate cuts and the increase in personal exemptions and the ZBA:

- About half of the revenue loss from corporate rate reductions and changes in the individual rate structure (including changes in personal exemptions, the ZBA, and the second earner deduction) is paid for by elimination of the deduction for state and local taxes and repeal of the investment tax credit.
- About 70 percent of the revenue loss is paid for by those two provisions, the "windfall recapture tax" on accelerated depreciation, and provisions that match income and expense from multiperiod production. All of these items raise more than $50 billion between 1986 and 1990.
- Almost all of the revenue loss is paid for by 18 provisions that all raise more than $5 billion between 1986 and 1990, even though there are many other base-broadening items in the proposal.

Thus, a small number of provisions are critical to achieving the rate reductions proposed by the administration without sacrificing revenue. If Congress, for example, did not want to eliminate the state and local deduction or the investment tax credit, it would have to substitute other major provisions to have a viable tax reform bill that meets the criteria of substantial tax rate reduction without increasing the deficit.

The administration proposal in its original form reduces individual taxes for all income groups and increases corporate taxes. It slightly alters the distribution of individual tax liability among income groups. The lowest and highest income groups are estimated to receive the largest percentage reductions in individual tax liability; middle income groups receive a smaller percentage tax reduction. Estimates of the distributional effects of the proposal published by the Treasury Department and congressional staff do not, however, take account of the distributional consequences of higher corporate taxes. Such estimates also fail to account for the distributional consequences of changes in relative prices brought about by the elimination of tax preferences. For example, eliminating the deduction for state and local taxes and preferences for rental housing, by raising relative costs of local public services and rental housing, indirectly affects low and middle income households even though most of the direct tax savings from these preferences is received by high income taxpayers. Thus, available estimates of the distributional consequences of the tax reform proposal must be regarded as incomplete, although the evidence does not suggest any dramatic change in the distribution of the tax burden.

The choice of base-broadening provisions in the administration's proposal reflects some important choices about social priorities. The tax reform proposal substantially reduces federal support for public services provided by state and local government, while basically continuing (though at a somewhat lower effective subsidy rate) incentives for individuals to support public goods provided by private charitable organizations. Tax incentives for rental housing and urban redevelopment (including historic renovations) are reduced or eliminated, while incentives for homeownership, oil and gas drilling, venture capital investments, and research and development are maintained. The elimination of the investment tax credit has the biggest direct effect on older, capital-intensive sectors. Thus, the proposal may help the expanding Sunbelt states relative to older industrial areas.

The effect of the proposal on overall saving and capital formation is difficult to determine. The increase in corporate taxes suggests a possible decrease in investment, but part of the short-run increase in corporate tax revenues will be reversed after 1990. The estimated effective tax rate on the return to corporate investments in machinery and equipment is increased, but the effective tax rates on structures and inventories decline due to the decline in the corporate tax rate. While the overall effects on capital formation are unclear, the proposal appears to promote a better long-run allocation of the capital stock by moving towards more neutral taxation among types of assets. This occurs because the elimination of the investment credit and the changes in depreciation rules move the effective tax rates on machinery and equipment, structures, and inventories closer together, and because many targeted industry subsidies are eliminated or reduced. As a result, the composition of investment under this proposal should more closely reflect market demands rather than tax considerations and the social productivity of the capital stock can be expected to increase.

The proposal will probably reduce the use of tax shelters on balance both because lower tax rates reduce the incentive to avoid tax and because some tax preferences are eliminated or scaled back. In addition, the extension of at-risk rules to real estate, the recapture of real estate depreciation, the restriction on interest deductions, and the proposed tightening of the individual minimum tax will directly affect some tax shelter investments. Nonetheless, the continued preferential treatment of many assets, including the continuation of accelerated depreciation and the capital gains exclusion, assures that tax shelters will not be eliminated entirely.

The administration proposal generally benefits low income persons. The increase in personal exemptions and the ZBA will eliminate income tax liability for many individuals and families with income below the official poverty line. Although the proposal eliminates the special exemption for the aged, low-income older persons are more than compensated by the increase in the personal exemption and by an expanded tax credit for the elderly, blind, and disabled. Finally, low income workers with children will be helped by the increase in the earned income credit. The expanded benefits for low income taxpayers in part compensates for increases in their tax burdens in recent years. Since 1978, the personal exemption, ZBA, and limits on the earned income credit have remained fixed, allowing increases in the general price level to bring more low income individuals and families onto the income tax rolls.

The proposal reduces the effects of the marriage penalty by flattening marginal tax rates, but a marriage penalty remains for couples with close to equal incomes. By increasing the personal exemption more than the ZBA, the proposal provides relatively more tax reduction to larger than to smaller families, reversing a trend of recent years. In addition, because of the elimination of the second earner deduction, the proposal helps one earner families relative to two earner families, again compared to current law.

Finally, the proposal may have consequences for receipts available for the social security trust fund. Payroll tax receipts will increase because of the broadening of the tax base to include some fringe benefits in taxable employee compensation. At the same time, income tax receipts attributable to taxation of social security benefits will decline because of the reduction in marginal tax rates. The revenue estimates of the tax reform proposal published by the Treasury Department do not show estimated changes in either payroll tax receipts or in that portion of income tax receipts attributable to taxation of social security benefits.

In summary, the administration proposal is a major initiative that, if enacted, would represent the most far-reaching tax reform enacted in many years. It maintains a graduated income tax, but with much lower rates and greater personal exemptions, combined with a broader tax base. Total revenue is estimated to be unchanged between 1986 and 1990, but may decline slightly after 1990. The distribution of individual taxes among income groups remains roughly constant, but with proportionately greater tax reductions for the lowest and highest income groups. The increases in personal exemptions and the ZBA remove most below-poverty households from the income tax rolls. There are major cutbacks in tax preferences. The largest in quantitative terms are the removal of the state and local tax deduction and the investment tax credit. Finally, although the net effects on savings and capital formation are debatable, the tax system is made more neutral among business investments and therefore the proposal would probably increase the efficiency of capital use in the economy.

At this time, the prospects for enacting a tax reform along the lines of the administration proposal are uncertain. The president and the Chairman of the Ways and Means Committee have committed their prestige to enactment of a major tax reform bill, but there is no clear indication of strong public backing. Some of the base broadening provisions have generated considerable opposition from interest groups and may also be unpopular with the general public, but the need to maintain revenue neutrality allows little room for Congress to compromise on these provisions unless it wants to substitute other, equally controversial, measures. Finally, some have argued that reducing the deficit is more important than tax reform and that Congress should not waste its limited political capital on a proposal that does not contribute to reducing the deficit. Others, however, may consider a better tax system a prerequisite for future increases in federal revenues.

Even if tax legislation resembling the administration proposal were enacted in this year or in 1986, such a bill is not likely to be the final word on tax policy. Under the administration proposal, the use of the tax system as a vehicle for social policy, not just raising revenue, will continue. The system will continue to be complex and, in some ways, may become even more complicated by the inevitable compromises in the legislative process. The fact that tax preferences will remain in the system means that new tax avoidance methods will be devised, and new anti-abuse provisions will be developed to combat them. There will continue to be controversy about how much support to give to certain sectors through tax incentives, and will continue to be conflicts among objectives of tax policy, such as equity, neutrality, simplicity, and the need to promote investment and economic growth.

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