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MEMORANDUM

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TO: FISCAL AWARENESS SERVICE Subscribers

FROM: Robert J. Kleine, Senior Economist

RE: FEDERAL INCOME TAX REFORM: A PRELIMINARY EVALUATION

In August of 1982, Senator Bill Bradley (D-N.J.) and Representative Richard Gephardt (D-Mo.) introduced a federal income tax reform proposal and ushered in the "decade of tax reform." Their "Fair Tax" was a simplified three-rate income tax retaining many existing specialized deductions and exemptions. The Bradley-Gephardt proposal received little attention at the time; however, it was a catalyst for legislative action on tax reform. Many federal proposals have been advanced since the Fair Tax, including the Treasury I, Treasury II, Kemp-Kasten, and recent congressional tax plans. Federal income tax reform activity culminated on August 16, 1986, in approval by a Senate/House conference committee of bipartisan House Resolution (HR) 3838.

Most Americans are aware that federal income tax reform is imminent, yet are unsure how tax code changes will affect their personal, corporate, state, and local income tax bills. While the detailed tax code changes must still be worked out, the basic reforms have been decided. Pending congressional and presidential approval, the new federal income tax code is expected to follow closely the provisions enacted in HR 3838.

House Resolution 3838

Personal Income Taxes

As Table A illustrates, the three most important tax changes for individuals are the tax rates, new standard deductions, and personal exemptions. By 1988, the standard deduction for taxpayers filing singly will increase by 21 percent to $3,000 and for those filing jointly, by 36 percent to $5,000. This, along with the 81 percent increase in personal exemptions that will be in place, is likely to produce a smaller federal tax liability for most individuals. Heads of household will also enjoy a lower tax burden; their standard deduction will increase 77 percent.

Blind and elderly taxpayers will experience three important changes because of the new plan. First, their current $1,080 personal exemption will be eliminated. Second, by 1988, their standard exemption--now also $1,080--will increase to $1,950. Third, they will receive a new standard deduction of $600 or $750, depending on filing status. The net effect of these three changes will reduce the tax liability of this group.

TABLE A
FEDERAL INCOME TAX REFORM

DEDUCTION OR EXEMPTION	CURRENT LAW		TAX REVISION	
Tax Rates	1986		1987	
Tax brackets for a married couple filing jointly. "Taxable income" is after exemptions and deductions (and standard deduction in 1987 and 1988).	Taxable Income	Rate	Taxable Income	Rate
	Up to $3,670	0%	Up to $3,000	11%
	$3,671-5,940	11	$3,001-28,000	15
	$5,941-8,200	12	$28,001-45,000	28
	$8,201-12,840	16	$45,001-90,000	35
	$12,841-17,270	18	$90,001 and up	38.5
	$17,271-21,800	22		
	$26,551-32,270	25	1988	
	$32,271-37,980	28	Taxable Income	Rate
	$37,981-49,420	33	Up to $29,750	15%
	$49,421-64,750	38	$29,751 and up	28*
	$64,751-92,370	42		
	$92,371-118,050	45	*Marginal rate is effectively 33% for incomes above $71,900 ($43,150 for single people) because of a 5% phased in surcharge.	
	$118,051-175,250	49		
	$175,251 and up	50		
Standard Deductions			1987	1988
Single filing	$2,480		$2,480 + inflation	$3,000
Joint filing	$3,670		$3,670 + inflation	$5,000
Head of household	$2,480		$2,480 + inflation	$4,400
Blind and elderly				
Married	Does not exist		$600 (1987)	
Unmarried	Does not exist		$750 (1987)	
Family Deductions				
Two-earner couples	10% of lower earner's income ($3,000 max.)		Nondeductible	
Dependents	Only need to be listed to claim		Need to be listed and have Social Security numbers	
Income averaging	May average over last 3 years for those with large income fluctuations		No averaging allowed	
Adoption expense for handicapped and hard-to-place children	Up to $1,500 deductible		Nondeductible	
Personal Exemptions				
Standard exemption	$1,080 (1986)		$1,900 (1987); $1,950 (1988); $2,000 (1989)	
Blind and elderly	$1,080 (1986)		No exemption	
IRAs			Nonpension Covered	
Standard deduction	$2,000		$2,000	
Nonworking spouse deduction	$250		$250	
			Pension Covered	
			Income	Deduction
			$25,000 (unmarried)	$2,000
			$40,000 (married)	$2,000
			$35,000 (unmarried)	$0
			$50,000 (married)	$0
Tax deferred interest	YES		YES	
Tax deferred capital gains	YES		YES	
Interest and Financial Earnings				
Consumer loans, credit cards	Deductible		1987 35% nondeductible	
			1988 60% nondeductible	

Interest and Financial Earnings		
Consumer loans, credit cards (continued)		
		1989 80% nondeductible
		1990 90% nondeductible
		1991 100% nondeductible
Mortgage loans (one or two homes)	Deductible	Deductible
Capital gains	Up to 60% tax exclusion (20% max. tax rate)	Taxed as income (1987) (28% max. tax rate)
Dividends	$100 per person deductible	Nondeductible
Nonhospital bond issues	No limit	Limited to $150 million in outstanding bonds
Contributions		
Itemizers	Deductible	Deductible (1987)
Nonitemizers	Deductible	Nondeductible (1987)
Political	Deductible	Nondeductible
Medical Expenses (Including Dental)	Expenses exceeding 5% of AGI are deductible	Expenses exceeding 7.5% of AGI are deductible
State and Local		
Real estate taxes	Deductible	Deductible
Income taxes	Deductible	Deductible
Personal property taxes	Deductible	Deductible
Sales taxes	Deductible	Nondeductible
Tax exempt bond issuance		
Private projects	Allowed	Restricted
Public projects	Allowed	Allowed
Employment		
Unemployment compensation		
Unmarried	Full deduction for AGI less than $12,000	Nondeductible
Married	Full deduction for AGI less than $18,000	Nondeductible
Business related employee benefits	Graduated scale	Expenses exceeding 2% min. rate deductible
Earned-income credit	$550 max.	$800 max. (1988)
401 (k) pension programs	$30,000 annual deferred limit	$7,000 annual deferred limit
Workers' compensation	Not taxed	Not taxed
Corporate Taxation		
Minimum tax	Not strictly enforced	Strictly enforced at 20% min. rate
Municipal bond interest		
Government projects	Tax free	Tax free
Nongovernment projects	Tax free	Subject to 20% min. tax rate
Business meals and entertainment	100% deductible	80% deductible
Investment tax credit	Credit from 6 to 10% of tax liability	No credit, retroactive to Jan. 1, 1986
Maximum tax rate	46%	34% (1987)
Depreciation		
Buildings	19 yrs., accelerated	31.5 yrs., straight line
Machinery	5 yrs., accelerated	5 yrs., more accelerated
Other Industries		
Banking, loan-Loss reserves	Deductible	Nondeductible
Farming, soil and water conservation expenses	Deductible	Nondeductible
Mining, royalties	Capital gains preference	No capital gains preference
Oil and gas, depletion protection and drilling cost losses	Deductible	Deductible
Real estate, passive investment losses,	Partially deductible	Deduction limited to amount risked
Real estate, depreciation	3 to 19 yrs. accelerated	27.5 yrs. or 31.5 yrs., straight line
Timber	Special capital gains rates	Repealed

The new tax rates, which will be fully phased in by 1988, are anticipated to be lower than most taxpayers' current rates. Because the maximum income level at which individuals do not pay taxes ("zero bracket" income) will be higher, approximately 6 million low-income persons now paying federal income taxes will no longer be on federal tax rolls.[1] Couples with taxable incomes of $3,671 to $12,839 and $29,751 to $32,269 will be taxed at higher rates, but even these people are expected to experience a net decrease in actual income taxes paid because of increased deductions and exemptions.

Another important tax change is the limitation on deductions allowed for individual retirement accounts (IRAs). Nonpensioned employees or pensioned employees earning less than $40,001 in adjusted gross income (AGI) will still be eligible for full IRA deductions ($2,000 per person). However, employees whose pension funds are guaranteed and who earn more than $40,000 in AGI will receive only a partial deduction, which will decrease on a sliding scale as AGI rises. Two important current benefits retained in the conference committee bill are deferrals of taxes on both interest and capital gains on IRAs.

The income taxes of most people are expected to decrease. Individuals with low incomes, few financial assets, and/or many dependents will probably experience reductions in their tax burdens of 10 to 15 percent by 1988. Elderly or single taxpayers without dependents will likely receive a 5 to 20 percent reduction in their tax bills; but high-income couples without dependents will probably be subject to a 2 to 8 percent tax bill increase and very high-income couples (above $100,000) using many tax "shelters" could pay 15 to 50 percent more in annual income taxes. In general, those who do not itemize or rely on specific deductions to reduce their tax liability will benefit from tax reform, while taxpayers who use shelters to protect part of their income from taxation will be hurt most by the tax changes.

Corporate Income Taxes

As widely publicized, nationally, the corporate tax liability will rise by a total $120 billion over the next five years to offset the tax relief given to individuals. Predicting which industries will be hurt by the tax code changes or how well these industries will cope with the new tax burdens is a subject for much speculation.

Automobile Industry. The automobile industry may benefit from the tax reform, while many other heavy manufacturing industries will be hurt by the tax code changes. Auto companies will be helped by lower tax rates, the extension of research and development credits, and favorable tax transition provisions that will be particularly helpful to the industry during the first few years of the new tax structure. Repeal of the investment tax credit will hurt the automobile industry, as will the extended write-off periods for depreciation (see Table B), the elimination of consumer sales taxes as a deduction, and the fact that foreign producers will be less affected by the provisions of the new code than will domestic producers. Also, under the new legislation, auto companies will pay higher taxes than formerly in low-profit years. On balance, however, the effect

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[1] "Baker: All Win with Tax Reform," Lansing State Journal, August 18, 1986, p. 1A.

TABLE B

AUTOMOBILE MANUFACTURERS' DEPRECIATION SCHEDULES

AUTO
Cost $15,000

Year	Current Law	Proposed Bill
1	3,200	3,000
2	4,800	4,800
3	4,800	2,880
4		1,728
5		1,728
6		864
	12,800*	15,000

PLANT
Cost $200 Million

Year	Current Law	Proposed Bill
1	17,600,000	6,084,656
2	16,800,000	6,349,206
3	15,200,000	6,349,206
4	13,800,000	6,349,206
5	12,600,000	6,349,206
6	11,400,000	6,349,206
7	10,400,000	6,349,206
8	9,400,000	6,349,206
9 - 19	8,400,000	6,349,206
20	400,000	6,349,206
21 - 31		6,349,206
32		3,439,164
	200,000,000	200,000,000

MACHINERY & EQUIPMENT
Cost $1 Million

Year	Current Law	Proposed Bill
1	150,000	142,900
2	220,000	244,900
3	210,000	175,000
4	210,000	125,000
5	210,000	89,300
6		89,200
7		89,200
8		44,500
	1,000,000	1,000,000

TRACTOR TRUCK
Cost $100,000

Year	Current Law	Proposed Bill
1	25,000	33,330
2	38,000	44,450
3	37,000	14,810
4		7,410
	100,000	100,000

SOURCE: Automotive News, August 23, 1986, pp. 1, 50.

of the tax changes will likely be neutral or slightly favorable for the automobile industry.

In the short term, there will likely be a surge in automobile sales as consumers take final advantage of the sales tax deduction, which will not be available next year, and the deduction for consumer interest, which will be phased out beginning next year. This expected increase in late 1986 sales will probably displace some 1987 sales.

Retailers. Retailers will probably pay lower taxes in the next few years because of the tax reform bill. The lower maximum corporate tax rates will apply to retailers and will significantly reduce most retailers' tax burdens; the investment tax credit's repeal is not expected to hurt retailers since very few currently take advantage of the credit. Furthermore, retailers are the most likely beneficiaries of the extra consumer dollars that will be spent because of lower personal taxes. However, consumers will no longer be able to deduct credit card and loan interest; this may partially offset the latter effect.

Banking. Annual income tax bills for banks will probably increase substantially under the tax reform package. Current deductions for bad loan reserves and municipal bond interest will end, as will credits for investment taxes.

Agriculture and Natural Resources. The provisions in HR 3838 that eliminate the investment tax credit, preferential capital gains treatment, and accelerated depreciation methods will likely cause higher tax burdens for farmers.

Oil and gas companies may be hurt by tax reform since retention of the petroleum industry's depletion allowances and quick write-offs are expected to be more than offset by adverse depreciation and intangible drilling cost changes.

The timber industry will come through the tax reform with special protection; probably only the industry's preferential capital gains treatment will be removed.

Real Estate. The real estate industry will undoubtedly be disadvantaged by the tax code changes, perhaps more than any other industry. Many tax breaks written into law in 1981 will be removed, including accelerated depreciation allowances, preferential capital gains treatment, and write-offs for losses incurred in real estate partnerships.

Health Care. Limitation of the personal medical expense deduction to costs exceeding 7.5 percent of AGI will negatively affect the health care industry. Moreover, the capital intensive nature of this industry suggests that the investment tax credit elimination will cut into after-tax profits. However, profitable health care organizations will benefit from the lower tax rates.

Education. Colleges and universities will be limited to no more than $150 million in outstanding tax exempt bonds under provision 501(c)(3) of HR 3838. This bond cap could impair development projects for institutions such as the University of Michigan, which currently has more than $150 million in outstanding bonds. These institutions may also suffer from reduced contributions since nonitemizing taxpayers no longer will be given deductions for charitable contributions.

State and Local Taxation

The adjusted gross income of taxpayers will rise as federal income tax deductions are eliminated. Since Michigan residents pay state income tax on their AGI, the higher AGI multiplied by the current state tax rates will produce extra state tax revenues. The Senate Fiscal Agency's preliminary estimates of Michigan's increase in tax revenues due to federal tax reform are $150-160 million for 1987 and $200-210 million for 1988. The changes in the federal tax code that will produce most of this revenue increase are smaller deductions for capital gains, IRAs, passive income losses, and for the blind and elderly. Governor Blanchard suggested lowering Michigan's income tax rate to 4.4 percent from 4.6 percent to reduce this windfall state tax revenue[2]; however, there are other ways to address the situation. At a recent meeting of the National Association of State Budget Officers, Dr. Robert Cline of Hope College recommended allocating this excess tax revenue to the state's low-income individuals by allowing increased exemptions. This proposal has merit because the increase in federal exemptions and the higher standard deduction will likely mean that more than 500,000 taxpayers will be exempt from the federal income tax, but still subject to state income tax; a situation fraught with administrative and political problems.

The elimination of the sales tax deduction will affect Michigan taxpayers less than taxpayers in other states because the sales tax burden in Michigan, when computed as a percentage of deductible taxes, is relatively modest (see Table C). However, from a tax policy standpoint, the loss of the sales tax deduction could limit legislative options for changes in the state tax structure. For example, there have been a number of unsuccessful legislative and ballot proposals to shift some of the property tax burden to the sales tax. Effecting such a shift will be even more politically difficult under the new federal tax system as many taxpayers may resist shifting from a tax that is deductible (the property tax) to one that is not (the sales tax). However, this difficulty may be counteracted by the sharp reduction in the number of taxpayers who itemize--an estimated drop nationally from the current 36.5 percent to 23 percent under the tax reform program.[3]

The effects of tax reforms on local units will probably be positive. Bond financing for public projects is not restricted in the tax reform plan. Investors will increasingly be drawn to public purpose bonds because competition from other income tax shelters will be eliminated or restricted, e.g., certain private bond issues will be capped at $150 million. This increasing attractiveness of public purpose bonds may eventually enable state and local governmental units to offer lower yields on their bonds and thereby reduce financing costs for their public projects. However, the restrictions placed on nonpublic tax exempt bonds will make funding some local projects more difficult.

Finally, the sixteen Michigan cities whose income taxes are tied to the State's AGI tax base may gain extra tax revenues in much the same way the State will.

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[2] Dave Everett, "State Rates May Drop; Total Bill Might Not," Detroit Free Press, August 19, 1986, p. 10A.

[3] Advisory Commission on Intergovernmental Relations, Washington, D.C.

TABLE C

SALES TAX DEDUCTIBILITY BY STATE

	As a % of all deductible taxes '82	Ave. Deduction Per Itemizing Household, '85	% of S/L Tax Benefits Lost by Ind.		As a % of all deductible taxes '82	Ave. Deduction Per Itemizing Household, '85	% of S/L Tax Benefits Lost by Ind.
New Mexico	72.8	687	36	Illinois	31.1	541	21
Louisiana	68.9	678	50	Maine	27.9	259	11
Nevada	67.0	613	47	North Carolina	27.4	621	13
Tennessee	60.8	585	48	Nebraska	26.5	430	17
Washington	59.2	786	45	Ohio	26.0	377	17
Mississippi	57.1	503	32	Kansas	25.7	339	16
West Virginia	55.8	394	20	Pennsylvania	25.1	366	14
Hawaii	51.8	561	18	Idaho	24.7	282	13
Alabama	50.7	550	31	New York	23.3	583	13
Florida	46.9	371	29	Minnesota	23.0	399	11
Texas	44.3	449	34	Virginia	22.7	388	14
Arizona	42.4	546	26	Rhode Island	22.1	517	15
Oklahoma	42.0	378	19	Iowa	20.8	318	12
Wyoming	39.6	624	52	Wisconsin	20.4	368	10
Utah	39.2	511	21	Michigan	20.2	375	11
North Dakota	38.5	351	23	New Jersey	19.7	380	12
Indiana	37.9	454	24	Maryland	18.9	427	12
Arkansas	37.4	305	17	Massachusetts	14.8	320	9
California	37.3	551	17	Vermont	12.2	257	9
Colorado	37.3	540	20	Alaska	10.9	635	22
Missouri	36.2	506	22	Delaware	0.0	39	1
Connecticut	34.7	631	22	Montana	0.0	60	3
Georgia	34.6	353	15	New Hampshire	0.0	41	2
South Carolina	33.8	381	17	Oregon	0.0	16	1
Kentucky	33.5	450	18				
South Dakota	32.2	505	42	**U.S. Average**	**31.4**	**476**	**16**

S/L = State/Local

SOURCE: Governors' Weekly Bulletin, May 16, 1986, p. 1.

Economic Growth

Dr. Saul Hymans of the University of Michigan has predicted that federal income tax reform will increase national consumption over the next few years, but likely depress investment during the same period because of the elimination of favorable investment deductions. The net result, suggests Dr. Hymans, will be a small rise in gross national product for the 1987-1989 period.[4] In addition, under HR 3838, tax advantage may play a lesser role in investment decisions, and investors may be less willing to take risks because loss write-offs will be curtailed.

Over the longer term, tax reform is expected to be very beneficial to the economy as business and individual decisions will tend to be based more on economic considerations and less on tax considerations. This will likely result in investments being channeled into more productive areas thereby increasing economic efficiency.

Summary

Most consumers will benefit from the reforms enacted in HR 3838, but many corporations will lose. Among those likely to experience tax breaks are taxpayers with low incomes and few financial assets. Industries such as retailing and automobile manufacturing may also gain from the tax changes.

Tax reform will hurt couples with high and moderately high incomes, individuals who currently use many tax shelters, and industries such as real estate and banking. Tax reform will increase the tax burden of these individuals and organizations; nevertheless, for the majority of taxpayers, federal income tax reform will result in lower taxes.

[4] Paper presented by Dr. Saul Hymans at a meeting of the National Association of State Budget Officers in Lansing, Michigan, August 21, 1986.

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