

# Symposium: The Economic Recovery Tax Act of 1981

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# SYMPOSIUM: THE ECONOMIC RECOVERY TAX ACT OF 1981

## INTRODUCTION

*William D. Andrews*<sup>†</sup>

Our federal income tax is said to dip deeply with a sieve, imposing taxes at rates that are too high on a base that is too narrow. Expanding the base by identifying and eliminating preferences that now enable too much income to escape tax could immensely improve the tax. That job is not easy: there are formidable practical problems, particularly in taxing noncash income; numerous interests—including simple reliance interests of investors—surrounding and supporting particular preferences; and, at the boundary lines, some genuine conceptual problems about the specification of an ideal, all-inclusive base.

All these difficulties are worth contending with, however, partly because elimination of preferences would itself make the tax fairer and less disruptive of normal economic behavior, and partly because broadening the base would permit a substantial reduction of rates. Some see base broadening as a means of achieving lower rates; others see lowering rates as a means of accomplishing base broadening; but many had thought (and continue to think) that the two are inextricably intertwined.

The first thing to note about the Economic Recovery Tax Act of 1981 (ERTA) is that it reduced income tax rates very substantially without any significant offsetting increase in the base. The top marginal rates were reduced from seventy percent to fifty percent forthwith at the beginning of 1982. Other rates were reduced by twenty-three percent across the board in three annual steps. The revenue loss from these rate cuts was to be offset by reductions in government expenditures. In addition, according to supply-side economic forecasts, the rate reduction would itself spur economic activity subject to tax, further offsetting revenue losses. Broadening the tax base was no longer required to reduce rates, and base broadening per se lacked a sufficient constituency to make it part of the Act for its own sake.

Russell Osgood's paper in this Symposium<sup>1</sup> raises (or reports) the question whether tax legislation is law at all. Whatever that question

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<sup>1</sup> Osgood, *The Ages and Themes of Income Taxation: Savings and Investment*, 68 CORNELL L. REV. 521 (1983).

ultimately means, lawyers—tax lawyers, that is, including particularly academic tax lawyers—have been deeply involved in the formulation and criticism of tax policy since the beginning of our income tax. The Treasury Department's professional tax policy staff consists principally of economists and lawyers, as do the staffs of the relevant congressional committees, and the literature of tax policy consists mostly of contributions from those two quarters. But lawyers' contributions have dealt mostly with the base-broadening side of tax policy: rate levels, along with the revenue needs on which they largely depend, have been thought to be political questions beyond the lawyers' special professional competence.

What then should be said in a law review symposium about ERTA, which was largely a massive rate reduction without compensating expansions in the base? Whatever questions one may have about tax legislation being law must be especially acute with respect to this particular statute.

The matter of rates, however, involves more than just meeting revenue needs, because rates can be adjusted in a variety of ways. Two of the papers in this Symposium are addressed directly to the question of rates, and are critical of the manner in which ERTA apportioned the reduction.

One persistent problem posed by the income tax rate structure is how to treat differences in family and marital status. This is a problem that is best addressed in the context of a general rate reduction, because differential rate increases may be especially hard to enact. In 1948, a substantial portion of the general post-war tax reduction was given to one-earner couples in common law states through the enactment of income splitting. In 1969, nominal rates were reduced, but only for unmarried taxpayers because they were thought to be paying too much as compared to married taxpayers with the same income. But this left rates too high for two-earner couples, who represent a much larger portion of the population now. A small portion of ERTA's rate reduction came in the form of new section 221,<sup>2</sup> a special deduction for two-earner married couples that provides, in effect, a ten percent rate reduction on the first \$30,000 of earnings of the second earner.<sup>3</sup> Pamela Gann's paper

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<sup>2</sup> Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 103(a), 95 Stat. 172, 187.

<sup>3</sup> The reduction in 1986 revenues expected to result from § 221 is \$12,624 million, while that projected to result from general rate reductions is \$143,832 million, more than 11 times as much. STAFF OF THE JOINT COMMITTEE ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 32, 37 (Comm. Print 1981). The income tax reduction attributable to income splitting in 1948 was \$803.5 million, while that attributable to general rate reductions was \$1.8 billion. For individuals with taxable income over \$10,000, splitting accounted for \$713 million out of a total tax reduction of \$1.36 billion. 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 1274 n.36 (1972). In 1969, when the new schedule for single persons was

in this Symposium<sup>4</sup> explains why this provision is inadequate, leaving a considerable marriage penalty in effect for many taxpayers, while increasing the marriage bonus for others. She advocates a return to separate individual filing for all taxpayers, but with earned income taxed to the earner even in community property states.

Alan Feld's paper<sup>5</sup> deals more generally with progressivity as affected by the shape of graduation in the rate and exemption schedules. On several prior occasions, tax reductions have been implemented simply by increasing the amount of the personal exemption. That technique was sometimes criticized as being too regressive because the exemption takes the form of a deduction: an additional exemption of \$100 would save a taxpayer in the sixty percent marginal bracket sixty dollars, but would result in a savings of only twenty dollars for one in the twenty percent bracket. Feld's paper shows that techniques employed by ERTA were more regressive still.

Feld also examines the effects of bracket creep and tax legislation over an extended period and offers a critical assessment of the long-term trend. It is very hard to reason about how progressive (or regressive) taxes ought to be, but Feld's paper shows how many ways there are to measure and talk about change.

Rate reduction is the central element in ERTA, but not the only element. The Act also contains important contractions of the base. These seem mostly designed to provide further incentives (or attempts to offset the general disincentives of an income tax) for investment and other business activity.

For example, ERTA restores the tax-favored treatment of stock options. These have been a source of administrative and judicial controversy for decades, and of recurring legislative revisions since the Supreme Court's 1956 decision in *Commissioner v. LoBue*.<sup>6</sup> ERTA provides for "incentive stock options,"<sup>7</sup> as compared with the qualified stock options and restricted stock options of earlier years, but the basic rules are similar. Michael Melton's paper takes a critical look at this development.<sup>8</sup>

The most sweeping structural change brought by ERTA, however, was the adoption of the accelerated cost recovery system (ACRS) in

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introduced, there was no general rate reduction for married taxpayers, although taxes were reduced by increasing the amount of the personal exemption and the low income allowance.

<sup>4</sup> Gann, *The Earned Income Deduction: Congress's 1981 Response to the "Marriage Penalty" Tax*, 68 CORNELL L. REV. 468 (1983).

<sup>5</sup> Feld, *Fairness in Rate Cuts in the Individual Income Tax*, 68 CORNELL L. REV. 429 (1983).

<sup>6</sup> 351 U.S. 243 (1956).

<sup>7</sup> Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 251, 95 Stat. 172, 256-59 (amending I.R.C. §§ 421-25).

<sup>8</sup> Melton, *The Alchemy of Incentive Stock Options—Turning Employee Income into Gold*, 68 CORNELL L. REV. 488 (1983).

place of ordinary depreciation.<sup>9</sup> ACRS was explained as simplifying administration by prescribing a limited number of statutory amortization schedules for various kinds of tangible assets. But mainly it was intended to stimulate investment by offering considerably shorter amortization periods than did prior law. Indeed, the combined effect of ACRS and the investment credit (after being cut back somewhat in 1982) is to approximate the effect of a simple, immediate deduction of the cost of property in the five-year class.<sup>10</sup> This class includes most machinery and equipment except automobiles and light trucks.

ERTA also extends the availability of individual retirement accounts (IRAs) to all employees, even if they are already covered by qualified retirement plans. Deductions are permitted for contributions of up to one-hundred percent of compensation or \$2,000 for each worker and a little more in the case of a one-earner couple.<sup>11</sup>

Both the IRA and ACRS provisions involve deductions for capital expenditures. Both were enacted to stimulate such expenditures: investment by business firms in the case of ACRS, and saving by individual earners in the case of IRAs. Moreover, in both cases permitting expensing or its equivalent has the effect of equalizing the after-tax return on after-tax investment and the pre-tax return on pre-tax investment, assuming no change in applicable tax rates. The effect on rate of return is the same therefore as simply exempting the return on these expenditures.<sup>12</sup>

Some have argued that the personal income tax could be greatly simplified and otherwise improved by treating all business and investment receipts and expenditures on a simple cash-flow basis—including receipts in full when received and deducting expenditures when made, without any distinction between current expenses and capital expenditures or between income receipts and return of capital. Whatever is received and not spent on business or investment must still be available for spending, or already have been spent, on consumption. The cash flow computation, therefore, provides an indirect measure of aggregate consumption expenditures for the period involved, and the tax would constitute a personal consumption expenditure tax.

Because the treatment of IRAs and the effective treatment of

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<sup>9</sup> The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201, 95 Stat. 172, 203-19.

<sup>10</sup> STAFF OF THE JOINT COMMITTEE ON TAXATION, 97TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 35-36, 40 (Comm. Print 1982).

<sup>11</sup> I.R.C. § 219 (Supp. V 1981).

<sup>12</sup> For a taxpayer at rate  $t$ , the after-tax cost of an immediately deductible asset will be  $C(1-t)$ , where  $C$  represents the pre-tax cost. When the cost has been deducted, the return should be fully taxed. Thus, the after-tax return will be  $R(1-t)$ , where  $R$  represents the pre-tax return, whenever received and in whatever form, so long as it does not escape tax. The ratio of  $R(1-t)$  to  $C(1-t)$  equals  $R/C$ . See also Osgood, *supra* note 1, at 541-42.

ACRS property in ERTA is similar to that which a personal consumption tax prescribes for all business and investment assets, the question arises whether ERTA represents a move toward such a tax. Russell Osgood's paper rejects any such interpretation for several reasons, one of which is that he is unpersuaded by the arguments in favor of focusing the personal income tax on consumption rather than accretion. I remain persuaded by those arguments, mostly for reasons already stated in the materials he cites.

It is still quite right, however, that ERTA cannot be interpreted convincingly as a move toward a comprehensive personal expenditure tax simply because it is not "comprehensive." One of the chief virtues of a consumption-type tax is that it could be made comprehensive much more readily, some of us think, than an accretion-type income tax. But ERTA does no such thing.

First, ERTA does not eliminate distinctions among different kinds of investments. IRAs, for example, are now treated quite differently from other forms of savings, even if invested quite similarly. This is wholly at odds with the vision of a tax system under which investment decisions would be uninfluenced by tax considerations.

The matter, however, is not just one of continuing to tax returns on some investments while effectively exempting others. ERTA has vastly expanded and extended our system of negative income taxes on investments for the well-to-do by providing accelerated deductions for capital expenditures without any corresponding changes in the treatment of borrowing. The effect of ACRS in particular is to create new mountains of wealth for distribution in the form of tax deductions through the tax shelter industry.<sup>13</sup> The effect of such deductions may well be to make

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<sup>13</sup> Consider, for example, a \$20 million housing project paid for with government-guaranteed loans. Suppose rental income just covers debt service—interest and principal. Owners of the project would compute taxable income by deducting interest and depreciation and would therefore enjoy tax losses equal to the excess of depreciation over principal payments on the loan. There will be a corresponding tax gain, over and above any actual cash gain, on disposition of the property, but it will probably be a capital gain. Thus 60% of the value of the tax losses will never be made up, and the other 40% will constitute, in effect, an interest-free loan from the government.

Prior to ERTA it was sometimes estimated that the owners' tax benefits would be worth around 10% of construction cost. The developer in our example, therefore, might well sell limited partnership interests to tax shelter investors for around \$2 million.

ERTA has sped up the depreciation deductions with the result that owners' tax benefits are now estimated to be worth considerably more than 10% of construction cost—as much as 25%, or \$5 million in our example. Perhaps over time this will provide an increased stimulus for the construction of new housing. ACRS deductions, however, are not confined to newly constructed property. The most immediate inducement, therefore, is to shift ownership of existing properties to new investors who can take advantage of the new benefits. "Resyndication" is the name of the game. New investors get a handsome rate of return based on increased tax deductions while the old investors and the developer, as general partner, realize handsome profits on their residuals. Aggregate taxes are thus substantially decreased, without the construction of a single new housing unit.

taxable income considerably less than consumption for many individuals.

A comprehensive personal consumption tax would avoid this effect by treating borrowing in the same manner as capital expenditures—on a simple cash-flow basis. The expenditure of borrowed funds for business or investment purposes would be immediately deductible, but the borrowing proceeds would be taxable receipts. The result would be a deduction limited to net investment. No deduction would be left over to shelter other income.<sup>14</sup>

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<sup>14</sup> An alternative way to curb shelter deductions would be to make interest nondeductible. Indeed, one could give taxpayers some leeway in choosing whether to treat any particular loan on a cash-flow basis (with proceeds taxed or set off against some otherwise deductible expenditure and repayments fully deductible, principal and interest alike) or on an after-tax basis (with no inclusion or deduction of anything). The effect of either treatment is to keep the after-tax cost of borrowing equal to the stated pre-tax interest rate. This is the only appropriate method if the effective rate of return on investments, viewed separately from the financing, is to be kept equal to the pre-tax rate of return by tax benefits equivalent to expensing.

For example, a 45% taxpayer could invest \$1,000 at a net after-tax cost of \$550. Suppose \$500 of that cost were borrowed, so that the net after-tax cost was held to \$50. Now suppose the interest payable on the loan is 12%, or \$60. Suppose further that the investment yields 12%, or \$120 which would be taxable. The tax will be 45% of \$120, or \$54. Income of \$120 minus interest of \$60 and tax of \$54 would leave a net yield of \$6, which is precisely 12% of \$50, the net after-tax investment. The tax of \$54 is itself just 12% of \$450, which is the amount of tax deferred by reason of deducting the \$1,000 investment.

If one experiments some with these figures, varying the rate of return on the investment, it will emerge that the government, in effect, has a 45% interest in the gross \$1,000 investment, while the taxpayer owns the other 55% on a highly leveraged basis. Suppose, for example, that the investment yield were \$140 instead of \$120. The government would then get \$63 instead of \$54, an increase of 16.6%, but the taxpayer would go from \$6 to \$17 (\$140 minus \$60 in interest and \$63 in taxes), an increase of 183.3%.

If loan proceeds were treated on a strict cash-flow basis, the taxpayer would have to borrow twice as much to achieve the same degree of leverage. The government's interest, in this case, would be effectively leveraged to the same degree; the government would be sharing with the taxpayer after the loan, not before.

These relationships make it quite feasible to permit a limited amount of borrowing on an after-tax basis, but it would be prudent to keep it within limits. Deduction of investments while borrowing on an after-tax basis has the effect of deferring taxes in relation to consumption expenditure. The deferral is in effect a loan from the government, though not an interest-free loan, as under an income tax. Even though there is implicit interest on the loan, however, it does not seem appropriate to give taxpayers an unlimited call on the government for partial financing of their investments.

Furthermore, the equivalence between cash-flow and after-tax treatment of borrowing is very sensitive to changes in tax rates. Suppose the tax rate dropped to 40% after the investment in the example above. In that case the government's subsequent return would go from \$54 to \$48, the lender's would stay at \$60, and the taxpayer's would go from \$6 to \$12(!) for a 24% after-tax rate of return, twice the pre-tax rate of return. Of course, an increase in tax rate would produce a similarly precipitous drop in after-tax return, but hardship to losers does not offset windfalls to gainers. This is partly true because they are apt to be different people, but even more because changes in individual tax rates are not wholly unpredictable. ERTA, for example, created a three-year schedule of tax reductions on which aggressive taxpayers might have played. There is no absolute assurance, of course, that scheduled rate reductions will actually become effective, but at least they load the dice in that direction.

A comprehensive net income tax would also achieve consistency, but in a reverse manner. Under such a tax there would be an effective deduction for interest paid, but consistency would be achieved by taxing all returns from the investment of borrowed funds comprehensively and currently as they occur. Such full taxation is not easy to achieve, however, either practically or politically. Our present system causes inconsistency by allowing full effective deductibility of interest expense while tolerating much less than full taxation of the returns from investing the borrowed funds. The IRA and ACRS provisions of ERTA move us away from either a comprehensive income tax or a comprehensive consumption tax by decreasing the effective tax on particular investments without any corresponding reduction in the effective deductibility of the cost of borrowing.

The income tax system as a generator of monetary wealth can be examined by looking at the two sides of particular payments. Generally any payment deductible by a payor should be taxable to the payee. There are many cases, of course, in which the converse is not true. For example, income to the payee may not be deductible by the payor because it represents either a personal expense or a capital expenditure or encounters some other prohibition. The consumption or accumulation associated with personal or capital expenditures is indeed the real object of the income tax. To allow the payor a deduction, however, and not tax the payee, in effect creates a negative tax on the payment.

Under a comprehensive *consumption* tax, interest, rental income, and other returns to newly accumulated capital are effectively relieved of tax, but interest cost is effectively denied the benefit of deductibility. After-tax interest rates are effectively equated with pre-tax rates for borrowers and lenders alike. In contrast, under a comprehensive *income* tax, interest and business rental payments are effectively deductible by payors, with consistency achieved by making them comprehensively taxable to recipients. If a recipient is in a lower tax bracket than the payor, the government will lose money on the payment, but properly so since the ultimate recipient's tax rate is the one that ought to apply.

Under our present law, payments are often deductible by the payor without being fully taxable to the recipient, even when the real beneficiary is a top-bracket taxpayer. Examples include interest payments from a taxable borrower to an IRA and rental payments by a business tenant for occupancy of premises financed with industrial development bonds.

Real estate financing typically involves a reiteration of such payments. A business tenant takes a deduction for payment of rent to a landlord for whom accelerated cost recovery offers the equivalent of substantial partial exemption on his rental income. The landlord simultaneously takes a full deduction for payment of interest, which is likely to be received by a pension fund (or an insurance company), for example,

which is itself exempt (at least partly) from tax and for whose beneficiaries the rules prescribing tax treatment of employers and employees (or owners of life insurance) provide an effective exemption from tax.<sup>15</sup>

One of the current themes of our income tax appears to be that the simple expedient of reducing effective tax rates on recipients of payments whose full effective deductibility is preserved for the payor can generate private, monetary wealth with limited effect on real economic activity. ERTA seems not to have interfered substantially with this process; IRAs provide a way for more to play the game, and ACRS has increased the rewards. Let us hope that this false and deceptive theme will prove less durable than the persistent general themes of taxation that Russell Osgood identifies and discusses in his paper.

The full story of ERTA is still unfolding, and may be quite different than can now be foretold. Budget deficits spawned by ERTA are likely to force us to tax increases of one kind or another, which may take the form of base broadening after all, rate restoration, or imposition of new taxes.<sup>16</sup> It may then again appear that rate reduction and structural change are inextricably intertwined, and that ERTA only showed that one way to get things done is by appearing to separate the inseparable and then proceeding first (and fast) with the more palatable part.

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<sup>15</sup> When a payment is taxed to either party without any offsetting deduction, economists describe the effect by saying it creates a wedge between payor and payee, causing the former to pay more than the latter receives. Who bears the burden of the tax, and how much it alters conduct by making previously profitable activity unrewarding, depends on elasticities of supply and demand, which in turn may depend on the availability of substitutes for the item transferred.

A deduction by the payor without any offsetting tax on the payee creates a negative wedge: the payee benefits more than the payor suffers. Who will capture this net benefit presumably depends on supply and demand of something, although it is not clear what. In addition the payments themselves, together with whatever real activity they entail, will be stimulated rather than deterred. If the system is to reach equilibrium, it presumably occurs at the point when the real, economic detriment of the behavior associated with the payment equals or exceeds the tax advantage. Many of the wealth-creating payments that can be made under the income tax today, however, are associated mainly with financial arrangements that the parties can often enter into without substantial, real, direct, detrimental effects, unless one counts diversion of ingenuity away from more productive pursuits. Scarcity does not enter into the calculus as it does in the determination of real economic behavior unless, again, one worries about wasted talents.

<sup>16</sup> Already we have had the Tax Equity and Fiscal Responsibility Act of 1982, which did not touch the individual rate reductions in ERTA, but was expected to increase budget receipts by \$18.0 billion in 1983, \$37.7 billion in 1984, and \$42.7 billion in 1985. STAFF OF THE JOINT COMMITTEE ON TAXATION, 97TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 12, 454-65 (Comm. Print 1982). The recently adopted congressional budget resolution for 1984 calls for another \$73 billion.