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Before the House Ways and Means Committee
Regarding Proposed New Tax Subsidies for Capital Gains and Corporate Profits Designed to Gut the Tax Reform Act of 1986
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I appreciate the opportunity to testify before the Committee on behalf of Citizens for Tax Justice. Our coalition of labor, public interest and grassroots citizens groups represents tens of millions of middle- and low-income Americans, who have a vital stake in fair, economically sound tax and budget policies.

The Republican "Contract with America" proposes an array of new tax breaks whose costs will be close to $100 billion a year once they take full effect. The bulk of these enormous revenue losses stem from two items: huge new tax breaks for capital gains and a major expansion in corporate depreciation write-offs. We strongly oppose these proposals. If enacted, they would undermine the gains in tax fairness and economic neutrality achieved in the 1986 Tax Reform Act. They would once again put Congress in the position of directing and allocating private investment, rather than leaving it where it belongs—in the hands of businesses and consumers. We would once again face rampant tax sheltering and outrageous high-income and corporate tax dodging. Ultimately, the price would be borne by average Americans, through higher interest rates and eventually, increased taxes. We therefore urge the Committee to reject these tax deforms, and instead to work to close remaining wasteful, economically harmful tax subsidies that benefit the few at the expense of most families.

Introduction

At the heart of the GOP Contract appears to be the premise that our current income tax is biased against savings. The drafters of the Contract seems to believe that this alleged bias has caused a lower national savings rate than we otherwise would have. And thus, they conclude, we need to tilt the tax code so that it rewards saving and punishes consumption.

This is an interesting theory, but it hardly squares with reality. The truth is that the current tax code includes huge tax breaks for savings and investment. The loopholes range from no tax at all on some kinds of investment income, to outright "negative" tax rates on the profits from some kinds of corporate investments, to industry-specific tax breaks targeted to the politically powerful. In fact, the $200-billion-plus annual cost of tax expenditures for savings and investment is now almost equal to the total annual amount of personal savings! It seems rather apparent that if our savings rate is too low, tax breaks have been part of the problem, rather than the solution.

Savings and investment tax breaks are not simply a failed experiment in macroeconomic engineering. They also cause significant distortions in business decision making—to the detriment of overall economic growth. Worst of all, most savings and investment loopholes seriously

undermine tax fairness, because they are extremely tilted toward the very best-off people in the country. To his great credit, President Ronald Reagan was able to overcome his initial inclination toward favoring loopholes, and his leadership was crucial to enactment of the Tax Reform Act of 1986. Thus it is distressing to see the new Republican Congress—supposedly dedicated to ending waste, defending the middle class and curbing unwarranted government interference in the free market—proposing vast new tax-based subsidies that look much more like central-planning than trust in market forces.

Capital gains

Capital gains are profits reflecting increased values of stocks, bonds, investment real estate and other "capital assets." Under current law, capital gains are treated much more favorably than other types of income, especially for the highest income people. In fact, total current capital gains loopholes are estimated to cost $170 billion over the next five years. In terms of cost and maldistribution—not to mention contentiousness—tax breaks for capital gains are without parallel.

Capital gains are not taxed at all unless and until they are "realized"—generally upon sale of an appreciated asset. And even when gains are realized, top-bracket individuals pay lower tax rates on capital gains than on so-called "ordinary" income.

As a result, investment markets that primarily service the well off are often designed to maximize the share of profits that are in the form of capital gains—both realized and unrealized. Indeed, on individual tax returns, total realized capital gains exceed total reported stock dividends by about 43%.

Which is not to say that capital gains are common for most taxpayers. In fact, only one tax return in every twelve filed reports any capital gains at all. Up to $100,000 in total income, dividends exceed reported gains. But for the highest income people—making more than $200,000 a year—realized capital gains exceed the total combined amount of both dividends and taxable interest.

Almost two-thirds of total capital gains reported on individual tax returns go to people whose incomes exceed $200,000. In contrast, only 7.6% of the total gains are reported by the three-quarters of tax filers with incomes of $50,000 or less. Thus, more than any other type of income, capital gains are concentrated at the very top of the income scale.

Average Capital Gains, Dividends & Taxable Interest By Family Income Group, 1994

Income ($-000)	Capital Gains	Divi-dends	Taxable Interest
<$10	$40	$70	$400
$10–20	70	200	820
$20–30	130	260	1,020
$30–40	210	390	1,360
$40–50	320	480	1,780
$50–75	660	870	2,180
$75–100	1,560	1,720	3,290
$100–200	4,630	4,110	6,310
$200+	66,070	27,120	33,660
All	**$1,320**	**$920**	**$1,920**

Averages for all taxpayers in group.
Source: CTJ Tax Model, January 1995.

Because the taxation of capital gains is more important to the rich and politically powerful than the treatment of any other type of income, capital gains taxation has been extremely controversial over the years. At the onset of the income tax, realized gains were taxed at the same rates as other income—up to 77% during the World-War-I period. When the GOP regained the White House after the war, however, the top capital gains rate was set at 12.5%—half the regular top rate of 25% from 1925 to 1931. The top regular rate rose to 63% in 1932, but the 12.5% top capital gains rate was briefly retained.

The onset of the Great Depression and public disillusionment with stock speculation of the Roaring Twenties, however, led to increased capital gains tax rates in the 1930s. For a brief period, realized gains were taxed under a complicated schedule that taxed gains from very short-term investments in full, but excluded as much as 70% of gains from sales of assets held for more than 10 years. This system was widely criticized as unwieldy and complex, and in the early 1940s it was scrapped. For the next 25 years, taxpayers had the option of excluding half of their capital gains or paying a maximum rate of 25% (useful to those whose regular tax brackets exceeded 50%).

In the late 1960s, the special 25% maximum rate was repealed. In conjunction with other tax changes, the top capital gains rate rose to about 39% by the mid-1970s. Then in 1978, congressional Republicans joined by a substantial minority of Democrats pushed through a major capital gains tax cut. It lowered the top rate to 28%, by excluding 60% of realized capital gains from tax. The 1981 cut in the top regular tax rate on unearned income reduced the maximum capital gains rate even further, this time to only 20%—its lowest level since the Hoover administration.

In conjunction with sharply increased depreciation write-offs in 1981 (see below), the 1978 and 1981 capital gains tax cuts caused a proliferation of tax shelters. Unneeded, unprofitable and often empty office buildings sprung up all across the country in response to the new tax subsidies (helping set the stage for the savings and loan crisis later in the decade). Esoteric capital-gains-based tax shelters in items like collectibles, freight cars and llama breeding abounded. Tax-shelter “losses” reported on tax returns jumped from about $10 billion a year in the late seventies to $160 billion a year by 1985. And since the goal of most of the shelters was not only to defer taxes, but to convert ordinary income into lightly-taxed gains, reported capital gains jumped as well.

Proponents of low capital gains tax rates like to argue that the surge in capital gains after 1978 and 1981 proves that capital gains tax cuts cause the well off to cash in more unrealized gains, thereby mitigating (if not eliminating) the apparent revenue loss from a special low capital gains tax. To be sure, reported gains before exclusion did increase rapidly in the late seventies and early eighties. In nominal terms, they rose from $45 billion in 1977 to $80 billion in 1980 to $176 billion by 1985. Adjusted for the growth of the economy, this represents a 90% increase in reported gains from 1977 to 1985, and a 48% increase from 1980 to 1985. Since the maximum capital gains rate was cut in half between 1977 and 1985, even these figures indicate that the tax cut lost revenues. More important, since a very large share of the increased capital gains in the first half of the eighties represents tax-shelter conversions of ordinary income into gains, the surge in reported gains actually indicates a much greater revenue loss.

If, as Michael Kinsley and I have noted, we cut taxes in half for people named "Newt," then we surely would find that Newts reported much more income on tax returns. Indeed, total taxes paid by people named Newt might even go up. But that would merely reflect millions of people changing their names to Newt to avoid taxes, not some magical supply-side effect on Newts' incentives to work, save and earn money. The same is true of tax breaks for income called "capital gains."

Of course, looking only at national, aggregate data, it's hard to isolate the effects of capital gains tax changes from other factors that might affect capital gains realizations, such as the performance of the stock market and the overall economy. A recent study by Congressional Budget Office economists Leonard Bermun and William Rudolph, however, compared capital gains realizations by a large sample of taxpayers in various states, with widely different tax rates, over time. They found large transitory effects when the federal government made major changes in capital gains taxation.[1] But on a long-term basis, the study found very little correlation between capital gains tax rates and levels of realizations. In fact, in technical terms, the study found that "[t]he permanent elasticity is not significantly different from zero."

Despite all the debate over how much reduced capital gains taxes might affect the level of asset sales in the short run, it's really a side issue. The heart of the case for a capital gains tax break is that it encourages savings, investment, jobs and economic growth. And that case is astonishingly weak. Just look at what happened when capital gains taxes were cut in the past.

The 1978 Revenue Act, enacted in November of 1978, cut the maximum capital gains tax rate from 39% to 28%. Over the 12 months prior to enactment of that change, the real GDP grew by 5.8%. But after the 1978 capital gains tax cut was approved, the economy faltered. In fact, the GDP dropped by 1% over the next year and a half. The annual growth rate for the two years following the 1978 capital gains tax cut was only 0.3%—5.5 percentage points lower than the growth rate prior to the cut.

In August of 1981, another capital gains tax cut was enacted, this time cutting the top rate to 20%. Over the 12 preceding months, the economy had grown by 3.5%, but in the 12 subsequent months the GDP fell by 2.8%. In the two years after the 1981 capital gains tax cut was enacted, the annual growth rate was only 1%—2.5 percentage points below the growth rate prior to the cut.

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[1]Most notably, in Sept. of 1986, Congress approved the Tax Reform Act of 1986, which increased the maximum capital gains tax rate from 20% to 28%, effective Jan. 1, 1987. This caused a rush by investors to cash in capital gains before what had become a temporary 20% rate expired. As a result, realized capital gains in corporate stock were nearly seven times as large in Dec. of 1986 as they had been in Dec. of 1985.

Contrary to the assertions of capital gains tax cut proponents, capital gains tax cuts have never led to improved economic performance. Tax laws that have increased the capital gains tax, however, typically have been followed by increased growth. After the 1976 Tax Reform Act was enacted, for example, the economy's growth rate jumped from 3.9% in the preceding 12 months to 5.2% over the next two years. Likewise, following enactment of the 1986 Tax Reform Act, the growth rate rose from 2.2% in the previous year to 3.8% over the next two years.

Date of Capital Gains Tax Cut	Jobless Rate	Two years later	Change
November 1978	5.8%	7.3%	**+1.5%**
August 1981	7.3%	9.3%	**+2.0%**
Date of Capital Gains Tax Hike	**Jobless Rate**	**Two years later**	**Change**
October 1976	7.6%	5.7%	**–1.9%**
October 1986	6.8%	5.2%	**–1.6%**

Source: U.S. Dept. of Labor, Bureau of Labor Statistics.

The record of capital gains tax cuts when it comes to jobs is equally dismal. In fact, the unemployment rate rose sharply after both the 1978 and 1981 capital gains tax cuts. Conversely, the jobless rate fell notably after the 1976 and 1986 capital gains tax hikes were enacted.

History belies the claims that low capital gains taxes stimulate the economy. The long-term economic case against capital gains tax loopholes is even stronger. In essence, capital gains tax cut proponents seem to believe that free markets don't work, that government needs to step in with subsidies designed to override the signals the market sends about the level and allocation of capital. But this idea that the government should be making investment decisions for business is terrible economics.

The truth is that paying people and corporations to make investments that otherwise make no business sense undermines economic growth. Capital gains tax breaks and other supply-side loopholes of the first half of the 1980s inspired construction of tens of thousands of unneeded office buildings and led to myriad other dramatic and wasteful misallocations of American capital and effort. But they completely failed to produce increases in total savings or investment.

Capital Gains Tax Changes & Economic Growth
(Changes in Real Gross Domestic Product)

Date Enacted	Growth in Prior Year	Annual Growth Rate Over Next 2 Years	Change in Growth Rate
Capital gains tax cuts:			
Nov. 6, 1978	+5.8%	+0.3%	**–5.5%**
Aug. 14, 1981	+3.5%	+1.0%	**–2.5%**
Capital gains tax increases:			
Oct. 4, 1976	+3.9%	+5.2%	**+1.3%**
Oct. 22, 1986	+2.2%	+3.8%	**+1.6%**

NOTE: Growth rates are from date of enactment of the capital gains changes.
Source: U.S. Dept. of Commerce. Compiled by Citizens for Tax Justice, 1992.

One of the key goals of the 1986 Tax Reform Act was to curb the harmful, tax-motivated economic distortions that the supply-side policies had produced. As the official report on the Act notes, in the loophole era "the output attainable from our capital resources was reduced because too much investment occurred in tax-favored sectors and too little

investment occurred in sectors that were more productive but which were tax-disadvantaged."

Certainly, the last thing our economy needs is to divert our nation's capital stock into other tax-motivated schemes at the expense of more productive investments. The right thing for our economy is to reduce the government's monstrous long-term budget deficits and to close—rather than expand—economically harmful tax loopholes.

Details on existing capital gains tax breaks:

28% maximum rate: One of the greatest achievements of the 1986 Tax Reform Act was to tax realized capital gains at the same rates as wages, dividends or other income. (Previously, realized capital gains had been 60% tax-exempt). But in 1990, Congress reinstated a small capital gains preference, by capping the capital gains rate at 28% while setting the top regular income tax rate at 31%. In the 1993 budget bill, this capital gains preference was greatly expanded to provide what amounts to a 30% capital gains exclusion for top-bracket taxpayers (the difference between the new 39.6% top regular tax rate and the continuing 28% maximum capital gains rate). The 1993 act provided an additional 50% capital gains exclusion for profits from certain "risky" investments that are considered likely to fail. A staggering 96% of the tax savings from the current 28% maximum capital gains tax rate for individuals goes to the best off 1 percent of all taxpayers.

Current Capital Gains Tax Break
(28% Maximum Rate)
By Family Income Group, 1994

Income Group ($-000)	% with Capital Gains	% of Total Capital Gains	Average Tax Break (all returns)	% of Total Tax Break
<$10	1.9%	0.5%	$ –	–
$10–20	3.5%	1.1%	–	–
$20–30	5.1%	1.7%	–	–
$30–40	7.2%	2.0%	–	–
$40–50	8.7%	2.3%	–	–
$50–75	13.3%	7.1%	–	–
$75–100	21.5%	6.2%	5	0.2%
$100–200	31.8%	13.8%	105	3.6%
$200+	48.5%	65.3%	8,510	96.2%
All	**8.5%**	**100.0%**	**$ 115**	**100.0%**

Source: CTJ Tax Model, January 1995.

Indefinite deferral of tax on unrealized capital gains: Capital gains are not taxed until assets are actually sold. As a result, investors can put off tax on their gains indefinitely. (They can also avoid tax on realized gains by selectively realizing losses on other investments in the same year.) This deferral is unavailable, of course, to most other kinds of income (such as savings account interest, even if the money is left in the bank). Multibillionaire Warren Buffett, for example, is said to pay extraordinarily little in federal income taxes despite his enormous wealth, because he has structured his investment company so that it hasn't paid a dividend since 1966. Instead, Buffett's $12 billion or so in accrued capital gains remain unrealized and thus untaxed.

Capital gains tax breaks for gifts and inheritances: Currently, heirs can sell inherited property and pay no tax on capital gains that accrued prior to the time they inherit. In other words, capital gains taxes on inherited property are completely forgiven. In the case of gifts, the recipient takes over the giver's "basis" in the donated property—generally the cost when the property was first acquired. That carryover of basis—rather than taxing the gain—allows a continued deferral of unrealized capital gains.

Special additional industry-specific capital gains tax breaks: Historically, favorable capital gains treatment has normally been limited to profits from the sale of investments (stocks, bonds, etc.). But several industries have succeeded in getting part of their normal business profits treated as capital gains. Special capital gains treatment is currently available for sales of timber, coal, and iron ore and for certain farm income.

Other special capital gains breaks include:

Indefinite tax deferral for so-called "like-kind exchanges" of real estate. Normally, when someone sells appreciated property he or she must pay tax on the capital gain. But someone who sells rental real estate and later purchases other rental property can put off paying capital gains taxes on the sale indefinitely by pretending to have "exchanged" the properties with another investor.

The refinancing loophole. Owners of investment assets that have gone up in value can cash in their capital gains without tax by borrowing against the appreciation. This is an enormous tax shelter for, among others, wealthy real estate speculators.

An exception from the normal $3,000 annual limit on net capital loss deductions for losses on the sale of certain "small business corporate stock." Except for a $3,000 a year de minimis rule, realized capital losses can only be used to offset realized capital gains. Otherwise, investors with a portfolio of winners and losers could realize losses to wipe out taxes on their wages and other income, even though their total capital gains position (realized and unrealized) was positive. But for certain "small business corporate stock" investments, up to $100,000 in losses can be deducted. This subsidy is presumably designed to ease the pain of backing money-losing operations, and thereby encourage wealthy investors to invest in businesses that are unlikely to succeed.

Indefinite deferral of tax on the sale of a broadcasting facility or cable system to a "certified minority-owned business," i.e., a company at least nominally owned or controlled by "a black, Hispanic, Asian American or Native American." The federal government has approved an astonishing 303 such "tax-deferral certificates" since this program began in 1979 (presumably using complex apartheid-style rules to assure that the potential nominal buyers met the racial classification requirements). On Wednesday, Jan. 4, 1995, the Washington Post reported on a particularly egregious example of how this tax subsidy works:

"Viacom, the New York-based entertainment and media conglomerate, intends to sell its cable television systems for more than $2 billion to a minority-controlled enterprise under a program that would give Viacom a federal tax break of as much as $400 million, sources close to the company said. . . .

"[C]orporate investors are putting up nearly all of the money for the purchase, but [black business executive Frank] Washington's management control of the [purchasing] partnership qualifies the group as minority-owned under FCC rules. Washington himself is investing slightly more than $1 million."

Apparently, this deal's "several giant corporate investors, including Tele-Communications, Inc., the world's biggest cable company," are paying Mr. Washington handsomely to use his name and race. In fact, Mr. Washington seems to have made his living on such deals since he came up with the idea for this particular racial preference while an official in the Carter administration. The Post reports that the Viacom deal would be Washington's fifth gorging at the "tax-deferral certificate" trough just since 1988. But whatever Mr. Washington personally clears on Viacom before he moves on to still another of these boondoggles, the bottom line is that the federal government has spent $400 million merely to make one multimillionaire, who happens to be black, even richer.

If the goal is to remedy the effects of racial discrimination, there must be better ways to spend $400 million than this offensive tax loophole.

Republican proposed additional capital gains tax breaks:

The GOP Contract with America proposes to replace the current 28% maximum capital gains rate with much bigger tax breaks. They include a 50% exclusion and indexing the basis of assets for inflation—applicable both to individuals and corporations. According to the Treasury Department, these changes would cost $183 billion over the next ten years—mostly benefiting the very rich.

The combination of indexing and a 50% capital gains exclusion would on average exclude about two-thirds of all capital gains from taxation. For assets held for relatively short periods of time before sale, the exclusion could be close to 90%, while it would generally be lower for gains from sales of long-term holdings.[2]

Total Capital Gain Tax Breaks If the GOP "Contract" is Adopted (1994 Income Levels)

Income	% of Total	Average
<$10,000	0.1%	$–2
$10-20,000	0.8%	–12
$20-30,000	1.2%	–22
$30-40,000	1.6%	–37
$40-50,000	1.9%	–61
$50-75,000	6.0%	–128
$75-100,000	5.3%	–310
$100-200,000	12.9%	–1,000
$200,000+	70.2%	–16,372
All	**100.0%**	**$–304**

[2]If an asset is going up in value by, say, 8% a year, while inflation is 3%, then indexing alone would cut the tax by 35% on the sale of the asset after one year. But if the asset is held for 20 years, indexing (alone)

The GOP's capital gains tax breaks would apply to corporations as well as individuals. As a result, large timber companies and certain other industries that are allowed to treat a large portion of their profits as capital gains could end up paying little or nothing in income taxes.

The tax-sheltering potential of the Republican capital gains breaks is staggering. Investments in depreciable property that actually lose money before tax could become highly profitable after tax under the plan.

Testifying before this Commitee a few weeks ago, the Treasury noted:

> "Increasing the preferential treatment of capital gains would create economic efficiency losses and make the tax system more complex by encouraging taxpayers to convert ordinary income into capital gains."

Even some conservative economists have expressed serious reservations about the GOP's proposed capital gains tax cuts. They note that capital gains are already the lowest taxed form of capital income (due to deferral and preferential rates), and they fear the likely waste of capital resources from new tax shelters. These are among the reasons why indexing, although it might seem attractive at first glance, is particularly inappropriate in the case of capital gains. In fact, indexing any type of capital income for inflation (whether interest, dividends, or whatever) is inappropriate unless interest costs are also indexed downward.

If the GOP capital gains tax plan is adopted, capital gains tax breaks going to the richest 1 percent of the population would soar to an average of almost $16,400 each per year. That's a very expensive subsidy to encourage uneconomic investments.

Accelerated depreciation

Born in scandal during the Nixon administration and the cause of many tax scandals thereafter, accelerated depreciation now is the largest of all corporate tax loopholes. Technically, accelerated depreciation lets companies write off the costs of their machinery and equipment faster than it actually wears out. In practice, that means sharply lower tax bills for companies that can take maximum advantage of the tax breaks.

In 1970 after the repeal of the investment tax credit the previous year, the Nixon Treasury Department sought a new way to subsidize corporate profits. What it came up with was called the "Asset Depreciation Range" or "ADR" system. Put into place by executive fiat, it shortened depreciation periods by 20% across the board and also allowed accelerated write-off methods that concentrated deductions in the early years that equipment is used.

Nixon's ADR approach was immediately challenged in court by public interest tax attorneys as far beyond Treasury's authority under the tax code and therefore an unconstitutional and shameful giveaway to big business. But while the lawsuit was pending, a heavily lobbied

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would cut the tax due by only 20%. When the GOP's proposed 50% exclusion is added on as well, the total exclusion for the one-year asset would be almost 70%, compared to 60% for the 20-year asset.

Congress passed Nixon's 1971 revenue act. That infamous bill retroactively ratified the ADR system, and reinstated the investment tax credit to boot. The combination was deadly for the corporate income tax. A sharp decline in corporate tax payments quickly ensued. Coincidentally or not, productivity growth also collapsed soon thereafter.

By the late seventies, widely publicized studies by the congressional Joint Committee on Taxation and the nonprofit Tax Analysts and Advocates were finding that many companies and even whole industries were paying effective tax rates far below those envisioned in the tax code. But worse was to come.

In 1979, Sen. Lloyd Bentsen (D-Tex.), Barber Conable (R-NY) and James Jones (D-Okla.) introduced a huge corporate tax cut bill. In it, they proposed to shorten depreciation periods and accelerate write-offs much more radically even than ADR. Disingenuously, Bentsen et al. claimed that their plan would cost only $2 billion a year. That was indeed the estimated cost of the plan in its first nine months. But the sponsors knew full well, although they never mentioned, that by its fifth year the plan was expected to cut business taxes by a staggering $50 billion annually.

Urged on by a massive corporate lobbying campaign, believing the low-cost promises of the sponsors and naively hoping to help the economy, hundreds of congressmen and Senators signed onto the Bentsen-Conable-Jones accelerated depreciation bill. In conjunction with an expanded investment tax credit, a version of the depreciation plan was adopted as part of President Reagan's hugely expensive 1981 tax cut act (and made retroactive to the start of 1981).

With that, the floodgates opened. By 1983, studies by Citizens for Tax Justice found that half of the largest and most profitable companies in the nation had paid no federal income tax at all in at least one of the years the depreciation changes had been in effect. More than a quarter of the 250 well-known companies surveyed paid nothing at all over the entire three-year period, despite $50 billion in pretax U.S. profits. General Electric, for example, reported $6.5 billion in pretax profits and $283 million in tax rebates. Boeing made $1.5 billion before tax and got $267 million in tax rebates. Dupont's pretax profits were $2.6 billion; after tax it made $132 million more! Subsequent CTJ studies found similar outrages in 1984, 1985 and 1986.

In response to public clamor, his own newfound misgivings and the disappointing economic results of the 1981 corporate tax cuts, Ronald Reagan helped lead the fight for the loophole-closing Tax Reform Act of 1986. The 1986 act repealed the investment tax credit and sharply reduced depreciation write-offs for buildings. The changes greatly scaled back corporate tax avoidance opportunities and made taxpayers out of most of the former corporate freeloaders.

While companies paid more in taxes after 1986, however, business investment flourished. To the chagrin of the supply-side advocates of corporate tax cuts, real business investment grew by 2.9% a year from 1986 to 1986. That was 43% faster than the paltry 1.9% growth rate from 1981 to 1986. Even more significant, while construction of unneeded office buildings tapered off after tax reform, business investment in industrial machinery and plants boomed. As money flowed out of wasteful tax shelters, industrial investment jumped by 5.1% a year from 1986 to 1989, after actually falling at a 2% annual rate from 1981 to 1986. As former Reagan Treasury official, J. Gregory Ballentine, told Business Week: "It's very difficult to find much relationship between [corporate tax breaks] and investment. In 1981 manufacturing had its largest tax cut ever and immediately went down the tubes. In 1986 they had their largest tax increase and went gangbusters [on investment]."

Despite its advances, the 1986 Tax Reform Act did not end corporate depreciation abuses. Even today, businesses are allowed to write off the cost of their machinery and equipment considerably faster than it actually wears out. This remaining loophole has proven much more expensive than originally anticipated by the drafters of the 1986 Tax Reform Act. In fact, accelerated depreciation tax breaks are expected to cost $164 billion over the next five years.

Like any tax break targeted to corporations, accelerated depreciation is primarily a windfall for the very well off. In fact, tax breaks from accelerated depreciation are worth more than $11,000 a year to people making more than $200,000.

Economists also complain—rightfully—that accelerated depreciation often skews investment decisions away from what makes the most business sense and toward tax-sheltering activities. This can, for example, favor short-term, tax-motivated investments over long-term investments. Moreover, when equipment is purchased with borrowed money, the current tax system produces outright "negative" tax rates—making such investments more profitable after tax than before tax! As a result, corporate buying and selling of excess tax breaks through equipment "leasing" deals have remained widespread (albeit not on the scale of the first half of the 1980s). General Electric, for example, avoided a total of $1 billion in federal income taxes from 1986 to 1992 due to activities of its leasing subsidiary, GE Capital Services.

Shares of Total Corporate Tax Breaks By Family Income Group 1994

Income Group ($-000)	% of Total Corporate Tax Breaks
<$10	0.6%
$10–20	4.2%
$20–30	4.4%
$30–40	4.7%
$40–50	4.7%
$50–75	10.4%
$75–100	7.6%
$100–200	14.7%
$200+	48.7%
All	**100.0%**

Based on shares of reported capital income. CTJ Tax Model, Jan. 1995.

Republican proposed additional depreciation tax breaks

With its huge cost, terrible distribution and sad economic record, accelerated depreciation might seem to have little going for it. Indeed, some might see curbs on excessive depreciation as a promising target for reducing the federal

budget deficit. The new GOP leadership in Congress, however, has promised quite the opposite in its Contract. In fact, through it's so-called "neutral cost recovery system," the GOP has proposed to expand depreciation tax subsidies far beyond their current levels. A quirk in the GOP approach causes it to raise corporate taxes in the very short run, and in a replay of the past, the Republicans are trying to count it as a revenue raiser. But the plan soon would add $30 billion a year or more to the budget deficit.

Under the Republican plan, rather than writing off the cost of machinery and buildings as they wear out, companies would write off considerably more than the actual cost. On a $10 million investment in machinery, for example, the GOP would allow almost $11.5 million in tax deductions over five years. Currently, excessive depreciation tax write-offs for a corporation buying $10 million in machinery are worth about $460,000 (in what economists call "present-value" terms). The Republican plan would boost value of the tax subsidy on such a purchase to more than $800,000.

Today's depreciation rules already reduce the effective tax rate on the profits from typical investments in machinery to about half the statutory 35% rate. But the GOP plan is intended to be the mathematical equivalent of writing off the full cost of capital investments—in machinery, buildings, land, etc.—immediately. Thus, the effective tax rate on profits from new corporate investments would be—at most—zero! For even partially debt-financed investments, the effective tax rates under the GOP plan would be sharply negative. Such investments thus would be much more profitable after-tax than before-tax.

If the Republican depreciation changes are adopted, there is no doubt that corporate tax-sheltering would proliferate, and that many major corporations would once again pay little or nothing in federal income taxes.