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1985 TAX REFORM

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

S. 409, S. 411 and S. 1006

MAY 9, 1985

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THURSDAY, MAY 9, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Roth, Chafee, Wallop, Symms, Grassley, Matsunaga, Bradley, and Mitchell.

[The press release announcing the hearing and the written statements of Senators Packwood and Wallop follow:]

[Press Release No. 85-026]

PRESS RELEASE

For immediate release, Friday, May 3, 1985.
Contact: Sam Richardson (202) 224-4515.

COMMITTEE ON FINANCE CALLS FIRST 1985 TAX REFORM HEARING

The first in what figures to be an extensive series of hearings on the overhaul of the Federal tax system was announced today by Senator Bob Packwood (R-Oregon), Chairman of the Committee on Finance.

Senator Packwood said the first hearing is to begin at 9:30 a.m., Thursday, May 9, 1985, in Room SD-215 of the Dirksen Senate Office Building.

The May 9 hearing will focus on three bills now before the Committee on Finance, all relating to comprehensive tax reform.

Those bills are:

S. 409, The Fair Tax Act of 1985, authored by Senator Bill Bradley (D-New Jersey) and Rep. Richard Gephardt (D-Missouri).

S. 411, The Broad-Based Enhanced Savings Tax [BEST] Act of 1985, authored by Senator William V. Roth, Jr. (R-Delaware) and Rep. Henson Moore (R-Louisiana).

S. 1006, The Fair and Simple Tax [FAST] Act of 1985, authored by Senator Robert Kasten (R-Wisconsin) and Representative Jack Kemp (R-New York).

"It is my belief we are on the threshold of a landmark year in this Congress," Senator Packwood said, "This hearing marks the kickoff of our deliberations over comprehensive tax reform.

"As I have said before, we intend to pursue tax reform, tax changes, tax fairness," Chairman Packwood said. "I think we can complete work on this huge task within a reasonable time after submission of a proposal by the President and have it back to the President late this year.

"The nation is watching us closely as we rewrite the tax code for the first time in 31 years. As we begin our work with this May 9 hearing, I'm sure the Committee on Finance will act expediently but thoroughly in compiling a wealth of information from which to draft our bill."

Senator Packwood said each of the six authors of S. 411, S. 409 and S. 1006 would testify before the Committee on Finance at the May 9 hearing.

STATEMENT OF SENATOR PACKWOOD
SENATE FINANCE COMMITTEE HEARING ON TAX REFORM
MAY 9, 1985

As we begin this first of what promises to be a long series of hearings on tax reform this year, I would like to compliment and congratulate the six members of Congress with us today.

Senators Roth, Bradley and Kasten, and Congressmen Moore, Kemp and Gephardt have committed literally thousands of hours of their time and staff time to the pursuit of this most vital issue.

The value of their efforts to this nation and its taxpayers cannot be understated.

I would like to thank them for their input, as we cross the threshold of this huge project of rewriting the United States Internal Revenue Code.

Let me define what it is we are about to undertake: Let this effort be known to all as genuine tax reform.

This is the issue that, beginning today, will be discussed, debated and acted upon this year.

Allow me to say, without equivocation, that as chairman of the Committee on Finance, I am going to do everything I can to get a tax reform bill to the floor of the Senate and through Conference Committee and to the President of the United States as soon as possible.

Today's hearing is the first of perhaps two dozen or more we expect in this Committee in the coming weeks on specific components of the Revenue Code and its restructuring.

Throughout these hearings, we will attempt to start and finish each and every one with the challenge of measuring each of those sections of the tax code in terms of their simplicity and fairness, with the emphasis on fairness.

We will do our best in these hearings to examine the tax code and its components from the most basic to the most specific points of view, inlcuding just what our national philosophy should be in regard to the use of our Federal Revenue Code.

This is only a beginning, of course. There are many, many individuals and organizations, virtually thousands of constituencies, which would like to be heard on this subject. Certainly, we can accommodate a significant number of those voices in the forum offered by this Committee. It is my belief we must hear from as wide as possible a range of opinions and prespectives on this subject, because we are talking about fundamental changes.

As we listen today to the views of these Senators and Congressmen, we will begin clearly formulating the basic options, facts and figures which are out there -- all of which are essential to the Committee on Finance, the Senate and the Congress making informed decisions on the restructuring of the tax code.

I would suggest now three basic tenets on which we will proceed:

- First, let us strive to develop a new code which will be more fair than the present 31-year-old collection of laws,
- Second, let us strive to creat a new code which will provide our nation with the revenues to carry out the Federal Government's domestic and foreign goals as we enter the 21st century.
- And, third, let us commit, dedicate and wed ourselves to a new tax system which promotes and, at the same time, does not inhibit economic activity, the growth of business and jobs and the expansion of personal achievement in this land of many hues, multiple races and a multitude of ideologies.

STATEMENT OF SENATOR MALCOLM WALLOP

TO THE

FINANCE COMMITTEE HEARING

THURSDAY, MAY 9, 1985

When first confronted by the concept of tax reform embodied by the Treasury proposal package, I, as many of my colleagues, reacted with knee-jerk opposition. I have been involved in sculpting tax laws for the last six years and never have voted for a tax bill which I felt was basically unfair or unjust. (Although I had objections with regard to parts of all of them.) However, my experience on the Finance Committee of the Senate, has given rise to new concerns. In the last four years we on Capitol Hill, have been responsible for three major changes in the tax law, each creating more complexity, each we felt was necessary to "refine" the tax system.

Upon reflection, we find that by making constant changes to the law we have frustrated the efforts of Americans to make intelligent investment decisions, and no doubt caused the loss of economic opportunities that will never pass our way again. With

exception of the tax reductions of 1981, the other tax bills have increased complexity within the tax law in geometric proportions. (Strange as it may seem, everybody understood the tax reductions.) In addition, as the law becomes more complex, we are forced to rely more and more on the expertise of the Treasury Department technicians, who, I can assure you, spend very little of their time in the real world.

Our present tax law has significant problems. It provides $400 billion in tax deductions and preferences, which are claimed annually. I am convinced that this level of distortion is too high. Think about it...$400 billion investment dollars that are being directed by the tax law. $400 billion dollars worth of ways to avoid paying the maximum tax. I have to believe that many of those dollars are being misdirected, or at least directed without any real need to do so.

Obviously the tax system has, in part, replaced the free market as the method of allocation of capital in America. Such a system is responsible for the misallocation of resources, the overbuilding of some industries, the overtaxation of others. It effects the everyday life of almost all Americans.
Not only is the tax law causing a pyramiding misallocation of resources, but its complexity baffles even the most astute businessman. Currently, before any investment decision is made one must before anything else consult a tax technician, with

mystical powers not understood by the rational man. Failure to do so can result in a loss of the very economic benefits sought in the first instance.

The current law encourages all kinds of activities, each one with a group that makes the logical arguments in its support, and each group leaves me wondering if they really wouldn't be better off with a flat tax imposing the burdens of government equally. Churchill said, "The idea that a nation can tax itself into prosperity is one of the crudest delusions which has ever befuddled the human mind."

We are befuddled. Many of us are under the belief that, but for certain deductions, certain industries would no longer exist, certain activities would stop. The truly perplexing part is, if we're right, what justification is there to sustain those industries or activities? Admittedly, there are superseding interests, but I cannot believe that there are $400 billion worth of superseding interests.

The tax law should be used to promote only very important social needs, benefiting all Americans and which are almost basic to our way of life and freedoms. Carving out little exceptions for small parts of our economy, which provide no real benefit for anyone who doesn't get that tax break causes not only complexity but a question as to the fairness of the law. Right now, the law includes small exceptions for almost everybody. Wouldn't we be

better off to trade in virtually all of those devices, all those deductions whose only merit is to reduce our tax burdens for a lower burden overall? We accomplish the same results with far less frustration, far fewer IRS agents, tax lawyers and accountants.

A system which impinges on the rational flow of capital, and causes the tax collection agency of a democracy founded on a Bill of Rights, not equaled by any other civilization, to impose on the cherished freedoms of its citizens, is not the best we can do. The President may be right, the time for reform may be upon us. Reform, done properly and carefully, will open new economic opportunities, new jobs, new economic freedoms. I am convinced a rational, relatively flat tax system, bringing neutrality to investment decisions and with encouragement to take risk, to save and invest, is the proper course.

The latest proposal offered by Congressman Kemp and Senator Kasten seems to come closest to my perception of the proper balance between use of the tax code to promote social goals and free market allocation of resources.

The Kemp-Kasten proposal proposes to have a modified flat tax using 24% and 35% as the highest tax rates for individuals and corporations respectively. Many deductions and preferences would be eliminated while still maintaining a tax system which encourages investment, savings and risk taking. The latest

proposal has been changed. It now includes a heightened awareness for rapid capital recovery through NCRS, which acknowledges how important that is to our economy and the business recovery. In addition, Kemp and Kasten have modified their plan to provide the capital gain differential which is so important to the formation of capital. The plan recognizes the important impact the deduction of intangible energy costs and percentage depletion have on America's energy independence. These provisions help to offset the great risks and cash flow needs of the exploration and development of America's energy resources, whether by mining or drilling. The plan also provides the incentives for savings for one's future, and will help move us away from a tax law which promotes spending rather than savings. There is much in the plan which is worthy of very serious consideration.

There are two circumstances, which if they were to occur, will cause my vigorous dissent to any so-called "tax reform." If the Congress produces a reform package where the actual reform is so minimal that there is no basic restructuring of the tax system, I would not support reform. Such a package would only continue the basic inequities and the frustration caused by yet another change in the tax law and would not be worth the cost.

Secondly, if tax reform is used as a guise for tax increases, I will use all of my energies to so inform the American people, and resist any such reform, The American voter made it clear in the last election: Tax increases are not acceptable. Deficit reduction can be accomplished only through spending cuts.

How do we get there? How can we commit such upheaval in the allocation of resources and such terror on the tax technicians without knowing where we'll end up?

Living in Washington DC and working on Capitol Hill, one is forced from time to time to reflect on the history of this great nation...if the framers of the Declaration of Independence had awaited certainty of results where would we be? Consider the economic growth that would occur if we could throw off the bondages of our present tax code and allow people to make economic decisions free of government influence. Think, how much a 24% maximum tax rate would do for our people's dedication to their trades and dreams.

If our new standard for change in our country is going to be "we will make no change unless we know with certainty, the outcome," then our economy, our freedoms, and lives are frozen -- on hold. Churchill said once, "Those whose minds are attracted or compelled to rigid and symmetrical systems of government should remember that logic, like science, must be servant and not the

master of man. Human beings and human societies are not structures that are built or machines that are forged. They are plants that grow and must be treated as such."

You know, often when we think of American freedoms, we think of the major ones, like freedom of speech or religion. Freedom for capital is not often contemplated. Indeed how can we contemplate it today! Yet a society based on freedom, has room to grow, to improve. Government intrusion on our economic lives would be significantly reduced if we were to initial a carefully crafted tax reform. Over the long run, or the short, people are wiser than governments when free to choose, free to act, free to decide.

I'm not here preaching an irresponsible doctrine for change at any cost, and without any concept of what will occur. Our history includes dramatic tax changes. That history has taught us that taxation does have significant impact on investment and business decisions. Careful drafting can promote an even more favorable business and investment atmosphere. We have also learned that by flattening the tax rate, the tax burden is spread more evenly. Statistically each time the tax rates have decreased the wealthy end up contributing more to the nation's revenues. Lower tax rates make tax shelters less attractive, and cause economic decisions to be made on economic bases. Who will tell me that stifles growth?

In the history of tax law changes we have also learned that with careful grandfathering and effective date provisions, the impacts of changes in the tax law can be moderated so that industry, business and rate-payers suffer little loss. I do not feel we are on a foolish or purely political course when challenged by tax reform. With the support of the American people, and of American business, we can go forward to higher levels of economic freedoms.

The CHAIRMAN. The hearing will come to order, please.

As we begin the first of what promises to be a very, long series of hearings on tax reform this year, I would like to compliment and congratulate the six witnesses we have before us today. The three Senators and the three Congressmen who will testify have done much to further the cause of tax reform. They have pushed it, debated it, and brought it to our consciousness. They deserve great credit, most of all Senator Roth who has been in this field longer than most of the Members have been in Congress. I take my hat off to you.

I want to say to the Members who are pursuing tax reform: As far as I am concerned, there will be a tax reform bill this year. We will set hearings in this committee about 2 weeks after the Ways and Means Committee begins hearings. When they have finished a markup, and we receive a bill, it would be my hope that we could have no more than another week or two of hearings, mark it up, get it through the Senate, get it to conference and get it to the President possibly by no later than the end of this year.

My standard in this bill is going to be fairness—not solely simplicity for the sake of simplicity, but fairness. Second, what the goals are we want to achieve, whether those be capital investment, savings, health insurance, or whatever else we think are worthwhile policies.

Whether those can all be combined in one bill, whether you can have a bill that is perfectly simple and perfectly fair will be a fair subject for hearings.

There will be no delay in this committee. I will have notices of our hearing schedule to the members shortly after the House commences. I will try to give the members 2, 3, or 4 weeks advance notice on the dates that are set. My guess would be that when we start hearings we will go 3 or 4 days a week for 4 to 6 weeks in a row.

I do have a complete statement that I ask unanimous consent to put in the record.

Senator Mitchell, do you have a statement?

Senator MITCHELL. Yes, I do, Mr. Chairman. Thank you very much.

The CHAIRMAN. Thank you.

Senator MITCHELL. I commend you, Mr. Chairman, for beginning these hearings promptly on what will prove to be a long process of consideration of fundamental tax reform legislation.

We have a long road ahead of us that will require careful consideration and thorough review of many alternatives.

Like most Members of Congress and the majority of the American people, I support fundamental tax reform to equalize tax burdens and simplify our tax system. Yet, I realize that we face many difficult decisions ahead as we attempt to reconcile our general support for the concept of reform with specific votes to eliminate or cut back tax provisions that have widespread public support.

It is one thing to speak in the abstract about the need to close loopholes and restore equity; it is quite another thing to make decisions to end tax programs that were created after careful analysis and study to achieve socially desirable objectives.

Nevertheless, the message is, and should be clear to all Americans, that public respect and confidence in our current Federal tax system is at an all-time low and continues to decline.

Reform of the Federal tax system is essential. Steady growth in tax incentives has eroded the revenue base so that average marginal tax rates must be high to support the activities of the Federal Government. Meanwhile, many taxpayers are able to avoid high tax burdens through skillful use of existing and legal tax incentives. The horror stories that we read about of large corporations and wealthy individuals paying little or no tax only serves to breed further contempt for our system. Everyone wants a piece of the action, and tax shelter investments have become a national pastime. Many of those who do not buy into tax shelters have their own way of avoiding tax liability by underreporting of income and overreporting of deductions. The tax cheating that was once engaged in by a few has become widespread, and now something like $100 billion in revenue goes uncollected each year. The process feeds on itself, and we will eventually have a house of cards ready to collapse.

I congratulate the chairman on saying that we are going to have action now. This is the time for action. We must do something fundamental to restore taxpayer compliance and confidence, to reduce marginal tax rates and create equity.

Fundamental rax reform must provide for a simpler tax system, but we must not delude ourselves on this point. Currently, two-thirds of all taxpayers do not itemize their returns; they send in the short form, and the polls indicate their major concern is not simplification but fairness.

We must send a clear message today throughout the Nation and to the President that fairness means maintaining a system of progressive taxation, and in fact strengthening that principle.

The 1981 tax cut bypassed low and middle income Americans largely, and significantly resulted in reductions for those in the upper income levels. That is a fundamental flaw, and it is an outrage that families below the poverty level must actually pay taxes while very large and profitable corporations get tax refunds and of course pay no taxes. The correction of this problem cannot wait another tax year.

This is a delicate and complex problem. The American people are understandably sensitive about their tax bills, and we must do it right the first time or we will only create further public concern and cynicism.

I am ready to begin this process, Mr. Chairman. I look forward to working with you and the other members of this committee on this problem.

The Chairman. Thank you, Senator Mitchell.

We will follow a slightly different procedure in terms of the order of the witnesses today. Normally, as a matter of tradition and comity, we would hear all of the Senators first, then the House members and then take them each in order of seniority. Today, however, because there are principal Senate and House sponsors on each bill, we will take Senator Roth and Congressman Moore—if he comes—first, Senator Bradley and Congressman Gephardt second, and then Senator Kasten and Congressman Kemp.

Our first witness today is Senator Bill Roth, the senior Senator from Delaware and a person who has been involved in tax reform and tax simplification for longer than any other Senator I think on this committee. He has been a good right arm to me in all the years I have been on the committee.

Senator Roth?

Senator ROTH. Thank you very much, Mr. Chairman.

First of all, let me congratulate you for your opening statement. There is nothing more important to be done by this Congress this year than tax reform, and I think your strong leadership will make that a reality. I look forward to working with you on this most important task.

I think tax reform is an idea whose time has come, and unless we return some basic fairness to the Tax Code through simplification and reform, I think we will have in this country, Mr. Chairman, the tax equivalent of the Boston Tea Party, except this time it will be the politicians instead of the tea that is thrown overboard if we fail to act.

Let me emphasize: It matters a great deal—a great deal—what kind of tax reform we enact. For tax reform to be worth the political bloodletting that is going to occur, it must do more—it must do more—than simplify. In my judgment it must improve significantly the climate for long-term economic growth in this country. Such growth can be accomplished most effectively if we do three basic things:

One, we must continue to lower marginal tax rates.

Two, most importantly, we must provide major savings incentives.

Three, it is important that we help level out the international trade playing field.

Mr. Chairman, that is why I have introduced a two-pronged approach to tax reform.

Now, my first is what we have called the Broad-Based Enhanced Savings Tax Act of 1985, what we like to refer to as 'the BEST plan.' Like a lot of other plans, this bill would greatly expand the tax base by eliminating most deductions, exemptions, and credits, and would reduce marginal tax rates.

Mr. Chairman, what makes our plan unique, unique among all the other plans, is that it is the only plan that deals decisively with the question of double taxation of savings. It would create what we call super savings accounts, SUSA's, which ultimately would allow an individual to participate in a tax-deferred savings plan and contribute up to $10,000 a year. It would function very much like an IRA, except those savings could be used for any purpose because there is no penalty for early withdrawal.

I think that is a most important change, Mr. Chairman, because current plans fail to provide incentives in many cases for young people who may want to save for a house or to send a child to college; so we have expanded it so that everybody will have a reason to save, and when he withdraws there would be no penalty as under the current proposal.

Now, I have a second bill which I introduced yesterday which would work in tandem with BEST. It is what we call the Business Transfer Tax Act.

Mr. Chairman, if you want to keep marginal rates as low as possible, decrease the double taxation of savings, and lower the cost of capital to business, then an alternate revenue source is needed to keep the total package revenue neutral. And that is why I have introduced the BTT.

Now, under the BTT, each business would add up its total receipts and subtract from it its total purchases including physical capital and raw materials. The remainder, the firm's net receipts, would be the tax base, and that tax base would be taxable at the rate of 5 percent.

Mr. Chairman, this tax proposal has a number of advantages. First of all, we would provide that this tax liability could be credited against a firm's FICA liability, or Social Security. So what it does, it removes a bias, a bias against employment. And we think that that is a most important goal and reason for this new taxation.

Second, the Business Tax Transfer would also help level the playing fields for trade. Let me point out that under this proposal, which is legal under GATT, the businessman would receive a rebate of any BTT taxes paid on American goods exported; while, on the other hand, any goods imported into the United States would be subject to that tax.

The reason this is important—let's take the case of an automobile. Bill Brock and others have said that American manufacturers of cars are handicapped roughly $600 per car because of the taxes the American manufacturer pays and the Japanese exporter of cars does not pay.

Let me explain how it works. Today a Japanese manufacturer, if he exports a car to the United States, has the Japanese taxes rebated at the border when it leaves Japan. When it comes to the United States, no tax is paid there. This contrasts with the situation of the American manufacturer who pays roughly $600 to $700 for each car he produces. But under this BTT we would help offset that situation. When the Japanese manufacturer exports a car to the United States, when it reaches our border, the BTT would be applied, and if it were say a $12,000 car—which is not that high these days—it would equal $600. So what the BTT does is to help level the trade playing field, which I think is a most important goal.

Let me reemphasize and underscore the fact that this tax is valid under GATT, and for that reason it is a very important matter.

Now, at the rate of 5 percent, the domestic liability of this new BTT would almost exactly equal the current law of FICA liability; it would just about offset Social Security taxes. And as I indicated, that could be credited against FICA. That amount that is credited would go directly into the Social Security trust fund.

Under a 5-percent tax, it would raise roughly $20 billion a year in new revenue. Only $3 billion of those billions would be from domestic sources; the other $17 billion would be from imports. That $20 billion, Mr. Chairman, could be used to lower marginal rates of taxation.

Now, as I said, we introduced this measure with a 5-percent tax rate. But I think consideration should be given to the effects of a higher tax rate. For example, if we have a 7-percent BTT, it would

raise roughly $45 billion. Or if you went as high as 10 percent, it would raise $75 billion in new income.

The CHAIRMAN. Let me ask you a quick question on that. Once you get above the 5-percent level and more or less get above the Social Security level, then it more or less evens out between foreign and domestic in terms of the payment?

Senator ROTH. That is correct.

Let me say that if we were to do that, Mr. Chairman, those additional sums should be used to lower the marginal rate of taxation. I want to underscore that, because I think it is critically important that we understand that, as far as I am concerned, this new tax should be used only for that purpose. In no way should it be used as a means to increase general taxation on the private economy. Instead, to the extent we raise additional revenue, it should be used, as I said, to continue lowering the marginal rate of taxation on individuals. I think that is critically important in order to promote work, savings, and investments.

Let me just make one comment on a comment that was made earlier that our tax reduction, our lowering of the marginal tax rate in 1981, has increased—I think it is important to understand this—has increased the amount of taxes paid by the more affluent citizens of this country. It has not been a tax break for them, but they have in fact paid higher taxes than they had in the past. And I think it is important that we continue to lower the marginal rate in an effort to spur long-term growth of this economy.

Well, in short, the BTT coupled with savings incentives such as BEST, I think, Mr. Chairman, offers us a revolutionary way of reforming the Tax Code, lowering individual marginal rates, encouraging higher savings, and it would help shrink the trade deficit. In my judgment BEST-BTT is the only plan that accomplishes all of these major objectives.

Let me once again say we must use this opportunity for tax reform to remove the bias against savings that permeates our code today. Frankly, a major reason we face economic challenges from countries like Japan is their individual savings rates. A lot of people think that that was part of the Japanese culture; that is not correct. It was sometime after World War II that the Japanese built these incentives into their tax code and rewarded savings. Lo and behold, the Japanese people did start saving. These savings were used to create the technological advantage that Japan has today over most of the world. To put it bluntly, we are not only competing against Toyotas and Sonys, we are also competing against the Japanese savings system. That must be corrected.

Now let me speak candidly. One of the greatest flaws, as far as I am concerned, is that the Treasury's first proposal is almost worse than nothing when it comes to savings. Just about the only provision that passes for a savings incentive is a small increase in the IRA limit, and they more than undo any good that is connected with that proposal by doubling the early withdrawal penalty on IRA's. Instead of a bold new brush stroke needed to paint a brighter economic future through greater savings, the administration's bean counters have given us a faded paint-by-numbers substitute.

What BEST proves is that you can have a broad-based low-rated system with major savings incentives that is revenue neutral, in

terms of aggregate revenue, as well as distribution of the tax burden by income groups.

The Joint Committee on Taxation—which, by the way, had substantial input in the development of this plan—has produced a four-rate system—12, 20, 30 and 34 percent—which satisfies that revenue criteria. At the same time, it substantially removes the double taxation of savings.

In closing—and I would ask that my entire statement be included, Mr. Chairman, as if read—in closing I think a basic goal of tax reform must be to create a long-term climate of economic growth. Failure to reduce marginal tax rates substantially, failure to provide major incentives for savings, would make the plan not worthwhile. And to be blunt, my support of tax reform will depend upon what we do in the area of marginal rates and savings generally.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Roth, thank you.

[Senator Roth's written testimony follows:]

STATEMENT BY SENATOR WILLIAM V. ROTH

SENATE FINANCE COMMITTEE

MAY 9, 1985

THE BEST/BTT TAX REFORMS MEAN GROWTH

Mr. Chairman, I congratulate you on holding these most important hearings. Tax reform is an idea whose time has come. Unless we return basic fairness to the tax code through simplification and reform, we will have in this country the tax equivalent of the Boston Tea Party, except that it will be the politicians instead of the tea that gets tossed overboard.

But it matters a great deal what kind of tax reform we enact. A plan that merely wipes out some deductions, saves others because of their political support, and in general creates new and different hoops for taxpayers and businesses to jump through in the name of reform isn't worth the agony we will most assuredly go through to pass it.

For tax reform to be worth the political bloodletting that is going to occur, it must do more than simplify. It must improve significantly the climate for economic growth in this country Such growth can be accomplished most effectively if we do four basic things--lower marginal

rates, provide major savings incentives, create jobs, and level out the international trade playing field. That is why I have introduced a two-pronged approach to tax reform.

The first is the Broad-based Enhanced Savings Tax Act of 1985 (BEST). This bill would greatly expand the tax base by eliminating most deductions, exemptions, and credits and would reduce marginal tax rates. But what makes the BEST plan unique among all the other plans is that it is the only plan that deals decisively with the double taxation of saving. It creates Super Savings Accounts (SUSAs) which would allow an individual to participate in a tax deferred savings plan and contribute up to $10,000 per year ($20,000 for a couple filing jointly). SUSAs would function much like IRAs except that the saving could be used for any purpose because there is no penalty for early withdrawal.

My second bill, which would work in tandem with BEST, is the Business Transfer Tax Act. If you want to keep marginal rates as low as possible, decrease the double taxation of saving and not increase the cost of capital to business, an alternative revenue source is needed to keep the total package revenue neutral. That is why I introduced the BTT.

Under the BTT, each business would add up its total receipts and subtract from it total purchases including physical capital and raw materials. The remainder, the

firm's net receipts, would be the tax base and would be taxable at the rate of 5 percent. This tax liability could then be credited against the firm's FICA liability. All credited amounts would be transferred to the Social Security Trust Fund. Under GATT, export receipts could be excluded from the tax base and all imports would be subject to a 5 percent tax. At the rate of 5 percent the domestic liability of this new BTT would almost exactly equal the current law FICA liability. Only about $3 billion additional would be collected from domestic sources and over 90 percent of existing firms would not have any net tax increase. On the other hand, a 5 percent BTT would raise about $17 to $21 billion from imports in a GATT-legal manner.

Let me also make clear that, although I introduced this measure with a 5% tax rate, consideration should be given to the effects of a higher tax rate, in order to provide even more revenue for reductions in the marginal tax rates for individuals and savings incentives. At a 7 percent rate, the BTT will raise about $45 billion, about $20 billion from domestic sources and the rest from foreign sources. A 10 percent BTT raises about $75 billion a year and a 20 percent BTT raises about $235 billion. The potential is there with BTT to substantially lower tax rates while keeping the plan revenue neutral overall. By lowering

rates we will encourage investment and productive use of our nation's capital.

Let me interject, Mr. Chairman, that BTT must not be looked at as some magical money machine that could wipe out the deficit if only we could set the rate high enough. The value of a BTT is that it allows us a way to lower rates and increase productivity and investment on a net basis in our economy. The BTT proposal should not be subverted to serve as a substitute for the painful but necessary process of spending reductions.

The BTT has several advantages as an alternative revenue source. It is compatible with the GATT and therefore will have positive effects on our trade problems. Because it essentialy replaces the FICA tax, it will create jobs by removing a major disincentive to firms hiring labor.

In short, the BTT, coupled with savings incentives such as BEST, offer us a revolutionary way of reforming the tax code, lowering rates, significantly encouraging greater personal savings and investment, and shrinking the trade deficit. In my judgement, BEST/BTT is the only plan that would accomplish all four of these major objectives.

Let us use this opportunity for tax reform to remove the bias against savings that permeates our tax code today, and is a major reason why we face economic challenges from countries like Japan. Years ago, the Japanese created a tax

system that rewarded savings. And, lo and behold, the Japanese people started saving. Those savings were in turn used to create the technological advantage that Japan now enjoys over most of the world.

We are not only competing against Toyotas and Sonys. We are also competing against the Japanese savings system tool

One of the greatest flaws in the Administration's initial tax reform proposal is that it is worse than nothing when it comes to savings. Just about the only provision that passesfor a savings incentive is a small increase in the IRA limits, and they more than undo any good connected with that proposal by doubling the early withdrawal penalty on IRAs. Instead of the bold new brush strokes needed to paint a brighter economic future through greater savings, the Administration "bean counters" have given us a faded "paint by numbers" substitute.

What the BEST bill proves is that your can have a broad-based, low rated system with major savings incentives that is revenue neutral in terms of aggregate revenue and distribution of the tax burden by income group. The Joint Committee on Taxation, which by the way had substantial input in the development of this plan, has produced a four rate system, 12, 20, 30, and 34 percent, which satisfies the

revenue criteria. At the same time, it substantially removes the double taxation of savings.

Our current tax code distorts economic decisions in a way that costs our economy billions of dollars a year. Precious, scarce American resources are wasted simply because an archaic tax code sends confusing signals to the millions of citizens who participate in our economy, and leaves many thinking that they are foolish to pay their fair and rightful share of taxes because everyone else is probably cheating. We must devise a tax system that is perceived by the American people as fair and understandable, and at the same time serves as a positive force for prosperity.

By adopting the BEST/SAT approach will will achieve the goals of reform in a way that will maximize growth in this country. I urge this committee to give it close consideration.

The CHAIRMAN. Let me say to the committee members now: As we start down this road on tax reform hearings—I would expect someplace between 20 and 25 days of hearings—I am going to ask the clerk to keep us very closely to our time limits. We will probably have requests for over 500 witnesses to testify. If we are going to get through the hearing process at all, we are going to have to observe our time limits on witnesses and questions. It has been my experience in the past that for as many questions we may have, if we stick to our 5 minutes, somebody else has thought to ask the same question, and they will normally ask it before you have to. So I am going to ask that you hold me to 5 minutes and hold the others as well.

Bill, I have a question. You want to encourage savings.

Senator ROTH. Right.

The CHAIRMAN. You have a provision in here to tax the inside buildup on life insurance, which to me seems contra to the encouragement of savings. I am curious why you put in the Susas, which indeed will encourage it but tax the inside buildup.

Senator ROTH. Mr. Chairman, that is not part of my proposal.

The CHAIRMAN. Oh, isn't it?

Senator ROTH. I understand that Treasury is going to do so, but it is not included as part of ours.

The CHAIRMAN. Then my information is wrong. I thought you were taxing it. I apologize.

Let me ask you a second question: When you have made a decision as to which deductions and credits to keep and which ones to exclude on the personal income level—you get rid of the day care credit, and the above-the-line deduction for charitable contributions, but you keep the old traditional charitable contribution deduction. How did you decide what you were going to keep and what you were going to get rid of?

Senator ROTH. Well, in the case of charitable deductions, Mr. Chairman, it seems to me, increasingly we are saying in Washington that we want more done in the private side through private means. As we are restraining the Federal budget it seems to me that we should not take steps that conceivably could reduce or lower charitable giving, because I think charitable giving becomes increasingly important as part of our efforts to have voluntary endeavors to help solve problems. So, I felt that we ought to continue charitable deductions as we have in the past.

In the case of mortgages, I think it is basic—I think it is basic to this country, a basic goal, let me put it that way—that everybody wants to own their own home. And for that reason I think we ought to continue the mortgage interest deduction. It not only helps achieve that American goal but it also creates many jobs.

The CHAIRMAN. The reason I pursue this a bit, Senator, is that every one of the bills we have before us on the personal income tax side keeps some deductions and gets rid of others. They all don't keep the same ones, and they all don't get rid of the same ones. I am trying to find out what the thinking was with all of them as to why certain ones were kept.

I think we all understand why the mortgage interest deduction was kept. I don't know any of them that get rid of it although some of them trim it a bit.

You have gotten rid of the above-the-line deduction for charitable contributions. Are you assuming that it is not an incentive for charitable giving, or that it is unneeded?

Senator ROTH. I am sorry, I didn't hear that.

The CHAIRMAN. Do you eliminate the above-the-line deduction for charitable contributions?

Senator ROTH. No, Mr. Chairman. Again, we kept present law.

The CHAIRMAN. Are you sure?

Senator ROTH. Present law does phase out above-the-line deductions, but we didn't change that; we just kept it as it is.

The CHAIRMAN. So after the deduction phases out, at the end of 1985 you would get rid of it?

Senator ROTH. Well, our basic purpose in doing that, Mr. Chairman, was just to keep the present law.

The CHAIRMAN. Let me move to your business transfer tax.

Senator ROTH. Yes.

The CHAIRMAN. Do you count that as a form of a consumption tax?

Senator ROTH. Yes.

The CHAIRMAN. Would you be willing to expand that further if it was used to lower individual rates?

Senator ROTH. That is correct, Mr. Chairman.

The CHAIRMAN. That is almost the only reason you would allow it to be expanded further?

Senator ROTH. Absolutely. I would oppose vehemently any effort to raise revenue by that means.

The CHAIRMAN. Does it trouble you that the argument is raised that it will be a regressive form of taxation? In essence, it is a quasi-excise tax that will be passed along in the cost of products, and we will have the same argument against it that other consumption taxes have?

Senator ROTH. Well, Mr. Chairman, our BTT has a number of very desirable goals, I think. First of all, as I pointed out, it would be credited against FICA. I think that is an important factor, because that helps promote employment.

Today an employer, if he is thinking about a new facility and whether he is going to do it with automation or with individuals, may very well opt out to use automation because of the high cost of new employment. Our legislation would neutralize that so that it would help encourage new jobs.

Second, I have gone into some detail as to the importance of leveling the trade field. This proposal—we have checked this out with the USTR—is valid under GATT. It does help level that trading field, which means that our manufacturers are in a more comparable position with those exporting to the United States. So that helps create jobs here. So, there are a number of reasons why I think this legislation is very important.

Of course, many of the basic reforms are all talking about trying to reduce the progressivity of the tax levels; so, essentially, this helps that out, too.

The CHAIRMAN. Senator Mitchell?

Senator MITCHELL. Thank you, Mr. Chairman.

Thank you, Senator Roth, for your testimony. The business transfer tax is a new and interesting concept. I just want to make

sure I understand it. What you would propose to do would be to tax a business' net receipts at the rate of 5 percent, and allow a credit against that for the FICA tax liability?

Senator ROTH. That is correct, Senator Mitchell.

Senator MITCHELL. And in your statement you say that, at the rate of 5 percent, the domestic liability of this new BTT would almost exactly equal the current-law FICA liability.

Senator ROTH. That is correct.

Senator MITCHELL. So, in effect, you are eliminating all taxes for businesses except for the current FICA tax?

Senator ROTH. No. All we do, Senator Mitchell, is say that the new tax, the BTT, could be offset, credited against the Social Security tax. That is the only change in business taxes. We are not repealing corporate income taxes or others, if that is what you are suggesting.

Senator MITCHELL. Oh, I see. Yes, that is what I was asking.

Senator ROTH. No. The only thing it impacts on is the Social Security tax. What it says to the businessman is, "Your BTT can be credited against Social Security," as you understand.

Senator MITCHELL. Right.

Senator ROTH. And that is the reason it is helpful from the standpoint of encouraging employment.

Senator MITCHELL. Right.

Senator ROTH. But it has no effect on corporate or other taxes.

Senator MITCHELL. So this is not a substitute for any other tax, but this is an additional, in your view, supplementary or complementary tax to existing taxes?

Senator ROTH. Yes. With the clear understanding that both additional revenues would be used to reduce marginal rates.

Senator MITCHELL. How about the deficit? Would you have any objection to any additional revenues being used to reduce the deficit?

Senator ROTH. Well, I am a strong believer that the deficit must be handled by the spending side. There is no question, Senator Mitchell, in my mind that if we raise taxes, that this year or next year or some year we will increase spending.

I think fundamental to the deficit, I think fundamental to the long-term growth of the economy, is that we regain control of the spending side. I think that means freeze and reform, but it does not mean higher taxes.

Senator MITCHELL. The proposal which you dealt with first, which you describe as the Broad-Based Enhanced Savings Tax Act, applies only to individuals?

Senator ROTH. That is correct.

Senator MITCHELL. And the tax we have just been describing, the business tax, of course, as you have indicated, does not change any existing tax. Does that reflect any decision on your part that no changes need be made in the remainder of the business tax structure?

Senator ROTH. Well, Senator Mitchell, when we drafted our proposal, I had some concern at that time about dealing with business taxes for two reasons: First, we had had a tax change almost every year, or at least in 3 of the last 4 years I think. To me, that is very

destabilizing to business in general. So I had reservations about doing anything in that area.

Second, there really was no consensus in the business community as to what needed to be done. I couldn't even get the chemical industry within itself to agree. And I thought that it was desirable that we had some guidelines and consensus from the business community itself.

But of course since then, the Treasury has proposed changes in the business taxation; so we have already destabilized—if you want to call it that—the situation.

Senator MITCHELL. Yes.

Senator ROTH. I think it is critically important that we go ahead and reform the business taxes as well as the individual; but frankly, once we do that, we ought to throw away the keys to this room and to the Ways and Means Committee room and leave the tax laws alone, so the businessman has some certainty and consistency to plan.

Senator MITCHELL. But that is after we make the changes?

Senator ROTH. Yes. I strongly support what the chairman said, that we ought to move ahead with tax reform, both business and personal.

Senator MITCHELL. Thank you.

Mr. Chairman, your admonition about time was so strong that I am going to finish before my time. You said you are keeping careful records, and I hope that in the future we get a little leeway, those who finish early.

The CHAIRMAN. Sort of a variation of a tax-loss carryforward? You want your time on another witness?

Senator MITCHELL. Yes; called the time carry-forward.

The CHAIRMAN. We will put it in the code. [Laughter.]

Senator Symms is gone. Senator Grassley?

Senator GRASSLEY. Senator Roth, in the 2 or 3 years that I have been listening to people suggest alternate tax forms and plans, I have been as concerned about the procedure—how you get from here to there—as the substance of it. What problems do you see with that? How long of a period of phase-in do you have, or is it an abrupt change? And what problems did you anticipate that you were able to take care of with your plan?

Senator ROTH. Well, I think you have asked a very pertinent question. I would like to say that in developing the BEST plan, which I want to publicly thank the Joint Committee on Taxation for their very able assistance and help, we phased in our proposal over a 5-year period. We thought that that would enable the changes to be made as evenly as possible.

Obviously, when you have some major changes in the Tax Code, it does have an impact. On the advice of the joint committee, we decided a 5-year was a reasonable period for our proposal.

Senator GRASSLEY. And then that works by phasing in 20 percent, going from 20 to 40 to 60 percent, on up to 100 percent over a 5-year period of time, and phasing down older taxes proportionately the same way?

Senator ROTH. Basically that is correct.

For example, we had expensing phased in over a 5-year period.

Senator GRASSLEY. Do you feel that that phase-in is going to be able to operate very smoothly?

Senator ROTH. Yes; under our proposal we do.

Senator GRASSLEY. Thank you very much.

The CHAIRMAN. Senator Symms?

Senator SYMMS. Just one brief question, and I thank you, Senator Roth, for your leadership in this area.

Did you say that you phased in 100-percent expensing?

Senator ROTH. Yes, that's correct.

Senator SYMMS. And that's for businesses, corporations, et cetera?

Senator ROTH. Well, of course we were then dealing with individual taxation, not the business side. But because individuals may have sole proprietorships, we did phase in expensing for individual proprietorships.

Senator SYMMS. And then you could just roll it forward so you use up the losses. Well, I think that is a real good thing. I think we should do that to our entire Tax Code; we would encourage a lot of growth.

Senator ROTH. Frankly, I think we would have been better off if we had done that in 1981.

Senator SYMMS. I think we would have, too. Thank you very much.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. Mr. Chairman, I will credit my account on this one and pass.

[Laughter.]

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

I apologize for not being here earlier for the first part of Senator Roth's presentation.

How many itemized deductions are done away with? Do you eliminate most of them? I heard you answer the Chairman's questions about the charities; but what about the others? What about things like historic preservation tax credits or solar tax credits?

Senator ROTH. Most of those are eliminated as part of an effort to broaden the tax base so we can reduce the marginals.

Senator CHAFEE. I see.

Now, what do you do about interest deductions?

Senator ROTH. Well, we keep the mortgage interest deductions.

Senator CHAFEE. For what? For the principal home?

Senator ROTH. No, we don't have any limits.

Senator CHAFEE. You don't have any limit? How about other interest deductions, on borrowing and so forth?

Senator ROTH. Consumer interest is repealed, but business interest is continued as a cost of doing business.

Senator CHAFEE. I see.

Well, first let me say that I think what you are doing here is very constructive in that you are zeroing in on the savings aspect in the so-called SUSA part. I must say I have a little trouble with it being so large. It's $20,000 for a joint return and there are no restrictions on it. I mean, a person could then withdraw the money at any time they want. They get the deduction and then when they

withdraw I assume that that money they withdraw is taxable income.

Senator ROTH. It becomes subject to taxation.

I think you raised a very important point. I think we want to build in incentives not only for retirement but for any purpose whatsoever, because what we are really trying to build is a national pool of savings for capital investment.

As I said in my opening remarks, one of the reasons the Japanese have been so successful—and I know last January when I talked to the Prime Minister about it, he credited the savings rate of Japan, which is 20 to 24 percent. Our savings rate is very poor in this country.

Let me just point out that there is a research bulletin put out by the conference board, a very distinguished organization, that makes an appraisal of international savings rates, and this study points out that in net saving rates—and that includes both Government and private individuals, everything—the United States, among the seven leading industrial countries, ranked last. Japan is No. 1. And the same thing on net household savings; the United States is second from the bottom.

Now, I feel very strongly that we have to have continuously a new flow of savings each year in order to help new business and to keep our plants the most modern in the world.

Senator CHAFEE. Well, I appreciate that and, as you well know from being a member of this committee, I think most of us feel the same way. It's how to get from here to there.

My concern is that a great disincentive to borrowing, obviously, would be the nondeductibility of the interest for the individual.

Senator ROTH. Sure.

Senator CHAFEE. Now, whether you need the other side of the coin, too, that is, not only in a disincentive to borrow but also an incentive to save, I don't know. Obviously it is attractive to have the incentive to save; but to let a family take $20,000 and get a deduction, which obviously is only going to be available to more wealthy families, well, that gives me a little bit of a problem.

Senator ROTH. Let me say this: Whether $10,000 is the right figure or something less is, that is a question we should look into. But I do think we need to substantially increase it. And of course, we would increase that to $10,000 over a period of several years. But it is really comparable an amount as to what the Japanese do, although they use a somewhat different approach.

Senator CHAFEE. Fine. Thank you very much.

I will bank the balance of my time, Mr. Chairman. [Laughter.]

The CHAIRMAN. Senator Mitchell, I wish you hadn't started this; we are going to be in trouble when we get down to the end.

I have no more questions. Are there any other questions of Senator Roth?

Senator GRASSLEY. I would just like to ask a short question about why you are one of the few plans that exempted the tax treatment of municipal bonds, other tax-exempt bonds.

Senator ROTH. Again and again, we just decided we ought to keep that the same as current law.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. I do have one more question. I want to make sure that my chart on your bill is right. Do you repeal the deduction for State and local taxes?

Senator ROTH. Yes, we do.

The CHAIRMAN. I want to go back again, then, to the question I asked: As you go through these you say you don't intend to keep the above-the-line deduction for charitable contributions. You get rid of the present dependent credit, which is basically a credit more useful to lower income people than to higher income people. You get rid of the historic preservation credit, and yet you keep others.

I am curious, in terms of value judgments, in how you came to keep certain ones and not others.

Senator ROTH. Well, we really kept very few. You are right, we kept the charitable, we kept the mortgage interest. But our main thrust was to try to eliminate as many as possible in the belief that it was more important to get the marginal rates as low as we could plus the incentive for savings.

The CHAIRMAN. Thank you very much.

Any other questions?

[No response.]

The CHAIRMAN. Come up and join us, now.

As Congressman Moore has not arrived yet, we will take Senator Bradley and Congressman Gephardt.

Do you want to go down there to testify, Bill?

Congressman, good to have you with us.

Mr. GEPHARDT. It is very good to be here. Thank you.

Senator BRADLEY. Mr. Chairman, thank you. This is a different vantage point down here. The committee takes on a totally different perspective.

The CHAIRMAN. You are one of the few witnesses that I can see over the cameras.

[Laughter.]

Senator BRADLEY. Let me thank you for the chance to come before the committee today and to make some comments about tax reform. I would ask unanimous consent that my full statement be printed in the record.

The CHAIRMAN. Without objection.

Senator BRADLEY. Mr. Chairman, I really think we have the best chance in a generation for major tax reform. I say that for a number of reasons. One is that legislators from both parties have introduced major tax reform legislation, the Treasury has come forth with a detailed plan, and the President has already endorsed the basic principles of tax reform, and he has made a commitment this year to lowering tax rates and making the tax system fairer. Now, that is an impressive mandate, and the special interests know it. That is why they are already beginning to spend millions of dollars to stop the American people from getting a lower rate of tax and a fairer income tax system.

Now, what do I believe are the criteria for essential tax reform? I think there are three criteria: First, tax reform must not increase the deficit; second, it must retain progressivity so that the tax burden on lower- and middle-income people is not increased; and third, it should offer the lowest possible tax rates for the greatest number of people.

Now, I think a tax reform bill that embodies these principles will clearly serve the general interests. In a nutshell, that's what the fair tax tries to do. It offers lower rates and fewer loopholes.

When we introduced it a couple of years ago, we tried to make the point that "tax reform" is not a code word for big government, or soaking the rich, or foreclosing on the middle-income homeowner. Instead, the fair tax, I think, is a realistic and concrete plan to achieve a tax system that is significantly fairer and simpler than the crazy-guilt structure that we labor under today.

Now, the fair tax shows that tax reform can do the following things: It can raise the same, or even somewhat more, revenue as the present tax system but with much lower rates and far fewer loopholes.

Second, it can keep the same degree of progressivity as the present system but ensure that equal incomes will pay equal tax.

Third, it can accomplish both of these goals while retaining the most widely used deductions like mortgage interest, child care, and retirement income.

Fourth, it can help reduce the deficit by raising over $30 billion in the third year and by improving the overall efficiency of the economy.

So, with one bill we lower rates, which means that if you earn more you will keep more; we have fewer brackets, which means relief from inflation and a tax break for working couples; we have fewer loopholes, which means everybody gets a simpler, fairer system, less cheating and more productive investment; we have a bigger standard deduction in personal exemptions, which means relief for young people, poor people, and the elderly struggling to get by on fixed incomes.

Last, the key itemized deductions are retained, which means a double benefit for middle income taxpayers who have invested in their community and who deserve a measure of certainty in a time of change.

Let me say again, the fundamental proposition of the fair tax is fairness. It is a choice. The choice is giving up loopholes in order to get the tax rates lowered.

The people want lower tax rates, while the special interests want the loopholes. What the fair tax does is close most of the loopholes and use those revenues to cut the tax rates. Four out of five taxpayers who now pay taxes in this country would pay no more than a 14 percent tax rate under the fair tax. In the first year of its existence, 70 percent of the taxpayers would pay the same or less tax; 30 percent would pay more. In the long run, most everyone who earns more—and what American doesn't believe they are going to earn more—would pay less tax because of the dramatic drop in the marginal tax rate.

For corporations, the same principle applies. And that is, you cut the tax rate by eliminating and repealing the loopholes.

Mr. Chairman, tax reform is not just about money. Restoring fairness to the Tax Code would bolster people's sense of security, of being in control of their own lives, while at the same time having a Government that is sensitive to their needs.

So, tax reform is about dignity and hope as well as money. It is a call to return to the values of our first leaders. That is why it

cannot be dismissed without simultaneously diminishing our heritage.

Tax reform, and I believe the fair tax, is a bridge between a past we are proud of and a future we are unsure about. It is a decision about our values and about the kind of country that we want to be.

Notwithstanding the social and economic importance, there is already tremendous opposition to tax reform, and it is going to get worse. You will find—as you already are beginning to see on television sets and in newspaper and magazine ads—groups telling the American people what they are going to lose: this loophole, that deduction. But they will never tell the American people what they are going to gain, which is a lower tax rate over time, which means that as they earn more, they can keep more.

In fact, if you look at the activity in Washington since the Treasury released its proposal in December, you have seen the emergence of a new coalition. Maybe it doesn't have a K-Street address yet, but it is there. That is the coalition for high marginal tax rates: People who don't care if the tax rate is 70 percent or 80 percent or 90 percent as long as they keep their exclusion or their deduction in the code. No wonder the special interests like the tax system, Mr. Chairman. The beneficiaries have done pretty well. It is the fastest-growing Government program.

In 1967 tax preferences were worth $37 billion—that's what the value of all loopholes were. Last year it was $370 billion and still growing.

Now, as you all know, no one argues to keep or expand a loophole by admitting that it is a subsidy; they prefer to call it "an incentive." Well, "subsidies" or "incentives"—working Americans who pay higher rates in order to give those subsidies or incentives have another name for them, and it is called "a ripoff."

It takes courage to resist the special pleaders by sticking up for the general interests, but that is what tax reform is all about. We need a tax system that facilitates change and rewards innovation, not one that enshrines the status quo, subsidizes the politically powerful, and short-changes our potential for economic growth.

That is why the fair tax's fundamental proposition is that everyone, not just the privileged few, deserves a tax break and a better chance to prosper.

Mr. Chairman, over the next few months we are going to have a lot of debate—as you said, 500 witnesses. We will be able to make these speeches several times a day for the next 4 to 5 months. But whatever we do, we should know that the American people will be watching, because it is they who stand to lose or gain the most.

In closing, Mr. Chairman, if I could briefly just touch on what awaits us out on the horizon as a tempting alternative to addressing fundamental tax reform, and that is the whole concept of moving toward a so-called minimum tax.

Now, in the judgment of Chairman Rostenkowski on the House side, and I believe he is correct: "The minimum tax is just a copout." Well, why is he right? Because, if we really succeed in reforming the Tax Code, we don't need a minimum tax. A minimum tax is an admission of failure. It demonstrates not only that the system is broken but also that Congress doesn't have the guts to fix the system.

Briefly, why am I so skeptical about the minimum tax? First, none of the proposals has a truly comprehensive base. Omitting certain preferences just introduces new distortions and complications, and casts serious doubts on the bills' claims to tax economic income.

Second, the corporate minimum tax affects firms in different ways, depending on whether they are separately owned or part of a conglomerate.

Third, layering yet another minimum tax on top of the existing system, which already has three minimum taxes, just compounds complexity and further complicates investment decisions.

Fourth, the minimum tax is simply inefficient, because it dilutes the existing subsidies in the tax law. Either these subsidies are worthwhile, in which case they should be allowed in full, or they are a waste of resources, in which case they should be repealed.

A minimum tax is a clumsy, inefficient way of cutting back on the value of subsidies. It is an admission both that the existing tax law doesn't work and that Congress isn't willing to bite the bullet and fix it.

Fifth, the minimum tax only addresses part of the problem troubling the American people—namely, that some rich individuals and profitable corporations aren't paying their fair share.

But a minimum tax holds out no hope to the hardworking men and women who see their tax system taking an ever bigger bite out of their paycheckes. Nor does it make the system any simpler; indeed, it complicates it.

Finally, I cannot understand why proponents of the minimum tax think the American people will be impressed by their proposal to tax millionaires at 15 cents on a dollar. The single taxpayer making $15,000 today, with no itemized deductions, now pays a 20-percent marginal rate. A hardworking couple raising kids on $30,000 a year pays a marginal rate of 25 percent. It is unlikely that people in these circumstances will be impressed to know that a millionaire or a corporation earning billions in profits will pay a top rate of 15 percent under a minimum tax.

So, Mr. Chairman, these are exciting times. The committee is beginning an important process. And if we are serious about making sure everyone pays their fair share, then we will really enact major tax reform legislation this year.

I thank the Chairman.

The Chairman. Thank you.

Congressman Gephardt?

[Senator Bradley's written testimony follows:]

TESTIMONY OF SENATOR BILL BRADLEY
BEFORE SENATE FINANCE COMMITTEE
THURSDAY, MAY 9, 1985

Mr. Chairman, members of the Committee, I am truly pleased to be here today as an advocate for tax fairness. At the outset, I want to commend the Committee for getting the ball rolling on fundamental tax reform.

I share President Reagan's optimism that 1985 will be the year for much lower tax rates, far fewer loopholes, and a fair deal for every American who works, earns, and saves. This hearing today is further evidence that there is indeed broad-based, bipartisan support for tax reform. I look forward to working with the Committee and my House and Senate colleagues to make tax reform a reality this year.

There will be plenty of naysayers and cynics who will dismiss what I have just said as wishful thinking. But there's good reason for optimism. Congressmen from both parties have endorsed specific tax reform bills. The Treasury has come forward with a detailed plan of its own and is about to unveil legislative proposals for making the tax code fairer, simpler and more efficient. The President has already endorsed the basic principles of tax reform. And he has made a public commitment to lowering tax rates this year.

As I see it, this adds up to an impressive mandate. And the special interests know it. That's why they are spending millions of dollars to deny Americans the fair, low rate tax system they need and deserve.

Naturally, I am proud that the Bradley-Gephardt Fair Tax, which Dick Gephardt and I unveiled in May of 1982, has attracted such a following. And while I'm sincerely flattered by all the imitations, this morning I want to tell you about the real thing. For I believe the Fair Tax best meets the three criteria that are essential for true tax reform.

What are these three criteria?

First, tax reform must not increase the deficit.

Second, it must retain progressivity so that the tax burden on low and middle income people is not increased.

Third, it must offer the lowest possible tax rates for the greatest number of people.

A tax reform bill that embodies these principles will clearly serve the general interest in giving Americans a fairer, simpler tax system with much lower rates and far fewer loopholes.

That, in a nutshell, is what the Fair Tax is all about--lower rates and fewer loopholes. Two years ago our bill set a new standard for tax policy. It showed that tax reform is not a code word for big government, "soaking the rich," or foreclosing on the middle-income homeowner.

Instead, the Fair Tax is a realistic, concrete plan to achieve a tax system that is significantly fairer and simpler than the crazy-quilt structure we all labor under today. The Fair Tax shows that tax reform can:

--raise the same, or even somewhat more revenue as the present tax system, but with much lower rates and far fewer loopholes;

--keep the same degree of progressivity as the present system, but ensure that people with equal incomes pay about equal tax;

--accomplish both these goals while preserving the most widely used and non-abused deductions, like mortgage interest, child care, and retirement income;

--help reduce the deficit by raising over $30 billion in its third year and by improving the efficiency of the economy.

This one bill combines:

--lower rates, which means more money and greater security for all those who work and earn;

--fewer brackets, which means relief from inflation and a tax break for working couples;

--fewer loopholes, which means everybody gets a simpler, fairer system, with less cheating and more productive investment;

--bigger standard deductions and personal exemptions, which means relief for young people, poor people and the elderly struggling to get by on fixed incomes;

--the key itemized deductions, which means a double benefit for middle class taxpayers who have invested in their community and who deserve a measure of certainty in a time of change.

Let me say it again. The fundamental proposition of the Fair Tax is indeed fairness. It simply isn't fair to burden tens of millions of taxpayers with needlessly high rates so that the narrow special interests can enjoy their favorite loopholes. That's the choice: lower rates versus loopholes. The people want the low rates while the special interests want the loopholes.

What the Fair Tax does is to close most of the loopholes and to use the revenue to pay for general rate cuts. Under Bradley-Gephardt, 4 out of 5 taxpayers would pay no more than 14% in tax. No one's tax would exceed 30%, compared with 50% under current law. The combination of cutting tax rates and eliminating loopholes leaves most taxpayers better off. In the first year of the Fair Tax, 70% of the taxpayers pay the same or less tax and 30% pay more. In the long run (years 2, 3, 4, 5, and so on), everyone will be better off because lower rates mean that as you earn more you keep more.

The same principle applies to corporations. The Bradley-Gephardt bill shows that the corporate tax can be reformed along the lines of the individual income tax, with a lower rate and fewer loopholes. By repealing many of the subsidies in the existing corporate tax, we eliminate economic distortions that stifle incentives and retard growth.

In particular, by scaling back on the grossly inefficient ACRS depreciation system, we will be able to get rid of most of the most frequently abused tax shelters that squander scarce capital and enrich a few special interests.

But tax reform is not just about money. Restoring fairness to the tax code would bolster people's sense of security, of being in control over their own lives while at the same time having a government that is sensitive to their needs.

So tax reform is also about dignity and hope. It is a call to return to the values of our first leaders. That is why it can't be dismissed without simultaneously diminishing our heritage. Tax reform--the Fair Tax--is a bridge between a past we're proud of and a future about which we are unsure. It's a decision about values and about the kind of country we want to be.

Notwithstanding its social and economic importance, there is already tremendous opposition to tax reform. And it will get worse. The special interests--the firms and the individuals who are using loopholes to avoid paying their fair share--will try and intimidate people, threatening them with what they'll lose without ever telling them that they'll get lower tax rates in exchange.

The special interests don't want lower rates. Because of the loopholes, they're paying zero now. And they want to keep it that way. You've all been visited by lobbyists for what I call "The Coalition for High Marginal Tax Rates." They represent special interests whose ideal is a world of 70, 80 or 90% tax rates with full deductibility of their "thing," be it oil wells, office equipment, races horses, avocados or shopping centers. The catch, of course, is that they use the loopholes to shelter their big incomes from taxes. But Mr. and Mrs. Average American are stuck with the high rates and they pay through the nose.

No wonder the special interests like the tax system the way it is. They are the beneficiaries of the fastest growing government subsidy program in existence. In 1967, tax preferences were worth a mere $37 billion. Today they cost $400 billion. But as you all know, no one who argues to keep or expand a loophole ever admits it's a subsidy--they prefer to call it an "incentive." Subsidies or incentives, working Americans who pay for them have another name--"rip-offs."

It takes courage to resist the special pleaders by sticking up for the general interest. But that's what integrity is all about. It takes vision, too, a firm sense that embracing change is the key to America's future. We need a tax system that facilitates change and rewards innovation, not one that enshrines the status quo, subsidizes the politically powerful, and shortchanges our potential for economic growth. That's why the Fair Tax's fundamental

proposition is that everyone, not just the privileged few, deserves a tax break and a better chance to prosper.

Mr. Chairman, the next few months will be an exciting time. It will be a time for choice. Do we stand boldly on the side of fairness, of change, of growth? Or do we stand on the sidelines, trading favors at the margin where "them that has gets? "Whatever we do, we should know that the American people will be watching, because it is they who stand to gain - or lose - the most.

In closing, I would just like to touch on the minimum tax and its role in the context of fundamental tax reform. In my judgment, Chairman Rostenkowski got it just right when he said "the minimum tax is a cop out." Why is he right? Because if we really succeed in reforming the tax code, we won't need a minimum tax. A minimum tax is an admission of failure. It demonstrates not only that the system "is broke" but also that Congress doesn't have the guts to fix it!

Why am I so skeptical about a minimum tax? For several reasons:

First, none of the current proposals has a truly comprehensive base. Omitting certain preferences just introduces new distortions and complications and casts serious doubts on the bills' claims to tax economic income.

Second, a corporate minimum tax affects firms in different ways, depending on whether they are separately owned or part of a conglomerate. I predict that adopting a new

corporate minimum tax will just encourage the mergers, acquisitions and consolidations that have already generated so muchg Congressional concern.

Third, layering yet another minimum tax on top of the existing system - which already has 3 minimum taxes - just compounds complexity and further complicates investment decisions.

Fourth, a minimum tax is simply inefficient because it dilutes the existing subsidies in the tax law. Either these subsidies are worthwhile, in which case they should be allowed in full, or they are a waste of resources, in which case they should be repealed. A minimum tax is a clumsy, inefficient way of cutting back on the value of subsidies. It's an admission both that the existing tax law doesn't work and that Congress isn't willing to bite the bullet and fix it.

Fifth, a minimum tax only addresses part of what is troubling the American people, namely that some rich individuals and profitable corporations aren't paying their fair share. But a minimum tax holds out no hope to the hard working men and women who see the tax system taking an ever bigger bite out of their paychecks. Nor does it offer relief to successful, highly taxed businesses that are now paying more than their fair share of the corporate tax.

So unlike the Fair Tax, a minimum tax is not a formula for growth and fairness. Nor will it enhance our economy's

capacity to take risks, to adapt to change, and to meet competition. On the contrary, it's the old fashioned zero sum approach to tax legislation.

Fifth, I cannot understand why the proponents of a minimum tax think the American people will be impressed by a proposal to make millionaires pay 15 cents on the dollar. A single taxpayer making $15,000 with no itemized deductions now pays a 20% marginal rate and a hard working couple raising two kids on $30,000 a year is now paying a marginal rate of 25%. It is unliekly that people in these circumstances will be impressed to know that a millionaire or a corporation earning billions in profits would pay a top rate of 15% under a minimum tax.

Finally, let me remind the Committee that we already have 3 minimum taxes in the law. They obviously don't work and there's no evidence that a new minimum tax will be any more effective.

If we're serious about making sure everyone pays their fair share, we'll enact real tax reform legislation like the Fair Tax. If we reform the system, we won't need a minimum tax. This Committee has a pivotal role in ensuring that we make the right choice. I am confident we will succeed in giving the American people the fair, simple tax system they need and deserve.

STATEMENT OF HON. RICHARD A. GEPHARDT, U.S. REPRESENTATIVE FROM THE STATE OF MISSOURI

Mr. GEPHARDT. Thank you, Mr. Chairman, and thank you, members of the committee, for allowing us to be here today and to have this important hearing. I commend your committee for holding these hearings so early in the process, and I look forward to working with you on the House side as we try to develop a comprehensive tax reform proposal in 1985.

I think Bill has well set out the basic arguments for our bill and for tax reform in general. I think it really is a very simple, basic choice about what kind of a tax system we want to have in this country. Do we want to have a tax system that has an eroded base and a lot of rates, and high rates, in order to bring in the revenue that we need to run the government? Or do we want to have a simpler tax, a fairer tax, that has a restored base and has fewer rates and lower rates than the system we have today? It is that simple a choice that we are making in this regard.

Some people have asked me: "Well, do you think the Tax Code is not to be used to focus economic and/or social behavior?" And I think that is a legitimate question to ask. I don't reject using the Tax Code to try to give incentives to get certain things to happen. I think, clearly, we have done that through the history of the Code, and we will probably continue to do that. I think it is a question of degrees. How much will we erode the base? How often will we erode the base? In what cases will we erode the base in order to try to direct economic or social behavior?

As Bill well pointed out, I think we simply have gone too far, too fast. We now have $370 billion worth of tax preferences in order to get people to do different things that we think they ought to do, that are good for society. I simply think that is too much; it is the biggest program that we have in the Government. I don't need to tell anyone on the committee the continuing pressure that we have to use the Tax Code to get things to happen in our society. It has increased tenfold in the last 10 or 15 years. As he said, in the late sixties we had $37 billion worth of tax preferences; now we are at $370 billion, and on our way to even higher figures in the future. As a result, we have to have 14 brackets, we have a top rate of 50 percent, and we have most Americans paying at rates that are probably higher than they should be. And we have the bad situation of Americans looking at the Tax Code and realizing that if they try to earn more money they are going to be driven into higher brackets.

So I think it is time to take stock, to back up, to begin to look at where we are, what our history has been, and say can't we get back to a simpler and fairer situation? No one or practically no one, is seriously suggesting that we throw all of the incentives out, that we take all of the preferences out and go to a single rate. Most of us are saying let's get back to where we were 20-25 years ago, let's move some of the preferences out, let's try to bring rates down, let's get rid of the number of brackets we have and see if we can't come up with a simpler, fairer Code.

I think Bill well treated this question of a minimum tax. I think it is a very legitimate question. We did not put a minimum tax in

our bill. I think you can consider a minimum tax, but I think that if it becomes a substitute for basic tax reform, it would fail to do the things that really need to be done.

If you do substantial basic tax reform, you certainly lessen the need for a significant minimum tax. If we don't do tax reform, then obviously we need a minimum tax; but a strong minimum tax is both complicating and, I think, really calls into question what you are trying to do with the Code to begin with. On the one hand you give the preferences to get people to do things, and then in effect you take all or most of them away, saying that we have created so many of them that now people are escaping taxation. So now we have to try to walk back up the path we just walked down. I don't think that makes a lot of sense.

For the purpose of fully stating the record, let me again simply state what our bill does: On the individual side we include a flat 14-percent tax rate for more than 70 percent of taxpayers. This would include individuals earning less than $25,000 a year and couples earning $40,000 a year. For those earning higher incomes, the bill provides for a progressive tax—and I think it is very important that we retain a progressive tax code—with rates of 26 and 30 percent.

We eliminate many deductions. The ones that we retain, including home mortgage interest, State and local income and real property taxes, charitable deductions, and medical expenses beyond a certain threshhold, would be worth the same to most taxpayers—14 percent in tax reductions for each dollar we spend, regardless of income level. Thus, as the marginal tax rate increases you don't have people scampering around to find deductions to reduce their taxable income. Decisions would be made more solely on economic not tax bases.

Again, on the corporate side the bill provides for a flat corporate tax rate of 30 percent.

In addition to several other changes, it provides for a new depreciation plan that simplifies the current system and applies it to a wide range of industries.

Perhaps most important is the removal of the vast portion of the tax underbrush that has favored tax investments in many areas that are inefficient and unproductive.

Since the adoption of the code in 1917, it has burgeoned from 17 pages to more than 2,000. Along with the regulations and various other ancillary material, the code and its supporting documents amount to more than 10,000 pages, more than 33 feet of shelf space. We have so riddled the code with preferences, exceptions, and deductions that I don't think the tax system makes tax sense or economic sense to most people in the country.

In conclusion, let me say that I have no illusions about the difficulty of enacting basic tax reform. Like you, I have in the past years watched the big, ever-growing, tax bills that we have passed. We all know the difficulty both in our committees and on the floor of trying to explain even to ourselves or our colleagues changes that we were trying to make. This is the most substantial change that has been asked in the code in many, many years, and it will be very difficult to explain it both to ourselves and our colleagues,

and to the public. It is going to take time; you can't do this overnight.

In the House, Chairman Rostenkowski has said we will have 2 months of hearings this summer on basic tax reform. You are having your hearings now, and I'm sure you will have a lot of hearings. I suppose we will try to move a bill sometime this fall. It will be a very hard process to go through, but I think it is an important one to go through. It is going to take a lot of time on our part. We are going to have to spend a lot of time talking with constituents and constituency groups. We are going to have to listen to the people who legitimately want to come and complain that they don't want their preference taken out of the code and therefore they question the whole idea of tax reform.

I think there is one very simple idea that we all have to keep in mind, and focus on with our constituents, and that is that in this tax reform exercise, unlike some in the past, there is a tradeoff, and the tradeoff is: If you are willing to give up part or all of your tax preference to restore the base, we can bring tax rates down. And if we can get all of us to look at that tradeoff and to be sure we understand what that tradeoff does to each of us and to each of the groups involved, I think the debate will be a lot healthier, and one that, I hope, will result in an overall tax reform proposal.

Again, I deeply appreciate you having these hearings, and I look forward to being able to respond to your questions.

[Representative Gephardt's written testimony follows:]

Testimony of
Representative Richard A. Gephardt (D-Mo)
before the
Senate Finance Committee
Thursday, May 9, 1985

Mr. Chairman, I want to commend you for holding these hearings. I believe they demonstrate the momentum that has been building behind tax reform. Your willingness to hold these hearings gives me real hope that we will be able to enact a comprehensive tax reform package this year.

The Fair Tax Act, which Senator Bradley and I first introduced in 1982, seeks to reform the tax code by broadening the tax base and concurrently lowering the tax rates. The bill broadens the tax base by including many items that are presently excluded or sheltered from the income tax. The bill, by decreasing tax rates increases economic incentives and reduces economic distortions.

The Fair Tax Act addresses the complexity of both the individual and corporate income taxes. On the individual side, the bill includes a flat 14% tax rate for more than 70% of taxpayers. This would include individuals earning less than $25,000 a year and couples earning $40,000 a year. For those earning higher incomes, the bill provides for a progressive tax with rates of 26% and 30%. The bill also eliminates most deductions. The ones we retain, including home mortgage interest, state and local income and property taxes, charitable contributions and medical expenses beyond a certain threshold, would be worth the same to most taxpayers -- 14% in tax reductions for each dollar spent -- regardless of income level. Thus, as the marginal tax rate increases, you don't have people scampering around to find deductions to reduce their taxable income. Decisions will be made solely on an economic, not tax, basis.

On the corporate side, the bill provides for a flat corporate tax rate of 30%. In addition to several other changes, it provides for a new depreciation plan that simplifies the current system and applies it to a wider range of industries. Perhaps most important is the removal of the worst portion of the tax underbrush that has favored investments in many areas that are inefficient and unproductive.

There are several things the Fair Tax Act doesn't do. It wasn't designed to raise any more money than the current system. It doesn't redistribute the tax burden among various income classes nor does it disturb the existing ratio between business and personal taxation. It will provide a tax cut for most taxpayers (approximately 70%) at the expense of those who currently are most sophisticated in taking advantage of our tax code.

Since the adoption of the tax code in 1916, it has burgeoned from 17 pages to more than 2000. Along with the regulations and various other ancillary material, the code and its supporting documents amount to more than 10,000 pages -- more than 33 feet of shelf space! We have so riddled the code with preferences, exceptions, and deductions, that the tax system doesn't make economic sense or tax sense anymore. Through the years the code has become a system that makes citizens distrust one another and their government. When that point is reached, you have to begin to question whether you've got the kind of system you want.

The tax code, while built on a sound foundation, is a sad structure that needs to be demolished -- we need to reform the tax code upon its sound foundation. The system is beginning to crumble under its own weight. When people ask us to address their problems by simply grafting on yet another new tax preference, they fail to recognize that they're actually worsening our general situation. Consider our efforts to create a level playing field for business in recent years. First we tried to smooth out disparities among various profitable businesses. Then we went a step further by giving tax benefits to businesses that weren't profitable. It is an endless process. With the Fair Tax, we reverse course and simply begin with a flat field, instead of adding still more cumbersome mechanical devices to jack up sections of the field that are already hovering well off the ground.

Whenever I try to come up with a logical explanation of our current tax system, I find myself turning, not surprisingly, to a journalist, George Orwell, and his analysis of a system where all were equal, but some were a bit more equal than others. So it is with our tax system. All are equal in that we use the same forms and obey the same laws. But some are more equal because they have expert tax counsel, or capital gains or new storm windows.

Real tax reform and the simplification of the tax code will be difficult. But it's hard to envision a time or a circumstance more conducive to reform than now. We have major proposals coming from both sides of the aisle and a reelected President who has expressed strong interest in reform. This year, 1985 is the year to take the giant and necessary steps to revamp the antiquated tax code.

Some contemporary proposals for reform are being called proposals for a "minimum tax." The idea is simple: Every individual with a good income, every corporation showing a profit, should shoulder some of the cost of pursuing our national goals -- regardless of the tax preferences they may be able to claim.

I couldn't agree with this idea more wholeheartedly.

That's why the minimum tax is so close to the heart of the Fair Tax bill. By eliminating or reducing the tax preferences, we not only simplify the tax code, we also cut away the dense underbrush in which tax avoiders now conceal their income. The Fair Tax would lower tax rates, but in doing so it would also make those rates apply equally. We want a fair rate of tax, and we want it fairly applied.

My only concern is that in achieving the one, we might sacrifice the other. That is to say, if we settle for just a minimum tax, will we still go on to create a fair set of rates and a simpler tax code overall? Or might some of the momentum we have today be dissipated?

The American people have lost faith in the tax code and have come to view it as unfair. If we can restore faith in the way the government collects taxes, the public's faith in their government and its programs may be restored as well. As elected officials, we are keenly aware that the people's faith in us is at stake as well. Tax reform will be difficult for all of us; but it is something we must not shrink from if we are to seek to serve the greater interests of the country.

The CHAIRMAN. Let me ask both of you a question. One of the criticisms of your bill is that it lacks indexing, and soon everyone will be in the 30-percent bracket. Do you want to respond to that?

Senator BRADLEY. Yes; it is not indexed. We made the decision in part because we are reducing brackets from 14 to 3; so the prospect of bracket creep as we have known it in the last 15 years would be much less.

We also are dramatically increasing the standard deduction and the exemption, so that we eliminate the need certainly in the next couple of years for indexing.

And then, of course, we recognized that the Finance Committee and the Ways and Means Committee might indeed like to provide tax cuts every couple of years for citizens.

It was on those grounds that we decided to eliminate the indexing. Now, none of these points is theological in nature. It is possible that in the course of a bill and in a negotiation that you might want to address the indexing question. As I point out in the statement, we end up with about $30 billion more in revenues, so we have some negotiating room that still allows us to meet the administration's apparent criteria of having revenue neutrality.

The CHAIRMAN. Congressman?

Mr. GEPHARDT. One other point I would add is that one of the reasons we decided not to index the rates was that, when you make the decision to index part of the code, you really have to ask about indexing other parts of the code. And I think that a total indexing approach is not a valid approach.

Now, you can distinguish between rate indexing and indexing, say, of the interest deduction, which the Treasury-I plan does. There are obviously different aspects to each of these decisions. But I think we felt that if you start walking down that road you create a logical inference that you should do it everywhere, and I am not sure that we want to have indexing of all parts of the code; I think it is very, very complicating. And I even question the theoretical assumptions in some parts of the code on which it is based.

But again, as Bill said, I think none of this is theological. And I would add one other point: Some people have said, "Well, you've got your bill. Would you agree to anything else? Are there parts that you would be willing to change?" I am sure that people will be asking the President in a week or two if he would put up with any changes.

I think that is clear that all of us are striving to lay out a road map for what we think would be a better code. None of us has a corner on truth or a corner on knowledge. We did our best. Three years ago we put together a bill. We sat down and went through all of the parts of it. We made decisions as we went along. The Treasury Department in putting together their bill did that. Bob Kasten and Jack Kemp did that. Many on the committee here have put together good tax reform proposals, and you have made your decisions.

The decision we make, if we make one, for a final tax reform proposal is going to be a congressional decision, a societal decision. We are going to come together in the House, you are going to do it in the Senate, we are going to get our best heads together in the committees, we are going to make our decision, we are going to go on

the floor. The whole Congress is going to make this decision. And when it is finished—if it is finished, and I hope it is, and that at some point we get a bill—it is going to be the best considered judgment of the majority of both Houses, and then we are going to go to the President with our product. And we are going to make a decision together on what we want in each part of the decisionmaking process.

The CHAIRMAN. Let me make sure I understand how your deductions work. They are deductions only against the 14-percent rate, is that correct?

Mr. GEPHARDT. That is correct.

Now, there is an exception. If you talk about the exemption of municipal bond interest, that would be one where it would apply up and down. But in almost all of the other cases it applies only to the first bracket; so it is worth 14 cents on the dollar.

The CHAIRMAN. Now let me again ask your thinking as to why some deductions and credits are kept and some are not. Going through your State and local taxes—and if I am wrong in the way I state it, correct me—you continue to allow the deduction for State and local property taxes.

Mr. GEPHARDT. Real property taxes.

The CHAIRMAN. Real property, yes. You do not allow the deduction for State and local personal property taxes. You do allow the deduction for State and local income taxes. You don't allow the deduction of State and local sales taxes. What is the thinking that comes to that conclusion? Why isn't income tax on a higher priority than a sales tax?

Mr. GEPHARDT. I would answer in this way: I think, as always, when you make these decisions, as you well know, it is a tension between base and rates. And if you leave everything in or too much in, then you can't bring the rate down. We started with some rate goals: we wanted a 14-percent rate for four out of five Americans; we wanted a top rate of 30 percent; we wanted a corporate rate that matched our top individual rate.

Having set those parameters, you limit what you can leave in and what you must take out. Obviously that played a part in our decision. If you left all of the state and local taxes in as deductible, then you affected your final outcome on rates. So we had to make some judgments within those taxes.

Our judgment was that State and local income taxes and real property taxes were the most significant taxes at the State and local level; that was first. And I still think they are.

Second, they are the most traditional forms of taxation; they really started before you got to a personal property tax or to a sales tax. And we felt that if there is an argument against double taxation, and I think there is some merit in that argument, we ought to recognize those taxes that had been most traditionally used for State and local efforts. So we tried to carve those out and make those continue to be deductible, to the extent we make things deductible, and to throw the others out.

Senator BRADLEY. If I could follow up on that, Mr. Chairman, particularly on the rate structure: You have a basic choice here, and the choice is, how high do you want the tax rates? If you allow the deduction against all taxpayers' highest marginal rate, you

would have to raise that marginal rate in order not to distort so-called distributional neutrality.

So we believe that we wanted to preserve the deductibility of certain items, in part because of what we call critical political mass, in other words, what we think is needed to move it, and we also wanted to preserve a certain distributional neutrality. And that meant that we not only wanted to get the tax rate down as low as possible for middle income people—and under ours, people making up to $40,000 per couple are taxed only at a 14-percent rate, as opposed to 32 percent under current law—but we also wanted to preserve those deductions that middle income people use most often and that are most important to them. So, by doing the basic tax surtax route, we were able to really lower the tax rate for the greatest number of people, plus we were able to preserve the top rate at 30 percent as opposed to a much higher rate.

Mr. GEPHARDT. Mr. Chairman, could I make just one additional point on State and local income tax? Some have said that because we limit the deduction for State and local income and real property taxes to the first bracket or 14 cents on the dollar, we have really lessened that deduction. That is true.

The other part of this, though, that we need to remember is that, if you broaden the base while lowering the rate, because 32 of the 50 States are piggy-backed, you are going to give a windfall in terms of State income taxes, to the extent a State has an income tax.

So, just through basic tax reform there is going to be an increase in revenue, to the extent States are piggy-backed, to State governments. And it would appear to me that State governments, if they were concerned about the partial or the total loss, if that is the decision of Congress, of State and local income taxes, could easily rebate to the individual taxpayers by lowering State income tax rates, so that the net outcome for the local and State income taxpayer would not be different.

The Chairman. Senator Mitchell?

Senator MITCHELL. Thank you, Mr. Chairman.

First, I would like to commend both Senator Bradley and Congressman Gephardt for their leadership in this area. They truly have been pioneers. If imitation is in fact the sincerest form of flattery, you should be very much flattered because, as you know, there have been many other plans offered after you blazed the trail, and indeed we are getting them now at the rate of about one a month. And I expect that before we are through there will be many, many others. But you certainly led the way, for which I think all the American people are in your debt.

I would like to ask Senator Bradley first, you have said on several occasions that your plan is good for middle-income taxpayers. I wonder if you would explain why you believe that is so?

Senator BRADLEY. Sure. I alluded to it in the answer to the previous question; but, what our plan says to the middle-income family, for example, is that if you earn a little bit more, you are going to keep more money in your pocket. For example, the rate at $40,000 under current law is 32 percent. The rate under ours would be 14 percent. So, on each additional dollar that the family would earn, they would be paying 14 cents instead of 32 cents.

Now, what does that mean? I think what that says to people is: If you go out there, and you work hard, and you believe everything that has been said about hard work, and you earn a little more, you are going to be able to better protect your family from the uncertainties of life. You are going to be able to attain a little more security and know that you have the self-reliance to do that. And I think that is a very powerful message for middle-income people across this country.

In addition to that, as I alluded to earlier, we do keep the deductions that most middle-income people use. So I think the Fair Tax says something powerful about work and savings, certainly, but it also says something powerful about—not to be too grandiose—economic freedom, that the individual citizen will have the money in his or her pocket to do with it what they choose. And this means that if you need some extra money to send your kids to college, and your spouse takes a job, you can calculate how much income you are going to have after tax, and you will know that if you are at a $25,000 level you can get a $5,000 raise or a $10,000 or $15,000 raise without being pushed into a higher tax bracket and without having to pay a higher tax rate. I think that is a powerful message that reinforces a lot of the values that we believe are very important in this country.

Senator MITCHELL. I would like to ask you both to comment, and perhaps you first, Congressman Gephardt. In his opening remarks, Senator Bradley commented at some length on the intense and mounting opposition to any tax reform plan by those who believe that the benefits are outweighed by the disadvantages to themselves, and I think in many cases sincerely to the society at large. Do you think a tax reform plan—yours or another, or some combination of them—can in fact be passed, in this year, in this Congress?

Mr. GEPHARDT. I think it can, and I think that for two reasons: One, the desire for tax reform is deeply felt by a great majority of the American people. They may have different things in mind. Some people think it means, "I am going to pay less tax." Some people may think that it is going to be a fairer system. Some people want to get rid of the complication.

I talked to a schoolteacher in Portland a couple of weeks ago. He said that he had filled out his forms, his short form until 3 years ago. He had made repeated mistakes, and he had been called on them by the IRS. He finally decided he had to go to H&R Block. He said that he now pays $200 a year to have H&R Block fill out his short form. He said it's a sorry day in America when an individual American has to pay $200 a year to figure out what his dues are to be a part of this society.

To others it just means that the code is too complicated for good economics. So there are a variety of reasons. But the intense public opinion is there: People want this to happen. And I think that is the main reason that it can happen in 1985.

Second, I believe you have a unique situation here, where there are a lot of different people in the Congress—some on the Democratic side, some on the Republican side—who are putting forward proposals. You have the President putting forward a proposal. It seems to me we have the chance to put together a congressional

proposal, which is the only way this is going to work, that really will embrace the tenets of basic tax reform.

So for those two reasons, I think we have a unique opportunity in 1985 to get this done, and that we can get it done.

Senator BRADLEY. I would simply add that when people understand the choice, I think you will see a very different atmosphere in the Congress. I argue that people suffer a little bit now from what I call "loophole illusion."

In the early seventies there was a concept called money illusion, which was: If you got a big raise, you thought you were in pretty good shape, until you found out at the end of the year that the raise didn't cover all your expenses, because inflation ate away the raise. That was called money illusion.

I think that today, we are suffering from loophole illusion, the belief that if you have your loophole you will be better off in the long run. As soon as it dawns on people that they are much better off in the long run with a fairer system, where equal incomes pay equal tax, and a system in which they are going to be paying a much lower rate and keeping that extra income themselves, then I think you will see a very strong movement toward tax reform.

I might also say that the way the process works the more groups these are out there and the more frequently they are commenting, the more chaotic their collective objections to tax reform. At that stage, if the President chooses, he can be a very clear voice about the benefits of lower tax rates. In addition to the two points that Dick made which I think are valid, that is another reason why 1985 is the year and the opportunity of a generation.

Senator MITCHELL. Mr. Chairman, I apologize for going over time; it is hard to stay in it when the Senator is the witness.

The CHAIRMAN. I deducted it from the time you have saved.

Senator MITCHELL. All right. [Laughter.]

The CHAIRMAN. Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman, and thank you, Congressman Gephardt and our colleague from the committee Senator Bradley.

The question I wanted to get clarified in my mind is: You have a single tax rate of 30 percent on corporations, but do you change a great many of the tax preferences that now exist in the code?

Mr. GEPHARDT. Well, we do, because we take out all the deductions that would apply to individuals or corporations except the ones we name. But I would quickly point out that the most important deductions for corporations are ordinary and necessary business expenses. We basically don't change that. The second issue is depreciation. We do change the present system of depreciation. Our depreciation scheme is less generous than present-day depreciation, but we think it is very adequate and generous, and we think it is simpler to use than the present system.

Senator SYMMS. Let us say a company builds an apartment house. What would the depreciation be on the apartment house?

Mr. GEPHARDT. We have gone from the present 18 years back to 40 years, but we have a system of accounting that allows a faster write off in the early years. It is not as generous as today's depreciation.

Senator SYMMS. But the corporation, assuming it is in a profit, instead of paying a 46-percent rate is down to a 30-percent rate. So do you think the corporation is going to be paying more taxes or less?

Mr. GEPHARDT. Well, it obviously would depend on their total situation. Let me say this to you: A lot of people in the real estate industry some of the biggest people and corporations in the industry, who build buildings and apartment houses and so on, say to me that they can live with our proposal and live well. They think that we got too generous, we funneled too much money too quickly into real estate from the 1981 act, and they feel that what we outline in our bill is most reasonable.

The one thing that I have heard them complain about is the indexing of interest that appeared in the Treasury I bill. That really has a lot of them deeply concerned because it would complicate their ability to raise sufficient capital. But they don't seem to be as troubled by our change in depreciation.

Senator SYMMS. Do any of the economists—and I am sure you have consulted with a lot of them—have any comments on what effect your proposal would have on rents for middle income families or lower income families?

Senator BRADLEY. There have not been a couple of studies, but they come to different conclusions. Of course, there is also a lot of blatantly self-interested analysis that has to be read with a healthy close of skepticism. I think that ultimately rents are determined by the market, and I think, that over time the rents in any kind of housing would adjust in accordance with the laws of supply and demand. And the industry would be less tax driven and more responsive to market forces.

If I could go back to your earlier point, and I really think that this is something that the committee and the Congress will have to focus on, the key question is, what is the total impact on corporate America?

You will find—no question—that if any one of these major reforms goes through, some corporations are going to pay more tax. Those are the corporations that are now not paying any tax. But you will find many other corporations having a significant tax reduction. You find a lot of innovative high-technology companies that are paying a 42 to 44 percent effective tax rate. Under our bill, those would drop to 30 percent.

I think you have to keep the total picture in mind.

We had a group of corporate leaders who came in about 3 weeks ago and endorsed tax reform generally. I made the point that some businesses represented by these leaders will pay more tax and some will pay less, but they are all for reform. The press asked, "Well, who will pay more?" Three people raised their hands. One was a major real estate developer in Texas, another was a high-tech entrepreneur out in Silicon Valley. And each of them when asked, "Well, why are you for tax reform if you end up paying more taxes?" made the following two points: One, "Look, we believe if we had a more efficient economy, and tax reform will make the economy more efficient, that would create greater stability, and we would all be better off with a more stable economy."

The other person said, "Look, yeah, we might pay more the first year; but with the lower tax rate, over time, since we think we are pretty good at what we do, we will end up paying less tax, and therefore we are for reform."

Senator SYMMS. Thank you, Mr. Chairman.

You gentlemen do very well.

The CHAIRMAN. I might just add one thing before I call on Senator Chafee. I had a large real estate developer talk with me who supports the reform, and I asked him why. He said, "Because ours are built."

Senator BRADLEY. How old was he, Mr. Chairman?

[Laughter.]

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Well, I want to also congratulate Senator Bradley and Congressman Gephardt. They were before the crowd on this, and I think they deserve a lot of credit for that.

I think you gave some eloquent testimony on your views on the minimum tax. Let me say as the author or coauthor of a minimum tax with Senator Moynihan, our attitude was not to have that permanent but to use that as a stopgap until we do get tax reform.

Second, what are the individual deductions you retain? I notice in Congressman Gephardt's testimony he talks of home mortgage interest, State and local income and property taxes, charitable contributions, medical expenses. What others? What about the IRA's?

Senator BRADLEY. We keep mortgage interest, charitable contributions, State income and property tax deductions, medical expenses and child care deductions. We also keep IRA's, KEOGH's, tax-exempt status for general obligation bonds, Social Security benefits, veterans benefits.

We eliminate most of the other provisions in the Code.

Senator CHAFEE. I see.

Mr. GEPHARDT. We eliminated about 40.

Senator CHAFEE. What do you do about the inside build-up of life insurance by corporations?

Senator BRADLEY. We tax that.

Senator CHAFEE. You tax that.

Now, as you pointed out, obviously there are social purposes in the code, and Congressman Gephardt's testimony said, "Where do you draw the line?"

What do you do, for example, on tax-free fringe benefits that is traditional for pensions, life insurance, and so forth.

Mr. GEPHARDT. We allow the present treatment of pensions, essentially. We do affect the people at the higher income levels under present law a bit, but essentially the present treatment is still allowed, for example, on life insurance, group insurance. We do take away the exemption for emoloyer-paid health care premiums, but we allow a deduction above 10 percent of AGI on medical, which is the catastrophic situation.

Again, in that area and in the other areas, when we went through our process of putting together the bill, we faced that constant tension between what you want your rate to be and what vou can leave in.

Senator CHAFEE. Have you had any studies on what would be the effect on the charitable deductions of keeping it at 14 percent? Do you have any concept of what the effect of that would be on big charitable giving? I don't expect it would affect small charitable giving.

Senator BRADLEY. If I could, Senator Chafee, on big charitable giving, or I should say those who receive big——

Senator CHAFEE. Big giving to charity.

Senator BRADLEY. Right, big giving to charity. Those who receive the big gifts seem to think that the most important provision is the deduction for donations of appreciated property. As you know, Treasury I simply allows for the cost plus inflation, and——

Senator CHAFEE. Well, let's not spend any time on that.

Senator BRADLEY. So what we do is, we keep appreciated property, but we allow the deduction only against the 14-percent rate.

Now, your specific question is: What is the effect of lowering the rate on taxable income to 14 percent?

If you look at the studies that have been done—and there have been recent studies by Rudney, Ortney, Coltfelter, and others, the one thing that they can agree on is that they don't have an accurate way to measure the impact of tax reform on charitable contributions; although, as Bruce Davie argues in his article in Tax Notes: You had a dramatic drop in tax rates in 1981, from 70 to 50, and there was no substantial decline in charitable contributions.

So, the short answer to your question is: There is no consensus based on empirical evidence that tax reform will destroy the incentive to give charity. But, as you know, there will be plenty of people who will assert that. My guess is that the committee will listen to them with interest.

Senator CHAFEE. Well, I also would point out that there was giving to charity long before the Internal Revenue Code came along. So I think your point is well taken.

I would just like to touch briefly on the historic preservation tax credit. You do away with those. Do you have any transition rules, or have you not gotten that far?

Mr. GEPHARDT. We have not concocted a transition rule. We felt that would be done by the committees.

Senator CHAFEE. I just wanted to say that this is a tough one, because clearly there is a cause and effect with these credits. We have seen the effect probably more dramatically in that particular tax credit than we have in most tax credits.

The CHAIRMAN. Which one did you say, John?

Senator CHAFEE. Historic preservation. You can see the results of the credit. The question is: What will the result be if we do away with it? It troubles me.

Mr. GEPHARDT. I have had a great deal of trouble with that as well. I am from St. Louis. We have one of the oldest housing stocks in the country. Historic credits have done a lot of good. The question is, how long do we keep it in, and what is the theory we are operating under? We have done a lot of rehabilitation in St. Louis. At some point I think we have to consider taking it out; maybe this is the time.

Senator CHAFEE. Fine.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Matsunaga?

Senator MATSUNAGA. Thank you, Mr. Chairman.

Can you tell me what consideration, if any, your proposal has given to the democratic if not American principle of taxation on the basis of the ability to pay?

Senator BRADLEY. Yes, I'll try that, and I'm sure Dick will want to follow on.

One of the absolute criteria that we established was that the relative tax burden on income classes not be changed from what it is under current law. So we retain the progressivity of the present income tax system. We do that in part by raising the threshold that someone can earn before they get to any taxable income. Under our bill, for example, a family with two kids would have to earn over $11,200 before they had any taxable income. And we try to keep the lowest possible rate for as many, the glenfest number of people—income up to $40,000 a couple is taxed only at 14 percent.

But then we have two progressive surtaxes of 12 and 16 percent, which gets the marginal rates to 26 and 30.

The combination of the high threshold, the progressive surtaxes, and the retention of deductions for middle income people keeps the progressivity of the income tax system as we know it today.

Senator MATSUNAGA. As compared to the present svstem, what change if any in the percentage of amounts paid by those better able to pay than those less able to pay?

Senator BRADLEY. There is no change. We raise the same revenue from each aggregate income group as current law.

Senator MATSUNAGA. Yes.

Mr. GEPHARDT. Obviously, when you do tax reform, you change within each income category who is paying the tax, to some extent. Some will pay more, some will pay less. So the ultimate effect of doing this kind of tax reform is to enact a broad minimum tax as a result of all that you have done. There would be an increase in taxation on some people in every bracket, and certainly people in the highest bracket who are now essentially escaping taxation.

Senator BRADLEY. You see, we believe that one of the real problems with the system is not only the fact that it is so complicated but also the fact that the average rate on the millionaire last year, people who likely made more than a million, was about 17 percent, and the average rate on the middle income person was double that. So, we believe that is important to try to rectify that disparity and to do it by making the whole system fair.

My view is that people's reaction is that the system is unfair. Yes, they are angry about the abuses they read about in the newspaper every other week. But you never correct those abuses by simply closing one little loophole; you have to do systemic reform.

Senator MATSUNAGA. One of the biggest complaints from charitable institutions when we proposed to reduce the maximum taxable bracket from 70 to 50 was this: They said—and Senator Bradley was there at the hearings—"When you lowered the top bracket from 90 to 70 percent, we lost one-third of our contributions. And when you propose to reduce is now from 70 to 50, we will lose another third of our contributions."

Now I note that you will reduce yours to 30. Well, what will that do to charitable organizations?

Senator BRADLEY. Well, I don't recall exactly which organizations were asserting that; but the point is, if one was asserting it, that means someone else is getting more contributions, because the overall level did not significantly decline. So, I think the important point is that there is no real substantial evidence that you would see a dramatic decline.

We are not here to carry this portfolio too hard, though, let me tell you. [Laughter.]

Senator MATSUNAGA. My time is up.

The CHAIRMAN. Are there any other questions for these two witnesses?

[No response.]

The Chairman. If not, let me say again to both of you, you are very, very excellent witnesses. It doesn't surprise me at all, but your statements are well thought out. I appreciate you taking the time to come. Thank you.

Senator BRADLEY. Mr. Chairman, if I could, just so the record could be complete, maybe we could put that article by Bruce Davie in the record.

The CHAIRMAN. Is this the one on charitable contributions?

Senator BRADLEY. Yes.

The CHAIRMAN. We will put it in along with Marty Feldstein and Charles Clotfelter's articles on charitable contributions.

[The articles follows:]

THE INCOME TAX AND CHARITABLE CONTRIBUTIONS: PART I—AGGREGATE AND DISTRIBUTIONAL EFFECTS

MARTIN FELDSTEIN*

"If charity cost nothing, the world would be full of philanthropists."

— quoted in Leo Rosten's Treasury of Jewish Quotations

ABSTRACT

Because charitable contributions are deductible in defining taxable income, the "price" of such gifts is less than the price of other consumption. This paper assesses the importance of this price effect by using a pooled time series of cross sections of charitable contributions by income class for the period 1948 through 1968 to estimate price and income elasticities. Alternative estimates of the price elasticity are generally greater than one and the cluster around 1.1. These results indicate that charitable contributions are increased substantially by the current provision of deductibility.

PRIVATE nonprofit organizations play a central role in the provision of a wide variety of public services. Higher education, research, health care, the visual and performing arts, welfare services, and community activities rely heavily on voluntary institutions. In 1972, American families contibuted $17 billion to support these philanthropic and religious organizations.[1] The volume and distribution of these contributions is affected by the personal income tax and by the special provisions with respect to the deduction of charitable contributions. The current paper provides new estimates of the effects of the income tax provisions on individual philanthropy.[2]

The income tax affects charitable contributions in two important ways. First, by decreasing disposable income the tax reduces all forms of philanthropy. Since effective average rates are higher for upper income families, the reduction in disposable income falls more heavily on education, health, the arts and other nonreligious charities.[3] Second, because contributions are deductible in determining taxable income, the tax makes the "price" of charitable contributions less than the price of other goods and services. More specifically, an individual with a marginal tax rate of 40 per cent can give $100 to charity by forgoing $60 of personal consumption; for him the net price of charitable contributions is only 0.6.[4] In 1970, approximately 90 per cent of individual contributions were itemized as tax return deductions; these contributions had an average net price

*Professor of Economics, Harvard University. I am grateful to Charles Clotfelter and Daniel Frisch for assistance with this research and to W. Andrews, M. Bailey, J. Brittain, R. Freeman, R. Musgrave, J. Pechman, J. Schwartz, H. Smith, S. Surrey, and W. Vickrey for useful discussions and comments on a previous draft. This paper is part of a larger study of the effects of fiscal policies on capital formation and income distribution.

[1] American Association of Fund-Raising Counsel (1973). Philanthropic organizations also received $2.7 billion from bequests, $0.8 billion from corporations and $2.2 billion from foundations.

[2] Earlier studies of this subject were reported by Kahn (1970), Schwartz (1972), Taussig (1967), and Vickrey (1962); see section 5 below.

[3] The most recent information on the distribution of contributions among types of charities in each income class is the Internal Revenue Service analysis of 1962 tax returns (Internal Revenue Service, 1965). In 1962, religious organizations received 61.0 per cent of total itemized contributions but only 31.3 per cent of the contributions of individuals with adjusted gross income over $25,000 and only 19.6 per cent of the individuals with adjusted gross income over $50,000. (Internal Revenue Service, 1962, p. 6).

[4] The implied price is lower and more complicated to compute when the contribution includes a gift of appreciated property; this is considered in sections 1 and 3 below.

of less than 0.74.[5] This price effect increases charitable contributions. Moreover, since marginal rates are higher in upper income groups, the induced increase in giving favors the same charities that lose most by the reduction of disposable income. The net impact of the tax on the total amount and distribution of contributions depends on the relative magnitudes of the income and price effects.

There are today a number of widely discussed proposals for changing the tax treatment of charitable contributions. These include the complete abolition of the deduction, the substitution of a system of tax credits, the introduction of a "floor" with a deduction or credit only for contributions above that level, and various modifications of the treatment of appreciated assets.[6] The issues raised by these proposals are complex and wide ranging. They involve the appropriate definition of income, problems of horizontal and vertical equity, the desirability of decentralized finance of public and quasi-public services, and the effects of the tax provisions on the level of contributions.[7] The current paper will not attempt to deal with this full range of analytic and philosophical questions. The focus is rather on the empirical issue of the income and price effects of the tax structure. With estimates of these effects it will be possible to evaluate the "efficiency" of the current tax treatment as a stimulus to charitable deductions, i.e., the amount of additional contributions received by charities per dollar of potential tax revenue forgone by the Treasury.[8] The price and income elasticities can also be used to assess the potential impact of any proposed tax change. Section 4 presents estimates of the effect that abolishing the charitable deduction would have on the distribution of charitable contributions, of tax payments and of net disposable income (income net of tax and charitable contributions).

The results presented in this paper indicate that charitable contributions are increased substantially by the current provision of deductibility. The alternative estimates of the price elasticity are generally greater than one and cluster around 1.1. This implies that the "efficiency" of the deduction as a stimulant to giving exceeds 100 per cent; the deduction increases the amount received by charities by more than it reduces the revenue collected by the Treasury. These results stand in sharp contrast to Taussig's (1967) widely cited conclusion that the price

[5] Total individual giving in 1970 was $14.4 billion (American Association of Fund-Raising Counsel, 1973) while itemized deductions for contributions were $12.9 billion (Internal Revenue Service, 1972). The average net price was calculated by applying the marginal tax rate for joint returns to the contributions in each taxable income class. Since gifts of appreciated assets and state income taxes are ignored, this overstates the average net price of charitable contributions.

[6] See, for example, the discussions in Brannon (1973), Goode (1964), Kahn (1960), McDaniel (1972a, 1972b), Pechman (1971), Rabin (1966), Surrey (1972), Weidenbaum (1973) and U.S. Treasury Department (1969). These proposals were considered in the 1969 Hearings of the House Ways and Means Committee and of the Senate Finance Committee, and in the 1973 Hearings of the House Ways and Means Committee.

[7] For thoughtful discussions of these issues, see the references cited in the previous footnote and papers by Andrews (1972), Bittker (1972), Vickrey (1962, 1973) and White (1959). None of these authors gives attention to the question of whether the charitable deduction is justified as a method of offsetting the income effect of the tax on charitable contributions. It is interesting in this context that the income tax law was amended to allow the charitable deduction in 1917 when tax rates were sharply increased to finance the war; the introduction of the deduction was intended to prevent the higher tax rates from substantially reducing philanthropy.

[8] This measure of the "efficiency" of the current tax rules has been central to much of the previous analysis. Taussig's (1967) widely cited study concluded that the "efficiency" was very low, approximately 5 per cent. Several writers have argued that such low efficiency in stimulating contributions is a sufficient reason to abolish the current deduction or to modify it very substantially; see, e.g., McDaniel (1972a), Taussig (1967) and Surrey (1972). In contrast, others have argued that the efficiency is irrelevant because the charitable deduction should not be regarded as a "tax subsidy" but as a necessary correction in the calculation of an appropriate taxable income; see Andrews (1972) and Bittker (1972).

effect is very small, that charities receive only five cents for each dollar of revenue forgone by the Treasury. They are closer to the estimates presented by Schwartz (1970) but indicate somewhat greater sensitivity to the deduction at all income levels. Possible reasons for these differences are discussed in section 5.

Since the present study is based on a richer sample of the same type of data used by Taussig and Schwartz, I believe that the current results should be given more weight in evaluating the evidence. Moreover, since this study was completed, Charles Clotfelter, Amy Taylor and I have used a variety of other microeconomic data sources to estimate the basic price and income elasticities of charitable giving. The results, presented in Feldstein and Clotfelter (1974) and Feldstein and Taylor (1975), are remarkably similar to those described in the current paper.

There are a number of problems that cannot be investigated adequately with the data used in this or previous studies. These limitations are discussed in Section 5. Most of these shortcomings can be overcome with the microeconomic data that I have studied with Clotfelter and Taylor. It is reassuring that explicitly incorporating such things as the individual's wealth or demographic characteristics does not alter any of the conclusions of the current study.

1. *Data and Specifications*

Every second year the Internal Revenue Service publishes the value of itemized charitable contributions in each adjusted gross income (AGI) class.[9] The current study uses a time series of these cross-sections for the even years from 1948 through 1968. With 17 AGI classes,[10] the sample has 187 potential aggregate observations. By pooling data in this way it is possible to obtain substantial variation in real income and in the price of charitable contributions without the collinearity between these variables that exists within a single year.

It is inevitable in empirical research that the available data does not correspond exactly to the relevant theoretical quantities. Fortunately, the current data provides some scope for testing the sensitivity of the results to alternative measures of particular variables. When this is possible, the different estimates generally support the same conclusions. The substantial variation in prices and incomes imply that any bias that might be introduced by certain stochastic measurement problems (e.g., errors or transitory components in measured income) will be small. There are however other potentially serious problems, e.g., the lack of data on wealth and the aggregation of charitable contributions to all donees, that cannot be remedied until new sources of data are examined.

A variety of functional specifications relating charitable giving (G) to income (Y) and price (P) have been investigated. The most basic specification is the constant elasticity equation:

$$\log G_{it} = \alpha + \beta \log Y_{it} + \gamma \log P_{it} + \epsilon_{it}. \quad (1)$$

The subscript i denotes the AGI class and the subscript t denotes the year. The variable ϵ_{it} is an unobservable residual that reflects random disturbances and specification errors. The more general specifications described below allow the income and price elasticities to vary with the levels of income and price.

The variable G_{it} is the average charitable contribution per return in AGI class i and year t. The contribution is defined as the *gross* amount given by the individual to the charity and not as the *net* cost of that contribution to the individual. These amounts include the value of donated assets as well as gifts of money. Contributions are measured in

[9] See, for example, Internal Revenue Service (1968), p. 65.

[10] The AGI class limits are $1000; $2000; $3000; $4000; $5000; $6000; $7000; $8000; $9000; $10,000; $15,000; $20,000; $50,000; $100,000; $500,000; $1,000,000; $1,000,000+.

constant 1967 dollars by deflating with the consumer price index. Of course, only those taxpayers with itemized returns are included in the sample.[11]

An ideal measure of economic income cannot be obtained from the data provided in the tax return. Nontaxable income, accrued capital gains, and accounting losses make the reported values different from the appropriate theoretical variable. Two alternative definitions of disposable income have been used in this study: (1) adjusted gross income minus the tax that would have been paid if no contributions had been made, and (2) taxable income plus charitable contributions minus the tax that would have been paid if no contributions had been made.[12] The value of Y_{it} is the average real income per return in AGI class i and year t, measured in constant 1967 dollars. In some of the equations reported in section 3, this real income variable is supplemented or replaced by a measure of relative income; the specific definition of relative income will be described at that point. Analyzing data that is grouped by income class reduces the potential bias that arises from using current income instead of permanent income. If the income groups correctly classify individuals by permanent income, the parameter estimates are consistent even if individual current incomes differ from permanent income.[13] More generally, the very great variance in permanent incomes in the population of taxpayers relative to the average transitory variance implies that the bias from this source would be quite small.

The price variable (P) measures the individual's opportunity cost per dollar of charitable contribution in terms of forgone personal consumption or saving. An individual whose marginal tax rate is m can choose between (1) contributing one dollar to charity and (2) having $1-m$ dollars for additional personal consumption or saving. We therefore define that individual's price of charitable giving by $P = 1-m$. In practice, P_{it} is measured by using the marginal tax rate for a joint return with the average taxable income in class i and year t.[14]

Contributions of appreciated assets create a special problem for measuring the price of charitable giving. When an asset is given away, its full value can be deducted from the donor's taxable income but there is no constructive realization and therefore no tax to be paid by the donor on the capital gain.[15] The opportunity cost (price) of a gift that is given in the form of an appreciated asset therefore depends not only on the individuals' marginal tax rate but also

[11] In 1970, 90 per cent of all individual contributions were deducted on itemized returns; see footnote 5 above. While only 47.7 per cent of all taxpayers itemized their deductions, 91.4 per cent of taxpayers with AGI over $15,000 itemized their deductions.

[12] Subtracting the tax that would have been paid if no contributions had been made is preferable to subtracting actual taxes paid because the latter depends on the contributions themselves. The results presented in an earlier version of this paper (Harvard Institute of Economic Research Discussion Paper No. 337, January 1974) were based on adjusted gross income minus tax actually paid.

[13] It is well known that the use of current income instead of permanent income is an example of the classical errors in variables problem. This use of grouped data is a generalization of Wald's (1940) method of instrumental variable estimation.

[14] The marginal rate is actually calculated for taxable income plus charitable contributions, i.e., it is the marginal rate for the first dollar of contribution. With the current aggregate data, the choice between the first dollar price and the last dollar price has little effect. When appropriate, the marginal rate is modified for the existence of a tax surcharge. To allow for the effect of using the alternative tax computation, average taxable income in class i and year t is adjusted by subtracting one-half of the net capital gains reported on returns using the alternative tax. No attempt is made to allow for income averaging. A more exact method of evaluating P_{it} would be to (1) cross-clarify returns in each AGI class according to taxable income class; (2) find the marginal tax rate at the average taxable income in each subclass; and (3) find the weighted average of these for the AGI class using the distribution of total taxable income among the taxable income subclasses. This calculation was performed for 1968, the only year for which such data are available. Fortunately, the correlation between these P_{it}'s and the more easily calculated P_{it}'s described in the text is very high: $r = 0.99$.

[15] Since income of the donee organization is not taxable, it can sell the appreciated asset without paying any tax.

on the fraction of the asset's value that is accrued capital gain and on the alternative disposition of the asset. An example will clarify the way in which these variables determine the relevant price. Consider an individual whose marginal rate is 40 per cent and who contemplates donating an asset that is now worth $100 and for which he originally paid $30. If he gives the asset away he reduces his taxable income by $100; he therefore reduces his tax liability by $40 and thus increases his after tax income by $40. If he instead sells the asset, he pays a tax of $14 (half of his marginal rate on the capital gain of $70) and increases his after tax income by $86. For this individual, the opportunity cost of the $100 contribution is therefore $46 of foregone consumption. If the price is defined in terms of forgone consumption, the price of the gift is P = 0.46. This price clearly depends on the ratio of the asset's original cost (or basis) to its current value: an original cost of $1 implies P = 0.40 while an original cost of $100 implies P = 0.60. More generally, $P = 1 - mc\,(1-B/A) - m$ where A is the current value of the asset, B is its basis or original cost, m is the marginal tax rate on income and mc is the marginal tax rate on capital gains; during the sample period, mc = 0.5m with a maximum of 0.25.

The preceding calculation defined the opportunity cost of a donated asset in terms of forgone immediate consumption, i.e., it assumed that if the asset were not given away it would be sold in the current year. The price is higher and the calculation is more complex if the opportunity cost is defined in terms of forgone saving or wealth, i.e., if it is assumed that the asset would not otherwise be sold in the current year. The individual in the preceding example could retain the $100 asset or he could give it away and add the $40 tax saving to his wealth. Viewed in this way, his opportunity cost price is 0.60, the same as for contributions of money; moreover, this price is independent of the ratio of the capital gain to the present asset value. Since the individual who does not give away the asset also has a future tax liability, this tends to overstate the opportunity cost of a prospective contribution. However, by postponing the sale of the asset the individual can substantially lower the present value of the tax and, if the asset is never sold during the individual's lifetime, the capital gains tax liability is completely eliminated when the asset passes at death.[16]

It has not been possible to reflect the full complexity of appreciated asset gifts in the current study. Although the fraction of total contributions in the form of assets is known for each income class, there is no reliable data on the ratio of original cost to current value for such assets.[17] There is of course no information on what would have been done with the assets if they had not been contributed. In practice, I have used the information about the share of contributions in the form of appreciated assets and examined the implications of different assumptions about the ratio of basis to current value. These results are reported in section 3.

Before 1952, the deduction of charitable contributions was limited to no more than 15 per cent of the taxpayer's adjusted gross income. An individual who contributed more than 15 per cent of his income would face a price of one for marginal giving.[18] The limit was in-

[16] If the individual gives the asset away to another person, there is no constructive realization and the tax is postponed until the recipient sells the asset. The original owner can also consume most of the value of the asset by using it as collateral to borrow funds which he then consumes, thus enjoying the consumption while postponing or avoiding the capital gains tax. See Bailey (1969) for evidence that a very large share of accrued capital gains are never subject to capital gains taxation.

[17] The Treasury published "estimates" of the ratio of cost to current value for charitable contributions deducted in tax returns for 1962. (Internal Revenue Service, 1962, p. 8). These "estimates" imply that most assets are worth exactly their original cost. It is clear that this data is without value. I inquired directly at the Treasury and was advised that these "estimates" were meaningless and should be disregarded.

[18] The special provision for individuals whose contributions plus taxes exceeded 90 per cent of their taxable income in eight out of the last ten

creased to 20 per cent in 1952 and then to 30 per cent in 1954. Since a significant number of high income taxpayers had previously been contributing at the maximum rate, these increases constituted reductions in their price of charitable contributions. The effective magnitude of these reductions depends on the number of taxpayers at each income level who had previously given the maximum and on the extent to which the effect of the limit was reduced by the carryover provision. The impact of these limits is examined in section 3.

Table 1 presents the values of G_{it}, Y_{it} and P_{it} for each AGI class for 1968, the most recent year in the sample.[19] The income variable is adjusted gross income minus taxes. The price variable is based on gifts of money. For each income class, the table also shows the ratio of contributions to net income after tax and the cumulative proportion of total contributions.

Preliminary analysis indicated that the information in the current data is not sufficient for studying the behavior of taxpayers in the lowest and highest income groups. Low income individuals who file itemized returns are an unusual group with a disproportionately high fraction of aged persons and those with substantial negative transitory income. At the other extreme, adjusted gross income is an inadequate measure of economic income and no information is available about wealth. Moreover, the special features of private foundations and charitable trust make it extremely difficult to measure price for the highest income groups. The analysis of this paper focuses on AGI classes with mean real net income between $4000 and $100,000.[20] Table 1 shows that in 1968 this group accounted for 91 per cent of all itemized contributions. Although the parameter estimates for this group are very similar to the results obtained when all 187 observations are used, restricting the sample provides more reliable estimates. Additional information on contributions of nonitemizers and on the income and assets of the wealthy is required to extend the current analysis to cover all individuals in a satisfactory way.

Each of the observations represents a different number of individual tax returns. However, the published values of total contributions and incomes are themselves estimates prepared by the Internal Revenue Service on the basis of a very large stratified sample of returns. The number of returns in each AGI class is selected to yield approximately the same sampling error in the resulting estimates. This suggests that relatively little gain in the efficiency of the parameter estimates could be obtained by using a weighted generalized least squares estimator.[21] The procedure of giving equal weight to all of the observations is therefore used in this study.

2. *The Basic Estimates*

For the estimates of this section, income (Y) is defined as the average real value per return of adjusted gross income minus taxes. The price of giving (P) is the opportunity cost of contributions of money, one minus the marginal rate of tax. Equation 2 presents the estimated equation with constant income and price elasticities:[22]

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years affected very few individuals and does not alter the basic point of this paragraph.

[19] Although data for 1970 is now available, a variety of changes in the tax treatment of charitable contributions in the Tax Reform Act of 1969 suggests that it would be unwise to pool 1970 with previous years without additional study.

[20] More specifically, an observation is included in the sample if the mean of AGI minus tax in 1967 dollars in that class and year is between $4000 and $100,000. This reduces the sample from 187 potential observations to 117 observations.

[21] The weighting would be complicated not only by the IRS sampling procedure but also by the fact that a log-linear specification is used. Only for returns with incomes below $6000 did the relative error of the estimate of giving exceed 4 per cent; above $10,000 the relative error was less than 1 per cent. See Internal Revenue Service, 1968, pp. 65 and 189.

[22] An earlier version of this paper (Harvard Institute of Economic Research Discussion Paper No. 337, January 1974) reported a price elasticity of -1.18 with P_{it} defined in terms of actual taxable income and Y_{it} defined as AGI minus actual

TABLE 1

CHARITABLE CONTRIBUTIONS BY INCOME CLASS, 1968

AGI Class ($1000)	Average Contribution (G)	Average Income* (Y)	Average Price** (P)	Contribution Ratio (G/Y)	Cumulative Percentage of Contribution
0-1	$ 90	$ 724	.86	.124	0.1
1-2	109	1,570	.86	.069	0.8
2-3	145	2,439	.85	.059	2.3
3-4	164	3,329	.84	.049	4.6
4-5	178	4,216	.83	.042	7.5
5-6	183	5,507	.83	.033	11.2
6-7	207	5,968	.82	.035	15.6
7-8	220	6,825	.82	.032	20.4
8-9	232	7,694	.80	.030	26.0
9-10	258	8,533	.80	.030	31.7
10-15	305	10,710	.80	.028	55.6
15-20	428	14,542	.76	.029	67.7
20-50	761	22,541	.66	.033	82.9
50-100	2,267	45,745	.43	.050	88.9
100-500	9,695	96,689	.31	.100	95.6
500-1000	68,749	366,594	.25	.188	97.2
1000+	287,651	1,111,360	.25	.259	100.0

*Income is adjusted gross income minus tax paid.
**Price is based on gifts of money; P = 1 - m.
All amounts in 1968 dollars

$$\ln G_{it} = -1.922 + 0.822 \ln Y_{it} - 1.238 \ln P_{it} \quad (0.032) \quad (0.101)$$

$$\$4000 < \text{Mean Real Net AGI} < \$100{,}000$$

$$\bar{R}^2 = 0.98 \quad SSR = 1.772 \quad N = 117 \qquad (2)$$

The income elasticity is 0.822 and the price elasticity is −1.238. The equation provides a very good explanation of the overall variation in the volume of contributions ($\bar{R}^2 = 0.98$). Despite the potential problem of collinearity between income and price, the standard errors of the estimated elasticities are quite small.

Several modifications of this basic specification are presented below. In general, these have elasticities of approximately the same size as equation 2. Before studying the additional estimates, it is therefore useful to consider the implications of these elasticity values. Since a full analysis is presented in section 4, only some individual examples are now examined. In 1968, taxpayers with adjusted gross income between $10,000 and $15,000 contributed an average of $305.[23] The average marginal rate for these taxpayers was 0.20, implying an average price of 0.80. If contributions were not deductible, the price would rise by 25 per cent (from 0.80 to 1.00) and therefore, given a price elasticity of −1.24 contributions would fall by about 24 per cent or $74.[24] The amount is not implausible nor contrary to the common assertion that the deductibility of contributions is likely to have only a "small" effect on the amount given by lower income households.[25]

tax. The income elasticity was very similar (0.828). The sum of squared residuals was lower (1.730) but this reflects the spurious simultaneity of giving and the explanatory variables.

[23] These amounts are all in 1968 dollars.

[24] More exactly, $(1.25)^{-1.24} = 0.76$ implying that contributions are decreased by 24 per cent or $73.72. These calculations assume that an additional small change is made in tax rates to leave total taxes paid (and therefore net income) unchanged.

[25] This point has been stressed by Aaron (1972), Kahn (1960), McDaniel (1972a) and Vickrey (1962) among others. In 1968, 55 per cent of the total itemized deduction for charitable gifts was on returns with AGI below $15,000 and 31 per cent on returns with AGI below $10,000. Although the implied effect on the average indi-

For taxpayers with adjusted gross incomes between $50,000 and $100,000, the average contribution was $2,267 and the average price of giving was 0.43. Most of the difference in average contributions between the $10,000 and $15,000 class and the $50,000 to $100,000 class is obviously due to the difference in income rather than the difference in price; lowering the price from 0.80 to 0.43 for the $10,000 to $15,000 AGI class would only raise their average giving to $659 per taxpayer. The low average price in the $50,000 to $100,000 class implies that the deductibility of charitable contributions has a substantially greater effect than in the lower AGI class. Eliminating the deductibility of contributions would raise the price by 133 per cent (from 0.43 to 1.00) and would therefore lower contributions by about 65 per cent or $1473.[26]

During the 20-year sample period, there have been a great many gradual changes in economic and social factors that may influence the rate of charitable giving. The rise in college attendance, the increase in government activities in areas previously dominated by philanthropic organizations, the changing role of religion and the growth of the suburbs are all likely to have different and countervailing impacts. To test whether these trends had any *net* effect on giving or on the previously estimated elasticities, an exponential time trend is added to the specification of equation 2:

$$\ln G_{it} = \underset{(0.023)}{-1.649 + 0.806 \ln Y_{it}} \underset{(0.071)}{- 1.272 \ln P_{it}} \underset{(0.001)}{+ -0.014 \text{ TIME}} \qquad (3)$$

$$\$4000 < \text{Mean Real Net AGI} < \$100{,}000$$

$$\bar{R}^2 = 0.99$$
$$\text{SSR} = 0.88$$
$$N = 117$$

The coefficient of the time variable implies a moderate negative trend in relative contributions; the income and price elasticities are essentially unchanged from equation 2.[27]

Although constant income and price elasticities are convenient simplifications, the log-linear form is an unnecessary restriction on the analysis. As a more general specification, the price elasticity is allowed to vary linearly with the level of the price and the income elasticity is allowed to vary linearly with the logarithm of the level of income. The estimated equation

$$\ln G_{it} = 3.647 + \underset{(0.702)}{(-0.404} \underset{(0.039)}{+ 0.069 \ln Y_{it}) \ln Y_{it}} \underset{(0.220)\ (0.578)}{-(0.981 + 0.545 P_{it}) \ln P_{it}}, \qquad (4)$$

$$\$4000 < \text{Mean Real Net AGI} < \$100{,}000$$

$$\bar{R}^2 = 0.98$$
$$\text{SSR} = 1.709$$
$$N = 117$$

shows that the income elasticity increases with the level of income but that the variation in the price elasticity is not significantly different from zero.[28] If the income elasticity is allowed to vary but a constant price elasticity is assumed, the estimated price elasticity is −0.910 (S.E., 0.207), slightly lower than the result in the basic specification of equation 2. But such differences must be regarded with great caution. It is always difficult to assess second order properties with any precision. It is therefore interesting to note that two quite different specifications with varying income and

vidual gift is small, the aggregate effect is substantial. I return to this in section 4.

[26]The price increases imply $(2.33)^{-1.34} = 0.35$ or a 65 per cent decrease in charitable giving.

[27]This may partly reflect the fact that the *relative* income of this group is declining slightly with time; when the entire sample is used, the coefficient of TIME is much smaller, positive and insignificant.

[28]The *logarithm* of the level of income is used so that the variable is not dominated by the top income classes. However, very similar results are obtained when the income elasticity is allowed to vary linearly with income and the price elasticity with price. The income elasticity is an increasing function while the variation in the price elasticity is not significant. There is no statistical basis for choosing between the equations; SSR = 1.707.

price-elasticities also support the basic result of equation 2.

The first alternative method of generalizing the constant price elasticity specification is to reestimate the basic equation with different price elasticities in different parts of the price range. For this purpose, the observations are grouped into those for which price exceeds 0.70, those for which price is between 0.30 and 0.70, and those for which price is less than 0.30. Estimating an equation with three price elasticities is equivalent to estimating three separate equations for the three groups of observations while constraining the income coefficients and constant term to be the same; i.e., three separate price variables appear in the equation but only one is non-zero for each observation. The estimates in equation 5 indicate a slightly lower price elasticity for the high of the price range (low income individuals) and a slightly higher price elasticity for the high end of the price range,

$$\ln G_{it} = 6.752 + (-1.121 + 0.109 \cdot \ln Y_{it}) \ln Y_{it} \quad (0.731) \quad (0.041)$$
$$- 0.865 \ln PL3_{it} \quad (0.206)$$
$$- 0.775 \ln P37_{it} \quad (0.217)$$
$$- 1.173 \ln PG7_{it} \quad (0.268) \quad (5)$$

$$\$4000 < \text{Mean Real Net AGI} < \$100{,}000$$
$$\bar{R}^2 = 0.98$$
$$SSR = 1.616$$
$$N = 117$$

where ln PL3 is the logarithm of the price if the price is less than or equal to 0.30 but is zero otherwise; similarly, ln PL37 refers to the price if it is between 0.30 and 0.70 while ln PG7 is the logarithm of the price when greater than 0.70. The differences, however, are small and not significantly different from each other. The large standard errors emphasize the difficulty of assessing variations in price elasticity with this data but again show that allowing for the possibility of such variation provides no indication that the simpler specification distorts the price elasticity.

The second alternative generalization is to reestimate the basic equation separately in several income classes without any constraints on the coefficients. The limits of the income classes were defined by mean real adjusted gross income. Equation 6 reports the result with adjusted gross incomes of less than \$10,000:[29]

$$\ln G_{it} = -0.803 + 0.679 \ln Y_{it} \quad (0.060)$$
$$- 1.796 \ln P_{it} \quad (0.564) \quad (6)$$

$$\$4000 < \text{Mean Real Net AGI} < \$10{,}000$$
$$\bar{R}^2 = 0.75$$
$$SSR = 0.774$$
$$N = 64$$

The income elasticity is below the overall value and the price elasticity is above the overall value. But the relatively large standard errors show the difficulty of estimating when the variation in income and price is substantially limited. Among taxpayers with real incomes between \$10,000 and \$20,000, the price and income elasticities are very similar to the basic equation:

$$\ln G_{it} = -2.053 + 0.846 \ln Y_{it} \quad (0.225)$$
$$- 1.035 \ln P_{it} \quad (0.757) \quad (7)$$

$$\$10{,}000 < \text{Mean Real Net AGI} < \$20{,}000$$
$$\bar{R}^2 = 0.66$$
$$SSR = 0.514$$
$$N = 27$$

Because of the limited range of variation and the very small number of observations, the standard errors are again quite large. It is reassuring therefore that very similar results are obtained for the next income class, from \$20,000 to \$100,000:

$$\ln G_{it} = -2.734 + 0.906 \ln Y_{it} \quad (0.169)$$
$$- 1.132 \ln P_{it} \quad (0.250) \quad (8)$$

[29] More specifically, an income class observation is included in this subsample if the real value in 1967 dollars of the mean AGI minus tax in the class is below \$10,000.

$20,000 < Mean Real Net AGI < $100,000

$\bar{R}^2 = 0.97$
SSR = 0.355
N = 26

In spite of the small number of observations, there is sufficient independent variation in both income and price to permit estimates with relatively small standard errors. Comparing the SRR value of equation 2 with the sum of the SSR values for equations 6, 7 and 8 shows that the disaggregation does not significantly increase explanatory power; the SSR is reduced by only 0.129 and the corresponding F statistic of 1.5 is not significantly different from zero.

Only in the highest income group (taxpayers with net income above $100,000) is the price elasticity substantially lower than the basic estimate:

$$\ln G_{it} = -6.772 + 1.377 \ln Y_{it} \quad (0.063)$$
$$-0.290 \ln P_{it} \quad (0.106) \qquad (9)$$

Mean Real Net AGI > $100,000

$\bar{R}^2 = 0.97$
SSR = 1.622
N = 31

This low price elasticity is very surprising in view of the widely held opinion that the high income taxpayers are likely to be most sensitive to changes in the price of charitable giving. It is clear that this low estimate of the price elasticity is associated with an estimated income elasticity that is higher than the value obtained in other equations. For taxpayers with incomes over $100,000, the ratio of contributions to income increases rapidly as income rises and price falls; equation 9 attributes this increase primarily to the higher income rather than to the lower price. The standard error of the income elasticity in equation 9 is quite small and the standard error of the price elasticity, although large relative to the coefficient, is small enough to imply that the estimated price elasticity is very much less than the average price elasticity of equation 2. However, these formal sampling properties of the parameter estimates are misleading; problems of measurement and specification are more important potential sources of error in this equation than the random sampling variability. At these very high income levels, adjusted gross income is a less adequate measure of economic income and wealth is a more important influence on giving. The measurement of price is also more clouded by the tax treatment of gifts of appreciated assets, by the limits on deductible contributions, and by the use of trusts and other indirect methods of giving. The next section deals briefly with some of these problems but the issues cannot be fully resolved with the current data. It is for this reason that the current study has been restricted to the sample of observations under $100,000.[30]

If these difficulties are ignored and all of the 187 possible observations are used, the resulting estimates are quite similar to the basic results of equation 2:

$$\ln G_{it} = -1.784 + 0.811 \ln Y_{it} \quad (0.027)$$
$$-1.455 \ln P_{it} \quad (0.077) \qquad (10)$$

All observations
$\bar{R}^2 = 0.98$
SSR = 16.19
N = 187

At the present, however, it is best to remain agnostic about the income and price elasticities of individuals with incomes over $100,000 and under $4000.[31]

[30] After this study was complete, I was able to use the Treasury Tax Files for 1962 and 1970 to calculate the average of the individual prices in each AGI class rather than the price for the average taxable income in that class. The values agree quite closely below $100,000 but are substantially higher above $500,000. This biases down the estimated price elasticity of equation 9.

[31] After this paper was accepted for publication, Joe Pechman and John Brittain suggested adding the term $\ln Y \cdot \ln P$ to the basic equation as a further test of the varying price elasticity. This variable is significant and implies that the price elasticity is an increasing function of income; the

Each of the equations of this section has been reestimated with the alternative definition of disposable income: taxable income plus charitable contributions minus the tax that would have been paid if no contribution were made. In each equation the estimated income elasticity is lower and the price elasticity is greater than in the corresponding equation with income measured by AGI minus tax. Comparing the sums of squared residuals for the corresponding equations shows that the AGI variable (Y) explains the variation in giving substantially better than the taxable income variable (YT). For example, equation 11 should be compared with equation 2 in which the estimated price elasticity is −1.24 and the sum of squared residuals is only 1.772.

$$\ln G_{it} = 1.69 + \underset{(0.031)}{0.445} \ln YT_{it} - \underset{(0.128)}{2.044} \ln P_{it} \qquad (11)$$

$$\$4000 < \text{Mean Real Net AGI} < \$100{,}000$$

$$\bar{R}^2 = 0.95 \quad SSR = 4.354 \quad N = 117$$

Although an after tax measure of income seems more appropriate, as a further test of the robustness of the estimated price elasticity the basic specification was reestimated using real AGI (not net of tax) to measure income. The parameter estimates are similar to the original specification but the estimates of equation 2 are preferable because net AGI is a theoretically better measure of income:

$$\ln G_{it} = -1.617 + \underset{(0.030)}{0.787} \ln Y_{it} - \underset{(0.112)}{0.903} \ln P_{it} \qquad (12)$$

$$\$4000 < \text{Mean Real Net AGI} < \$100{,}000$$

$$\bar{R}^2 = 0.98 \quad SSR = 1.772 \quad N = 117$$

These alternative estimates lend some weak support to the relative high price elasticities reported in equations 1 through 9. They also suggest the possibility of substantial bias from using an inappropriate measure of income. If a broader definition of income than AGI is the true determinant of charitable giving, the use of AGI might bias the estimated price elasticity. To evaluate the likelihood that this would cause an upward bias in the absolute price elasticity, it is useful to examine the way in which the bias occurs. Let the true specification be given by:

$$\ln G = \alpha + \beta \ln I + \gamma \ln P + \epsilon \qquad (13)$$

where I is the "true" measure of income. Consider the effect of using adjusted gross income (y) as the measure of income and estimating

$$\ln G = \alpha + \beta \ln y + \gamma \ln P + u. \qquad (14)$$

The residual u in equation 12 is equivalent to $\epsilon + \beta \ln I - \beta \ln y = \epsilon + \beta \ln (I/y)$. From the usual formula for the analysis of specification bias (Theil, 1966), it follows that the expected value of the estimate of γ in equation 12 would be:

$$E(\hat{\gamma}) = \gamma + \beta E[\text{reg}\ (\ln (I/y), \ln P \mid \ln y)] \qquad (15)$$

where reg (ln (I/y), ln P | ln y) is the coefficient of ln P in the regression of ln (I/y) on ln P and ln y. If this auxiliary regression coefficient is negative, the expected value of $\hat{\gamma}$ will be less than the true value γ, i.e., the absolute value of the price elasticity will be biased upwards. The auxiliary regression

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specific point estimates imply a *positive* price elasticity for income below $8300, a price elasticity of −0.98 at $50,000 and a price elasticity of −1.36 at $100,000. Although a specification that implies a positive price elasticity is clearly unacceptable, the evidence does strongly suggest that the absolute price elasticity increases with income. Some preliminary analysis with a rich body of microeconomic data (the 1970 Treasury Tax file) supports this conclusion and indicates that the price elasticity is relatively constant and below one for low and moderate incomes but then rises rapidly with income. These results will be discussed in detail in Feldstein and Taylor (1974).

coefficient will be negative if at each level of adjusted gross income (y), those taxpayers with higher marginal tax rates (i.e., lower value of P) have higher ratios of "true" income to adjusted gross income.

It is not clear whether this is more likely than the opposite. There are two countervailing effects. First, at each level of adjusted gross income, those with the highest marginal tax rates have the greatest incentive to reduce their taxable income through such things as the holding of tax exempt bonds, home ownership and the substitution of accrued capital gains for realized income. All of these things would increase the ratio of total economic income to AGI. Such a positive association between marginal tax and the ratio of "true" income to AGI would cause an upward bias in the absolute value of the estimated price elasticity. Against this reason for an upward bias one must balance a reason for a downward bias. It follows from the definitions of AGI and taxable income that, at each level of AGI, those with the highest marginal tax rates have the least deductions for interest, taxes and charitable contributions. These smaller deductions are likely to indicate smaller amounts of "other income" not included in AGI: imputed income on residences and accrued gains on assets used to secure loans. This would imply a negative correlation at each level of AGI between the marginal tax rate and the ratio of true income to AGI. This in turn would imply that the absolute price elasticities of this section are actually biased downwards rather than upwards. Unfortunately, only when estimates have been made with more comprehensive data will it be possible to know whether the use of AGI imparts any substantial bias.

3. *Additional Specifications*

This section presents several alternative modifications of the basic model. The use of relative income instead of real absolute income is examined first. The implication of the special tax treatment of gifts of appreciated assets is then studied. Finally, the effects of the limits on deductible gifts are examined.

Relative Income. Charitable contributions support activities that produce positive externalities. A philanthropic activity generally benefits not only those who are the direct recipients of its service but also those who, like the individual donor, believe that the service should be provided. Thus, an alumnus who contributes to his college's scholarship fund benefits not only the scholarship student but also the other alumni who enjoy seeing their college support students in this way. In deciding how much to contribute, an alumnus may consider how his own income compares with the other alumni who are also potential contributors and "indirect beneficiaries." Similarly, a member of a church congregation may apply a relative "ability to pay" criterion in deciding what he believes to be his "fair share" of his church's expenses. Such considerations suggest that some measure of relative income should be added to the basic specification examined above.[32] An extreme form of this hypothesis would use relative income instead of real absolute income.

The examples of college and church donations indicate the difficulty of developing an appropriate measure of relative income. Moreover, the options are severely limited by the aggregate form of the current data. Only the most obvious possibility has been examined in this study: the ratio of donor's income (AGI minus tax) to average per capita income for that year. This is denoted YR.

Equation 16 shows that when the relative income variable is added to the basic specification, its coefficient is highly significant but the price elasticity is essentially unchanged. The result is similar

[32]Note that this reason for including relative income is quite different from Schwartz' (1970) emphasis on the relative incomes of donors and recipients.

$$\ln G_{it} = 2.882 + \underset{(0.064)}{0.199} \ln Y_{it} - \underset{(0.072)}{1.255} \ln P_{it} + \underset{(0.059)}{0.613} \ln YR_{it} \quad (16)$$

$$\$4000 < \text{Mean Real Net Income} < \$100{,}000$$

$$\bar{R}^2 = 0.99$$
$$SSR = 0.904$$
$$N = 117$$

if YR is added to the specification with varying price and income elasticities.

The more extreme assumption that contributions depend only on relative income and price does not explain the variation in contributions as well as the basic model. Equation 17 shows that substituting YR for Y slightly increases the price elasticity and reduces the sum of squared residuals from 1.772 to 0.980.

$$\ln G_{it} = 4.428 + \underset{(0.022)}{0.784} \ln YR_{it} - \underset{(0.071)}{1.329} \ln P_{it} \quad (17)$$

$$\bar{R}^2 = 0.99$$
$$SSR = 0.980$$
$$N = 117$$

Appreciated Assets. The special problems raised by gifts of appreciated assets have already been discussed. Gifts of appreciated property lower the effective price of giving. Since such gifts are more common in higher income classes,[33] the basic price series used above does not decrease rapidly enough as marginal tax rates increase. The result is likely to be an overestimate of the absolute price elasticity.

The available data severely limits the possibility of dealing adequately with this problem. There is information on the value of contributions in each AGI class that are in the form of assets but no information on the original basis of those assets or the fraction of those assets that would have been sold if they had not been given away. Separate calculations have been made using different assumptions about the ratio of appreciation to asset value. In each calculation, the ratio of appreciation to value is assumed to be the same for all taxpayers. It is further assumed that all assets that are donated would otherwise be sold, an assumption that biases downward the price associated with each ratio of appreciation to value. The resulting estimates must therefore be regarded as a very imperfect attempt to deal with gifts of appreciated assets.

Equation 18 shows the result of assuming that 50 per cent of the value of donated assets is the original basis while the remaining 50 per cent is appreciation. The estimated price elasticity (−1.11) is only slightly smaller than in the basic equation while the estimated income elasticity is unchanged.[34] Comparing the sum of squared

$$\ln G_{it} = -1.934 + \underset{(0.031)}{0.825} \ln Y_{it} - \underset{(0.094)}{1.166} \ln P50_{it} \quad (18)$$

$$\$4000 < \text{Mean Real Net AGI} < \$100{,}000$$

$$\bar{R}^2 = 0.98$$
$$SSR = 1.754$$
$$N = 117$$

residuals with that for the original specification (1.772) suggests that the current assumption is barely preferable.[35] In interpreting these results, the statement that "an average of X per cent of the value of donated assets is appreciation" should be interpreted a

[33] In 1966 the fraction of contributions in the form of assets rose from 3.8 per cent for adjusted gross incomes between $10,000 and $15,000 to 47 per cent for adjusted gross incomes over $100,000.

[34] The variable $P50_{it}$ is defined as the weighted average of $(1-m_{it})$ and $1 - m_{it} - .50mc_{it}$ where m_{it} is the marginal rate on income and mc_{it} is the marginal tax rate on capital gains; the weights are the fractions of donations in money and in assets in income class i.

[35] Comparing the sums of squared residuals is equivalent to a likelihood criterion in the context of the current specification. The assumed ratio of appreciation to asset value with the lowest sum of squared residuals yields the maximum likelihood estimator of that ratio and of the other regression parameters.

shorthand for the more correct statement that "taxpayers respond to both the actual appreciation ratio and the opportunities to postpone realization by acting as if the assets had to be realized immediately if not donated but that the appreciation ratio is only X per cent." This implies that the ratio of appreciation to value implied by the estimate will be appropriately lower than the actual (unknown) appreciation ratio of donated assets.

Alternative assumptions about the ratio of appreciation to value have only very slight effects on the estimated elasticity and the sum of squared residuals. If the ratio of appreciation to value is 0.25, the price elasticity is −1.202 and the SSR is 1.762. With an appreciation ratio of 0.75, the price elasticity is −1.128 and the SSR is 1.749. It is clear that there is too little information in the data to estimate the appreciation ratio. Fortunately, the choice of appreciation ratio does not affect the estimated price elasticity.

Deduction Limits. Raising the limit on the maximum charitable deductions increased the amount of giving by high income taxpayers. The ceiling was raised from 15 per cent of adjusted gross income to 20 per cent in 1952 and then to 30 per cent in 1954. Internal Revenue Service data show that the early limits were reached by a significant fraction of taxpayers with adjusted gross incomes over $50,000 but by almost no taxpayers with lower incomes (Kahn, 1960, p. 79). A natural way to express the effect of these changes in deduction limits is as proportional reductions in contributions by high income taxpayers in the years before 1954. In equation 19, the variable DL1 is equal to 1 for 1948 and 1950 in income brackets over $50,000 and equal to zero otherwise; DL2 is 1 for 1952 in those income brackets and zero otherwise.[36] The coefficients of these dummy variables are estimates of the proportional reductions in giving due to the limits in those years and should therefore be negative.[37]

The estimates of equation 19 imply that the limits on deductions before 1954 reduced total contributions in the specified income

$$\ln G_{it} = -1.857 + \underset{(0.034)}{0.812} \ln Y_{it} - \underset{(0.123)}{1.332} \ln P_{it} - \underset{(0.093)}{0.163} DL1 - \underset{(0.114)}{0.145} DL2 \quad (19)$$

$$\$4000 < \text{Mean Real Net AGI} < \$100{,}000$$

$$\bar{R}^2 = 0.98 \qquad SSR = 1.711 \qquad N = 117$$

groups. The income and price elasticities are essentially unchanged from equation 2.

Because the sample is restricted to observations with mean real net AGI below $100,000, equation 19 does not provide any estimate of the overall effect of the deduction limit on all high income donors. Equation 20 uses the full sample of 187 observations to obtain some very tentative values of this effect for the three high AGI groups:

$$\ln G_{it} = -1.731 + \underset{(0.027)}{0.803} \ln Y_{it} - \underset{(0.078)}{1.533} \ln P_{it} - \underset{(0.111)}{0.176} DL1 - \underset{(0.158)}{0.511} DL2 \quad (20)$$

$$\bar{R}^2 = 0.98$$

All Observations $\qquad SSR = 15.19 \qquad N = 187$

4. *Aggregate and Distributional Effects*

The current parameter estimates are clearly preliminary and may be subject to serious error. Some possible sources of bias are discussed in the next section. It is nevertheless interesting to examine what these estimates imply about the effects of the current tax treatment on

[36] Here the income bracket is defined by the *current* dollar AGI *before* tax.

[37] They will, of course, also reflect other specific factors that caused the behavior of those years to depart from the remainder of the period.

the volume and distribution of charitable contributions, tax payments and net personal income. More specifically, this section examines the effects of eliminating the deduction for charitable contributions and reducing all tax rates (on itemized returns) proportionately to keep government revenue constant. The elimination of the deduction reduces giving while the reduction in the tax rates increases giving. However, since income after tax remains unchanged while the price of giving rises, the net effect is a fall in charitable contributions.

To develop estimates of the full aggregate and distributional effects requires estimates of the income and price elasticities for all income classes. The basic method used in this section is to assume that the values obtained for incomes between $4000 and $100,000 hold for other incomes as well. Although this group contains about 90 per cent of the itemized contributions, the dangers of such an extrapolation are obvious. With this method, the calculations show that the reduction in total contributions is large, probably about 35 per cent of itemized giving and therefore about 30 per cent of all individual contributions. Since the reductions are particularly large in high income groups, religious organizations are affected relatively less than educational, cultural and other nonreligious organizations.

Table 2 presents detailed results for 1968. These illustrative predictions use the basic specification of equation 2 with constant income and price elasticities. Eliminating the deduction would raise the price of giving to 1 in all income classes. The additional tax revenues that would result are redistributed in this calculation by a proportional reduction in the effective tax rate in every income class.[38] The resulting change in contributions in each income class is then calculated from the equation:

$$\ln G'_{it} - \ln G_{it} = 0.822\,(\ln Y'_{it} - \ln Y_{it}) + 1.238 \ln P_{it} \quad (21)$$

Where G'_{it} is the predicted average contribution after the tax change and Y'_{it} is the average adjusted gross income minus the new tax on that income. Since eliminating the deduction raises the price of giving to 1, $\ln P'_{it} = 0$ and therefore does not appear in equation 21.

The average contribution in 1968 is given for broad income classes in column 3 and the corresponding predicted contribution if the deduction is eliminated appears in column 4. Total 1968 giving falls from $11.1 billion to $7.3 billion.[39] The ratios of predicted contributions to actual contributions that are presented in column 5 show that the relative reduction in giving is much greater among high income individuals than in lower income groups. While taxpayers with adjusted gross incomes of $10,000 to $15,000 would cut contributions by 24 per cent (from $305 to $233), a reduction of 75 per cent is predicted for taxpayers in the $100,000 to $500,000 class (from $9,695 to $2,380).

Eliminating the charitable deduction and returning the additional revenue by a common proportional tax reduction

[38]The new tax at each income level in 1968 is calculated as follows: (1) The additional tax revenue due to eliminating the deductible is calculated for each income class as the product of the 1968 deduction and the corresponding marginal rate. (2) The sum of these additional tax revenues is added to total 1968 tax collections. (3) The ratio of actual tax collections to the new sum is the factor by which all tax liabilities are scaled down. The value of this was 0.943 reflecting additional revenues of $3.3 billion and a 1968 total collection from itemized returns of $56.9. (4) This factor is then applied in each income class to the sum of the 1968 tax and the additional revenue from eliminating the charitable contribution deduction. All dollar amounts are in current 1968 dollars.

[39]Two things should be remembered in interpreting these numbers. First, these totals refer only to itemized giving; all individual giving in 1968 was estimated to be $12.6 billion. Second, although the reduction reflects the redistribution to taxpayers of the additional tax revenues, this has very little effect on total contributions; if the additional revenues were retained by the government, predicted giving would fall by $3.9 billion.

TABLE 2

BASIC PREDICTED EFFECTS OF ELIMINATING THE CHARITABLE DEDUCTION 1968*

AGI Class ($1000) (1)	Number of Itemized Returns (1000's) (2)	Average Charitable Contributions G_{it} (3)	G'_{it} (4)	G'_{it}/G_{it} (5)	Tax Ratio† (6)	Net Disposable Income Ratio (7)
0-5	5,328	156	126	0.810	1.076	1.005
5-10	12,233	221	172	0.778	1.000	1.007
10-15	8,731	305	233	0.764	0.982	1.009
15-20	3,132	428	307	0.718	0.982	1.012
20-50	2,232	761	460	0.605	0.988	1.017
50-100	294	2,267	816	0.360	1.002	1.032
100-500	77	9,695	2,380	0.245	1.037	1.056
500-1000	2.6	68,749	12,827	0.187	1.101	1.083
1000+	1.1	287,651	54,117	0.188	1.152	1.104
Average		$348	$238	0.657	1.0	
Total	32,030	$11,139 million	$7,316 million	. . .	. . .	. . .

Based on parameter values of equation 2. Total government revenue remains constant.
† Biased upward by the presence of nontaxable returns. See text.
Totals may not agree because of rounding.

would raise the taxes paid by high income individuals and lower the taxes paid by low income individuals. Column 6 shows the ratios of the tax payments if the deduction were eliminated and tax rates cut to maintain the actual total tax payments in 1968. Middle income individuals pay reduced taxes while those with incomes above $50,000 would pay increased taxes.[40] The differences are quite substantial. Although average taxes fall by only two per cent in the $10,000 to $15,000 class, taxes rise by 10 per cent in the class of taxpayers with incomes of $500,000 to $1,000,000.

The distributional effect of eliminating the deduction is quite different if we focus on the change in net disposable income rather than the change in tax payments. Net disposable income available for personal consumption or saving is defined as adjusted gross income minus taxes and charitable contributions. Because charitable contributions fall sharply in higher income groups, their predicted personal consumption and savings increase despite the greater taxes that they pay. Column 7 presents the ratio of predicted net disposable income to actual 1968 net disposable income. Net disposable income rises at every income level, with the increase ranging from less than two per cent for incomes under $50,000 to more than 8 per cent over $500,000.

Although the effect of eliminating the charitable deduction is of course greater if government revenues are not constrained to remain constant, the difference is quite small. Eliminating the deduction would yield an additional $3.3 billion in tax revenues in 1968.[41] If this revenue is not returned to the taxpayers through a general tax cut, total charitable contributions would fall by $3.8 billion. The gross "efficiency" of the deduction as measured by the ratio of additional contributions received by charities per dollar of potential tax revenue forgone is 1.15.

[40] These are of course only averages for each income class. The tax ratio falls below one at an AGI of $7000. Since no distinction is made between taxable and nontaxable returns, the increased taxes are overstated for the lowest income classes. Many of those returns are nontaxable and would remain so even if the charitable deduction were excluded. The amounts involved are so small that the resulting misestimate of additional revenue would have no significant effect on higher income classes.

[41] This ignores the additional revenue that would result if some of the donated appreciated assets were sold instead.

Generally similar results are obtained from calculations with other equations for charitable contributions. When gifts of appreciated assets are distinguished and an effective appreciation ratio of 0.5 is used (based on equation 18), charitable contributions in the absence of the deduction are estimated to be $7.4 billion. Finally, equation 10 (which uses the entire sample of 187 observations) implies contributions of $6.9 billion. Although there are some differences in the distributional impacts, in each case eliminating the deduction would reduce giving proportionately more in high income groups and would result in greater increases in their net disposable income than that of lower income groups.

5. *Conclusions and Caveats*

The empirical findings of this study are clear. The aggregate Internal Revenue Service data for 1948 through 1968 imply that the volume of charitable contributions is quite sensitive to the price of giving that is implied by the tax treatment. Almost all of the estimates of the price elasticity are greater than one. Eliminating the current deduction of charitable contributions would reduce total itemized giving by approximately 28 to 56 per cent,[45] depending on the particular equation specification. The loss of contributions would be relatively greatest for educational, medical and cultural organizations. Philanthropies would lose more in the contributions they receive than the government would gain in additional tax revenues. Net disposable income after tax and charitable contributions would rise in all income groups with the highest percentage increase in the highest income groups.

These empirical results must however be regarded with substantial caution. Those who wish to assess the impact of our tax system on charitable giving must balance the current results against the conclusions of previous research on this subject and must consider the important factors that have been neglected in all of this work. It is appropriate to conclude this paper by reviewing these problems.

Although a number of writers have discussed the impact of the tax treatment of charitable contributions,[43] only two studies have used explicit statistical models to separate the income and price effects. The most frequently cited of these studies is the research of Michael Taussig (1967). Taussig examined a sample of 47,678 itemized individual tax returns for 1962. He found extremely low price elasticities (absolute elasticities not greater than 0.10) and concluded that the current tax deductibility of charitable contributions therefore does little to stimulate charitable giving.[44] Taussig's own paper is full of warnings about the shortcomings and potential biases of his results; these need not be repeated here.[45] However, three basic problems with Taussig's method should be emphasized. First, he used the marginal rate for actual taxable income, i.e., net of the individual's charitable contribution. An individual who gives more to charity therefore has, ceteris paribus, a lower marginal rate and a higher price. This introduces a spurious positive association of price and giving and therefore biases the negative price elasticity towards zero. Although this is relatively insignificant for aggregate data, it is quite important for microeconomic data.[46] Second, in-

[45]Since itemized giving accounts for approximately 90 per cent of total individual giving, these reductions in itemized giving correspond to between 25 and 50 per cent reduction of total individual giving.

[43]See the works cited on pages 81 and 82.

[44]Taussig's estimates are based on a specification like the current equation 2 except that the logarithm of the marginal tax rate is used instead of the logarithm of the price. The corresponding price elasticities were derived from these marginal rate elasticities by Schwartz (1970, p. 1280).

[45]See also the discussion of Taussig's work in Schwartz (1970), pp. 1280-82.

[46]After this study was complete, I was able to reanalyze the original 1962 microeconomic data that was studied by Taussig. The results of this reanalysis, presented in Feldstein and Taylor (1975), indicate the importance of the bias due to Taussig's endogenous price variable.

come was also measured net of taxes actually paid rather than of the taxes that would have been paid with no charitable contribution. This introduces a spurious simultaneity between income and contributions since the relevant budget constraint is defined by disposable income before any contributions are made. Third, because Taussig's sample is limited to only one year, the marginal tax rate and the price of charitable giving is an exact function of the individual's taxable income. Although relating charitable contributions to adjusted gross income net of tax avoids the existence of an exact functional relation, the problem of collinearity between income and price is exacerbated by Taussig's procedure of dividing his sample into five income classes. Taussig notes that within each class "the main source of variation in the tax rate facing the taxpayer still remained the tax schedule used by the filer of the return" (Taussig, 1967, p. 8). Since these different types of tax schedules (i.e., married couples, single individuals and heads of households) represent demographic differences that would be expected to have substantial effects on giving, the primary source of variation in the tax price in Taussig's sample is itself mainly a reflection of other important influences.[47]

The study by Schwartz (1970) is methodologically closer to the current research. Schwartz used aggregate time series data based on the summaries of tax returns that are published by the Internal Revenue Service. Instead of developing a time series of cross sections as in the current study, Schwartz aggregated the data into only three time series and estimated separate equations for each time series.[48] For the period from 1929 through 1966, this produced 31 observations for each regression. Since the introduction of the standard deduction in 1941 and its extension to incomes over $3000 in 1944 had a very substantial effect on the extent of itemizing, Schwartz also estimated his equations for the subsamples 1929 through 1943 and 1944 through 1966.[49] The recent sample contained only 16 observations. With this data, Schwartz estimated equations like equation 3 of the current study (the basic constant elasticity equation with a time trend).[50] For each annual observation, the income variable was the average disposable income for the entire income class (e.g., $10,000 to $100,000) and the price variable was the average price of money gifts for that income class.

The relatively small number of observations and the use of separate samples by income groups preclude precise estimation; in more than half of the cases, the estimated price elasticity is less than twice its standard error. These difficulties are compounded by the use of single annual averages to represent the very wide range of incomes and prices *within* each of the three groups.[51] In spite of these problems, the evidence does indicate the existence of considerable price elasticities. For the interval 1929 through 1966, Schwartz found a price elasticity of −0.69 for incomes below $10,000, −0.76 for incomes of $10,000 to $100,000, and −0.41 for incomes over $100,000. The corresponding standard errors are 0.49, 0.20, and 0.10. For the period after 1943, the elasticities in the groups with incomes below $10,000 and above $100,000 are almost identical to the value for the entire period. In

[47]Single individuals have a higher marginal rate and therefore lower price than married couples. Since single individuals tend for other reasons to make smaller contributions, Taussig's procedure introduces a further spurious positive association between price and giving.

[48]The three time series corresponded to taxpayers grouped by current income into those with less than $10,000 of adjusted gross income, those between $10,000 and $100,000, and those with more than $100,000. The use of current dollar limits to define these groups implies that the real income limits change substantially over time.

[49]When the complete sample was employed, a dummy variable was used to represent the shift in giving after 1943. No allowance was made for the effect of the change in deduction limits in 1952 and 1954.

[50]A more general equation with a relative income variable was also estimated; see above, footnote 34.

the middle range ($10,000 to $100,000), the estimate is substantially less (−0.17) and has a large standard error (0.32), reflecting the very narrow range of price variation (except for one year, the price remained between 0.558 and 0.671). In short, Schwartz' estimates are imprecise but generally imply a substantially higher price elasticity than that found by Taussig and a lower elasticity than that found in the current study.

The current study as well as the research of Taussig and Schwartz suffers from the limits imposed by the use of the official tax return data. Perhaps the most serious problem is the lack of information on permanent economic income and wealth. Adjusted gross income becomes a less adequate measure as income rises. Similarly, the influence of wealth rather than current income is likely to be very important at the highest income levels. A second important shortcoming is restriction to analyzing the contributions of taxpayers with itemized returns. While this restriction is unimportant for high income individuals, it eliminates substantial information on the behavior of those with lower income. In addition, demographic characteristics, educational background, religious affiliation and other factors that influence charitable giving[52] may be correlated with the income and price variables in a way that biases the estimates of the structural parameters and the derived predictions of the effects of tax changes. Feldstein and Clotfelter (1974) have analyzed survey data on households[53] which contains better measures of income and wealth, income on demographic characteristics, and the contribution of households that did not itemize. The estimates obtained with this data strongly support the current conclusions.

Explaining aggregate charitable contributions to all types of organizations by a single equation may hide important differences in the relations governing gifts to different philanthropies. The different effects of prospective tax changes on the major types of philanthropies is at least as interesting as the total effect on all charitable contributions. The substantial differences in the distribution of religious and nonreligious giving suggests the potential importance of such decomposition. An analysis of the differences in the impact of alternative tax policies on religious, educational and other charitable organizations is presented in the second part of this article and will appear in the next issue of the *National Tax Journal*.

[51] If the log-linear model is appropriate at the individual level, an aggregate log-linear specification should use *geometric* means for the income, price and contributions variables. The error involved in using arithmetic mean increases with the size of the interval and therefore represents a more serious problem in Schwartz' work than in the current study.

[52] On the importance of such factors, see Morgan *et al.* (1962) and Barlow and Morgan (1966).

[53] The data is the Federal Reserve Board Survey of Consumer Finances (Projector and Weiss, 1966).

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TAX INCENTIVES AND CHARITABLE CONTRIBUTIONS IN THE UNITED STATES

A microeconometric analysis

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1. Introduction

The American public sector relies substantially more on private nonprofit institutions than is common in most other countries. Higher education, health care, the visual and performing arts, and general community services are produced by voluntary institutions. Even when these institutions receive most of their income from user charges and public funds, they depend on private contributions to provide the basic 'equity capital' and to support new ventures.[1]

The federal income tax law allows the value of contributions to be deducted in calculating taxable income. The 'price' of one dollar's contribution to a philanthropic organization, measured in terms of foregone income after tax, therefore varies inversely with the individual's marginal tax rate. There are today a number of widely discussed proposals for changing the tax treatment of charitable contributions. These include the complete abolition of the deduction, the substitution of a system of tax credits, the introduction of a 'floor' with a deduction or credit only for contributions above that level, and various modifi-

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[1]Ginsburg (1970) discusses the analogy between charitable contributions in nonprofit organizations and equity capital in profit-making organizations. The charitable endowment provides the basis on which to borrow and the income with which to subsidize services that receive public support of less than 100 percent. In 1973, philanthropic and religious organizations received $18.2 billion from individual contributions, $3.1 billion from bequests, $0.95 billion from corporations and $2.4 billion from foundations [American Association of Fund-Raising Counsel (1974)].

cations of the tax treatment of appreciated assets.[2] The current paper will not attempt to deal with the complex and wide-ranging issues raised by these proposals. Our focus is on the empirical issue of the magnitude of the price and income elasticities of charitable contributions. These parameters are crucial for the evaluation of the impact of any proposed change.

There has been substantial controversy about the extent to which current tax rules affect the magnitude of charitable contributions. The earliest econometric evidence was Taussig's (1967) study of the 1962 Internal Revenue Service Tax File, a stratified sample of 70,596 individual federal income tax returns with itemized deductions. Taussig's often quoted conclusion was that the deduction has little or no effect on the total volume of charitable contributions. More specifically, Taussig's parameter estimates indicated a price elasticity of less than 0.10 and therefore implied that, for each dollar of potential revenue foregone by the Treasury, charities receive less than ten cents in contributions. An error in Taussig's analysis, the accidental omission of 22,918 observations, makes this conclusion questionable.[3] There are, moreover, serious problems with Taussig's specification and method of estimation; these are discussed in Feldstein (1975a) and Feldstein and Taylor (1975). A reanalysis of the 1962 data with the full sample indicates a price elasticity of approximately one.[4]

Schwartz (1970) used aggregate time series based on the summaries of tax returns that are published by the Internal Revenue Service. The estimated price elasticities differed among income classes and between the prewar and postwar periods but averaged about 0.6. Unfortunately, the relatively small number of observations and the use of separate samples by income groups precluded precise estimation; more than half of the estimated price elasticities are less than twice their standard error. Feldstein (1975a) used a time series of cross sections based on the value of itemized charitable contributions in each adjusted gross income class for even years from 1948 through 1968. The estimates indicate that the volume of charitable contributions is quite sensitive to the price of giving that is implied by the tax treatment; almost all of the estimates of the price elasticity are absolutely greater than one.

The studies by Taussig, Schwartz and Feldstein are all limited to the use of official tax return data. This is the source of several potential problems. First, there is no information on permanent economic income or on wealth. Adjusted gross income becomes a less adequate measure as income rises. Similarly, the influence of wealth rather than current income is likely to be important at high

[2]See, for example, the discussions in Andrews (1972), Bittker (1972), Brannon (1973), Goode (1964), Kahn (1960), McDaniel (1972a, 1972b), Pechman (1971), Surrey et al. (1972), Vickrey (1962, 1973), Weidenbaum (1973), White (1959), and U.S. Treasury (1969).

[3]We are grateful to the Bookings Institution for making available a copy of the 1962 Tax File Tape. Taussig has explained to us that he was aware that his copy of the tape was missing a large number of itemized returns and that he had tried to see if there was anything systematic about the missing observations.

[4]The results of this reanalysis are described in Feldstein and Taylor (1975).

income levels. A second shortcoming is the restriction to taxpayers with itemized returns. While this restriction is unimportant for high income individuals, it eliminates substantial information on the behavior of those with lower income. Demographic characteristics (age, sex, marital status and race), educational background, occupation and other personal attributes that influence giving may be correlated with income and price variables in a way that biases the estimates of the price and income elasticities. Although these limitations might not affect the estimated price and income elasticities, the reliance on tax data alone is a source of uncertainty about all previous estimates.

The current study presents a new type of evidence about the effects of the income tax treatment of charitable contributions that avoids the restrictions imposed by the official tax return data. By using household survey data, we are able to relate charitable giving to economic income, wealth, tax rates and personal characteristics. It is very reassuring that the estimated price elasticities are very close to the values obtained in Feldstein (1975a), despite the substantial differences in the nature of the data and the level of aggregation.

The next section describes the survey data and indicates the definitions used to construct the key variables. Sections 3, 4 and 5 present the basic parameter estimates and examine whether the price elasticity varies among wealth or income groups. The special problem of gifts of appreciated property is studied in detail. Section 6 specifies and estimates alternative models of interdependent behavior in which each individual's contribution depends on the volume of contributions made by others. Simulations of the effects of four possible tax changes are presented in section 7. There is a brief concluding section.

2. Data, specification and definitions

In 1963 and 1964, the Board of Governors of the Federal Reserve System conducted a national survey of the income, assets and savings of 2,164 households [Projector and Weiss (1966)]. With the assistance of the Internal Revenue Service, the survey greatly over-sampled the very high income individuals; e.g., 18 percent of the sample, but less than one percent of the population, had 1962 incomes over $25,000. For the current analysis we eliminated a relatively small number of households that did not report one or more key variables (charitable giving, income, age, children and saving) or that reported a negative net worth. A further group with very low 1963 adjusted gross income (less than $1,721) was also eliminated.[5] The final sample contains 1,406 households.

The equations that we have estimated relate charitable giving (G) to disposable income (INC), the price of giving (i.e., net cost to the donor per dollar received by the donee) (P), net worth (W), and additional variables measuring age and

[5]The value $1,721 represents the 20th percentile of adjusted gross income. These households were excluded to eliminate observations in which current income was very different from permanent income. Other methods of dealing with this problem are described below.

other personal characteristics (X). The basic specification uses a log-linear equation to estimate constant elasticities with respect to INC, P and W,

$$\ln G_i = \beta_0 + \beta_1 \ln INC_i + \beta_2 \ln P_i + \beta_3 \ln W_i + \sum_{j=4} \beta_j X_{ji} + \varepsilon_i. \qquad (1)$$

Alternative specifications allowing more general nonlinear relations will be described below.

The survey obtained information on all charitable giving in 1963(G), including gifts of assets as well as of cash. The survey estimate of aggregate giving is relatively close to the official internal Revenue Service value; actual 1962 giving was $7.5 billion for itemizers and the corresponding survey estimate for those whom we identified as itemizers in 1963 was $6.2 billion.[6] One can only speculate on how much of the difference is due to underreporting in the survey and how much to overreporting in the tax returns.[7] In principle, the survey contains information on the value of gifts to trusts but it is not clear how accurately this information reflects the actual value of such gifts. There is no information on gifts of services, gifts made by corporations that the donors control or anticipated testamentary bequests.

The correct concept of disposable income for this study is total income minus the taxes that would be due if no charitable contributions were made.[8] The basic measure of disposable income (YD) in this study uses total income received in 1963 minus an estimate of the tax that would be due with no contribution; the method of estimating the tax is described below. To approximate permanent income, an average of this disposable income measure for 1962 and 1963 has also been used, $YDP = 0.5\,(YD + YD62)$.[9]

There are two disadvantages with this common measure of permanent income: (1) it uses only income received and excludes the accrued gains on various assets, and (2) it uses only two years' income data while the individual may base his own perception of permanent income on much more information.

[6]No information or actual itemized giving is published for odd-numbered years.

[7]The difference may also reflect the methods of valuing gifts for tax purposes and errors in the division of the sample into itemizers and nonitemizers; one method of identifying itemizers is described below. Although we used all of the available observations in this calculation (not just the 1,406 observations used in the regression), households that refused to tell how much they gave were treated as giving zero; these households were excluded in the regression sample. The definition of charitable giving in the survey was intended to correspond exactly to the definition in the tax law.

[8]The usual measure of disposable income, i.e., income minus taxes *actually* paid, is endogenous because such taxes depend on the amount of charitable contributions. This is unimportant for low income individuals and for aggregate data but could matter with the current sample.

[9]$YD62$ is converted into 1963 dollars by the consumer price index. The value of $YD62$ cannot be calculated as accurately as the value for 1963 because the tax for 1962 must be approximated on the basis of 1963 data by assuming the same average tax rates.

The first of these may not be a very serious problem because the basic specification of eq. (1) includes the value of wealth. Nevertheless, this allows neither for the fact that different portfolios have different amounts of accrued income and realized income nor for the differences in the contribution of wealth to permanent income at different ages. We have therefore constructed as an alternative measure of permanent income the value of the annuity that the individual could obtain from his current wealth and labor income. More specifically, YDA is the sum of the current labor income and the annual payment of an annuity based on the head of the household's age and an interest rate of 5 percent, net of the tax that would be due if no charitable contributions were made.[10]

The annuity measure of permanent income is still restricted to using current labor income to approximate permanent labor income. A quite different approach to measuring permanent income can be based on the permanent income theory of consumption. Because of the log-linear form of eq. (1), we must restate the permanent income model in a multiplicative form,

$$\tilde{C} = k Y_P \tilde{U}, \tag{2}$$

$$\tilde{Y} = Y_P \tilde{V}, \tag{3}$$

where $\tilde{C}$ is actual consumption, Y_P is permanent income, $\tilde{Y}$ is actual income and $\tilde{U}$ and $\tilde{V}$ are multiplicative random errors. In addition, ln U and ln V are independent of each other and of ln Y_P. If permanent income is more closely correlated with current consumption than with current income, it is advantageous to replace INC in eq. (1) by consumption and to use current income as an instrumental variable in the estimation procedure.[11] For this method of measuring permanent income, we include charitable contributions in the definition of total consumption[12] and use YD as the measure of current income.

The price of charitable giving (P) is the amount of after-tax income or wealth that the individual foregoes to add one dollar to the receipts of a donee. If the individual uses the 'standard deduction', i.e., if he does not itemize his deductions, his price is 1 regardless of his marginal rate. If the individual itemizes his deductions and his marginal rate is m, the price of a one dollar cash contribu-

[10]It would be interesting to try alternative definitions of this annuity, including the use of a human wealth measure, allowing for social security benefits, income for the surviving spouse, etc.

[11]Since ln V is uncorrelated with ln U, this is a consistent procedure. A more efficient method could be developed by extending this along the lines suggested by Zellner (1971) and Goldberger (1972).

[12]The definition of consumption used by Projector and Weiss (1966) is inconsistent; it includes *cash* contributions but not gifts of assets. It therefore underestimates consumption relatively more for high income households. We also estimated with consumption defined net of contributions; the two sets of coefficients are very similar.

tion is $1-m$.[13] For this purpose, we define m as the marginal rate applicable to the first dollar of charitable contributions.[14]

Contributions of appreciated assets create a special problem for measuring the price of charitable giving. When an asset is given away, its full value can be deducted from the donor's taxable income but there is no constructive realization and therefore no tax to be paid by the donor on the capital gain.[15] The opportunity cost (price) of a gift that is given in the form of an appreciated asset therefore depends not only on the individual's marginal tax rate but also on the fraction of the asset's value that is accrued capital gain and on the alternative disposition of the asset. An example will clarify the way in which these variables determine the relevant price. Consider an individual whose marginal rate is 40 percent and who contemplates donating an asset that is now worth $100 and for which he originally paid $30. If he gives the asset away, he reduces his taxable income by $100; he therefore reduces his tax liability by $40 and thus increases his after-tax income by $40. If he instead sells the asset, he pays a tax of $14 (half of his marginal rate on the capital gain of $70) and increases his after-tax income by $86. For this individual, the opportunity cost of the $100 contribution is therefore $46 of foregone consumption. If the price is defined in terms of foregone consumption, the price of the gift is $P = 0.46$. This price clearly depends on the ratio of the asset's original cost (or basis) to its current value: an original cost of $1 implies $P = 0.40$, while an original cost of $100 implies $P = 0.60$. More generally, $P = 1-mc(1-B/V)-m$, where V is the current value of the asset, B is its basis or original cost, m is the marginal tax rate on income and mc is the marginal tax rate on capital gains; in 1963, $mc = 0.5m$ with a maximum of 0.25.

The preceding calculation defined the opportunity cost of a donated asset in terms of foregone immediate consumption, i.e., it assumed that if the asset were not given away it would be sold in the current year. The price is higher and the calculation is more complex if the opportunity cost is defined in terms of

[13]A deduction was not allowed in 1962 for contributions exceeding 30 percent of adjusted gross income, but any excess can be carried forward. The limit affects extremely few individuals, especially after the carryover is taken into account. No attempt was made to take this into account.

[14]An individual who gives a substantial amount in relation to his income will lower his marginal rate as well as his tax liability. If we used the marginal rate applicable to the last dollar of charitable contribution, we would introduce a spurious correlation between price and giving; since more giving would, ceteris paribus, raise the individual's price, the estimated price elasticity would be biased up toward zero. There is no satisfactory way to reflect the *entire* exogenous price *schedule* that the individual faces. The only other candidate for an exogenous price variable would be to use the marginal rate that the individual would have if he gave the average gift at his income level. This would have almost no effect at low incomes but would raise the price at higher incomes. Although we have not investigated this price variable, it would seem that reducing the rate at which price declines with income would tend to increase the estimated price elasticity.

[15]Since income of the donee organization is not taxable, it can sell the appreciated asset without paying any tax.

foregone saving or wealth, i.e., if it is assumed that the asset would not otherwise be sold in the current year. The individual in the preceding example could retain the $100 asset or he could give it away and add the $40 tax saving to his wealth. Viewed in this way, his opportunity cost price is 0.60, the same as for contributions of money; moreover, this price is independent of the ratio of the capital gain to the present asset value. Since the individual who does not give away the asset also has a future tax liability, this tends to overstate the opportunity cost of a prospective contribution. However, by postponing the sale of the asset the individual can substantially lower the present value of the tax and, if the asset is never sold during the individual's lifetime, the capital gains tax liability is completely eliminated when the asset passes at death.[16]

It has not been possible to reflect accurately the full complexity of appreciated asset gifts. Although the fraction of total contributions in the form of assets is known for each individual, there is no data on the ratio of original cost to the current value for such assets. There is of course no information on what would have been done with such assets if they had not been contributed. The price of gifts of appreciated assets can therefore be known only conditional on an assumed ratio of basis to value. Moreover, with the same ratio of basis to value for all households, the prices of cash gifts and of asset gifts are very highly correlated. In practice, we have constructed a price index as a weighted average of the cash price and asset price using the share of contributions in the form of assets for all households in the same broad income class.[17] A maximum likelihood procedure, described below, was used to estimate an appropriate ratio of basis to current value.

The survey did not specifically ask for the individual's marginal rate or taxable income or even whether the taxpayer itemized his deductions. To estimate this information we begin by calculating adjusted gross income (*AGI*) as the sum of income from all taxable sources plus short-term capital gains plus half of long-term capital gains.[18] We then classify the taxpaper as an itemizer or non-itemizer in the following way.[19] We calculate the exemptions and standard

[16]If the individual gives the asset away to another person, there is no constructive realization and the tax is postponed until the recipient sells the asset. The original owner can also consume most of the value of the asset by using it as collateral to borrow funds which he then consumes, thus enjoying the consumption while postponing or avoiding the capital gains tax. See Bailey (1969) for evidence that a very large share of accrued capital gains are never subject to capital gains taxation.

[17]Using weights based on the household's own contributions would be inappropriate because it would make the price variable a function of contributions.

[18]These items of taxable income refer to the husband and wife but exclude income of other family members. Unfortunately, the data on contributions is for the entire family. We can assume that the difference is likely to be small. The estimates reported below actually use pretax income and wealth of the entire family but tax variables based on the husband and wife. We have also reestimated equations using pretax income of the husband and wife only and obtained virtually the same results.

[19]The classification actually finds whether they would or would not itemize in the absence of charitable contributions. This is in keeping with our definitions of price and disposable income.

deduction that the taxpayer would have if he did not itemize and find the resulting tax liability by consulting the appropriate tax schedule. We then estimate the taxpayer's potential deductions (excluding charitable contributions) as the sum of 5 percent of the value of owned residences[20] plus a percentage of *AGI* that varies by *AGI* class to represent other itemizable deductions.[21] The tax liability, if the taxpayer itemizes, is then calculated and compared with the liability if the standard deduction is used. The taxpayer is assumed to choose the method that minimizes his tax liability. The appropriate tax schedule then defines the marginal tax rate and the corresponding rate for capital gains.[22]

Each family's net worth (W) is defined as the algebraic sum of the value of portfolio and other investment assets, business assets, real estate and automobiles, minus the value of all debts. This definition thus omits consumer durables (except automobiles), the cash value of life insurance and the present value of future pension rights and social security benefits.

The remaining variables will be defined as they are introduced.

3. The basic parameter estimates

Parameter estimates for the sample of 1,406 households are presented in eq. (4),

$$\begin{aligned}\ln G = {} & -5.42 + \underset{(0.15)}{0.80} \ln YD - \underset{(0.31)}{1.55} \ln P \\ & + \underset{(0.06)}{0.10} \ln W + \underset{(0.21)}{0.12}\, AGE3554 + \underset{(0.25)}{0.25}\, AGE5564 \\ & + \underset{(0.30)}{0.49}\, AGE65+, \qquad (4)\end{aligned}$$

$$R^2 = 0.20, \quad N = 1{,}406.$$

The income elasticity is 0.80 and the price elasticity is -1.55; despite the potential problem of collinearity between income and price, the standard errors of the

[20]This is intended to reflect the deductible mortgage interest on the owner's equity plus the local property tax.

[21]Together with the 5 percent of the value of owned residences, the percentages of *AGI* are intended to estimate all itemized deductions other than charitable contributions (including interest, medical expenses, state and local taxes). A search procedure was used to find the percentages, within each broad *AGI* class, which made the weighted proportion of taxpayers who itemized in the sample equal to the actual proportion of returns which were itemized in 1963. These percentages are for all itemized returns, not just those that would have itemized if there were no deduction for contributions.

[22]The calculation ignores state income taxes. There is no information on the taxpayer's state of residence. These rates were generally still quite low in 1963.

elasticities are quite small. Although the wealth elasticity is relatively low, tl very substantial range of wealth within each income class implies that weal differences are responsible for a substantial part of the variation in contribution Although the individual age dummies are not statistically significant, tl coefficients suggest that giving rises substantially with age: families in which tl head is between 35 and 54 years old give 12 percent more than similar famili in which the head is under 35; for those 55 to 64 the difference is 25 percent an for those over 65 the difference is 49 percent.

Table 1

Price and income elasticities of charitable giving based on alternative definitions of price ar income.[a]

Equation	Price		Income		SSR
	Definition	Elasticity	Definition	Elasticity	
1.1	P	−1.55	YD	0.80	9,836
		(0.30)		(0.15)	
1.2	P	−1.57	YPD	0.83	9,823
		(0.30)		(0.15)	
1.3	P	−1.54	YDA	0.79	9,856
		(0.31)		(0.15)	
1.4	P	−1.44	$\hat{C}$	0.95	9,836
		(0.31)		(0.17)	
1.5	$P[50]$	−1.14	YD	0.84	9,792
		(0.20)		(0.14)	
1.6	$P[50]$	−1.15	YPD	0.87	9,780
		(0.20)		(0.14)	
1.7	$P[50]$	−1.10	YDA	0.81	9,832
		(0.21)		(0.15)	
1.8	$P[50]$	−1.07	$\hat{C}$	0.99	9,793
		(0.20)		(0.16)	

[a]The equations all contain a constant term, a wealth variable and age variables. All estimat relate to the sample of 1,406 observations. The price variables are: $P = 1 - m$, where m is th marginal tax rate; $P50$ is a weighted average of P and $1 - m - 0.50\,mc$, where mc is the margin rate for capital gains if an asset test is satisfied, and P if the test is not satisfied. For nonitemizer $P = 1$. The income variables are: disposable income (YD), permanent disposable incom (YPD), disposable annuity income (YDA) and consumption with an instrumental variab estimator ($\hat{C}$). See text for additional details.

Table 1 compares the basic parameter estimates for different definitions o income and price using the same specification as eq. (4). The constant terms an the coefficients of wealth and of the age variables are not shown. The price elasticity of approximately −1.5 is essentially unaffected by the choice of income definition (equations 1.1 through 1.4). Before considering the implication o these elasticity values, it is important to study the alternative price definition that reflect the contribution of appreciated assets.

The special problems raised by gifts of appreciated property were briefly discussed in section 2. The available data severely limits the possibility of dealing fully with this problem. The price for the gift of appreciated property that would otherwise be sold is $1-m-mc(1-B/V)$, where mc is the marginal tax rate on capital gains and B/V is the ratio of the basis (usually cost) to the current value of the asset. There is unfortunately no data on the B/V ratio for property gifts. Moreover, if the asset would not otherwise be sold immediately, the present value of the reduction in the capital gains tax is less than $mc(1-B/V)$. If we denote the present value of this reduction in the capital gains tax by $\alpha mc(1-B/V)$, where $0 \leqq \alpha \leqq 1$ is the relevant discount factor, the price of a gift of appreciated property is $1-m-\alpha \cdot mc \cdot (1-B/V)$. Since neither α nor B/V is known, and since only their product enters the price variable, we have used a maximum likelihood search procedure (described below) to estimate the composite parameter $\alpha(1-B/V)$. The value of $\alpha(1-B/V)$ is assumed to be the same for all taxpayers.

For any given value of $\alpha(1-B/V)$ there is still a problem of how to combine the separate price variables for gifts of cash and for gifts of appreciated property. Although the price for gifts of property is always less than the price for cash gifts, individuals who make gifts of property almost always also make gifts of cash. These individuals may prefer cash gifts for contributions below some minimal size or for contributions to particular types of donees. Since there is a very high correlation between the two prices,[23] it is better to use a weighted average of the two prices than to use the two prices separately. The relative importance of the two prices clearly differs among the income classes: the survey indicates that gifts of assets accounted for less than one percent of total giving by households with income below $15,000, but for more than 60 percent of total giving by households with income over $100,000. Although weights could be assigned to each taxpayer on the basis of the composition of that taxpayer's gifts, doing so would introduce a very substantial element of inappropriate simultaneity in the definition of price. Instead, households are classified into seven income classes, with the relative weights for all households in each class based on the average composition of the gifts in that class.

Not all taxpayers can take advantage of the option to contribute appreciated property. An individual who does not own common stock is unlikely to have an appreciated asset that is suitable for making charitable gifts.[24] As a precautionary measure, we assume that any taxpayer who does not have common

[23]The correlation between $1-m$ and $1-m-mc(1-B/V)\alpha$ would be 1 if mc were proportional to m. In fact, $mc = 0.5\,m$ for all taxpayers with marginal rates below 0.50 and $mc = 0.25$ for all other taxpayers. For nonitemizers, both prices are 1.

[24]Other forms of liquid assets do not, in general, appreciate. Bond prices were generally falling in the period before 1963. Although gifts of real estate, works of art and other property are possible, these are relatively uncommon and are unlikely for individuals who do not hold common stock. Our analysis takes no account of gifts of 'income property', e.g., personal papers and artists' own creations.

stock worth at least three percent of his adjusted gross income will make only cash gifts.[25]

The final price variable will be written $P[\alpha(1-B_iV)]$ to emphasize that it is conditional on the parameter $\alpha(1-B_iV)$. The variable is defined by

$$\begin{aligned} P[\alpha(1-B_iV)]_i &= 1 \text{ for nonitemizers,} \\ &= 1-m_i \text{ for itemizers with insufficient common stock,} \\ &= W_i(1-m_i)+(1-W_i)[1-m_i-\alpha(1-B_iV)mc_i] \text{ for others,} \end{aligned} \tag{5}$$

where the weight W_i is the ratio of the value of cash gifts to total gifts for the income class of which household i is a member. For eight values of $\alpha(1-B_iV)$ between zero and one, the logarithm of $P[\alpha(1-B_iV)]_i$ is substituted for $\ln P_i$ in the basic specification of eq. (4). The value of $\alpha(1-B_iV)$ for which the regression has the lowest sum of squared residuals is the maximum likelihood estimate of this composite parameter and the estimated coefficients for this value are the maximum likelihood estimates of the corresponding parameters.[26]

The likelihood function is relatively flat between $\alpha(1-B_iV)=0.25$ and $\alpha(1-B_iV)=0.75$, but reaches a maximum at $\alpha(1-B_iV)=0.50$. The income, wealth and age coefficients are not substantially different from the results obtained in eq. (4) with the simple price variable. The price elasticity falls from 1.55 to 1.14 (S.E. = 0.20). This specification implies a smaller response to any given change in price. The estimated price elasticity is again quite insensitive to the definition of income (see eqs. 1.5 through 1.8).

The alternative definitions of income have little effect on the estimated price elasticity. Because permanent disposable income (YPD) corresponds to the lowest sum of squared residuals, we present the full equation,

$$\begin{aligned} \ln G = &-5.90+0.87 \ln YPD-1.15 \ln P(50) \\ &\quad (0.14) \qquad (0.20) \\ &+0.10 \ln W+0.14\, AGE3554+0.26\, AGE5564 \\ &\quad (0.65) \qquad (0.21) \qquad (0.26) \\ &+0.45\, AGE65+, \\ &\quad (0.30) \end{aligned} \tag{6}$$

$$R^2 = 0.21, \quad N = 1{,}409, \quad \text{SSR} = 9{,}792.$$

[25]The three percent is arbitrary but conservatively small. A comparison of the sum of squared residuals with and without this qualifying test shows that the test improves the explanatory power of the model.

[26]This, of course, assumes that the disturbances are normal, independent and homoskedastic. This overstates the price for nonitemizers who do avoid capital gains tax on gifts of property. However, since there are almost no gifts of property by individuals with incomes below $20,000 and almost no nonitemizers above that income level, the effect of this is extremely small.

The wealth and age coefficients are almost identical to those of eq. (4) and are thus not sensitive to the measurement of income or price.

Before studying additional modifications of this basic equation, it is useful to consider the implications of these elasticity values. Since a full analysis is presented in section 5, only some individual examples are now examined. In 1963, households with incomes between $8,000 and $10,000 contributed an average of $165. The average price for these taxpayers was 0.84. If contributions were not deductible, the price would rise by 19 percent (from 0.84 to 1.00) and therefore, given a price elasticity of −1.15, contributions would fall by about 18 percent or $30.[27] This amount is neither implausible nor contrary to the common assertion that the deductibility of contributions is likely to have only a 'small' effect on the amount given by low income households.[28]

For households with disposable income between $25,000 and $50,000, the average contribution was $2,125 and the average price was 0.49. The lower average price in this income class implies that the deductibility of charitable gifts has a substantially greater effect than in the lower income class. Eliminating the deductibility would raise the price by 104 percent (from 0.49 to 1.00) and would therefore lower the contribution by about 56 percent, or $1,190.

It is interesting to note the special implication of a price elasticity of exactly minus one. With this price elasticity, the value of giving responds to changes in price in such a way that the *net* cost to the individual donor is unaffected by the deductibility. Donees receive an amount equal to the sum of the net cost to the donors (which remains constant) plus the revenue foregone by the Treasury. The efficiency of the incentive to charitable giving, i.e., the ratio of additional funds received by donees to revenue foregone by the Treasury, is 100 percent. The actual estimated price elasticity of −1.14 implies an efficiency greater than 100 percent, i.e., philanthropic organizations receive more in additional funds than the Treasury loses in foregone revenue.

In concluding this section, it is useful to compare the current parameter values with the estimates based on aggregate data by income class for the years 1948 through 1968. Feldstein (1975a, eq. 18) reported an income elasticity of 0.82 (S.E. = 0.03) and a price elasticity of −1.17 (S.E. = 0.09).[29] The two estimates are remarkably close to the current values of 0.87 and −1.15 in spite of the great differences in the source of the data and level of aggregation.

[27]More exactly, $(1.19)^{-1.15} = 0.82$, implying that contributions are decreased by 18 percent or $30. This assumes that the increased tax revenue is not redistributed to the taxpayers; allowing for such a tax cut would have almost no effect since the individuals would spend only about 2 percent of the increased disposable income on charitable giving.

[28]This has been stressed by Aaron (1972), Kahn (1960), McDaniel (1972a) and Vickrey (1962) among others. Although the effect on the average gift is small, the aggregate effect is substantial. We return to this in section 5 below.

[29]These aggregate equations defined income as adjusted gross income and did not contain wealth or age variables. The maximum likelihood price variable also assumes a basis to value ratio of 0.50.

4. Additional specifications and tests

This section and the next section test the sensitivity of the basic results to number of generalizations of the specification and restrictions of the sample The evidence all tends to confirm the conclusions that the price elasticity i slightly greater than one and that the income elasticity is slightly less than one We begin by restricting the sample, first to taxpayers who itemize and then t taxpayers under age 60. A variety of demographic factors associated with givin are examined next. Section 5 considers alternative specifications in which th price and income elasticities are allowed to vary with income and wealth.

4.1. Taxpayers with itemized deductions

A taxpayer who does not itemize his deductions has a price of 1 for al charitable contributions. Section 2 explained how we decided whether eacl household would (in the absence of any charitable contributions) have itemized its deductions or used the standard deduction. A total of 486 of the origina 1,406 households were treated as nonitemizers. To see whether the price effect of itemizing is similar to the price effect due to the variation in the marginal rate for itemizers, we reestimated the basic regression of eq. (6) (with price defined as $P[50]$) for the sample of 920 households who itemized (and would have itemized even in the absence of charitable contributions). The price and income elasticities are very similar to the values for the entire sample that were presented in eq. (6). The itemizers' income elasticity (0.93, S.E. = 0.20) is a little higher than for the full sample (0.87), and the price elasticity (1.39, S.E. = 0.24) is also slightly higher than the value of 1.15 obtained for the full sample. Although this suggests a somewhat stronger response to change in marginal rate than to itemizing per se, the difference is very small and well within the standard error of the parameter estimate.

4.2. Aged and nonaged taxpayers

It seems plausible that the philanthropic behavior of older taxpayers may differ substantially from the behavior of younger ones. Decisions about current giving and charitable bequests are likely to be more interdependent than at earlier ages.[30] Current income may be a very poor measure of permanent income and current giving may reflect patterns established earlier in life. For both reasons, wealth may be more important than at younger ages. Our sample contains 304 households in which the head was 60 years old or older.[31] The

[30]See Aronson and Schwartz (1960), Feldstein (1974) and Shoup (1966) on the effects of taxation on charitable bequests.

[31]This group contains some who are completely retired and others who have reduced their work without being completely retired. Because it is not possible to distinguish the 'partly retired' from those who are fully employed, we focus on age alone.

income elasticity (0.79, S.E. = 0.26) and the price elasticity (0.84, S.E. = 0.30) are smaller for this group, and the wealth elasticity is substantially larger (0.22, S.E. = 0.14), than in the entire sample. The size of the sample (N = 304) results in larger standard errors, and the usual analysis of variance test shows that dividing the population into aged and nonaged does not significantly improve the explanatory power of the model.[32]

4.3. *Other demographic and economic factors*

The survey data provide other information about the demographic and economic attributes of each household. An analysis of the effects of these factors on charitable giving is both interesting in its own right and useful as a way of testing whether the previously observed price and income elasticities are biased because of the simpler specifications. For this purpose, households have been classified with respect to seven factors in terms of the characteristics of the head of the household: age, sex, race, community size of residence, employment, home ownership and education.

Table 2 shows that allowing for the influence of these factors has almost no effect on the estimated price, income and wealth elasticities. In particular, the price elasticity of −1.098 is extremely close to the value of −1.15 obtained in eq. (6) when the other explanatory variables are omitted. The additional variables are themselves also generally insignificant: only 6 of the 11 coefficients exceed their standard error and only one is more than twice its standard error. The one factor with a substantial effect is community size: households in medium size cities contribute the most (given their income, price, wealth and other characteristics), while households in large cities contribute the least.

The insignificant impact of such factors as home ownership and education appears contrary to the common observation that home owners and college graduates give more than renters and those who did not graduate from college. Such observations do not, of course, adjust for the effects of price and wealth. Column 3 presents the unadjusted average[33] gifts in each group. These averages conform to the usual presumptions. For example, college graduates contribute more than three times as much as nongraduates and the difference of $275 is more than four times the standard error. Comparing columns 1 and 3 thus shows that many of the factors associated with greater contributions are simply indirect reflections of income.

[32] For the complete sample, the sum of squared residuals is 9,792, while for the two subsamples it totals 9,760. The F statistic is 0.91, less than the 5 percent critical value of 2.21 with 5 and 1,394 degrees of freedom. The price elasticity for those below age 60 is −1.43 with a standard error of 0.27.

[33] These are weighted averages in which the relative weight is the inverse of the sampling probability for the household.

Table 2

Effects of demographic and economic factors on charitable giving.

	Adjusted effects		Unadjusted effects	
	Coefficient	Standard error	Mean ($)	Stand. error
	(1)	(2)	(3)	(4)
Income (ln *YPD*)	0.772	0.156	-	-
Price (ln *P50*)	−1.098	0.201		
Wealth (ln *W*)	0.095	0.057	-	-
Age				
< 35	-	-	91	(38)
35–54	0.170	(0.212)	159	(33)
55–64	0.300	(0.258)	169	(54)
65+	0.466	(0.320)	247	(65)
Sex				
Male	−0.085	(0.264)	163	(24)
Female	-	-	98	(70)
Race				
White	0.250	(0.194)	166	(25)
Nonwhite	-	-	111	(55)
Community size				
< 250,000	-	-	103	(35)
250,000–1,000,000	0.517	(0.157)	211	(33)
> 1,000,000	−0.257	(0.246)	123	(72)
Employment				
Self-employed	0.161	(0.200)	268	(58)
Employee	-	-	133	(26)
Not working	0.138	(0.318)	161	(77)
Home ownership				
Renter	0.005	(0.189)	104	(39)
Owner	-	-	182	(28)
Education				
College graduate	0.293	(0.201)	397	(64)
Other	-	-	122	(24)

5. Varying price elasticities[34]

The specification of a constant price elasticity is clearly an assumption convenience. We have therefore examined several alternative specifications which the price elasticity is allowed to vary as a function of income, price and wealth. Although there is some variation in the price elasticity, the evidence supports the conclusion that the average elasticity is approximately one.

Three different forms of varying price elasticity have been estimated. T

[34]A more detailed discussion of this subject is available in an earlier version of this p that was distributed as Harvard Institute of Economic Research discussion paper no. 3 September 1974.

first modifies the basic specification by replacing the constant price elasticity by a price elasticity that varies linearly with the logarithm of income, price or wealth. For example, when the price elasticity is posited to depend on price, we obtain

$$\begin{aligned}\ln G = & -5.85 + 0.86 \ln YPD - (1.16 + 0.004 \ln P50) \ln P50 \\ & \quad (0.14) \qquad (0.44)\ (0.106) \\ & + 0.096 \ln W + 0.14\, AGE3554 + 0.26\, AGE5564 \\ & \quad (0.056) \qquad (0.21) \qquad (0.26) \\ & + 0.45\, AGE65+, \qquad (7) \\ & \quad (0.30) \\ R^2 = 0.21, \quad & N = 1{,}406, \quad \text{SSR} = 9{,}780.\end{aligned}$$

The coefficient of ln *P50* varies only very slightly with ln *P50*, and the additional coefficient is very much smaller than its standard error. Using the same form of the equation to allow the price elasticity to vary with income (*YPD*) or wealth also produces completely insignificant effects.

The second method of generalizing the constant price elasticity specification is to reestimate the basic equation with different price elasticities in different parts of the price range:

$$\begin{aligned}\ln G = & -5.97 + 0.88 \ln YPD - 1.16 \ln P50(< 0.3) \\ & \quad (0.15) \qquad (0.20) \\ & - 1.26 \ln P50(0.3\text{–}0.7) - 1.82 \ln P50(> 0.7) \\ & \quad (0.42) \qquad (0.64) \\ & + 0.084 \ln W + 0.13\, AGE3554 + 0.26\, AGE5564 \\ & \quad (0.057) \qquad (0.21) \qquad (0.26) \\ & + 0.48\, AGE65+, \qquad (8) \\ & \quad (0.30) \\ R^2 = 0.21, \quad & N = 1{,}406, \quad \text{SSR} = 9{,}771,\end{aligned}$$

where ln *P50*(< 0.3) is either the logarithm of *P50* if *P50* is less than 0.3 or is equal to zero, and ln *P50*(0.3–0.7) and ln *P50*(> 0.7) are defined similarly. Each of the separate price elasticities is absolutely greater than the overall value of 1.15 but the differences are not statistically significant. Similar equations with separate price elasticities for different income groups were also estimated. The price elasticities vary substantially but have large standard errors: −2.75 (S.E. = 0.80) for income below $8,000, −0.75(S.E. = 0.32) between $8,000 and $40,000, and −1.16 (S.E. = 0.18) above $40,000. A corresponding

specification by wealth group shows that price elasticities decrease as weal increases but the standard errors are again very large: −3.22(S.E. = 0.85) fi wealth less than $10,000, −1.68(S.E. = 0.45) for wealth between $10,000 an $100,000, and −1.09(S.E. = 0.20) above $100,000.[35] In short, the evidenc appears strong that the price elasticity exceeds one, but the data does not perm inferences about differences in the elasticity among income or wealth groups.

The third and most general specification is to allow all of the coefficien to vary among the income and wealth classes. Although there are rather sul stantial elasticity differences among the income classes, the standard errors ar large and the disaggregation is not statistically significant.[36] The results ar very similar for the disaggregation by wealth groups: the elasticities diffe greatly but the standard errors are quite large: with net worth below $10,00(the price elasticity is −3.69(S.E. = 0.97); for net worth from $10,000 t $100,000, it is −1.83 (S.E. = 0.62). Although in the group with net worth ove $100,000 the price elasticity is only −0.52(S.E. = 0.31), this is primarily du to the very large fraction of older persons in this sample of wealthy household For households in which the head is less than 60 but net worth exceeds $100,00 the price elasticity is −1.09, essentially the same as for the whole sample. It the wealthy aged for whom the complex interaction between estate taxes a income taxes makes the current model least appropriate; only further work c data that links bequests and lifetime giving will be able to provide an estim of the price elasticity for this group with an adequate adjustment for the ef of estate taxes.[37]

6. Interdependence among individuals in charitable giving

It is widely believed that the amount that each individual contributes charity is substantially influenced by the amounts that he perceives others to giving. Social experiments confirm that individuals on the street who do know they are participating in an experiment are more likely to make charit contributions if they have just witnessed someone else making a contribut [Krebs (1970)]. Fund raisers emphasize the importance of 'leadership gi large gifts by some high income individuals that motivate similar individual make comparable gifts and lower income individuals to make gifts that larger than they would otherwise make.

[35]Although the value of −3.2 for low wealth households seems inappropriately lar should be noted that the average price is so close to one that even an elasticity of −3.2 implies that tax deductibility raises giving by 35 percent.

[36]The price elasticities and standard errors are: −2.50 (0.91) for income < $8,000, − (0.41) for $8,000 < income < $40,000, and −0.70 (0.39) for income > $40,000. The F of 1.27 is less than the 5 percent critical value of $F(14, \infty) = 1.69$.

[37]For example, a wealthy aged individual may prefer to forego the income tax deductio make a charitable bequest, because this increases the size of his gross estate and therefo amount that can be given free of estate tax to his wife under the 50 percent marital deducti

It is not clear, however, whether this demonstration effect appreciably alters each individual's total giving or only changes the distribution among different charities. The existence of an interdependence among individual behavior is both an interesting question in itself and a matter of substantial importance for the impact of alternative tax treatments of charitable contributions. If each individual's giving does depend positively on the gifts of individuals with the same or greater income, an increase in the price of giving for the highest income groups will not only depress their giving but would depress the giving of lower income individuals as well.

The current section extends the previous specification to a model in which each individual's giving is a function of the average giving in his own income class and in the income classes above him. More specifically, to the previous equation we add the variable

$$g_i^* = \frac{\sum_j W_{ij} \ln \bar{G}_j}{\sum_j W_{ij}}, \tag{9}$$

where $\bar{G}_j$ is the mean giving per household in income class j, and W_{ij} measures the 'economic proximity' of individual i and income class j. The summation is taken only for the individual's own income class and the classes above him.[38] The economic proximity is defined by

$$W_{ij} = \left(\frac{\bar{Y}_i}{\bar{Y}_j}\right)^{\lambda}, \qquad \lambda \geqq 0, \tag{10}$$

where $\bar{Y}_j$ is the mean income in income class j, and $\bar{Y}_i$ is the mean income in the income class of individual i. With a positive value of λ, the economic proximity of an income class declines with the difference between the individual's income and the mean income of that class.

The new variable g_i^* is thus a weighted average of others' contributions with weights that are specific to each individual. The basic equation has been re-estimated after introducing values of g_i^* corresponding to all integral values of λ between 0 and 15. The sum of squared residuals increases with λ until $\lambda = 10$ and then remains constant. This value of λ implies that the weights on all other income classes are so small that the giving by other classes can be ignored;[39] the value of g_i^* is effectively $\ln \bar{G}_i$, the logarithm of the mean giving in the individual's own income class. Moreover, the coefficient of this variable is itself insignificant (0.22, S.E. = 0.24). When the estimated price coefficient

[38] The specification of g^* uses 7 income classes, with lower limits of: zero, $5,000, $10,000, $15,000, $25,000, $50,000 and $100,000.

[39] Only the values for income class i matter because of the high value of λ. With $\lambda = 10$, the relative weight to giving in other classes is always less than 0.006.

(−0.96, S.E. = 0.28) is adjusted for the effect of interdependence, the implied total price elasticity is −1.23, slightly higher than in the original specifications.[40]

The essentially negative conclusion about interdependence prompted us to consider an alternative specification. A potential donor might focus on how much others give relative to their income rather than on the absolute amount that they give. We therefore redefined the interdependence variable of eq. (9) replacing $\ln \bar{G}_j$ by $\ln (\bar{G}_j / \bar{Y}_j)$. The results with this new specification were very similar to those with the old specification: a high value of λ, a similar coefficient (0.15, S.E. = 0.19) and an implied price elasticity of −1.19.

The estimates presented in this section thus provide no support for the view that the total amount that an individual contributes is a function of the amount given by others. Although these results are clearly not definitive evidence against the notion of such interdependence among individuals, we believe that the burden of proof now rests with those who support a theory of interdependent giving.

7. Simulated effects of alternative tax changes

This section uses the estimated price and income elasticities to calculate the effects of alternative changes in the income tax treatment of charitable contributions. The simulations show, for each income class, the change in the average gift,[41] the change in the average income tax and contributions.[42] It is a perhaps ironic and unintended effect of several of the proposals that, although they increase the taxes paid by the higher income groups, they also increase the average disposable income after tax.

Four possible tax changes have been examined. The first alternative is the complete elimination of the deductibility of charitable contributions, i.e., raising the price of giving to 1 for all households. The second proposal is to replace the deductibility with a tax credit at the rate of 20 percent, i.e., chang

[40]To evaluate the full effect of price on individual giving, we must recognize that g_i^* is a function of price. We can approximate the total price effect by assuming that all individuals within each class are identical except for age. The values of ln G_i (the dependent variable) and g_i^* are then identical for each age class, and the basic equations can be solved, i.e., the total price elasticity is the partial price coefficient (−0.96) divided by 1 minus the g_i^* coefficient 0.22, i.e., −0.96/0.78 = −1.23.

[41]No attempt is made to calculate the effect on total giving because the simulations are done with the same restricted sample of 1,406 households as the original regressions.

[42]Net disposable income is equal to personal consumption expenditures plus saving. Although individuals obtain satisfaction from making charitable gifts, we believe that there is a significant difference in kind between personal consumption and charitable giving. Tax policy decisions that are concerned with distributional equity should not be indifferent between a dollar of personal consumption and a dollar of charitable giving. Moreover, charitable giving has much greater positive externalities than most other forms of consumption. Net disposable income (*NDI*) understates the individual donor's welfare but *NDI* plus charitable giving will overstate welfare since the individual pays less for charitable giving than for other types of consumption whenever $P[50] < 1$.

the price of giving to 0.8 for all households, including those that do not currently itemize.[43] Note that this is equivalent to a matching scheme in which the donor receives neither a credit nor a deduction but the donee receives a matching grant from the government equal to 25 percent of the total contributions that it receives. The third proposal is also a tax credit but with a rate of 30 percent, or, equivalently, a matching system with a matching rate of 43 percent.

The final alternative is to continue the deduction of charitable contributions but to eliminate the taxpayer's ability to contribute appreciated property without paying any tax on the capital gains. More specifically, this proposal is to tax the donor on the capital gains component of his gift, i.e., to make the price of all gifts $1-m$, where m is the marginal rate of income tax.[44] The importance of this change for each taxpayer obviously depends on that taxpayer's current use of gifts of appreciated property. For the simulations, we have treated this proposal as equivalent to changing the price from P50 to $1-m$.[45]

Associated with each of these proposals is an across-the-board change in all tax rates designed to keep the tax revenue unchanged. The calculation of this compensatory change and the actual process of simulation can be described most easily for the first proposal. Complete elimination of the deductibility of charitable contributions has two effects: (1) for itemizers, it raises the price of giving from $P50$ to 1; (2) this yields additional tax revenue to the government equal to $\sum_i (1-P50_i)G_i f_i$, where G_i is the amount given by individual i before the change in the tax rate and f_i is the weight to individual i based on the original sampling probabilities.[46] The ratio of this additional tax revenue to total tax receipts is the factor by which all tax rates can be reduced and leave the government with the same total tax revenue that it had before the elimination of the deduction. This reduction in all tax rates reduces each individual's tax liability and therefore increases his value of 'income after tax that would be due if no contributions were made' (YD and YPD). The resulting change in each individual's contribution is then calculated from the equation[47]

$$\ln G_i' - \ln G_i = 0.87\,(\ln YPD_i' - \ln YPD_i) + 1.15 \ln P50_i, \tag{11}$$

[43] I ignore the possibility that some households pay no taxes and cannot benefit from a tax credit. Alternatively, the proposal might be regarded as paying a cash subsidy to any household in which the credit exceeds the tax liability.

[44] Nonitemizers would be unaffected by this proposal and would continue to face a price of 1.

[45] Recall that $P50$ for household i is equal to $W_i[1-m_i]+(1-W_i)[1-m_i-0.50mc_i]$, where W_i is the ratio of cash gifts to total gifts for households in that income class, m_i is the marginal rate of tax on income and mc_i is the marginal rate of tax for capital gains. See section 3 above.

[46] If the entire sample were used, $\Sigma_i f_i$ would equal the total number of households. All of the current calculations are based on Σf_i for the restricted group of 1,406 households.

[47] The parameter values are taken from eq. (6); although there is some evidence that the price elasticity varies with income and wealth, the varying parameter values are too uncertain and unreliable. Recall that G_i is one dollar more than the contribution actually reported by the individual. Note that the age variables, wealth variables and constant terms can be ignored because the equation calculates only the relative change in each individual gift.

where G_i' is the predicted contribution after the tax change and YPD_i' is original value of 'permanent income minus the tax that would be due if contributions were made' plus the value of the tax reduction for individua Since eliminating the deduction raises the price of giving to 1, $\ln P50_i' =$ and therefore does not appear in eq. (11).

The analysis of the effects of a 20 percent tax credit is more complicat First, each individual's price is changed from $P50$ to 0.80. If each individu giving remained unchanged, this would yield additional tax revenue to t government equal in value to $\sum_i (1 - P50_i - 0.20) G_i f_i$. If all tax rates are cut the ratio of the additional tax revenue to the original revenue, the individua income increases to YPD'. This 'trial' value of YPD' is then used to calculat new gift according to

$$\ln G' - \ln G = 0.87\,(\ln YPD' - \ln YPD) - 1.15\,(\ln 0.80 - \ln P50). \qquad (1$$

The new G' values of giving imply a different cost to the government of the t credit and therefore a different total revenue gain from the tax chang $\sum (1 - P50 - 0.20) G'$. The incomes are again adjusted (to YPD'') and a new set gifts (G'') are calculated using a specification analogous to eq. (9). Although th process might be repeated again, the additional accuracy that could be gain at this stage is too small to warrant the additional computations.

A similar iterative procedure is used to assess the effect of changing the t treatment of appreciated assets, but this time the tax reduction alters the pri term as well as the income term. Thus, the first round simulation becomes

$$\ln G' - \ln G = 0.87\,(\ln YPD' - \ln YPD) - 1.15\,[\ln (1 - m') - \ln P50], \qquad (1$$

where m' is the marginal tax rate after the tax cut has been put into effect.

Table 3 presents the predicted effects of the four tax changes on the avera contributions per household in each gross income class.[48] Consider first t complete elimination of the deductible. The simulations indicate that this wou reduce the average gift (in 1963) from $157 to $116, a reduction of 26 percent.[49] Of course, the relative change differs substantially among income class Households with incomes below $5,000, a group that includes many nonite zers, had an average current price of 0.94. Removing the deductibility of co tributions only raises the average price by 6 percent. It is not surprising, the

[48]The income classes are defined in terms of total income before tax.

[49]Because these averages include the gifts of both itemizers and nonitemizers, the reduct of 26 percent is necessarily smaller than the 34 percent reduction for itemizers only that previously reported in Feldstein (1975a). For nonitemizers, this proposal raises giving s price is unchanged while income rises.

fore, that the average contribution only falls from $59 to $53, or 11 percent.[50] In contrast, households with incomes over $100,000 faced an average price of only 0.14 and would respond to the tax change by cutting their contributions by 95 percent.[51,52]

The replacement of the deduction by a 20 percent tax credit (including a credit

Table 3

Effects of alternative tax changes on average contributions.

Income class ($000)	Average charitable contribution ($)				
	Current law	Eliminate deduction	20% tax credit	30% tax credit	Constructive realization of asset gifts
0–5	59	53	60	64	60
5–10	150	126	156	177	158
10–15	193	148	185	211	196
15–20	315	228	284	325	321
20–50	670	381	475	545	684
50–100	2,062	767	940	1,063	2,198
100+	22,528	1,173	1,380	1,521	8,029
Average	157	116	141	159	155
	Contributions relative to actual 1963 gifts				
0–5	1.00	0.89	1.02	1.08	1.02
5–10	1.00	0.84	1.04	1.18	1.05
10–15	1.00	0.77	0.96	1.09	1.02
15–20	1.00	0.72	0.90	1.03	1.02
20–50	1.00	0.57	0.71	0.81	1.02
50–100	1.00	0.37	0.46	0.52	1.07
100+	1.00	0.05	0.06	0.07	0.36
Average	1.00	0.74	0.90	1.01	0.99

[50]It might seem at first that contributions should fall even less since a six percent price increase and a price elasticity of −1.15 imply a fall of only seven percent, which the tax cut, by raising incomes, partly offsets. But the relevant price change is not the unweighted average but the weighted average in which the weights are the original amounts of the contribution. Since lower original prices are associated with larger original contributions, the weighted average effect is larger than the unweighted effect.

[51]An increase in price from 0.14 to 1.00 would in itself cut giving by 90 percent. But, as the previous footnote indicated, the negative correlation between original price and original giving implies that this underestimates the effect of the tax charge.

[52]This represents a substantially greater change than the 78 percent decrease calculated in Feldstein (1975a) because that calculation made no allowance for the effect of gifts of appreciated assets. Although the average price for this group is $P50 = 0.14$, the average price of cash gifts is 0.22.

to nonitemizers) only decreases average giving by 10 percent, while a 30 percen credit actually increases average giving by one percent. This substitution does, however, have a substantial effect on the distribution of contributions among different income classes. A 30 percent credit raises the average gift of household with incomes below $20,000, but decreases the average gift of households with $50,000 to $100,000 by 48 percent and the average gift of households with income over $100,000 by 93 percent. Such a change in the sources of total giving would have an important impact on the distribution of gifts among different types of donees. Religious organizations receive a large share of the gifts of low and middle income families while higher income families give primarily to education, health, cultural and community organizations.[53]

Finally, the constructive realization of gifts of appreciated assets causes a substantial reduction (64 percent) in giving in the highest income class and very small increases in all other classes. These increases occur because the tax change and the reduced contribution yield substantial additional tax revenue from the highest income class which permits increasing disposable income in all other classes. These increases in income outweigh the small increases in price. Just as with the introduction of a credit, there is almost no effect on total giving but a large change in the relative importance of different donors, and therefore a significant shift in the distribution of total giving among different types of donees.

Table 4 shows the effects of the four tax proposals on the tax paid in each income class and on the net disposable income after both tax and charitable contributions. As in table 3, each of the changes in the tax treatment of charitable contributions is accompanied by a proportional change in all tax rates to keep current total tax collections unchanged. The tax ratios, i.e., the ratio of taxes under the proposed alternative to current taxes, are all between 0.98 and 1.04 for households with incomes (before tax) of less than $100,000. The only significant changes in tax liability occur for households with incomes over $100,000. The smallest increase in tax liability (11 percent) results from the constructive realization of appreciation in gifts of assets. The largest increase (21 percent) occurs when the current deduction is replaced by a 30 percent credit.

The net disposable income ratios show a rather surprising result. Although there is almost no change (less than 3 percent) for households with incomes below $100,000, the highest income households actually have an increase in net disposable income of between 5 and 12 percent. The fall in charitable contributions in this highest income group exceeds the increase in taxes, leaving the households with a greater net income for personal consumption or accumulation.

[53]See Feldstein (1975b) for an analysis of the impact on different types of donees of alternative changes in the tax treatment of charitable contributions.

Table 4

Effects of alternative tax changes on tax payments and disposable income.

Income class ($000)	Tax ratios[a]			
	Eliminate deduction	20% tax credit	30% tax credit	Constructive realization of asset gifts
0–5	0.99	0.98	0.97	1.00
5–10	1.00	0.98	0.97	1.00
10–15	0.99	0.98	0.99	1.00
15–20	0.99	0.99	1.00	1.00
20–50	1.00	1.01	1.02	1.00
50–100	1.01	1.02	1.04	0.99
100+	1.17	1.19	1.21	1.11
	Net disposable income ratios[b]			
0–5	1.00	1.00	1.00	1.00
5–10	1.00	1.00	1.00	1.00
10–15	1.01	1.00	1.00	1.00
15–20	1.01	1.00	0.98	1.00
20–50	1.01	1.01	1.00	1.00
50–100	1.03	1.01	1.00	1.00
100+	1.12	1.08	1.05	1.10

[a]The tax ratio is the ratio of taxes due under the alternative to 1963 taxes under the current law. All ratios are rounded to the nearest 0.01.

[b]The net disposable income ratio is the corresponding ratio of income minus tax minus contributions. All ratios are rounded to the nearest 0.01.

8. Conclusion

This paper has presented a detailed analysis of the sensitivity of charitable giving to alternative tax treatments. The evidence indicates that the elasticity with respect to the price or net cost of giving is slightly greater than one. This implies that any increase in price will reduce the total contributions received by charitable organizations by more than it increases the taxes collected by the Treasury.

The price and income elasticities estimated in the current study are very similar to the values obtained by Feldstein (1974a) with a very different type of data: total contributions on itemized returns as reported by the Internal Revenue Service for each adjusted gross income class in the even years from 1948 through 1968. Some preliminary analysis of a yet different type of data, a large sample of individual tax returns for 1962 and 1970, appears to provide further support for these elasticities.

The appropriate tax policy in this area depends on a complex set of issu and value judgments. The key empirical question is the extent to which alt native tax treatments would affect the volume and distribution of charital contributions. We hope that the current study will provide a useful empiric basis for any future policy analyses.

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THE INCOME TAX AND CHARITABLE CONTRIBUTIONS

BY MARTIN FELDSTEIN AND AMY TAYLOR[1]

Charitable contributions are an important source of basic finance for a wide variety of private nonprofit organizations that perform quasi-public functions. The tax treatment of charitable contributions substantially influences the volume and distribution of these gifts. The current study presents new estimates of the price and income elasticities of charitable giving. The parameter estimates are then used with the United States Treasury Tax File to simulate the effects of several possible alternatives to the current tax treatment of charitable giving.

INDIVIDUAL CHARITABLE CONTRIBUTIONS are an important source of basic finance for a wide variety of private nonprofit organizations. Higher education, research, health care, the visual and performing arts, welfare services, and community and religious activities rely heavily on the voluntary institution. In 1970, American families contributed more than $17 billion for their support.

The volume and distribution of charitable gifts is influenced by the personal income tax treatment of charitable contributions. There are today a number of widely discussed proposals for changing these rules. The appropriate tax treatment of such gifts involves a complex series of economic issues. Critical to a resolution of these issues is an understanding of the likely quantitative effects of alternative tax rules: the effects on the total volume of charitable gifts and its distribution among the different types of donees; the effects on the distribution of tax burdens among income classes; and the effects on the distribution of net income for personal consumption and accumulation.

It is the purpose of this study to shed some new light on these important questions. This paper presents new evidence on the price and income elasticities of charitable giving based on the special Treasury tax files for 1962 and 1970. These data sets provide very large samples of individual observations with exact information on the tax price and charitable giving. The basic parameter estimates are very similar to earlier results that were obtained using aggregate pooled cross-section time-series data (Feldstein [8]) and household survey data (Feldstein and Clotfelter [11]). The parameter estimates are used here with the 1970 Treasury tax file to simulate the effects of several possible alternatives to the current tax treatment of charitable giving.

Section 1 describes the basic specification and data that are used to derive the estimates. The second section presents parameter estimates for 1962 and 1970 using different definitions of the key variables. Section 3 combines data for 1962 and 1970, thus using the historical change in tax rates as the basis for estimating

[1] We are grateful to Bernard Friedman and Daniel Frisch for assistance with the research, to the Commission on Private Philanthropy and Public Needs for financial support, and to M. Bailey, M. Boskin, G. Break, J. Brittain, N. McClung, J. Morgan, J. Pechman, G. Rudney, L. Silverstein, E. Sunley, S. Surrey, and M. Taussig for useful discussions. This paper was written while Feldstein was Ford Research Professor at the University of California at Berkeley.

the price elasticity. The fourth section discusses the evidence on separate elasticities by income class. The simulation method and results are presented in Section 5. There is a brief concluding section.

1. SPECIFICATION AND DATA

Because charitable contributions are deductible in determining taxable income, the current income tax system makes the "price" of charitable contributions less than the price of other goods and services. An individual with a marginal tax rate of 40 per cent can give $100 to charity by forgoing $60 of personal consumption; for him the net price of charitable contributions is only 0.6. More generally, for an individual whose marginal tax rate is m the price of charitable giving is $P = 1 - m$.[2]

The basic specification of the behavioral equation relating charitable giving (G) to income (Y) and price (P) is the constant elasticity relation:

$$\log G_i = \beta_0 + \beta_1 \log Y_i + \beta_2 \log P_i + \beta_3 MAR_i + \beta_4 AGE_i + \varepsilon_i \tag{1.1}$$

where MAR_i is a dummy variable indicating that the taxpayer is married and AGE_i is a dummy variable indicating whether the taxpayer was over age 65. The primary definition of income that is used in this study is adjusted gross income minus the tax that would have been paid if no charitable contribution were made. The marginal tax rate is based on the corresponding taxable income, i.e., the taxable income of the individual if no charitable contribution were made. In this way, the income and price variables are exogenous, at least to the extent of not depending on the individual's charitable giving.[3]

The 1970 Treasury Tax File is a sample of individual tax returns for the year 1970. These returns are a stratified random sample of all returns for that year with a sampling fraction that increases with income until there is 100 per cent sample for incomes over $200,000. To limit the computational costs of analyzing these data, we drew a 20 per cent random sample from the tax file. After eliminating the returns of non-itemizers, the sample contained 15,291 returns.

As we indicated above, the price variable depends on the marginal tax rate for the taxable income that the individual would have had if he had made no charitable gift. For most taxpayers this was calculated easily by adding actual charitable giving to actual taxable income and using the tax tables to find the marginal rate on this expanded taxable income. Special calculations were made for taxpayers who used income averaging or the alternative tax method. The Treasury assisted us by adding the state marginal income tax to each record, together with an indication of whether federal taxes are deductible in computing state taxable income. Each individual's total marginal tax rate was calculated by combining state and federal marginal tax rates, with full allowance for the reciprocal deductions where appropriate.

Contributions of appreciated assets create a special problem for measuring the price of charitable giving. When an asset is given away, its full value can be deducted

[2] When the contribution includes a gift of appreciated property, the price is lower and more complicated to compute. We return to this below.

[3] Other measures of price and income have been studied and will be discussed below.

from the donor's taxable income but there is no constructive realization and therefore no tax to be paid by the donor on the capital gain. The opportunity cost (price) of a gift that is given in the form of an appreciated asset therefore depends not only on the individual's marginal tax rate but also on the fraction of the asset's value that is accrued capital gain and on the alternative disposition of the asset. An example will clarify the way in which these variables determine the relevant price. Consider an individual whose marginal rate is 40 per cent and who contemplates donating an asset that is now worth $100 and for which he originally paid $30. If he gives the asset away, he reduces his taxable income by $100: he therefore reduces his tax liability by $40 and thus increases his after-tax income by $40. If he instead sells the asset, he pays a tax of $14 (half of his marginal rate on the capital gain of $70) and increases his after-tax income by $86. For this individual, the opportunity cost of the $100 contribution is therefore $46 of forgone consumption. If the price is defined in terms of forgone consumption, the price of the gift is $P = 0.46$. This price clearly depends on the ratio of the asset's original cost (or basis) to its current value: an original cost of $1 implies $P = 0.40$, while an original cost of $100 implies $P = 0.60$. More generally, $P = 1 - mc(1 - B/V) - m$ where V is the current value of the asset, B is its basis or original cost, m is the marginal tax rate on income, and mc is the marginal tax rate on capital gains.

The preceding calculation defined the opportunity cost of a donated asset in terms of forgone immediate consumption, i.e., it assumed that if the asset were not given away it would be sold in the current year. The price is higher and the calculation is more complex if the opportunity cost is defined in terms of forgone saving or wealth, i.e., if it is assumed that the asset would not otherwise be sold in the current year. The individual in the preceding example could retain the $100 asset or he could give it away and add the $40 tax saving to his wealth. Viewed in this way, his opportunity cost price is 0.60, the same as for contributions of money; moreover, this price is independent of the ratio of the capital gain to the present asset value. Since the individual who does not give away the asset also has a future tax liability, this tends to overstate the opportunity cost of a prospective contribution. However, by postponing the sale of the asset the individual can substantially lower the present value of the tax and, if the asset is never sold during the individual's lifetime, the capital gains tax liability is completely eliminated when the asset passes at death.[4]

If we denote the present value of the reduction in the capital gains tax by $\alpha\, mc(1 - B/V)$ where $0 \leqslant \alpha \leqslant 1$ is the relevant discount factor, the price of a gift of appreciated property is $1 - m - \alpha \cdot mc \cdot (1 - B/V)$. Since neither α nor B/V is known, and since only their product enters the price variable, we have used a maximum likelihood search procedure (described below) to estimate the composite parameter $\alpha(1 - B/V)$. The value of $\alpha(1 - B/V)$ is assumed to be the same for all taxpayers.

[4] If the individual gives the asset away to another person, there is no constructive realization and the tax is postponed until the recipient sells the asset. The original owner can also consume most of the value of the asset by using it as collateral to borrow funds which he then consumes, thus enjoying the consumption while postponing or avoiding the capital gains tax. See Bailey [5] for evidence that a very large share of accrued capital gains are never subject to capital gains taxation.

For any given value of $\alpha(1 - B/V)$ there is still a problem of how to combine the separate price variables for gifts of cash and for gifts of appreciated property. Although the price for gifts of property is always less than the price for cash gifts, individuals who make gifts of property almost always also make gifts of cash. These individuals may prefer cash gifts for contributions below some minimal size or for contributions to particular types of donees. Since there is a very high correlation between the two prices,[5] it is better to use a weighted average of the two prices than to use the two prices separately. The relative importance of the two prices clearly differs among the income classes: the data indicate that gifts of assets accounted for less than one per cent of total giving by households with income below $15,000 but for more than 60 per cent of total giving by households with income over $100,000. Although weights could be assigned to each taxpayer on the basis of the composition of that taxpayer's gifts, doing so would introduce a very substantial element of inappropriate simultaneity in the definition of price. Instead, households are classified into seven income classes with the relative weights for all households in each class based on the average composition of the gifts in that class.

Not all taxpayers can take advantage of the option to contribute appreciated property. An individual who does not own common stock is unlikely to have an appreciated asset that is suitable for making charitable gifts. As a precautionary measure, we assume that any taxpayer who does not report dividends or capital gains will make only cash gifts.

The final price variable will be written $P[\alpha(1 - B/V)]$ to emphasize that it is conditional on the parameter $\alpha(1 - B/V)$. The variable is defined by:

$$
\begin{aligned}
P[\alpha(1 - B/V)]_i &= 1 - m_i \quad \text{for taxpayers with insufficient common stock} \\
&= W_i(1 - m_i) + (1 - W_i)[1 - m_i - \alpha(1 - B/V)mc_i] \quad \text{for others.}
\end{aligned} \tag{1.2}
$$

where the weight W_i is the ratio of the value of cash gifts to total gifts for the income class of which household i is a member. For alternative values of $\alpha(1 - B/V)$ between zero and one, the logarithm of $P[\alpha(1 - B/V)]_i$ is substituted for $\ln P_i$ in the basic specification of equation 1.1. The value of $\alpha(1 - B/V)$ for which the regression has the lowest sum of squared residuals is the maximum likelihood estimate of this composite parameter and the estimated coefficients for this value are the maximum likelihood estimates of the corresponding parameters.

The Treasury Tax File for 1962 is very similar to the 1970 File.[6] The 20 per cent random sample of itemized returns provided 13,770 observations. The primary difference in procedure is that the marginal tax rate refers only to the federal tax rate since no information on state rates was available.[7]

[5] The correlation between $1 - m$ and $1 - m - mc(1 - B/V)\alpha$ would be 1 if mc were proportional to m. In fact, $mc = 0.5m$ for all taxpayers with marginal rates below 0.50; until 1969 $mc = 0.25$ for all other taxpayers while after that $mc = 0.25$ only for the first $50,000 of capital gains.

[6] We are grateful to the Brookings Institution for making the 1962 file available to us.

[7] To test the likely sensitivity of the results to this lack of data, we estimated the 1970 equation with the state tax rates set equal to zero. This had very little effect on the estimated parameter values.

2. THE BASIC CROSS-SECTION ESTIMATES

The estimate of the basic equation with data for 1970 is presented in the following equation:

$$\ln G = \underset{(0.070)}{-1.419} \ln P + \underset{(0.023)}{0.768} \ln Y + \underset{(0.048)}{0.317} MAR + \underset{(0.038)}{0.443} AGE - \underset{(0.201)}{2.580}, \quad R^2_{1970} = .404. \tag{2.1}$$

The price elasticity is -1.419 and the income elasticity is 0.768. In spite of the potential problem of collinearity between price and income, the standard errors are very small. The coefficient of the dummy variable for married taxpayers (0.317) indicates that married couples give 37 per cent more than single individuals with the same income and price. The coefficient of the age dummy indicates that taxpaying units in which one or both of the taxpayers is over 65 years old give 56 per cent more than younger taxpayers with the same income and wealth.

Equation (2.2) shows that the price and income elasticities for 1962 are very similar to those for 1970:

$$\ln G = \underset{(0.036)}{-1.305} \ln P + \underset{(0.018)}{0.745} \ln Y + \underset{(0.042)}{0.265} MAR + \underset{(0.034)}{0.132} AGE - \underset{(0.160)}{2.100}, \quad R^2_{1962} = 0.52. \tag{2.2}$$

The elasticity estimates are also very similar when the sample is restricted to married taxpayers below age 65:

$$\ln G = \underset{(0.043)}{-1.274} \ln P + \underset{(0.020)}{0.799} \ln Y - \underset{(0.176)}{2.351}, \quad R^2_{1962} = 0.52. \tag{2.3}$$

The special problems raised by gifts of appreciated property were briefly discussed in Section 1. As we noted there, the available data severely limit the possibility of dealing fully with this problem. It is necessary to summarize both the effects of allowing the contribution of property at market value without constructive realization for capital gains taxation and the possibility of alternative untaxed dispositions through personal gift or bequest by a single measure of the "discounted gain-to-value ratio". Since no data are available on the actual gain-to-value ratio of contributed assets or the alternative way in which the asset would otherwise have been used, a maximum likelihood search over possible discounted gain-to-value ratios is employed. The sum of squared residuals changes very little (less than one per cent) as the discounted gain-to-value ratio varies between zero (where asset gifts are equivalent to cash gifts) and one (where asset gifts are all appreciation and have no basis.[8] The minimum occurs at 0.875 in 1970 and at zero in 1962. Neither of these extreme values seems plausible. Although the assets given away

[8] In 1962, at the very highest marginal tax rates, individuals could face a negative price for gifts of appreciated property if the discounted gain-to-value ratio was sufficiently high. We imposed a lower bound of 0.10 on the price variable for the current estimates.

may have an actual ratio of gain-to-value near 0.875, sophisticated taxpayers are aware of the alternative opportunities for avoiding capital gains taxation. The discounted gain-to-value ratio is therefore almost certainly lower than 0.875. But a value of zero implies that there is no incentive to give assets instead of cash and thus conflicts with the substantial proportion of the gifts of high income individuals in the form of appreciated assets. Moreover, the two previous studies of this question (Feldstein [8]) and Feldstein and Clotfelter [11]) both found that the maximum likelihood estimate was a discounted gain-to-value ratio of 0.50. Imposing this value with the current data implies the following equation for 1970:[9]

$$\begin{aligned} \ln G = &-1.285 \ln P(50) + 0.702 \ln Y + 0.341\, MAR \\ &\quad (0.059) \qquad (0.024) \qquad (0.048) \\ &+ 0.419\, AGE - 1.933, \qquad R^2_{1970} = .406. \\ &\quad (0.038) \qquad (0.214) \end{aligned} \tag{2.4}$$

Using this price variable for appreciated asset gifts does not alter any of the basic implications of equations (2.1) and (2.2). The price elasticity of -1.285 is slightly lower than the previous estimate but still implies substantial price sensitivity.[10] The estimates for 1962, shown in equation (2.5), are also quite similar to equation (2.4):

$$\begin{aligned} \ln G = &-1.088 \ln P(50) - 0.757 \ln Y + 0.184\, MAR \\ &\quad (0.033) \qquad (0.185) \qquad (0.042) \\ &+ 0.134\, AGE - 2.066, \qquad R^2_{1962} = 0.52. \\ &\quad (0.035) \qquad (0.166) \end{aligned} \tag{2.5}$$

Before studying any further modifications of this equation, it is useful to consider the implications of this estimate of the price elasticity. Among families with disposable incomes between $10,000 and $15,000 in 1970, the average price of giving was 0.80 and the average gift was about $300. If contributions were not deductible, the price would rise by 25 per cent (from 0.80 to 1.00) and therefore, given a price elasticity of -1.285, contribution would fall by about 25 per cent, or $75.[11] This amount is neither implausible nor contrary to the common assertion that the deductibility of contributions is likely to have only a "small" effect on the amount given by lower income households.[12]

[9] This raises the residual sum of squares for 1970 by less than 0.2 per cent. The data are thus quite uninformative about this parameter.

[10] The price elasticity varies with the assumed "discounted gain-to-value ratio" although these differences are not large. For example, the 1970 price elasticity was -1.083 at the ratio of 0.875. The change implication of changing the gain-to-value ratio is therefore partly offset by the resulting change in the price elasticity. The aggregate effect of eliminating the deductibility of contributions is therefore influenced much less by the assumed gain-to-value ratio than either that ratio or the price elasticity alone would imply. The estimated effects of other changes, e.g., the substitution of a credit for the deduction, are more sensitive and additional evidence on this question would be very useful.

[11] More exactly, $(1.25)^{-1.285} = 0.75$, implying that contributions are decreased by 25 per cent or $75. This assumes that the increased tax revenue is not redistributed to the taxpayers; allowing for such a tax cut would have almost no effect since the individuals would spend only about two per cent of the increased disposable income on charity.

[12] This has been stressed by Aaron [1], Kahn [12], McDaniel [13], and Vickrey [18], among others. Although the effect on the average gift is small, the aggregate effect is substantial. We return to this in Section 5 below.

For households with disposable income between $50,000 and $100,000, the average contribution was $2,000 and the average price was 0.42. The lower average price in this income class implies that the deductibility of charitable gifts has a substantially greater effect than in the lower income class. Eliminating the deductibility would raise the price by 138 per cent (from 0.42 to 1.00) and would therefore lower contributions by about 67 per cent, or $1,344.

It is interesting to note the special implication of a price elasticity of exactly minus one. With this price elasticity, the value of giving responds to changes in price in such a way that the *net* cost to the individual donor is unaffected by the deductibility. Donees receive an amount equal to the sum of the net cost to the donors (which remains constant) plus the revenue forgone by the Treasury. The efficiency of the incentive to charitable giving, i.e., the ratio of additional funds received by donees to revenue forgone by the Treasury, is 100 per cent. The actual estimated price elasticity of -1.285 implies an efficiency greater than 100 per cent, i.e., philanthropic organizations receive more in additional funds than the Treasury loses in forgone revenue.

The current parameter values are very similar to those obtained in earlier studies with very different bodies of data. Feldstein [8] used aggregate Internal Revenue Service data by income class for the years 1948 through 1968. With the same price and income definitions as in equations (2.4) and (2.5), the aggregate analysis implied a price elasticity of -1.17 (S.E. = 0.09) and an income elasticity of 0.82 (S.E. = 0.03). Feldstein and Clotfelter [11] analyzed household survey data collected for the Federal Reserve Board in 1963. The corresponding price and income elasticities are -1.15 (S.E. = 0.20) and 0.87 (S.E. = 0.14).

The implications of this research stand in sharp contrast to the results of an earlier and often cited study by Taussig [17]. Taussig examined a sample of 47,678 itemized individual income tax returns for 1962. He found extremely low price elasticities (absolute elasticities not greater than 0.10) and concluded that the current tax deductibility of contributions, therefore, does little to stimulate charitable giving.[13] We believe that the basic reason for this striking difference in results is that Taussig used inappropriate measures of price and income. More specifically, Taussig used the marginal rate for actual taxable income, i.e., income net of the individual's own charitable contribution. An individual who gives more to charity therefore has, ceteris paribus, a lower marginal rate and a higher price. This introduces a spurious positive association of price and giving and thus biases the elasticity with respect to price (or marginal rate) toward zero. Taussig's measure of income was also inappropriately dependent on the individual's actual contribution, i.e., income was also measured net of taxes actually paid rather than of the taxes that would have been paid with no charitable contribution. Equation 2.6 shows the results of using this inappropriate measure of price (PT) and income (YT) with our 1962 Treasury Tax File sample of married taxpayers less than 65 years old:

[13] Taussig's estimates are based on a specification like the current equation (2.1) except that the logarithm of the marginal tax rate is used instead of the logarithm of price. Re-estimating our equation with the logarithm of marginal rate instead of the logarithm of price does not alter our conclusions.

$$(2.6) \qquad \ln G = \underset{(0.045)}{-0.520} \ln PT + \underset{(0.019)}{1.053} \ln YT - \underset{(0.166)}{4.734}, \qquad R^2_{1962} = 0.51.$$

The price elasticity of -0.520 is very much lower than the value of -1.274 obtained in equation (2.3) with the more appropriate measure of price. Taussig's use of incorrectly dependent price and income variables thus accounts for more than two-thirds of the difference between our estimate and Taussig's earlier result. It is not clear to us why Taussig's estimated price elasticity was actually smaller than the value we obtained in equation (2.6).[14] One possibility is a problem with Taussig's data. Taussig's sample of 47,678 itemized returns was part of the 1962 Treasury Tax File used in the current study. Unfortunately, part of the original data tape containing 22,918 returns (33 per cent of the total sample of itemizers) was missing in the computer tapes with which Taussig worked. The frequency distribution of the Taussig sample by income class and other attributes (reported in [16]) are quite different from those for the complete sample. If Taussig's observations were a random sample from the Tax File, this loss of data should not affect the expected value of the estimates. It is worth noting, however, that with this incorrect definition of price and income and results are quite sensitive to the particular sample. When equation (2.5) is re-estimated with the 1970 sample, the estimated price elasticity is actually a small but insignificant positive value: 0.025 with a standard error of 0.079. It should be remembered in contrast that equations (2.1) through (2.4) show that the 1962 and 1970 results agree quite well with each other when the correct measures of price and income are used.

3. THE EFFECTS OF CHANGES IN TAX RATES

The basic problem in estimating the impact of taxation on charitable giving is to separate the effects of price and income. Since price depends on marginal rate and marginal rate depends on taxable income, there is a correlation between price and our estimate of economic income. The relatively small standard errors of the price and income elasticities in the equations of Section 2 show that the traditional problem of collinearity is not serious in the current context. But the traditional problem of collinearity is limited to *linear* dependence. It is possible, however, that the association between price and economic income implies a more fundamental problem of nonlinear under-identification. Suppose that the true relation between giving and income is not one of constant elasticity but involves a more general functional relation. Although the logarithm of price has a low correlation with the logarithm of income, it might have a high correlation with the "correct" function of income. The attempt to estimate this correct functional specification would then lead to very imprecise estimates of the price elasticity.

We do not believe that this is a serious problem. The bivariate distribution of price and income in Table I shows that there is substantial variation of price within

[14] An attempt to reproduce Taussig's exact specification produced an elasticity of 0.24 with respect to the marginal tax rate. The implied elasticity with respect to price is $-0.24P/(1-P)$. Thus at a price of 0.6 the implied elasticity is -0.36.

TABLE 1

DISTRIBUTION OF CHARITABLE GIVING BY PRICE AND NET INCOME, 1970*

(Each cell presents the number of returns and the average ratio of charitable giving to net income)

Price	Net Income											
	< 2,000	2,000-4,000	4,000-6,000	6,000-8,000	8,000-10,000	10,000-15,000	15,000-20,000	20,000-50,000	50,000-100,000	100,000-500,000	500,000-1,000,000	1,000,000 +
0.31									260	2,992	33	16
									0.093	0.159	0.359	0.740
0.31									2,508	2,105	73	46
0.37									0.077	0.137	0.315	0.307
0.37								1,410	5,845	2,333	42	12
0.46								0.049	0.055	0.092	0.064	0.039
0.46								6,045	2,099	1,599	45	8
0.61								0.039	0.053	0.057	0.026	0.013
0.61					1	4	2,476	5,334	308	313	9	7
0.72					2810	0.039	0.031	0.033	0.061	0.038	0.016	0.013
0.72						1,748	3,554	769	37	55	3	1
0.75						0.031	0.029	0.039	0.057	0.038	0.037	0.006
0.75					251	4,867	1,259	321	26	36	4	1
0.78					0.044	0.029	0.029	0.041	0.073	0.028	0.019	0.002
0.78			61	746	1,909	2,161	253	109	20	34	2	1
0.81			0.081	0.044	0.033	0.031	0.043	0.069	0.094	0.030	0.010	0.006
0.81	3	283	1,016	987	427	214	42	70	20	74	6	2
0.86	0.068	0.081	0.053	0.043	0.049	0.058	0.103	0.082	0.032	0.015	0.004	0.001
0.86-1.00	111	233	222	89	54	40	15	58	37	113	18	6
	0.326	0.091	0.069	0.073	0.063	0.092	0.027	0.078	0.036	0.028	0.020	0.010

* Net income is AGI minus the federal tax liability with no charitable contributions. These returns are for married taxpayers less than age 65

individual income classes. Nevertheless, we have developed an alternative to the cross-section regression that permits price elasticities to be estimated without any restrictive assumption on the effect of income on giving.

The new method utilizes the fact that tax rates were substantially reduced in 1964. At each real income level, the price of charitable giving in 1970 was higher than the price in 1962. The average charitable contribution at each income level was also lower in 1970 than in 1962. A separate price elasticity could be calculated for each income class if we could be confident that no exogenous factor was responsible for any change in giving. This restrictive assumption is unnecessary if we wish to calculate a common price elasticity for all income levels. We shall allow for an exogenous "trend" factor that raises or lowers giving at all income levels by a common factor and then estimate the price elasticity in a way that involves no assumptions about the effect of income.

Table II shows the changes in the price and amount of giving between 1962 and 1970. More specifically, column 1 indicates the 1962 net income class (adjusted gross income minus tax liability with no charitable contributions) and column 2 shows the real income in 1970 corresponding to the midpoint of that class. Column 3 shows the ratio of contributions to net income for taxpayers who itemized in each income class in 1962 ($g62$) and column 4 shows the corresponding value at the 1970 income level ($g70$). The estimate for 1970 is obtained by interpolating from a list of ratios similar to column 3 that was derived with the 1970 Treasury Tax File. It is clear that in every case (except the class with incomes over $750,000 in 1962) the value of charitable gifts declined between 1962 and 1970; the ratio of $g70$ to $g62$ is presented in column 5. Columns 6 through 8 present the corresponding information about the price for cash gifts. In every case (again except the class with incomes over $750,000 in 1962) the price was higher in 1970 than in 1962.

The change in price and corresponding change in giving can, in principle, be used to calculate price elasticities for each income class on the assumption that the change in giving is due only to the change in price. That is,

$$\left(\frac{g70}{g62}\right)_k = \left(\frac{p70}{p62}\right)_k^{\eta_k} \tag{3.1}$$

where the subscript k denotes the kth income class. The results of this calculation are shown in column 9. The price elasticities decrease rapidly until the $20,000 income level and then vary between 1.1 and 2.7.[15]

The very high elasticities in the first three income classes are associated with very small price changes. This suggests that there was a systematic exogenous fall in giving in addition to the price effect. To estimate both the price effect and the exogenous change, we replace equation (3.1) by

$$\left(\frac{g70}{g62}\right)_k = C \cdot \left(\frac{p70}{p62}\right)_k^{\eta} \cdot \varepsilon_k \tag{3.2}$$

[15] This calculation assumes that giving is influenced by real incomes rather than relative incomes. If the calculation is repeated by comparing giving and prices at the same relative incomes, the price elasticities average 0.94 (after excluding two income classes in which the price changed less than five per cent and the resulting price elasticities were extremely large).

TABLE II

TAX CHANGES AND CHARITABLE GIVING: A COMPARISON OF 1962 AND 1970

Income ($1,000's)[a]		Ratio of contribution to income			Price of cash gifts			Arc	Price of gifts including assets (p^{50})		
1962	1970	g^{62}	g^{70}	g^{70}/g^{62}	p^{62}	p^{70}	p^{70}/p^{62}	elasticity[b]	p^{62}	p^{70}	p^{70}/p^{62}
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
10-12	13.6	.035	.031	.886	.750	.763	1.017	−7.180	.749	.761	1.016
12-15	16.6	.037	.032	.865	.718	.735	1.024	−6.114	.717	.733	1.022
15-20	21.6	.040	.033	.825	.654	.695	1.063	−3.149	.653	.692	1.059
20-30	30.8	.048	.041	.854	.532	.605	1.137	−1.229	530	600	1.132
30-40	43.2	.060	.046	.767	.434	.517	1.191	−1.518	432	.506	1.171
40-50	55.5	.092	.064	.696	.369	.452	1.225	−1.786	.367	.440	1.199
50-60	67.8	.115	.067	.583	.303	.420	1.386	−1.653	.287	.392	1.366
60-70	80.1	.152	.075	.493	.295	.408	1.383	−2.181	.279	.380	1.362
70-80	95.6	.179	.097	.542	.275	.378	1.375	−1.923	.218	.348	1.349
80-100	114.1	.189	.118	.624	.296	.398	1.345	−1.591	280	.370	1.321
100-150	154.1	.224	.143	.638	.318	.382	1.201	−2.454	.290	.323	1.114
150-200	215.8	.229	.162	.707	.350	.400	1.143	−2.590	.314	.323	1.029
200-350	339.1	.256	.202	.789	.370	.413	1.116	−2.159	.325	.338	1.027
350-500	524.0	.230	.195	.848	.366	.423	1.156	−1.137	.321	.349	1.087
500-750	770.6	.257	.213	.829	.418	.448	1.072	−2.697	.366	366	1.000
750-1,000[c]	1,078.9	.284	(.300)	(1.056)	.435	(.421)	(0.968)	−1.675	.384	(.335)	0.872

[a] Income is AGI minus the federal tax liability with no charitable contributions. 1970 incomes correspond to the same real income as the midpoint of the 1962 range.

[b] Arc elasticity is estimated as $\theta = [\ln (g^{70}/g^{62})]/[\ln (p^{70}/p^{62})]$

[c] Figures in parentheses are uncertain because of interpolation procedure

where C is a constant (presumably less than 1) and ε_t is an independent random variable. After a logarithmic transformation, the estimated equation is:

$$(3.3) \qquad \ln\left(\frac{g70}{g62}\right) = \underset{(.040)}{-.083} - \underset{(0.214)}{1.540} \ln(p70/p62), \qquad \bar{R}^2 = .77; N = 16.$$

The price elasticity of -1.540 is very similar to the price elasticities estimated for individual cross-section data for 1962 and 1970. The constant term of -0.083 implies that there was an exogenous decrease of eight per cent from 1962 to 1970 or approximately one per cent per year.

A similar calculation can be done with the price variable measured to include the effects of appreciated asset gifts. Columns 10 through 12 compare the price based on a 50 per cent "discounted gain-to-value ratio". The estimated response to the change in this price is:

$$(3.4) \qquad \ln(g70/g62) = \underset{(0.033)}{-0.143} - \underset{(0.189)}{1.393} \ln\left[\frac{p(50)70}{p(50)62}\right], \qquad \bar{R}^2 = 0.78; N = 16.$$

The price elasticity of -1.39 corresponds well to the cross-section estimates of -1.28 for 1970 and -1.09 for 1962.

There is a potential problem with the data for the lower income classes. The fraction of individuals itemizing at each income level below $20,000 decreased between 1962 and 1970. There is a danger therefore of comparing dissimilar households in these income groups. Fortunately, the estimated price elasticity is quite insensitive to the exclusion of the bottom three income groups: the estimated price elasticity changes only from -1.393 to -1.344.

These estimates give equal weight to each of the income classes. However, each observation represents a different number of individual tax returns in our sample. Fortunately, the estimates are not sensitive to weighting the observations. With each observation weighted by the number of individual returns in that class, the price elasticity rises from -1.393 to -1.575.

In short, the method of this section provides strong evidence that there is no identification problem in the cross-section estimates. The current methods literally hold income constant in relating the change in giving to the change in price. The results strongly confirm the cross-section estimates of price elasticities between -1.0 and -1.5.

4. ESTIMATING SEPARATE PRICE ELASTICITIES BY INCOME CLASS

The assumption that there is a single price elasticity for the entire population is clearly a simplification. Individuals will, of course, differ in their sensitivity to price. Using a single "average" price elasticity to describe everyone's behavior is nevertheless appropriate if these differences in price elasticity are distributed randomly in the population. But if the "average" price elasticity differs substantially among income classes, it would be appropriate to reflect these differences in simulations of alternative policies.

It is worthwhile therefore to examine whether the price elasticity does vary with income. There are several ways to do this. The simplest method is to extend the current specification by allowing an interaction term, the product of the logarithm of price and the logarithm of income. This allows the price elasticity to vary continuously with income but forces the variation to assume a smooth and monotonic form with the same relative sensitivity to income changes at all levels. The results of such a specification with the 1970 data are presented in equation (4.1):

$$(4.1)\qquad \ln G = \underset{(0.475)}{5.351}\ln P + \underset{(0.031)}{0.519}\ln Y - \underset{(0.042)}{0.602}\ln Y\cdot\ln P + \underset{(0.049)}{0.307}MAR + \underset{(0.038)}{0.395}AGE + \underset{(0.306)}{0.114}, \qquad \bar{R}^2_{1970} = 0.406.$$

The coefficient of the cross-product term implies that the absolute price elasticity rises substantially with income. Indeed, for incomes below $7,455, the implied price elasticity has the wrong sign. This indicates that the attempt to fit such a smooth and monotonic relation between price and income is not appropriate. In order to fit the observations well at high income levels, the functional form is forced to be inappropriate at low levels.

A more general specification allows the price elasticity to vary among income classes and imposes no particular parametric form on the relation between income and price elasticity. There are two ways in which this can be done. A separate equation can be estimated for each income class, thus allowing not only the price elasticity but also the income elasticity and the effects of marital status and age to vary by income class. Alternatively, a single regression can be estimated with a separate price elasticity by income class but a common income elasticity and common effects of marital status and age. Both methods have been used.

Table III presents the estimated price and income elasticities in four income classes when all coefficients are allowed to vary. For incomes above $20,000, the

TABLE III

PRICE AND INCOME ELASTICITIES BY INCOME CLASS[a]

Income class ($1,000's)	1962 Price P(50)	1962 Income Y	1970 Price P(50)	1970 Income Y
4–20	−3.67	0.53	−0.35	0.80
	(0.45)	(0.07)	(0.52)	(0.10)
20–50	−0.97	0.61	−0.85	0.89
	(0.26)	(0.19)	(0.31)	(0.16)
50–100	−1.10	1.90	−1.12	0.87
	(0.19)	(0.20)	(0.22)	(0.20)
100+	−1.29	1.02	−1.74	1.03
	(0.04)	(0.04)	(0.08)	(0.04)
All	−1.09	0.76	−1.28	0.70
	(0.03)	(0.19)	(0.06)	(0.02)

[a] Based on separate regressions for each income class with dummy variables for marital status and age. Price is based on a discontinued gain-to-value ratio of 0.50.

results in both years are similar to the constant elasticity regressions of equations (2.4) and (2.5). There is some indication that the price elasticity increases with income but, except for the highest income class in 1970, the differences are relatively small. The results for taxpayers with incomes below $20,000 differ substantially from the basic constant elasticity regressions. The results also differ greatly between 1962 and 1970. The estimate for 1962 is -3.67 with a standard error of 0.45. In contrast, the 1970 estimate is only -0.35 with a standard error of 0.52. Both of these estimates require further comment.

Consider first the high price elasticity for 1962. This value is not very different from the low income price elasticity estimated previously with the Federal Reserve Board survey data for 1962: -2.50 with a standard error of 0.91 [11].[16] It should be remembered also that this price elasticity reflects a response to a relatively small price differential among lower income households. The vast majority of households with incomes under $20,000 faced a price of 0.8 or greater. Eliminating the deduction would therefore raise their price by less than 25 per cent. Even with a price elasticity of -3 this would reduce their giving by less than 50 per cent.

The estimated price elasticity for low income households in 1970 reflects the collinearity between price and income in this subsample. In higher income groups there are some taxpayers with low marginal rates and other taxpayers with high marginal rates. But among low income taxpayers there are no high marginal rates. The large standard error of the price elasticity indicates that these data are just not sufficiently rich to provide accurate information on both price and income elasticities. However, by restricting the income elasticity and the effects of marital status and age to be the same at all income levels it is possible to obtain more precise estimates of the price elasticity. In effect, this procedure avoids the collinearity problem by using information about the effect of income at all levels in the estimation of the effect of price at each level. Equation 4.2 presents the estimated equation for 1970 with five separate price elasticities:

$$
\begin{aligned}
\ln G = {} & \underset{(0.418)}{-2.264} \ln P(50) < 10 - \underset{(0.235)}{1.818} \ln P(50)10/20 \\
& - \underset{(0.135)}{1.469} \ln P(50)20/50 - \underset{(0.085)}{1.168} \ln P(50)50/100 \\
& - \underset{(0.061)}{1.267} \ln P(50) > 100 + \underset{(0.031)}{0.782} \ln Y \\
& + \underset{(0.050)}{0.365}\, MAR + \underset{(0.039)}{0.403}\, AGE - \underset{(0.324)}{2.843}, \qquad \bar{R}^2_{1970} = 0.403,
\end{aligned}
\tag{4.2}
$$

where $P(50) < 10$ is equal to $P(50)$ if the taxpayers' income is less than $10,000 but equal to 0 otherwise, $P(50)10/20$ is equal to $P(50)$ if the taxpayers' income is between $10,000 and $20,000 but equal to 0 otherwise, etc. The implied price

[16] Some new evidence based on a special survey conducted by the Survey Research Center of the University of Michigan provides further support for relatively high price elasticities for low income households. The alternative price elasticities based on different estimating methods for households with incomes under $30,000 in 1973 center between -2.0 and -3.0. See Boskin and Feldstein [7].

elasticity in the lowest income class is now −2.26 with a standard error of 0.42 and thus rather similar to the corresponding price elasticity with other bodies of data. The other price elasticities at income below $50,000 are also slightly higher than the constant price elasticity of equation 2.4 while the price elasticity between $50,000 and $100,000 is very slightly lower.

These attempts to estimate separate price elasticities for individual income classes indicate the difficulty of obtaining such information. The disaggregated results are generally much less accurate than the overall price elasticity. The low income itemizers are an unrepresentative sample of low income households. Nevertheless, the current estimates and the previous evidence on this question do present a reasonably consistent and clear picture. First, there is evidence in all the sources of data that the price elasticity exceeds one for incomes over $20,000. There is some indication that the elasticity may increase at the highest income level. Any estimate less than one has a large enough standard error to preclude excluding the possibility that the elasticity exceeds one. Second, although the estimates for taxpayers with incomes below $20,000 are more uncertain, the evidence generally supports the previous finding of a higher absolute price elasticity that is probably in the range of −2 to −3.

5. SIMULATED EFFECTS OF ALTERNATIVE TAX CHANGES

This section uses the basic parameter estimates for 1970 (equation (2.4)) to calculate the effects of alternative changes in the income tax treatment of charitable contributions. The simulations show, for each income class, the change in the average gift, the change in the average income tax, and the change in net disposable income after both taxes and contributions. The effect on aggregate giving and on gifts to particular types of donees will also be presented. All of the estimates are for 1970 and use the 1970 Treasury Tax File.[17]

Any change in the income tax law will alter the price of charitable contributions that a taxpayer faces. Let P_i be the current price faced by individual i and P_i' be the price after a proposed change in the tax law. Similarly, let G_i be the current charitable contribution of that individual and G_i' the contribution after the change in the tax law. Consider first how the calculation of the effect of a tax change would be done if all households filed itemized returns. For a change in the tax law that alters only price and not income[18] or the demographic dummy variables, it follows that the predicted change in the individual's contribution is:

$$\ln G_i' - \ln G_i = -1.285(\ln P_i' - \ln P_i). \tag{5.1}$$

[17] The use of equation (2.4) with its constant price elasticity represents a possibly restrictive simplification. The previous section suggests that this may understate the relative effects of tax changes in the highest and lowest income groups. An actual policy analysis should also consider alternative simulations with varying price elasticities.

[18] These calculations assume that the government does not change tax rates to offset any change in total revenue resulting from the change in the tax treatment of contributions. Allowing for such a compensating change would have relatively little effect on charitable giving since the average propensity to spend on charitable giving is only about three per cent.

Since the current actual giving is known for individual i, equation (5.1) can be used to calculate the expected giving under the alternative tax system. If the tax change alters income as well,[19] the change in giving is the following:

$$(5.2) \qquad \ln G_i' - \ln G_i = -1.285(\ln P_i' - \ln P_i) + 0.702(\ln Y_i' - \ln Y_i).$$

To extend the calculation to taxpayers who do not itemize, it is necessary to estimate the amounts of the contributions that are currently made by these individuals. Let $\hat{G}_i$ be the estimated gift in 1970 by individual i who used the standard deduction. Similarly, let $\hat{G}_i'$ be the gift that the individual would make under the alternative tax treatment of charitable contributions. Since $\hat{G}_i$ is unknown, the value of $\hat{G}_i'$ cannot be estimated from the expected *change* in giving as it was on the basis of equation (5.1) for taxpayers who itemize. Instead, we now estimate $\hat{G}_i$ and $\hat{G}_i'$ separately on the assumption that the only relevant difference between itemizers and non-itemizers with the same income is the different price that they currently face.[20]

Because the estimated equations for itemizing taxpayers do not explain their giving perfectly, there is a residual difference between actual giving and the giving predicted on the basis of equation (2.1). Each residual reflects the use of a loglinear approximation and the omission of variables other than income, price, and the two demographic effects. These residual differences are automatically taken into account for itemizing taxpayers by the method of equation (5.1). For the non-itemizing taxpayers, an estimate of the residual is calculated by averaging the residuals of all itemized returns in that individual's income class: for this purpose, nine income classes are used. With u_i estimated in this way, the calculated value of giving by non-itemizer i is simply the value predicted by equation (2.1) with the appropriate values of P_i and Y_i plus the estimated residual u_i.

The Treasury Tax File provides a weight for each individual return. The estimates for each individual can therefore be aggregated to yield totals for each income class and for all households that file returns.

The data for estimating the effect on individual donees are much less adequate than the data that are available for estimating the effect on all types of donees together. Every second year the Internal Revenue Service publishes the value of itemized charitable contributions in 17 adjusted gross income classes. For 1962 only, the published report divided these contributions into five major types of charities: (i) religious organizations, (ii) educational institutions, (iii) hospitals, (iv) health and social welfare organizations (including United Funds, the Red Cross, and specific disease associations), and (v) a residual group including libraries, museums, zoos, musical organizations, and literary, educational, and scientific foundations. This is the only source of data on the distribution among different types of charities of the contributions of middle and high income households. Feldstein [9] used these data to estimate separate price and income elasticities for

[19] This is true for such proposals as the minimum tax that affect not only the tax treatment of charity.

[20] Feldstein and Clotfelter [11], using survey data on giving by itemizers and non-itemizers, show that there is little difference between the income and price elasticities estimated for itemizers only and for the whole sample and that a variety of other economic and demographic factors have no effect on giving when income and price are taken into account. This is confirmed by Boskin and Feldstein [7].

giving to the five different types of donees. That analysis showed that gifts to religious organizations and to health and welfare organizations have lower price and income elasticities than gifts to the other types of charities. This was confirmed by estimates using three different specifications. The current simulations use the quite conservative assumption that the price elasticity is actually the same for all of the donees and that only the income elasticities differ.[21] This tends to reduce the sensitivity of gifts to educational institutions and hospitals relative to the sensitivity of gifts to religious and health welfare organizations. Since the educational institutions and hospitals are still much more sensitive than other types of donees, this type of conservative assumption is probably warranted by the general inadequacy of the data on giving to individual types of donees.

Consider first the implications of completely eliminating the deduction without substituting any other provision that encourages charitable giving. The simulation indicates that this would reduce total giving in 1970 from $17.3 billion[22] to $12.8 billion, a decrease of 26 per cent. Eliminating the deduction also increases total tax revenue by $3.5 billion. This implies that the current deductibility induces $1.29 of additional charitable giving per dollar of revenue lost.

Table IV shows that the reduction in contributions differs substantially among the five major types of donees. Religious giving falls least, only 22 per cent. This reflects the concentration of religious giving in the lower income households for whom the price change implied by eliminating the deduction would be least. In contrast, gifts to educational institutions and hospitals would fall nearly 50 per cent. Community health and welfare organizations are more similar to religious organizations while the residual category contains museums, orchestras, zoos, and other charities favored by higher income donors.

Table V presents detailed results of the effects by income classes.[23] The average contribution in 1970 is given for broad income classes in column 3 and the corresponding prediction if the deduction were eliminated appears in column 4. The ratios of predicted contributions to actual contributions that are presented in column 5 show that the relative reduction in giving is much greater among high income classes than in lower income classes. While taxpayers with adjusted gross incomes between $10,000 and $15,000 would reduce their gifts by 22 per cent (from an average of $290 to $225), a reduction of 75 per cent is predicted for taxpayers in the $100,000 to $500,000 class (from $9,184 to $2,246).

Eliminating the charitable deduction would raise the average taxes paid in every income class but the increase would be greatest at the higher income levels.

[21] The actual technique is to assume that each individual's total gift is divided among donees in proportions that depend on his income class but not on the specific provisions of the tax law.

[22] In 1970 total giving on itemized returns was $13.0 billion. The remaining $4.3 billion is our estimate of the total giving by taxpayers who filed non-itemized returns (i.e., who used the standard deduction). This amount is estimated for each non-itemized return and aggregated with the appropriate weights. Note that this procedure omits a small amount of giving by those households with income so low that they are not required to file returns. Our re-estimate is nevertheless higher than the estimate of individual giving that is produced by the American Association of Fund Raising Counsel [2] using methods that we believe are much less accurate.

[23] A similar table based on aggregate data was published in Feldstein [8]. In comparing the tables it should be borne in mind that the current estimates are for all taxpayers while the previous table referred only to taxpayers who filed itemized returns.

TABLE IV

EFFECTS OF ELIMINATING THE CHARITABLE DEDUCTION

	Contributions in 1970 (in millions of dollars)		
	Actual	Predicted with no deduction	Percentage change
Religious organizations	10,441	8,158	−22
Educational institutions	679	355	−48
Hospitals	289	156	−46
Health and welfare organizations	2,499	1,819	−27
All others	3,417	2,281	−33
Total giving	17,324	12,770	−26

TABLE V

DISTRIBUTIONAL EFFECTS OF ELIMINATING THE CHARITABLE DEDUCTION, 1970

AGI class ($1,000's) (1)	Number of itemized returns (1,000's) (2)	Average charitable contributions G_1 (3)	G_1' (4)	G_1'/G_1 (5)	Tax ratio (6)	Net disposable income ratio (7)
0–5	28,350,064	90	86	0.949	1.029	1.000
5–10	21,540,224	207	175	0.844	1.033	1.001
10–15	13,686,661	290	225	0.778	1.034	1.001
15–20	5,532,010	392	277	0.707	1.037	1.002
20–50	3,568,912	690	408	0.591	1.045	1.003
50–100	353,158	2,022	756	0.374	1.053	1.006
100–500	74,631	9,184	2,246	0.245	1.090	1.017
500–1,000	1,795	72,038	12,646	0.176	1.148	1.048
1,000+	655	257,678	54,912	0.213	1.135	1.099
Average		237	175	0.737	1.042	1.002

TABLE VI

EFFECTS OF ALTERNATIVE TAX TREATMENTS OF CHARITABLE GIVING

(Billions of 1970 Dollars)[a]

No	Proposal	Change in Total gifts	Change in Tax payments	Percentage change Total gifts	Percentage change Gifts to educational institutions
1	Eliminate deduction	−4.555	+3.521	−26	−48
2	25 per cent tax credit	+0.685	−0.725	+4	−24
3	30 per cent tax credit	+2.304	−2.060	+13	−17
4	Floor on deduction: 3 per cent of AGI	−3.515	+2.727	−20	−36
5	Constructive realization of gifts	−0.458	+0.287	−3	−8
6	Limit maximum charitable deduction to taxes paid	−0.073	+0.046	−0.5	−2
7	30 per cent optional credit, all returns	+3.448	−2.957	+20	+8
8	30 per cent optional credit, itemizers only	+1.532	−1.308	+9	+4
9	Extend the deduction to non-itemizers	+1.241	−0.993	+7	+3
10	Increase standard deduction (min. $1,500, max. $2,500)	−0.975	−8.259	−6	−3

[a] All price elasticities based on appreciated asset gifts valued at "discounted gain-to-value ratio" Total gifts $17.3 billion. Educational gifts $6.79 billion.

Column 6 shows the ratios of the tax payments if the deductions were eliminated to the actual tax payments in 1970. Although taxes rise by only 3.4 per cent in the $10,000 to $15,000 class, taxes rise by 14.8 per cent in the class of taxpayers with incomes of $500,000 to $1,000,000.

The distributional effect of eliminating the deduction is quite different if we focus on the change in net disposable income rather than the change in tax payments. Net disposable income available for personal consumption or saving is defined as adjusted gross income minus both the taxes actually paid and the charitable contributions. Because charitable contributions fall sharply in the higher income groups when the deduction is eliminated, their predicted consumptions and savings increase despite the greater taxes that they pay. Column 7 presents the ratio of predicted net disposable income to actual 1970 net disposable income. Net disposable income rises at every income level, with the increase ranging from less than 0.3 per cent for incomes under $50,000 to more than five per cent over $500,000.

Most of those who have suggested eliminating the charitable deduction have proposed that some alternative be introduced to encourage charitable giving. Table VI summarizes the effects that several different common proposals would have on total charitable giving, total taxes paid, and on charitable gifts to educational institutions. Perhaps the most common proposal has been to replace the deduction with a tax credit. While the deduction makes each individual's price depend on his own marginal tax rate, the tax credit would make every taxpayer face the same price.[24] Proposal number 2 of Table VI shows the predicted results of replacing the current deduction with a uniform tax credit of 25 per cent. With this rate of credit, total giving and the total tax collections of the Treasury remain approximately at their current levels: giving increases by $0.69 billion while taxes fall by $0.73 billion. Although the aggregates are essentially unchanged, the impacts on particular donees and particular individuals differ substantially. Gifts to religious organizations actually increase by about 9.8 per cent while gifts to educational institutions fall by 24 per cent. The net disposable income of individuals with incomes between $10,000 and $15,000 would remain almost unchanged while individuals with incomes above $500,000 would increase their net disposable incomes by 6.4 per cent. Proposal 3 shows that even a 30 per cent tax credit, which would cost the Treasury an additional $2 billion in forgone revenues, would still leave educational institutions with a 17 per cent reduction in gifts.

Another common proposal is to continue the current deduction but to limit it to contributions in excess of some percentage of income. Proposal 4 shows the effect of a three per cent of adjusted gross income floor. Total giving would fall by 20 per cent and gifts to educational institutions would fall by 36 per cent. This probably overstates the effect because it assumes that individuals do not accumulate the contributions for several years in order to take advantage of the deduction.

[24] A tax credit is equivalent to a matching grant except that the tax credit in these simulations is limited to the individual's tax liability, i.e., the tax credit is nonrefundable. A refundable credit is exactly equivalent to a matching grant. In practice, the difference would be small because of the relatively small aggregate giving by individuals who do not currently file taxable returns.

The frequent comparison of this floor to the current medical expense floor is inappropriate because of the much greater ease with which charitable gifts can be postponed and "bunched" to obtain the deduction.

Several critics of the current tax treatment of charitable gifts have proposed changing the treatment of gifts of appreciated property by treating such gifts as realization for tax purposes. This would eliminate the desirability of donating property and would substantially increase the effective price for high income donors. Proposal 5 shows that this change would have a relatively small total effect but would reduce gifts to educational institutions by eight per cent. Moreover, the net disposable income would rise for high income taxpayers. For individuals with incomes over $500,000, the simulation shows that net disposable income would rise by two per cent if the constructive realization of property gifts were instituted.

Much of the public and political criticism of the current tax treatment of charitable gifts occurs because some high income individuals make substantial charitable gifts but pay no income taxes. Although the current rules that limit charitable giving to no more than 50 per cent of adjusted gross income were intended to prevent such avoidance of tax, individuals with sufficient non-charitable deductions are still able to pay no tax while making substantial deductible gifts. There is a simple way to eliminate this problem by changing the nature of the contribution limit to a limit in relation to tax paid instead of the current limit in relation to adjusted gross income. For example, each individual's charitable deduction might be limited to no more than the amount of tax that he actually pays in that year. Proposal 6 shows that this would have very little effect on total giving (a reduction of 0.5 per cent) or on gifts to educational institutions (a reduction of 2 per cent).

Not all proposals to change the tax treatment of charitable gifts would reduce giving. Some have proposed to increase the incentive to lower income households while maintaining the current deduction for higher income households. One way to do this is by an optional credit, leaving individuals the opportunity to use either the deduction or a credit of, say, 30 per cent. Proposal 7 shows that such an option would cost an additional $3 billion of forgone revenue but would increase total giving by 20 per cent and educational gifts by 8 per cent. If the optional credit were limited to itemizers only (on the grounds that non-itemizers are implicitly given a tax reduction for charitable gifts in the standard deduction), the cost to the government would fall to only $1.3 billion while gifts would increase by only 9 per cent (see Proposal 8). A quite different type of stimulus would be achieved by extending the opportunity for charitable deductions to those who do not itemize other deductions (Proposal 9). This would cost approximately $1 billion in lost taxes and would stimulate giving by 7 per cent, primarily to religious organizations. Some change of this type may be regarded as important to offset the effect on giving that would otherwise result from the currently proposed increase in the standard deduction. Proposal 10 shows that increasing the minimum standard deduction to $1,500 and the maximum standard deduction to $2,500 would, in 1970, have decreased total giving by some 6 per cent.

6. CONCLUSION

This paper has presented a detailed analysis of the sensitivity of charitable giving to alternative tax treatments. Three different sets of estimates were developed: cross-section estimates for the 1962 and 1970 Treasury Tax Files and estimates based on the change in tax rates at each income level between these two years. All three sets of estimates agree in placing the key price elasticity between -1.0 and -1.5. This value implies that the current deductibility of charitable gifts is a very efficient incentive, yielding more in additional gifts than the Treasury forgoes in potential additional revenue.

The price and income elasticities estimated in the current study are also very similar to the values obtained in Feldstein [8] and Feldstein and Clotfelter [11] with very different types of data. Feldstein [8] used total contributions on itemized returns as reported by the Internal Revenue Service for each adjusted gross income class in even years from 1948 through 1968. The basic estimate of the price elasticity with that data was -1.17. The analysis of Feldstein and Clotfelter used a large survey of individual households with a sample that was heavily weighted toward high income households. With that data the key price elasticity was -1.15. In short, there is very strong evidence from a variety of sources for the current conclusion about the relatively high price elasticity of charitable giving.

Legal discussions of the appropriate tax treatment of charitable gifts have stressed the abstract logic of a consistent definition of taxable income (Andrews [3], Bittker [6], and Surrey [15]). In contrast, we have emphasized the empirical effects of alternative policies on both donees and donors. We believe that the effects of alternative tax treatments on the volume and distribution of gifts among donees and on the distribution of tax liabilities and of net disposable income among taxpayers are the crucial aspects for evaluating these proposals. We hope that the evidence presented in this study will provide a useful foundation for future policy discussions.[25]

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NOTES

EFFECTS OF THE CHARITABLE DEDUCTION ON CONTRIBUTIONS BY LOW INCOME AND MIDDLE INCOME HOUSEHOLDS: EVIDENCE FROM THE NATIONAL SURVEY OF PHILANTHROPY

Michael J. Boskin and Martin Feldstein*

Economists and tax lawyers have long debated the efficacy and propriety of the income tax deduction for charitable contributions.[1] The effect of the deduction is to lower the individual's net cost of giving if he itemizes his deductions. More specifically, the net cost to the donor per dollar received by the charitable donee is equal to one minus the individual's marginal tax rate.[2] If the elasticity of total giving with respect to this price (or net cost) is absolutely greater than one, the charitable deduction causes donees to receive more in additional gifts than the Treasury forgoes in revenue. Alternatively, if the price elasticity is absolutely less than one, the deduction is less than fully efficient in this sense.

In a series of recent papers, Feldstein and his collaborators (1975a; 1975b; Feldstein and Clotfelter, 1976; Feldstein and Taylor, 1976) obtained estimates of the price elasticity that cluster around −1.2 from a variety of different data sources. All but one of these studies (Feldstein and Clotfelter, 1976) are based on the gifts of only those taxpayers who itemize their deductions. Since substantially more than half of the households either do not itemize deductions or do not file any tax return, the estimated price elasticities have been obtained primarily from the top half of the income distribution. While this part of the population accounts for a disproportionate share of charitable contributions, extrapolation to the entire population may not be warranted. A variety of policy proposals that are currently being considered, e.g., a tax credit for all taxpayers for charitable gifts or extension of the charitable deduction to non-itemizers, would alter the price of giving for households that do not now itemize. An accurate estimate of the price elasticity for this income group is required to predict the effects of such policies. The results presented in the current paper indicate that *households with income under $30,000 are very sensitive to tax-induced variations in the cost of giving; the estimated price elasticities generally exceed two.*

I. The Data

The data for this study were collected by the 1974 National Study of Philanthropy, a special household survey conducted by the Survey Research Center of the University of Michigan (Morgan et al., 1975). Because our focus is on the behavior of low and middle income households, data for households with incomes over $30,000 were deleted. We have also deleted all households that reported incomes below $1,000. The key variables used in the analysis will now be described.

Charitable Contributions: The dependent variable of our study is the household's gifts to charity in 1973 in the form of both cash and property. Because we will estimate a loglinear equation to obtain constant price and income elasticities, the small fraction of households that report no contributions poses a problem. We believe that most of those who report no giving actually did give a small amount which has since been forgotten or was regarded as too small to mention. Three alternative modifications of the reported giving have therefore been examined. First, we assigned a gift of $1 to all those who reported no giving; if reported giving is denoted G, this estimate is $G1 = G$ if $G > 0$ and $G1 = 1$ if $G = 0$. The second alternative assigns $10 instead: $G10 = G$ if $G > 0$ and $G10 = 10$ if $G = 0$. Finally, we try adding $10 to everyone's reported giving; this variable is denoted $G + 10$. We also estimated equations using a regression specification that directly accounts for the non-negativity of

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* We are grateful to James Morgan for the survey data used in this paper; to Joseph Pechman for insisting on the importance of obtaining estimates for these income groups; to William Barsky and Henry Moore for programming assistance; and to the Commission on Private Philanthropy and Public Needs for financial support. A more detailed analysis of this data is presented in an earlier version presented as Harvard Institute of Economic Research Discussion Paper No. 427 and Stanford University Center for Research in Economic Growth Research Memoranda Series No. 150.

[1] See, e.g., Aaron (1972), Andrews (1972), Bittker (1972), Kahn (1960), McDaniel (1972), Surrey (1972), Taussig (1967), and Vickrey (1962).

[2] This refers to gifts of cash or of depreciated property. Gifts of appreciated property have a lower net cost because no tax is paid on the appreciation.

piling up at zero of charitable contributions. The results of this procedure (which are available upon request) are quite similar to our basic results.

Price: For households that itemize their deductions, the price of a $1 charitable gift is $1-m$, where m is the household's marginal tax rate. For those households that do not itemize, the price is simply 1. Because charitable deductions are almost always a small part of a taxpayer's itemized deduction, we assume that the decision to itemize is exogenous.[3] Two different definitions of the marginal tax rate have been studied. $P1$ was the estimated marginal tax rate that the individual would face if he made no charitable gift, i.e., $P1$ is the price for the first dollar of charitable giving. Alternatively, $P2$ uses the estimated marginal tax rate that the individual would face if he made the average charitable contribution in his income class. Both measures assure that the individual's price measure is exogenous, i.e., not a function of his own amount of charitable giving.

The relevant marginal rate was estimated for each taxpayer on the basis of his reported total income, the number of his dependents, marital status, and either the relevant standard deduction for nonitemizers or an estimate of the amount of nonchartiable deductions based on Internal Revenue Service averages for homeowners and others by income class (U.S. Treasury, 1974).

Income: The survey collected information on the respondent's income bracket but not his exact income; we have used the midpoint of each narrow bracket to measure gross income.[4] The net income variable, Y, is defined as gross income minus the federal income tax liability that would have been paid had no charitable contribution been made.[5]

Age: The fraction of income contributed to charity increases with age. The current study therefore includes three age dummy variables to measure proportional shifts in giving: $A3554=1$ if the head of the family is aged between 35 and 54 and equal to zero otherwise. $A5564=1$ if the head is 55 to 64, and $A65+=1$ if the head is over 64. The omitted category is households with heads under age 35. Separate estimates were also made with the sample limited to households containing a married couple with the head between the ages of 35 and 54. This should eliminate the special problems of transitory income associated with young households, the aged, widows, etc.

[3] No adjustment is made for the special tax treatment of appreciated property since such gifts are very unimportant in the income range that we are concerned with in this paper. In 1970, the last year for which data are currently available, only 4% of charitable gifts were not in the form of cash for taxpayers with incomes below $30,000.

[4] The bracket intervals correspond to units of 1-2, 2-4, 4-8, 8-10, 10-15, 15-20 and 20-30 thousand dollars.

[5] Feldstein and Taylor (1976) show that collinearity between price and income need not be a serious problem; the inclusion of both nonitemizers and itemizers in the current study further reduces the correlation. The survey collected some data on wealth but did not obtain any information on debts or the value of pension rights; we have therefore not explored the implications of wealth here. Feldstein and Clotfelter (1976) found that higher net worth did increase charitable giving (for fixed levels of income and price) but that the inclusion of a net worth variable did not alter the estimated price elasticity.

II. The Basic Results

Equation (1) presents the basic estimate of the price and income elasticities for the sample of households with incomes between $1,000 and $30,000:

$$\ln(G+10) = \underset{(0.28)}{-2.54}\ln P1 + \underset{(0.06)}{0.69}\ln Y + \underset{(0.07)}{0.46}\,AGE\,3554 + \underset{(0.09)}{0.75}\,AGE\,5564 + \underset{(0.09)}{0.86}\,AGE\,65+ - \underset{(0.49)}{2.17} \qquad (1)$$

$$N=1621,\quad R^2=0.30,\quad SSR=2125.75.$$

Note first that the estimated price elasticity (-2.54) is very large and significantly greater numerically than 1. The elasticities and age effects are all estimated quite precisely.

The estimated price elasticity is quite consistent with the much less precise results obtained for low and middle income groups in the previous studies (Feldstein and Clotfelter, 1976, and Feldstein and Taylor, 1976).[6] The estimated price elasticity for low and middle income households in thus substantially larger than the corresponding elasticity for higher income groups. The previous studies for the entire population found overall price elasticities that clustered around -1.2 (Feldstein, 1975a, Feldstein and Clotfelter, 1976, and Feldstein and Taylor, 1976).

The estimated price elasticity of -2.54 implies

[6] For these studies the data, income classes, and estimated price elasticities are as follows: 1962 Federal Reserve Board Survey, $1,721-$8,000, -2.50 (S.E. 0.91); 1962 Treasury Tax File, $4,000-$20,000, -3.67 (S.E. 0.45); 1970 Treasury Tax File, $4,000-$20,000, -0.35 (S.E. 0.52). Feldstein and Taylor (1976, section 4) explain that the data for 1970 itemized tax returns contain too little independent variation in price and income to permit estimation of separate price and income elasticities for this group. Using a single equation for all 1970 Tax File observations but allowing separate price elasticities by income class indicates a price elasticity of -2.10 (S.E. 0.40) for $4,000-$10,000 and -1.59 (S.E. 0.23) for $10,000-$20,000.

that contributions are very sensitive to their tax treatment. The current deductibility of contributions substantially increases the total value of gifts by these lower and middle income households. For each dollar of revenue that the Treasury forgoes because of the charitable deduction, donees receive an additional $2.54.

As we noted above, several alternative adjustments were made to deal with households that reported no gift to charity. Replacing these zero reports by $10 (instead of adding $10 to *all* reported gifts) slightly increases the estimated price elasticity to −2.65 (S.E. 0.28). Since the logarithmic transformation becomes quite steep as we approach zero, the adjustment that adds only $1 to the 0 reported by some households yields a high price elasticity that may overstate the difference in giving for small price differences: −2.99 (S.E. 0.39).

The age coefficients of equation (1) confirm the importance of age as a separate determinant of giving. For example, the basic estimates of equation (1) imply that those aged 35 to 54 give 58% more than those less than 35, that those 55 to 64 give 34% more than those age 35 to 54, and that those over 64 give 49% more than those aged 35 to 54. To show that this effect is basically a proportional shift and does not involve a changing price elasticity, we present a reestimate of equation (1) with the sample limited to households headed by a male between the ages of 35 and 54; the price elasticity is −2.76 (S.E. 0.53).

Finally, we can report that the substitution of $P2$ (the price based on average gift) for $P1$ (the price based on the first dollar of giving) has essentially no effect on the estimated parameters. The price elasticity is −2.51 (S.E. 0.36).

All of our basic results thus indicate that the price elasticity of charitable giving is numerically somewhat larger than −2 for those households with incomes between $1,000 and $30,000. We turn next to the question of whether the price elasticity varies within this income range. When equation (1) is reestimated for households with incomes between $1,000 and $20,000, the price elasticity is −2.36 (S.E. 0.31) and the income elasticity is 0.69 (S.E. 0.06). More refined tests indicate no difference in price elasticity between those with incomes below $10,000 and those with incomes between $10,000 and $20,000. Since the current tax law lowers the price of giving to charity only for those who itemize their deductions and since a substantial percentage of low income and middle income households use the standard deduction instead of itemizing, the question arises as to whether the difference in charitable contributions across households which we attribute to price really reflects an effect of itemization itself. To this we now turn.

III. Is There an Itemization Effect?

To test for the presence of a pure "itemization effect" in addition to a price effect, we consider two alternate approaches. First, we use the sample of non-itemizers, all of whom face a price of 1, to estimate the income elasticity of charitable giving. This estimate is clearly not "contaminated" by either collinearity or any possible itemization effect. This income elasticity is then used as "prior information" which is imposed as a constraint on the itemizers in the sample to estimate the price elasticity. Since this price elasticity is based on data for itemizers only, there is again no itemization component in the estimated price elasticity.

Equation (2) shows that the income elasticity for non-itemizers is 0.63:

$$\ln(G+10) = \underset{(0.06)}{0.63}\ln Y + \underset{(0.11)}{0.31}\,AGE\,3554 + \underset{(0.13)}{0.86}\,AGE\,5564 + \underset{(0.12)}{0.71}\,AGE\,65+ - \underset{(0.66)}{1.60} \qquad (2)$$

(non-itemizers only) $N = 724$, $R^2 = 0.16$, SSR = 890.19.

Using this as an extraneous estimate of the income elasticity for the itemizers, we find a price elasticity of −2.3:

$$\ln(G+10) - 0.63\ln Y = \underset{(0.60)}{2.32}\ln P1 + \underset{(0.09)}{0.55}\,AGE\,3554 + \underset{(0.12)}{0.67}\,AGE\,5564 + \underset{(0.16)}{1.07}\,AGE\,65+ - \underset{(0.16)}{1.54} \qquad (3)$$

(itemizers only) $N = 897$, $R^2 = 0.08$, SSR = 1221.58.

Similarly, imposing this income elasticity on the full sample yields a price elasticity of −2.7. The estimated price elasticity therefore reflects a genuine price effect and not the effect of itemization per se.

A more direct test of the itemization effect is obtained by estimating separate constant terms for itemizers and non-itemizers. Any itemization effect would show up in different constant terms. This is formally equivalent to estimating two separate equations for the two groups subject to the constraint that the income elasticity and proportional age effects are the same for the two groups. For our basic specification, this yields the equation (4) where item = 1 for itemizers (and 0 otherwise)

and non-item = 1 for non-itemizers (and 0 otherwise).

$$\ln(G+10) = \underset{(0.50)}{-2.14}\ \text{item} \underset{(0.52)}{-2.44}\ \text{non-item} \underset{(0.64)}{-1.38}\ln P1 + \underset{(0.06)}{0.72}\ln Y + \underset{(0.07)}{0.45}\,AGE\,3554 + \underset{(0.09)}{0.75}\,AGE\,5564 + \underset{(0.09)}{0.86}\,AGE\,65+ \quad (4)$$

$N = 1621$, $R^2 = 0.30$, SSR = 2120.95.

The two constant terms are similar in magnitude and not significantly different. Comparing equation (4) with equation (1), we may use the sum of squared residuals from each to construct an F-statistic to test the hypothesis that the coefficients of the itemizer and non-itemizer dummy variables are equal. This yields an $F(1,1617) = 3.58$; the difference between the constants is insignificant. In any case, the difference between -2.14 and -2.44 is so small that the estimates clearly imply no economically significant effect of itemization.

IV. Conclusion

We have examined a new and rich body of data on philanthropic activity by households with incomes below $30,000. Using a variety of estimating equations and subsamples of the population, we find that in each case charitable contributions are quite price elastic throughout this range of income. Almost all of the evidence indicates a price elasticity that is absolutely greater than 2.

Our experience in discussing this work has taught us that some economists are at first surprised and skeptical about the high price elasticity because it seems "contrary to intuition and common observation." We do not agree with this view. Among families with adjusted gross incomes between $10,000 and $15,000 who itemize their deductions, the average price of giving is about 0.80 and the average annual giving is about $300. Eliminating the deduction would raise the price to 1, an increase of 25%. Would eliminating the deduction reduce average giving in this group by $100? If so, the elasticity is approximately -2. We doubt that intuition and common observation are capable of answering this question. We therefore do not find that the statistical estimates are in conflict with our informal judgment about the behavior of individuals in this group.

This discussion does imply an important caution in interpreting high price elasticities for low income groups. An elasticity of -2 may not be appropriate for very large decreases in price faced by this group. For example, a 50% credit would lower the price from 0.80 to 0.50, a reduction of 37%. A price elasticity of -2 would imply an increase in giving from $300 to $768, i.e., from a net cost of $240 to a net cost of $384. While this cannot be excluded as impossible, it may be larger than is likely. It is not possible to learn how the elasticity might change outside the range of current and past experience for this group.

Fortunately, however, the current estimates are appropriate for the analysis of the policies that are more likely. The extension of the charitable deduction to non-itemizers, or the availability of an optional credit at 25% or 30%, are well within the range of experience that we have studied. The current estimates therefore have important policy implications: Tax incentives to encourage giving by low and middle income households would induce a substantial increase in the flow of funds to charitable organizations.

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Macroeconomic Behavior

Finally, several members of the FMME program, including Roger Waud, Sanford Grossman, Mervyn King, and Friedman all did research on aspects of economic behavior that are more directly macroeconomic.[1] In one paper Waud concludes that both supply shocks and effects of the variability of inflation had importantly influenced the relation between price inflation and real economic growth in the United States, while more classically oriented influences had been less important. In another paper Waud concludes that the same two factors had also explained much of the deterioration over the past quarter-century in the U.K. output-inflation trade-off.

Grossman analyzes the effects of shocks to relative demands and to production technology in a world with optimal labor contracts. He argues that, under conditions involving asymmetric information among industries about technology shocks, even a fully observed shock to relative demand would cause aggregate unemployment to fall. King analyzes recent contributions to the theory of household saving behavior, together with empirical evidence on the subject, focusing in particular on the conditions required for the familiar "life-cycle" representation of household consumption plans to be applicable. Last, Friedman argues that the experience of costly disinflation in the early 1980s contradicted the central policy promise of the new classical macroeconomics just as sharply as the experience of accelerating inflation in the 1970s contradicted the chief promise of earlier thinking.

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Research Summaries

Federal Tax Policy and Charitable Giving*

Charles T. Clotfelter

In answer to a question about the possible effects of eliminating the charitable deduction in the nation's income tax, Ronald Reagan replied that Americans "are the most generous people on earth" and that they would remain so without a deduction (*Wall Street Journal*, July 7, 1982, p. 4). The question was prompted by one of several major proposals for reforming the U.S. tax system: a low-rate comprehensive income tax. Indeed, concern over economic incentives, the effects of inflation, tax compliance, and distributional equity appears to have reached a new level in the United States. From 1976 to 1983 an average of one major tax bill was enacted every two years and mounting discussion of comprehensive tax reform continues. As the question to the president suggests, one source of concern amid these actual and potential tax changes is the effect that they will have on charitable giving. This may be a particularly important topic now, following recent cuts in federal social welfare expenditures. In fact, the philanthropic sector has long shown a keen interest in tax provisions affecting their support and operation.

The project from which this article is drawn concerns the relationship between federal taxes and charitable giving. Its objective is to present and discuss statistical evidence on this relationship in order to assist in the evaluation of tax policy. Econometric analysis has focused on four major areas of charitable behavior: individual contributions, volunteering, corporate giving, and charitable bequests. There is also some empirical evidence on the effect of taxes on foundations, but no econometric studies have been done in that area. The bulk of econometric analysis and attention in economic studies has been directed toward individual giving, which seems appropriate since a large share of total gifts is accounted for by individuals. Contributions by individuals vary widely by income level and age as well as among individuals within those classifications. The major tax policy instrument affecting individual giving is the charitable deduction allowed in

* This article is derived from the introductory chapter of Federal Tax Policy and Charitable Giving by Charles T. Clotfelter an NBER monograph forthcoming from the University of Chicago Press.

the calculation of taxable income for taxpayers who itemize their deductions. As a result of this tax treatment, there are two major tax effects on individual giving: the tax liability affects the aftertax income from which taxpayers can make contributions, and the deduction reduces the net price per dollar of the contribution made. The econometric analysis of individual giving implies that the income tax has a strong effect on giving. This is not to say, however, that taxes are the only or the major influence on individual contributions, but they are one significant factor.

Taken as a whole, the empirical work on tax effects and individual giving is notable for the number and variety of studies in the area and the consistency of the findings. In few other applied areas in public finance has there been such extensive replication of empirical findings using different data sets. Studies of charitable contributions have used aggregated and individual data, data from tax returns and survey data, and foreign as well as U.S. experience. The consensus of these studies is that the price elasticity for the population of taxpayers is probably greater than one in actual value, although there are certainly estimates that are smaller or considerably larger than this. The range of most likely values appears to be about -0.9 to -1.4. That is, a 10 percent increase in the price of contributions, through a change making the charitable deduction less attractive, would result in a 9 to 14 percent cut in contributions. Taxes also influence giving through an income effect, with most estimates of the income elasticity falling between 0.6 and 0.9. In other words, a tax-induced increase in income of 10 percent tends to increase contributions by 6 to 9 percent.

In order to appreciate the implications of these findings, it is necessary to consider the specific hypotheses, different uses of data, and qualifications that apply to the studies themselves. For example, one hypothesis is that itemization status and marginal tax rate work together through the price effect to affect giving and that there is no separate "itemization effect." Separate tests of such an effect, in fact, confirm this hypothesis. Another important question is whether the price elasticity varies by income level. The extensive analysis on this question has failed to provide a definitive answer, but it appears that the elasticity rises in absolute value with income. It is reasonable to conclude, however, that the price elasticity is significantly less than zero even for low-income taxpayers. A question of particular importance for evaluating the impact of tax policy is whether taxpayers respond immediately to changes in price and income. Evidence on this questions suggests that there are substantial lags in giving behavior, with the result that short-run responses are much less comprehensive than those in the long run. One other question related to the impact of fiscal policy on contributions is whether increased government spending "crowds out" private giving. The econometric evidence on this question shows little if any effect of this sort in spite of the apparent relationship observed among nations in the size of government and the strength of private giving. Throughout this empirical literature certain econometric issues have had to be dealt with, in particular the high correlation between price and income. Based on attempts to correct for possible biases as well as for the variety of data and models used in these studies, it appears that these econometric problems are not a major factor in explaining the pattern of estimates.

Along with individual contributions, volunteering is one of the two major sources of private support for the charitable sector. In contrast to individual giving, however, our knowledge about the tax effects on volunteering is quite limited. For one thing, data on volunteering are sparse, and data linking volunteering to tax variables are even more limited. In theory, income taxation can have two broad effects on volunteering: a direct effect through the influence of tax rates on the allocation of time and an indirect effect through the charitable deduction for donations. The former effect depends on whether volunteering is simply a competing use of time, such as leisure, work, and household production, or whether it is a form of investment in human capital. The latter depends on whether gifts of money and gifts of time are complements or substitutes. The evidence on these questions is both limited and mixed. An analysis of volunteering by women suggests that contributions and volunteering are complements, implying that the charitable deduction encourages volunteering as well as donations. Also, volunteering tends to be crowded out by market work. To the extent that work and volunteering are rival uses of time, tax policies that encourage labor force participation among women tend to reduce their volunteering.

There is a much larger econometric literature on the effect of taxes on corporate giving. The new evidence presented in this study is broadly consistent with earlier findings and suggests that the corporation tax has both a price and a net income effect on corporate giving. Such behavior by firms would be consistent with a number of models other than pure profit maximization. The estimates of the income elasticity, using the cash flow measure of income, are close to one, suggesting that contributions are proportional to aftertax income. An important question remains, however, regarding the proper specification of this income measure. Qualitatively similar results are obtained using aftertax net income. The estimated price elasticities appear to be smaller than those estimated for individual contributions, but the estimates presented here leave some doubt because of the difference in results using marginal and average tax rates, respectively. Taken together, these results suggest that the price elasticity is less than one in absolute value. Finally, there is evidence that corporations time their gifts in order to take more deductions during years in which tax rates are higher.

Tax effects are also apparent in bequest giving and foundation activity. The econometric evidence of bequest giving presented in this study, like previous work, produces estimates subject to substantial variation. Nevertheless, these estimates imply that the deduction in the estate tax by and large has quite a strong effect. Most estimates of the price elasticity are greater than one in absolute value. Bequests also rise with estate

size, but the elasticity of estate size is substantially smaller than one. On estimates obtained for the very important group of the wealthiest decedents, those with net estates over $1 million, the estimated price elasticity is greater than two in absolute value, and the income elasticity exceeds one. In any assessment of the aggregate effect of estate tax changes on charitable bequests, the largest estates are of paramount importance because they account for most bequest giving. No comparable econometric evidence on foundation activity has as yet been produced. The limited information that is available suggests, though, that the provisions in the Tax Reform Act of 1969 relative to private foundations had the effect of raising payout rates without threatening the existence of foundations.

The major conclusion arising from this empirical work is that federal taxes, especially tax provisions affecting charitable giving, have important effects on the size and distribution of giving. The deductions in the individual, corporate, and estate taxes are of course most important, in the sense that no other tax changes with comparable revenue effects would influence charitable giving as much as the elimination of these deductions. But other, more general tax provisions and changes also have profound effects on giving. Probably the most important of these effects arises from the combination of the standard deduction, nominal tax schedules, and inflation. The effect of inflation has been to erode the value of the standard deduction, causing an increase in the proportion of taxpayers who itemize their deductions. This in turn affects the price of giving. Another important set of tax changes not directly related to charitable giving have been revisions in the rate schedule itself. In particular, the decline in top marginal tax rates from 91 to 50 percent over the last three decades has had a sizable effect on the prices faced by taxpayers in the highest income classes. Tax reforms such as the 1981 tax act combine several changes that are likely to affect charitable giving. Simulations based on estimated models of individual giving suggest that the combined effect will be a slight increase in the rate of giving, resulting from a large increase in giving by nonitemizers caused by the "above-the-line" deduction and a slight decline in giving among upper-income taxpayers resulting from the drop in tax rates.

Similarly, the econometric evidence implies that federal taxes will affect other forms of giving as well. Policies that encourage labor force participation of women —for example, the deduction for secondary earners— may tend to discourage volunteering. The extension of the charitable deduction to nonitemizers, on the other hand, may encourage volunteering if gifts of time and money are complementary. The recent changes in the corporate tax resulting in an increase in the number of firms with no tax liability will tend to discourage corporate giving by raising its average net price. The implications of the empirical analysis of bequests are similar to those applying to individual contributions. The 1981 tax act, which reduces the number of taxable estates and lowers the marginal tax rate for many estates, is likely to discourage bequest giving by raising the net price of charitable bequests.

Simulations of individual giving show that one of the most important implications of existing empirical work is that tax policy can affect the distribution as well as the level of contributions. Since donors at various income levels differ markedly in their propensities to make gifts to various kinds of charitable organizations, tax changes that affect the distribution of giving among income classes will tend to affect the distribution of support to various parts of the philanthropic sector. For example, the 1981 tax act had the effect of significantly reducing marginal tax rates for taxpayers in the top brackets in both the income and estate taxes. If the effect of such price changes outweighs the influence of changes in net income or net estate, which they in fact appear to do, these tax changes are likely to cut the relative share of giving undertaken by the wealthy. This would imply a decline in support for institutions such as colleges, universities, cultural institutions, and private foundations and toward religious organizations and certain health and welfare groups. It is important to emphasize, however, that implications such as these are based on price and income effects and do not account for any changes in behavior by donors or charitable organizations caused by other factors.

The econometric estimates also have implications for proposed or hypothetical tax provisions. Simulations in the text examine several proposals that involve changes in the charitable deduction or general tax rate revision. Probably the largest effect would be observed if the charitable deduction were eliminated altogether, perhaps as part of some comprehensive income tax. Such a change would have important effects on the distribution as well as the level of contributions, with gifts by wealthy taxpayers falling the most. Substituting a tax credit for the present deduction, depending on the rate used, primarily would have the effect of redistributing the pattern of gifts between low- and high-income groups. Smaller changes would come about as a result of less sweeping revisions, such as the constructive realization of appreciated assets given as gifts or the expansion of the deduction at low- and middle-income levels. Each of the proposals noted here would affect overall tax revenues, and it is important in simulating their effects to adjust for this. Similar effects could be calculated for bequest giving, with the elimination of the deduction in the estate tax having much the same kind of effect.

SPECIAL REPORT

TAX ANALYSTS

TAX RATE CHANGES AND CHARITABLE CONTRIBUTIONS

by Bruce F. Davie

Bruce F. Davie is Chief Tax Economist for the Committee on Ways and Means, U.S. House of Representatives. The views expressed here are solely his own. He wishes to thank Rosina Barker, Emil Sunley and Randy Weiss for helpful comments on an earlier draft.

This article takes issue with those who argue that tax reform proposals would have a dramatic negative effect on charitable giving. He shows that high-income taxpayers have not reduced their charitable contributions in response to recent reductions in tax rates.

The Treasury Department's November 1984 tax reform proposal, and other tax reform proposals were recently analyzed by Charles T. Clotfelter in terms of their expected impact on charitable giving.[1] Clotfelter estimates that the Treasury proposal would reduce giving by 20 percent at 1985 levels of income. Other studies have suggested similar results.[2] These widely publicized results have set off fire alarms among officials of charitable institutions.[3]

My purpose here is to argue that recent tax return data are not consistent with the proposition that reductions in marginal tax rates lead to dramatic reductions in charitable giving, particularly among upper-income groups. If indeed changes in tax rates have a major impact on charitable giving, there ought to be some persuasive evidence over the last 10 years since the price of giving has been increased by reductions in capital gains rates in 1978 and by the marginal rate cuts enacted in 1981. I find none.

The Clotfelter Analysis

The argument made by Clotfelter can be summarized as follows. Giving is affected by both income and the price of making a gift. That price is determined by the tax treatment of contributions. Thus, for example, the Treasury proposal raises the minimum price of a $1 cash contribution from 50 cents to 65 cents for taxpayers subject to maximum marginal tax rates. The price of giving is also affected by the proposed limitation on contributions of appreciated assets to inflation adjusted basis, a two percent floor under deductible contributions, the repeal of most of the percent of income limitations on charitable contributions and the repeal of deductibility for nonitemizers. An elasticity estimate of -1.27 was used for simulating the price effect of reform proposals, that is, a 10 percent increase in the price of giving leads to a 12.7 percent decline in the amount given. An elasticity estimate of .78 was used for the income effect, that is, a 10 percent increase in income leads to a 7.8 percent increase in giving. These elasticity estimates are representative of several econometric investigations published in recent years based on a variety of data sources. The change in the price of giving resulting from the reform proposal was calculated for different income classes and standard assumptions for economic growth and inflation used. Applying the elasticities against the income and price changes applicable to different income classes and aggregating produces the estimated change in giving—a 20 percent reduction.

Surveys of household patterns of charitable giving show variation by income level among types of recipient institutions. In lower-income groups, contributions to religious organizations predominate; at upper-income levels, contributions to higher education and cultural organizations are more important. The effective price of contributions is increased by higher percentages at upper-income levels under the Treasury proposal. When the price effect is combined with the survey results, Clotfelter estimates that the Treasury proposal would lead to a 27 percent decline in contributions to higher education. When he uses price and income elasticities that are variable across income classes, the estimated decline in giving to higher education is 34 percent. No wonder college presidents are writing their congressmen in opposition to the Treasury proposal.

Recent estimates of the impact of the Treasury tax reform proposal on charitable giving are seriously exaggerated.

[1] "Tax Reform and Charitable Giving in 1984," *Tax Notes*, February 4, 1985, pp. 477-487.

[2] See also Gabriel Rudney, "Charitable Deductions and Tax Reform: New Evidence on Giving Behavior," *Tax Notes*, January 28, 1985, pp. 267-8 and Lawrence B. Lindsey, "The Effect of the Treasury Proposal on Charitable Giving," Harvard University and National Bureau of Economic Research (mimeo), February 12, 1985.

[3] Clotfelter's caveats regarding estimating techniques and the possibility of a time lag before giving behavior fully adjusts to the new tax law have been ignored by the press and the representatives of charitable institutions.

SPECIAL REPORT

The Doughnut or The Hole

At first blush the data shown in Table 1 give added weight to concerns about the impact of marginal tax rate reductions on charitable giving. Over the last 10 years average contributions per return have declined in some cases dramatically in all five top AGI classes. The decline would be even more dramatic if measured in constant dollars. Clearly the reductions since 1977, a vintage year for high marginal tax rates when the maximum tax rate on unearned income was 70 percent, the maximum rate on capital gains in typical situations was 35 percent (in some cases due to interaction with the maximum rate on earned income and the minimum tax, capital gains rates were even higher. In 1983 the maximum marginal tax rate on all ordinary income was 50 percent and 20 percent on capital gains. Moreover the point at which the 50 percent rate on ordinary income applies had been pushed well up the taxable income scale. Why is it that the data from Table 1 should not be taken as convincing evidence for the position taken by Clotfelter and others?

First keep your eye on the doughnut and not the hole. Itemized contributions have increased rather dramatically over the last 10 years. As indicated in Table 2, these contributions totalled $37.5 billion in 1983 and were only $13.9 billion a decade earlier. Itemized contributions as a percentage of total adjusted gross income on all returns increased from 1.7 percent in 1973 to 1.9 percent in 1983. This percentage is of course similar to the percentage of tax returns claiming itemized deductions but that percentage was roughly the same in those two years. Itemized contributions as a percent of the AGI of itemizers only increased from 2.86 percent in 1973 to 2.98 percent in 1983.

What then explains the apparent contradiction between average contributions per return in the top AGI categories and total itemized contributions increasing as a fraction of total AGI? Because of radically increasing numbers of returns in the top AGI brackets these categories are not useful objects of comparison. See Table 3. Inflation and real growth in AGI pushes taxpayers up out of one AGI category into the next. The number of "pushees" was large relative to the number of taxpayers previously in the next higher AGI category. The new entrants into any particular high income AGI category are likely to be concentrated at the bottom end of that range. The distorting effect is magnified by the width of these upper-income categories. One way to illustrate the effect is to note that average AGI in real terms and in some cases in nominal terms declines over time in each AGI group. It is more appropriate to make comparisons of tax returns constituting specific small fractions of returns rather than comparing returns in particular AGI categories. Such a comparison is shown in Table 4.

The published SOI data permit a comparison of the top .2 percent returns in 1983, with the top .2 percent returns in 1974 and 1975. This time span fully covers the period of reduced capital gains rates and marginal income tax rates which might be thought to affect the giving behavior of high income taxpayers. This comparison shows the average contributions of high income taxpayers not falling like a rock, but more than doubling in nominal terms.

*In his paper referred to in note 2 (p. 9), Lindsey refers to these data as indicating that "the recent experience of a sharp marginal rate reduction at the top of the income scale confirms a price elastic response."

Table 1

AVERAGE CONTRIBUTIONS PER RETURN (1978-1983)*

	Adjusted Gross Income ($000)				
	$0-100	100-200	200-500	500-1,000	over 1,000
1973	$1,970	$3,500	$10,727	$65,176	$270,813
1974	1,843	4,243	16,246	57,227	246,451
1975	1,853	4,494	16,397	58,216	265,643
1976	1,887	4,934	16,891	60,619	265,340
1977	1,792	4,795	15,578	57,804	235,196
1978	1,657	4,429	14,257	55,250	230,798
1979	1,614	4,270	13,655	48,300	212,531
1980	1,610	4,357	13,200	45,903	200,849
1981	1,646	4,554	14,235	49,571	202,565
1982	1,568	4,376	11,881	34,117	144,189
1983	1,639	4,689	11,977	33,246	125,782

*Total itemized contributions divided by all returns.

Source: Department of the Treasury, Internal Revenue Service, Statistics of Income, Individual Income Tax Returns for years 1973-82; Advance Data for 1983.

Table 2

CHARITABLE DEDUCTIONS AND TAX RETURN DATA (1973-1983)

	Total Number of Returns (thousands)	Total AGI (billions)	Percent Itemizing	Itemized Contributions: Amount (billions)	Itemized Contributions: Percent of AGI
1973	80,693	$ 827.1	34.7	$13.9	1.68
1974	83,340	905.5	35.5	14.9	1.65
1975	82,229	962.9	31.7	15.4	1.60
1976	84,670	1,053.9	30.7	16.8	1.59
1977	86,635	1,165.8	26.4	17.3	1.48
1978	89,772	1,302.4	28.7	19.7	1.51
1979	92,694	1,490.2	28.6	22.2	1.49
1980	93,902	1,642.3	30.8	25.8	1.57
1981	95,396	1,804.0	33.1	30.8	1.71
1982	95,337	1,917.0	35.1	33.5	1.75
1983	96,294	1,950.8	36.6	37.5	1.92

Source: Department of the Treasury, Internal Revenue Service, Statistics of Income, Individual Income Tax Returns for years shown; Advance Data for 1983.

Table 3

NUMBER OF TAX RETURNS IN HIGH INCOME CATEGORIES (1977 and 1983)

Adjusted Gross Income ($000)	1977	1983
50-100	1,140,784	4,420,812
100-200	225,150	623,471
200-500	46,386	165,226
500-1,000	5,232	26,098
over 1,000	1,785	11,526

Source: Department of the Treasury, Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, 1977; Advance Data for 1983.

Table 4

**CONTRIBUTIONS DEDUCTION
TOP 0.2 PERCENT OF RETURNS**

	1983 (returns with AGI over $200,000)	1974 (returns with AGI over $100,000)	1975
Number of returns	202,6[illegible]	166,47[illegible]	185,9[illegible]
Percent of total returns	0.21[illegible]	0.230	0.226
Aggregate AGI (millions)	$83,68[illegible]	$29,5[illegible]	$32,5[illegible]
Number of contributors	196,5[illegible]	15[illegible]	17[illegible],315
Aggregate contributions (millions)	$4,29[illegible]	$1,498	$1,7[illegible]5
Average contributions	$21,534	$9,48[illegible]	$9,67[illegible]
(constant 1967 dollars)	$7,3[illegible]	$6,42[illegible]	$5,9[illegible]
Contributions as a percent of AGI	4.78	5.08	5.2[illegible]
Net capital gain as a percent of AGI	21.7	12.5	11.[illegible]

Source: Department of the Treasury, Internal Revenue Service, Statistics of Income—Individual Income Tax Returns (various years) and Advance Data for 1983.

Table 5

**CONTRIBUTIONS DEDUCTION
TOP 38,000 (APPROX.) RETURNS**

	1983 (returns with AGI over $500,000)	1975 (returns with AGI over $200,000)	1976
Number of returns	37,624	33,603	41,761
Aggregate AGI (millions)	$42,903	$12,682	$15,732
Number of contributors	36,109	32,267	40,311
Aggregate contributions (millions)	$2,312	$969	$1,205
Average contributions	$62,972	$32,268	$29,916
(constant 1967 dollars)	$21,103	$20,31[illegible]	$17,545
Contributions as a percent of AGI	5.38	7.64	7.67
Net capital gain as a percent of AGI	29.9	17.9	18.3

Source: Department of the Treasury, Internal Revenue Service, Statistics of Income—Individual Income Tax Returns (various years) and Advance Data for 1983.

and increasing in constant dollar terms. Contributions as a percent of AGI for these taxpayers has declined slightly, but this decline is probably attributable to the larger fraction of AGI constituted by net capital gains in 1983 than in the earlier period. Realization of capital gains is an income event for tax accounting purposes, but in economic terms represents a change in the composition of the taxpayer's assets. Accrual rather than realization would be a more appropriate way to account for capital gains as an element in an income variable used to explain the pattern of contributions. There are reasonable grounds for expecting a large transitory element of capital gains income to be reflected in AGI for 1983. There was probably some unlocking as a result of reduction in the capital gains tax rates, merger activity may have resulted in unplanned realizations for a number of high-income taxpayers and 1983 was a period of markedly improved stock prices relative to the prior year. Stock prices in 1974 and 1975 were down relative to what they had been in 1973.

Table 5 attempts a similar comparison. Here the focus is on an even more exclusive group, those with AGI over $500,000 in 1983. There were 37,624 such returns. In 1975 and 1976 returns with adjusted gross income of over $200,000 were about the same number. The results are similar to those in Table 4. Average contributions about doubled and also increased in terms of constant dollars. Here the decline in contributions as a percent of AGI is a bit more dramatic, but again higher fractions of AGI represented by net capital gains would seem to explain a large part of the difference.

The increased rather than decreased itemized charitable contributions of accurately categorized high-income taxpayers over a period of significantly declining tax rates resolves the apparent contradiction between the data in Tables 1 and 2. These findings shed considerable doubt on the predictions currently being made of the impact of various tax reform proposals on charitable giving based on prior estimates of income and price elasticities. Consider the results shown in Table 4 comparing 1975 with 1983. Real AGI per return, measured in 1967 dollars, increased from $108,751 to $148,172, a 36.2 percent increase without making any adjustment for additional capital gains in 1983. Average real contributions for this top 0.2 percent of taxpayers rose 29.1 percent. Ignoring any price effect, this would imply an income elasticity of .80. Although that elasticity is approximately equal to Clotfelter's .78, it implies a zero price elasticity. Alternatively, these findings could be consistent with a higher income elasticity and a price elasticity that is negative to some degree. But they are certainly not consistent with an income elasticity of .78 and a price elasticity of -1.27 over a period in which the price of giving increased for upper-income taxpayers, as was true for this time period. For those affected by the reduction in maximum rates from 70 to 50 percent, the price of giving went up 66.7 percent.

Itemized contributions have increased rather dramatically over the last 10 years.

The econometric problem of sorting out price and income effects [illegible] in a world where there is a close relationship between income and price created by a progressive rate [illegible] of an econometric [illegible] are bound to be misleading if they are based on classifications of taxpayers by AGI class or any other classification fixed in nominal dollars. The findings presented here suggest that econometric work based on taxpayers classified by their position in the income distribution may produce results that are more consistent with SOI data.

Of this number, [illegible] claimed [illegible] contributions. They are the [illegible]

• SPECIAL REPORT

Past Predictions

In a 1982 National Tax Journal article Clotfelter and Salamon used the same technique and estimates to predict the impact of the 1981 Act on charitable giving.[1] They concluded that over the 1982-84 period charitable giving would be $10 billion lower in constant 1980 dollars than it would have been under pre-1981 law. They expected $8.6 billion of the difference to be accounted for by the top 15 percent of returns (returns with AGI of over $25,000 in 1978, the year for which SOI data form the basis for their analysis). Of the total $10 billion difference, $3.8 billion was expected in 1983, and presumably 86 percent of that amount, or $3.3 billion, would have been accounted for by the top 15 percent of returns.

In 1978 taxpayers with AGI of $25,000 or more represented 15.3 percent of all returns and made itemized contributions of 2.26 percent of their aggregate AGI. In 1983 the top 15.3 percent of returns made itemized contributions of 2.92 percent of their aggregate AGI. Their total itemized contributions in 1980 dollars increased from $17.0 billion in 1978 to $15.6 billion in 1983. This is not consistent with the Clotfelter-Salamon prediction.

Unfortunately, Clotfelter and Salamon did not publish a prediction for itemized charitable contributions for 1983. They did indicate that $35.5 billion in 1980 dollars of itemized deductions were expected under pre-1981 law in 1984 but that the amount would be $30.4 billion under the 1981 Act. Since actual total itemized charitable contributions in 1980 dollars were $31.4 billion in 1983, $1 billion greater than their estimate for 1984, it is reasonable to expect that actual 1984 total itemized chari-

[illegible]

[illegible]

Conclusions

[illegible]

charitable giving are [illegible]

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[1]Charles T. Clotfelter and Lester M. Salamon, "The Impact of the 1981 Tax Act on Individual Charitable Giving," National Tax Journal, June 1982, pp. 171-187.

To estimate 1983 data for the top 15.3 percent of returns, data from the SOI Advance Data were used for all returns with AGI above $40,000 plus 41.6 percent of AGI and itemized contributions reported on returns in the $30,000 to $40,000 AGI class. This interpolation technique gives a conservative bias to the estimate of contributions as a percent of AGI for these taxpayers.

PRIOR COVERAGE OF CHARITABLE CONTRIBUTIONS AND TAX REFORM

For a news story on a Brookings Institution conference on federal tax policy and charitable giving, see Tax Notes, February 18, 1985, pp. 626-627.

For a special report by Duke University professor Charles T. Clotfelter on "Tax Reform and Charitable Giving," in 1985, see Tax Notes, February 4, 1985, pp. 477-487.

For a special report on charitable deductions and tax reform by Gabriel Rudney, a senior research associate in the Program on Nonprofit Organizations at Yale University's Institution for Social and Policy Studies, see Tax Notes, January 28, 1985, pp. 367-368.

For a summary of a National Bureau of Economic Research (NBER) monograph on federal tax policy and charitable giving, see Tax Notes, December 24, 1984, pp. 1252-1254.

For a news story on charitable groups pushing to keep the current write-off for charitable contributions, see Tax Notes, December 17, 1984, p. 1056.

WHITE HOUSE NEWS

REAGAN SPEECHES CONTINUE TO URGE TAX REFORM AS VEHICLE FOR FAIRNESS, ECONOMIC GROWTH. President Reagan reaffirmed his commitment to tax reform as a vehicle for achieving greater equity and lasting economic growth in speeches before the Conservative Political Action Conference (CPAC) March 1 and the National Association of Counties (NAC) March 4. "I believe our tax system currently acts as the single biggest threat to stronger enterprise and lasting economic expansion," Reagan told the NAC. "Many of our citizens are required to pay more than their fair share of the tax bill, while others are permitted to pay less. Today's tax code drives money needed for investment and future growth ... into unproductive tax shelters. And hundreds of millions of dollars are wasted in needless paperwork. Plain and simple, the [current] tax code is unfair, inequitable, counterproductive, and all but incomprehensible. We must institute a fair tax system and turn the current one on its ear," the President said.

Reagan also told both groups there would be no increase in taxes and called on Congress to pass a responsible budget with at least $50 billion in spending cuts. He also called for consideration of his urban enterprise zones proposal. "We want hope and opportunity to reach every nook and cranny of our great land, and these initiatives deserve your support," he said. The texts of Reagan's speeches before the CPAC and the NAC have been placed in the March 11, 1985 *Tax Notes Microfiche Data Base* as Docs 85-1901 and 85-1902 respectively.

Senator MATSUNAGA. Mr. Chairman, could I ask one more question, purely on a philosophic basis?

The CHAIRMAN. Sure.

Senator MATSUNAGA. There appears to be two philosophies relative to taxation: One, solely for the purpose of raising revenues; the other, not only for the purpose of raising revenues but also for engineering social policies to attain desirable social objectives.

Now, was any consideration given by Senator Bradley or Congressman Gephardt with relation to what philosophy should be the basis of your formulation of taxation?

Mr. GEPHARDT. We think our philosophy is consistent with what the philosophy of the American income tax system has been for some time, but we believe that we have erred in recent years on the side of trying to use the Code too much for directing social and economic behavior. And we simply think that backing off of the degree to which we have been willing to use it for that purpose would make sense. We do not reject the idea that you can use it that way. We keep a number of the most popular, universally used deductions to get people to allocate capital, and to get people to do certain other things in the society. It is simply a matter of degree—how far do you want to go?

There is a tension between the two goals. We think the tension has gone too far toward directing social and economic behavior. We think we would do far better by moving back—more neutrality, less direction in the Code—and having a simpler and fairer system.

Senator BRADLEY. If I could just add one comment. The other thing to consider is what is it worth to have a much cleaner, more comprehensible income tax system, what is it worth to get the rates down as low as possible?

In making that kind of calculation, we made some fairly tough choices, and we did that in order to get the rates down and restore fairness to the system.

Let me just give you one anecdote. I was on the dais with a corporate executive in New Jersey about a year ago, and he said, "I'm really worried about my son." You know, you are a politician and you don't know—do you ask the question or do you not ask the question? I was up for reelection, so I asked him, "Well, what's wrong?" [Laughter.]

He said, "My son is 25 years old, and all he can think about is how to avoid paying taxes." And I told him, "Go to work, pay your fair share, but don't worry and don't scheme all these things."

Then he made the telling comment. He said, "You know, I'm worried about the fact that there might be a generation out there who feel no responsibility to support the legitimate functions of government."

Now, I believe that flows in part from the complexity of the present system. So, we are not 100-percent pure; we don't eliminate everything; we keep certain things in the Code. But I think, as Dick said, what has happened is that we have erred grossly on the wrong side of the ledger, and we need to get the rates down and make the system a lot fairer.

Senator MATSUNAGA. Thank you, Senator. Thank you very much, and I congratulate you both.

The CHAIRMAN. Thank you.

Now we will hear Congressman Kemp and Senator Kasten.

Congressman Kemp will go first, as Senator Kasten is over voting.

Congressman KEMP. Do you mean I wasn't going to go first before? [Laughter.]

The CHAIRMAN. Let me say one thing, Jack, about your plan, that I highly admire. There is much in it to be admired, but I particularly appreciate the way you treat employee benefits. It very much comports with my views of the fact that these are basic benefits for middle income and lower income taxpayers; these are not perks for corporate presidents. You have not taxed them, and I think that is a very wise position. Go right ahead.

STATEMENT OF HON. JACK F. KEMP, U.S. REPRESENTATIVE FROM THE STATE OF NEW YORK

Mr. KEMP. Mr. Chairman, I want to thank you not only for your comments today about not taxing fringe benefits, but also for your long-time position on the issue. I agree with you on this, and I think it is an issue important to blue-collar working men and women.

As I think Senator Bradley pointed out, the reason that social policy is inseparable from the Tax Code is that the income tax code affects every single human being in this country and obviously that makes it a social issue in and of itself. Those working men and women, who have negotiated contracts to provide against risks to their health and lives, predicated upon certain aspects of the Tax Code, it seems to me that was good social policy.

I want to commend you for your effort in this area and say that I agree with Bob Packwood and, strangely enough, Lane Kirkland of the AFL-CIO.

The CHAIRMAN. Thank you very much.

Mr. KEMP. I also want to thank you also for holding the hearings. I really think it is important to highlight aspects of the various plans, and I want to pay my public tribute to Bill Bradley and Dick Gephardt for advancing tax reform as far as they have.

I don't think tax reform began with any one person or any one bill. Ronald Reagan had something to do with it in 1981, when we dropped the rates by 25 percent and cut the 70 percent bracket to 50, but it was done on a bipartisan basis, Mr. Chairman, as you know, and I think that is the spirit we have to have if there is to be any restructuring of the U.S. Tax Code in 1985, which I favor and I think you do. And Congressman Rostenkowski, the Democratic Chairman of the Ways and Means Committee, has also expressed his agreement.

I am encouraged, Mr. Chairman I think we can do it in 1985. And certainly your efforts and support and thoughts and hearings are absolutely critical to this whole process.

The one other comment I wanted to make is that there is too much talk about winners and losers, Mr. Chairman. We want the economy and the American people to be the winner. And I hope that we stop looking at this as zero-sum, assuming that one gains only at someone else's expense. It seems to me that we all have a

big stake in how this economy performs and how we can encourage labor and capital and the family to move forward.

I have submitted my statement for the record. I have cut way down, which is unlike me in testifying, As I said, I really appreciate this chance to testify, Mr. Chairman. I applaud your committee, Bill and Dick, and also Jim Baker and Don Regan. It is going to take the President's personal efforts, and I think it is going to be there. My friend Bill Bradley always says, "If Ronald Reagan gets involved." Well, he is involved. He helped start it and move it forward, and I am convinced after my talks with him, and I know you have had some, too, that the President is going to endorse not just the cause of the restructuring of the Code, but he is going to advance a particular bill—I think it will be an amalgamation of those that are being discussed.

As the author of Kemp-Kasten along with my colleague Bob Kasten—who is over in the Senate right now voting—I just want to say that I think we can come up with a pro-growth, pro-family, fair and simple tax system for the American people. They will be the winners.

I would like to outline just briefly some of the advantages of the Kasten-Kemp bill—that's what Bob would have said.

We give a large break to the working poor, Mr. Chairman. A family of four under Kemp-Kasten would not pay any tax, up to $14,125 of income. I think that is very important. The poverty level next year for a family of four is about $11,500. The reason that we have removed the working poor from the Federal income tax rolls, Mr. Chairman, is that right now if a woman on welfare takes a job and she has two or three children, she has to earn about $15,000 to $16,000 in pretax income to get the equivalent of an $8,000 to $9,000 transfer payment income, which as you know is not taxed. So we have created such a disincentive that it has raised that first rung of the ladder, and both Bob Kasten and I believe that we should remove those families up to about 125 percent of poverty level.

We also provide the most relief for the traditional family with children. We double the personal exemption to $2,000. My friend Bill Bradley and Dick Gephardt keep the child exemption at $1,000, and the Treasury has talked about $1,800. I don't know what the final product would be, but I am not much in a compromising mood on this issue, because had the personal exemption been indexed to the share of per capita income that it represented to the American family in 1948 many people observe that it would be close to $5,600 for every single dependent in America today. Indexing for inflation alone, it would have to be over $2,500. Doubling it to $2,000 and indexing it will make up in part for that devaluation, if you will, of the American family.

The Kemp-Kasten bill increases the value of deductions for home mortgage, for property taxes, contributions to charity, and the personel exemption itself. We allow for the full write-off of the property tax, the full write-off of charitable contributions, and of course the child exemption. The value of these deductions is generally reduced under Bradley-Gephardt and the other plans.

Our plan is now the only one that increases the earned income tax credit. It relates the credit to the family size and modifies it to

significantly reduce the high marginal tax rate that really constitute, Mr. Chairman, the poverty trap in America.

We also have the lowest top tax rate. It is about 28 percent. Bradley-Gephardt is 30, the Treasury-1 is 35, and I understand that Treasury-2 is also 35. I am willing to compromise at 28½. I said that, with tongue in cheek, but I am very serious in suggesting that we have got to get the personal rates low enough to make up for the loss of certain deductions. I would prefer no higher than 30, and I think Bill Bradley prefers 30. I would hope that we could get it down to 28.

The Kemp-Kasten—whoops, here comes Senator Kasten. The "Kasten-Kemp" bill——

[Laughter.]

Mr. KEMP [continuing]. Has the lowest top capital gains rate. I think both Bob and I believe that the venture capital markets, the entrepreneurial sector of this economy, the people, the men and women who create jobs, require some differential. We offer an option of indexing instead of the exclusion, but Bob and I both believe the top rate should be closer to 17 or 20 than to tax it as ordinary income. And as you know, Bradley-Gephardt and Treasury-1 tax capital gains as ordinary income at 30 percent and 35 percent respectively.

The Kasten-Kemp bill has reduced and graduated tax rates for small business, 15 percent and 25 percent for those businesses that earn less than $100,000 of taxable corporate income.

We don't tax fringe benefits such as medical and life insurance. I think that is an important blue-collar issue as does my colleague Bob Kasten. And we reduce the very high marginal tax rates on senior citizens. I don't need to go into it, but every senior American knows what happens at a low level of income, with Social Security. There is a huge tax rate on their income, and we significantly and dramatically reduce that high marginal tax rate on senior Americans.

We have debated depreciation since 1981, Mr. Chairman, and Senator Kasten and I believe that we should not change the depreciation schedules to where we interfere with the legitimate plans to modernize the equipment and technology and the plant and machinery of the industrial sector of the economy. Bob and I think we have come up with a very innovative way of solving the dilemma. As you know, Treasury-1 stretches depreciation out to up to 65 years; Bradley-Gephardt stretches depreciation schedules out to almost 45 years. Senator Kasten and I have what we call the "NCRS," Neutral Cost Recovery System. It is the economic equivalent of first-year expensing, Mr. Chairman, and in effect it allows for extra write-off with indexing, which provides for a way to get economic equivalent of expensing, without the upfront revenue cost. So it is something we have asked the Treasury to look at as a way of combining incentivies for investment with neutrality among investments.

Let me skip to my conclusion. As I said earlier, the Treasury is putting forward what will commonly be called "Treasury-2" or perhaps even "Reagan-1." There has been considerable discussion, though nothing that I would call negotiation, among the principal proponents of tax reform about what that proposal should contain.

The specific details of that proposal are not yet public, but it is increasingly clear that on a number of issues Treasury-2 would be substantially improved over Treasury-1.

I am concerned however, as I said earlier, Mr. Chairman, about what I consider the two most important unresolved issues: The maximum tax rate on personal income, and the size of the personal exemption.

Tax reform involves a tradeoff—lower tax rates and the broadening of the tax base. And it is important that most typical taxpayers gain more than they give up from tax reform. The original Treasury plan contained a top rate of 35 and a personal exemption of $2,000, and according to news reports the draft of Treasury 2 tentatively has a 35-percent top rate and an exemption of about $1,800. If this is the case the top rate will be too high, Mr. Chairman, and the exemption too low.

There is another important consideration. In high tax rate States like New York—and there are others, like Wisconsin, Minnesota, Michigan, and California—the typical taxpayer will come out ahead of the Federal tax rate is no higher than 28 or 30 percent and the exemption is $2,000.

Senator CHAFEE. That is based upon the assumption that you repeal the deductibility of the State and local taxes?

Mr. KEMP. Yes. Every deduction, Mr. Chairman, every credit, every gimmick in the Tax Code is in there for one basic reason, to protect the taxpayer against the effects of a high marginal tax rate on his or her income. But to make the tradeoff worthwhile, the rates have to be low enough. And I am pleased that Bob and I, and indeed Senator Bradley and Bob and I, agree that the whole purpose should be in simplification to get the personal rates as low as possible to make the tradeoff worthwhile. And I am announcing, along with Bob, that so far the top rates that have emerged from Treasury 2 appear to us to be considerably higher than they need to be or should be.

So, if we can get the personal exemption up to $2,000 immediately and get the top tax rate or maximum rate down to 30 or 28, I think there is going to be unanimity on the center left and center right of the political aisle. There will be many issues yet to discuss, but I am particularly pleased to advance what I consider to be the very best modified flat tax plan in America today, notwithstanding some of the very fine plans that have been introduced by our colleagues.

Senator CHAFEE. Thank you very much, Congressman Kemp. We appreciate your taking the time to be here.

Senator Kasten?

[Congressman Kemp's written testimony follows:]

TESTIMONY BEFORE THE SENATE FINANCE COMMITTEE
BY CONGRESSMAN JACK KEMP (R-NY)
Washington, D.C.
Thursday, May 9, 1985

THE CASE FOR KEMP-KASTEN

Mr. Chairman and members of the Senate Finance Committee, I am grateful for this opportunity to testify in favor of comprehensive federal income tax reform.

Mr. Chairman, until recently the main question about tax reform was whether we would have it at all. But now it is clear, even to opponents of tax reform, that there is a broad, bipartisan consensus to lower tax rates and simplify the tax code. I am convinced that Congress can, must, and will pass a good tax reform bill this year. The proponents of tax reform -- Senators Bradley and Kasten, Congressman Gephardt and myself, the Treasury -- have begun working, as has this committee and the Senate Finance Committee, toward achieving a good consensus tax reform bill.

This remarkable consensus has been made possible by the unshakable resolve of tax-reform advocates, on both sides of the aisle, not to split up the tax reform posse before we got into town. As we have said many times, the points on which we agree are more important than the points on which we disagree. All of us can agree on four main principles: tax reform should be revenue-neutral, it should not significantly shift the tax burden among income classes, it should increase economic incentives and efficiency, and above all, tax reform should encourage economic growth.

Now that it is clear that there will be tax reform, it is appropriate to focus on the specific details that will make for the best consensus bill.

In the world of tax economists, there are two competing consistent theories of tax reform -- the comprehensive income tax, and the consumption tax. Yet of the three major tax reform proposals on the table -- Bradley-Gephardt, Kemp-Kasten, and the Treasury plan -- none is a either a pure flat income tax or a pure consumption tax.

The reason is that both the pure flat income tax and the pure flat consumption tax violate some of the objectives I mentioned earlier. Briefly, a pure flat-rate comprehensive income

tax, if it is revenue neutral, tends to shift the tax burden from the top to the bottom of the income scale; it can also have even more of a bias against saving than current law. A pure consumption tax, which defers the tax on investment income, has an even worse distributional problem because so much saving is done by upper income taxpayers. And a consumption tax tends to discriminate against certain taxpayers, such as families with children, who must consume more than other taxpayers with an equal income.

In order to overcome some of these difficulties, each of the three major tax reform plans is a hybrid of the two "pure" approaches. But each has its own unique mixture, and within the broad political agreement on principles of tax reform, there can be surprising differences in philosophy. The purpose of my testimony today is to outline the philosophy behind Kemp-Kasten and to outline some of its advantages for American families.

KEMP-KASTEN: GENERAL OUTLINES

All of the tax reform plans lower tax rates and simplify the tax code. But there are two distinguishing characteristics of the Kemp-Kasten "Fair and Simple Tax" (H.R. 2222, S. 1006).

First, Kemp-Kasten has given more attention to the total tax rates which result from government policies, including but not limited to the federal income tax. It's the total tax rate that affects people's decisions to work, save, invest, and so on. When you think about it, the real problem with a pure flat-rate tax is not that it isn't fair, but that it isn't flat. The Social Security payroll tax is added on top of the income tax, so that a flat income tax rate means a regressive total tax rate: the payroll tax starts on the first dollar of wages but stops at about $40,000. In addition, marginal tax rates are imposed by means-tested transfer payments, such as welfare benefits, the earned income tax credit, and even certain rules for Social Security benefits. When a person has to give up 50 cents in benefits for every extra dollar of income, it amounts to a 50% marginal tax rate. Our plan looks at the total marginal tax rate from all these sources whenever possible.

Second, Kemp-Kasten is a pro-family tax reform bill. In fact, it is the most favorable overall in its treatment of what might be called investment in human capital. Over the years we have put in all kinds of tax loopholes to protect various groups from rising tax rates -- but not the traditional family. Back in 1948, the personal exemption was $600. Despite an increase in recent years, in constant (1948) dollars the exemption has still

shrunk to only $237, or to less than two-fifths of its value almost 40 years ago. Mr. Chairman, we don't believe children should be treated for tax purposes like so many consumer durables. They shouldn't be taxed like refrigerators and sailboats. They are our greatest investment.

In many important respects, Kemp-Kasten was guided by asking how tax reform would affect the traditional family of modest means trying to raise children. We also have special provisions favorable to senior citizens, the working poor, single people and two-earner couples; after all, a family doesn't stop being a family when the children grow up and the parents grow old. But our bill is based on the idea that the family, not the individual considered in the abstract, is the basic unit of our society.

From both points of view, three of Kemp-Kasten's features are especially important:

First, there is a flat 24% tax rate on taxable income.

Second, there is a new exclusion: in general, people can exclude 20% of their wages and salaries up to the amount on which they pay Social Security tax. The exclusion is phased out by adding back 20% of income in excess of the maximum Social Security wage base.

Third, we double the personal exemption to $2,000 for each taxpayer, spouse, dependent (as well as the extra exemption for the elderly, blind and disabled).

We also retain the current deductions for mortgage interest, real property taxes, charitable contributions, and catastrophic medical expenses, as well as the tax deferral of all kinds of retirement saving. We also retain the exclusion for employer-provided health and life insurance. Many of the other tax preferences in the tax code are eliminated. The exemptions and zero bracket amounts are indexed for inflation.

Summary of advantages. This approach has several major advantages over progressive income tax rates. It allows a much higher tax-free income threshold than the other tax reform plans without greater cost. It also allows a lower marginal tax rate at the top. It substantially removes the unequal tax rates on labor and capital income, and results in a virtually flat combined income and payroll tax rate. Finally, it avoids shifting the tax burden like a pure flat income tax rate.

Let me explain these advantages by considering their effect on various taxpayers.

Wage-earners. For many years upper-bracket taxpayers faced a higher tax rate on investment than on employment income. This distinction was removed in the 1981 tax bill. However, there still exists a distinction between labor and capital income at middle and lower incomes. Under current law (and the other tax reform plans) the payroll tax is added on top of the the personal income tax rate for labor income, but not for capital income. Therefore the tax rate on workers is higher than the tax rate on savers. This is true under current law and under all tax reform plans other than Kemp-Kasten.

For example, in 1986 a non-itemizing single taxpayer earning $35,000 would pay marginal tax rates of 34% under current law, 26% under Bradley-Gephardt, and 25% under the Treasury plan, on capital income -- but 41% under current law, 33% under Bradley-Gephardt, and 32% under the Treasury plan on labor income. But under Kemp-Kasten, because the wage exclusion offsets most of the payroll tax, the same taxpayer would pay 24% on capital income and 26% on labor income -- almost the same. (Graph 1)

For a similar reason, there are regressive and irregular federal tax rates on wages and salaries. Since the payroll tax base stops at about $40,000, the marginal tax rate on labor income can be higher at a lower than a higher income level, under both current law and the other tax reform plans. Viewed by income level, the combined marginal tax rate structure above the income tax threshold behaves as follows. Current law: the tax rate starts at 18%, rises to 41%, falls to 34%, then rises to 50%. Bradley-Gephardt: the tax rate starts at 21%, rises to 37%, then falls to 30%. Treasury plan: the tax rate starts at 22%, rises to 42%, then falls to 35%. Under Kemp-Kasten, the income and payroll tax rates are co-ordinated, so that the tax rate starts at 26% for labor income, 24% for capital income, and ends at 28% for both.

The working poor. Right now, families living in poverty pay rather stiff rates of federal income tax. The poverty level in 1985 is $11,101 for a family of four (it will probably be more than $11,500 next year), while the income tax threshold for a family of four is $7,700 (or $9,436 including the earned income tax credit). Much of the worst impact of inflationary bracket creep has been felt by low-income families, who used to be exempt from income tax but have been swept on to the tax rolls by inflation. The tax disincentives are compounded because in many cases the disposable income obtainable through transfer payments for not working is almost as great as or even greater than after-tax wages at a comparable income. This is the famous "poverty trap."

Kemp-Kasten addresses this problem in several ways. One way

is significantly to raise the tax-free threshold of income. The income tax threshold for a family of four is raised to $11,800 under the Treasury plan, and $11,500 under Bradley-Gephardt, or just about to next year's poverty line. But under Kemp-Kasten the tax-free level of income for a family of four is raised to $14,125 (Graph 2). For a single taxpayer, the income tax threshold is $5,750 under Kemp-Kasten, compared with $4,800 under the Treasury plan, $4,600 under Bradley-Gephardt, and $3,430 under current law. Under Kemp-Kasten, the income tax threshold for a retired couple is raised from $7,700 to $14,125, and for a retired single person from $4,470 to $8,250. The income tax threshold for a single parent with two dependents is increased from $5,720 (not including the earned income tax credit) to $11,500. This removes about 1.5 million of the lowest-income taxpayers from the tax rolls, and indexing will keep them off the rolls for as long as they are poor.

Another Kemp-Kasten change which cuts high effective marginal tax rates at low incomes, is to modify the earned income credit. Under current law, the earned income credit is 11% of earned income up to $5,000. The maximum credit of of $550 is phased out by reducing the credit by 12-2/9% of income in excess of $6,500. This makes the credit disappear at $11,000. Phasing out the credit adds a marginal tax rate of 12-2/9% to the usual tax rate; and since the bottom income tax brackets overlap the phaseout range of the earned income tax credit, this can result in fairly high effective marginal tax rates at low incomes, under current law and under the other tax reform plans. For example, a single head of household earning $10,000 with one dependent faces a marginal income tax rate of 26% under current law and under Bradley-Gephardt, and 27% under the Treasury plan, plus the 7% payroll tax rate and the 50%-75% effective marginal tax rates from foregoing transfer payments.

Kemp-Kasten makes three important modifications to the earned income tax credit which address these problems.

First, we tie the EITC to the Social Security payroll tax rate. This raises the credit from 11% to 14.3% in 1986. The percentage will increase with the payroll tax rate in later years. This recognizes that the EITC is not welfare -- it is a refund of taxes actually paid by workers with families.

Second, we relate the size of the EITC to family size. Right now, the credit is the same for a family of two as for a family of four or five. Kemp-Kasten gives a larger credit for a larger family. This is done by starting to phase out the credit at $4,500 for a family of two, at $5,000 for a family of three, and at $5,500 for a family of four or more.

Third, Kemp-Kasten lowers the high marginal tax rates on the poor by raising the tax-free level of income and phasing out the EITC before that level is reached. For example the credit is phased out at about $8,800 for a family of two, which is just below the $9,000 level at which a single head of household with one child starts paying income tax. The credit is phased out at $10,750 for a family of four, which is below the income tax threshold of $14,125 for a traditional family of four.

This important feature -- eliminating the overlap between the EITC and the bottom tax brackets -- reduces effective federal marginal income tax rates on the working poor by about one-quarter below current law and the other tax reform plans (Graph 3). Kemp-Kasten also indexes the earned income credit for inflation, for the first time.

Important as the "poverty trap" is, cutting high effective marginal tax rates alone will not magically cure poverty. The more we understand about the causes of poverty, the more we are drawn to the conclusion that it has at least as much to do with the stability of families as with after-tax income. While this question goes far beyond the realm of tax policy, I believe that the "pro-family" aspects of Kemp-Kasten, which I will describe in a moment, should be considered as an integral part of its anti-poverty strategy.

Lowest top marginal tax rate. Besides having the highest tax-free level of income at the bottom, Kemp-Kasten has the lowest marginal tax rate at the top. Kemp-Kasten raises about the same amount of revenue in static terms from taxpayers over $100,000 as the Treasury plan, despite a much lower top marginal tax rate -- 28% instead of 35%.

This is due in large part to the flat rate and disappearing wage exclusion. The exclusion effectively lowers the marginal tax rate from 24% to 19% below about $40,000, while phasing out the exclusion effectively raises the marginal tax rate from 24% to about 28% above $40,000. However, Kemp-Kasten raises more revenue and results in greater progressivity of the tax burden than an ordinary system of progressive tax rates of 19% and 28%, for two reasons.

First, the exclusion applies to wages and salaries, but not generally to interest and dividends. As I mentioned, this offsets the payroll tax and equalizes the tax rates on labor and capital income. This raises more revenue from a number of sources of non-wage income than an ordinary system of progressive tax rates.

Second, deductions and exemptions are deducted against the 24% flat rate, even when the effective marginal tax rate is 19%

or 28%. This increases the value of deductions below about $40,000, and reduces them slightly above $40,000, compared with the effective marginal tax rate. The result is greater progressivity in the tax burden than would result from an ordinary system of progressive tax rates.

Families with children. According to Treasury economist Eugene Steuerle, the drastic erosion of the personal exemption by inflation has caused taxes to rise almost twice as fast for families with children as for other taxpayers since the Second World War. If the personal exemption had been indexed for inflation since 1948, it would have to be more than $2,500 today. Instead, it is only $1,040 in 1985.

However, the value of the personal exemption depends not only on its size, but also on the nature of its deductibility. For example, the same $1,040 exemption under current law is worth $114 in the bottom tax bracket, but $520 in the top tax bracket.

Bradley-Gephardt increases the exemption for adults to $1,600, but reduces the exemption for dependent children from $1,040 in 1985 to $1,000 in 1986. Because of the higher bottom tax rate, the value of the exemption for each child rises a bit from $114 to $140 a year, though Bradley-Gephardt repeals inflation-indexing. Since the Bradley-Gephardt plan allows the exemption only against the 14% bottom tax rate, the exemption is worth $140 for all taxpayers, including those in the 26% and 30% tax brackets. This represents a reduction of the tax value for the exemption in the top bracket from $520 to $140.

The personal exemption is worth $2,000 and indexed for inflation under both Kemp-Kasten and the Treasury plan. But because of the different rate structures, the effect of the $2,000 exemption is different under the Treasury plan than under Kemp-Kasten.

Under the Treasury plan, with tax rates of 15%, 25% and 35%, the value of each child exemption rises from $114 to $300 in the bottom tax bracket, but from $520 to $700 in the top tax bracket. Under Kemp-Kasten, all deductions and exemptions are worth 24 cents on a dollar. Therefore, the value of each child exemption for a low-income family more than quadruples, from $114 to $480 a year. At high incomes the value of the exemption remains about the same, $480 compared with $520 under current law (Graph 4). The increased value of the child exemption under Kemp-Kasten is concentrated at middle and low incomes. Because the personal exemption is such a large revenue item, this is another reason why the top marginal tax rate can be lower under Kemp-Kasten than under the Treasury plan.

Homeownership. The Kemp-Kasten philosophy is unabashed in believing that home-ownership ought to be encouraged. One of the interesting features of Kemp-Kasten is that it reduces the cost of homeownership for typical families earning near or less than the median income.

Our bill retains the deductions for mortgage interest and real property taxes. And as with the personal exemption, the value of these deductions is increased at moderate and lower incomes, though reduced at high incomes. The effective marginal tax rate on wages is 19%, because of the exclusion, but deductions are worth the full 24% flat tax rate. According to the National Association of Homebuilders (NAHB), Kemp-Kasten would reduce the cost of homeownership by 3% for a typical family earning $20,000 a year, while the Treasury and Bradley-Gephardt plans would increase the cost by 6% and 10% respectively (Graph 5).

Incidentally, the treatment of homeownership under current law and Kemp-Kasten is essentially similar to its treatment under a consumption tax: families must pay principal out of after-tax income, but the imputed rent is not taxed. I do not believe that tax theory requires us to punish home-ownership.

Investment in human capital. Kemp-Kasten differs significantly from the other tax reform plans in its approach to investment in human capital. Progressivity plays a role here as well. With progressive tax rates, tax deferral of retirement savings is normally favorable to capital income because a taxpayer is generally in a lower tax bracket after he retires than when the deduction is made. Progressivity has the opposite effect, though, for the few deductions allowed for investment in human capital, because a person is generally in a low tax bracket when the investment is made, but the increased value of personal services push the taxpayer into a higher tax bracket. The Kemp-Kasten treatment of deductions is therefore more favorable to investment in human capital than either current law, a progressive consumption tax, or the other tax reform plans.

Beyond encouraging homeownership, Kemp-Kasten retains the deduction for real property taxes because the property tax is almost always devoted to local education. Retaining the deduction is another way of offsetting the bias against investment in human capital. And we allow the deduction for interest on education loans without limit.

Another important difference is that Kemp-Kasten preserves the exclusions for employer-paid health and life insurance. Bradley-Gephardt taxes both employer-paid health and life insurance; the Treasury plan taxes group term life insurance

premiums and caps the exclusions for health insurance. These costs could be viewed as depreciation allowances for human capital. We believe that private rather than public insurance of risk should be encouraged where possible. When the private sector is discouraged from providing for such basic needs, the usual result is to increase the pressure for public provision.

More family issues. Kemp-Kasten seeks to equalize the tax treatment among families in several ways. Both Bradley-Gephardt and the Treasury plan repeal the child care credit and replace it with a deduction for child care expenses, which generally helps only two-earner families with children below school age. Kemp-Kasten repeals the credit and devotes the extra revenue, in effect, to helping all families with children by increasing the personal exemption. Compared with current law, this helps one-earner families with children more than two-earner families; but in general the Kemp-Kasten treatment is absolutely more favorable for all low- and moderate-income families than either Bradley-Gephardt or the Treasury plan. For example, a family of four earning $15,000, with the second spouse earning a third of the income and child care expenses totaling 10% of the family's total income, pays a federal income tax in 1986 of $393 under current law, $475 under Bradley-Gephardt, $419 under the Treasury plan, and $168 under Kemp-Kasten. With only one earner and no child care expenses, the federal tax is $868 under current law, $532 under Bradley-Gephardt, $480 under the Treasury plan, and $168 under Kemp-Kasten.

In this way, Kemp-Kasten equalizes the treatment of families with children, regardless of their parents' employment status. Any other approach seems to imply that the effort of the parent who stays at home to care for the children is worth less than if he or she worked outside the home. It does not seem fair to recognize the expense of earning a second income, but ignore the cost of giving up a second career, which often goes with the decision of a spouse to remain at home to raise the children.

At the same time, Kemp-Kasten removes a bias against two-earner couples, which exists under current law and the other major tax reform plans. A two-earner family with combined wages in excess of the Social Security payroll tax base pays a higher Social Security payroll tax and therefore a higher combined marginal tax rate than other taxpayers on the same income. Under Kemp-Kasten, two-earner couples may figure out their 20% wage exclusions separately and add the two, if this results in a larger total exclusion. This offsets 5 of the 7 percentage-point increase in the combined marginal tax rate that occurs under current law and the other tax reform plans. In a sense, then, the Kemp-Kasten wage exclusion acts like a second-earner deduction for married couples.

Senior citizens. Kemp-Kasten has a number of features which help senior citizens.

First, Kemp-Kasten increases the personal exemptions for each senior citizen from $2,080 to $4,000 (which amount is indexed for inflation). (Bradley-Gephardt increases the total exemptions to $2,600, while the Treasury leaves the exemption at $2,000, plus a special credit at low incomes.)

Second, the special rule allowing the 20% exclusion to apply to all income up to $10,000 (single) or $15,000 (joint) is designed to protect senior citizens who live mostly from investment income rather than from wages (which benefit from the wage exclusion). These amounts are indexed for inflation.

Together, these provisions substantially increase the income tax threshold for senior citizens -- from $7,700 to $14,125 for a retired couple, and from $4,470 to $8,250 for a retired single person.

In addition, reducing the top income tax rate from 50% to 28%, and continuing the exclusion for income from general-obligation municipal bonds, is beneficial to people whose income is primarily from investment of lifetime savings.

The deductibility of property taxes is also especially important for senior citizens. For retired homeowners who have paid off the mortgage, it is often the largest itemized deduction. And because the property tax is a tax on capital rather than on income or consumption, its incidence is greatly magnified. Assuming a 4% real rate of return, a 2% property tax is equivalent to a 50% marginal income tax rate. Under current law, federal deductibility can mean the difference between a 25% and a 50% income-tax-rate-equivalent.

The "96% bracket." Beyond these general advantages, Kemp-Kasten addresses a number of anomalies in current tax law which affect senior citizens, largely due to the lack of co-ordination between the income tax code and the Social Security system. In general, in Kemp-Kasten we have tried to reduce excessively high marginal income tax rates on senior citizens without changing the basic structure of Social Security.

A combination of tax and benefit provisions can result in what has been called the "96% bracket" for senior citizens, though it can actually exceed 100%. These high tax rates are caused by an interaction of the following provisions:

First, the "retirement test" reduces Social Security

benefits by 50 cents for every dollar above $7,320 earned by those between the ages of 65 and 70. This creates, in effect, a 50% marginal tax rate on wages and salaries for Social Security beneficiaries.

Second, the 1983 Social Security amendments effectively increased the federal marginal income tax rate on many senior citizens to at least 150% of the statutory rate. This is because a taxpayer must add 50 cents in benefits to taxable income for each dollar of income above a certain threshold of redefined adjusted gross income -- $25,000 for single taxpayers and $32,000 for married couples -- until one-half of benefits are taxed.

Finally, such taxpayers must also pay ordinary federal, state and local income and payroll taxes.

For example, a retired couple with $32,000 in adjusted gross income and $12,000 in Social Security benefits would have been in the 25 percent federal income tax bracket in 1984 before the new method of taxing Social Security benefits was enacted. The new method of taxing benefits effectively pushes the family from the 25% into the 42% bracket on investment income, while the retirement test adds another 50% marginal tax rate on wages and salaries. Together with the payroll tax, this results in a 99% effective marginal tax rate on wages.

Kemp-Kasten eliminates the "96% bracket" in the following way:

First, the bill would phase out the retirement test, by cutting the benefit reduction from 50 to 25 cents on a dollar of earnings immediately, and zero benefit reduction after five years.

Second, the bill reduces the marginal taxable amount of Social Security benefits, from 50 to 25 cents per dollar of income in excess of the adjusted income thresholds, though up to half of benefits may still be taxed.

For the retired couple I just mentioned, Kemp-Kasten's provisions reduce the effective marginal tax rate due to the retirement test from 50% to 25%, then to 0%. The effective marginal federal income tax rate is cut from 42% to 24%, both because of marginal tax rate reduction and because of the new method of taxing Social Security benefits. The combined effective marginal federal tax rate on this family's wages is ultimately cut from 99% under current law to 32% under Kemp-Kasten.

INVESTMENT INCENTIVES

Capital gains. The treatment of capital gains is especially important for the encouragement of initiative and risk-taking, which are indispensable to a dynamic economy. The Treasury plan taxes capital gains as ordinary income but indexes the capital basis for inflation. Bradley-Gephardt taxes capital gains in full without indexing. The first version of Kemp-Kasten resembled the Treasury treatment, except that we had a 25% instead of a 35% top tax rate on ordinary income and a 10-year transition period during which taxpayers could choose a 25% capital gains exclusion in lieu of indexing.

There are two kinds of investors who must be considered, and no single, simple treatment is likely to make them whole. The typical investor holds an asset for a long period and receives a fairly modest real rate of return; for this investor, indexing of basis is very important to avoid the taxation of capital as income, as was the case throughout the 1970s. However, the entrepreneur and the high-risk venture capitalist typically have a basis in an investment which is very low or even zero, and they seek a high real rate of return as the reward for successfully risking their capital. When a stock goes from 50 cents to 10 dollars, indexing the 50 cents doesn't help much. Taxing the gain as ordinary income would therefore penalize the risk-taker, especially if the top tax rate rises from 20% to 35% as under the Treasury plan.

We decided in our new bill to offer two permanent options. Under the current version of Kemp-Kasten, in any year, a taxpayer may elect to have his capital gains taxed as ordinary income with indexing, or else forego the indexing and receive a 40% exclusion (or in the case of corporations, a reduced 20% alternative capital gains rate). With the 40% exclusion, the top marginal tax rate on capital gains would effectively be reduced from 20% to about 17% for individuals. I believe this approach is fair both to the ordinary investor and to the entrepreneur or venture capitalist.

Corporate provisions. For business, all three major tax reform plans lower the corporate tax rate into the low 30's, and repeal the investment tax credit and many other corporate tax preferences. However, both Bradley-Gephardt and the Treasury plan move in the direction of depreciation according to the comprehensive income tax, under which writeoff periods try to approximate the estimated useful lives of assets. This approach has been criticized by some for increasing the cost of capital for new investment, and for increasing the disparities in present values of depreciation allowances between short- and long-lived assets.

On the other hand, current law has been criticized because

the combination of the investment tax credit and the Accelerated Cost Recovery System (ACRS) depreciation allowances enacted in 1981, when inflation was expected to continue in double digits, can result in an outright subsidy when the discount rate is low enough -- that is, the capital cost can exceed the value of expensing when inflation is low. Yet at higher rates of inflation, capital cost recovery falls short of expensing, by amounts which increase with asset class life. Part of this disparity comes from the fact that not all kinds of investment qualify for the investment tax credit. And because both ACRS and the investment tax credit are heavily "frontloaded," current law has also been criticized for lending itself to tax shelters based on up-front cash flow rather than economic value.

The first version of Kemp-Kasten kept the current-law Accelerated Cost Recovery System (ACRS) depreciation, repealed the investment tax credit and most other corporate tax preferences, and lowered the top corporate tax rate to 30%, with a reduced 15% rate for small business below $50,000. This in itself went a long way toward removing the disparities in effective tax rates across industries and among different kinds of investments, while maintaining incentives for capital formation. However, we found a way to improve upon it.

The new version of the bill cuts the top corporate tax rate from 46% to 35% and modifies the ACRS depreciation allowances into something we call the Neutral Cost Recovery System (NCRS). NCRS is designed to provide the present value of investment expensing without some of its practical problems. We keep the same asset classes as ACRS, but the writeoff period is slightly lengthened and the total writeoff is increased to include inflation indexing and a 3.5% real rate of return.

For example, the ACRS 5-year class, which includes most business machinery, becomes six years, but the total writeoff is increased from 100% of the initial cost to 110% plus indexing. Assuming 5% inflation, on a $1,000 investment a company could therefore write off $1,153 over six years instead of $1,000 over five years. Similarly, the three-year class for vehicles becomes four years and the writeoff increases from 100% to 106% plus indexing; the 18-year class for real estate becomes 25 years and the total writeoff is 148% plus indexing.

In each case the present value of the depreciation allowance is equivalent to expensing, assuming a 3.5% real rate of return on capital, which is approximately the post-war average. Kemp-Kasten therefore removes both the outright subsidy to new investment at low rates of inflation, and the bias against capital investment at high rates of inflation. A study released in the past week by the Institute for Research on the Economics

of Taxation (IRET) compared the neutrality of tax treatment of depreciable investment under various tax plans, and concluded: "The inflation-indexed Neutral Cost Recovery System (NCRS) included in the Kemp-Kasten "FAST" proposal would much more nearly satisfy the inter-asset neutrality criterion, at any rate of inflation, than either RCRS [the Treasury plan] or ACRS-ITC [current law]. It would also effectively eliminate the prevailing income tax bias against investment in durable capital. It is an innovative approach to resolving the problem of the front-loaded ACRS-ITC without the advsere effects on the cost of capital in the RCRS [Treasury proposal]."

Since the writeoffs are stretched out, the plan avoids the up-front revenue costs of pure expensing; in fact, NCRS would raise corporate receipts for several years. Because capital cost recovery under Kemp-Kasten is "backloaded" compared with current law (after the first year, which uses a half-year convention, the writeoffs are staightlined in round percentages), NCRS and the sharply reduced marginal tax rates under Kemp-Kasten reduce the possibilities for tax shelter while increasing after-tax incentives for capital investment. This treatment effectively eliminates the double taxation of corporate income, eliminating the need for integration schemes which add to the complexity of the tax code. Finally, industries which face high effective tax rates under current law because they cannot take advantage of items like the investment tax credit will benefit substantially from the reduced corporate tax rates and increased present value of depreciation for plant.

Mineral industry. The current bill, introduced in April, retains current law for the domestic mineral industry concerning intangible drilling costs, percentage depletion allowances, and mineral development costs. The earlier bill provided NCRS expensing-equivalent treatment for intangible drilling costs; the current bill reverts to expensing. Since the economic value of the two is the same, the change on IDCs affects the timing but not the total revenues collected. It was made to remove what seemed a bias against small independent oil producers: it is more difficult for an independent wildcatter than for a big oil company to borrow against the prospect of future cash flow.

These changes, though not large in terms of revenue, are extremely important. The mineral industry is extremely depressed, and we are still heavily dependent on imported energy -- we spent $60 billion last year to import foreign oil. More than 60 percent of our operable drilling rigs are idle. Yet merely to replace depleting domestic oil reserves we need to drill 100,000 new wells a year, almost double current rates. The new version of the bill will be a substantial improvement for the independent producers who find most of our new oil.

Small business. Kemp-Kasten has important features for small business, too. We retain reduced tax rates of 15% up to $50,000, and 25% from $50,000 to $100,000. The Treasury has a flat rate of 33%, and Bradley-Gephardt a flat rate of 30%. (Graph 6) Kemp-Kasten also retains a current-law provision permitting expensing of up to $10,000 of investment per year.

Revenue considerations. Earlier versions of our bill were estimated by the Joint Committee on Taxation to be revenue-neutral in 1985, and distributionally neutral in all income classes up to $100,000. (There would be static revenue losses -- small in dollar amount -- of about 10% for the income class in excess of $100,000.) We do not yet have official estimates for our new bill, but anticipate that the results will be similar.

One of the main reasons for tax reform is to change people's incentives, so that they produce, save and invest more than before. As many reports in the past week have demonstrated, based on two straight years of evidence, the 1981 tax-rate reduction has increased the revenues and share of the tax burden paid by upper-income taxpayers. Lowering excessively high marginal tax rates has been followed by dramatic increases in reported taxable inceom.

For this reason, a well-designed tax reform which was revenue neutral in a static sense would dramatically reduce the deficit. A recent study by the Harris Bank of Chicago reached the following conclusions:

"By 1990 the leading tax reform proposals would enable the economy to produce anywhere from $430 billion to $750 billion (1985 dollars) more output than under the present system. . . . Of the major tax reform proposals, the best overall performance occurs under the Kemp-Kasten plan. . . . Implementing [the Kemp-Kasten] provisions leads to an additional $750 billioni (1985 dollars) of potential output in 1990 over what would be the case under present law. The difference represents more than $5,000 of additional real income per worker in 1990. Beyond 1990 the effect of compounding results in even more dramatic results. . . . This proposal provides the best opportunity of economic stability."

If the Harris Bank study is correct, the additional $750 billion in GNP under Kemp-Kasten would mean more than $140 billion in additional federal revenues and $107 billion in additional state receipts which could be used for better services or further tax-rate reduction.

CONCLUSION

Mr. Chairman, the time has come for a comprehensive reform of the federal income tax. We need such a reform in the interests of fairness, simplicity, and economic growth. I believe there will soon be a bill representing a consensus upon the best features of the tax reform plans now on the table. I would urge, Mr. Chairman, that this committee and other interested parties closely examine the approach we have taken in Kemp-Kasten, and its advantages for families with children, the working poor, homeowners and others. For this is where we must begin and end, Mr. Chairman -- with the American families whose effort, thrift and initiative are the mainspring of our progress as a nation. The proper measure of tax reform is how well it helps American families in their daily lives to fulfill their hopes through their own efforts. I look forward to working with you and your committee to meet this challenge.

Thank you.

EXPLANATION OF THE KEMP-KASTEN WAGE EXCLUSION

One of the distinguishing features of the Kemp-Kasten approach is that, instead of progressive tax rates, there is a flat rate of 24%, combined with a progressive or "disappearing" exclusion. In general, a taxpayer excludes 20% of wage and salary income up to about $40,000, and adds 20% of gross income in excess of that amount.

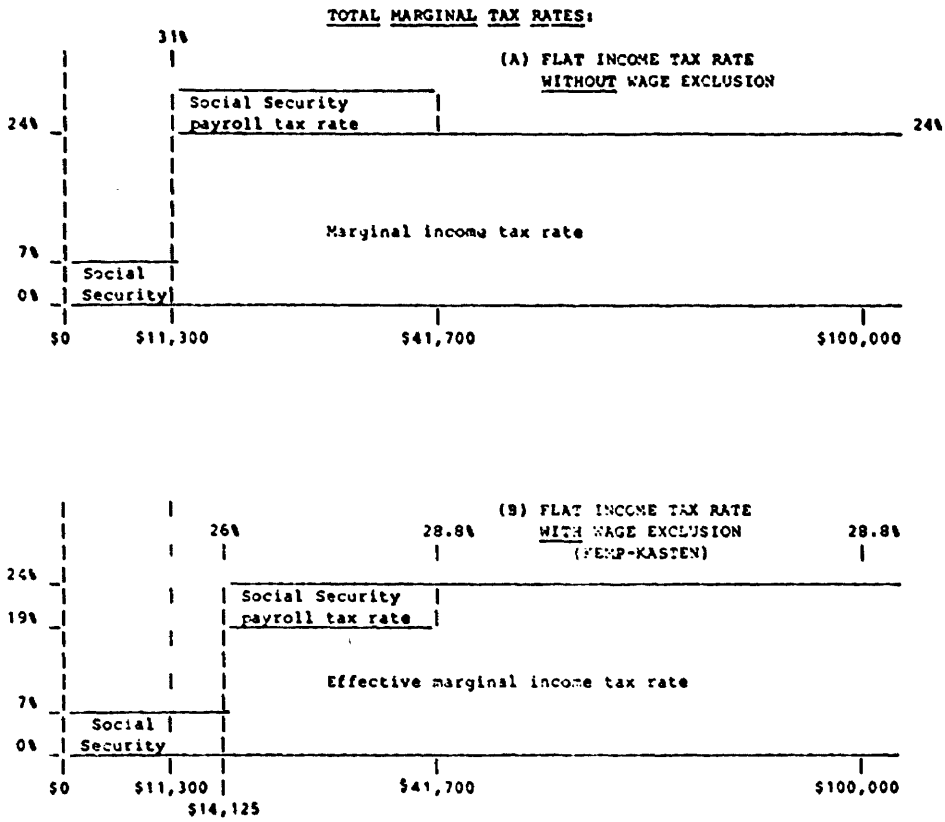
Specifically, taxpayers may exclude one-fifth of wages and salaries up to the amount on which they pay Social Security tax. This lowers the effective marginal tax rate from 24% to 19.2%, up to the maximum Social Security earnings level. The Social Security wage base is expected to be $41,700 in 1986, which would make the maximum wage exclusion $8,340 in that year. The wage base is already indexed by law to grow with inflation and real average wages.

The exclusion figured in this way is reduced at upper incomes by adding back an amount equal to 20% of a taxpayer's income in excess of the Social Security maximum taxable earnings base. The net exclusion is therefore zero at twice the FICA wage base, or $83,400 in 1986. Just as the exclusion lowers the effective marginal tax rate at lower incomes, phasing it out increases the effective marginal tax rates at higher incomes, from 24% to 28.8%.

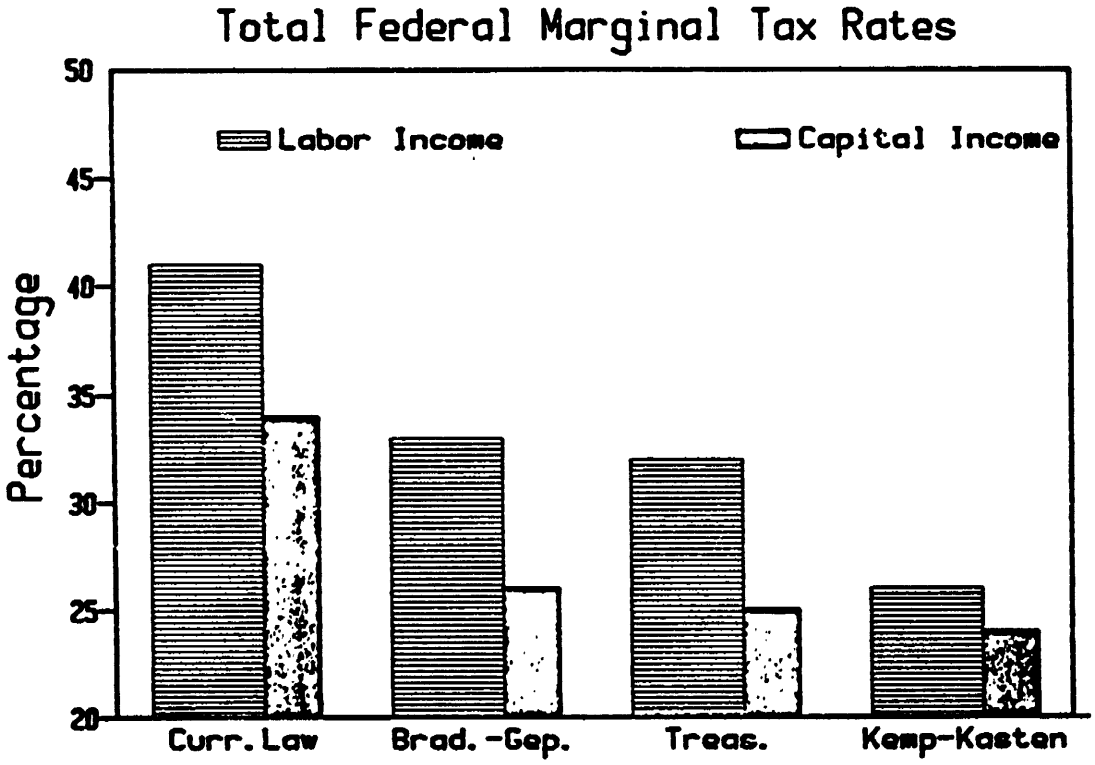
(Earlier versions of the bill had a "notch" when the effective marginal tax rate fell from 28% to the flat tax rate once the wage exclusion was completely phased out. Also, the exclusion permitted for non-wage income was not phased out. In the new bill, the phaseout applies to both labor and capital income and generally the net exclusion is negative at incomes in excess of two times the maximum Social Security tax base; this effectively keeps the marginal tax rate at about 28% for all taxpayers above about $40,000.)

There are two special rules. First, taxpayers with wages and salaries less than $10,000 for single people, or $15,000 for married couples, may exclude 20% of income from any source up to those amounts. The $10,000 and $15,000 amounts are indexed for inflation. Second, two-earner couples with combined wages in excess of the Social Security wage base may exclude 20% of the total amount on which they paid the payroll tax. The phaseout still applies jointly.

THE EMPLOYMENT INCOME EXCLUSION: A BREAK FOR LOWER AND MIDDLE INCOME WAGE-EARNERS
(Non-itemizing one-earner family of four, 1986)

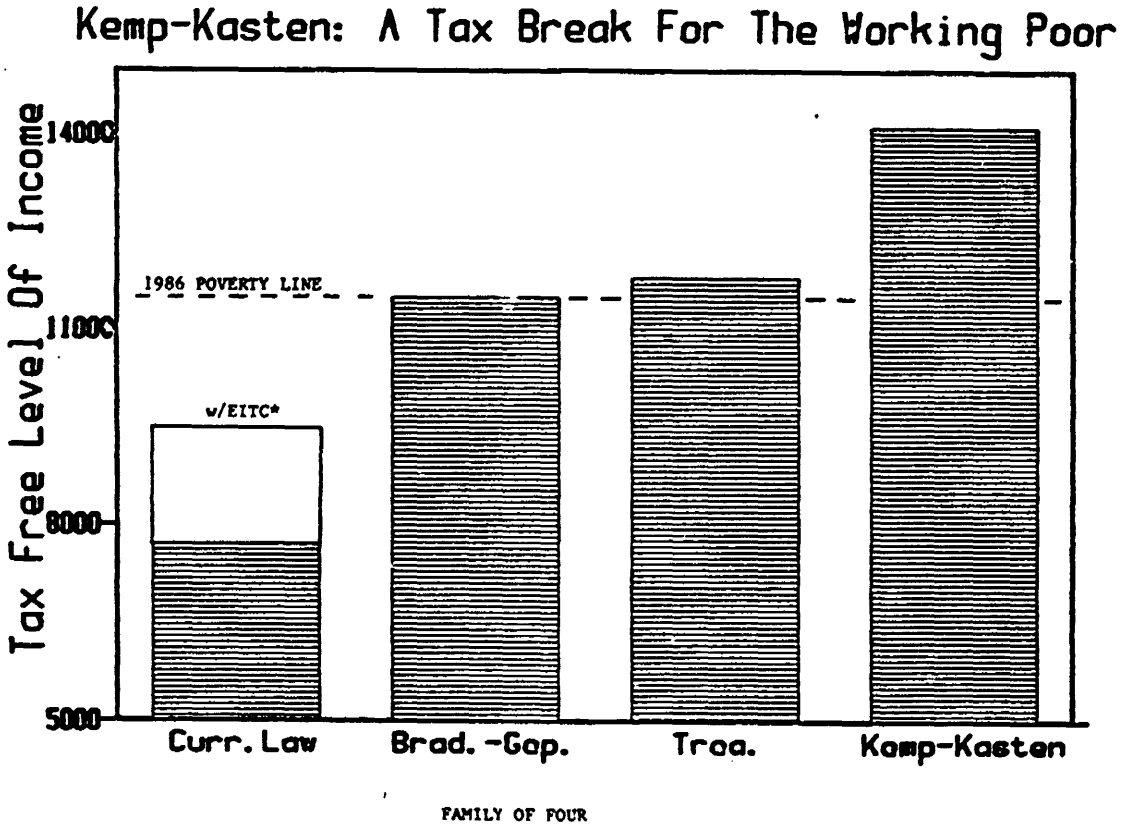


GRAPH 1



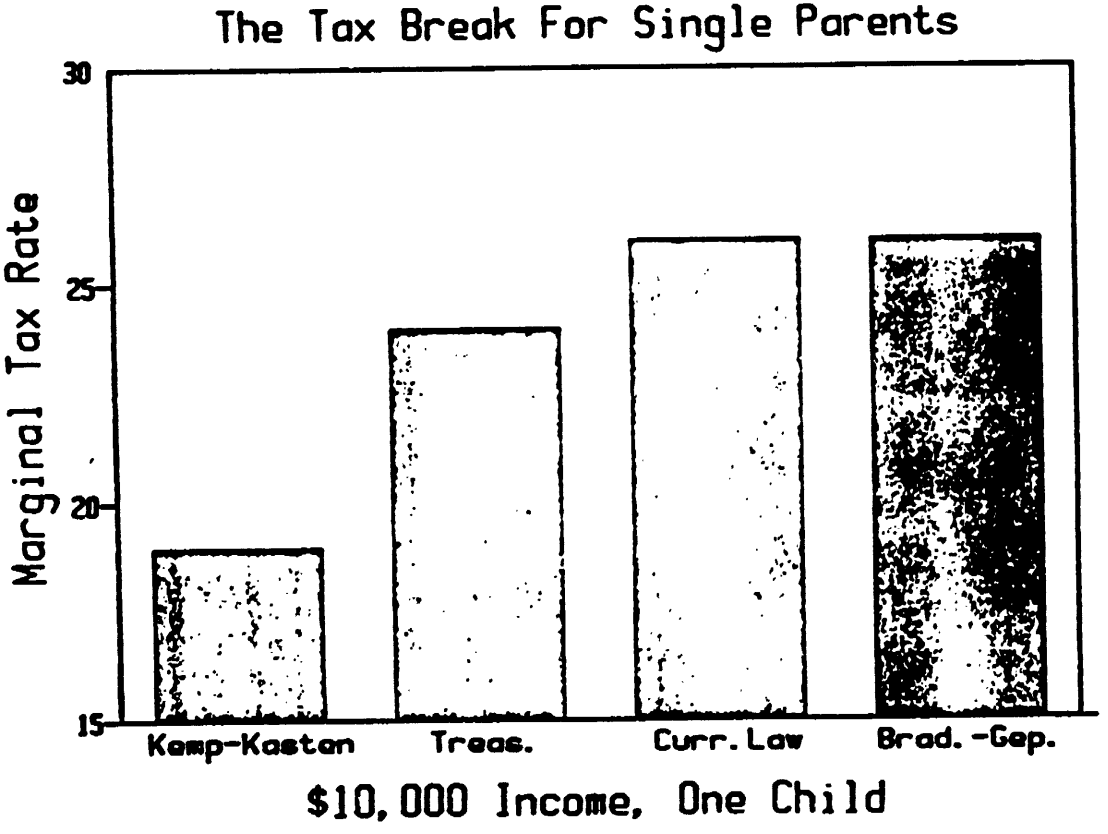
(SINGLE TAXPAYER EARNING $35,000, 1986)

GRAPH 2

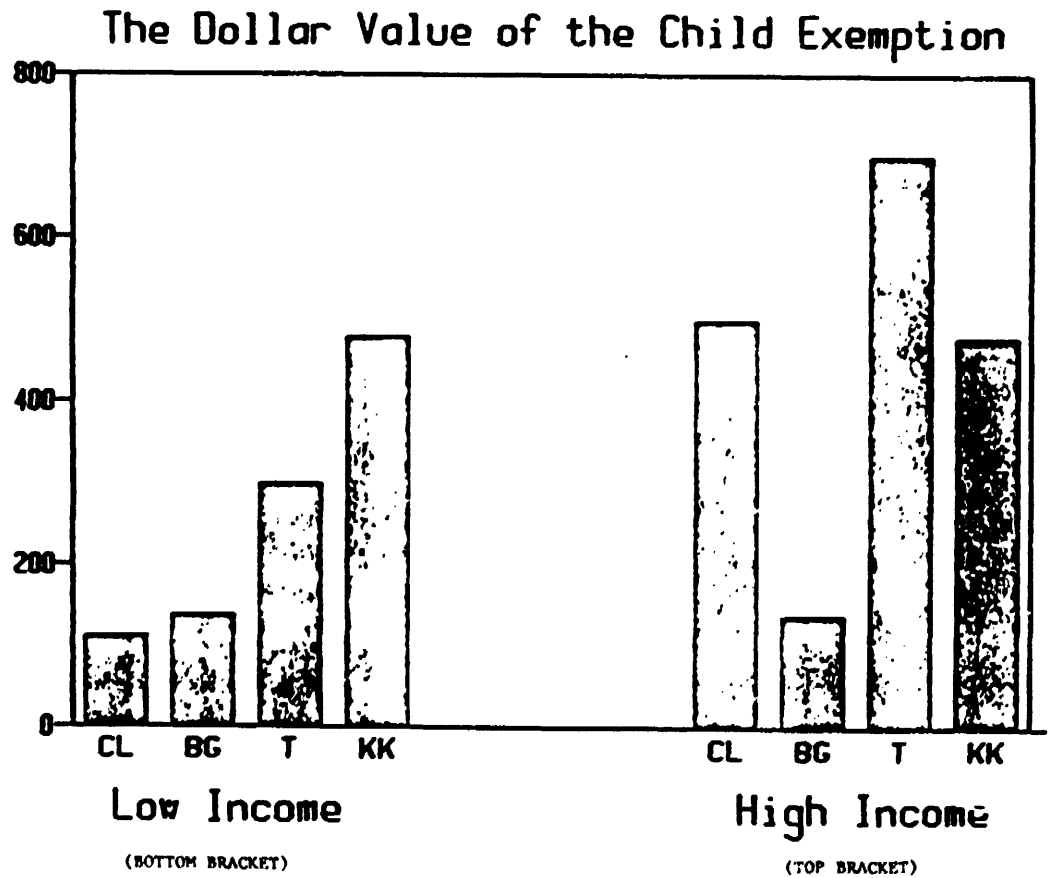


* With earned income tax credit

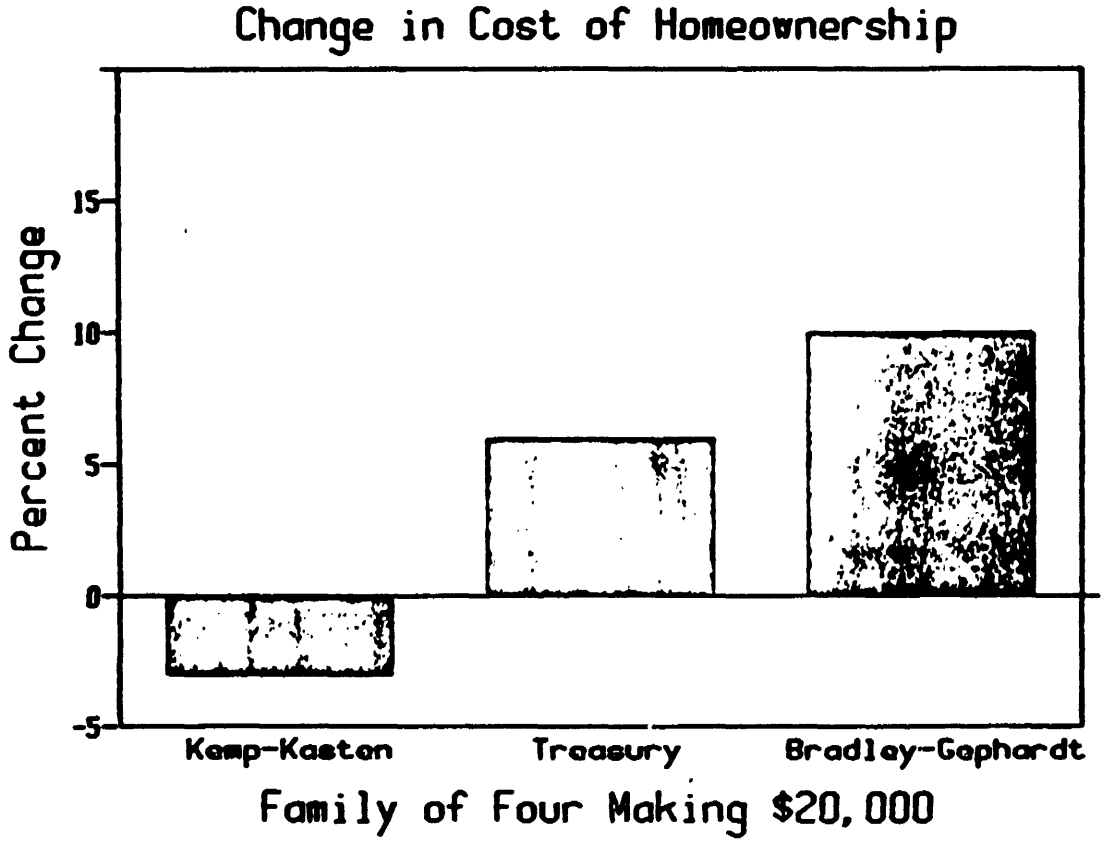
GRAPH 3


The Tax Break For Single Parents
Marginal Tax Rate
30
25
20
15
Kemp-Kasten
Treas.
Curr. Law
Brad.-Gep.
$10,000 Income, One Child

GRAPH 4

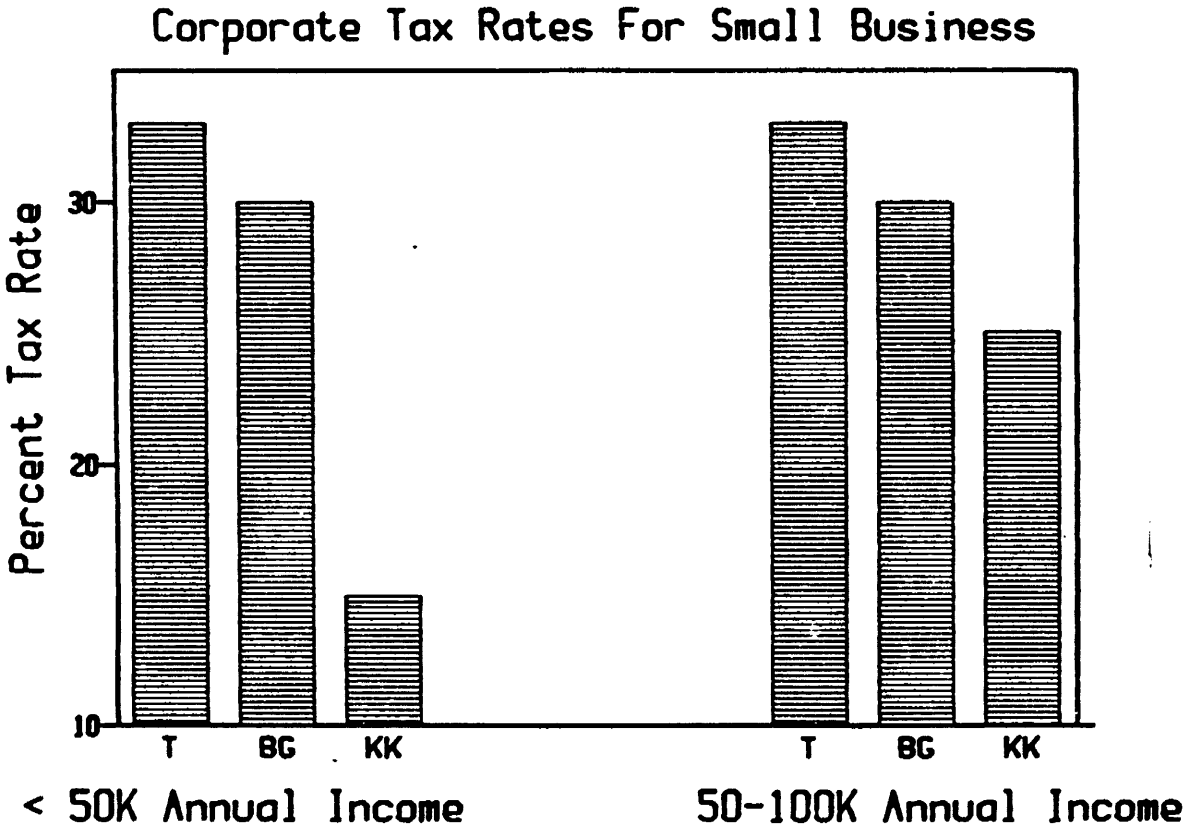

The Dollar Value of the Child Exemption
800
600
400
200
0
CL
BG
T
KK
CL
BG
T
KK
Low Income
(BOTTOM BRACKET)
High Income
(TOP BRACKET)

GRAPH 5



SOURCE: NAHB

GRAPH 6


Corporate Tax Rates For Small Business
Percent Tax Rate
30
20
10
T
BG
KK
T
BG
KK
< 50K Annual Income
50-100K Annual Income

THE NEUTRAL COST RECOVERY SYSTEM (NCRS): CAPITAL COST RECOVERY UNDER KEMP-KASTEN

The Kemp-Kasten "Fair and Simple Tax" (FAST) modifies the current-law Accelerated Cost Recovery System (ACRS) to provide the economic equivalent of investment expensing -- the Neutral Cost Recovery System (NCRS).

The ACRS depreciation classes are retained. The depreciation allowances are indexed for inflation. The class lives are slightly lengthened and the total nominal writeoffs are increased to provide the present value of expensing. For example, the 5-year writeoff for machinery is lengthened to 6 years under NCRS, but the total depreciation allowance is increased from 100 to 110 percent of the initial investment (plus inflation-indexing). This is equivalent to expensing at a 3.5% real rate of return, which is slightly above the postwar average. [NCRS is more favorable than ACRS depreciation for real interest rates up to 24% (3-year property) or 48% (5-year property).]

NCRS is neutral with respect to long-lived and short-lived investments, unlike current law. It is also neutral with respect to the relative value of capital assets and consumption goods. And an expensing-equivalent depreciation schedule effectively eliminates the double tax on corporate income.

NCRS avoids a drawback of pure expensing: a large up-front revenue loss which could be recouped only in later years. Though the cost of capital is lower under NCRS than under current-law schedules, NCRS is not "front-loaded" like ACRS, and should raise corporate tax receipts for several years.

Aside from instituting NCRS, Kemp-Kasten repeals most corporate tax preferences, including the investment tax credit, and cuts the top corporate tax rate from 46% to 35%.

1/30/85

AMOUNT OF DEPRECIATION
ALLOWANCES UNDER NCRS
COMPARED WITH ACRS:

CURRENT 3-YEAR CLASS
(per $1,000 investment)

Year	ACRS 3-YEAR	NCRS 4-YEAR 0% INFLATION	NCRS 4-YEAR 5% INFLATION
1	$250	$160	$160
2	$380	$300	$315
3	$370	$300	$331
4		$300	$347
Nominal total	$1,000	$1,060	$1,153
Inflation adjusted total	$913	$1,060	$1,060
Present value			
0% inflation	$963	$1,000	
5% inflation	$913		$1,000
Assumptions:			
Real return	3.5%		
Inflation	5.0%		
Nominal discount rate	8.7%		

AMOUNT OF DEPRECIATION
ALLOWANCES UNDER NCRS
COMPARED WITH ACRS:

CURRENT 5-YEAR CLASS
(per $1,000 investment)

YEAR	ACRS 5-YEAR	NCRS 6-YEAR 0% INFLATION	NCRS 6-YEAR 5% INFLATION
1	$150	$100	$100
2	$220	$200	$210
3	$210	$200	$221
4	$210	$200	$232
5	$210	$200	$243
6		$200	$255
Nominal total	$1,000	$1,100	$1,260
Inflation adjusted total	$904	$1,100	$1,100
Present value			
0% inflation	$931	$1,003	
5% inflation	$844		$1,003
Assumptions:			
Real return	3.5%		
Inflation	5.0%		
Nominal discount rate	8.7%		

AMOUNT OF DEPRECIATION ALLOWANCES UNDER NCRS COMPARED WITH ACRS:

CURRENT 18-YEAR CLASS
(per $1,000 investment)

YEAR	ACRS 18-YEAR	NCRS 25-YEAR 0% INFLATION	NCRS 25-YEAR 5% INFLATION
1	$50	$40	$40
2	$90	$60	$63
3	$80	$60	$66
4	$80	$60	$69
5	$70	$60	$73
6	$60	$60	$77
7	$60	$60	$80
8	$50	$60	$84
9	$50	$60	$89
10	$50	$60	$93
11	$50	$60	$98
12	$50	$60	$103
13	$40	$60	$108
14	$40	$60	$113
15	$40	$60	$119
16	$40	$60	$125
17	$40	$60	$131
18	$40	$60	$138
19	$20	$60	$144
20		$60	$152
21		$60	$159
22		$60	$167
23		$60	$176
24		$60	$184
25		$60	$194
Nominal total	$1,000	$1,480	$2,844
Inflation adjusted total	$715	$1,480	$1,480
PRESENT VALUE			
0% inflation	$785	$1,004	
5% inflation	$585		$1,004
Assumptions:			
Real return	3.5%		
Inflation	5.0%		
Nominal discount rate	8.7%		

STATEMENT OF HON. BOB KASTEN, U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator KASTEN. Mr. Chairman, thank you.

First of all, we are all pleased to be here this morning, and we thank you for this hearing to discuss tax reform.

Before I begin, I would like to make one point. I think that the statement that Jack just made is exactly right. Our approach to tax reform—the Kemp-Kasten or the Kasten-Kemp approach—for a fair and simple tax is the best. But, I also believe that many of the elements in Bradley-Gephardt are good and that a number of the elements in the Treasury plan are good. The most important thing, however is that we are all working toward a modified flat tax. This is more important than any title, than any name, than any pride of authorship.

Mr. Chairman, while hearings like this tend to emphasize differences, I think it is very important that we recognize that there is a movement going on—a kind of populist, conservative movement going on—President Reagan is going to be personally involved in this issue, and we are going to make a change in the Tax Code.

The change is not going to be enactment of the Kemp-Kasten plan, the Bradley-Gephardt plan, the Baker plan, the Reagan plan, or the Regan plan. It is going to be based the collective work of people interested in putting together a tax system that has incentives for work, savings, investment, and job creation.

Senator CHAFEE. It was my understanding that Secretary Baker has consulted with both of you. Is that not so?

Senator KASTEN. We have had a number of meetings with Secretary Baker. We had a number of meetings with Secretary Regan while he was Secretary. Our colleagues, Bill Bradley and Dick Gephardt, have been included in some of those meetings. They have also had separate meetings with Secretaries. It is also my understanding that there have been meetings with the leadership of the Ways and Means and Finance Committees. We are all working together.

The point I want to emphasize is that we are going to have tax reform this year because everyone will be working together for a fair and simple tax system with incentives for work, investment, and savings. That is the direction that all of us are taking, and we will be successful.

In my statement, I talked about the features of our tax plan—a single tax rate applied to an expanded tax base, with special provisions for the working poor, for families with children, for homeowners, for savers, and for small business. In brief, what we are talking about is a plan that caps the tax rate at 24 percent, doubles the personal exemption, provides an employment income exclusion and maintains many essential deductions that are now in current law.

It is a tax plan designed to provide incentives for work, saving, investments, risk taking, and economic growth. Our plan also provides a fair system that discourages those who have mastered the art of exploiting the Tax Code.

But no matter what plan or hybrid plan is adopted, I think there are some essential features that must be part of it. In fact, I would

find it nearly impossible to support a plan that does not include these basic features:

The first basic feature we must have is revenue neutrality. The tax modification plan cannot be an excuse, will not be an excuse, for a tax increase. And I think this is something that all of us—Bradley, Gephardt, Kemp, Kasten, and Treasury are working toward. No new tax system should be designed to bring in any more revenue than the current Tax Code. Of course, we believe in the long run that tax reform will provide more economic growth and, hence, more revenue to the Federal Treasury. But we cannot have tax reform as an excuse or as a cover for a tax increase.

The second key point: We must have lower marginal rates. Lower rates will reduce the disincentives for work, saving, investments, and risk taking that are also in our current Tax Code. Ideally, the number of rates should be reduced, as we have done, to a single low rate or at most three rates. The top rate should be no more than 30 percent; 28 percent would be preferable. But I would have great difficulty in supporting any rate that was above 30 percent.

The third key point is that we have got to have protection for low-income earners. No one below the poverty level should pay taxes, and many low-income taxpayers should be removed from the tax rolls. Kemp-Kasten, Bradley-Gephardt, and Treasury all make an effort at removing lower income taxpayers from the tax rolls. This can be accomplished by increasing the tax threshhold above the poverty level. Under Kemp-Kasten, we do this by doubling the personal exemption, increasing the standard deduction, and with an employment income exclusion. At the very least, any tax reform measure must include increasing the personal exemption to $2,000 in order to protect families and the working poor.

Those are the three key elements. There are a couple more that I would just like to touch on:

First of all, fairness. With our current tax system, depending on the source of income and, the opportunity to take advantage of certain tax preferences, taxpayers with the same amount of income pay very, very different rates and very, very different amounts of tax. The system is not fair. As Congress passes laws which in one way or another exclude large amounts of income from the tax base, higher tax rates must be applied to the remaining income just to break even. Taxpayers who can't use the preference items to avoid higher tax rates—and that's about 70 percent of all taxpayers—go ahead and pay higher and higher taxes. And it is not fair.

The second element is simplicity. Tax reform should eliminate many of the conflicting rules of taxation and substitute a few basic rules that everyone can understand. The perception of understanding, the perception of simplicity, is very, very important. Dick Gephardt made the comment earlier today about the person going to H&R Block and spending $200 to get his short form filled out. But individual after individual in Wisconsin has come to me talking about the problems. The Wall Street Journal had an article about how "Even the IRS doesn't know the rules." They accompanied a family—armed with the same facts, the same income figures, and the same deductions—to different IRS offices and were given completely different tax bills to pay. Even the IRS doesn't have it

straight. Under the current Tax Code there are as many different tax codes as there are industries. There is no fair playing field for businesses, and that also is not fair.

On the whole, tax reform should provide a more neutral and efficient tax system that doesn't target any particular industry or individual and that minimizes tax interference in the free market.

Mr. Chairman, that we are all working toward the same goals. I believe we are going to have tax reform this year, and we will accomplish this through the kind of meaningful discussions that are taking place with this committee this morning. I thank you for the opportunity of testifying.

Senator CHAFEE. Thank you.

[Senator Kasten's written testimony follows:]

TESTIMONY FOR

SENATOR ROBERT W. KASTEN, JR.

SENATE FINANCE COMMITTEE

HEARING ON TAX REFORM

MAY 9, 1985

MR. CHAIRMAN, I AM PLEASED TO APPEAR HERE THIS MORNING TO DISCUSS TAX REFORM. YOU ARE TO BE COMMENDED FOR HOLDING THIS HEARING, AND FOR GIVING EVERYONE A VOICE IN THE PROCESS OF REFORMING THE TAX CODE. I AM DELIGHTED TO BE HERE WITH MY COLLEAGUES WHO HAVE ALSO WORKED HARD ON THE ISSUE, AND WHO HOPE--AS I DO--THAT A COMPREHENSIVE TAX REFORM PROPOSAL WILL BE SIGNED INTO LAW THIS YEAR.

THIS HEARING IS ESPECIALLY IMPORTANT SINCE THE ADMINISTRATION WILL SOON ANNOUNCE ITS REVISED TAX REFORM PROPOSAL. OUR PRESENCE HERE SHOWS THAT YOU ARE CLEARLY EXAMINING ALL ISSUES AND PROPOSALS INVOLVED IN TAX REFORM. IT IS MY STRONG HOPE THAT BY THE TIME WE HAVE WORKED THROUGH THE LEGISLATIVE PROCESS, THERE WILL BE A REAGAN-BAKER-ROSTENKOWSKI-KEMP-BRADLEY-PACKWOOD-KASTEN-GEPHARDT PLAN FOR TAX REFORM.

MR. CHAIRMAN,I BELIEVE THAT WE MUST FORMULATE A TAX SYSTEM THAT IS FAIRER, SIMPLER, AND LESS OF A BURDEN ON OUR NATION'S ECONOMY AND TAXPAYERS. OF COURSE, I PREFER THE APPROACH TO TAX REFORM EMBODIED IN THE KEMP-KASTEN FAIR AND SIMPLE TAX PLAN.

THE FAIR AND SIMPLE TAX PLAN OFFERS THE BEST FEATURES OF A FLAT TAX--A SINGLE TAX RATE APPLIED TO AN EXPANDED TAX BASE--WITH SPECIAL PROVISIONS FOR THE WORKING POOR, FAMILIES WITH CHILDREN, HOMEOWNERS SAVERS, AND SMALL BUSINESSES.

IN BRIEF, OUR PLAN CAPS THE TAX RATE AT 24 PERCENT, DOUBLES THE PERSONAL EXEMPTIONS, PROVIDES AN EMPLOYMENT INCOME CREDIT, AND MAINTAINS MANY ESSENTIAL DEDUCTIONS IN CURRENT LAW.

IT IS A TAX PLAN DESIGNED TO PROVIDE INCENTIVES FOR WORK, SAVING, INVESTMENT, RISK-TAKING AND ECONOMIC GROWTH, AND, TO PROVIDE A FAIR SYSTEM THAT DISCOURAGES THOSE WHO HAVE MASTERED THE ART OF EXPLOITING THE TAX CODE.

BUT, NO MATTER WHAT PLAN--OR HYBRID OF PLANS--IS FINALLY ADOPTED, THERE ARE SOME ESSENTIAL FEATURES THAT MUST BE PART OF IT. IN FACT, I WOULD FIND IT NEARLY IMPOSSIBLE TO SUPPORT A PLAN THAT DOES NOT INCLUDE THESE FEATURES.

THE ESSENTIAL FEATURES ARE:

1) REVENUE NEUTRALITY. I FIRMLY BELIEVE THAT TAX REFORM SHOULD NOT BE AN EXCUSE FOR TAX INCREASES. THE NEW TAX SYSTEM SHOULD NOT BE DESIGNED TO BRING IN ANY MORE REVENUE THAN THE CURRENT TAX CODE. OF COURSE, WE BELIEVE THAT IN THE LONG RUN, TAX REFORM WILL PROVIDE MORE ECONOMIC GROWTH, AND HENCE, MORE REVENUE TO THE FEDERAL TREASURY.

2) LOWER MARGINAL TAX RATES. LOWER--AND LESS PROGRESSIVE TAX RATES--WILL REDUCE THE DISINCENTIVES FOR WORK, SAVING, INVESTMENT, AND RISK-TAKING THAT ARE INHERENT IN OUR CURRENT TAX CODE. IDEALLY, THE TOTAL NUMBER OF RATES SHOULD BE REDUCED TO A SINGLE LOW RATE, OR AT MOST 3 RATES. THE TOP RATE SHOULD BE 30%, IF NOT LOWER.

3) PROTECTION FOR LOW-INCOME EARNERS. NO ONE BELOW THE POVERTY LEVEL SHOULD PAY TAXES, AND MANY LOW-INCOME TAXPAYERS SHOULD ACTUALLY BE REMOVED FROM THE TAX ROLLS. THIS CAN BE ACCOMPLISHED BY INCREASING THE TAX THRESHOLD ABOVE THE POVERTY LEVEL.

UNDER KEMP-KASTEN, WE DO THIS BY DOUBLING THE PERSONAL EXEMPTION, INCREASING THE STANDARD DEDUCTION, AND WITH AN EMPLOYMENT INCOME EXCLUSION. IN FACT, UNDER FAST A WORKING FAMILY OF 4 WOULD PAY NO TAX ON THE FIRST

$14,125 OF INCOME.AT THE VERY LEAST, ANY TAX REFORM MEASURE MUST INCLUDE INCREASING THE PERSONAL EXEMPTION IN ORDER TO PROTECT FAMILIES AND THE WORKING POOR.

THIS FEATURE ALSO HELPS MILLIONS OF AMERICANS GET OUT OF THE WELFARE TRAP. BECAUSE OF HIGH MARGINAL TAX RATES, AMERICANS RECEIVING WELFARE PAYMENTS NOW HESITATE TO TAKE A JOB FOR THE SAME AMOUNT OF MONEY. AFTER PAYING TAXES, THEY HAVE LESS THAN THEY DID BEFORE THEY TOOK THE JOB. SINCE FAST RAISES THE TAX THRESHOLD ABOVE THE POVERTY LEVEL, THE CHOICE BETWEEN WORKING AND RECEIVING WELFARE IS AVOIDED.

IN ADDITION, I THINK THAT 2 OTHER ELEMENTS THAT ARE MOST IMPORTANT IN PUTTING TOGETHER A TAX REFORM PLAN. THESE ELEMENTS ARE:

--FAIRNESS. WITH OUR CURRENT TAX SYSTEM--DEPENDING ON THE SOURCE OF INCOME AND OPPORTUNITY TO TAKE ADVANTAGE OF TAX PREFERENCES--TAXPAYERS WITH THE SAME AMOUNT OF INCOME CAN PAY VERY DIFFERENT RATES AND AMOUNTS OF TAX.

AND, AS CONGRESS PASSES LAWS WHICH, IN ONE WAY OR ANOTHER, EXCLUDE LARGE AMOUNTS OF INCOME FROM THE TAX BASE, HIGHER TAX RATES MUST BE APPLIED TO THE REMAINING INCOME JUST TO BREAK EVEN. TAXPAYERS WHO CAN'T USE PREFERENCE ITEMS TO AVOID HIGHER TAX RATES--AND THAT'S ABOUT 70% OF THEM--MUST GO AHEAD AND PAY HIGHER AND HIGHER TAXES. IT ISN'T FAIR.

--SIMPLICITY. TAX REFORM SHOULD ELIMINATE MANY OF THE CONFLICTING RULES OF TAXATION, AND SUBSTITUTE A FEW BASIC RULES THAT EVERYONE CAN UNDERSTAND. UNDER THE CURRENT TAX CODE, FOR EXAMPLE, THERE ARE AS MANY DIFFERENT TAX CODES AS THERE ARE INDUSTRIES.

ON THE WHOLE, TAX REFORM SHOULD PROVIDE A MORE NEUTRAL AND EFFICIENT TAX SYSTEM THAT DOESN'T TARGET ANY PARTICULAR INDUSTRY OR INDIVIDUAL, AND MINIMIZES TAX INTERFERENCE IN THE FREE MARKET.

MR. CHAIRMAN, I KNOW THAT MANY PEOPLE ARE CONCERNED THAT A TAX REFORM WOULD ELIMINATE SOME DEDUCTIONS THAT MOST MIDDLE INCOME AMERICANS CONSIDER ABSOLUTELY ESSENTIAL. BUT A CLOSER LOOK SHOWS THAT THIS ISN'T SO. IN THE KEMP-KASTEN PROPOSAL WE MAINTAIN THE CURRENT TAX LAW TREATMENT FOR SOME DEDUCTIONS SUCH AS MORTGAGE AND INVESTMENT INTEREST, CHARITABLE CONTRIBUTIONS, PROPERTY TAXES, ORDINARY BUSINESS EXPENSES, PENSIONS, AND IRAS.

KEMP-KASTEN ALSO MAINTAINS THE CURRENT LAW TREATMENT OF SOCIAL SECURITY--WITH MINOR LIBERALIZATION OF THE TAXATION OF BENEFITS. BUT IN KEEPING THE CURRENT TREATMENT OF SOCIAL SECURITY, WE WERE CONCERNED ABOUT THE REGRESSIVE NATURE OF THE PAYROLL TAX. TO MAKE SURE THAT LOW AND MIDDLE INCOME TAXPAYERS DO NOT FACE A TAX INCREASE AS A RESULT OF THE

INTERACTION BETWEEN THE 24 PERCENT TAX RATE AND THE FICA MARGINAL TAX RATES, WE PROVIDE AN EMPLOYMENT INCOME EXCLUSION.

THE EXCLUSION ALLOWS TAXPAYERS EARNING LESS THAN THE WAGE BASE--ABOUT $40,000--TO EXCLUDE 20 PERCENT OF THEIR WAGE AND SALARY INCOME FROM TAXATION. THIS EXCLUSION COUPLED WITH THE HIGHER ZERO BRACKET AMOUNTS AND DOUBLED PERSONAL EXEMPTIONS, WORK TO ACTUALLY LOWER TAXES IN MANY CASES. THE EXCLUSION IS PHASED OUT FOR INCOME EARNED OVER THE WAGE BASE.

MR CHAIRMAN, MANY CRITICS OF TAX REFORM FOCUS ON THE WINNERS AND LOSERS. I THINK THIS IS THE WRONG PERSPECTIVE FROM WHICH TO EVALUATE TAX REFORM. THOSE WHO MAY LOOK LIKE WINNERS AT FIRST MAY END UP LOSERS OR WITH NO CHANGE AT ALL. FOR EXAMPLE, WHILE AMERICANS IN THE UPPER INCOME BRACKETS WILL HAVE THEIR INCOME TAX BRACKETS REDUCED FROM 50 TO 24 PERCENT, MANY OF THE TAX PREFERENCES THEY NOW USE TO SHELTER INCOME WILL NO LONGER BE AVAILABLE. THE BIG LOSERS WILL BE THOSE TAXPAYERS WHO HAVE MASTERED THE ART OF EXPLOITING THE TAX CODE.

ALTHOUGH FAST IS DESIGNED TO BE REVENUE NEUTRAL IN STATIC TERMS, WE BELIEVE THAT OVER TIME THE FEDERAL GOVERNMENT WILL GAIN MORE REVENUE FROM IT. NOT ONLY WILL WE

SEE MORE REVENUE FROM A GROWING ECONOMY, BUT PAYING A LOWER TAX RATE OF 24 PERCENT WILL BE MORE AGREEABLE TO UPPER INCOME AMERICANS THAN CHASING AFTER SHELTERS.

THIS WOULD BE VERY MUCH LIKE THE REVENUE EFFECT WE ARE NOW SEEING AS A RESULT OF THE REDUCTION IN THE TOP TAX RATE FROM 70 TO 50 PERCENT. PRELIMINARY TREASURY DATA SHOWS THAT TAXPAYERS IN THE UPPER INCOME BRACKETS ARE ACTUALLY PROVIDING MORE REVENUE TO THE TREASURY.

AS A MODIFIED FLAT TAX, FAST SOLVES MANY OF THE PROBLEMS INHERENT IN A PROGRESSIVE TAX SYSTEM. PROBLEMS SUCH AS THE MARRIAGE PENALTY FOR A FAMILY WITH TWO INCOME EARNERS, THE DISINCENTIVES OF INCREASING MARGINAL TAX RATES AS EARNINGS RISE, AND BRACKET CREEP JUST DO NOT APPLY. MANY OTHER LEADING TAX PROPOSALS DO NOT REALLY ADDRESS THESE PROBLEMS.

ON THE BUSINESS SIDE, FAST ALSO PROVIDES INCENTIVES FOR WORK, SAVING, INVESTMENT, AND BUSINESS ENTERPRISE. THE TREATMENT OF CAPITAL GAINS IS GENEROUS. THE TOP CORPORATE RATE IS DROPPED FROM 46 TO 35 PERCENT, AND THE ACCELERATED DEPRECIATION SYSTEM IS MODIFIED TO PROVIDE THE ECONOMIC EQUIVALENT OF EXPENSING.

WITH FAST, THE EMPHASIS IS ON REWARDING PROFIT BY TAXING IT AT THE LOWEST POSSIBLE MARGINAL TAX RATE. THE BASE IS ALSO BROADENED BY ELIMINATING MANY CORPORATE TAX AVOIDANCE SCHEMES.

I BELIEVE THAT TAX REFORM REALLY HAS MORE TO DO WITH THE AVERAGE AMERICAN TAXPAYER. ACCORDING TO THE DEPARTMENT OF TREASURY, ONLY 30 PERCENT OF ALL AMERICAN TAXPAYERS ITEMIZE THEIR DEDUCTIONS. THEREFORE, SPECIAL TAX PREFERENCES--AND WHETHER OR NOT THEY REMAIN AS PREFERENCES--REALLY DON'T MATTER TO 70 PERCENT OF ALL TAXPAYERS. LOWER TAX RATES, HOWEVER, DO MATTER TO THEM.

THE AMERICAN TAXPAYERS DESERVE A BREAK FROM HIGH TAX RATES AND A COMPLEX TAX CODE. IN FACT, A WASHINGTON POST/ABC POLL DONE EARLIER THIS YEAR FOUND THAT 63 PERCENT OF THE AMERICAN PEOPLE FAVOR CURRENT EFFORTS TO REFORM AND SIMPLIFY THE FEDERAL TAX CODE.

UNFORTUNATELY, AMERICANS MAY NEVER SEE TAX REFORM, BECAUSE THE SPECIAL INTERESTS IN WASHINGTON, D.C., ARE OPPOSED TO IT. THEY HAVE A VESTED INTEREST IN KEEPING THE CURRENT TAX SYSTEM--AND THE SPECIAL DEDUCTIONS, CREDITS, OR EXCLUSIONS THAT BENEFIT THEM. THE LAST THING THEY WANT TO SEE IS TAX REFORM, AND THEY CHARACTERIZE TAX REFORM AS JUST ANOTHER FEDERAL RAID ON THE WALLETS OF AVERAGE AMERICAN TAXPAYERS.

AS THIS HEARING INDICATES, THERE IS A GREAT DEAL OF INTEREST IN TAX REFORM IN WASHINGTON--AND ALL ACROSS THE COUNTRY. FOR YEARS, WE HAVE ALL RECEIVED LETTERS AND

POSTCARDS FROM CONSTITUENTS EXPRESSING THEIR IRRITATION, DISSATISFACTION, AND JUST PLAIN ANGER AT OUR TAX SYSTEM. THE AMERICAN TAXPAYERS DESERVE A TAX SYSTEM THAT IS FAIR, SIMPLE, AND YET PROVIDES INCENTIVES FOR SAVING, INVESTMENT, RISK-TAKING, AND ECONOMIC GROWTH. IT'S TIME FOR AN OVERHAUL OF OUR CURRENT TAX SYSTEM, AND THE FAIR AND SIMPLE TAX WILL DO IT.

Senator CHAFEE. Congressman Kemp, I personally have had many New Yorkers say to me that the deduction for the State and local income and personal tax is extremely important. Actually, they were dealing with Treasury-1 at the time.

Mr. KEMP. That's right.

Senator CHAFEE. If we repeal the deductibility of those, they say it would create "a desert out of New York City and it would not long survive." I found that a little bit alarmist, but what is your answer to that? Obviously you have given a lot of thought to it.

Mr. KEMP. Well, the top tax rate in New York City on personal income is about 18 percent. If we abolished the Federal income tax, the disparity between New York City or New York State and other States would still exist, because it is ultimately caused by their high tax rates. So, as we move toward modification of the Federal system—Senator Matsunaga a few minutes ago reminded us that the rates used to be 91 percent in the United States of America prior to John F. Kennedy; he brought them down, President Reagan has brought them down further——

Senator CHAFEE. There was an 8-percent collection fee allowed under that system. [Laughter.]

Mr. KEMP. But the point is that the State of New York needs a modified flat tax itself. The State income tax deductibility is regressive. Everybody is criticizing President Reagan for suggesting that he wanted to reduce the steep progressivity of the U.S. Tax Code. But I would point out to you, Senator, that the New York tax code is regressive. Wealthy New Yorkers are paying their State income tax with 50-cent dollars because they are in the upper Federal bracket, but working men and women from Buffalo—steel workers, auto workers, machine tool workers, secretaries, and teachers—are paying their State tax with 80-, 90-cent dollars. So the burden of the New York State income tax is falling on the poor or the working man or woman, and it is being reduced for very, very high income or wealthier taxpayers.

It seems to me that New York State has an obligation to reduce its steeply graduated income tax rates, which are discouraging the investment in new enterprises in our State that is critical to jobs and moving us out of that welfare trap into an enterprise society.

But, having said that, I have been able to show many of my friends in New York, most of them—although there is a lot of pain and gnashing of the teeth over this issue—that they should wait and see what the final product is. If the top rate is what Kasten and Kemp would like it, at about 28, then the tradeoff of the State income tax is a real plus. It wouldn't be if it were 35 percent. I am suggesting that we wait and see. We don't want to put our feet in concrete and say that we are not going to support anything; we want to see what the final product is, and see, Mr. Chairman, if we can't influence Treasury-2 and President Reagan to bring the top rate down to something like 30 or below in order to get a more favorable tradeoff on the State income tax deduction.

Senator CHAFEE. All right.

Now, for individuals you have in effect one rate, for corporations you have three rates. Why is that, Senator Kasten? Why did you happen to choose that? Why not go to a flat tax for corporations, too?

Senator KASTEN. We just decided that this is the fairest and best way to do it. Our plan allows deductability of basic business expenses, but the rate system as we have it is important.

We wanted to make an effort to deal with the differences between larger and smaller businesses.

I would like to go back, if I could, to one point that Jack was making. Wisconsin is also a high tax State. In Kemp-Kasten, we want to have a system with deductions everyone can take advantage of, not just itemizers from high tax States. We want a system in which deductions are used for, if you will, a "good social purpose." In other words, we want to encourage savings, so we keep IRA's and Keogh's. We want to encourage homeownership, so we keep mortgage interest deductions. We want to encourage charitable contributions, so we keep charitable contributions with no threshholds. We want to encourage fringe benefit programs, so we don't allow for their nondeductibility.

We don't necessarily, Mr. Chairman, want to encourage higher and higher State taxes. Therefore, we don't want incentives in the tax system for high taxes. I think it makes sense. If we can get the top tax rate below 30 percent, and the personal exemption to $2,000, then, even though State and local taxes are no longer deductible, we can prove to the average taxpayer in Wisconsin and New York that they are better off under this system than they are under present law.

The Chairman. Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman, and thank you, Congressman Kemp and Senator Kasten, for your excellent presentation. I have to tell you that your new additions to your bill certainly have made it a lot more attractive from my perspective. As I have told both of you, I am in favor of all the tax deductions and in favor of all the tax rate reductions. [laughter.]

Senator SYMMS. Because I think if we really believe in the philosophy you espouse, the static numbers of Treasury are really rather meaningless, anyway. In fact, Senator DeConcini and I have introduced the Hall-Rabushka plan, which is a 19-percent tax rate which truly is the simplified peer version of what you are getting at.

Mr. KEMP. Right.

Senator SYMMS. There is a question I want to ask that I am very interested in. First I would like to phrase the question in terms of my State of Idaho and talk just a little parochial politics.

Our biggest income earner is agriculture, then forest products and minerals are second in line as far as importance to the States. But another very, very large industry in our State is second homes—Sun Valley, ID, for example. There are 10 counties in Idaho that have over 20 percent of the homes in the counties as second homes. What would you anticipate is going to happen to some of these areas if we change the tax system.

In other words, my concern has been, and my reluctance to jump on board with your bill, that with agriculture down, the forest products industry sick, minerals industry sick, the last thing left is the tourist industry, and we can't afford to have something happen in the tax system that would cause people not to invest in McCall, Cordelain, Sun Valley, and these wonderful places for recreation.

What would happen, in your view, if this proposal were accepted? Do you allow the deduction on the second homes?

Senator KASTEN. In the area of deductibility of mortgage interest, there are differences between Treasury-1, Kemp-Kasten, and Bradley-Gephardt. In Kemp-Kasten, the mortgage interest for that second home is deductible without any limit.

The Treasury made an effort in Treasury-1 to limit the mortgage interest deduction to the principle residence.

Senator SYMMS. So you have second-home deductions, then?

Senator KASTEN. We have second-home deductions.

Senator SYMMS. OK, the next question, because I am going to run out of time here, but I am going to go back in the second round. But you have the second-home deduction in?

Senator KASTEN. We do.

Senator SYMMS. And that is a 24-cent dollar that you are talking about deducting?

Senator KASTEN. That's right.

Senator SYMMS. That's one good thing about all of these; the deductions are less important anyway, because the rate is lower.

But the second point: Kemp-Kasten Neutral Cost Recovery System, NCRS—now, I have been one of those people, I guess, that thought that ACRS has really been good for the country. Now, they can talk about "tax-driven investments," but I can take you to Idaho and show you brand new, modern potato warehouses and packing plants that weren't there before 1981, that have been built because of the incentives that are built into the ACRS system. I favor 100-percent expensing. That is one of the reasons why I introduced the Hall-Rabushka plan, because it gives 100-percent expensing up front with unlimited carry-forward.

Senator KASTEN. Right.

Senator SYMMS. OK. Tell me how this works specifically. Let's say you've got a potato-farming growing and packing operation, and a person wants to build let's say a million-dollar packing facility to store and pack potatoes. Tell me how it would work.

Senator KASTEN. All right. Right now he can write it off over—what—18 years.

Senator SYMMS. But all the equipment inside the building gets 5 years.

Senator KASTEN. Yes.

Senator SYMMS. And the way they do these things, most of it is all equipment inside, and there is just a little shell around the outside. I mean, you understand that.

Senator KASTEN. Right.

The Treasury-1 would write it off over 65 years. That is ridiculous.

Senator SYMMS. That is a disaster. I mean, I am 47; I am not going to invest in anything that takes that long. [Laughter.]

Mr. KEMP. I am trying to save that investment.

Bradley-Gephardt would write it off over about 40 years. Kasten-Kemp would write it off over 25 but allow for 148 percent of the cost to be written off, and it would be indexed for inflation; this provides the economic equivalent of expensing without the first year cost. In effect, we are getting the expensing you want without the upfront costs.

Senator SYMMS. OK. Go back through that again, a little slower. The guy builds the warehouse.

Mr. KEMP. He writes off 148 percent of his cost over 25 years, and it would be indexed.

Senator SYMMS. So he can write off $1,480,000, divided by 25.

Mr. KEMP. So the effect of the extra write-off, if it is indexed for inflation, is the economic value or equivalent of writing off 100 percent the first year, but without the huge cost of going from the ACRS right now to expensing.

Now, incidentally, Dan Rostenkowski, the chairman of the Ways and Means Committee in the Democratic-controlled House, advocated in 1981 a 100-percent expensing—a 30-percent cut in the corporate rate and 100-percent expensing phased in over 5 years. I think there is an emerging consensus that depreciation schedules should be shortened, and indexed, and move toward encouraging investment not only in a plant in Idaho but in mineral extraction, or energy development, or a new plant and machinery and equipment in Buffalo, NY, so we can create some more jobs in this country.

Senator SYMMS. My time has expired; but, Mr. Chairman, when we get to the second round I want to go back to this point to get it clear as to how it affects some other industries.

The CHAIRMAN. Senator Wallop?

Senator WALLOP. Thank you, Mr. Chairman.

I might just say one thing in addition to the response, and it will be developed further, that this incorporates the concept that was originally introduced by Treasury into the Tax Code of the time value of money, and that is the 148 percent over that period of time. So, that is where you get the economic equivalent of expensing, I think.

Mr. KEMP. Right.

Senator WALLOP. Let me just say that I welcome both Congressman Kemp and Senator Kasten here, and I am pleased to be a cosponsor of that legislation, because I think, of all the plans, it has the most opportunity to provide the country with a genuine economic explosion.

One of the problems that I have, and I don't know how we will ever get over it, is that Treasury revenue estimates are always static. The most perverse example of that is that if you raise the capital gains tax, you raise receipts to the Federal Government, and clearly that has not been the case. But on a static model, it is the only defensible case.

I think that one of the problems that we face, those of us who are in favor of the Kemp-Kasten approach, is the Treasury static projections of revenue. How we get around that, I don't know, but I have a significant faith that this will peel off an enormous layer of inhibition in the American economy that will generate revenue.

Senator SYMMS. The way to get around it is to give up revenue neutrality.

Senator WALLOP. One level of revenue neutrality. I don't think I would want to go to the other way of raising revenue.

Jack, I would like to ask you a question, because I think it is important in this whole business, and that is that the tax obligation of an individual finally comes down to one reality and that is the

marginal rate. In your opinion, is there still a great deal of incentive to tax avoidance at a marginal rate that is as high as Treasury—35?

Mr. KEMP. Under current law?

Senator WALLOP. Under current law or in the Treasury proposal. I mean, is it still an incentive to tax avoidance at a rate that high?

Mr. KEMP. Well, you are talking about the 35-percent rate that has been bandied about in the papers, I assume.

Senator WALLOP. That's right.

Mr. KEMP. Well, the 35-percent rate is certainly an improvement but it's not enough. I give the President and Baker and Regan and my colleagues Bradley and Gephardt credit. I mean, let's face it, 25 years ago the top rate was 90, then it went to 70, then it went to 50, now we are talking about 35. It is an incredible debate in America that the Democratic Party and the Republican Party are debating whether the top rate should be 30 or 25. We have come a long way. So I want to give credit where credit is due.

But the point I made earlier, Senator, is that the 35-percent rate, if you take out the property tax and take out the personal income tax deductibility, is frankly, for many States in this country, a problem. It causes not only political problems, but it will manifest itself in a higher avoidance of taxable sources of income and thus force people into what Senator Bradley talked about, that young boy who is 25 years of age who spends his whole business career trying to figure out how to look for the tax consequences of a particular decision. That is a shame. I would imagine that most of our sons and daughters spend an awful lot of time—my son plays pro football and my daughter is teaching school. I can tell you, they both spend too much time looking for the tax consequences from their income, and what to do with it. I think that is a shame in this country. So I don't think 35 percent is low enough.

I would just like to put a footnote on my answer by suggesting that one good study of the econometric effects of Kemp-Kasten was done by Harris Bank.

Senator WALLOP. By who?

Mr. KEMP. Harris Bank—Chicago.

Senator WALLOP. Yes.

Mr. KEMP. They said implementing the Kemp-Kasten provision would lead to an additional $750 billion of output by 1990, over what would be the case under present law. That represents more than $5,000 of additional real income per worker by 1990. That is a dynamic impact upon the economy and upon the income of the working man and woman.

Senator WALLOP. It has a real impact on revenue, too.

Mr. KEMP. Yes, it means $140 billion of revenue for the Federal Government and over $100 billion more for the States.

The good sense of the American people knows well that if we can increase the national income of our economy, revenues will rise. They know it. The problem is here in Washington, with static-oriented old-guard Democrats and Republicans, who have not yet come to grips with the fact that the tax system is, as you pointed out, Senator, a disincentive to the most productive use of human and physical resources.

Senator WALLOP. Thank you.

The CHAIRMAN. At what level do the deductions become almost irrelevant? If you had a sliding scale of 5 to 15 percent, would deductions at that stage make much difference, whether you had them or didn't have them?

Senator KASTEN. Obviously, as you get lower and lower they have less and less. But take, for example, the president of Dartmouth College who is concerned about this issue of charitable contributions. A number of people were saying that lowering the rate to 25 percent would eliminate much of the incentive for charitable contributions. But he said, "No, I'm for tax reform." He stood up at a press conference along with a couple of leading business people, and whatever.

I don't know if a 20-percent rate or a 15-percent rate or a 5-percent rate or a 1-percent rate make deductions irrelevant. Obviously at one point the whole thing becomes meaningless. But I think a 25 percent-rate and a 20-percent rate up to $40,000 of earned income makes sense, and I think that that is where the rate should be.

The CHAIRMAN. Well, you are both to be complimented. And Jack's right: To consider that we are now talking about 35 versus 25 versus 50 is a giant step forward from where we were. You both deserve a great deal of credit for getting us there.

Let us talk about revenue neutrality again, not necessarily among businesses or between businesses or between businesses and individuals. But would you be willing to move to a kind of a further expansion of a tax like Senator Roth's, his business transactions tax, or some other consumption tax, if its sole purpose was used to further lower individual rates?

Mr. KEMP. No.

The CHAIRMAN. Why?

Mr. KEMP. No. No, no, no, no, no, Senator, Mr. Chairman, please. That is a diversion. It would be a vehicle for a tax increase. That would be basically a value-added tax on the United States of America. The value-added tax has helped put a blanket on the incentive for the European economies to grow. It is a very severe problem in Europe and England and France.

The CHAIRMAN. Is it severe because of their total tax level, or is it severe because of the tax in and of itself?

Mr. KEMP. It is a tax on consumption, Senator.

The CHAIRMAN. I understand that.

Mr. KEMP. We already tax consumption at the State and local level. And another tax on consumption would act as a depressant to production just as much as a tax on production.

The CHAIRMAN. What you are saying is, the value of it is not sufficient, even when used to offset the marginal rates, so that you lower them further and further?

Mr. KEMP. Lowering the top rates will allow us enough income to cut the tax on the poor. By bringing down the rates we make the code more efficient and increase the national income of the economy, and thus we can afford, because we have lowered those rates, to get to some level of equilibrium at which we can afford to lower the tax on the poor and the working families.

The CHAIRMAN. Is there any end to that rainbow?

Mr. KEMP. Yes.

The CHAIRMAN. I mean, can you get the rates so low that they have gone too low?

Mr. KEMP. Yes. Sure.

The CHAIRMAN. Where is that?

Mr. KEMP. I don't know, but it is closer to zero than to 100. Maybe they both would raise no revenue. The point that Kasten and Kemp are making, and I think Symms is making, and Wallop is making, and you have made in your own inimitable style, Mr. Chairman, is that when you begin to tax people above the level of about, I'd say, maybe 19 to maybe 29—I don't know exactly where it is. I think it is part of the political process to have a couple of parties competing to see how low the rates should go. That is democratic, small-d democratic. But most economists say that anything beyond 25 percent forces people to begin to take into consideration the tax consequence of a particular act—most economists, classical economists, notwithstanding even our friends on the left side. And as far as I am concerned it is closer to 25 percent. That is why we set our sale at 24. Senator Symms talks about 19 percent, and some have talked about 10 percent.

The CHAIRMAN. Are you talking about total tax, or income tax?

Mr. KEMP. I am talking about the rate, the marginal rate, which people face. They don't face effective taxes; they face marginal rates.

The CHAIRMAN. Yes, I understand that. I think you are right, in terms of how it affects their actions, whether they will do a certain thing or not do a certain thing. When I proceeded with Senator Roth's Business Transaction Tax you said, "No, no; that's a tax on consumption." But the taxes on consumption seem to have less effect on individuals 'actions than the taxes at the marginal rates.

Mr. KEMP. But the income tax is a tax on consumption. You are taking money away from the wage earner. And it is basically counterproductive to have it too steeply graduated, I think most people now agree. And the problem is, that is a tax on consumption, because you are inhibiting the ability of people to produce what they want to consume either now or in the future. Savings is consumption deferred to the future.

The CHAIRMAN. All right. So basically what you are saying is that what you want to do is get down the total level of taxing, not just the income tax but the total level of taxation. You are not interested in a tradeoff of a tax on consumption for a lowering of a tax on income.

Mr. KEMP. I am interested in the marginal rates being low. And if revenue dynamically went up, Mr. Chairman, I would not be opposed to that. I favor a more efficient tax system. Bob obviously will speak for himself on this subject, but I would favor having the economy grow and the tax system be more efficient, and the underground economy coming down to where we could actually get more revenue at a lower rate of taxation. I think that is possible and probable, and it is certainly the strong suggestion made by Harris Bank in their survey of what Kemp-Kasten would do.

The CHAIRMAN. Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman.

Mr. Chairman, I might just comment that probably one of the biggest taxes on consumption that we have in the country today is

the corporate income tax, because the corporate income tax is the tax that either has to come out of the consumers or it comes back to the means of production where they have to take it out of new plant expansion, new jobs, or lower wages to people—somewhere, to get the money. So I think that is one point.

But I want to go back, because I am interested in this. Senator Packwood asked you a question about at what point you would lower it. I might just say that the Hoover Institute in Stanford, who prepared the bill that Senator DeConcini and I introduced, they do away with all deductions, and they have a 19-percent rate. And they maintain that the Hoover Institute, which is financed by charitable contributions, would have no problem surviving on a 19-percent dollar. But they also tax all income only once. So their estimates are that, with no deductions on interest and no taxes charged against interest earned or no taxes on dividends, where no income is taxed twice, they believe that interest rates would be lowered as much—everything being equal, like where we are today with a 12-percent prime rate—they say if their tax bill were put into effect the rates would go to 8 percent overnight. Now, do you believe that?

Mr. KEMP. I have no way of knowing what Mr. Volcker is going to do at the Fed. He has more control over the Federal funds rate and the discount rate than the Hall-Rabushka tax reform would. But certainly savings would go up.

Senator SYMMS. What do you think would happen in your tax book?

Mr. KEMP. Let me answer the question, though, Steve, please. You make a valid point. And here is where social policy comes in, I would say to the chairman. We have made it a conscious decision in America to encourage families by having an exemption. We have made it conscious social policy to encourage charitable contributions by allowing for the writeoff or the deduction of that contribution. We have interest on mortgages that is fully deductible. Those are social goals.

The problem with Hall-Rabushka, as good as it is, and I give high credit to Hall and Rabushka for the work that they are doing in this area, and yourself included, in effect what they are doing is dropping the rate to 19 for the very wealthiest in our society and raising it to 19 for the very poorest in our society. And with all due respect, I don't think this country is ready to go to that type of a tax system.

Senator SYMMS. But can't that be fixed by just raising the zero bracket?

Mr. KEMP. Then you get back into social policy, Senator.

Senator SYMMS. Well, I am in favor of doing that.

You see, I think you have come a long wav, if I understand it. You have changed your bill dramatically since it was originally introduced.

Mr. KEMP. Not really.

Senator SYMMS. Well, you have this neutral ACRS in there.

Mr. KEMP. We saved ACRS in the beginning, and we just changed it by adding that extra writeoff so we could get to the economic equivalent of expensing. But that is not a dramatic change in the intent.

Senator SYMMS. Well, to my way of thinking, that is a very big improvement which you are to be complimented for.

Mr. KEMP. Thank you.

Senator KASTEN. Steve, we began with Hall-Rabushka, basically. The intellectual beginning for Kemp-Kasten was a flat tax—Hall-Rabushka. As we have worked through the practical political problems, and some of the social welfare kinds of things, we evolved into Kemp-Kasten as it is today. We want home ownership, we want savings, we want investment, we want those incentives in, and so they're in Kemp-Kasten. But the problem with Hall-Rabushka is that it doesn't have the family orientation that we have brought to the tax system.

Senator SYMMS. How are you going to treat taxes on corporate dividends?

Mr. KEMP. Well, lowering the personal rate by almost 50 percent and going to expensing-equivalent reduces the disparity or the disincentive of double taxation of dividends, Senator.

Senator SYMMS. You don't change that.

Mr. KEMP. No; we don't change it, but the best way to get at it is to drop the personal rates. I don't favor giving a corporation a 50-percent exclusion or credit against the double taxation of their dividends. Why give that to the corporation? Why not reduce the bias in the Tax Code or the double taxation of dividend impact by lowering the personal rates to 25? You get the very same effect, but you do it for people instead of for the corporation.

Senator SYMMS. Thank you, Mr. Chairman.

The Chairman. Senator Wallop.

Senator WALLOP. Mr. Chairman, I just want to explore one other area. Perhaps it has already been done, but if it has it bears exploration once again. And that is the value of deduction becomes a subsidy for the wealthy, the more graduated the tax is. So, under Treasury's 3- or 4-phase proposal the wealthy individual would have 35 percent of his interest costs written off as opposed to the lower rate of the poor.

So, once again you are driving those who need it the least into the decision to borrow or into the decision to find some deduction at the expense of the lower spectrum of American earnings. I would like either of you or both of you to comment from your perspective on it.

Senator KASTEN. That is exactly right. That is the whole concept. And that is why—right now—we are trying to work to get that Treasury rate in Treasury-2, or whatever it is going to be called, below 30 percent. We think we can do it. We think we have got a consensus among all the groups to drive that rate down.

Mr. KEMP. And Senator, you said exactly what Senator Symms said earlier in a different way: The incidence of taxation is different than the burden. Most people on the left and the right, from Joe Pechman at Brookings to Senator Symms of Idaho, recognize that there is a difference between the incidence of taxation and the burden. And if the incidence of taxation is placed on the formation of capital or the creation of new jobs or savings, the seed corn of our society, the burden then falls on those who go without the jobs, those who go without the income, those who go without the opportunity to climb that ladder up out of poverty.

So what we are now for the first time in our country actually asking people to reconsider, what the President suggested the other day, is that if you have too steep a progressivity in the rates, in effect you are not progressive; you are, as Senator Wallop said, actually regressive, because then the burden will fall on those who never get a chance to pay any taxes because they don't get any jobs. It is a very important debate that is going on in America today, and I think President Reagan is going to come down on the right side of it.

Senator WALLOP. I compliment you on it, because it was not possible, if you will, to suppose that you were achieving tax equity by lowering tax rates on people who are higher earners. But what we have seen in the efficiency of the delivery of taxes is that it works to the benefit and not to the detriment of the wealthy taxpayer.

Senator KASTEN. It is not only achieving tax equity, but also in fact increasing tax revenues. That is the point you were making before. We have fought with Bill Steiger on this same issue for capital gains. We fought this battle in 1981 for lowering the top tax rate from 70 to 50 percent.

The fact is that we have made the system more efficient, made the system simpler, lowered those rates, and we have seen a growing economy as a result.

Senator WALLOP. I love the positive nature of your saying "we have made it." I think what you have done is proposed to make it, and I hope that people can understand that proposal for what it is, because that is what it achieves. And you will find a great many people who like to write about these things with no economic perspective from which to come to it, write that what you have done is to try to favor the wealthy. But in point of fact, you will have achieved exactly the opposite.

Mr. KEMP. Mr. Chairman, it is very valuable to have the comments that Senator Wallop has made, and Senator Symms, and yourself. But I want to just say that one of the most valuable contributions that we can make to the understanding of the tax system is to remind ourselves of one very important thing: Our current system is not a tax on the wealthy; it is a tax on the people who would like to get wealthy. It is not a tax on the rich, it is a tax on the poor who would like to get rich, or at least get richer. It is not redistributing wealth, it is inhibiting the creation of wealth. And in effect, we can go through a process in which we can unite the left and the right with an idea that is becoming more popular not only here but throughout the world, that the way to help the poor is to create a climate in which they can escape poverty. And I would suggest that the impact we could have on this country would only be matched by the impact we would have on the rest of the world, who need the type of tax reform that is being discussed in the United States—from Israel to Bangladesh, to the Third World, to West Germany, to England and other countries.

So, forward, Mr. Chairman. We are going to cut the world's tax rates. [Laughter.]

The CHAIRMAN. Any further questions?

Senator WALLOP. I might just observe that the economic situation in this country, were we to do something as enlightened as

this, might not in fact lower the dollar but raise it, because it would be the world's best economic climate.

Mr. KEMP. It already is.

The CHAIRMAN. I am willing to run that risk.

Senator WALLOP. I am, too. I am quite willing to. But I think it is an interesting perspective of it.

The CHAIRMAN. Fellows, good job. Thank you very much for spending so much time with us.

[Whereupon, at 12:12 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

Testimony on Tax Simplification before Senate Finance Committee
W. Henson Moore, M.C.
May 9, 1985

Mr. Chairman and Members of the Committee, one month and a half ago each of us appearing on this panel today testified before the House Ways and Means Committee on the scope and direction of tax simplification having more in common than in dispute over inputs, margin consolidation, and rate reduction within our own simplification bills. My initial comments then pointed out 60 percent of all private savings in this nation would likely be used to finance the federal deficit. This compares with a historic average of around 25 percent.

Since then, news of how much private savings would be consumed by deficit financing has worsened. On page 3 of the April 15 budget expenditure compromise, we are warned federal borrowing will consume 78 percent of net private savings this year. Only if substantial expenditure control of the magnitude called for in the compromise is undertaken would the level fall to 63 percent next fiscal year, 46 percent the following year, and finally 30 percent in 1988. This would approach, but not yet reach, the historic average. We are not provided news of what would result if no expenditure savings is secured or if it is insufficient. But we can imagine how bleak that news would be.

Each of you has wrestled with budget function figures for weeks. I commend you for taking the initiative and exhibiting the courage to make the tough choices. I honestly wish I could report the House Budget Committee, on which I serve, had moved forward in a responsive manner to date. It has not. It has decided to let the tough issues be taken on here until settled here.

Mr. Chairman, I would like to borrow a little imagery from my friend Jack Kemp for a moment. For years he has been motivating us toward fiscal and tax policy that would provide a larger economic pie for the nation to sustain lasting expansion. I suggest we must now observe too much of the nation's savings pie is being consumed by the deficit. You are honestly trying to reduce this using expenditure control. I urge you to persist in your efforts. I also ask you to think about adding a second means to reduce deficit savings consumption. It is to make a larger savings pie so federal debt financing at any level would not consume as much savings as it does now. Every additional dollar saved offsets the pressure on interest rates caused by a dollar worth of spending. If a larger savings pie is made, interest rate pressures will subside as public and private credit demands will be satisfied without public debt refinancing requirements rationing the availability of private credit and driving up interest rates.

Senator Bill Roth and I trade in many of the same Tax Code components available to individuals as my colleagues here use, but we add one more

feature. We allow a $10,000 annual deduction for a Super Savings Account (SUSA) deposit under rules similar to those guiding Individual Retirement Accounts. We want to begin to approximate savings benefits available to Japan's economy where savings formation outpaces credit demand, the prime rate is half ours, and yet their deficit in recent years has been as perilous as our own based on economies of scale.

We want to expand the IRA success story that took form four years ago. We believe our Broad-based Enhanced Savings Tax (BEST) Act is in fact the BEST choice as its acronym suggests. It builds upon savings evidence amassed since Senator John Chafee and I wrote expanded IRA opportunities enacted four years ago. Two months ago the Investment Company Institute released findings that the IRA added $10 billion to savings deposits in 1983 that otherwise would have been spent. By late last year, 23 million households had opened an IRA. Nearly two-thirds of these had household incomes under $40,000 a year. IRA assets climbed from $26 billion at the start of 1982 when everyone with earned income became eligible for these plans, to $132 billion at the end of 1984. These are strong signals that the IRA is doing its intended job.

Then Senator Roth and I asked ourselves if we would modify the IRA to do an even better job. Here again, the Investment Company Institute findings agree with the direction of our improvements in building a Super Savings Account as the focal point of our revenue-neutral tax simplification format. While 23 million households now have an IRA, those the Investment Company Institute surveyed indicated 5 million more would open an IRA-type account if full spousal eligiblity would be provided, 6 million would open one if matching non-deductible additions would be allowed, and 19 million households would open one if withdrawals could be made at any point with the only tax consequence being treatment as ordinary income at the highest marginal rate the taxpayer would pay. The Super Savings Account will motivate these non-participating households to establish do-it-yourself retirement and savings protection available to nearly everyone. It will broaden the base of savings formation. This is why we retained IRA investment diversity, increased deductible limits to $10,000, and removed the lack of access barrier present in the current IRA early withdrawal penalty. Younger survey respondents found the penalty waiver an especially strong motivating force to open an account and this group has the lowest IRA participation now.

Savings formation assures capital formation. Federal debt refinancing and private sector credit needs can be accomodated without the first crowding out the second if there is sufficient reason to save. Senator Roth and I believe our tax simplification format is the nation's BEST chance for economic growth for years to come.

Statement of

The Associated General Contractors of America

Presented to

The Senate Finance Committee

on the Topic of

National Tax Policy

May 4, 1985

AGC is:

* More than 32,000 firms including 8,400 of America's leading general contracting firms responsible for the employment of 3,400,000-plus employees;
* 110 chapters nationwide;
* More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities.
* Over $100 billion of construction volume annually.

The Associated General Contractors of America (AGC) represents more than 32,000 firms, including 8,400 of America's leading general contracting companies. These member firms perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities. We appreciate the opportunity to present testimony on the important topic of national income tax policy.

AGC's comments primarily address the Treasury Department's report to the President on "Tax Reform for Fairness, Simplicity, and Economic Growth. Although different, the Bradley- Gephardt and Kemp Kasten proposals follow a similar policy of reducing marginal rates at the expense of capital formation provisions of the Internal Revenue Code and our views of these proposals roughly parallel those of the Treasury Report.

The impact of the Treasury Department proposals on the construction industry would be severe. Owners of structures would be subject to significantly higher taxes on their investments. Increased taxes would increase the cost of all structures. New construction starts would be expected to significantly decline. In addition to raising taxes on real estate investments, the Treasury proposal would also restrict the methods used to syndicate real estate developments. Construction contractors would also be subject to revised accounting procedures under new income measurement rules which, in proposed form, do not vary in substance from theories already rejected by Congress.

The general policy thrust of the Treasury Report can be

described as "tax neutrality", meaning that the Code should not recognize differences between different types of economic activities. This is a reversal of the traditional orientation of the Code which recognizes different types of economic activities. The major distinction between activities is based on the difference between capital investment and ordinary transactions. The proposed elimination of this fundamental principle is to be implemented by revising virtually every tax provision involving capital investments. In exchange for eliminating these provisions marginal tax rates would be lowered for both corporations and individuals.

AGC believes that the theory of tax neutrality is not an acceptable policy basis for developing a system to tax income. Capital investments are inherently different than transactions in the ordinary course of doing business. Capital investments in the national economy are crucial to the continued economic health of the nation. Increasing taxes on these fundamental investment activities will lead to a smaller capital base for the national economy and result in a weakened national infrastructure.

AGC's objections to the Treasury proposal are best illustrated by reviewing the major individual provisions of the report affecting construction contractors and the markets in which they do business.

Proposals

Income Measurement for Multiperiod Production - An issue of critical concern to the construction industry is the proposal to revise the completed contract method of accounting. The Treasury proposes to establish a single set of period cost capitalization rules for taxpayers reporting income from long-term contracts, self-constructing assets, certain agricultural production activities, and manufacturing inventories. The completed contract method was thoroughly reviewed by Congress in 1982 and specific statutory rules were developed to administer the accounting method in the Tax Equity and Fiscal Responsibility Act (TEFRA). The TEFRA provisions confirmed the use of the completed contract method of accounting as used in the construction industry with virtually no change. Significant revisions to the accounting method were made as they apply to multiperiod production contracts such as contracts for missiles and airplanes. Despite the detailed policy review in 1982 the Treasury has re-proposed elements of its earlier recommendations under the newly created theory of tax neutrality. AGC recommends that this Congress reject this proposal as the preceding Congress did in 1982.

The completed contract method was revised at the regulatory level in 1976 when manufacturing contracts were added to eligibility status for the method. Construction contractors have been eligible to use the method since the inception of the U.S. income tax in 1916. The accounting method is based on the fundamental tax principal known as the all events test. This test requires that a taxpayer recognize a gain or loss from a contract after

all events required under the contract are performed so as to establish the taxpayer's claim to gain or loss.

The regulations published in 1976 were based on 54 years of IRS experience in administering the accounting method in construction. Cost accounting rules included in the regulations reflect tax policy and accounting principles for determining which costs are allocable to a contract. The use of these cost accounting rules was approved by Congress for virtually all construction contractors in 1982 -- all construction contractors with annual gross receipts of less than $25 million can use the 1976 rules, and any construction contract lasting less than 36 months is accounted for by using the 1976 rules. Manufacturing contracts were distinguished by Congress and use these rules for contracts lasting less than 24 months. New severing and aggregating rules were developed to restrict multi-unit contract extensions when additional units are added to the contract by change orders.

TEFRA allowed the IRS to publish revised cost accounting rules for contracts of exceptional duration called extended-period long-term contracts. In construction these rules are only applicable to contracts lasting more than 36 months. It is these rules which the Treasury originally proposed to apply to all contracts in 1976 and is re-proposing now as part of its neutrality theory. AGC opposes this proposal. Congress has already rejected the neutrality theory as it applies to manufacturing and construction contracts in TEFRA by providing sound administrative rules based on contract duration and taxpayer size, and should again reject the Treasury Department's proposal.

Capital Consumption Allowances - The Treasury proposal would replace the Accelerated Cost Recovery System (ACRS) and Investment Tax Credit (ITC) with the Real Cost Recovery System (RCRS). The new system would replace the three basic ACRS depreciation periods (3, 5, and 18 years) with seven periods ranging from 5 to 63 yers. RCRS would provide a declining balance depreciation method and an inflation adjustment to the unrecovered basis (cost) of the asset being depreciated. The percentage of basis depreciated annually varies from 32 percent for 5 year property to 3 percent for 63 year property.

RCRS replaces all investment tax credits, including the rehabilitation tax credit, and the present ACRS system. Since RCRS requires significantly longer periods to recover capital investment amounts than ACRS, there is no replacement for the investment tax credit. Depreciation under RCRS is chacterized as "economic" and reverses the fundamental principle of accelerated cost recovery embodied in the ITC and ACRS provisions enacted in the Economic Recovery Tax Act of 1981.

The 1981 Act emphasized a policy recognizing the importance of accelerated capital recovery periods. Capital asset costs are recovered faster under ACRS/ITC than the mere useful life of an asset. This policy regarding capital investment recovery was based on recognition that capital assets are a crucial factor in expanding the overall economy and that continued recapitalization is required before physical obsolence of assets occurs. The wisdom of this policy is being demonstrated today with the ongoing expansion of the economy.

The RCRS depreciation schedule requires a substantially

longer period of time to recover capital costs, unless inflation substantially exceeds present levels. The RCBS structure depreciation period of 63 years would provide the smallest annual deduction for depreciation in the first year. As a result, capital investment in structures must wait longer to recover costs both in time and amounts, reversing the present ACRS structure of larger annual deductions early in a shorter recovery period. This policy would increase the cost of investing in real estate by requiring longer investment periods before the recognition of the capital investment depreciation by the taxpayer.

The RCRS system would also affect construction contractor's depreciation methods for their equipment. The RCRS treatment of construction equipment illustrates the inadequacies of the economic depreciation scheme. Construction equipment, under the RCRS systems, would be depreciated over a 12 year period at 24 percent of adjusted basis. Most types of construction equipment do not even have a useful life of 12 years. As a result, contractors will be required to wait until after the equipment's useful life to recover their investment costs. Similarily, trucks would be depreciated over 8 years, which frequently exceeds the useful life of trucks used in the construction industry.

A serious conceptual ommission is also made in the Treasury proposal concerning depreciation. No provision is made to allow taxpayers to use a "unit of production" method of depreciation as allowed under present law. This method allows a taxpayer to depreciate an asset as it is "used up" or physically wasted, if such occurs over a shorter period than is provided by the

depreciation schedule. This method matches economic depreciation in any normal understanding of the concept and the ommission is a serious failing in the integrity of the Treasury proposal.

Cash Method of Accounting - The Treasury report proposes to prohibit the use of the cash method of accounting with respect to a trade or business unless both of the following conditions are met:

(1) the business has average annual gross receipts of $5 million or less; and,

(2) no other method of accounting has been used to determine income, profit, or loss of the business for the purpose of reports or statements, or for credit purposes.

Although the completed contract method of accounting is the dominant method used in the construction industry, cash accounting is also used. For example, engineering and architectural contracts are not eligible for completed contract reporting. Small construction firms (exceeding the $5 million annual gross-receipts limit) use the method as an election for all accounting purposes. The cash method is a fundamental accounting method and a necessity and must be retained.

Municipal Bonds - The Treasury report proposes to eliminate the tax exempt status of interest earned on bonds issued by state and local governments for "private purposes". These bonds are typically used to finance housing, commercial and industrial development activities within the bond issuing jurisdiction. Annual volume limits are already imposed on these bonds which are an important tool in the financing required for our national infrastructure needs. Any further restrictions on the issuance

of such bonds, such as the elimination of tax exempt interest, are not necessary and will result in the long-term deterioration of the national infrastructure.

International Tax Issues - The Treasury report contains two provisions of significant concern to international construction contractors. The first concerns the reimposition of the per country limitation rule on the foreign tax credit. Construction contractors compete in countries where they are able to win contracts, the location of job sites cannot be chosen for tax planning purposes and any restrictions on offsets for taxes paid in these countries is not justified.

Construction would also be severely restricted in U.S possessions if the possessions tax credit is repealed. The credit has been most frequently used for projects built in Puerto Rico. The replacement of the credit with a temporary wage credit is not a satisfactory alternative and will lead to a decline in development in U.S. possessions, particularly in Puerto Rico.

Estate and Gift Taxes - AGC supports proposals which ease the tax burden on estates with ongoing closely- held businesses following the death of a controlling principal. The Treasury report proposes to increase tax liabilities on gifts and to eliminate the special 4 percent interest rate for installment payments of estate taxes when a closely-held business composes a significant portion of the estate. Both of these proposals will make the transfer of active business enterprises more difficult and should be rejected.

Fringe Benefits - The Treasury report proposes to repeal the statutory fringe benefit exclusions for most types of fringe

benefits and restricts maximum contributions for employer provided health care. The present fringe benefit rules allow employers to structure fringe benefit packages suitable to the employees' needs and have been of significant benefit to the nation. AGC recommends the continuation of the present fringe benefit rules because of their record of success in providing needed benefits at market determined prices.

Deductibility of State and Local Taxes - The Treasury report proposes to eliminate the itemized deduction for state and local taxes that are not incurred in carrying on a trade or business. These taxes include real and personal property taxes, income taxes and general sales taxes. The report states that the elimination of the deduction is necessary to eliminate any "subsidy" for local public services such as public education, road construction and repair, and sanitary services. AGC believes the deduction for state and local taxes is based on sound policy considerations. The deduction prevents taxpayers from being taxed on taxes.

Capital Gains - The Treasury report proposes to repeal the long-term capital gains exclusion as part of the tax neutrality theory. Presently, the maximum corporate tax rate of 46 percent is reduced to only 28 percent on a net capital gain if the liability resulting from the lower rate is lower than the corporation's regular tax. For individuals and other non-corporate taxpayers 40 percent of a long-term capital is included in income (and taxed at ordinary rates). The basis of the asset would be indexed for inflation during the holding period of the asset.

The capital gain exclusion has traditionally recognized

the risk of long-term investments and its retention is an important element in the fair tax treatment of long-term investments. Taxing the income generated by the disposal of long-term capital assets at ordinary rates fails to recognize the risks associated with such investments. While indexing the basis of the capital asset alleviates some of the harshness of the rule, indexing is not a suitable alternative to the present exclusion. The present exclusion recognizes that capital transactions should be taxed at different rates because of the risks associated with investments, inflation is only one risk factor.

Interest Expenses and Income - The Treasury report proposes to limit all personal interest deductions, except for mortgage interest deductions for a principal residence, to $5,000 per year over investment income. Interest subject to the investment interest limitation includes (a) all interest not incurred in connection with a trade or business, (b) the taxpayer's share of all interest expense of Subchapter S corporations unless the taxpayer actively participates in the corporation, and (c) the taxpayer's distributive share of interest expense from limited partnerships.

Limiting interest expense deductions will prevent many taxpayers from investing in long-term capital projects even though the expense incurred is clearly related to an income producing activity. A distinction between taxpayers based on existing income is inequitable because it does not provide the same tax treatment for identical investment activities.

The Treasury report also proposes to index both business and personal interest (income and expense) for tax purposes.

A fractional amount of interest income would be excluded from income while a deduction for a corresponding fraction of interest expense would not be allowed. This dramatic change in the tax treatment of interest expense and income is difficult to assess. The rule, however, favors lenders by excluding a portion of interest income with a corresponding negative treatment for borrowers and consequently will restrict capital raising activities.

Limited Partnership Restrictions - The Treasury report proposes to tax limited partnerships with more than 35 partners as corporations. Limited partnerships afford investors an opportunity to limit their risk on a partnership activity to their contributed investment, provided they do not participate in the management of the partnership. The limited partnership mode of doing business is well established in the common law. There is no justification for its elimination. Without this type of investment vehicle, many investors will find it difficult to participate in an investment as owners.

Extension of the At-Risk Limitations - The Treasury proposal would impose restrictions on non-recourse financing used in real estate developments. The code's "at risk rules" have never applied to real estate syndication (or certain equipment leasing transactions) and provide flexibility in developing financing arrangements where significant physical assets exist. No specific real estate abuses of valuation are identified as a reason for proposing this change.

Corporate Tax Rates - Although the Treasury report has been widely promoted as reducing the maximum corporate rate of tax

from 46 percent to 35 percent, the report also recommends that many corporate tax rates be increased. Corporate tax rates have been partially graduated since 1935. The present maximum corporate tax rate of 46 percent only applies to corporations with annual incomes in excess of $140,500. Rates of 15, 18, 30 and 40 percent are available for corporations making less than $100,000 annually. These rates for lower income corporations allow smaller firms to generate needed capital by retaining income in the corporation at the lower corporate rates and should be retained.

Summary

AGC is opposed to eliminating the capital recognition provisions of the Code as proposed by the Treasury Department.

o Private sector construction activities will decline as a result of the elimination of ACRS, ITCs, capital gains, and restrictions on investment vehicles.

o Public sector construction activities will also decline because of the elimination of tax-exempt bond financing and the deduction for state and local taxes.

o Construction companies will also be adversely affected by proposed changes to the completed contract method of accounting which have already been rejected by Congress as unnecessary.

AGC recommends retaining present law and continued regular review of the code to assure ongoing policy justification of provisions and to assure adequate compliance in lieu of proposals such as the Treasury Department's Report.

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