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INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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REFORMING TAXATION: ATTRIBUTES OF A GOOD TAX SYSTEM AND PRINCIPLES TO GUIDE REFORM*

Since winning reelection, President Bush has reiterated his call for wide-ranging tax reform and simplification. He has appointed an advisory panel of economic and public policy experts to offer guidance to the Secretary of the Treasury. Treasury Secretary John Snow has been active in the tax reform arena, and served as a member of the National Commission on Economic Growth and Tax Reform. The possibility of real tax reform is higher now than at any time since 1986.

The current tax system is a hybrid. It is basically a broad-based income tax, which imposes multiple layers of taxation on income used for saving and investment, but it contains provisions that treat some saving and investment as they would be treated under a saving-consumption neutral system (or consumption-based system). Economists generally acknowledge that a neutral tax system would result in a higher level of capital formation and per capita output and income than would the income tax, and would also be simpler than the income tax in a number of ways.

The people and their political leaders are used to thinking in terms of the current tax system. Its definitions of income and its structure of taxes seem normal, even though they are often at odds with reality, logic, and sound economics. It would be tempting for the Commission to operate within the prevailing mind-set and merely tinker with the current system. This would not serve the country well. Rather, the Commission should use its position to improve the public's understanding of the nature of income, what constitutes a sound tax system in a democratic society, and the advantages of making significant changes.

The Commission should begin by taking stock of the purposes and attributes of a good tax system, to give itself a standard against which to judge the many proposals it will consider. The Commission should charge itself with crafting a plan that improves the formulation of public policy by making the tax system more transparent to the voters and less susceptible to manipulation by special interests, either commercial or political. It should craft a plan that improves the functioning of the economy and the level of income. It should develop and explain its concept of the ideal tax base, and report what the economic consequences of that choice would be. In particular, the Commission should determine whether the reforms that it proposes would move in the direction of a more neutral tax base, with a lower cost of capital than the present system and the potential to increase capital formation, productivity, and per capita output and income.

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The Commission must consider how the tax is to be collected and administered. There are trade-offs between a tax that is highly visible and transparent to the voters, and one that is simpler to comply with but less informative of the cost of government. The Commission should also review the basic concepts of fairness and efficiency in taxation, to ensure that they reflect the nature of production and income. The Commission should think though these fundamental issues before making decisions on the details and minutia of the new tax code.

Such issues were not considered in 1986, and the results were not good. The Tax Reform Act of 1986 was often described as "broadening the base and lowering the rates." Although this is sometimes offered as a definition of a sound tax reform, it misses many basic points. In fact, the 1986 Act was a major disappointment. It lowered personal tax rates at the margin, which was a good step toward economic efficiency. However, it sharply raised tax rates, at the margin, on new saving and investment, increasing the income tax bias against those activities. It did so, in the guise of base broadening, by removing provisions that mitigated the multiple layers of tax imposed on income from saving and investment. The Act eliminated the investment tax credit, lengthened asset lives for cost recovery purposes, ended the capital gains differential, imposed or tightened income and contribution limits on tax deferred retirement savings plans, and introduced passive loss rules on real estate that depressed returns in that sector for investors who were not active managers of their properties. The minor efficiency gains that came from canceling a few peculiar tax breaks for certain other activities in no way made up for these across-the-board increases in the taxation of capital.

In effect, the Tax Reform Act of 1986 moved the hybrid tax system in the direction of a purer broad-based income tax. The Act paved the way for the stock market crash of October 1987, and led to weakness in investment in plant, equipment, and real estate that, along with two payroll tax increases in 1988 and 1990, set the stage for the recession of 1991-92. The 1986 Act also removed several million people from the income tax rolls, making them less concerned about the cost of government and less interested in controlling federal spending and tax rates in the future.

This time around, it will be essential to avoid the mistakes of 1986. Toward that end, we offer the following framework to guide the development of alternatives to the current tax system.

FRAMEWORK FOR TAX REFORM[1]

TWO PURPOSES OF A SOUND TAX SYSTEM

A sound system of taxation has two purposes:

1. Raising revenue to pay for government goods, services and activities; and

2. "Pricing" government to let people know how much they are being charged for government goods and services so that, as taxpayers and voters, they may decide in an informed manner how much government activity they wish to support with their votes.

The current federal tax code fails to accomplish these purposes in an effective and efficient manner. In order to ensure that any restructuring of the federal tax system achieves these purposes in a more effective and efficient manner, the new tax system should be grounded in an understanding of key economic realities, conform to a set of fundamental principles of taxation derived from these realities, and possess specific attributes that work with the realities and fulfill the principles.

TWO BASIC CONCEPTS VITAL TO UNDERSTANDING TAXATION

What Is Income? Income is correctly understood to be the earned reward for supplying labor and capital services to the market. Except in rare instances, income closely matches the value of the effort and services provided by individuals to produce additional output.

Income is a net concept: revenues less the cost of generating those revenues. Just as a business cannot reasonably be said to have a profit until its revenues exceed its costs of production, neither can a worker or saver be said to have income until his revenues exceed the amounts spent on acquiring the skills (through education) or in purchasing the assets (through saving and investing) that generate the revenues. To obtain a realistic measure of a person's income, the full value of all costs of earning revenues (including education expenses, saving, and investment outlays) should be subtracted from revenues before any tax is imposed. All returns from such efforts that exceed these costs should be taxable.

Who Pays Taxes, and With What? In reality, only people pay taxes, and all taxes are paid out of income. Goods and services do not pay taxes; businesses do not pay taxes. Sales and excise taxes either depress sales of the taxed products, reducing the income of the people who provide the labor and capital used to make them, or they reduce the purchasing power of that income when the workers and savers attempt to spend it. Taxes collected by businesses fall in reality on the income of the businesses' shareholders or other owners, lenders, workers, or customers in the form of lower returns, lower wages and/or higher prices.

THREE PRINCIPLES OF A SOUND TAX SYSTEM

Economic Efficiency: A sound tax system must be economically efficient. An economically efficient tax is one that inflicts as little damage as possible on the economy as it gathers revenue. Every tax system distorts economic decisions and leads to less economic activity than otherwise would occur, resulting in what economists call "deadweight loss." A sound tax system should be designed to minimize these losses, while satisfying other requirements of a sound tax system.

Every tax constitutes a "wedge" in the market. Excise and sales taxes separate the gross price paid by buyers from the net price received by sellers. Income and payroll taxes separate the gross wage paid by employers from the net wage received by workers. Personal and corporate income and estate taxes separate the gross returns earned by capital from the net returns received by savers and investors.

These tax wedges reduce the incentives for the affected economic actors to be productive, and lead directly to lost output. The income and payroll taxes make untaxed leisure more attractive than working to acquire taxable income with which to buy market goods and services. The taxes on saving cause people to save and invest less and consume more. Selective excise taxes discourage the production and consumption of specific items. Applying different tax rates to different activities or to different producers exacerbates the distortion of economic decisions and increases the deadweight losses due to the tax system.

Technical Efficiency: A sound tax system should be technically efficient. That is, it should impose on taxpayers the smallest possible compliance and preparation burdens, and should minimize the administrative and enforcement costs for the government, consistent with other requirements of a sound tax system.

Every tax system imposes direct costs on taxpayers in terms of man-hours devoted to tax preparation and/or direct costs to purchase the services of professional tax preparers. Every tax system also forces some taxpayers to retain the services of tax attorneys and accountants to provide legal counsel and accounting assistance on tax matters and to settle disputes with the government that arise over tax-related matters. Every tax system diverts a portion of tax revenues raised by the tax to pay the cost of administering and collecting the tax and enforcing its provisions. A sound tax system would minimize these costs.

Political Efficiency: A sound tax system is politically efficient, distorting as little as possible voters' choices regarding the amount and the composition of public goods and services produced by the government and consumed by the public. It should also be a system that the public views as correct and is willing to support, allowing it to remain stable without constant churning and tinkering by government.

As long as collective decision making in a democracy occurs by less than unanimous rule, governing majorities have an incentive to impose taxes on minorities and to utilize the resulting tax revenues for purchasing government goods and services that particularly benefit themselves. The ability to shift the tax burden to others and duck the cost of government should not be possible in an efficient tax system.

Tax systems governed by a non-unanimity rule also create incentives for governing majorities to go beyond the two basic purposes of a tax system — raising revenue for government goods and services and costing out government for the voters — to employ the tax system for additional, often pernicious, purposes. One such mischief is the creation of government tax/transfer programs that redistribute income from unfavored minorities to those in the governing majority. Another is the imposition of taxes that are aimed at regulating social behavior or solving social issues that are better handled through regulation or spending programs, or better left to private choice and responsibility.

A sound tax system, once implemented, should be protected by statutory and constitutional barriers that limit the ability of political majorities to go beyond the two basic purposes of a tax system to exploit minorities in these ways. This may require the adoption of specifically designed tax-limitation rules to govern the legislation of tax laws. At a minimum, political efficiency requires the adoption of super-majority voting rules to apply to changing the definition of income subject to taxation or to alter the rate(s) at which that income is taxed. Super-majority voting rules may also be required to prevent tax revenue from growing at a rate faster than national income.

FOUR ATTRIBUTES OF A SOUND TAX SYSTEM

Neutrality: Tax ***neutrality*** means measuring income correctly and then levying taxes evenly, at equal rates, on all uses of income by all income producers. Defining income correctly results in an appropriate tax base. An even tax rate applied to that base without bias minimizes the distortion of economic activity and the harm to economic growth.

When consumers call for an extra unit of output, it can be provided at lowest cost if the most efficient producer delivers the goods. Placing a higher tax rate on a more efficient producer than a less efficient producer may cause the former to produce less and divert production to the less productive source, reducing the total output available and driving up the cost to consumers.

An economically neutral tax is unbiased across economic activities. In particular it should not overly penalize work in favor of leisure or tax income used for saving and investment more heavily than income used for consumption.

The current tax code taxes some income at higher rates than other income through two main devices. First, it employs graduated tax rates on taxable income. Second, it imposes multiple layers of tax on some types of income by adding the same income repeatedly to the tax base. Examples include taxing corporate income at the company and shareholder levels, and imposing estate and gift taxes on saving that was already taxed. Both devices are violations of neutrality.

Moreover, there is an intrinsic income tax bias against saving and investment that must be addressed. After-tax income used for consumption generally faces no additional federal tax (except for a few distorting excises) as one enjoys the use of the purchase. However, if after-tax income is used for saving, which is the purchase of assets that earn additional income, there is an added federal tax on the earnings. This constitutes a second layer of tax on saving that is not imposed on consumption. This basic income tax bias against saving can be eliminated by correctly treating saving and investment as costs of earning income.

Design Implications of Tax Neutrality:

- Economic Neutrality requires that ***all income be taxed at the same rate***. It is improper to tax some income at a higher rate than other income, either through graduated tax rates or by imposing multiple layers of tax on some types of income but not on other types of income. No tax system can easily avoid penalizing labor relative to leisure. However, ***keeping tax rates as low as possible*** and ***avoiding graduation*** avoids the worst of this distortion.

- To make the tax system even-handed or neutral across various types of saving and investment, and between saving and investment and consumption, the intrinsic income-tax bias against saving and investment must be attenuated by correctly ***treating saving and investment as costs of earning income***. All saving must receive the sort of tax treatment currently afforded pensions, various types of IRAs, 401(k), Keough, SEP, and other saving-deferred plans currently in the tax code.

- ***Investment outlays and purchases of inventories must be deducted in the year the outlay is made (expensed)***, rather than depreciated over time, or otherwise delayed or ignored, and ***research and development expenses should be treated as a cost of earning revenues and hence deductible in the year in which they are incurred (expensed).***

- Neutrality also means that ***multiple layers of tax on capital must be avoided.*** In particular, the ***dual taxation of Schedule C corporate income at the corporate and individual level must be eliminated.***

- The ***transfer tax on estates and gifts must be eliminated*** (since most of an estate is saving that has already been taxed or will be subjected to the heirs' income tax).

Neutrality is more than an essential attribute for achieving economic efficiency. It also results in a far simpler tax system with fewer costs of compliance and enforcement than the current system. Stripping away complexity and minimizing the collection points for taxation also means that neutrality makes taxes more visible and transparent. Transparency helps the public see if everyone is paying what he or she owes, and makes people more comfortable with the fairness of the system.

Visibility: ***Visibility*** means a tax system is transparent to the taxpayers so it is clear how much government costs and who is paying for it. Visibility is necessary for voters to determine effectively the amount and composition of government spending at which its benefits match its costs. Visibility is a key element in providing political efficiency.

Design Implications of Visibility:

- Visibility requires that ***taxes be levied as openly as possible*** with some form of annual accounting that confronts individuals with the full amount of taxes they have paid over the course of the year. ***Visibility also requires that revenues not be collected from taxes buried in businesses transactions.*** Turning businesses into tax collectors merely results in the taxes being passed invisibly forward to consumers and backwards to investors and lenders. Since taxes are really paid out of people's incomes, taxes are most visible when they are collected directly from people out of income (properly defined and measured).

- ***Visibility also requires that as many people as possible be subject to tax, excepting only the very poor***, so that they can see that government is not a free good. Everyone who can do so should pay something toward the cost of government. ***It should not be possible for a majority of voters to shift a disproportionate share of the tax burden onto a minority of taxpayers.***

Fairness: ***Fairness*** means equal treatment under the law, equal treatment for those equally situated, and no discrimination among taxpayers unequally situated unless that discrimination is consistent with the purposes and principles of a sound tax system.

A fundamental purpose of democratic government is to protect life and property. One's income is a basic component of one's property. All people, therefore, have an obligation to pay taxes to help pay for the protections afforded by government. It is also fair to demand that people pay for the public goods and services provided by government that they and their families consume. Since all taxes are paid out of income by people, not by businesses, and not by goods and services, fairness requires that people fulfill this political obligation by paying taxes commensurate with their income. Charity requires that the very poor be relieved of this burden, but insofar as possible, everyone should contribute something to these communal efforts.

Equality of opportunity should be a guiding force in our tax system, not equality of outcomes. The tax system should not be used as an instrument of wealth and income redistribution or social engineering.

<u>Design Implications of Fairness:</u>

- As mentioned above, income is the earned reward for contributing to the production of goods and services. This fact, combined with the juridical principle of equal treatment under the law, strongly urges that ***a proportional (single-rate) tax on income is the fairest.***

- ***Allowing all individuals, regardless of income, an equal personal exemption is perfectly consistent with this definition of fairness.*** In combination, these steps would provide that ***persons of higher income pay more in tax than persons of lower income, but not in a greatly disproportionate manner.***

Simplicity: ***Simplicity*** means a tax system is not unnecessarily complicated beyond what is required of it to be consistent with the purposes and principles of a sound tax system. Albert Einstein's general admonition to "make everything as simple as possible but not simpler" applies in particular to designing a sound tax system.

Much complexity in the current tax code stems from its ad hoc approach to defining taxable income, its non-neutral treatment of income from capital, and its taxation of income from foreign sources offset by a tax credit for foreign taxes paid. The code is not based on any clear understanding of what constitutes income or an accurate measurement of income or any set of coherent principles regarding the imposition of tax. The complexity deriving from this lack of guiding principles, and the resulting incoherent and ambiguous definition of income, make for difficulties in administration and compliance because neither the IRS nor the taxpayer can figure out clearly what is in or out of the tax base.

<u>Design Implications of Simplicity:</u>

- Simplicity requires a clear definition of income, elimination of multiple layers of taxation on the same income that leads to unequal tax rates, and strict adherence to the two purposes of a sound tax system.

- It is a serendipitous fact of life that, to a considerable extent, simplicity, neutrality, and fairness (properly defined) are consistent attributes of a sound tax system. Neutral tax systems that are not biased against saving and investment are inherently simpler and fairer than non-neutral ones. ***A simple tax system***

should be neutral in its treatment of saving and consumption. Systems that restrict taxation to income earned domestically are likewise simpler than systems that tax global income with a credit against foreign taxes paid. ***A simple tax system should be territorial, levied on income earned within the country.***

- The most visible tax systems are the most neutral. However, the very simplest systems, those that would have businesses collect all taxes without income earners or consumers seeing what is taken or having to do any work, would be a violation of visibility and would be difficult to make fair for individuals in different circumstances. In line with Einstein's dictum, therefore, ***simplicity should not be an excuse to remove large numbers of people from the tax rolls or to eliminate periodic tax filing.*** Some small amount of effort by the citizens in paying tax is a fundamental requirement of a tax system that informs the citizen-voters about what government is doing, enabling them to fulfill their civic responsibility in a democratic society.

PRESERVING A STABLE TAX SYSTEM

If people and their elected representatives come to understand the principles that define a sound tax system, and reach a consensus to implement such a system, then one would hope that they would be reluctant to tamper with it. However, the incentive to shift the tax burden onto others, or to hide the true cost of government from the voters, may prove irresistible. Therefore, legal or constitutional barriers that limit the ability of political majorities to go beyond the two basic purposes of a tax system may be required.

Design Implications of Preserving a Stable Tax System:

- Stability and preservation of the ideal attributes of a sound tax system may require the adoption of tax-limitation rules such as super-majorities for changing the definition of income subject to taxation or altering the rate(s) at which that income is taxed. Super-majority voting rules may also be needed to prevent tax revenue from growing at a rate faster than national income.

CONCLUSION

If you don't know where you are going, then any road will get you there; but if you have a destination clearly in mind, then the road to be taken is far more certain. Tax reform proposals should be judged on whether they will improve the functioning of the economy, raise living standards, reduce compliance and enforcement costs, and promote better government. Reform proposals that are designed with the principles and attributes mapped out above will have a far greater chance of leading to those outcomes than plans cobbled together with no vision and no guideposts.

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Endnote

1. This framework owes much to the work of IRET's founder, the late Norman B. Ture. See his papers: "Taxes and the Good Society," September 13, 1995, available on the Internet at ftp://ftp.iret.org/pub/TaxesGoodSoc.PDF; "Restructuring The Federal Tax System" *IRET Policy Bulletin*, No. 65, December 15, 1995, at ftp://ftp.iret.org/pub/BLTN-65.PDF; and "Federal Tax Policy and the U.S. Economy: Policy Options for Improving Both," March 13, 1997, at ftp://ftp.iret.org/pub/FedTaxPol-Improv.PDF. For an overview of a model tax system that Dr. Ture proposed based on these principles, see Stephen J. Entin, "The Inflow Outflow Tax — A Saving-Deferred Neutral Tax System", at ftp://ftp.iret.org/pub/InflowOutflowSum.PDF.
