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BILL BRADLEY SHOOTS FOR HIGHER TAXES

Former Senator Bill Bradley stated in December that, if elected President, he would use *none* of the projected federal budget surplus for tax relief unless there is a recession. He said, "I don't think that that would be the most prudent use of public revenues." Instead, he plans to spend much of the surplus on higher government outlays. (Interview with *The Washington Post* on December 2, 1999, accessed at www.washingtonpost.com/wp-dyn/articles/A12313-1999Dec3.html.) On January 4, Senator Bradley proposed a package of primarily business tax increases to finance part of his spending program. He said the tax package would "save American taxpayers roughly \$125 billion over ten years." (Fact sheet on plan accessed at www.bill-bradley.com.)

The first thing to note is that raising taxes on one group of taxpayers does not "save" money for other taxpayers, as Mr. Bradley claims, unless the tax hikes are used to fund tax cuts, which Mr. Bradley expressly rules out. Businesses do not pay taxes, only people do. All the tax increases in the Senator's proposal will ultimately fall on business

owners, workers or consumers, who will pay, not save. The tax hikes mean more money for Washington to spend on programs that the population may or may not favor as highly as the private-sector output that will be crowded out in the process.

Second, the Bradley plan is badly flawed in terms of the specific tax changes that he recommends. Most of the tax provisions Senator Bradley brands as "loopholes" are actually proper tax treatment designed to offset what would otherwise be damaging multiple layers of tax on the affected activities, or are normal tax planning techniques. Many of the tax proposals would not raise the expected revenue because the activities they hit are not widespread and would shrink as a result of the tax change. All the proposals would raise taxes on investment income and would retard capital formation.

Specific proposals

Tougher enforcement and penalties. Most of the Bradley tax increase, \$100 billion over 10 years, is supposed to come from tougher IRS treatment of large corporations. According to Senator Bradley, this big jump in corporate taxes, about 5% compared to current law, can be collected by means of an

IRS "crack down" on abusive tax shelters. He proposes stepped up IRS audits of large companies, stiffer tax penalties, a requirement that companies explain any differences between financial-statement income and taxable income, and a ban on contingency fees for tax advice.

Assuming more taxes from large companies through tougher tax enforcement and higher penalties rests on the mistaken notions that major corporations routinely commit large, blatant tax

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violations and that the IRS could spot and correct them if only it looked. The IRS already closely scrutinizes the tax returns of major companies, with many large corporations under virtually continuous IRS audit. They are among the taxpayers *least* likely to submit fraudulent tax returns. Disputes do arise with the IRS, but they are usually due to the complexity of the tax code as enacted by the Congress and the ambiguity of the regulations drafted by the Treasury.

Mr. Bradley echoes a claim made by the Clinton Administration when he charges that tax shelters are out of control. The term "tax shelter", however, is frequently applied loosely to both legal and illegal methods of lowering tax liabilities. For instance, the government describes many people's retirement pensions as "tax expenditures" and specifically refers to some as "tax sheltered" annuities. Calling something a tax shelter does not necessarily make it either illegal or bad tax policy. Many observers think that egregious tax shelters are already well controlled. For example, the IRS National Taxpayer Advocate's *Annual Report to Congress* says that inappropriate shelters are now less of a problem than they may have been in the past because "Congress has significantly restricted shelter investments." (Reprinted in *Daily Tax Report*, January 5, 2000, page L-4 to L-26.)

True, businesses would pay higher taxes if they abandoned prudent tax planning, but careful tax planning is neither illegal nor unethical. It is also true that businesses would pay more taxes if they always accepted the IRS's position, but challenging the IRS in court, and often winning, is not illegal or unethical. Where businesses lose in court, they

already face heavy fines and penalties. Heavier tax penalties are not needed.

While it is possible that more and tougher audits of businesses could extract added tax dollars (just as they could from most groups of taxpayers), that may not be a good idea because of the costs associated with Mr. Bradley's more hostile tax collector. Harsher Treasury interpretation of ambiguous tax provisions would raise taxes on capital formation and hurt output and productivity. It would be riskier and less attractive to invest, and compliance costs would climb because businesses would have to devote still more resources to tax records, preparation, and litigation, leaving fewer resources for productive activities.

The victims of such a policy would be the people. People, not corporations, ultimately pay any added business taxes. All taxes collected at the business level are passed on to people: owners earning smaller after-tax returns on their investments, employees receiving lower wages, and customers paying higher prices. With taxes taking a near record level of people's output and incomes already, should the government really be taking more? Further, if the government does take more, shouldn't it do so through visible taxes people know they are paying rather than through hidden ones that conceal the full price of government?

Senator Bradley's proposal to hold companies accountable for differences between financial-statement income and tax-return income is reminiscent of a provision in the Tax Reform Act of 1986. The current income that is reported for tax purposes does not,

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and should not, always match the income that is reported to shareholders. Financial statements often mix income and balance sheet concepts to give shareholders a smoothed, long-term picture of the firm's prospects. (For example, to avoid confusing shareholders with large swings in reported income, the firm may spread the reporting of a cost of a major investment over time to show the outlays gradually in the years that the associated income from the investment is earned, even though the actual investment outlay preceded the return.) These differences between financial-statement and tax-return income are normally due to timing factors that later reverse, and are unrelated to tax cheating. Attempts to tax these differences merely penalize the use of commonly employed financial reporting systems to accelerate tax collections for the Treasury.

Superfund tax restoration. The bulk of the remaining revenues, about \$20 billion over 10 years, would come from reimposing the Superfund taxes that expired in 1995. The Superfund taxes lapsed, however, for good reason. Congress refused to renew them because of dissatisfaction with the operation of the government's Superfund program and a growing realization that its dedicated taxes had little to do with pollution. One bizarre Superfund tax required corporations to compute their alternative minimum taxable incomes (AMTI, taxable income as defined for the alternative minimum tax) and pay a special "environmental tax" of 0.12% on their AMTI above \$2 million, regardless of whether they owed the AMT itself. Many of the companies subject to Superfund taxes had little or no connection to past or current pollution. Despite repeated Administration requests, Congress has responsibly insisted that the Superfund program be reformed before it again receives

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dedicated taxes. Even if the program is straightened out, the old Superfund taxes were too arbitrary, complicated, and distorting to be deserving of reinstatement.

Other proposed revenue raisers. These include a higher fee for grazing livestock on federal land, expansion of the alternative minimum tax (AMT) for oil and gas producers, repeal of a tax provision that allows oil and gas producers and hard rock mining companies to deduct certain exploration and development costs when the costs are incurred, repeal of a current-law tax credit for enhanced oil recovery costs, and increased taxation of foreign source income.

Intangible drilling costs. Senator Bradley would expand the AMT for oil and gas businesses by adding to their AMT tax base the intangible drilling costs that are subtracted from their regular tax base. This provision would reduce the tax benefits of intangible write-offs, and penalize businesses that explore for oil and gas and then seek to develop and operate the resulting successful wells. The drillers would avoid the penalty by selling out to operating companies, and no revenue would be raised.

Intangible write-offs level the tax playing field between drillers that keep and drillers that sell their successful properties. If drilling businesses try to develop and operate the wells themselves, they are taxed at ordinary tax rates. However, if the exploration companies sell their successful wells to operating companies for a profit, they realize a capital gain, and are taxed at lower capital gains tax rates. Without depletion and intangible drilling allowances, they would always be better off selling out to large

developers. The ownership pattern of the industry would be distorted by the tax differences. With the intangible write-offs, drillers can keep and develop their properties and pay income tax at roughly the equivalent of the tax rate on a capital gains transaction.

This arrangement may seem to be a violation of normal income tax rules. Remember, however, that the normal rules are biased against investment by deferring the deduction of costs and over-stating income. Under a neutral cash-flow (consumption-based) tax, all costs would be expensed, not depreciated over time; then, all returns would properly be taxed at the same rate, with no distinction between capital gains and ordinary income. (See below.) However, there would be no overstatement of the investment income, and no double taxation of corporate income. The effective tax rate would be lower than under the income tax.

Curbs on expensing. The Bradley plan would also restrict a current-law provision that allows oil and companies and hard rock mining companies to deduct when incurred (expense) certain exploration and development costs. Businesses are generally allowed to deduct their costs because income is a net quantity: revenues minus costs. Costs need to be recognized for tax purposes when they occur if the write-offs are to reflect the full value of the costs. Otherwise, deductions will lose value due to inflation and the time value of money, causing costs to be understated and income overstated, in present value terms. (Alternatively, if write-offs are delayed, adjustments need to be made for the time

value of money and inflation.) Wages, raw materials, and certain other costs are deducted in the year they are incurred. But the deductions for the costs of most investments in capital assets are strung out over many years, steeply reducing the value of the write-offs. Thus, depreciation penalizes investment, while expensing provides an accurate measurement of income. Instead of being rolled back per the Bradley plan, expensing should be extended to a wider range of investment costs.

Foreign source income. Mr. Bradley would also tighten U.S. taxation of income earned abroad by U.S. companies. U.S. tax treatment of foreign source income is already too punitive. His proposal would go in the wrong direction, would further complicate what is already one of the most complex areas of the tax code, and would make it harder for U.S. companies to compete abroad against foreign rivals.

Themes with a sour note

Broader is better. A theme running throughout the Bradley plan is that a broader tax base is better than a narrower tax base. But that is only true if the broader tax base is a more accurate definition of income. The Bradley plan seems to have been designed with no concept of the *current* tax reform debate, which centers on the economic gains to be had from moving away from the "broad-based" income tax toward a consumption-based or consumed-income-based tax that more accurately accounts for the cost of earning income. Unprincipled base-broadening exacerbates

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the tax biases already rampant in the income tax code when it denies or delays write-offs for legitimate business costs, or taxes some uses of income several times. These practices result in higher tax rates on the affected income than are imposed on income used for other purposes.

Most base broadening proposals would discourage saving and investment and hold back gains in productivity, wages, and employment. Many of the items that Senator Bradley calls loopholes are designed to offset tax biases against saving and investment relative to income used for consumption. The tax code is fairer, more neutral, and less damaging to growth with these tax "loopholes" than without them.

Era of bigger government. Another theme in Senator Bradley's spending and tax proposals is that the federal government should expand to take over various activities now carried out by the free market system. Mr. Bradley wants tax hikes, which he is reluctant to call by their true name, disingenuously describing them as "budget savings" and savings for American taxpayers, in order to finance an expansion of government. The poor records of governments in this and other countries as program managers, the perverse incentives government programs frequently create, and the anti-production incentives of many taxes should all lead to questions about whether bigger government is the correct direction in which to take the United States.

Government as economic traffic cop. Mr. Bradley says he would cut taxes only as "counter-cyclical" policy, if "we got into a

downturn". But the time to fight the next recession is before it starts, not after it's half over.

Mr. Bradley is embracing the Keynesian "government knows best" view that the private economy is naturally unstable and that it takes wise government to keep economies prosperous by regulating total demand. Mr. Bradley's twin faiths that government leaders are able to fine tune the

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economy and that the supply-side affects of government actions are of secondary importance are misplaced. Counter-cyclical fiscal policy was discredited years ago. Tax cuts do not "stimulate demand", because they have to

be paid for by cutting spending or borrowing income that would otherwise have been spent by the private sector. Government spending must likewise be paid for through higher taxes or borrowing; it crowds out private spending, and does not add to the total. Conversely, tax hikes and spending cuts do not "tighten" demand.

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Taxes and spending policy must be analyzed according to the effect they have on the incentives to supply labor and capital to the market for the production of goods and services — that is, the choice between labor and leisure and the choice between saving and consumption. To strengthen the economy, taxes that discourage work, saving, and investment should be reduced and reformed — the sooner, the better.

Bill of Rights — or wrongs? Senator Bradley links several of the tax increases he seeks to contributions companies have made to political party committees. His attempt to justify multi-billion dollar boosts in taxes on the basis of campaign contributions is disturbing. Being able to express

one's views in the political process is not illegal. It is protected by the First Amendment, and it is an essential component of an open political process. Unless the real aim is to muzzle dissent, those who express their views should not be threatened with billions of dollars in extra taxes.

Conclusion

Former Senator Bradley's spending and tax proposals are reminiscent of what many people in the 1960s and 1970s regarded as activist, progressive government. In that vision, government

programs bring justice and economic progress and should be enlarged, while taxes are a minor inconvenience that do not really hurt the economy and further social justice. The growing doubts since then, based on theory and real-world experience, about the economic and social effects of expansive government spending and high taxes lend support to tax and spending reforms contrary to those Mr. Bradley espouses.

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