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Tax Reform: Is There a Better Way?*

President Reagan has presented to the Nation a tax reform program calling for the most sweeping changes in the income tax structure since its inception early in this century.

In the huge array of tax changes in the President's tax reform package, the proposed reductions in the statutory tax rates for individuals and corporations, the reduced rate of tax on capital gains, and the modest dividend paid-deduction stand out as shining lights. Until early September one would also have included the proposal to index inventories for inflation under the FIFO inventory accounting system. This proposal recently was deleted from the package in the interests of raising \$15.3 billion more in tax revenues over the five-year period 1986-1990. Indeed, very little in the package other than the rate reductions, the dividend-paid deduction, and the lower rate on capital gains can be justified as making significant contributions to achieving the announced goals of the proposed tax reform -- simplification, fairness, and economic efficiency and growth. These objectives are unquestionably laudable; there should be no reservations about pursuing them with all vigor. At issue is whether the tax reform program as a whole is on the right track or whether, with the exceptions noted above, it is not likely to continue to reverse the constructive thrust of tax reform initiated in the Economic Recovery Tax Act (ERTA) of 1981.

Reducing marginal tax rates for corporations, no less than for individuals, should take priority second to no other changes in the income tax structure. The correct rate of tax on corporate income is zero. In the light of all three of the President's tax reform objectives -- simplicity, fairness, and economic growth -- there should be no income tax levied on corporations.

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No corporate income tax has ever served the objective of simplicity. Corporate income taxes are inherently complex, and as corporate activities and the economies in which corporations operate become ever more complicated, corporate income taxes become ever more a source of tax complexity, not merely for corporate tax executives but for shareholders, as well. Unhappily, the changes in the corporate income tax proposed by the Administration, with the sole exception of the rate reductions, would greatly increase tax complexity for most corporations.,

Fairness, too, calls for imposing no income tax on corporations, but only on corporate individual shareholders. The demagogic calls for corporations to bear their "fair" share of the total tax burden, coming from the Administration as well as from some in the Congress, are utterly at odds with reality. There simply is no meaningful or operational standard of fairness that can be applied to corporations as taxpayers. The demand that corporations pay their "fair share" of the tax load really is a demand for increasing the amount of taxes levied on corporations which comes down to increasing taxes on corporations' customers, employees, and shareholders.

Corporations do not pay taxes; they only collect them. Only real, living people ultimately pay all taxes; they pay the taxes levied on corporations either as owners of corporations, as corporate employees, as customers, or as all three. No one knows how corporate income tax liabilities are distributed among real people in one or another of these roles. Corporate executives have no way of knowing who among these three groups of real people pay the income tax on corporations or in what proportions. Neither do tax policy makers who insist on increasing the aggregate amount of income tax liabilities that corporations should collect.

Even if we knew how corporate income tax liabilities are distributed among individuals as customers, employees, and/or shareholders, it would be only by the rarest chance that we would deem that distribution to be fair, to conform with any criteria of fairness that we would find acceptable. Once we recognize what both common sense and rigorous economic analysis tell us, that corporations don't pay taxes -- only real people do, and we don't know how much who pays, it is overwhelmingly clear that there is no way to determine the "fair share" of the income tax burden that all corporations or any one corporation should bear. There simply is no basis for determining how much of the tax load, all of which is ultimately borne by individuals as savers, workers, or consumers, should be collected by corporations.

The adverse effects of the corporation income tax on the economy also urges minimizing reliance on this revenue source, if we can't get rid of it entirely. The corporation income tax is an

incremental layer of tax on the returns on saving undertaken by individuals. It therefore has the effect of raising the cost of saving and of capital, the consequences of which are that there is less capital committed to corporate enterprises than there otherwise would be. As a result, the capacity of corporations to produce goods and services is less than it otherwise would be. In addition, by virtue of the fact that there is less capital in the corporate community associated with labor in the production process, labor's productivity, real wage rates, and total employment are lower than otherwise in the corporate sector. This means, in turn, that there is unemployment and lower aggregate output and an uneconomical and inefficient shift of labor and capital resources into the noncorporate sector. The overall effect on the economy as a whole is a loss of efficiency, a loss of productivity, a loss of output capacity, a loss of real income, and a loss of employment.

The simplification, equity, and economic growth and efficiency objectives of tax reform call for eliminating the corporation income tax. The harsh political facts of life tell us that's most improbable, at least at this time. We should, therefore, applaud and vigorously pursue efforts to reduce corporate tax rates. We should not, however, allow corporate statutory tax rate cuts to be used as a screen for enormous increases in corporate income tax liabilities, necessarily implying increases, hidden though they may be, in the real marginal tax rates that a very large number and proportion of corporations would have to face.

This is, regrettably, precisely what the President's tax package would do. Over the five fiscal years, 1986-1990, corporate income tax liabilities would total almost \$136 billion more than projected under present law (relying on the Treasury's static revenue estimates). But this tells only a small part of the story. The principal corporate tax changes that would reduce tax liabilities -- the rate reductions and dividend-paid deduction -- would save corporations \$157.7 billion over the five fiscal years; other tax savings would come to about \$13.0 billion, with the total of the five-year reductions amounting to \$170.7 billion. Against these tax reductions, a long list of changes would increase corporate income tax liabilities \$293 billion over the five years. About two-thirds of this amount -- \$187.6 billion -- would come from repeal of the investment tax credit, the so-called "recapture of the rate differential on accelerated depreciation" (the infamous windfall recapture proposal), and the replacement of the Accelerated Cost Recovery System (ACRS) by the Capital Cost Recovery System (CCRS). The remaining \$105.4 billion would be raised by a large number of changes that would increase tax liabilities in one industry after another. These facts are adamantly at odds with the White House assertion that the additional corporate tax liabilities would fall only on corporations that haven't been paying their "fair share."

These revenue estimates tell us that the proposed tax reforms would increase the corporate income tax base to a far greater extent than it would reduce corporate tax rates. In the fiscal year 1990, for example, the estimated revenue effect suggests a 75 percent increase in the tax base over the present law base in that year. This base increase is over and above that anticipated under present law from expansion of the economy.

All of this enormous increase in revenues would be obtained from tax changes that would act to increase the cost of capital used by the affected corporations. By all odds, the major adverse impact would be on capital-intensive companies, but corporations in construction, real estate, the financial sector, mining and natural resources, and those operating subsidiaries in foreign markets would also be adversely affected by capital cost-increasing tax changes particular to their activities and situations.

There are, of course, many corporations for which the proposed reduction in tax rates would outweigh the effect of the so-called base-broadening, tax-increasing changes. The managements of these companies, understandably, are likely to oppose efforts on behalf of the companies bearing the brunt of the base-broadening measure to delete or moderate one or more of the "reforms" that would increase the tax liabilities of the latter companies.

The inclination of corporate executives to assess the proposed tax reform package on the basis of its effect on their bottom line is certainly understandable. For them, taxes are matters of immediate concern, not public policy abstractions. But the route to the bottom line begins with the top line -- gross sales or revenues. A tax revision program that slows the trend growth in output and income in major sectors of the economy may well shrink the top line more than enough to offset the effect that revenue losers in the tax reform package might otherwise have in improving the bottom line.

We must also remember that the single largest source of saving in our economy is the sum of corporate retained earnings and capital recovery allowances. The proposed net increases in corporate tax liabilities are highly likely to reduce corporate sector saving at least dollar for dollar. In other words, this saving would fall off by close to \$136 billion over the five fiscal years 1986-1990. Some of this loss of saving by corporations would probably be offset by increases in saving by individuals whose income tax liabilities would go down in the aggregate by roughly \$147 billion in that period. But prudence dictates that we proceed on the assumption that the President's program, if implemented, would cut into the total pool of gross private saving by \$70 billion or more. This decline in saving, moreover,

is matched dollar for dollar by a decrease in private capital formation, with obvious and unhappy implications for growth in the economy's production capability.

We must also keep in mind that the \$136 billion in additional corporate income tax liabilities really are additional taxes borne by individuals as corporate customers, employees, and/or shareholders. Individuals may not be conscious of this additional burden, because its imposition on corporations tends to hide it from those who ultimately bear it. It is there to be borne by them, nonetheless.

A very large number of people, not only in their capacities as corporate customers, employees, and owners, but as individual taxpayers as well, would be called upon to help finance individual rate reduction, the increase in the zero bracket amount, the increase in the personal exemption, and a handful of other individual revenue losers. A very long list of tax revisions would raise individual tax liabilities, calculated at the reduced individual tax rates, by \$380.9 billion over the five years 1986-1990, to help finance the \$528.2 billion of (gross) reductions in individual taxes. By no stretch of the imagination can this huge, \$380.9 billion base-broadening increase in taxes be deemed to be confined to tax abuses and tax abusers. Indeed, the Treasury identifies only \$11.5 billion of this amount as coming from eliminating tax abuses and tax shelters. Of the \$380.9 billion in revenue raisers, the overwhelming majority would come from individuals of modest means. For example, \$33.1 billion would be raised by the proposed repeal of the second-earner deduction; another \$16.7 billion would come from treating a portion of employer-paid health insurance premiums as employees' current taxable income. By far the single largest revenue gainer is the proposed repeal of the deductibility of state and local taxes. Don't let anyone tell you that the \$166.3 billion of additional tax liabilities from repeal of this deduction would rest only on high-bracket individuals in high-tax states; this proposal would punish a huge number of individuals, in low- and high-tax jurisdictions, only a relatively small number of whom are in upper brackets.

What the tax reform program boils down to, therefore, is a huge shifting around of a given amount of tax burdens among individuals. If the Treasury's revenue estimates are anywhere near correct, there is no lightening of the tax load for individuals taken altogether, although some will assume more of the load, some less than they now bear.

The Administration's tax reform program would exact far too high a price for the benefits that would be afforded by lower tax rates. Those benefits are very substantial, indeed, particularly in the case of corporate taxpayers. But the route the Administration would have us follow to achieve those benefits

would be so damaging to the economy as to offset -- very likely, far more than offset -- these benefits. Administration spokesmen try to dismiss criticism of the tax reform base broadeners as merely pleading by greedy special interests. But base broadeners that would generate \$293 billion of additional corporate tax liabilities and \$380.9 billion of additional individual taxes over a five-year period can hardly be seen as eroding only the tax benefits enjoyed by special interests.

The gains from reducing tax rates are far too great to allow rate cuts to be held hostage to unacceptable base broadeners. Because tax reform this time around must confront outlandishly large federal budget deficits, the process of revising the income tax structure must be self-financing -- revenue neutral, to use the current expression. Of course, the revenue effects of each of the proposed tax changes are estimated in a static sense, that is, as if no one reacts to the changes in costs and in rewards that tax changes necessarily involve. The one certain thing one can say about these revenue estimates is that they are certainly wrong. Be that as it may, these are the revenue estimates with which the Congress and the Administration insist on evaluating tax change options. Combined with the insistence on revenue neutrality, they impose the harsh constraint that for every dollar of revenue-gaining base-broadening change that is rejected, there must either be a new revenue gainer that is added or there must be less of a rate reduction for corporate and/or individual taxpayers. There aren't many revenue raisers of any moment that are not in the present proposal. If history is a reliable guide, the dynamics of the tax legislative process almost certainly will result in substantial cutbacks in some of the more objectionable revenue raisers; the results of this process are likely to be substantially smaller rate reductions for high bracket individuals and a top corporate rate significantly higher than 33 percent. We might well wind up with the thoroughly unsatisfactory outcome of much too modest rate reductions combined with far too extensive and far too punitive base broadeners.

We need a different approach to funding individual and corporate tax rate cuts at least as substantial as those proposed by the President. We should look to an alternative tax source for the revenues needed to make up the principal part, at last, of the revenue loss from rate reductions.

One such alternative revenue source would be a value added tax. On several occasions in the last few decades, serious consideration has been given to substituting a value added tax for some part of the individual and corporate income taxes. The advantages of doing so in terms of easing tax deterrents to economic growth and reducing the anti-saving bias of the income tax have long urged this substitution as a major feature of a constructive tax reform program. Added urgency comes today from

the need to finance individual and corporate rate cuts without having to resort to base broadeners that cannot be justified on the grounds of fairness, simplification, or growth but that, on the contrary, are seriously out of keeping with these announced objectives of tax reform. There is, therefore, much to be said in favor of the substitution on this score alone.

In addition, however, the United States is now confronting one of the most serious protectionist threats since Smoot-Hawley. Unless something is done to blunt this drive, President Reagan is going to be very busy in the coming months vetoing protectionist measures and attempting to prevent overrides of those vetoes.

The inclusion of a value added tax, with its border tax adjustments, as part of an overall tax reform program would not only provide the means of financing the constructive tax rate reductions the President had proposed, it would also afford a powerful means for eliminating the existing tax bias against U.S. business in both the domestic and international market places. No tax change, in and of itself, is the entire answer to the problem of restoring American competitiveness in the world economy, but the proposed substitution would surely make an important contribution in this respect.

This contribution would be obtained not merely from the VAT's border tax adjustments that are not available under corporate income tax but also from the far more favorable treatment of all kinds of business capital under a VAT than under the income tax. The border tax adjustments would allow our exports to go abroad unburdened by the VAT, while requiring imports into the U.S. to bear the VAT to the same degree as domestic production. The expensing of capital outlays under the VAT would provide neutral tax treatment of the uses of our production capability and income for consumption or for capital formation and of the use of capital or labor inputs in the production process throughout the private sector of the economy. Moreover, this treatment affords tax neutrality with respect to differing kinds of capital.

For example, a business would expense its purchases of materials for work in process and for additions to inventory just as it would expense its purchases of machinery and equipment, all of its outlays and costs incurred for research and development, and any other purchases it would make from other firms. Contrast the obvious benefits of this approach with the punitive changes in the capital recovery system and the repeal of the investment tax credit in the Administration's tax reform package.

No tax change such as substituting a value added tax for the revenue raisers in the Administration's tax reform proposal is costless. Although a VAT is a simple tax, any addition to the tax system adds some complexity. The addition of a VAT would undoubtedly raise objections by state and local government heads,

who might see their fiscal turf invaded by the federal government. This objection, on the other hand, might be muted if relying on a VAT to finance rate cuts would eliminate the need for the proposed repeal of the deductibility of state and local taxes, one of the principal revenue-raising base-broadeners. And one would have to anticipate objections from those who insist on identifying the VAT as a regressive tax on consumption rather than a tax on businesses based on their payments for the use of labor and capital services. By far the most serious objection would come from those who fear that adding so effective a revenue source to the federal tax system would ultimately lead to another explosion in government spending. That, very likely, is the President's chief concern about using a VAT to finance income tax rate reductions. That hazard to our long-term fiscal health is indeed embodied in adopting a VAT, even as a substitute for the base broadeners in the President's tax reform program.

It is a risk worth taking. The rewards for the economy from reducing income tax rates are substantial. These rewards should not be offset by revenue-raising, base-broadening measures that would be unfair, that would greatly increase compliance and enforcement costs, and that would intensify income tax disincentives for the kinds of activities upon which the nation's economic progress critically depends. These disincentive effects for the economy as a whole might well more than offset the positive incentive effects afforded by statutory rate cuts. **That** risk is not worth taking.

We needn't give up on tax rate cuts nor leave them exposed to the bargaining mischances of the tax legislative process. There is an alternative course of action that would materially enhance the likelihood of securing the income tax rate cuts, preclude the need for damaging base-broadeners, and improve our international competitiveness. It will take political courage and leadership of the highest quality to shift to this alternative route. Let us hope that the Congress and the President will show that courage and provide that leadership.

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