IRET Institute For Research On The Economics Of Taxation

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WHAT'S FAIR, ANYWAY? A NEW TAX PLAN FOR AMERICA

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As the assigned title of my discussion indicates, I've been asked to present two lectures today. One of these is to address the issue of "tax fairness" that has preoccupied the federal government, to a degree unseen in many years, ever since George Bush became president. The second lecture is to address just as heroic a question: what's the ideal tax system for America. I am flattered to have been asked to bring these two matters to light in twenty to thirty minutes and embarrassed about my own temerity in undertaking to do so.

The Fairness Issue

If you've been watching economic policy making during the past four years, you must have been struck by the extent to which "fairness," not merely in tax policy but across virtually the entire economic policy spectrum, has dominated the framing of issues. I do not have any certain information that the Democratic leadership explicitly decided that their best hope for excising Reaganomics from public economic policy was to resurrect the so-called equity issue. Whether Democrats carefully crafted it, the fairness strategy certainly appears to have succeeded in revealing the economic policy ineptness of the Bush Administration. The Administration's fumbling of the policy ball was evident from the start, when the only significant economic policy initiative advanced with any vigor at all was the proposed reduction in the rate of tax on capital gains. Standing alone, as if it were the be-all and end-all of a pro-growth tax policy, the capital gains proposal must have been greeted with delight by Democrats, answering their most burning question, to wit, "How do we paralyze this administration, make sure it can't successfully carry forward the thrust of Reaganomics, and recapture the White House?" In practice, the answer has been to assail the Administration as pro-rich and pro-business, to characterize the fiscal and

budget policies of the Reagan Administration, of which, presumably, the Bush Administration was to be the ideological heir, as benefitting the rich while injuring the poor.

At no time has the question of what is fair been explicitly addressed by those leveling this charge against the Bush, and by extension, the Reagan administrations. Instead, the concept of fairness has been finessed by extravagant quasi-statistical exercises, aimed at demonstrating that under Reagan and Bush, the rich have become richer while the poor have become poorer and that this alleged shift in the distribution of income is attributable to deliberate Reaganesque policies. Astonishingly, Congressional Republicans have played the Democrats' game, forgoing any effort to come to grips with the basic question of defining fairness but instead insisting that the other side's numbers are distorted, as indeed they are. Despite their heroic efforts, Congressman Dick Armey and the minority staff of the Joint Economic Committee clearly haven't been able to make Democrats, the Clinton campaign, and the media acknowledge the errors of their statistical ways.

If one is to play the numbers game, one should at the least be at pains to identify what the numbers are and what they are intended to show. Presumably, the aim of these exercises is to measure the effect of government's fiscal interventions on the distribution of income, year by year. For the moment, let's ignore the question of why we should care. To pursue this objective, clearly, we need to start with an appropriate definition and measurement of income, distributed by whatever intervals are deemed to be appropriate, that exclude the direct effects of the fisc. In essence, this income consists of the claims that are generated by current production activity in each year. It excludes, among other things, government transfer payments, irrespective of their purpose, as well as taxes. It also excludes capital gains, either realized or accrued. It must allocate income originating in corporate businesses to the individual owners of the corporations. It must include as part of personal income that part of compensation committed to pension and similar retirement plans and the current earnings of the plans, while excluding pension benefits actually received. And so on. To capture the distributional effects of fiscal intervention, this income should be compared with that resulting from the addition of government transfer payments and the subtraction of taxes.

My colleague, Steve Entin, has produced a soon-to-be-released study of the conceptual and measurement requirements of meaningful statistical analyses of income distributions and of the extraordinary shortfalls of Congressional efforts. One of his most important conclusions is that the data requirements of the correct analyses are daunting and that the "studies" that are now produced and that so titillate liberals and the media — forgive the redundancy — come nowhere close to overcoming these difficulties, hence produce grossly misleading results.

Virtually all of the various statistical exercises find that the distribution of (mismeasured) pre-tax, pre-transfer income became more unequal during the last decade or so. One of the most seriously mistaken conclusions drawn from these gravely flawed statistical analyses is that the measured pre-fiscal-intervention income distributions are the result of the bad fiscal policies of

the Reagan and Bush administrations. Never mind the fact that for the most part, the actual fiscal policy developments year by year often did not closely reflect the administrations' policy preferences. If one is to assert that the Reagan and Bush tax and spending policies shifted pre-tax and pre-government spending income to the rich and away from the poor or middle income people, one must show how this happened. I need hardly call to your attention that no such demonstration has been forthcoming.

This raises an important question in connection with virtually all discussions of tax fairness, to wit, is the fairness issue concerned with the distribution of tax liabilities by income classes or does it address the structure of the tax system and how it assigns tax burdens among individuals with differing amounts of income? Perform with me a simple arithmetic exercise, taken from a paper by my colleague Roy Cordato, to illuminate the distinction between these concerns.

Consider an income tax under which the first $25,000 of a person's income is taxed at 20 percent, while the tax on the next $25,000 is imposed at a rate of 10 percent. In the structure sense, this tax would be characterized as regressive; its marginal tax rate on the higher income is lower than that on the lower income. But suppose the population consists of two people, one with $25,000 of income and the other with $50,000. The $25,000-income person pays $5,000 in tax while the $50,000-person pays $7,500, or 60 percent of the total. On the basis of shares of total tax, the tax system would be characterized as progressive. Comparing tax share and income share, the tax system would again be described as regressive. Quite obvious to anyone who has followed the fairness debates, the distributional measure that is selected by the debate participant is the one that confirms his or her preferred result.

Similarly, lacking any objective standard against which to assess the fairness of the tax system, what is one to make of the often-heard assertion that the "rich" should pay their "fair share" of taxes? The share of total income taxes now paid by the "rich" is vastly disproportionate to their numbers in the population and to their share of total income. In 1990, for example, the top one percent of federal income tax returns reported 14.3 percent of total adjusted gross income and 25.6 percent of total income tax liabilities. Making allowance for the limitations of the adjusted gross income concept, in what sense do these numbers suggest that the "rich" are underpaying their fair share? How much larger must this share be to persuade policy makers that the rich are at last bearing their fair share of the tax burden?

The implication, unstated by those who play the fairness game, is that income distribution is a zero-sum game, so that if the income of the people in one or another income interval increases, that of people in one or more other intervals must fall. But in a free society, relying on free markets with voluntary exchanges, it simply is not true that the rich are rich because they've taken from the poor or that the poor are poor because the rich have deprived them of part of their income and wealth. With few exceptions, one's income closely approximates one's

contribution at the margin to total output. Moreover, one's income, with few exceptions, also at least roughly equals the costs one has incurred to attain the level of productivity for which that income is the reward. And it must be kept in mind that no one earns his or her income in isolation. Unless the laws of production, prevailing ever since Adam and Eve were sent out of the Garden, have been repealed, the greater one's productivity and the higher, therefore, one's income, the greater are the output and incomes of the owners of the other production inputs with which one's services are combined in production activity.

An even more fundamental consideration in examining tax fairness is the basic ethical issue in the context of our American heritage. Borrowing from my colleague, Roy Cordato, let me point out that an essential element of that heritage is that in all relevant respects we are supposed to stand equal before the law. In one area of societal concern after another, we have been at pains to ensure that the equality of rights is identified and respected. The single most distressing exception has been the differential treatment of individuals based on the amount of their property rights, reflected in their income or wealth. It has become widely accepted that fairness calls for imposing taxes at increasingly heavy marginal and effective rates the greater one's income and wealth. Our income taxes, in particular, impose increasing excise taxes on — increasingly raise the opportunity cost of — increasing one's productivity. In simple truth, this means that the greater is one's productivity, i.e., the greater is the amount of one's property rights embodied in human and physical capital, the greater is the tax erosion of the value of those rights, hence, the lower is one's standing before the law. If this is fairness, let's all strive for unfairness in taxation.

Against this standard, which I believe is far more compelling than any ability-to-pay notion, any redistributional tax policy is unfair. Fairness, instead, calls for imposing taxes at a fixed marginal rate on a correctly defined tax base, the subject of the second lecture to which I now turn.

The Ideal Tax System for America

At the outset, let's get over the oxymoronic hurdle in speaking of an "ideal" tax system. We do better, I believe, to focus on a tax system that performs the essential function of taxes with the least damaging economic effects. This focus identifies the two sets of considerations to which we should direct our attention in seeking to come up with a far better tax system than we now have.

<u>The basic tax function</u>

As I have elsewhere and often noted, the essential function that taxes should perform is to inform the body politic about the cost of government services. This tax function is uniquely appropriate for free societies in which the public has both the opportunity and responsibility,

through the political process, of determining what functions and services it wants its government to perform and in what amounts. This determination cannot be effectively made without knowledge of the opportunity costs of those services, without knowing the value of the other uses of the society's production capability that must be forgone to obtain those government services. In a society as large, complex, and dynamic as ours, with governments that have such huge inventories of activities, undertaken in enormously diverse ways, meeting these information requirements activity by activity is virtually impossible. It is not feasible to cost out each of the things that our governments do, most of which most of us are not even aware of. The best we can do is to try to determine the costs of differing inventories of government activities, and on that basis determine a preferred aggregate level of such activities, assigning our policy makers the responsibility for allocating that aggregate in the most satisfactory way among those diverse activities. Moreover, we cannot precisely identify and measure the opportunity costs of any given bundle of government activities. We need a proxy that at least roughly approximates those costs. That proxy is the amount of taxes needed to fund any such set of government services.

Several conclusions are obvious, given this function of taxes. First, except in extraordinary circumstances, aggregate government outlays should not be planned to exceed planned aggregate tax revenues. The difference between the two aggregates — the deficit, however widely reported and known by the public, has no real information content. No one has a meaningful sense of the cost of the government activities that are covered by borrowing, because the borrowing involves a voluntary exchange between the government and the lenders. Only taxes can come close to informing the public about the cost of those activities. Finessing the question of budget process, the information content of taxes must act as the economizing constraint on spending decisions.

Clearly, taxes can't perform this essential function if people aren't conscious of their tax liabilities. This dictates relying only on taxes that are paid directly by individuals. It rules out, therefore, corporate taxes. It also rules out taxes that are more or less hidden by virtue of the institutional arrangements for their imposition and collection. Sales taxes and even selective excise are, on this basis, to be rejected. Unless, moreover, one believes that only certain groups in the population are to have the responsibility for determining how much cost government is to impose, taxes must be imposed on the broadest possible part of the population, not confined to the "rich" or disproportionately imposed on them. And, finally, taxes should be imposed as uniformly as possible with respect to the properly defined base.

Relevant economic considerations

As suggested before, the taxes we rely on to perform the fundamental function of taxes should be as least economically damaging as possible. Here, too, the consideration of economic efficiency is relevant only in a free society that relies on private markets to perform the basic economic functions. In the performance of those functions, markets generate relative prices that

reflect the preferences of market participants engaging in voluntary transactions. These price relationships provide the clues for optimizing the allocation of market participants' resources and income.

In their very nature, taxes distort the price relationships that the market system would otherwise cast up. Every tax ever invented has the effect of changing the price of the thing that is taxed relative to the prices of other things, and policy makers should not aspire to the fashioning of a tax utterly devoid of these excise effects. The policy goal, instead, should be to minimize these distortional features, to make the tax system as nearly neutral as possible.

In the context of our present tax system, this policy dictum calls for:

- eliminating the corporate income tax,
- eliminating the transfer — the estate and gift — taxes;
- eliminating payroll taxes;
- eliminating selective excise taxes;
- recasting the individual income tax to minimize its differential excise effects.

The fiscal offenses committed by the corporate income tax are well known. Briefly summarized, the tax is the equivalent of an excise tax on doing business in corporate form. It is also a stiff excise on saving committed to corporate businesses; as such, it severely accentuates the anti-saving bias inherent in traditional income taxation. Income generated by corporate businesses should be attributed and taxed to the individuals who own them.

Estate and gift taxes are similarly additional excises on saving. If one rejects income redistribution as a tax policy objective, it is impossible to justify the incremental bias that these taxes impose on saving relative to consumption uses of income.

By all odds, the most blatant tax distortion in the revenue system today is the severe excise imposed by payroll taxes on the supply of and demand for labor services. The tenuous, at best, connection of these taxes to employees' social security benefits does not offset their severely punitive effects on employment. Nor can they be justified as essential for the financing the social security system, which should in any event be phased out and transformed into a means-tested welfare system.

Selective excises, too, have no appropriate role to play in the tax structure of a free society relying on private markets. In their very nature, such taxes lead to allocations of resources that diverge from those that would be preferred by market participants freely exercising their choices. The rationale for these taxes boils down to the view that people don't know what's good for them and that it's the responsibility of public policy makers to make better choices for them. In truth, this elitist rationale is a cover for the fact that excises are "easy" revenue raisers

that allow policy makers to assign revenue burdens that should be generally assumed to people who can be characterized as naughty.

Finally, the basic guiding rule in recasting the income tax should be to define taxable income as the excess of one's revenues over the costs incurred to obtain them. To this end, every effort should be made to minimize the tax bias against saving and in favor of consumption and against market-oriented personal effort and in favor of leisure uses of one's time, energy, talents, etc. On the first score, a universal, unlimited IRA should be introduced, allowing everyone to deduct from taxable income the amount saved out of current income, while including in taxable income all of the gross returns on that saving. The second goal is far more difficult to achieve, but the bias against effort may be substantially reduced by allowing deductions for the costs of education, training, skill attainment and honing, etc. Moreover, the tax should be imposed at a flat rate on taxable income in excess of whatever minimum amount of income is deemed to be an appropriate zero-rate bracket.

Many, if not most, of the current discussions of tax reform stress the potential of such reforms for promoting economic growth. Fora free society, relying on an effective market system, this goal of reform is irrelevant, at best, and potentially hazardous at worst. With the most nearly nonintrusive or neutral tax system as possible, the rate of growth that emerges from the market's operation is necessarily that which conforms most closely with the preferences of the public. It is difficult, to say the least, to come up with a justification for public policies that set that judgment aside.

The approach outlined in my discussion is not likely to be implemented in the foreseeable future. We can, nevertheless, realize substantial gains if we treat it as a guide, allowing it to indicate to us the directions in which we should move toward a tax system more nearly consonant with the requirements of a free, progressive society in the coming century.