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THE TAX REFORM AGENDA: GOALS AND CRITERIA

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OVERVIEW: WHY AMERICA NEEDS A NEW TAX REFORM AGENDA

Proposals for renewed efforts to reform the federal tax system often meet with a cool reception. The lack of enthusiasm doesn't reflect a conviction that the current tax system isn't "broke" so it doesn't need fixing. Instead, it reflects skepticism, based on experience, that tax reform programs often hurt rather than help. The monumental Tax Reform Act of 1986 (TRA86) was widely heralded as simplifying the income tax, promoting growth, and making the tax system fairer. Many business and personal taxpayers, however, believe that TRA86 fell far short of achieving these goals. For these taxpayers, tax reform has become synonymous with higher taxes, greater complexity, more costly compliance burdens, and greater difficulties in advancing their economic growth. A widely held view is that bad as the present tax system is, tax policy should leave it alone, lest new tax reform acts make matters worse.

Although this skepticism and suspicion is quite understandable, there is an urgent need to address at least the major deficiencies in the existing federal tax system. The United States has never enjoyed, any more than any other nation, a tax system that conformed with the fundamental principles of taxation and that allowed taxes to perform their basic function of informing the citizenry about the cost of government. Over the past decade, however, tax legislation has departed increasingly from those principles and has increasingly impaired the tax system's ability to perform its basic function. Federal taxes have become more and more an obstacle to efficient functioning of the free market system, to economic growth, and to the competitiveness of American business in the global economy.[1]

In very large part, these tax developments have been an unfortunate byproduct of the concerns of public policy makers about the persistent federal budget deficits. Beginning with the Tax Equity and Fiscal Responsibility Act of 1982, raising additional tax revenues to reduce the deficit has been the prime mover in tax legislation. Even TRA86, in its specification of changes in the income tax base, was guided very largely by revenue considerations -- the perceived need to offset the huge revenue losses anticipated to result

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from the decreases in personal and corporate income tax rates and from the increases in the personal exemptions and the standard deduction.

These tax increases, obviously, have failed to achieve their deficit-reduction objective; the federal budget deficits projected for the fiscal years 1992-96 aggregate close to a trillion dollars. Tax increases, moreover, have also eroded incentives for saving by households and businesses, raised the cost of capital confronting American business at home and abroad, and also increased the cost of labor services. Tax-increasing legislation has distorted the market's price signals and impaired the market's function in informing households and businesses about the most productive ways to use the resources at their disposal. Successive rounds of tax legislation have also increased the complexity of the tax laws, hence raised the costs of compliance, administration, and enforcement.

There is a growing awareness in the public policy community that the federal tax system needs repair. In his legislative proposals in 1989, 1990, and again this year, President Bush called for a limited number of tax changes aimed at reducing tax obstacles to economic growth. A number of Congressmen and Senators have introduced tax bills intended to promote saving, increase investment, and expand employment.[2] Many business leaders have urged a new look at the tenor of American tax policy in the light of the increasing globalization of business.[3] Public policy research organizations and tax scholars in the academic community and in private practice continue their efforts to explain the deficiencies in the existing law and to recommend ways to overcome them.

Over the past year, the policy focus has shifted from long-run concerns to overcoming recessionary forces and to easing the tax load on the "middle class." Whatever the legitimacy of these concerns, one must hope that they will not cause policy makers to lose sight of more basic issues generated by the federal tax system.

The concerns about tax policy are welcome developments. They signal growing awareness that tax policy should be refocused from revenue raising toward improving the tax structure in the interests of making it better suited to the fiscal and economic requirements of our times. To this end, a broad-based instead of a piecemeal approach to reform is called for. Too often in the past, tax policy has pursued an ad hoc agenda in which adherence to basic tax principles has been conspicuous by its absence. Any future effort to achieve a better tax system should begin with a clear identification of the attributes of a good system and of the criteria that system should satisfy.

CORE OBJECTIVE OF REFORM

The basic function of taxes in a free society is to cost out its government activities -- to inform the body politic and the persons they choose to represent them in government about what must be paid for what they ask government to do.[4] Taxes are -- or should function as -- the prices people pay for government services.

A continuing challenge to the body politic in a free society is to make efficient decisions about how production capability should be allocated between the public and private sectors. These decisions cannot be efficient if the cost of government's use of that production capability is obscured. In real terms, that cost is the value of the forgone output for private sector use that the government activity entails. This cost is at least approximated if government outlays are fully financed by taxes,[5] if the taxes are not hidden, and if the taxes are imposed as uniformly as possible on the largest possible number of real persons in the society. It is difficult to think of any other way in which people can be fully informed about the cost of government. Financing government activities by borrowing, for example, must hide the cost of the activities from the population until at some later time, if ever, additional taxes are imposed to service the debt. The public cannot make intelligent choices about the size and composition of government activities if it lacks complete information about the costs of these activities.

ATTRIBUTES OF A TAX SYSTEM THAT EFFICIENTLY PRICES GOVERNMENT

Two attributes of a tax system are essential if it is to be effective in informing the population about the cost of government. For one thing, taxes must be imposed only on individuals. Corporations and other legal but not real persons do not pay taxes; only real, living human beings can pay taxes, whether in their capacity as sellers of productive services or buyers of products and services. Taxes levied on corporations tend to escape perception by the individuals who will ultimately bear their burden.

Second, taxes should be imposed on the largest possible number of people and in such a manner as to make each of them as aware as possible of his or her tax liability. Taxes can't be efficient in confronting society as a whole with the cost of government if large numbers of individuals are excused from assuming tax liabilities or if they are unaware of the taxes they bear. Removing large numbers of individuals from the tax rolls, for whatever reason, is directly at odds with achieving a tax system that ensures the voting population's awareness of the burden that public spending imposes on them.

CRITERIA FOR TAX POLICY

In addition to possessing these essential attributes, the taxes relied upon to inform the population about the cost of government should meet certain fundamental criteria -- the so-called canons of taxation. These tax principles are well known, but they are honored far more in the breach than in the observance in tax policy. One of the major challenges confronting a constructive, coherent, and feasible tax reform effort is communicating to public policy makers the content of these criteria and the requirements they impose for their effective implementation.

Equity

The most demanding of these criteria is that taxes must be fair. Unfortunately, this is also the most elusive tax canon. Applied to the income tax, fairness customarily is perceived to mean that persons in the same economic circumstances should pay the same amount of taxes. The problem is how to identify the circumstances that are relevant for this purpose. What are the attributes, economic or otherwise, that determine whether any two persons' circumstances are the same or differ in ways that urge differences in their tax liabilities? Is income the best measure of circumstance? If so, how should income for tax purposes be defined to insure that its implementation in the tax laws does not conflict with other appropriate criteria? The range and magnitude of the difficulties encountered by policy makers in attempting to deal with these and similar questions over the years is reflected in the relentless expansion of the size of the Internal Revenue Code.

Even more ambiguous is how to differentiate tax liabilities among persons whose circumstances, however measured, are different. Since the end of World War II there has been a continuing conflict in the public policy forum over this issue. Although the issue has never been resolved in equity terms, the historical trend has been to compress the range of lowest-to-highest income tax rates; TRA86 took a drastic and dramatic step in this direction. Nonetheless, this so-called "vertical equity" issue remains a very urgent one confronting tax policy makers.

Because of the difficulty of resolving these problems, the idea that taxes should be fair, however appealing, is -- and always has been -- a policy will o' the wisp. Equity is an impossible tax policy criterion to satisfy in any rigorous sense; its pursuit, based on ill-defined or impressionistic concepts, is fraught with peril for attainment of other policy criteria.

While not always recognized by policy makers, the vertical equity or tax fairness goal is essentially equivalent to an income redistribution objective. The implicit assumption on which this objective rests is that the economy operates subject to the rules of a zero-sum game in which rich people are rich because they have made poor people poor. Recognizing that in an effectively operating market economy a person's income closely reflects his or her contribution to the economy's total output, the so-called moral basis for tax fairness is questionable, to say the least. Indeed, if we were to affirm that in a free society, every one should have equal standing in the law, the whole fairness issue would be materially refocused.[6] Those who urge a redistributive tax policy should be required to demonstrate any moral or ethical gain therefrom that outweighs the immorality of exactions from those who produce income to provide income to those who don't.

We should give higher priority to uniformity as a policy guide than to the use of taxation to alter the distribution of income and wealth. Uniformity sidesteps the conceptual issues posed by equity and focuses instead on the similarity of economic activities and transactions, rather than on attributes of individuals as taxpayers. Uniformity is conspicuous by its absence in the existing tax system; indeed, uniformity has been done great

violence by tax provisions enacted in the name of tax fairness, differentiating the tax treatment of particular transactions on the basis of the amount or source of the taxpayer's income or other attribute. Perhaps the most egregious examples are provided by the alternative minimum tax and the limitations on the deduction of so-called "passive investment losses."

The lack of uniformity is particularly apparent in the case of the tax treatment of saving and investment and of the income the saving and investment produce. For example, personal saving invested in corporate ownership is treated differently from saving invested in unincorporated businesses. Saving invested in corporate equities receives harsher tax treatment than that invested in corporate debt. The returns on saving committed to so-called "passive" investments are, in some cases, taxed more heavily than those on saving invested otherwise. The list of differentials can be greatly extended.

At one time or another, tax policy makers have given lip service to uniformity as an important standard against which to judge the goodness of taxes. TRA86, for example, was characterized by its proponents as providing a "level playing field," particularly for business taxpayers, although the Act's accomplishments in this regard are meager, to put the matter nicely. In fact, the present state of the income tax and the great variety of excise taxes in the federal revenue system are evidence of the failure to achieve anything like uniformity in the tax system.

Reviving interest in uniformity and elevating its significance as a policy criterion might well be an important step in the development of a realistic tax reform agenda. Apart from the intrinsic merit in doing so, achieving greater uniformity would also facilitate satisfying other criteria of good tax policy. It would contribute materially to tax simplification, and it would be both an input to and a byproduct of tax neutrality.

Simplicity

Simplicity is another criterion of tax policy that is always urged but almost always violated. In an operational sense, simplicity means that neither taxpayers nor enforcement and administration agencies need commit significant amounts of resources to complying with or administering and enforcing the tax laws and regulations. TRA86 was heralded as a major simplification reform. Except for the individuals who were dropped from the tax roll by the increase in the personal exemptions and standard deduction, however, few. if any, individual or corporate taxpayers found their compliance costs reduced, nor have the Internal Revenue Service's manpower requirements diminished.

Indeed, the acid test of simplification efforts is whether they reduce the IRS's budget and payroll. On the basis of this test, tax policy appears to be dedicated to violating, rather than satisfying, the simplicity criterion.

The enemy of simplicity in U.S. tax policy is particularization. Tax laws, regulations, rulings, court decisions seek to deal with every conceivable variation in taxpayers' situations, transactions, income sources, expenses, modes of operation, financing methods, etc. In view of the enormously varied and continually changing circumstance and activity of households and businesses, this policy approach results in an ever-increasing volume and detail in the law and regulations. For the taxpayer, determining how the law applies in his or her circumstances becomes increasingly difficult, time consuming, and costly. For the Internal Revenue Service and the Treasury Department, the task of insuring that the intent of the law, often only dimly perceptible, is implemented in regulations, rulings, and enforcement procedures also becomes increasingly difficult, time consuming, and costly.

It may well be that the only route to real simplification is significant refocus of tax policy away from the particulars of each taxpayer's situation and toward broad and general rules that would cover most economic behavior and transactions. The application of the uniformity standard, as explained above, would contribute significantly to simplification in this approach.[7]

An example is provided by the change in the tax treatment of depreciation, beginning in 1971. Prior to the adoption of the Asset Depreciation Range (ADR) system in that year, depreciation allowances for business taxpayers were determined very largely on the basis of the experience of each taxpayer with the particular assets employed in each particular way in the taxpayer's business. The adoption of ADR was an effort to conventionalize capital cost recovery, to deemphasize the differences among taxpayers in setting the rules for capital write-offs. The enactment of the Accelerated Cost Recovery System (ACRS) in 1981 aimed at eliminating most, if not all, of the contests between taxpayers and the Internal Revenue Service over the "correctness" of capital recovery allowances. ACRS was not wholly successful, but it did provide progress toward simplification based on uniformity of treatment.

The suggested change in focus might well entail a cost -- some loss of tax revenues to the government. Uniformity would very likely mean forgoing the revenue gained by very closely identifying the particulars of differing transactions and activities. Uniformity, after all, implies a kind of averaging by which the extremes in the array of transactions and activities are disregarded. It is certainly possible, however, that the reduction in compliance, administration, and enforcement costs resulting from the change in approach would far exceed the tax revenue lost from any additional lapses in compliance.

<u>Revenue adequacy</u>

Revenue adequacy is always advanced as a fundamental canon of taxation. In the light of the basic function of taxes in a free society -- to inform the body politic about the cost of government activity, however, this canon requires careful delineation.

In conventional discussions, revenue adequacy is expressed as the ability of the tax system to raise the amount of revenues necessary to defray the costs of government. This articulation implies, of course, that the amount and composition of government activities should be determined without reference to the cost of the activities, presumably on the basis of policy makers' judgment about "need," in some absolute sense.

In fact, however, the tax system should convey to the population the price of differing amounts of various kinds of government activities, so that policy makers' decisions about how much to spend and on what are constrained by the willingness of taxpayers to pay for those activities. Revenue adequacy, as a policy criterion, is not properly a matter of raising revenues equal to predetermined government outlays, but of assuring that taxes are an effective input in decisions about spending.

Neutrality

A final criterion that has achieved prominence only in recent years is neutrality. Tax neutrality is correctly defined in terms of the impact of a tax or tax provision on relative costs and prices. A perfectly neutral tax system would not alter any of the cost or price relationships that would prevail in an efficiently functioning private market, free of influence from government actions or policies.

No tax ever devised has been perfectly neutral. One of the inherent properties of every tax is that it raises the cost or the price of the thing that is taxed relative to the costs or prices of other things. Every tax, in other words, has an excise effect. In an operational sense, therefore, the neutrality criterion calls for taxes that minimally distort the price and cost relationships that the market system would produce in the absence of taxation.

As applied to the income tax, neutrality calls for designing the tax in such a way as to alter in the same proportion the costs and prices of all alternatives confronting taxpayers. The tax should raise the cost of saving in the same proportion as it raises the cost of current consumption, and it should raise the cost of each form of saving and of each kind of consumption to the same degree. It should raise the cost of any particular employment in the same proportion that it increases the cost of doing any other kind of work. It should increase the cost of using capital services in the same proportion as it raises the cost of using labor services in production processes. It should have the same proportionate effect on the cost of any one kind of capital use as it has on that of any other.

The existing income tax severely violates the neutrality criterion. Income taxation, per se, is at odds with neutrality because the tax increases the cost of activities that generate income subject to tax relative to the cost of all other activities. Apart from this basic conflict, however, the tax as now imposed in the United States and in most other jurisdictions is biased against saving and in favor of current consumption uses of current

income. It is biased against the use of one's time and resources in activities that give rise to income that falls within the tax's purview and in favor of uses that produce nontaxable rewards, i.e., "leisure." It increases the cost of activities that enhance one's productivity, hence earnings. It discriminates against long-lived capital and in favor of shorter-lived facilities. It favors financing corporations' capital requirements with debt as opposed to equity. It raises the cost of using capital services proportionately more than it raises the cost of using labor services. And so on. [8]

The concerns about neutrality are seldom stated in these terms in the public policy forum. Instead, these concerns are expressed in criticism of various features of the existing income tax that are perceived to burden growth-generating activities, or in citing needed changes in the law to make it less of an obstacle to growth. Similarly, there is increasing expression of concern that various public policies, especially tax policies, impair the competitive position of American business in the world market place, thereby depriving the domestic economy of gains in efficiency and productivity.

As a corollary, there appears to be increasing sentiment that the emphasis in tax policy should shift from revenue considerations to structural features of the tax system, particularly of the income tax, and their effects on the economy's performance. Tax policy, in this view, should be primarily concerned with improving the structure of the tax system in the interests of moderating, if not eliminating, its adverse effects on efficiency in the use of production capability, on growth-generating activity, and on the capacity of American businesses to compete with foreign businesses at home and abroad. In short, although not often identified in these terms, the emerging consensus is that tax policy should give priority to tax neutrality among the criteria to be served.

Tax reform that meets the neutrality criterion will not seek to subsidize business growth and competitiveness. It will, instead, eliminate or at least moderate the excise effects of the existing income tax. The economic consequences of this tax reform are difficult to predict and to quantify. They may exceed or fall shy of expectations about growth rates, job creation, capital formation, and so on. If the resulting tax system conforms reasonably well with the neutrality criterion, as delineated above, however, public policy makers should not seek other tax changes to produce different economic outcomes that might be deemed to be preferable. To be sure, other public policies may be the source of less than optimal performance by the economy, but tax policy should not relinquish neutrality to compensate for the shortcomings of these policies.

CONCLUSION

We are currently observing a spate of tax proposals from members of the Congress and from numerous individuals and groups in the private sector. Although these are welcome because they are greatly heightening the interest of policy makers in tax policy issues, most of them are ad hoc, lacking any adherence to basic principles. As such, they tend to preempt policy makers' concern, displacing interest in trying to develop an agenda

of tax reforms that will provide us a tax system better serving the basic canons of taxation and better suited to the requirements of America in the world economy. It is to be hoped that this conference will provide a wholesome refocus of policy makers' interests.

Notes

1. Tax policies of state and local governments also burden economic efficiency, progress, and competitiveness. Although this discussion focuses on the federal tax system, it is clear that many, if not all, of the observations herein apply as well state and local government taxation.

2. Notable examples include the Economic Growth and Jobs Creation Act of 1991, fashioned by Congressman Tom DeLay and Senator Malcolm Wallop, the IRA liberalization proposed by Senators Bentsen and Roth, the reduction in the capital gains tax rate and the indexing of the basis of capital gains, proposed by Senator Robert Kasten, and the reduction in the payroll tax rate proposed by Senators Daniel Moynihan and Senator Kasten.

3. See, for example, the statements by James Q. Riordan then Vice Chairman, Mobil Oil Corporation, Barry K. Rogstad, President, American Business Conference, Abraham Krasnoff, Vice Chairman and Chief Executive Officer, Pall Corporation, among others, in U.S. Foreign Tax Policy and the Global Economy, New Directions for the 1990s, Institute for Research on the Economics of Taxation (Washington, D.C., 1989). See also U.S. Foreign Tax Policy: America's Berlin Wall, IRET Conference Proceedings, University Press of America (Lanham, Md., 1991).

4. The function of taxes is often identified as a fiscal device for transferring production resources, output, or income claims from persons in the private sector to government. Taxes are not needed for this purpose. Governments can commandeer resources without recourse to a formal tax system. A manpower draft for military or other purposes offers a simple example of government's taking resources for public purposes without making a market-determined payment for the resources and without relying on taxes to pay for them. Government-imposed mandates on businesses and households to do specific things or to make specific payments to other persons in the private sector are contemporary examples of government's non-tax direction of resource uses.

5. A major exception to this proposition arises in the case of government mandates and regulations, the budgetary costs of which seldom, if ever, approximate the net costs they impose on the economy.

6. For a searching and rigorous discussion of the tax fairness issue, see Roy E. Cordato, "Tax Fairness or Moral Bankruptcy?," IRET Policy Bulletin No. 53, September 6, 1991.

7. A splendid example of the way in which differential tax treatment complicates the tax law is provided by the income basket and expense allocation rules in the foreign source income provisions in the tax code. Uniformity of treatment of all income derived abroad and of all expenses incurred in connection with foreign operations would greatly simplify the law and very substantially reduce costs of compliance and enforcement.

8. For explanation and illustration of these excise effects of the income tax, cf. Norman B. Ture, "Supply Side Analysis and Public Policy," in David G. Raboy, Ed., **Essays in Supply Side Economics** (Washington D.C.:The Institute for Research on the Economics of Taxation, 1982) pp. 16-21; Norman B. Ture and B. Kenneth Sanden, **The Effects of Tax Policy on Capital Formation** (New York, N.Y.: Financial Executives Research Foundation, 1977), pp. 58-73; and Norman B. Ture and John B. Egger, **Corporations' "Fair Share" of Federal Taxes** (Washington, D.C.: National Chamber Foundation, 1988), pp. 27-45.