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CAPITAL FORMATION, ECONOMIC GROWTH, AND JOBS: A HERETICAL TAX STRATEGY FOR ECONOMIC GROWTH

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Introduction: Public Policies and the Costs of Growth-Generating Activities

Promoting economic growth has long been a byword of public policymakers of all ideologies and party affiliations. For the most part, however, the concept of growth as a public policy goal has not been carefully articulated, nor have the criteria to guide pro-growth policies been spelled out and subjected to critical examination- It isn't surprising, therefore, that even while the emphasis on growth as a policy goal has increased over the last several years, few, if any, public policy initiatives have effectively pursued that objective. Indeed, many policy developments have added new impediments to achieving this goal. A cynical observer may be forgiven for viewing policy makers' self-proclaimed dedication to economic growth as merely rhetoric masking undeviating pursuit of their own agendas.

In fact, however, there has been some modest advance in the policy community's grasp of the concept of economic growth, its sources, and of the way in which public policies affect

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Prepublication excerpt from *Economic Policy, Financial Markets, and Economic Growth*, Benjamin Zycher and Lewis C. Solomon, Eds., Westview Press, 1993.

growth. In the last decade and a half, for example, there has been a growing consensus that increasing the rate of national saving is a key to achieving more rapid growth. There remains, to be sure, a sharp division of views about the means by which public policy can achieve any significant increase in saving as a share of national product — whether the focus should be on aggregate fiscal-budgetary policies to reduce the budget deficit or on changes in the tax structure and spending programs to moderate the saving disincentives facing household and business decision makers.[1]

Nevertheless, the broad consensus that increasing saving contributes to growth is a significant advance over the notion prevailing not so long ago that saving deterred economic progress.

Implicit in the emphasis on increasing saving is recognition that the essence of the growth process is expansion of production capability. Policy makers tend to focus narrowly on saving as the means of financing additions to the stock of physical capital, which they deem to be the critically important element in economic growth. I do not mean to deprecate this emphasis. Increases in such capital contribute directly to potential output, and increases in the capital to labor ratio are needed to help maintain or increase the rate of advance in labor's productivity. In turn, the higher level of labor's productivity is equivalent to an increase in the demand for labor services that when implemented results in increases in-employment, output, and real wage rates.

This perception of the importance of saving in this connection, a commonplace in today's policy forum, represents a huge advance in policy makers' thinking about growth over the view, prevailing in much of the postwar era, that growth is generated by increases in aggregate demand and that growth and associated increases in employment have to be weighed against the increases in inflationary pressures allegedly resulting therefrom.

Largely overlooked by public policy makers, however, is that growth entails real costs -- that increasing production capability requires forgoing alternative uses of time, talents, energies, and other resources. For any person or business, the pace of growth depends on how much additional income and wealth can be obtained by incurring any given amount of these opportunity costs and how much of these costs one is willing to incur today for the gains in future well-being that may be obtained thereby. In a free society, growth of the economy as a whole is determined by the aggregation of these decisions. Because they tend to overlook the opportunity costs of growth-generating activities, policy makers ignore how policy initiatives affect these costs, hence are not mindful of the growth implications, often adverse, of the policies they promote.

[1] Little attention is given, on the other hand, to the effects of regulatory policies and legislated mandates on saving behavior, possibly because these policies are viewed in different terms from those in which the effects of fiscal measures are assessed.

This failure to identify the opportunity costs of growth-generating activities accounts for the inconsistencies, indeed, the incoherence, of public policies. Examples abound, particularly in the area of so-called social policy, where many legislative initiatives have overlooked their effect in raising the cost of labor services, thereby limiting employment gains and the associated increases in output potential. The Civil Rights Act of 1991 and the 1990 Americans with Disabilities Act are prime examples of legislation in the development of which no consideration was given to how these laws would affect employment costs and the employment even of those for whose benefit the legislation ostensibly was intended.

In similar vein, the many and varied legislative initiatives to raise taxes on upper-income individuals either disregard the resulting increases in the opportunity costs of productivity-enhancing efforts or assume that such efforts are substantially unresponsive to their costs. This assumption implies that large shares of the compensation and other income that affluent people receive represent quasi-rents — receipts in excess of the costs incurred to produce them. In some — the most dramatic — cases, this must surely be true.[2] But the compensation of most highly paid people closely approximates the opportunity costs they've incurred to achieve the levels of productivity reflected by their rewards.

Also ignored by policy makers are the consequences for other suppliers of production inputs of any curtailment of efforts or less productive uses of resources by those subjected to high marginal tax rates. The compensation of these individuals is not earned in economic isolation but by the combination of their efforts with various other production inputs- Unless the laws of production have been repealed, any reduction in the inputs of the highly paid reduces the productivity of these other inputs and the incomes of their suppliers.

Given the near-universal conviction that we save too little, it is ironic that in no other case is the failure to consider opportunity costs more blatant and more damaging than with regard to the impact of public policies on private saving. Tax and other policies that raise the cost of saving tend not only to curtail capital formation, but have more far-reaching anti-growth consequences. Saving — the reservation of current income and production resources from consumption uses to acquire sources of income — is essential if a wide range of growth-generating activities are to be undertaken. Research, mineral exploration and development, enhancement of educational attainments and skill training, reorganization of production arrangements, and other activities that add to the productivity as well as the amount of production inputs require reserving the use of production inputs and income from current consumption. Important as it is in expanding production potential, capital formation in the usual sense of additions to the stock of physical production facilities is not the uniquely important use of saving or source of growth. Depressing saving by raising its cost, therefore, has wide-ranging anti-growth consequences.

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[2] It is also true in these cases that their compensation falls short of their actual contributions to the total value of output, the more so the rarer their talents and the more highly specialized their arts or skills.

While tax policy is a prime culprit, other public policies as well raise the cost and depress the amount of private saving. Recognizing that saving is the acquisition of sources of income -of property or rights to property, any public policy that erodes property rights or limits their exercise increases the risk of holding them and reduces the risk-adjusted returns for doing so. Clearly, this must raise the cost of saving and reduce the share of income used for this purpose. Income taxes, of course, directly erode the value of property rights by taking some of the returns thereto; less obviously, so do regulatory policies and government mandates that constrain the acquisition, use, or disposition of property. All such public policies, accordingly, must be seen as inhibiting private saving. That the effects of such policies on the cost and volume of saving are almost entirely ignored in policy formulation is obvious and regrettable.

Taxes and the costs of growth-generating activities

As indicated, the barrier to growth imposed by taxes stems -from their raising the relative cost of growth-generating activities. Every tax, taken by itself, exerts an excise effect, that is, raises the cost of the thing that is taxed relative to the costs of other things. A perfectly neutral tax system would raise the cost of all private sector activities in the same proportion relative to the cost of public sector activities and uses of resources. Such a tax system would to the same degree raise the cost of personal "effort" and of "leisure", of consumption uses of income in the same proportion as saving, of any one consumption product or service in the same proportion as any other, of labor services in the same proportion as the services of capital, of any one sort of labor or capital service in the same proportion as any other, etc. A neutral tax system, in short, would impose a uniform excise on all private-sector economic choices and behavior.

The existing federal tax system, far from imposing a single excise on private sector activity, levies a bewildering array of differential excises. The most obvious examples are the explicit excises imposed on the manufacture or sale of a wide variety of products and services. These excises, however, account for a relatively small fraction of the total amount of federal tax revenues. In fiscal 1992, they are estimated to have produced $46.0 billion in budget receipts, only 4.3 percent of total receipts of $1,073.6 billion. Vastly larger and of far greater consequence for the economy's performance and growth are payroll taxes, amounting to $410.4 billion, 38.2 percent of total estimated receipts. However else one might wish to characterize them, payroll taxes are fundamentally selective excises on the supply of and demand for labor services. Individual and corporate income taxes, estimated to have raised $566.3 billion in fiscal 1992, are a bewildering array of differential excises, imposing widely varying marginal tax rates, depending on a mind-boggling number of variables pertaining to taxpayer attributes and the activities in which the taxpayer is involved.

The overall effect of these differential excises is to raise the costs of growth-generating activities relative to the costs of other uses of resources Clearly, imposing income and payroll taxes on the taxable compensation of labor services while not taxing the nonpecuniary returns of "leisure" uses of time and resources raises the cost of the former relative to the latter.[3] With a combined federal payroll and income tax marginal rate of between (roughly) 30 percent and 43 percent for the vast majority of employed individuals, these taxes raise the relative opportunity cost of labor by between 43 percent and 75 percent. Accounting for state and local income and payroll taxes, the tax-induced increase in the opportunity costs of labor ranges between 54 percent and 92 percent. The higher is the marginal tax rate, clearly, the greater is the impact of these taxes in raising the opportunity cost of effort that is rewarded by taxable income, hence the greater is the cost of productivity-enhancing effort. Graduation of the rates of tax on such income is the equivalent of imposing a system of increasing selective excises on productivity advances.

Even more pronounced is the tax bias against saving compared with consumption uses of income. The prototype income tax includes in the tax base the portion of current income that is saved and the returns on that saving when realized. Some saving by individuals, to be sure, is excluded from the tax base under the existing tax provisions; employer contributions to employee retirement and health insurance plans are the principal examples. And some returns on saving, principally interest on municipal bonds, are exempt from federal income tax. Notwithstanding, most private sector saving is included in the income tax base; so, too, are most of the returns earned by that saving. In addition, most of the saving and its returns are also included in the bases of state income taxes; a significant part of those returns are subject to both individual and corporate income taxes; the capitalized value of much of those returns are subject to state and local property taxes; and some of the accumulated saving is subject to death and gift taxes. In contrast, income that is used for consumption is subject to federal and, with some exceptions, state income taxes and relatively modest sales or excise taxes, but the satisfactions provided by consumption, analogous to the returns on saving, are not taxed.

The differential tax treatment of income that is saved and income that is used for current consumption raises the cost of the former relative to the latter.[4] With the current tax 'structure, taxes raise the cost of saving relative to consumption roughly two and a quarter times. Because saving is required for a vide range of productivity-increasing activities, from adding to knowledge

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[3] Designating the opportunity cost of an hour of labor services as the forgone value = w of an hour's leisure and the combined marginal payroll and income tax rate as t_w, these taxes raise the cost of labor relative to leisure by $1/(1 - t_w)$.

[4] In the absence of taxes, the optimum division of current income between saving and consumption uses would be such that a marginal dollar of income could purchase a dollar of consumption (C) or an income stream with a present value of (R*), equally valued by the income recipient. With an income tax of the present configuration and sales taxes, a marginal dollar of income can purchase $(1-t) of consumption (where t = the overall marginal income plus sales tax rate). With no change in the real yield per dollar of saving, the same marginal dollar of current income obtains a pre-tax income stream with a present value of $R^*(1-t)^2$. But that income stream is also taxed, so that a marginal dollar of current income can obtain a net of tax income stream of only $R^*(l-t)^2$. Hence, the existing taxes raise the cost of saving relative to consumption by $(1-t)/(1-t)^2$, or by $1/(1-t)$.

and production skills to additions to the stock of capital, its treatment in the existing tax system is the equivalent of an extraordinary excise on a major source of progress.

Particularly significant in the global context of economic activity are the barriers the existing U.S. tax system erects to the movement of saving, particularly that embodied in business capital, and business. ventures across national borders. The federal income tax treatment of the costs and earnings of American multinational companies in their foreign business operations is more protectionist than the prevailing trade policy. The North American Free Trade Agreement, while falling short of providing truly open trade borders, reflects a major policy thrust toward removing trade barriers. Nothing comparable is to be seen on the tax front; indeed, many of the tax policy initiatives in this area, from the Tax Reform Act of 1986 (TRA86) on, have aimed at further impeding American businesses' undertaking business in foreign jurisdictions and at deterring investment and business undertakings by foreign companies in the United States.

The inventory of anti-growth features of the existing tax system could be extended at length, but those described above suffice to indicate how steeply that system is stacked against growth-generating initiatives in the economy's private sector.

How consequential is the anti-growth thrust of these features? A widely held view is that neither personal effort nor saving are significantly affected by the perverse excise effects of the existing tax system. In this view, the so-called income effect of increases in real rates of compensation tends to offset, if not, indeed, to outweigh the incentive effect; by the same token, the income effect of cuts in real compensation rates at least offsets the adverse incentive effect. This view is a very fragile basis on which to formulate public policy. The notion that with a given level of wealth, an increase in the marginal rate of tax on the rewards for personal effort, hence an increase in the opportunity cost of that effort, will not reduce the quantity of effort supplied implies something very peculiar, indeed, about the utility systems of the affected individuals.[5]

A similarly perverse view, reflected in the emphasis many public policy makers give tax increases to reduce the federal budget deficit, holds that saving, too, is unaffected by the impact of taxes on its opportunity cost. The presumption on which this view appears to rest is that tax increases reduce only consumption uses of current income, so that private sector saving is substantially unaffected by tax increases while the public sector's "saving" rises or its dissaving falls by the amount of the additional taxes. In the usual exposition of the argument for tax increases, no distinction is drawn regarding which taxes should be raised.

[5] This is not to gainsay that a change in wealth has no effect on the conditions of supply of personal effort. It may well be the case that, other things being equal, the higher is the level of one's wealth, the less is the amount of effort provided at a given rate of real after-tax compensation.

The rationale for this peculiar view is that saving is "interest inelastic." of course, if this is the case, it must also be true that saving is also inelastic with respect to its opportunity cost, the amount of current consumption that must be forgone to obtain a dollar of additional income. But if the cost of saving is raised by increasing the tax on its returns, then the cost of consumption clearly must be reduced. Then if one maintains that a tax-induced increase in the cost of saving and concomitant decrease in the cost of consumption reduces consumption but not saving, one must hold that the higher is the cost of consumption, the greater is its amount. The implication of this notion for individuals' utility functions is challenging, to say the least.

Essentially, this view about individuals' work and saving responses to tax changes is equivalent to asserting that the demand for income is positively sloped — that the greater is its cost in terms of forgone leisure or forgone consumption, the greater is the amount of income people will seek to obtain. By the same token, this view implies that the lower is its opportunity cost, the less is the amount of income people want. It is difficult to conceive a more unappealing view of how people pursue satisfaction.

There is method in the madness of this view. The insistence that saving is unresponsive to changes in its opportunity cost, for example, allows policy makers to give priority to so-called "tax fairness" without perceiving any conflict with the growth objective they espouse. Implementing tax fairness or "make the rich pay their fair share" calls for tax changes that for the most part increase the real marginal rate of tax on saving or the returns thereto. By disregarding the effect of income tax rate increases in raising the cost of saving or by holding that saving is unresponsive to changes in its opportunity costs, tax fairness proponents are free to pursue their redistributive goals without bearing the onus of being anti-growth.

It may not be possible confidently to assess the weight of the anti-growth thrust of the tax system, but surely one can comfortably assert that the economy's growth path is lower than it would be if the tax system conformed more closely with the neutrality standard.

Moving toward tax neutrality

Focusing on how public policies affect the costs of growth-generating activities provides the basis for a pro-growth tax strategy. The objective sought by this strategy is not to promote jobs, saving, capital formation, or any other specific growth-generating activity. Alt is, instead, to seek out the provisions of the existing tax laws that raise the relative costs of these activities and to modify these provisions in order to moderate their excise effects. The key element of this strategy, in other words, is to seek to make the tax laws more nearly neutral — to reduce to the greatest possible extent their distortion of the cost and price relationships that would prevail in efficiently operating markets in the absence of taxation. The strategy eschews the pick and choose approach that is the essence of industrial policy. It does not seek to provide incentives, (read "subsidies"), but to moderate the disincentives in existing tax laws.

What can and should be done to moderate the distortional features of the present tax system? An agenda of major tax changes to this end should focus on reducing the tax-elevated opportunity costs of the activities that contribute significantly to economic progress.

Moderating the tax bias against labor

In view of the fact that labor services account for the preponderant share of total production, moderating the differential cost of labor compared with leisure clearly should be given a high priority on a pro-growth reform agenda. one heroic step, obviously, is to eliminate payroll taxes, hence the existing social security and unemployment insurance systems. Another is to moderate the anti-effort, pro-leisure bias in the income tax.

Reduce payroll taxes

The, socialization of provision for retirement income surely must have eroded private retirement income provisions. Payroll taxes do not finance the acquisition of additional capital facilities the returns on which might provide future retirement annuities. The notion of "social security wealth" is, accordingly, entirely fanciful. So, too, is the rationale for payroll taxes that so heavily burden the supply of and demand for labor services.

It is time, therefore, to initiate a major privatization of social security’s retirement system by (1) reducing payroll tax rates without raising the cap on taxable wages and salaries, (2) reducing the rate of growth in initial benefits of future retirees, and (3) including only the net return on social security "contributions" in the income tax base, and providing more nearly neutral income tax treatment of personal saving, whether undertaken by the individual or by employers on behalf of employees. Ultimately, what remains of social security should be a means-tested welfare system, clearly of vastly more limited scope than the tax-transfer system now in place.

Much the same fate should befall the other elements of the social security system. It is surely timely to move toward dismantling the existing Medicare system, the operations of which are probably the single weightiest source of escalation in medical care costs. It is difficult to find a tenable rationale for requiring people aged 65 and over, irrespective of their income or wealth, to benefit from subsidized medical care, provided primarily by younger people by virtue of their participation in the labor force. Converting Medicare into a component of a means-tested welfare system and providing neutral tax treatment of saving, including that devoted to the purchase of health insurance, would permit substantially eliminating the hospital "insurance" component of payroll taxes.

The unemployment insurance component of payroll taxes, an excise on the use of labor services, also should be scrapped. Unemployment is surely a privately insurable event. The premiums employers would pay for such insurance as part of their employees’ compensation would be highly useful inputs in employees’ decisions about the kinds of jobs they seek and would improve the functioning of labor markets by more accurately pricing the real costs of alternative uses of labor inputs.

Income tax adjustments

One of the principal distortional elements of the income tax treatment of personal compensation is that it makes no allowance for the opportunity costs incurred to produce taxable income. In effect, all compensation is identified as quasi-rents, whereas in truth a substantial part of the compensation represents recovery of the costs of providing the services for which the compensation is received. The supply prices of these services, therefore, are higher than they would otherwise be, with adverse consequences for the amount of them that is employed.

To address this distortion, a deduction should be allowed for recovery of these opportunity costs. 'Their precise identification and measurement for each individuals would be virtually impossible, but partial and rough justice could be done by allowing deductions for education and training associated with one's employment, including the explicit costs incurred to secure promotions or higher-paying positions.

Beyond this, all graduation of ***marginal*** tax rates, whether by explicitly statutory provision, phase-outs of deductions, or other tax base provisions, should be eliminated. overt or disguised marginal rate graduation defies justification in terms of any meaningful social policy objectives. It is, at best, a suboptimal means for reducing income or wealth inequality, even ignoring its adverse effects on the levels of overall income and wealth. It is, moreover, an ethically repugnant way to strive for wealth redistribution, because it announces that one's property rights are less secure the more productive one is. If, notwithstanding, it is believed that tax liabilities should be graduated with income, this result would be better achieved with a flat rate of tax imposed on a correctly defined tax base, with a zero-rate bracket large enough to produce whatever is the desired graduation of ***average*** tax rates.

Moderating the tax bias against saving and investment

Neutral tax treatment of saving implies that the tax does not change the opportunity cost of obtaining the additional income that saving provides relative to the cost of current consumption. The opportunity cost of saving, simply put, is the amount of current consumption that must be forgone to obtain any given stream of additional income, while the opportunity cost of any given amount of current consumption is the additional income that is forgone by not saving that amount. With an income tax, these opportunity costs that would prevail in the absence of taxes are not altered if either (a) income that is saved is excluded from the tax base while all returns on the saving, including the gross proceeds from the disposition of the property rights acquired with the saving, are fully taxed, or (b) income that is save is currently taxed but none of the returns are subject to tax.[6]

Expensing savings and capital outlays

As indicated earlier, the tax treatment of some personal saving satisfies these requirements for tax neutrality. The part of personal compensation represented by employer contributions to qualified retirement plans is not included in the employees' current taxable -Income, but the subsequent withdrawals by the employee of the accumulated earnings and principal are taxed. The tax treatment of Individual Retirement Accounts (IRAs) meets the neutrality standard for the limited amounts of deductible saving by eligible persons committed to these accounts. Saving committed to the purchase of tax-exempt municipal bonds similarly gets neutral income tax treatment. A few other forms of saving receive partially or fully neutral tax treatment. These are exceptions, however. The generally applicable income tax treatment of saving fails the neutrality test by taxing both the income that is saved and the returns on the saving.

Overcoming the income tax bias against saving could be achieved by universalizing and eliminating the limits in the existing IRAs. Indeed, retiring Congressmen Richard Schulze and Ed Jenkins, toward the end of the 102nd Congress, introduced a bill that would allow every individual to deduct any and all amounts contributed to an IRA; withdrawals could be made at any time and would be fully included in taxable income, but no penalty tax for early withdrawal would be imposed.

Not all personal saving would receive this treatment. Payments to reduce mortgage indebtedness, a substantial portion of personal saving, would fall outside the purview of the proposed treatment. So, too, would saving channeled into the purchases of "collectibles." Nevertheless, implementing the universal IRA would go a long way toward eliminating the existing tax bias against personal saving. It would, moreover, substantially eliminate the existing differences in the tax treatment of various saving channels — the so-called second-level differential excise effect.

In essence, the universal IRA approach to providing neutral tax treatment of saving calls for expensing — immediate deduction from taxable income — of outlays for the purchase of property or property rights that produce income of a character that is subject to the income tax. The same principle should apply in the case of business taxpayers' purchases of any and all kinds

[6] With a tax imposed at rate t, a marginal dollar of consumption requires current income = \$1/(1-t). If saving is deductible while the income stream produced by the saving is taxable, to acquire an income stream with a present value of \$1 also requires \$1/(1-t) of current income; no tax is paid on the income that is saved, but tax is paid on the income stream it produces. In the alternative treatment, an income stream with present value of \$1 is not reduced by the income tax, but because no deduction is allowed for its purchase, \$1/(1-t) of current income is needed.

of production facilities, intangible as well as tangible, as well as to all expenses incurred in research and experimentation, in mineral exploratory and development activity, and so on. With expensing, all of the gross income produced by the facilities, as well as proceeds from their sale or other disposition, would be included in taxable income. Equivalent tax treatment would be to require the write-off of such outlays against taxable income over a number of years, provided that the inflation-adjusted present value of the deductions equaled the amount of the outlays. Senators Robert Kasten and Malcolm Wallop and Congressmen Tom DeLay and Vin Weber have repeatedly urged the latter approach to reducing the existing income tax bias against investment in depreciable property.

Expensing or its equivalent would confine the income tax on the returns to capital to the quasi-rents, if any, included in those returns. If the present value of the gross returns produced by the property just equaled the outlay for the property, by definition no quasi-rents would be produced. In this case, the present value of the taxes on the income produced by the property would be just equal to the taxes forgone by expensing of the outlays to acquire it. Only if the present value of the gross returns exceed the capital outlay would the present value of the taxes on those returns exceed the tax forgone by expensing.

Under either of the approaches described above, the income tax would not affect the cost of saving relative to consumption uses of current income or the cost of using- existing production capability to produce consumption goods and services compared with production facilities. Because taxes account for a very substantial fraction of the total returns to saving and capital, the result of moving to neutral tax treatment would be a significant reduction in the service price of capital.

Integrating the personal and corporate income taxes

A significant part of the tax-induced escalation of the service price of capital is attributable to the multiple layers of tax imposed on the earnings of property. One of these extra tax layers, the corporate income tax, imposed on income generated by corporate businesses, is in addition to the individual income tax on (1) the income that was saved and invested in corporations by their owners and (2) the corporate earnings distributed to the shareholders or the capital gains shareholders may realize upon the disposition of their equity interests in the corporations. The corporation income tax, therefore, is appropriately perceived as a selective excise on the corporate form of organizing business activity.

It is difficult to identify any justification for the tax — any significant social purpose that requires it. No useful purpose is served by making it more costly to do business in corporate than in unincorporated form, nor is there constructive purpose served by raising the service price of capital used by corporations relative to that of unincorporated firms. Moreover, because the market mechanism tends relentlessly to equalize returns on saving and capital in all uses, the tax-induced increase in the price of corporate capital services results in a higher service price of capital for all businesses.

The principal rationale that used to be offered for the corporate income tax is that in its absence, individual shareholders would seek to shelter their earnings from the individual income tax by having these earnings retained by the corporation. Preventing shareholders from deferring their tax liabilities on their share of the earnings generated by the corporations they own, if this is deemed to be an appropriate objective, can be accomplished without the adverse effects of the corporate income tax. The means of doing so is to allocate corporate-generated earnings to individual shareholders as the earnings are generated. The mechanics of this attribution were detailed in a Treasury study published in 1977 and have again been examined in the 1992 Treasury study of the issues of separate taxation of corporate income.[7]

The basic objective of integration is to eliminate a separate, additional income tax levy on corporate business-generated income. This objective is often misconstrued in the public policy forum; the focus more often than not is on equalizing the tax treatment of dividends and interest payments in order to eliminate the tax bias in favor of the latter. To this end, the solution that is .generally proposed is to allow corporations to deduct dividend distributions as well as interest payments or to allow shareholder to credit against their taxes on the dividends they receive the amount of the corporate income tax deemed to be attributable to the dividends. An allegedly equivalent approach is to deny the deductibility of interest payments but to exclude both dividends and interest from the taxable incomes of their recipients.

Although any of these alternatives would be a step in the right direction, they fall short of fully satisfying the neutrality requirement. Also needed would be to exclude from the taxable income of shareholders any gains realized on the disposition of their shares to the extent that these gains equaled the accumulated earnings retained by the corporation. The difficulties of implementing this treatment of capital gains on corporate shares are a major stumbling block to the approaches derived from focusing on the bias against equity financing under present law.

Irrespective of the method for effectively eliminating the corporate income tax, achieving neutrality also requires expensing, or-its equivalent, of all business purchases of property for the .correct measurement of corporate-generated taxable income. Failing this, although the tax on the returns on saving channeled into corporate businesses would be less punitive than at present, a substantial tax bias against saving and investment would remain.

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[7] The 1977 study by David Bradford and the staff of the U.S. Treasury Office of Tax Policy, *Blueprints for Basic Tax Reform*, was reprinted by Tax Analysts: Arlington, Virginia, in 1984. The U.S. Department of the Treasury released its study, *Integration of The Individual and Corporate Tax Systems — Taxing Business Income Once* in January 1992.

Substituting value added taxes for business income taxes?

The proposal to replace the present business income taxes with a value added tax has received increasing attention in recent years. In large part, the recent interest in the proposal stems from notions about the allegedly favorable effect of the substitution on the competitive position of American manufacturers in both domestic and foreign markets, but some of the most vigorous VAT proponents emphasize its neutrality with respect to saving and capital formation compared with consumption.[8]

Irrespective of the method of assessing and collecting the liabilities they impose, all so-called consumption-based VATS are imposed on the same base -- the difference between a business's total sales revenues and its purchases from other businesses. The base of the VAT, therefore, is the sum of the business's payroll and its net capital income -- the gross returns to the capital it uses less its capital outlays. The VAT treatment of capital conforms with that called for by the neutrality standard and would, therefore, be free of the bias imposed by the income tax against business use of capital. As a ***substitute*** for the income tax on business income, therefore, the VAT would reduce the overall tax bias against saving and capital. It would not, however, eliminate the personal income tax penalty on saving resulting from taxing both the income that individuals save and the returns on that saving that they receive. Introduced as an additional tax, on the other hand, the VAT would not abate the bias against saving, although it would intensify it less than if additional tax revenues were sought from the present income taxes.

Unless the VAT were to substitute for the personal income tax as well as business income taxes, its favorable effect in reducing the bias against saving would be countered by its intensifying the tax bias against labor. The largest component, by far, of the VAT base consists of compensation for labor services -- payroll and employee fringe benefits, most of which is also taxed under the individual income tax. In contrast, the base of business income taxes does not include employee compensation. Substituting the VAT for business income taxes and leaving the

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8 The allegedly favorable trade effects are naively ascribed to the border tax adjustments that are widely but erroneously perceived to be inherent features of value added taxes. Applying the VAT to imports would not favor sales of domestically produced products (also subject to the VAT) over imported products. Remitting VAT on exports would not affect the terms of trade for products sold at world market prices, although it would permit producers of significantly differentiated products to reduce their export prices, if they deemed this to be an effective marketing strategy. In either case, rebating the tax on exports would increase profit margins on export production relative to production for domestic markets and would induce a shift in the composition of output from the latter to the former. The border adjustments are predicated on the view of a VAT as a tax on consumption rather than, in fact, the equivalent of a proportional income tax on labor and capital incomes. For a discussion of these VAT features, see Norman B. Ture, *The Value Added Tax: Facts and Fancies*, Fiscal Issues 1, (Washington, D.C.: Institute for Research on the Economics of Taxation (IRET) and The Heritage Foundation, 1979).

personal income tax in place would subject labor income to both taxes and enormously increase the opportunity cost of personal effort relative to leisure.

A standard argument on behalf of substituting a VAT for business income taxes is that this would lead to substantial increases in the stock of capital and in the capital-labor ratio, resulting in an increase in labor's productivity, hence in the demand for and use of labor services, and in output and real wages. Overlooked is that by increasing the opportunity cost of labor, the substitution would reduce the supply of labor services. The resulting decrease in capital's productivity would offset, in some part, at least, the decrease in the service price of capital resulting from the substitution. The use of capital services would, therefore, increase less than otherwise and might even decline, resulting in a contraction in total output. In short, the pro-growth implications of the substitution of a VAT for business income taxes requires far more careful examination than its proponents ordinarily undertake.

<u>Revising the tax treatment of foreign source income</u>

Over the last three decades, but particularly as a result of the TRA(86), the tax treatment of the foreign source income of American multinational companies has become extraordinarily complex and has persistently raised the costs of the foreign business operations of these companies. The overall thrust of these changes in the foreign tax provisions of the federal income tax has been to accelerate the payment and thereby increase the effective rate of tax on American businesses' foreign-source income, to curtail the effective deductibility of costs incurred in the production of that income, and through an ever-increasing array of rules for allocating expenses and sourcing income, to erode the credit of foreign tax against U.S. federal tax liabilities, thereby raising the cost of capital committed to foreign operations. During much of this period, in contrast, the tax treatment accorded by many foreign governments to the foreign operations of their multinationals moved in the opposite direction. The consequence has been that as economic borders have widened, with the resulting expansion of the growth opportunities that market expansion affords, American businesses have been at an increasing disadvantage compared with foreign companies in responding to these opportunities.

The current trend in U.S. foreign tax policy is precisely opposite to that called for by neutrality. Recent legislative initiatives would seek to restrict expansion of American business operations abroad, presumably in the interests of confining these operations to the domestic economy. Whether public policy makers subscribe to the principle of comparative advantage in the area of trade policy, they tend to be highly mercantilist in tax policy. The notion on which tax protectionism is based, that the foreign operations of American businesses are at the expense of the operations these companies otherwise would undertake at home, is both bad economics and at odds with actual experience. Indeed, to the extent tax protectionism prevails, it impairs the efficiency and productivity of the domestic economy and lowers its growth path.[9]

The neutrality standard precludes taxing both a business and its owners on the income generated by the business. The implementation of this standard would eliminate the U.S. federal corporate income tax, no matter in what jurisdiction the corporation produced the income. It would not, of course, go beyond this to cancel any taxes that a foreign jurisdiction might impose on the income produced within its jurisdiction by an American business. Application of this "source rule" or territoriality principle, moreover, would remove the results of the American business' foreign operations completely and permanently from the purview of the federal income tax.

The inventory of tax changes to conform the tax system more closely than at present with the requirements of neutrality encompasses a very large number of other issues and provisions of existing law. The preceding discussion should suffice, however, to indicate very clearly the basic strategy that is proposed to deal with any of these other issues, to wit, to identify the features of the tax system that disproportionately raise the costs of growth-generating activities and the changes in those provisions that would mitigate, if not eliminate, their excise effects.

Implementation of any substantial part of the agenda outlined above would, in all likelihood, result in significant reductions in the flow of tax revenues to the Treasury. This result should be identified as a plus, not a minus. For one thing, if the agenda were adopted and implemented, it would reveal a preference among the majority of public policy makers for shifting resources from the public sector's to the private sector's use; by the same token, it would reflect a decision to cut back federal outlays. Secondly, adoption of the agenda would reflect policy makers' judgment that the principal objective of economic policy is to allow the economy to operate more efficiently, to permit the operation of the market system to reflect more accurately the preferences of market participants.

It may well be that even if policy makers were to embrace the agenda and its objectives, they might believe it to be imprudent to implement it until the level and growth of federal spending could be decreased sufficiently to prevent significant increases in annual budget deficits. The agenda nevertheless should serve the highly useful purpose of providing policy makers with guides for future policy initiatives. As such, the agenda might help to deter enactment of

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[9] For a discussion and exploration of the issues in this area, see Norman B. Ture, "Taxing Foreign Source Income," in *U.S Taxation of American Business Abroad* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1975), and Norman B. Ture and George C. Carlson, "Tax Policy to Address The Challenges and Opportunities of the Growing World Marketplace," in *U.S. Foreign Tax Policy - America's Berlin Wall*, IRET Conference Proceedings (Lanham, New York, London, University Press for Institute for Research on the Economics of Taxation, 1991).

additional anti-growth provisions and to permit a better balanced consideration of budgetary and growth considerations.

Pro-growth strategy: a neglected issue

How effective would the implementation of this strategy be in raising the growth path of the U.S. economy? For policy activists, this is always the bottom line question. How big a bang we get for the bucks we have to "spend" on this or that pro-growth policy initiative appears to be the principal criterion applied in policy formulation. It should not be. It implies, mistakenly, that the "resources" whose use is to be economized in a pro-growth policy are federal tax revenues. The implementation of that policy also implies acceptance of subsidizing some activities that contribute to growth, with or without recognition of the fact that doing so necessarily raises the opportunity cost of one or more other activities. At bottom, this approach is industrial policy.

Most simply put, the issue is whether good public economic policy should identify specific measures of aggregate economic performance as appropriate policy goals and craft public policies that give priority to the attainment of those goals. Or should public policy instead be guided by perceptions of the basic attributes of a good society and of the institutional arrangements consistent with these attributes? Should public economic policy formulation be guided by the specific outcomes that are desired and expected or should it rather be guided by some set of principles and criteria that define goodness of policy, divorced from likely outcomes?

It must be avowed that the latter position is far less widely held than the former. Across virtually the entire political spectrum in the United States, indeed, in most of the Western world, the former view is a given; policy debates are framed on the implicit assumption that government can and should use its policy tools to produce desirable economic outcomes.

Overlooked, as a consequence, is the more basic question concerning where responsibility for economic progress should reside. The fundamental, but neglected, reservation about policy activism concerns the desirability of efforts, irrespective of their philosophical or analytical orientation, to manage the economy's performance. Even if we could be far more confident than experience warrants about our ability to design policies that will have the desired economic consequences, do we want to assign that function to government? Industrial policy is governmental control of economic behavior, no matter its objectives.

Nor is the issue properly framed as whether one set or another of demand management policies is more "effective" than one or another mode of supply management in accelerating economic growth or expanding jobs, etc. Industrial policy, in either case, means that public policy makers, not market participants, are supposed to shape market outcomes and the economy's performance. The issue isn't whether public policy makers are up the challenge; it is whether they should be asked to accept it.

Rejecting the control approach identifies a different responsibility for public economic policy. It should be addressed to identifying and eliminating the encumbrances that government imposes on markets. Government responsibility should not extend beyond creating the least distortional set of policies and institutional arrangements. Having done, government should then get out of the way.

Suppose government's presence in our daily lives were much reduced, sufficiently so that market price signals and outcomes were little affected by government policies and activities and much more than now reflected the preferences and the opportunity cost constraints of its participants. Given those suppositions, on what basis should the market's outcomes be a matter of public policy concern? If under those circumstances, the trend rate of growth of total output were to be, say, 2 percent, what would be the justification for government's adopting policies seeking to raise that rate to, say, 3 percent? The government's doing so necessarily would entail costs that, clearly, market participants chose not to incur. In a free society, it is difficult, at the least, to identify any basis for government's overriding market-determined preferences regarding the trade off of future vs. present states of affairs.

The role that I suggest for public policy is not a minor one, given the extent and variety of intrusive policies now burdening the economy, nor is it a negative one. It is a different role, however, from that articulated or at least implied by policy activists, be they Keynesians, monetarists, supply-siders or whatever. It calls for identifying fundamental principles and criteria that are to guide and constrain the relationship of government to private sector entities -- to set a framework that will maximize the opportunity for the market system to perform the basic economic functions in a free society as efficiently as possible.

The question, therefore, about how effective the agenda of tax changes discussed above would be in raising the economy's growth path should be treated as substantially irrelevant. In the contemporary, highly growth-repressive public policy setting, these policy changes are likely to be quite effective indeed, but their desirability should be determined not on the basis of what bang they will give for the buck but, instead, on whether they will allow the market system to perform more effectively.