IRET Institute For Research On The Economics Of Taxation

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TAXES, GROWTH, AND EMPLOYMENT

Statement of
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Mr. Chairman, let me commend the Task Force for holding this hearing. The Congress is in the process of completing an extravagant exercise in fiscal folly, prompted by the President's demand for action on his embarrassingly inadequate program of recovery and growth tax proposals. The President has promised to veto any tax measure that includes a tax increase, presented to him by the Congress. It is certainly to be hoped that he will keep this promise. Moreover, one must certainly hope that he'll veto the bill if it contains disguised tax hikes, not merely if it includes tax rate increases. With the present legislative initiative out of the way, it will be timely to deal soberly and objectively with the question of what needs to be done in fiscal policy to lay the groundwork for the nation's long-term economic progress.

This Task Force can make a major contribution to the development of constructive measures to this end provided it focuses on basics, shunning the glitzy gimmickry that has characterized tax and budget developments following the Economic Recovery Tax Act of 1981. Let me take the liberty of imposing on the Task Force while laying out what I believe are some of those basic considerations.

To begin with, we should make sure that we are focusing on the correct objective. We should not aim at using public policy instruments to control the short-term pace of economic activity. Apart from the fact that we won't succeed, as the historical record clearly shows, any such policy orientation will actually be counterproductive. Cyclical movements in a free market economy are for the most part reflections of corrective adjustments, and they should be allowed to do their work. To be sure, much of those cyclical movements result from counterproductive government activities and policies; attempting to correct for past mistakes, however, reflects just as much as the mistakes themselves an interventionist policy bent. What is needed, instead, are efforts to produce the right policy framework, in the first place, and a resolve to allow the market system to do its thing, given that set of institutional arrangements.

Focusing on the long-term, rather than short-run, aspects of public policy allows us to clarify the concept of economic growth. Economic growth is usefully perceived as the expansion of capacity to produce valued goods and services, not the expansion of gross national or gross domestic product. The changes in GDP are functions of changes in capacity and in the effectiveness and rate of its use. This is an obvious proposition, still frequently overlooked by Keynesians who argue for stimulating consumption outlays as a means of promoting growth, overlooking the consequence for additions to the capacity to produce more products and services in the future. To emphasize the point, long-term growth depends on the expansion of production capacity and the effectiveness of its use.

Productive capacity doesn't consist, of course, merely of plants and machines. It includes, obviously, the labor force, its skill and training levels, the state of the industrial arts, and any number of factors that influence the stock of production inputs and their productivity. Of signal importance in the latter connection is the effectiveness of business firms in organizing production processes.

This brings us to a third basic proposition, viz., that in a free society private businesses are the prime mover for growth. The creation of new businesses and the expansion of established businesses are the vehicles for additions to the stock of capital and for the expansion of employment opportunities. To a very substantial extent, the creation of employment opportunities depends on the capital additions, since increases in the capital to labor ratio are major influences on labor's productivity, hence on the demand for labor services. In turn, additions to the stock of capital — investment — depends on saving — on the willingness of people to save and on the costs they confront in doing so.

Business growth and new business creation the costs confronting business and entrepreneurship. One of the most unfortunate trends of our times is the government-imposed escalation of those costs. Government regulations, government spending, and taxation, no matter how desirable we may perceive the specific policy objectives to be, have exerted greater and greater upward pressure on business costs. Indeed, it is a testimonial to the underlying strength of the free market system and the business community that it has been able to surmount the cost obstacles raised by government policies and actions.

The basic objective of long-term growth policies, therefore, should be to curtail government's role in the nation's economic life. An essential element of that policy must be not merely to restrain the growth of the public sector but to roll it back, as well. Government purchases of goods and services necessarily raise the costs of production inputs and final products and services to the private sector. So, too, in a less obvious way do government transfer payments. Government regulations, too, necessarily make it more costly for businesses and households to undertake their activities. Every tax ever devised raises the cost of something compared to other things, hence not only raises private sector costs but also distorts their relationships. Achieving higher levels of production potential requires scaling back business costs by reducing the scope and limiting the character of the public sector's presence in our economic life.

Major changes in the cast of federal tax policy would make an enormously important contribution to reorienting public policy toward long-term growth objectives. The guide to framing those tax changes should be to conform the tax system as closely as possible to the neutrality criterion, i.e., to eliminate to the greatest possible extent those tax provisions that distort the relationships among prices and among costs that would result from the operations of an efficient free market. To this end, tax policy should not be concerned with promoting investment and job creation; it should, instead, focus on removing government-imposed distortions of private individuals' decisions about saving, investing, employment, etc. Similarly, tax policy should avoid the "what gives us the biggest bang for a buck" approach. That approach almost invariably fails the neutrality test. It implies acceptance of subsidies and leads to an industrial policy cast of public policy.

Last fall, I presented to a conference jointly sponsored by the National Federation of Independent Business and IRET an agenda of tax changes that I believe should be the core of an effort to remove public policy impediments to economic growth, efficiency, and competitiveness. Let me offer that agenda to this Task Force for its consideration.

Payroll tax rate reduction

One of the major impediments to growth, market efficiency, and international competitiveness is the artificial escalation of unit labor costs resulting from government policies. Payroll taxes are major offenders in this regard. They increase the employer's total compensation costs, hence curtail the amount of labor services demanded by employers. At the same time, payroll taxes raise the price that employees demand for their services, thereby curtailing labor supply. It is impossible to reconcile payroll taxes that impose these excise effects with the widely-professed desire by public policy makers to improve the competitive position of American business in the world market. Payroll taxes should be reduced, as proposed in the DeLay-Wallop tax package.

Individual saving provisions

The tax bias against saving in the existing income tax can and should be eased by various tax changes such as Senator William Roth's Super IRA proposal or the Bush Family Saving Plan and by substantial liberalization of employer-provided pension plans, including 401(k) provisions, enhanced flexibility of self-employed health insurance plans and more flexible arrangements for employees' health insurance deductions, etc. Neutrality in the income tax treatment of saving and consumption calls for either excluding from income subject to tax income that is saved while fully taxing all of the gross returns on the saving, or including income that is saved in the tax base while fully exempting from tax all of the returns on the saving. The Super IRA and the Family Saving Plan are of the latter variety; the exclusion from employees' taxable income of employers' contributions to retirement income plans conforms with the former approach to providing neutral tax treatment of saving. Limits on the amount of employees' income that may be saved in this way and excluded from taxable income are arbitrary and should be eased, if not eliminated. Employers' contributions on employees' behalf to health insurance plans necessarily represents saving by the employees, hence should not be included in the employees' current taxable income. Consistency with the neutrality standard, however, would appear to require the inclusion of insurance proceeds in the employees' taxable income.

Reduction in marginal tax rates on capital gains

Neutral tax treatment of saving, as explained above, calls for the complete exclusion of capital gains from taxable income, given the fact that the saving invested in capital assets was subject to tax. Not only does taxing capital gains violate the neutrality criterion, it also distorts the signals cast up by the financial markets and impairs the efficiency with which these markets operate by immobilizing capital assets. As a first step toward neutrality in this respect, the rate at which capital gains are taxed should be significantly reduced. To prevent the effective rate from escalating thereafter, the basis of capital assets should be indexed by the inflation rate. Senator Bob Kasten has introduced legislation to reduce the top capital gains tax rate to 15 percent and to index capital asset bases.

An alternative approach to moderating the tax bias against saving in this regard would be to provide rollover treatment for capital gains, deferring the tax on realized gains to the extent they were reinvested in other eligible assets, reducing the basis of the new assets by the amount of the deferred (indexed) gain.

Improved capital recovery provisions

Tax neutrality requires expensing of outlays for depreciable business property or equivalently multiple year deductions in amounts such that the present value of the deductions equals the amount of the costs incurred to acquire the property and put it into use. The ACRS provisions and the increase in the investment tax credit enacted in 1981 roughly approximated expensing for a wide variety of depreciable property. TEFRA in 1982 rolled back much of the benefits of the 1981 legislation, and TRA86 repealed the investment credit and further curtailed ACRS. Since 1981, the tax law has moved in the wrong direction with respect to production facilities.

Although expensing may not be a feasible option for the near future, the equivalent of expensing would be afforded by the so-called "neutral cost recovery system." First proposed by then Congressman Jack Kemp and Senator Bob Kasten in 1985, neutral cost recovery calls for writing off capital outlays over a period of years in annual deductions the present value of which equals the amount the capital outlays. The pattern of such deductions could be set in any number of ways, subject only to the constraint that the discounted value of the deductions equals the price paid for the property. Under this approach, moreover, the unrecovered basis of the property would be adjusted each year for inflation.

Particularly at a time when so much emphasis is mistakenly given to minimizing revenue losses, this approach to reducing the tax bias against investment in depreciable property has much to commend it. The principal drawback in this approach is perceived to be its failure to generate large increases in cash flow in the early years after the acquisition of such property.

Even if expensing or its extended period equivalent is rejected, a number of other reforms would at least move the tax treatment of depreciable property in the right direction. One possibility would be to provide a significant <u>additional</u> first-year deduction for capital outlays. The deduction might be 100 percent of the first, say, $200,000 of capital outlays in the taxable year, plus, say, 10 percent of any outlays in excess of $200,000 in the year. An alternative approach might be to maintain the present write-off schedules for depreciable property and to provide a significant additional deduction when the property is retired and replaced. Neither the additional first-year or terminal year deductions should be treated as a preference item for alternative minimum tax purposes.

<u>Provide expensing of research and development outlays</u>

R and D outlays differ from other capital outlays primarily with respect to the greater risk their undertaking involves. In the usual case, a substantial amount of such outlays result in no direct income-generating results. For this reason, requiring the write off of R and D outlays over some specified period of years is entirely arbitrary. For R and D as for investment in depreciable property, tax neutrality calls for expensing. While it may be feasible in the case of depreciable property to approximate expensing with extended period write offs, as suggested above, it more difficult to do so in the case of R and D. As a first step, therefore, some significant fraction of R and D expenditures, say 50 percent, should be expensed. Short of this, the R and D credit should be made permanent and should apply to all R and D outlays, not merely to incremental expenditures.

Reduce the alternative minimum tax

The alternative minimum tax on corporations, enacted as part of TRA86, is in effect a special additional excise on corporate business growth. In most cases, AMT is triggered by additions to the company's stock of depreciable assets, because the capital recovery allowances for ordinary tax purposes exceed those allowed for AMT purposes during the first several years after the property is acquired. The ordinary tax capital recovery allowances, as pointed out above, are a retreat from neutral tax treatment of investment in depreciable property; the AMT allowances are wholly arbitrary. This anti-growth excise effect should at the least be moderated, by drastically reducing the AMT rate or by substantial modifications in the designation of preferences, particularly in the case of capital recovery allowances. It would be desirable, for example, to replace the AMT system of capital recovery allowances by those used for ordinary tax purposes, so that significant capital outlays would no longer trigger the AMT's imposition.

Repeal the passive loss limitation provision

TRA86 imposed highly punitive limitations on the deduction by upper-income individuals of so-called passive losses, i.e., losses incurred by an individual as an investor who does not take an active role in the conduct of the business in which the investment is made. The limitation was aimed primarily at limited partners in real estate syndicates. The ensuing sharp decline in the real estate industry and the resulting collapse of a very large number of thrift institutions demonstrates clearly just how effective the limitation has been in curtailing mobilization of the savings of the targeted individuals for investment in such ventures.

There is no justification in principle for distinguishing between active and passive investment activity and for differentiating the tax treatment of the results of the investments. There is still less of a case in principle for limiting the deductibility of so-called "passive investment" losses merely on the basis of the adjusted gross income of the investor. The passive loss limitation provision not only violate the tax neutrality canon but also represent indefensible class legislation. The provision should be repealed.

Simplify the tax treatment of inventory accounting

Tax neutrality calls for expensing of business purchases for additions to inventories of stock in trade, raw materials, and work in process. TRA86, however, moved in the opposite direction by requiring the capitalization and write off over a period of year of a number of inventory elements. At the least, the TRA86 changes should be repealed, and efforts should be made to shift from the cost-of-goods-sold approach to expensing. Expensing would not only conform with neutrality, but would also eliminate the complexities involved in adjusting for changes in the price level.

Reduce estate and gift taxes

On neither tax policy nor economic policy grounds does there appear to be any justification for the imposition of taxes on the transfer of property by gift or at death. The traditional rationale is that such taxes are desirable, if not absolutely essential, in preventing undue accumulations of wealth and economic power. There is little empirical evidence that these taxes ever were significant in this regard. In any event, any such rationale lies beyond the basic canons of taxation that should be adduced in the formulation of tax policy. Moreover, in the contemporary economic environment, gifts and inheritances are insignificant elements in the accumulation of personal fortunes and are inconsequential elements in the determination of the locus of economic power.

Despite the fact that these taxes are minor revenue raisers, accounting for only one percent of Federal budget receipts in recent years, they do violate the neutrality criterion and exert significantly adverse economic influences. These property transfer taxes are additional layers of tax on saving. Admittedly, their effect in increasing the relative cost of saving is modest for young individuals; the cost effect increases, however, with the age of the individual and the approach of the time at which accumulated saving will be transferred to a donee or an heir. The inducements these taxes provide to arrange otherwise inefficient transfers, to liquidate business enterprises prematurely, to sell family-held businesses to publicly-held corporations, etc., are additional distortions attributable to these taxes.

The tax reform agenda should include one or more measures to reduce the presence of these taxes, leading eventually to their complete elimination. Initial steps might include a significant increase, perhaps a doubling, of the unified tax credit (now $600,000) and a reduction in both the number of tax brackets and the top tax rate (now 55 percent). The large number of estate brackets with upward-graduated rates produces a degree of progressivity that is functionally useless. Moreover, because the amount of the transferred property is the capitalized amount of the future income generated by the property, the top rate imposed on the transfer should not exceed the top individual income tax rate.

An alternative, conceptually more appealing method of initiating reform in this area would be to provide a kind of rollover treatment of property transferred by gift or at death. Estate or gift tax would be deferred so long as the transferred property remained in corpus in the recipient's hands; the property's basis in the recipient's hands would be the same as it was for the transferor; and the capital gains rollover treatment, if adopted would apply to gains realized by the transferee upon disposition of the transferred property.

Repeal or modify TRA86 foreign tax provisions

TRA86 made extensive and drastic changes in the tax treatment of the income derived from foreign operations of U.S. multinational companies. These changes not only made this tax treatment extraordinarily complex, thereby greatly increasing compliance costs, but also significantly increased the cost of capital employed in the foreign operations. Moreover, the reasons given for the changes conform with no acceptable criteria relevant to the taxation of foreign-source income. In an era of expanding economic opportunities in a broadening world market place, it is difficult to rationale the imposition of new and substantial tax barriers to effective competition by U.S. businesses with foreign competitors, both at home and abroad.

The tax neutrality standard articulated above calls for excluding entirely from the purview of the federal income tax the income or losses sustained by American businesses on their foreign operations. This territorial principle should have guided the changes made in 1986 in the foreign tax provisions, given the then rapidly growing perception of the competitive disadvantages of U.S. businesses. TRA86, however, moved in the opposite direction. A further change in direction is called for in the interests of tax neutrality and to reduce the tax-imposed limitations on the ability of American businesses to compete with foreign businesses.

Realistically, the territoriality approach is not likely to be adopted in the near term. It should serve, however, as a guide to changes that should be made in the foreign tax provisions. Interim reform measures should include repeal of the TRA86 multiple basket treatment of differing types of foreign earnings, expense allocation rules, and the expanded reach of the Subpart F provisions. Remaining tax barriers to U.S. companies selecting low-tax jurisdictions in which to undertake their foreign operations should be critically examined, looking to their early repeal or modification.

Initiate efforts to integrate the individual and corporate income taxes

One of the major violations of the neutrality criterion in the existing income tax is the imposition of the income tax on income generated by corporate businesses, in addition to taxing corporate distributions to individual shareholders and capital gains these shareholders may realize upon disposition of their equity interests. The corporate tax represents an additional layer of tax on earnings that in economic reality are those of the individual shareholders. The long-standing rationale for the corporate income tax is that in the absence of the tax, individuals would use the corporation as a means of sheltering their earnings from the individual income tax. The answer to this, of course, is to allocate corporate-generated earnings to individual shareholders as those earnings are realized. That such allocations can be made without significant increases in complexity or compliance and administration-enforcement burdens was demonstrated by David F. Bradford and the U.S. Treasury Office of Tax Policy staff in *Blueprints for Basic Tax Reform* (Tax Analysts: Arlington, Virginia, 1984).

Complete elimination of the corporation income tax is not a realistic prospect for the near term. Progress toward this end, however, can be initiated as part of the tax reform agenda. One step in this direction is the proposed change in the tax treatment of capital gains. A companion measure would be to provide for the deduction by the corporation of dividends paid with respect to net new issues of its common stock.

This program will cut tax revenues substantially, even allowing for substantial revenue gains from the resulting economic expansion. These revenue losses should not be seen as a drawback to the program. Policy makers should not feel constrained to seek "revenue neutrality," one of the most insane tax policy constraints ever fashioned. On the contrary, the revenue losses should be identified as the occasion for dramatic cutbacks on the spending side of the budget, a goal to be sought on its own grounds. This would violate the 1990 budget agreement, of course. Instead of being embarrassed by that accusation, policy makers ought to come out in favor of discarding one of the most egregious bits of budgetary flummery every perpetrated on the American public.