IRET Institute For Research On The Economics Of Taxation

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

FEDERAL TAX POLICY AND THE U.S. ECONOMY: POLICY OPTIONS FOR IMPROVING BOTH

Statement Presented by Norman B. Ture, President
Institute for Research on the Economics of Taxation (IRET)
to the Joint Economic Committee
March 13, 1997

Mr. Chairman, members of the Joint Economic Committee, I am Norman B. Ture, president of the Institute for Research on the Economics of Taxation (IRET). IRET is a tax-exempt public policy research organizations focusing its research efforts on analyzing the effects of tax, budget, and other public economic policies on the effectiveness with which the free market system operates.

High on our research agenda for 1997 and beyond is restructuring of the federal tax system.

WHY TAX RESTRUCTURING?

The simple answer to this core question is that the existing tax system, evaluated against appropriate principles and criteria, is widely deemed to be unacceptable. There is a rapidly broadening consensus that the existing system has erected major obstacles to economic progress, although the how and why of these adverse tax effects on growth are not widely understood. There is a well-nigh universal consensus that the existing tax system is unfair, but it is not clear what people really mean when they make this charge. A standard complaint about the system is that it is terribly complicated and that it imposes extraordinarily high costs of compliance, administration, and enforcement. For a substantial number of taxpayers who receive significant amounts of their incomes in the form of returns on their saving and investment or who have complex compensation arrangements with their employers this is certainly true, but for the preponderant number of individual income taxpayers, compliance burdens are relatively slight.

Almost entirely overlooked by critics of the existing system is that it miserably fails to perform the core function of taxation for a free society — to inform the body politic about what they must pay for government's activities and services. Our prevailing fiscal system obscures rather than informs us in this regard. Financing some government outlays by borrowing conceals and understates what we have to pay for government programs; little wonder that we don't more successfully resist growth in programs. The taxes we rely on, moreover, are of such a character and are imposed in such a way that we are little aware of paying them, let alone in what amount. I am confident that no one in this room knows what amount of the federal corporate income tax he or she paid in 1996. How much federal gasoline excise did you pay last year or for that matter the last time you filled your tank? I suspect that a fair number of the people present had 1996 incomes high enough to have topped out on their FICA bills and given a few moments, could figure out how much their payroll tax amounted to last year, but I doubt that many of us remember our income tax liability or could reconstruct the amount before the close of business today. In short, we pay a huge amount of taxes every year and because of the nature of those taxes, we are not acutely aware of how much we pay.

To recap briefly, we have a tax system that interferes with our economic progress, that we believe to be unfair, that we are convinced is complicated and costly to live with, and fails to perform the key function of a free society's tax system. It would seem obvious that we should be about the business of replacing it. Examination of the deficiencies in the existing system should persuade us that we need to focus on fundamentals and shun the long-standing nickel-and-dime "reform" approach that, each time it is undertaken, has made our tax system worse, not better.

Permit a brief digression in this respect concerning the current agenda of tax "reforms" proposed by the Administration. Ostensibly, the long list — more than 50 — of proposed corporate tax changes are aimed at closing prevailing corporate tax "subsidies," but analysis reveals that each of the proposed changes is in fact a grab for additional federal revenues and each will increase the cost of saving and investment, hence would intensify the anti-growth impetus of the existing tax structure. I offer the Committee a prepublication copy of a paper produced by my colleague, senior economist Dr. Michael Schuyler, that provides a rigorous examination of several of the most counterproductive of the Administration's anti-saving, anti-investment tax proposals.

One might hope that if these $80 billion of anti-growth tax increases are to be pushed as part of the Administration's five-year budget policy, there would also be included therein some major tax initiatives that would address the fundamental deficiencies in the existing tax system. Instead, we are offered a new round of "targeted" tax cuts. The Administration's tax policy people appear to have lost sight of the well-nigh universal consensus that the long-standing pick and choose tax favors and tax penalties approach to tax legislation is largely

responsible for the dissatisfaction that so strongly urges scrubbing the existing system and starting from square one to produce a tax environment that would conform with basic principles and criteria of an acceptable tax system. The Administration's tax policy proposals should be summarily rejected; Congressional tax policy initiatives should be based on a careful identification of those principles and criteria, to which I now turn.

GUIDING TAX PRINCIPLES

Effective Performance of the Core Function of Taxation

Achieving an acceptable tax system requires relying on clearly specified tax principles, instead of on ad hoc suggestions reflecting the particular interests of one or another group of taxpayers. However appealing may be the notion of reducing the taxes to be paid by families with children of a given age or less, there is no principle of taxation that validates any such targeted tax change. Enacting this sort of tax change creates new barriers to basic tax restructuring and inevitably leads to modifications and additional complexity. The Congress should turn its back on this proposal as well as on the various proposals for tax subsidies of higher level educational outlays by families in specified economic circumstances. The Congress needs to make a statement opposing targeted tax revisions and in favor of tax initiatives that address the basic deficiencies in our existing tax structure.

To this end, the Congress should seek to make the tax system a more effective device for pricing government. As indicated earlier, the core function of an acceptable tax system in a free society is that it effectively informs the public about what must be paid for the services and activities of government. The first principle to be observed, therefore, is that the tax should be imposed only on real people, since determining that any of the total tax revenue to be collected should be collected from corporations or other organizations inevitably conceals that tax burden from the individuals who ultimately bear it. A corollary to this basic rule is that corporations or other organizations would not act as payers of the tax liabilities of their owners, for even though the burden of the tax would rest on the owners, their perception of that burden would be diminished by its discharge by some other entity.

A collateral rule to be observed is that the tax should not be confined to the so-called affluent; the largest possible proportion of the population should be called upon to pay some tax; only the truly destitute should be excluded from taxpaying responsibility. Finally, the tax should be so designed that each of us is acutely conscious of paying it. Abiding by this stricture precludes relying to any significant extent on sales and excise taxes, as well as on taxes paid by others on our account.

Equity

For most people, the instinctive response to the question "what is a fair tax?" is one in which all people are treated the same. This is, of course, a woefully unsatisfactory response because it tells us nothing about what "the same" is for people whose circumstances differ, nor does it even help us to understand what differences in circumstances should be relevant variables in determining our tax liabilities. In tax policy formulation, such questions are seldom confronted. The bottom line question almost invariably is what will such or so a tax initiative do to the distribution of tax liabilities by income level, hence what will it do to the distribution of after-tax income? The fact that we have no adequate data or methods of analysis with which to answer these questions has not deterred policy makers from initiating legislative changes that often are vigorously anti-growth, hence act to accentuate economic inequality, all in the interests of tax fairness.

In my judgment, this approach affords no useful guide to providing for fairness in taxation. The underlying premise is that inequality among our citizens in the distribution of income, wealth, or any other significant economic magnitude is per se unfair. I can’t think of any analytical basis on which to rest such a judgment. Validating this approach to tax fairness requires two things, one — persuasive evidence that poor people are poor because rich people have taken their — he poor’s — substance, and two — persuasive evidence that redistributive fiscal policies succeed in leveling out income and wealth. The first of these propositions is challenged by the facts of life in a free society. With very few exceptions, the income a person receives and the wealth he or she accumulates closely matches what that person has contributed to the economy’s total output and income. Rich people are rich because they are more productive than people who are less rich, not because they’ve deprived the poor of the income or wealth they’ve earned. Policy makers should give themselves the luxury of contemplating the possibility that it is highly unfair to tax away a larger portion of the income of the productive rich in order to transfer income to the less productive, less rich.

What the most basic economics tells us is that if we wish to increase the income and wealth of those who have little, we must find some way of combining their productive efforts with a greater amount of more productive capital, be it machinery, equipment, and other nonhuman capital or of the more or less productive human capital that the individual begins to accumulate at the time of birth.

A far more satisfactory approach to the principle of tax fairness should be derived from the basic prescripts for a free market economy. First among these is that taxes should to the least possible extent violate each person’s property rights. It must be recognized that this proposition is very much a contradiction in terms, since every tax is an exaction rather than a free, voluntary exchange of property rights among willing transactors. Nonetheless, recognition of this basic flaw should constrain tax imposition. At the least, it should militate

against increasing the rate of government confiscation of property rights on the basis of how productively these rights are used.

Second, an operational equity principle should be based on recognition of the constitutional principle that all of us stand equally before the law. Differences in our productivity should not be inputs in determining a more or less favored position in our standing with respect to any issue of the acquisition, use, or disposition of property. With respect to taxation, this principle argues that each of us should bear the same percentage tax obligation, rather than increasing obligations as our contributions to society's total output increases.

Minimize Costs of Compliance, Administration, and Enforcement

Complaints about the complexity and the resulting compliance burdens of the income and payroll taxes probably exceed in frequency and magnitude those about the unfairness of the income tax. Estimates of compliance costs in terms of dollars of the time and paper work dedicated to compliance run into the hundreds of billions of dollars. The point at issue, however, is not how much we and the Internal Revenue Service must spend to comply with, administer, and enforce the law. It is, rather, whether the results we get provide a sufficiently accurate measure of our taxable income and tax liability to warrant incurring those costs. Few, if any of us, would confidently answer in the affirmative.

The common assumption is that these compliance and administrative costs are generated by oppressive rule-making by IRS officials. In fact, they are the fall-out from legislative enactments, for which the IRS has the responsibility to translate into rules of compliance. If the statutory provisions are vague in substance, one must expect that the regulations produced by the IRS to implement them will leave many taxpayers floundering in attempting to determine whether they are in compliance.

The fundamental source of the difficulty is that the statutes are written without the benefit of close and clear definitions of what is to be taxed and how that is to be measured. Nowhere does the Internal Revenue Code define income or offer any conceptual guides to what is to be treated as taxable income and what is to be allowed as deductions or other offsets thereto. Instead, the approach is to provide an ever-expanding, ever-changing list of revenue items and expenses that are taken into account on the basis of other attributes of the taxpayer.

The consequence of this approach is that many people whose income is principally compensation for labor services confront little complexity, except with respect to tax accounting for those compensation elements that are retirement saving. Roughly two-thirds of individual income tax returns rely on the standard deduction and obtain virtually all the

information needed to complete the return from the W-2 the employer provides. The major compliance burden for these taxpayers arises from their assuring themselves that the standard deduction rather than itemized deductions will minimize their taxes.

In the case of business taxpayers and those receiving some substantial fraction of their incomes as returns on their saving and investment, complexity results from the enormous variety of transactions and activities that generate income. Lacking any basic definitional rules, the policy approach has been to tailor the law to the greatest degree possible to every possible variation in situation, taxpayer attribute, type of transaction, etc. The result is a jumble of statutory provisions and regulations that defy business, saver, and investor capability to determine whether they are in compliance with the law.

Minimizing compliance, administration, and enforcement costs, all of which are dead weight, should be a major goal of tax restructuring. Achieving that goal, in turn, requires defining the base of the appropriate tax to replace the existing revenue measures.

Neutrality

Much of the impetus for basic tax restructuring during the last several years has reflected the conviction that the existing system, with its emphasis on income and payroll taxes, has imposed major roadblocks to economic growth. Much of the policy discussion has focused on eliminating the income tax and replacing it with one or another consumption tax. Underlying this position is the observation that the national saving rate — the fraction of our total output and income reserved from consumption and used to add to our stock of capital — is too low to provide an acceptable rate of increase in productivity, employment, and real income. The inadequacy of national saving, moreover, is attributed in very large part and with much justification to the biases against saving and investment that are inherent in income taxation.[1]

More fundamentally, the problem is not the reliance on income and payroll taxation, but the fact that these taxes distort the relationships among prices and costs that would otherwise result from the operations of an efficient market system. The consequence is that individuals are misinformed about the opportunity costs for saving — reserving part of their current incomes from consumption uses in order to acquire sources of additional future income. Similarly, both the income and payroll taxes tell people that producing additional income by the use of their labor services — more accurately, their human capital — requires

[1] An exposition of the anti-saving, anti-investment, as well as of the anti-effort bias of income taxation is presented in Norman B. Ture, "The Economic Effects Of Tax Changes: A Neoclassical Analysis," in 96th Congress, 2nd Session, Joint Committee Print, *Special Study on Economic Change*, Volume 4, Joint Economic Committee, December 17, 1980, pages 322-328.

them to incur a greater cost in terms of foregone "leisure" uses of their time, energy, and resources. Minimizing this tax non-neutrality — distortion of relative prices — should be a major target of tax restructuring, but it doesn't call for scrapping the income tax. Instead, it calls for clearly defining the concept of income to be embodied in the tax.

The most compelling reason for this position is that all taxes, no matter their name, are paid out of income. We may choose to design taxes so that liability for their payment is triggered by some particular kind of behavior, e.g., buying a tankful of gasoline, but the tax payment comes out of income, no matter the occasion for the payment.

For reasons discussed earlier, it is essential to define income correctly for tax purposes. Income consists of the claims generated by production activity, by the use of production inputs to produce valued products and services. Clearly, the aggregate amount of income claims generated by production activity and the market value of the total output of products and services must always be the same.

For income tax purposes, the correct concept of income is readily derived from this basic proposition. One obtains income only as a reward for providing production inputs. The amount of that reward is the plain common sense concept: all of one's revenues less all of the costs one necessarily incurs to produce those revenues. Where the revenues come from, what kinds of costs must be incurred to obtain them, attributes of the revenue or cost generator are irrelevant considerations for purposes of defining income.

Moreover, this concept of income dictates that revenues and costs are taken into account when they are incurred, not spread over time in a mistaken effort to match the timing of the one against the other. Thus, in measuring the amount of income generated in a business enterprise on behalf of its owners, the amount the business spends for machinery, raw materials, additions to inventory, labor services, research and development, etc., should be deducted in full when the outlays are made. By the same token, the revenues received by the business should be taken into account at the time of receipt irrespective of when they may be deemed to have been "earned." The reader may recognize that so far as timing is concerned, the proposed concept of income conforms with the so-called "cash flow" tax, and rejects the generally accepted accounting principles approach that underlies so much of the complexity in the existing income tax.

Clearly, a major cost of obtaining revenues is forgoing the use of current income for current consumption purposes, instead using that income to purchase income-producing assets. This saving, therefore, should be deductible as of the time it is undertaken, irrespective of the form it takes. By the same token, consistent with the basic income concept, all returns produced by this saving should be included in revenues for tax purposes. No capital gains provisions would remain in the tax law; the full proceeds from the sale or other disposition of

assets would be included in revenues. Insofar as these revenues are reinvested, i.e., saved, they would be deducted from revenues in arriving at taxable income. In short, the proposed restructured tax would provide for automatic roll-over of investments.

The proposed concept of income excludes neither the revenues nor the costs associated with financing a business or household activities. Thus, proceeds from borrowing or from the sale of an ownership interest in a business should be included in revenues at the time of their receipt, while service of any such debt and payment of dividends should be treated as deductible expenses at the time the payments are made. The form of the debt service and/or dividends should have no bearing on the tax treatment.

As indicated and stressed earlier in this discussion, businesses and other organizations would not be tax paying entities under this restructured tax. Insofar as they generated income, as defined above, these organizations would assign the income to individual owners. As under present law, many businesses, guided by the preferences of their individual owners, would choose to retain some of the net income, as defined above, that they generate. By definition, such earnings retentions are saving that would be used by the business to increase its revenue-generating capacity or to stem a decline in revenues. In either event, the tax consequences would be exactly the same as if the individual owners had received the net revenues from the business and had chosen to reinvest the same amount as the retained earnings.

Only revenues and costs generated in the United states would be taken into account in determining the amount of income generated by U.S. businesses. This territoriality treatment is called for by the effort to implement the neutrality standard far more fully than under present law.[2] Moreover, because no tax is to be imposed on the business per se, attempting to impose the tax on individual owners of companies producing income in foreign jurisdictions would produce the very sort of complexity the restructured tax seeks to eliminate.

No so-called "border adjustments" — rebating the tax on exports and imposing it on imports — would be provided under this restructured income tax. For one thing, such adjustments make no sense in a tax that is imposed only on individuals. More fundamentally, in a tax on income as defined herein, the source or destination of products and services has no relevance for measuring the amount of income the individual produces and receives.

---

[2] For a detailed, technical examination of the territoriality issues, see Norman B. Ture, "Taxing Foreign-Source Income," in *U.S. Taxation Of American Business Abroad*, American Enterprise Institute for Public Policy Research, Washington, D.C., 1975.

During the tax restructuring discussions of the past few years, much was made of the question of allowable tax deductions, concentrating mostly on the charitable contribution, mortgage interest deductions, and other itemized deductions. The mantra was to maximize the size of the tax base. Far more appropriate, of course, is to define the tax base correctly, irrespective of the deductions, credits, etc., doing so might call for. A basic tax principle leads to quite a different set of answers about such deductions. The principle is that one should not pay tax on income over which one does not retain control. Everyone is familiar with the proposition that one shouldn't pay taxes on taxes. Neither should you include in your taxable income amounts such as alimony, child support payments, or damages that a court of law has ruled you must pay to someone else. If you choose to give some of your income to some one else, you should exclude that amount from your income and the recipient should include it in his or her income.

This principle dictates that charitable contributions must be deductible. When you make such a contribution, you give up control of the donated income and assign it to someone else. The recipient of the contribution should take it into its income, but except under extraordinary circumstances is likely to spend these revenues on deductible research, wages, and other costs, including the donations and gifts it makes to its beneficiaries. Many of the beneficiaries, of course, would be too poor to owe tax.

CONCLUSIONS

Whether the desirability of a completely restructured federal tax system is as urgent as many of us believe is a matter for the Congress to resolve. There is, in my judgment, a very high price to be paid in either rejecting the difficult chore of constructing a new tax system or in fudging the job with nickel and dime revisions. That price may be delineated in terms of a fiscal system that every day further relaxes the constraints on government's preemption of our production resources and that every day intensifies the distortions of the market's price signals, resulting in less and less efficient use of our production capabilities. One of the major, least understood consequences thereof is the erosion of our property rights and the effectiveness with which we use them.

The price is too high to regard with equanimity. What brings people like me to bear witness to the Committee is the hope that we can persuade you to act on the basis of principles that you deem to be appropriate for a free society.