Reforming or Transforming the Federal Tax System: (A Review Essay)

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ABSTRACT. Several proposals to reform the *federal income tax system* are under active consideration. Professor *Richard W. Lindholm* has proposed instead that we abolish the *individual and corporate income taxes* and the *estate and gift taxes.* To replace the lost revenue he proposes a flat 15 per cent *value-added tax* and a flat 2 per cent *net wealth tax.* He posits five goals for successful *tax reform* and discusses his proposed system in terms of them. He finds his system would be simpler and less disruptive of markets than even a simplified income tax structure.

FEDERAL TAX REFORM is again in the center of American political debate. Three major packages have been proposed recently: Bradley-Gephardt, Kemp-Kasten, and the Treasury plan announced by the then Secretary Regan. Each proposal would reduce the number of exemptions, flatten the rate structure, and reduce rates. The primary intent of each plan is not to increase the revenues of the government, but to reduce the tax implications of economic decisions and to restore the logic of the market to resource allocation. However, each plan would maintain individual and corporate income taxes as the mainstay of federal finances along with payroll taxes to support social security programs.

There is increasing evidence that Americans no longer believe the tax system is fair. They point to loopholes benefiting someone else and want them closed. However, closing loopholes sounds better in the abstract than when a specific plan is presented for consideration ("Simpler Tax Plan Threatens Middle Class, Taxpayer Panel Says," *Wall Street Journal,* December 12, 1984, pp. 1 and 28). Each loophole is in the present system to remedy a market failure, to encourage risk-taking or to improve the equity of the system. For the current fiscal year these "tax expenditures" will amount to $370 billion compared with combined individual and corporate income tax revenues of $415 billion. Certainly closing of loopholes would allow sufficient broadening of the base to substantially lower rates and maintain revenues.

What are the chances for such a logical and timely adoption of a tax reform and simplification package which has support from a spectrum of interests from Ralph Nader groups to the Reagan administration? Not good, according to most press reports, because most of the tax expenditures are received by

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powerful, vested interest groups at the upper income levels and by those at the lower income levels who are most likely to be adversely affected by budget cuts. The middle class, which primarily enjoys tax benefits of home-ownership, sees the reform movement as a smokescreen for a tax increase which would fall mainly on them. This reluctance of the middle class to support reform is especially perplexing to reform advocates who point out that only one-third of the taxpayers itemize deductions presently. Also, incentives, even for homeownership, built into a progressive rate structure grant greater effective benefits to those subject to higher rate brackets. If we really wanted to spread the benefits of homeownership to those now excluded, rather than financing higher quality homes for the rich, we would use our tax revenues to build houses for the poor. Direct expenditures would be no more expensive than tax expenditures as a means to cure this "market failure," and would be more effective.

The Lindholm Plan

WITH ALL of this built-in resistance to reforming the present structure, Professor Richard W. Lindholm has a better idea. In his new book,[1] Professor Lindholm[2] proposes that we abolish the individual and corporate income taxes and the estate and gift taxes. He would replace the lost revenues by enacting a comprehensive value-added tax (VAT) and a net wealth tax. According to Professor Lindholm, among the beneficial effects of the new system would be a tax base broad enough to allow low rates and stable revenues. Low rates would reduce the effect of tax considerations on economic decisions and stable revenues would reduce the need for constant tinkering with the tax system. Lindholm believes the present narrow base, high rates and unstable revenues amplify the business cycle rather than mitigating it. Our best attempts to induce investment and consumption during a recession and curbing spending during inflation have been worse than ineffective; they have been one of the major causes of 'stagflation'—inflation accompanied by decline or no growth in the economy and by high unemployment. As a result, neither monetary nor fiscal policies can be effective in stabilizing the economy. The result has been more uncertainty for decision-makers and greater government deficits. Rather than simply discouraging savings, the system has diverted creative talent away from production to accounting, law and finance. The way to stimulate savings is to stimulate income through production. Tax planning does not create income (which is the source of savings), it simply directs the use of savings toward loopholes.

Professor Lindholm estimates that we could maintain the present level of revenues with a flat 15 per cent value-added tax rate ($265 billion in 1983) and a 2 per cent flat rate on net wealth ($60 billion in 1983). Revenues would increase in the future as we re-direct resources away from tax planning to production. To his credit, Lindholm does not suggest that the budget can be balanced with the current level of revenue. The budget submitted by the Reagan administration for fiscal year 1985 estimated 36 per cent of the revenues would be derived from individual income taxes; 8 per cent from corporate income and 29 per cent from payroll taxes. This is compared to 20 per cent from borrowing. Moreover, if all but the top four functional categories of expenditures (defense, social security programs, interests on the debt and income security) were totally eliminated, savings would amount to $187 billion compared to an estimated deficit of $180 billion. Clearly the government must raise more revenue than the eroded income tax base will generate without prolonged controversy over reform. Lindholm believes his proposed system could generate the extra revenue with only slightly higher rates since his tax base is considerably broader than the existing one.

The Goals of Tax Reform

PROFESSOR LINDHOLM SAYS successful tax reform must meet five goals (pp. 111–112).

> First, the number of general taxes in use cannot be increased. Second, the complexity of compliance must be substantially reduced. Third, the rich and powerful must bear relatively heavy taxes. Fourth, the tax base must be as stable or more stable than the general economy. Fifth, the tax system cannot make a higher net return necessary if investment is to be made.

In terms of the first goal, his system is obviously successful. He would abolish three taxes and create two new ones. The estate and gift taxes are probably more troublesome to the taxpayer than they are worth at present and projected collection levels. The corporate income tax is quickly approaching that point with collection levels in the last few years about equal to collections from excise taxes. The major reason for maintaining the corporate income tax is to prohibit the rich from avoiding taxation of income retained by the corporation. All recent proposals to integrate the corporate and individual tax systems have failed, and the proposal in the current Treasury plan to partially integrate the two taxes is one of the more controversial elements of that plan. Coupling these remarks with the experience of countries that have a value-added tax and a net wealth tax would support his claim that the complexity of compliance would be substantially reduced.

It is in his third goal of maintenance of progressivity that Professor

Lindholm will have to provide more evidence to satisfy his critics. Representative Conable cities evidence that the present system is considerably more progressive than perceived. He states that the top 10 per cent of the taxpayers pay 50 per cent of the aggregate individual income taxes, while the bottom 50 per cent pay only 10 per cent (*Wall Street Journal,* December 7, 1984, p. 22). Professor Walter W. Heller, one of the critics of the value-added tax, wrote the following. "Regressivity: without a complex set of refundable credits—food exemptions won't do it—VAT would cause a one time jump in inflation and might become embedded in wage/price decisions." ("A Rocky Road to Tax Reform," *Wall Street Journal,* November 28, 1984, p. 32).

Professor Lindholm presents arguments and data from countries that have a value-added tax to refute the contention that it will cause a one time jump in inflation. "The data, however, are not sufficiently complete to say definitely that VAT introduction, whether as a replacement tax or as an additional revenue-raiser, increased or reduced price levels" (p. 132). He also argues that the value-added tax has been wrongly labeled a consumption tax. "The VAT is a tax on production required to make a good or service a part of the economic process from man-made production to man enjoyed consumption" (p. 130). That is, of course, true, but it seems to me that the flat rate structure would take most of the progressivity out of the system. Lindholm argues that spending policy rather than tax policy should be the major instrument for helping the poor. The net wealth tax is probably progressive even at a flat rate because, "It is estimated that 50 per cent of the people above 25 years of age in a typical Western industrial nation are without wealth in the conventional sense" (p. 170). However, the net wealth tax would raise $60 billion compared to $265 billion from the value-added tax. Also it would seem that taxable wealth would be equally as difficult to define as taxable income. Professor Lindholm devotes considerable space to a discussion of these difficulties.

On the fourth goal, the stability of the tax system, it is clear that a broad-based system is more stable than a narrow one. To the extent that we could prevent erosion of the new base, his structure would provide more stable revenues. Some macroeconomists might want to debate the desirability of a goal of stable revenues rather than fluctuating revenues to stabilize the economy, but perhaps it is time to have that debate. Current fiscal policy tools are not particularly well-designed to cope with 'stagflation.'

In terms of the fifth goal, to avoid discouragement of investment, his plan has several advantages. First, unlike the corporate income tax which is really a profit tax, the value-added tax is a tax on all the factors of production. Moreover, the income tax penalizes the manufacturing sector of the economy.

It pays 47 per cent of the income tax but would pay 25 per cent of the value-added tax. All other sectors except wholesale trade and finance would pay a larger share under the value-added tax. For example the service sector would pay 15 per cent compared to 3 per cent under the per cent system (pp. 150–151). The net wealth tax should provide an even greater incentive to productive investment. Since the taxpayer must have sufficient income to pay the tax, he would be discouraged from holding assets in the form of gold or art objects which get their value from scarcity, and be encouraged to hold wealth in the form that would produce use value.

In addition to these five goals, Professor Lindholm wants a tax policy that will not continue to penalize the U.S. *vis-à-vis* our trading partners. "When the United States does not have a VAT and its trading partners do use a substantial one, U.S. exports must overcome a border tax equal to the VAT of the importing country but an equal border tax cannot be levied on imports" (p. 142). Given our growing trade deficits and the increasing importance of the foreign sector in our economy, it is time we give international trade considerations their due weight in tax policy debates.

Professor Lindholm also believes that his plan will give states more options in dealing with the evolving fiscal federalism. This will be an increasing concern since any future budget cuts will fall heavily on state-local governments if defense and social security continue to be off limits to budget cutters. The recent budget cuts have already hit federal assistance to state-local governments disproportionately.

This book is rich in detail about the evolution of our income tax structure, and the constitutional debates over the definition of indirect and direct taxes, and the treatment of this distinction in our national income accounts. No review can do justice to these discussions, but they are important to his argument that we should transform rather than reform the federal tax system. Professor Lindholm is an outstanding student of the tax systems of the U.S. and our major trading partners. His plan deserves to be placed on the table for discussion along with proposals to simply reform the present system.

Notes

1. Richard W. Lindholm, *A New Federal Tax System* (New York, N.Y. 10175: Praeger Publishers, 1984, pp. 223, cloth, $23.95).

2. Dean emeritus and professor of finance, College of Business Administration, University of Oregon and director, Regulation Study Center, University of Oregon. Member, Committee on Taxation Resources and Economic Development (TRED). He is co-author with Hartojo Wignjowijoto of *Financing and Managing State and Local Government,* editor of *Property Taxation and the Finance of Education* and co-editor of *Land Value Taxation: The 'Progress and Poverty' Centenary.*