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THE NEW THEOLOGY OF TAX POLICY: REFORMATION OR HERESY

BRUCE F. DAVIE

A great deal of public attention has been given this fall to the 500th anniversary of the birth of Martin Luther. This quintcentenary has provided an opportunity to reflect upon the great watershed in western theological thought that occurred at the beginning of the 16th century. My own reflections lead me to conclude that there are significant similarities between the current state of what I regard as the theology of tax policy and the theological debates of the early 1500's. What better place to discuss these issues than in what, by American standards, is an ancient university, a university founded at a time when theology was at the center of all learning. After all, the separation of the study of law and economics from the study of theology as distinct educational enterprises is a relatively modern development.

Most of us in this room formed our theological views about tax policy in an era when a singular view was universally held and not subject to any significant intellectual attack, just as the peasants and princes of the 15th century held a single view of the relationship between man and God. We grew up with a set of widely shared beliefs regarding the appropriate normative features of a tax system. We were taught that an income tax is the only fair tax because it is based upon ability to pay. We learned that a broad base, low rate tax is a better way to raise a given amount of revenue than a narrower base with higher rates. Tax law should enable taxpayers to determine their liability with certainty so as to reduce compliance costs and render the law easily administrable. Those of us who went to different types of Sunday schools—law, economics, accounting, political science—all studied the same catechism. There was a revered set of texts. At the economics Sunday school I attended, it all started with Adam Smith who was, after all, a professor of moral philosophy. Admittedly, the emphasis was different in the different schools. Economists emphasized the advantages in terms of efficient revenue allocation of a neutral tax and the fortuitous Keynesian characteristics of an income tax in terms of automatic economic stabilization. Accountants worried about the proper matching of income and expense and the differences between tax accounting and financial accounting. Lawyers got lost in the application of these general principles to complex transactions such as mergers and acquisitions. Political scientists seemed interested in the impact of a progressive income tax on the distribution of political power.

I refer to these shared beliefs about "the good tax" as a theology of tax policy because the fundamental principles lying behind these beliefs

—such as the ability to pay concept—are not subject to empirical verification. They are essentially articles of faith.

During the past 20 years or so, the theology of tax policy that we grew up with has been shaken both by events and by ideas, just as both events and ideas shook accepted doctrine in the early 16th century.

First, regarding events. The institution of the investment tax credit in 1962 was a major event in this history. This was not simply an overlay of Keynesian economics on top of accepted tax policy. It was not simply a tax cut designed to stimulate aggregate demand. Rather, the investment tax credit was intended to be nonneutral, to favor investment in machinery and equipment over investment in housing and commercial real estate. The tax system was being used for a purpose quite separate from raising an appropriate amount of revenue. The second major event was more in the nature of a pervasive phenomenon, the inflation that began in the latter 1960's and continued at a faster and faster rate during the 1970's. Tax scholars began to discuss and dispute the ways in which the mechanics of the tax system might be adjusted to fit an inflationary world. Most of that discussion was, however, within the confines of traditional tax theology—how to adjust capital cost recovery provisions, how to treat interest payments and indexation of the rate structure. The third event, again in the nature of a phenomenon, was the disappointing performance of the American economy during the 1970's, both in absolute terms and by comparison with that in other countries. Accusing fingers were pointed at the tax system.

What began with the investment tax credit continued apace. Using the tax system to address economic and social problems quite unrelated to raising revenue became fashionable. Inflation caused an unindexed tax system to generate Federal receipts at a faster rate than the nominal rate of growth of the economy. Adjustments were periodically made to eliminate what was called "fiscal drag." The tax reduction bills of the 1970's did more than adjust rates and other basic parameters of the tax system for inflation. Part of the "inflation bonus" was spent out in the form of special credits, deductions and exclusions. Over the period, individual income taxes as a percent of personal income, as measured in the GNP accounts, remained roughly constant at around 10 percent. Effective marginal tax rates, however, began to creep up as the base was narrowed. In an attempt to keep track of what was happening, the tax expenditure budget was invented. Indeed, the whole tax expenditure concept is rooted in the old theology of a normative income tax. Tax expenditures are defined as all the exceptions to that normative structure. The 16th century analogy to the proliferation of tax expenditures is, I suppose, the selling of indulgences.

Public attitudes toward the income tax eroded over the decade of the 1970's as measured by the annual opinion survey conducted by the Advisory Commission on Intergovernmental Relations. When asked,

“Which tax do you think is the worst tax, that is, the least fair?”, thirty-five percent of respondents in May of 1983 said the Federal income tax. In 1972, the figure was only 19 percent.¹

Now with respect to ideas. Reformations in theology may be influenced by events but it is ideas that matter most. A new theology of tax policy is being developed, mostly by academic economists,² though many business groups have found this new body of thought compatible with their own, more parochial views of tax policy. This new, normative view of tax policy is that consumption rather than income is the desirable tax base. In the most simple case, such a tax could take the form of a national retail sales tax or a value-added tax on the European model. To meet equity objectives, a progressive expenditure tax could be adopted. The administration of such a tax would be very similar to that of the income tax. An annual return would be filed. Net saving would be deducted from income (along with presumably other allowable deductions) to determine the expenditure tax base. If net savings were negative, that is, if borrowing and the drawing down of existing assets exceeded current saving, that amount would be added to income to determine the tax base. Personal exemptions and standard deductions could easily be incorporated into such a System. Either a flat rate or a set of progressive rates could be applied against the expenditure tax base.

The proponents of consumption-based taxation argue that, unlike an income tax, such a tax would have a neutral impact on the decisions of households to consume currently or to save for future consumption. An income tax, it is argued, biases that decision in favor of current consumption, thus tending to retard savings and investment. Consumption-based taxation is said to promote faster economic growth. Indeed, this result can be demonstrated with theoretical rigor. Despite the theoretical sophistication with which a consumption-based tax can be modeled, or econometric investigations of the responsiveness of savings to after-tax rates of return undertaken, this new normative view of tax policy is, like the older view, essentially theological. The primacy of economic growth rather than fairness as the ultimate test of good tax policy is not a proposition subject to empirical verification.

The proponents of consumption-based taxation are quick to point out—and they are quite right—that many important features of our current tax system are entirely consistent with their normative precepts. Two important examples will suffice. Present law treats most savings for retirement through qualified employer pension plans, Keogh plans and IRAs in precisely the same way savings would be treated under a

¹ *Changing Public Attitudes on Governments and Taxes*, Advisory Commission on Intergovernmental Relations, Washington, D.C., 1983.

² For a good review of the debate, see Joseph A. Peckman, Ed., *What Should Be Taxed: Income or Expenditure?*, The Brookings Institution, Washington, D.C., 1980.

consumption tax. No tax is paid on the contributions to a pension plan and the interest build-up on pension funds is tax-free. When funds are withdrawn (presumably to finance consumption during retirement) they are taxed. The combination of present law ACRS deductions and the investment tax credit are the economic equivalent of expensing for most investments in tangible personal property. Expensing is fully consistent with a consumption tax because it sets the tax rate on income from new investment at zero.

Whether or not the arguments of the reformers move out of academia and into the broader arena of public debate remains to be seen. The Reagan Administration has floated a couple of trial balloons lately suggesting that in 1985 they may propose a major change in taxation, moving toward a consumption tax. A presidential proposal would touch off a broad debate on the merits of alternative tax structures, particularly if made in the context of raising revenue. (The conventional wisdom in Washington at the moment is that 1985 will be the year when a major package of tax increases and spending cuts will have to be enacted to reduce Federal deficits.) The question of whether the new theology of tax policy is to become a genuine reformation or is a mere heresy, would these be joined.

My own view is that when a proposal to make a radical shift in Federal tax policy away from income taxation to a consumption-based tax is put to the test of public opinion, the answer will be heresy. I think the issue should be put quite simply. Consider two couples both consuming \$25,000 per year. The income of the first is also \$25,000 from the earnings of both spouses, but the income of the second is \$100,000. Let's suppose this second couple is enjoying an affluent retirement, including the use of consumer durables acquired over a lifetime. Should these two couples pay the same tax, as they would under a consumption tax, or should the second pay more as under an income tax? If the issue is put that way, I believe most Americans will prefer to stick with an income tax. This fundamental value judgment is quite apart from all the other issues raised by a full blown expenditures tax such as transition rules, treatment of housing and education expenses, and treatment of gifts and bequests. Once the debate begins, we will no longer be comparing our current income tax, with all the warts it has collected over 70 years, with a theoretically pure consumption tax. Proponents of radical change will be obligated to spell out the details of their proposal.

It is quite possible then that 1985 will be the year when the new tax theology is tested in the political arena. If so, let me draw the historical analogy to the 16th Century to a close by reminding you that the Reformation was followed by a counter reformation, an inquisition, and 100 years of religious war. As tax practitioners, you may well find yourselves to be canon fodder in the war.