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The Tax Reform Now Passing Through Congress Evades the Issue Of Fairness …The Political Issue of Tax Reform Will Not go Away

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from the not-so ivory tower

By Hyman Minsky

A tax reform is about to pass the Congress and the President has indicated he will sign the bill. The reform which once was hailed as the greatest thing to hit our economy since sliced bread is now recognized as a flawed effort. It is well understood that it will not make any substantial difference, one set of loopholes for the rich will be replaced by another.

In truth the measure was never a serious effort to modernize the tax structure. It was a political gimmick that distracted attention from the obvious failure of the 1981 tax "reform" and the economic stagnation that set in two years ago. This administration has been a master of puffery, blowing its measures up as fundamental changes, even as the substance is either empty or quite crassly serves the special interests of the rich.

Tax bill unfair

The 1986 tax bill avoids facing the basic tax problem created by the 1981 legislation, revenue inadequacy. It is blatantly unfair for it further shifts the burden of taxes away from the rich. It will not alleviate either our deficit in international trade or in the governmental budget. It does nothing about our worst tax, which is the euphemistically labeled employer's "contribution" to social security. It increases the corporate income tax, which may be second only to the employer's "contribution" for social security in its delilterious effect upon the economy. It sharply cuts back the most meaningful contribution to economic rationality of the 1981 tax bill, the individual retirement accounts.

This is the second tax reform of the Reagan era. The first in 1981 embodied what George Bush had correctly called Voodoo economics when he campaigned against Reagan for the Republican nomination in 1980. The first Reagan tax reform reflected the strange supply side belief that lower tax rates would lead to such a great rise in incomes that the total tax revenues of the government would increase.

'81 reform created deficits

We now know that this supply side view on taxation was wrong. The tax reform of 1981 resulted in the greatest peace time deficits in the country's history. Supply side economics doubled the national debt in five years. Government spending on interest has increased by more than the much heralded savings on welfare. As far as balancing the budget and meeting our nation's needs, the 1981 tax changes made things worse not better.

Because our economy is inherently unstable, the Federal government needs to be at least 20 percent and perhaps as much as 25 percent of gross national product in order to contain tendencies for crises and depressions to develop. Because all debts, including the national debt, draw their value from the revenues of the debtor, the tax system of a heavily indebted country must be at least conditionally balanced.

Deficits, which are necessary and desirable when the country is in recession, must be accompanied by a tax structure that would lead to a balanced budget when the recession is over. This means that the tax structure that is in place must be designed to yield a balanced budget if the country is at a target level of employment and a surplus if the target level of employment is accompanied by inflation. From the end of World War II until the 1981 tax bill, our budgets were always conditionally balanced, although because of recessions and incidents like Viet Nam deficits predominated.

It has long been accepted that ability to pay is a key to tax fairness. This principle reflects the common sense idea that a billionaire can pay proportionately more in taxes than an ordinary worker.

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Progressive tax no barrier

A progressive income tax, which increases the tax rate as income increases, is the fairest of taxes. Our country's greatest prosperity, during the first two decades after World War II, was achieved while the income tax was progressive. As we all know the progressive income tax was not a barrier to the growth of private fortunes in the four decades since the end of World War II.

The flaw in the progressive income tax that was "reformed" in 1981 was that the brackets had not kept up with the general rise in incomes due to inflation, and the indexing of government spending meant that inflation did not lead to government anti-inflationary surpluses. Furthermore, as the government percentage of Gross National Product grew because of the maturing of the welfare programs and the expenses of the cold war, it became politically impossible to raise the revenues needed for the conditionally balanced budget by the income tax. It is now evident that the progressive income tax needs to be supplemented by other taxes in the current political environment.

The employees "contribution" to the Social Security Fund is a flat partial income tax. It begins at the first dollar of wage income and halts at some moderately high income. Because of the Social Security tax, the income tax rate paid on wage income is higher than the rate on income from property and, at the cut off income, the rate dips.

The employee's "contribution" to social security should be fully integrated into the income tax. A flat tax on all incomes with progressive surtaxes that begin at the incomes where the present income tax begins is a straight forward way to integrate social security and income taxes. If necessary, a fiction can be maintained that 7.5 percent of some part of wage income is the comprehensive social security tax. If this is done, all wage income up to some designated level could be the basis for benefits.

There is a great deal of confusion about the value added tax. For each business the difference between sales revenues and the cost of purchased materials is the value added. This value added is divided into wages paid and various types of "profit" incomes (interest, rents, dividends and retained earnings). A value added tax is a percentage tax on wages and profit incomes.

Replace employers' tax

The employer's contribution to social security is a tax on the value added by labor, it is a tax on hiring labor. It promotes the substitution of capital for labor, it tends to increase unemployment. A value added tax would be even handed between hiring labor and using capital. In meaningful tax reform, a value added tax would replace both the employers contribution to social security and the corporate income tax.

The corporate income tax is recovered in prices. It is not a tax on capital. The only economic reason for a corporate income tax is that corporations can be used as devices for evading the personal income tax. Either an undistributed profits tax or the full imputation of per share earnings to the stockholders for calculating the personal income tax would be far superior to what we have and what the pseudo reforms of 1986 will bring us.

There is little doubt that the economy has been more stable and grown more consistently since World War II than in the first 40 years of the 20th century. This success has largely been due to the much greater role of government in the economy.

For big government to be successful in stabilizing the economy, tax receipts need to pay for the interest on the government's debt. This is not true with the current tax system and the "reformed" tax system Congress is about to pass. The need to pay the Government's bills implies that income taxes will need to be high enough so that they "hurt." A successful tax system will need to include indirect taxes like the value added tax as well as a progressive income tax.

The tax reform now passing through Congress evades the issue of fairness and neglects to supplement the income tax with other broad based taxes. The political issue of tax reform will not go away until a tax system is in place that will pay for the needs of a late 20th, early 21st century society. ■

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Income taxes must be high enough so they hurt.

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