TAX REFORM UNVISITED: THE NEED FOR AN ACADEMIC VOICE

Roger L. Lirely, Western Carolina University

ABSTRACT

The number of tax reform proposals that would scrap our current federal income tax system and replace it with an alternative system continues to grow. Despite the proliferation of major tax reform proposals, research from finance and accounting professionals on the impact of proposed research is scant. The author briefly discusses some of the more popular proposals and identifies research questions that academic researchers need to address.

INTRODUCTION

Recently I heard a radio advertisement encouraging taxpayers to call a toll-free number and voice their support for a “fair” tax. The ad, placed by an organization called Americans for Fair Taxation, advocated a national sales tax to replace our current federal income tax. Because my research interests include tax equity and efficiency, I have more than a passing interest in what others think constitutes a “fair” tax. To satisfy my curiosity, I accessed the organization’s web page the following morning. The web page is both impressive and comprehensive. One can read position papers that analyze the impact of a national sales tax on wages, the underground economy and tax evasion, interest rates, the stock market, various industries, tax fairness, households, charitable giving, agriculture and numerous other economic factors.

The voices calling for major tax reform and/or replacement of the federal income tax continue to increase both in numbers and in volume. Congress has heard the call. For example, on June 17, 1998, the House passed the Tax Code Termination Act (H.R. 3097). The following day the Senate referred the Resolution to the Senate Finance Committee for consideration where, it is quite possible, it will die in committee and never come before the Senate for a vote. Nonetheless, H.R. 3097 is only one of 8 bills introduced in Congress since September 1997 which calls for terminating the current Internal Revenue Code. There appears to be a growing interest in replacing our current progressive income tax system with an alternative system.

Neither H.R. 3097 nor any of the other bills contain specific proposes for an alternative system. The Resolution merely states that “…any new Federal tax system should be a simple and fair system and should:

- Apply a lower tax rate to all Americans;
- Provide tax relief to working Americans;
- Protect the rights of taxpayers and reduce tax collection abuses;
- Eliminate the bias against savings and investment;
- Promote economic growth and job creation; and
- Not penalize marriage or families (H.R. 3097, Sec. 3a).

Despite the absence of a specific proposal in the Resolution, there are proposals to replace the current tax system that have received considerable political support.

In 1996, the American Institute of Certified Accountants and Martin A. Sullivan published *Changing America's Tax System: A Guide to the Debate* (AICPA and Sullivan, 1996). The stated purpose of the book was to introduce interested parties to the various approaches to replacing our current income tax. The authors provided an in depth discussion of some of the major alternatives to the federal income tax including a national retail sales tax, a value-added tax, the Armey Flat Tax Plan and the Nunn-Domenici Unlimited Savings Allowance (USA) Tax. Although the authors cover a broad range of topics, they cautioned that their discussion does "not do justice to the enormous issues involved in totally revising federal tax policy (AICPA and Sullivan, 1996, at 182)." They concluded their discussion with a number of questions that they felt needed to be addressed and/or researched, including a number of issues that are clearly the within the domain of accounting and finance academics. Nonetheless, nearly three years after AICPA and Sullivan and despite growing public and private support for revamping of the federal income tax system, there remains a dearth of accounting and finance research regarding alternative tax systems.

The purpose of this comment is to challenge accounting and finance academics to enter the tax reform debate by undertaking research that addresses the questions raised by AICPA and Sullivan. I start by briefly reviewing the four alternatives discussed in AICPA and Sullivan and two others, the Specter Flat Tax and the Gephardt 10 Percent Tax. Second, I reiterate the questions posed by AICPA and Sullivan that are as yet unanswered. I conclude with a "call for research," an invitation to accounting and finance academic researchers to lend their expertise and voice in the considerations to revamp the U.S. system of taxation.

THE ALTERNATIVES

There are myriad proposals to reform or replace our current tax system. Because most of the proposals do not tax income, but permit business to deduct compensation, they are variants of a consumption tax. Because consumption, rather than income, is taxed, consumption taxes generally exempt savings and investment from taxation. The Gephardt 10 Percent Tax is an income tax rather than a consumption tax but represents a major departure from our current tax system in a number of important ways.

Armey Flat Tax

The Armey Flat Tax plan (H.R. 2060, S. 1050), sponsored by House Majority Leader Richard K. Armey (R-TX) and Senator Richard Shelby (R-AL), is based on the Hall-Rubushka flat tax proposal (Hall and Rubushka 1995). The plan would replace the individual and corporate taxes with a business tax and an individual tax, both imposed at a single rate of 17 percent. The individual tax would repeal all existing tax deductions and credits except standard deductions and personal exemptions, which would both be increased to the point where a family of four would pay no tax until their combined incomes exceeded $31,400. Because the plan would exempt interest, dividends and capital gains, only labor income and pension distributions would be taxed.

The business tax would apply to all businesses not just corporations. The tax would be imposed on business revenues reduced only by cash wages and contributions to qualified retirement plans and cash purchases from other businesses. Although business would lose deductions for fringe benefits and interest payments, payments for plant and equipment acquisitions would be deductible in full in the year of acquisition.

Specter Flat Tax

The Specter Flat Tax plan (S. 488) is also based on the Hall-Rubushka proposal, but differs slightly from the Armey plan. The Specter plan would impose a slightly higher rate, 20 percent as opposed to 17 percent, for both individual and business incomes and would offer lower standard deductions and personal exemptions. These modifications enable the Specter plan to retain modest deductions for charitable contributions and home mortgage interest.

National Sales Tax

Senator Lugar (R-Indiana) and Representative Hefley (R-Colorado) have proposed replacing the current income tax system with a national sales tax (S.Res. 16, H.R. Res. 111). Although a detailed legislative proposal has not been introduced, Senator Lugar has suggested that a tax rate of about 17 percent, with minimal exemptions, would be sufficient to replace the federal income tax. There are no details as to what goods or services would be exempted.

Nunn-Domenici USA Tax

The Unlimited Savings Account Act of 1995 (S. 722), sponsored by Senators Sam Nunn (D-Georgia) and Pete Domenici (R-New Mexico), would replace the current tax system with two separate tax systems. The tax on individuals would be similar to our current income tax but would allow deductions for unlimited new savings, child support paid and certain educational expenses, while eliminating deductions for state and local taxes, medical expenses and interest on home equity loans. Withdrawals from savings, child support received , fringe benefits and life insurance proceeds would be taxable. As proposed, the plan would create a three-tiered tax rate structure.

A European-styled subtraction-method value-added tax on all businesses would replace the corporate income tax. The bill would retain most accrual accounting concepts of current tax law regarding the timing of business receipts and expenses. The tax would be imposed at a rate of 11 percent on business gross profits, which the act generally defines as the excess of taxable business receipts over business purchases.

Gephardt 10 Percent Tax

House Minority Lead Richard Gephardt (D-Missouri) estimates that about 75 percent of households would pay taxes at a flat rate of 10 percent under his proposal. The Gephardt plan would eliminate all tax deductions except those for ordinary and necessary business expenses, home mortgage interest, alimony, half of self-employment taxes, investment interest and employee business expenses. Further, the plan would essentially eliminate all credits (the earned income credit is a notable exception), preferential tax rates and exclusions. Gephardt proposes a five-tiered tax rate schedule with rates ranging from 10 to 34 percent.

THE NEED FOR ACCOUNTING AND FINANCIAL RESEARCH

AICPA and Sullivan (1996) identified numerous issues regarding revising our tax system that are deserving of further research. They categorized the issues as questions for or concerning (1) tax administration, (2) state and local governments, (3) businesses, (4) households and (5) economic issues. Of particular interest to accounting and finance academics are the questions for businesses and households.

Questions for businesses that should be addressed by accounting and finance academics include questions regarding (AICPA and Sullivan, 1996):

- business compliance including changes in recordkeeping and reporting requirements, new information needs, computer software requirements, staffing changes and retraining, and the implementation costs of these changes;
- the possible need to reconfigure multinational operations where current tax rules are a determinant of the current configuration;
- business organizations and reorganizations under new tax system that would not discriminate between organizational forms and would not tax capital investment;
- debt/equity structure if interest on indebtedness becomes nondeductible;
- employee remuneration issues if fringe benefits become taxable;
- the need to restructure deferred compensation/pension plans if all savings enjoy tax exemption.

Household issues in need of further attention and/or research include (AICPA and Sullivan, 1996):

- the need to alter financial planning if taxes play a reduced role in choosing between investment alternatives;
- the impact of tax revision on gift and estate taxation and estate planning;
- the need to revise charitable contribution behaviors if charitable contributions are not deductible;
- the effect of non-deductible state and local income and property taxes on relocation decisions of both businesses and individuals.

There is also a need for input from accounting and finance researchers in other areas. For example, questions remain unanswered regarding the administration costs of the proposed taxes. Research needs to investigate mandated changes in audit procedures and how federal audits would be coordinated with state and local audits and ongoing federal audits under current law. Another extremely important area is examining the effects of federal tax revision on state and local tax systems. Without a federal income tax return as a starting point, states may need to revise forms and instructions and information reporting procedures. Under the current tax system, the federal government shares compliance information with state and local governments. Without information sharing, states may have to implement new audit and collection procedures to maintain current levels of compliance.

CONCLUSION

The clamor for tax system revision practically ensures that Congress will enact some type of major tax reform within the foreseeable future. The danger for academics in accounting and finance is that the reform will become a reality without our input. We cannot let this happen. I urge my colleagues to join me in educating ourselves about the alternatives and then undertaking serious empirical research that addresses some of these unanswered questions. As academics, we can learn and shape tax reform now or learn and teach tax reform later.