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Tax Reform Options in the Real World

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January, 2005

Introduction

The mere mention of the words “tax reform” sets people off talking in lofty, philosophical terms about ideal tax systems. These discussions are stimulating and provide useful benchmarks. But the real challenge is changing the system in a way that will work not just on paper, but also in a real world populated by politicians, lobbyists, tax shelter experts, and taxpayers who want their own individual taxes cut and who have strong, but malleable views on equity. To paraphrase Donald Rusted, we need to debate tax reform with the tax and political system that we have.

The System We Have

The current federal tax system features an enormous number of expiring tax provisions and a rapidly growing alternative minimum tax, with revenues that in 2004 were at their lowest share of GDP in over 50 years, and with spending under current law projected to rise to never-before-seen peacetime levels in the coming decades. The political system features both Houses of Congress and the White House held by a majority party whose members have overwhelmingly signed the “no new taxes” pledge, yet who also voted overwhelmingly for the largest entitlement increase in recent history (the Medicare prescription drug benefit), cut taxes four times in four years, and passed one of the most loophole-laden and egregiously complicating tax acts in recent memory in 2004.

As a result of these actions, the central tax question facing the country currently is whether to make permanent the Administration's tax cuts – all of which expire between now and 2010. The loss in revenues from making the tax cuts permanent would be enormous: equal to several times the resources needed to repair the entire Social Security problem, which the President has declared a “crisis.” We don't know how this fiscal hole would be filled because, despite advocating basically the same tax policy since 1999, the Administration has never proposed a way to pay for the cuts, and last year actually proposed deceptive accounting rules that would have let the tax cuts be made permanent without even showing a cost in the budget.

There are only two ways to pay for the tax cuts. One is to raise other taxes, but this would require massive repudiation of the “no new taxes” pledge. The other option is

to cut spending. Estimates suggest that the combined effects of the tax cuts financed by spending cuts would likely make most households worse off, even after accounting for the positive effects on economic growth. Moreover, the required spending cuts would be enormous. For example, in 2014, if reductions for Social Security, Medicare, Medicaid, defense, homeland security, and net interest were off-limits, the rest of federal spending would have to be cut by almost half to pay for the tax cuts.

To the extent that tax increases or spending cuts did not occur—and they do not seem likely—the revenue losses would have to be financed by borrowing, which merely postpones the ultimate payment. Moreover, the net effect of the tax cuts plus borrowing would be to reduce long-term economic growth, according to studies by academics and the Congressional Budget Office.

In short, whether the tax cuts are made permanent is a first-order economic issue. If permanent tax cuts were financed by spending cuts, most households would be worse off, even though growth would likely rise. If they were financed by borrowing, long-term growth would fall. In either case, if the tax cuts are made permanent, revenues would be a smaller share of GDP when the baby boomers retire than the average revenue share over the past thirty years. This would leave the country wholly unprepared for addressing the coming budget problems.

Whether the tax cuts are made permanent also has important implications for the tax reform debate. First, President Bush has asked the tax reform commission to consider “revenue neutral” reforms. But it is unclear if that is relative to current law—where the tax cuts expire—or relative to the President’s budget proposal—where the tax cuts are presumed to be made permanent. The time frame for revenue-neutrality is also unclear. Second, making the tax cuts permanent would greatly increase the number of people on the alternative minimum tax, a source of complexity, inefficiency and inequity in the tax code and potentially a motivating factor for tax reform. At the very least, the discussion of tax reform needs to be integrated with analysis of making the tax cuts permanent.

Tax Reform

Turning to traditional reform issues, the features of a desirable tax system seem straightforward and broadly accepted: it should raise the revenues needed to finance government spending in a manner that is as simple, equitable and conducive to economic growth as possible. Thus, tax reform appropriately involves consideration of both the level of revenues and the structure of taxation.

Although people agree that the current system clearly falls short of at least some of these goals, how the system should be reformed is subject to enormous controversy. People define the underlying goals differently— notions of fairness, for example, are clearly “in the eyes of the beholder.” People disagree on the most effective policies for attaining a particular goal, such as more economic growth. And most importantly, people have differing value judgments, which make agreement on policy almost impossible in the nearly ubiquitous case where there are trade-offs among the goals.

Fundamental Reform

The most radical approach to tax reform would be to junk the whole system and start over. Under a national retail sales tax (NRST), for example, a single tax rate would apply to all sales by businesses to households. Sales between business and between households would be untaxed. Under a value-added tax (VAT), each business would pay tax on the sum of its total sales to consumers and to other businesses less its purchases from other businesses, including investments. Thus, the increment in value of a product at each stage of production would be subject to tax. Cumulated over all stages of production, the tax base just equals the value of final sales by businesses to consumers—that is, the same in theory as in an NRST. The flat tax, originally developed by Hoover Institution scholars Robert Hall and Alvin Rabushka, is simply a two-part VAT: the business tax base would be exactly like the VAT except that businesses would also be allowed deductions for wage payments and pension contributions. Individuals would pay tax on wages and pension income that exceeded personal and dependent exemptions. Businesses and individuals would be taxed at a single positive flat rate.

The NRST, the VAT and the flat tax are all flat-rate, broad-based consumption taxes. Advocates claim that fundamental tax reform could boost growth significantly, slash tax burdens, simplify compliance, and eliminate the IRS. Unfortunately, however, a more realistic assessment is less sanguine.

The required tax rate in the national retail sales tax to replace almost all existing federal taxes and maintain government programs would be at least 40 percent and probably significantly higher – not the 23 percent rate advertised by its supporters.

The pure flat tax could replace the existing income and corporate tax with a rate of about 21 percent. But doing so would cause massive relocation in the economy, which would see significant declines in charitable contributions, real housing prices, and the number of households with health insurance. Businesses would see wild gyrations in their tax liability relative to the current system, and would find taxes were no longer based on profits. Realistic versions of the flat tax – which smoothed out these problems by allowing transition relief, individual deductions for mortgage interest, charity, and state taxes, and business deductions for health insurance and taxes – would require tax rates of 30 percent or higher.

Both the NRST and the flat tax would provide large tax cuts for the wealthiest households, and make up the revenue with tax increases on low- and middle-income households. The potential to simplify exists with each tax, but avoidance and evasion would continue, and in some areas it would increase. The sales tax would have difficulty controlling tax evasion. Under the flat tax, firms could easily relabel cash flows and reduce their taxes enormously.

Many of the problems and trade-offs created by fundamental tax reform could be mitigated if reform boosted growth dramatically. In their pure form, the NRST and flat

tax could have positive effects on economic growth, but when the taxes were subjected to the realistic considerations noted above and the higher tax rates such considerations would require, studies suggest that the taxes would likely generate little if any net growth and could actually reduce growth.

An alternative fundamental reform plan, the USA tax, would replace the existing tax system with a VAT on businesses with a personal consumption tax. Under the personal tax, people would report all income from earnings, investments, and receipt of loans, but they would be allowed a new deduction for all net saving and repayment of loans. Thus, the personal tax falls on the difference between income and saving, which is consumption. In addition, the USA tax would retain some of the deductions and credits allowed under the current personal income tax and would have progressive rates. The USA tax has been judged to have substantial administrative problems.

Five Easy Pieces

Completely replacing the existing system would create enormous administrative, legislative, and economic upheavals. This has led some to advocate piecemeal or partial replacement of the income tax system.

The basic notion is that by making changes one at a time, progressive taxes on income and wealth can be transformed into a flat, consumption tax. The changes typically include: reductions in marginal income-tax rates, especially for high-income households; increases in contribution limits for tax-preferred savings accounts; expensing (immediate write-offs) of business investment, rather than depreciation over time; repeal of the estate tax; and a reduction in dividends and capital gains taxes. Many of these items are reflected in the Administration's recent rate cuts, dividend and capital gains tax cuts, expansions of contribution limits to IRAs and 401(k)s and temporary "bonus depreciation" provisions. The Administration has also promoted vastly expanded tax-free savings accounts.

The problem is that these changes do not add up to a well-defined tax system. First, tax rate cuts by themselves do not reflect a change in the tax base, so they can be consistent with almost any tax base. Second, a well-designed consumption tax would (a) collect adequate revenues to cover expenditures over time and avoid reducing national saving through higher government deficits; (b) broaden the base to lessen interference in the economy; (c) tax already-existing capital—that is, concentrate any revenue relief on new saving or investment; and (d) treat interest income and expense in a consistent manner. But these piecemeal proposals and legislative changes of recent years fail all four tests. They (a) lose substantial amounts of revenue; (b) do not broaden the base; (c) reduce taxes on existing capital; and (d) increase the difference in the tax treatment of interest income and expense.

Some tax over haulers downplay such concerns, arguing that the criticisms represent the perfect being the enemy of the good. But the underlying point is that the system that emerges has many of the worst features of *both* the previously existing tax

system and a fundamentally reformed system. First, the tax cuts accompanied expenditure expansion, leading to deficits that may reduce long-term economic growth. Second, there will be no efficiency gains from broadening the base if no base-broadening occurs. Third, there will be efficiency losses from increasing taxpayers' ability to shelter income if there are enlarged differences between the taxation of capital income and capital expense. Particularly important here is the tax treatment of interest payments. A well-designed income tax would tax interest income and allow deductions for interest payments. A well-designed consumption tax could tax borrowing and allow deductions for lending (saving), or it could allow for nontaxation of interest income *coupled with nondeductibility of interest payments*.

The key point is that *any* well-designed tax system would treat capital income and capital expenses in a symmetric, consistent manner. Proposals for expanded tax-preferred saving accounts would move the system even further toward treating the two sides of the ledger inconsistently and increase opportunities for tax sheltering.

Finally, since it seems likely that high-income households are more financially sophisticated and can better afford financial advice, proposals simply to expand nontaxable saving deposit vehicles could lead not just toward a wage tax, but toward a wage tax that was only paid by low- and moderate-income households (who could not so easily reduce their tax base even below wages paid through the use of interest deductions).

“Back to the Future”

Yale University Law Professor Michael Graetz has a proposal he describes as “Back to the Future.” He would, among other things, raise the income tax exemption to about \$100,000, tax income above that level at a 25 percent tax rate, remove some shelters from the income tax, cut the corporate tax rate in half. This would cut revenues from these taxes in half, and the lost revenue would be replaced by a broad-based VAT.

This proposal has significant advantages. It would reduce the number of income tax returns filed by roughly 100 million. Transition problems would be reduced relative to fundamental reform because the income tax and corporate tax are not being abolished.

But there are also a number of concerns. The main issue is that the proposal has not been specified in sufficiently detailed manner to gauge its effects. Relevant details include what would be excluded from the VAT base, which low-income credits would be retained and what mechanism would be used to provide those credits (since these households would not file income tax returns), and how the income tax base would be structured. Although the proposal is intended to be neutral with respect to revenue and distribution, in the absence of additional details it is unclear what the implications of those constraints are for the required tax rates and relevant tax bases. My own estimates suggest a VAT rate of about 15-20 percent would be required, which would then require heroic efforts to maintain distributional neutrality. Having the Treasury Department provide estimates of alternative sets of required rates and the resulting distributional

effects would help clarify these issues. Also, if states did not abolish their income tax or raise their exemptions to \$100,000, there would be little saving in tax complexity.

Real-World Reforms

The following options are less ambitious than the ones discussed above, but may in turn prove more enactable and indicate ways that the existing system could be made simpler, fairer, more conducive to economic growth, and consistent with spending needs.

1. Integrate the Corporate and Individual Income Taxes

About a quarter of corporate income appears to be taxed at both the individual and corporate level, and all of that is now taxed at a maximum rate of 15 percent at the personal level. Corporate income can avoid taxes at the corporate level through shelters. It can avoid taxation at the individual level to the extent that it accrues to non-profits and pensions. About one quarter of corporate income is taxed at the individual level, but not the corporate level, one quarter is taxed at the corporate level, but not the individual level, and one quarter appears never to be taxed. While the emphasis and public discussion has been on the so-called double taxation of corporate income, the non-taxation of corporate is certainly now a bigger problem.

Reforming, or integrating, the individual income tax and corporate income tax should involve several features that need to be dealt with *simultaneously*. First, the integration should occur only for income stemming from *new* corporate investment. There is no reason to give tax breaks on the income stemming from old investments; those tax breaks would be pure windfall gains. Second, individual-level taxation of corporate dividends and capital gains (on new investments) should be removed only if the full tax has been paid on the income at the corporate level. If corporate taxes were not paid, then corporate dividends and capital gains should be taxed at the *full* individual rate (not capped at 15 percent). Third, efforts to shut down corporate tax sheltering need to be beefed up substantially. This could include both increased enforcement as well as altered accounting procedures that require more conformity between book and taxable income. Fourth, a wholesale attack on corporate tax expenditures would be a final, key element in this package. To be clear, my sense is that this package of changes would likely raise net federal revenues from corporate source income.

2. Integrate the Payroll and Individual Income Taxes

For about 75 percent of all households, and virtually all filers in the bottom 40 percent of the income distribution, payroll tax burdens exceed income tax payments. The payroll tax imposes a burden of roughly 15 percent on the very first dollar of earnings. In contrast, a family of four does not fall into the 15 percent marginal income tax bracket until its income exceeds \$36,000 and does not pay an average 15 percent income tax rate until its income is \$120,000, which is actually higher than the payroll tax cap for Social Security.

Integrating the payroll tax and the income tax could take different forms, but each would make the burden of payroll taxes more progressive. This would be particularly important if a consumption tax were either added to the system or replaced part of the system, to offset some of the regressivity of that tax.

3. Simplify

There are a number of ways to simplify the system, even without enacting massive reform. The Administration's efforts to unify the definition of a child in the tax code is one such example. Return-free filing could be achieved for as many as 50 million taxpayers with relatively minor changes in the tax code. Return-free filing is in existence in dozens of countries around the world and would relieve the hassles of filing and compliance for the households least able to address such issues. The number of households who could avoid filing would be greatly enhanced, and other simplifications would occur, if the personal exemption, the child credit, and the earned income credit were consolidated into a single program, and if the standard deduction were increased. Likewise, increasing the standard deduction by the value of a personal exemption and reducing the number of personal exemptions by one would simplify taxes further by reducing the number of people that itemize. Another area ripe for simplification via consolidation involves education subsidies and retirement saving programs.

4. Restructure deductions into credits

On simplicity, equity, revenue, and possibly efficiency grounds, the itemized deductions should be converted to refundable, flat rate, capped credit. Although they are immensely popular and subsidize activities thought of as "good," itemized deductions create numerous problems. They largely subsidize activity that would have occurred anyway. They complicate tax filing and enforcement. They erode the tax base and are regressive, giving bigger benefits to high-income than low-income filers. Finally, the deductions hide subsidies that would be obvious if they were spending programs. Imagine that instead of a mortgage interest deduction, we had a program called "homeowner welfare" in which taxpayers earned a "welfare entitlement" equal to their annual mortgage interest payment times their tax rate. Anyone whose entitlement was below a certain threshold, say \$6,000, would receive nothing. Anyone whose entitlement exceeded the threshold would receive the entitlement in cash. This program would be decried as wasteful and a sop to the rich. Yet it is not dissimilar to the way the mortgage interest deduction works. Items that represent true reductions in ability-to-pay taxes should be deducted in full, but none of the itemized deductions completely meets that standard. Relative to the existing treatment of deductions, the proposal would reduce revenue loss, dampen regressivity, minimize the other unfair aspects of deductions, and simplify tax filing and compliance by reducing the number of itemizers by about 30 percent, or 9.5 million people. At the same time, it would continue to allow a subsidy for activities that society may deem as "preferred" for one reason or another. The changes would have no effects on the 72 percent of taxpayers who do not itemize or on an additional 6 percent of taxpayers who itemize and currently face a 15 percent rate.

5. The Alternative Minimum Tax

The alternative minimum tax should be abolished, if—and these are some big ifs—(a) the anti-tax-sheltering provisions of the AMT are brought into the income tax, (b) if dividends and capital gains are taxed as described above, and (c) the revenue is made up by adjusting income tax rates.

6. Private and National Saving

The enormous efforts over the past twenty five years to stimulate private saving by providing tax incentives for *contributions* into particular accounts (which is quite different from “saving”) do not appear to have been very successful in raising overall private saving and even less successful in raising national saving, the sum of private and public saving. Currently, federal tax expenditures for pensions and other saving incentives are larger than the entire level of personal saving.

Part of the problem is that the accounts do not subsidize saving, which requires a reduction in consumption spending and living standards. Instead, they merely subsidize contributions into an account. These contributions can be made in many “painless” ways that do not involve reducing one’s living standard. High-income, high-wealth households are the most able to make such painless contributions, drawing from income they would have saved anyway or assets they already have saved. Another part of the problem is that the immediate incentive to contribute – as measured by the tax deductions that are allowed – is largest for the same high-income households.

Likewise, studies that acknowledge the role of precautionary needs for saving and the extent of saving incentives already in the current system, find that a consumption tax would have a very small impact on the national saving rate. In short, if increasing saving is the problem, tax reform is unlikely to be the answer.

A much more effective, less expensive and simple approach to encouraging national saving, and the economic growth it can generate, is to improve the operation of existing accounts by encouraging automatic enrollment and automatic escalation of contributions over time in existing 401(k) accounts. This would raise contribution rates among low- and moderate-income workers who are less likely to be using the accounts as tax shelters. Likewise, encouraging people to save their tax refunds or allowing automatic payroll deductions for individual retirement accounts would have similar effects. Relative to increasing contribution limits for tax-preferred saving or moving to a consumption tax, these options would raise national saving as much or more, and would be more progressive.

7. Administration

An intelligent tax reform would equip the Internal Revenue Service with the resources it needs to enforce and administer the system. Many taxpayers simply do not pay taxes they actually owe, while the Internal Revenue Service lacks the resources to

enforce payment. Providing the IRS with additional resources generally would boost revenues by about \$4 or so for every dollar spent—provided the money is put to enforcement. At the same time, one can only go so far in this direction, as the additional manpower used reduces net product in the economy as a price for producing a fairer distribution of the tax burden.

8. Meeting government spending needs

Although tax reform has traditionally been debated in a revenue-neutral manner, this is a luxury that we can no longer afford, however. Under plausible projections, federal spending will rise to 30 percent of GDP in the not-too-distant future. Historically, revenues have stayed below 20 percent of GDP. Unless policy makers intend to cut future spending by mammoth amounts, revenue-neutral reforms are no longer sufficient, and serious thought needs to be given to the best way to structure taxes designed to raise *additional* revenues. Note that higher revenue needs make it even more important to keep rates as low as possible and the base as broad as possible.

Social security reform requires some combination of benefit reductions and tax increases relative to current law. One possibility, especially if income tax rates are held at 35 percent, would be to apply a Social Security tax at 3 percent on all earnings above the current earnings cap, similar to Medicare's 2.9 percent rate.

Other options involve new taxes. It is an open question whether the taxes discussed below might best fall into general revenue or be earmarked to help with the financing of medicare, Medicaid or social security. One possibility here—at least one where there is very strong evidence that it can be administered—is a value-added tax (VAT). A broad-based VAT, one with only a few exclusions, would generate revenue of about 0.6 percent of gross domestic product for each 1 percentage point of tax. It would also increase the cost of government purchases and reduce the income tax base. The net contribution to deficit reduction, therefore, would be about 0.4 percent of GDP for each 1 percentage point of tax. On net a 10 percent VAT, then, could raise an additional 4 to 5 percent of GDP in revenue if the VAT tax base was kept fairly broad. The great advantage of a VAT over a national retail sales tax is that the VAT is a proven collection system that is in force in more than 100 countries around the world. Exporters could follow established procedures for getting rebates at the border. Unlike the retail sales tax, the VAT does not have great difficulty in taxing services, as opposed to goods. One form of VAT uses credits that effectively reduce the amount of cheating by requiring users of inputs to make up for missing VAT if their input suppliers have not paid them. Administrative concerns make the NRST a much more iffy proposition, even as a supplement to the existing system.

Another option – a tax on carbon emissions, combined with a market in rights to emit carbon – would deal with a major environmental problem as well as contribute to revenues. The goal of this program would be to reduce greenhouse gas emissions and reduce the harm caused by global climate change. Total carbon emissions would be capped. Companies would need a permit to emit carbon. Each year the government

would auction permits authorizing the emission of carbon at some specified level. As an illustration, suppose that the number of carbon permits were set at the actual 1990 level of carbon emissions. Suppose further that the permit price turned out to be \$25 per ton of carbon. At that price and quantity, the auctions would raise \$34 billion in 2014. A \$25 per ton carbon price would raise gasoline prices by about 25 cents per gallon. After taking into account the increase in prices paid by the government, the net revenue increase would amount to 0.1 percent of GDP.

Conclusion

As even the cursory discussion above show, tax reform in the real world is about much more than taxes and faces many landmines. As the nation turns to address these issues, we should not let the perfect be the enemy of the good, but nor should we let flawed programs be enacted just because they invoke soaring rhetoric.