

Options for Tax Reform

The current Federal tax system is unnecessarily complex and distorts incentives for work, saving, and investment. As a result, it imposes large burdens on taxpayers and on the U.S. economy as a whole in the form of high compliance costs and distortions in economic decisions.

Tax reform could make the tax system simpler and fairer and promote growth of the economy. Various tax reform proposals have been made to replace the current tax system. Most of these proposals are variations on a few basic types of taxes. This chapter discusses these basic prototypes for reform. The President has not endorsed any specific proposal, and this chapter does not advocate the adoption of any particular prototype for reform.

The key points in this chapter are:

- The current tax system imposes high costs on society in addition to the taxes actually collected.
- Income taxes and consumption taxes are the primary alternatives for raising government revenues.
- The main types of consumption taxes are the retail sales tax, the value added tax, the flat tax, and the consumed income tax.
- While the tax system could be completely redesigned, important benefits could also be obtained through simplification and reform of the current tax system.

Why Do We Need Tax Reform?

People often think of the tax burden in terms of the dollar amounts of taxes paid, but this is only part of the total burden. The tax system also imposes two indirect burdens: the costs (in time and money) of complying with tax rules and the costs (including slower economic growth) of tax-induced distortions of economic activity. Although all tax systems impose direct and indirect costs, such costs are unduly high under the current system.

The Direct Burden of the Tax System: Taxes Paid

As measured by the revenues collected, the direct burden of Federal taxes is estimated to be \$2.1 trillion, or 16.8 percent of GDP in fiscal year 2005 (Table 3-1). This percentage is less than the average of about 18 percent for the last 50 years because of the effects of the recession and of temporary

TABLE 3-1.— *Sources of Federal Revenues, Fiscal Year 2005*

Source	Billions of dollars	Percent of total revenues	Percent of GDP
Individual income taxes	894	43.5	7.3
Corporation income taxes	227	11.0	1.9
Social insurance receipts.....	774	37.7	6.3
Excise taxes.....	74	3.6	.6
Estate and gift taxes	24	1.2	.2
Customs duties	25	1.2	.2
Miscellaneous receipts.....	36	1.8	.3
Total	2,053	100.0	16.8

Note: Detail may not add to totals because of rounding.

Source: Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2006*.

economic stimulus provisions that expired at the end of December 2004, but is projected to return to the historical average under proposed policies. The largest share of revenues (over 92 percent) comes from taxes on income and its components: the individual income tax (43.5 percent), payroll taxes for Social Security and other social insurance programs (nearly 38 percent), and the corporate income tax (11 percent).

Even when state and local taxes are included, the United States relies more on taxes on income than most other developed countries (Table 3-2). Over 70 percent of taxes imposed by all levels of government in the United States are individual income, corporate profit, and payroll taxes, compared to the 62 percent average for all Organization for Economic Cooperation and Development (OECD) countries. The United States relies much less on taxes on consumer goods and services (under 18 percent) than other countries (32 percent average). Much of this difference reflects higher total tax burdens in other OECD countries, which generally impose value added taxes (VATs) on sales of goods and services in addition to income and payroll taxes.

TABLE 3-2.— *Comparison of Tax Revenues: United States, G-7, and OECD, 2002*
[Includes subnational governments]

Revenue source	United States	Canada	France	Germany	Italy	Japan	United Kingdom	OECD average
Percent								
Total revenue as percent of GDP	26.4	33.9	44.0	36.0	42.6	25.8	35.8	36.3
Revenue by type as percent of total:								
Income and profit.....	44.4	46.2	23.9	28.0	32.5	30.6	37.8	35.3
Social security and payroll.....	26.1	17.2	39.5	40.3	29.4	38.3	17.0	26.3
Property and wealth ¹	11.9	9.8	7.5	2.3	5.1	10.8	12.0	5.5
Goods and services.....	17.6	26.3	25.4	29.2	26.9	20.1	32.7	31.9
Other0	.5	3.6	.0	6.0	.3	.0	.9

¹Includes taxes on real estate, net worth, estates, inheritances, and gifts.

Note: Detail by type may not add to 100 percent because of rounding.

Source: Organization for Economic Cooperation and Development (OECD), *Revenue Statistics*.

High Compliance Costs

The complexity of the U.S. income tax is legendary (Box 3-1), and it leads to high compliance costs for taxpayers and the government.

The costs of the Internal Revenue Service (IRS) administering the tax system and monitoring compliance are about 0.5 percent of revenues. But these are just a small part of the compliance costs associated with the tax system, which are estimated to be as much as 10 percent of revenues. The complexity of the current system imposes substantial burdens on taxpayers in time and money spent to prepare and file tax returns, maintain tax-related records, read and understand instructions, engage in tax planning, and, for more than half of individual taxpayers, pay a tax preparer. The IRS estimated that for tax year 2000, individual taxpayers spent 3.2 billion hours on tax compliance, an average of 25.5 hours per return. Assuming a value of \$15 to \$25 per hour for

Box 3-1: Complexity of the Current System

The current tax system includes many provisions that duplicate or conflict with each other and that are unnecessarily complicated. Some examples of complexity affecting large numbers of taxpayers are:

- There are approximately 30 different kinds of special retirement or special purpose savings accounts under the tax system. Each has its own rules, and participation in one of them can affect whether an individual can participate in another.
- Numerous phaseout provisions intended to limit tax benefits to lower-income taxpayers require additional calculations and create high marginal tax rates in the phaseout range. Two such provisions apply to the taxation of Social Security benefits.
- Tax complexity is not just the bane of the wealthy. The Earned Income Tax Credit, which provides a subsidy to the working poor and is a basic element of our national income support system, has 13 pages of instructions and complex eligibility requirements.
- The Alternative Minimum Tax (AMT) requires taxpayers to calculate their income taxes twice—once under regular tax rules and a second time under AMT tax rates and rules. By 2010, more than one in five taxpayers will have to calculate the AMT and pay it if it is higher than their regular tax.
- Over 10 million dependents have to file income tax returns each year. Many of them are teenagers with jobs or young children who have modest amounts of investment income. The so-called Kiddie Tax applies to a much smaller number of dependent filers, but involves complex rules and can result in very high marginal tax rates in certain cases.

taxpayers' time and adding the \$19 billion spent on tax preparers, computer software, and similar expenses results in a total estimated individual compliance cost between \$67 billion and \$99 billion. Burdens vary substantially among taxpayers. For example, taxpayers with self-employment income spent almost 60 hours preparing returns. Other taxpayers spent an average of 13.8 hours, but 10.9 more hours if they filed the Alternative Minimum Tax (AMT) form.

Effects on Behavior and Excess Burden

The third type of burden imposed by the tax system, called *excess burden*, arises when high tax rates reduce incentives for work, saving, and investment, distort economic decisions, and divert resources from productive activity into tax avoidance. Excess burden means that it costs the economy more than one dollar to raise one dollar in revenue. High excess burden ultimately reduces economic growth and lowers living standards. This section examines the evidence of the effects of high tax rates on economic behavior and how these effects translate into measures of excess burden.

Tax Effects on Individual Behavior

An individual's after-tax return from increased work effort, saving, or investment depends on the individual's *marginal tax rate*, the tax rate that applies to the last dollar of the individual's income. For example, the after-tax return from earning one additional dollar is \$0.75 for a taxpayer in the 25 percent tax bracket. By reducing after-tax returns, high marginal tax rates reduce incentives for additional work effort. The same principle applies to saving and other economic activities.

A variety of statistical studies have found that high income tax rates adversely affect labor supply, particularly for certain segments of the population. The income tax rate reductions in the 1980s significantly increased the labor force participation and hours of work of high-income married women, with a total increase in labor supply of as much as 12-15 percent. The effects were much smaller for men (up to 2-3 percent) and for female heads of households (up to 4 percent). Some economists argue that these studies understate the effects of taxes on labor supply because they do not include tax effects on the intensity of work effort, career choice, and investments in human capital (such as education), which are more difficult to measure.

In addition to reducing the numbers of hours they work, taxpayers respond in many other ways to avoid the effects of high tax rates. For example, taxpayers take their compensation in nontaxable forms such as health insurance and alter their portfolios to focus on tax-favored investments. The total effect of such responses is summarized by the responsiveness of taxable income to changes in marginal tax rates. While the results vary among studies,

a reasonable estimate is that a 10 percent decrease in after-tax returns leads to about a 4 percent decrease in taxable income. Thus, for example, if the marginal tax rate was increased from 25 percent to 28 percent, this would reduce after-tax returns by 4 percent. Taxpayers' behavioral responses would reduce taxable income by 1.6 percent (0.4 times 4 percent), and this would reduce the addition to revenue by nearly 15 percent.

Tax Effects on Business Behavior

Businesses can respond to taxes in various ways, including changing their level of investment and employment, their method of finance, and their organizational form. Current law distorts many business decisions, resulting in inefficient use of resources and reduced economic output.

Some of the largest distortions are associated with the corporate income tax. This tax results in corporate income being taxed once under the corporate income tax and then a second time at the individual level when received as dividends or when reinvested earnings result in taxable capital gains. This double taxation of corporate income favors financing investment with debt instead of equity because interest paid by the corporation on its debt is deductible while dividend payments to shareholders are not.

Double taxation of corporate income also creates a bias in favor of using business forms not subject to the double tax, such as partnerships, sole proprietorships, limited liability companies, and subchapter S corporations. The double tax also discourages paying dividends. As a result, prior to the 2003 reductions in dividend tax rates, dividend payments by corporations had declined since the 1980s (Box 3-2).

Current tax law also distorts decisions about investment in equipment and buildings. Under an income tax, proper measurement of income requires that the cost of investment in new equipment be depreciated by deducting the decreases in economic value over the useful life of the investment, sometimes called *economic depreciation*. Current depreciation rules, however, differ significantly from an ideal measure of economic depreciation, leading to biases among investment choices. For example, if a company chooses offices with plaster walls, it would have to depreciate those walls over 39 years. But because cubicle partitions are considered to be office furniture under IRS rules, they can be depreciated over 7 years. Thus, the tax law favors the purchase of cubicle partitions because the faster tax write-off saves the company money.

Other research has shown the adverse effects of high tax rates on entrepreneurial activity. Several studies examined the response of small businesses to the tax reductions of the 1980s and found that when income tax rates were reduced, entrepreneurial businesses grew faster, were more likely to invest in new equipment and structures, and were more likely to hire additional workers.

Box 3-2: The Initial Effects of the 2003 Reductions in Tax Rates on Dividends

Corporate income is taxed twice, first under the corporate income tax and then a second time under the individual income tax as dividends or capital gains. Consequently, the total Federal tax rate on corporate income can be very high. For example, in 2000, the total Federal tax rate on a dollar of corporate income paid out as a dividend could be as high as 60.75 percent (calculated as the 35 percent corporate rate plus an individual tax rate of up to 39.6 percent on the 65 cents of after-tax corporate income available for dividends). State income taxes add to this total.

Economists are in broad agreement that this system creates serious economic distortions. Indeed, historically the United States was almost alone among advanced countries in failing to provide some form of relief from double taxation of corporate income. A key provision of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) reduced the double tax by reducing the individual income tax rates for both dividends and capital gains.

Proponents of JGTRRA argued that it would lead to more dividends being paid by corporations. Was this prediction correct? One study reported that in the first three months after the law was passed, corporate boards of directors increased dividends by 9 percent at their first opportunity following enactment. A subsequent study found that the percentage of publicly traded firms paying dividends began to increase precisely when the new law became effective in 2003. This percentage had been declining for more than 20 years. The study found that nearly 150 firms started paying dividends after the tax cut, adding more than \$1.5 billion to total quarterly dividends. The most notable example of a company initiating payments is Microsoft Corporation, which previously had not paid dividends in spite of accumulating large cash reserves. Many firms already paying dividends raised their regular dividend payments, and a smaller number of firms made special one-time dividend payments to shareholders.

Overall, the response has been unprecedented in the recent history of tax changes. Based on statistical analysis of the historical relationships between dividends and tax rates, another study estimated that over time, dividends will increase by 31 percent, about \$111 billion in additional annual dividends at 2002 levels.

Excess Burden

Because taxes distort economic decisions and lead to inefficient use of resources, they cause reductions in economic welfare that exceed the amount of tax collected. These costs above and beyond the revenues collected are called the “excess burden” of the tax system. Higher marginal tax rates lead to more distortion in behavior, and therefore to greater excess burden. In addition, the more responsive taxpayers are to higher marginal tax rates, the greater the excess burden will be. A recent study estimated that the excess burden associated with increasing the individual income tax by one dollar is 30 to 50 cents. In other words, the total burden of collecting \$1.00 in additional income taxes is between \$1.30 and \$1.50, not counting compliance costs.

Income Taxation Versus Consumption Taxation

The main bases available for Federal taxation are income and consumption. Economists define *income* as the increase in an individual’s ability to consume during a period of time. By this definition, anything that allows a person to consume more is income, including compensation for services, interest, rents, royalties, dividends, alimony, and pensions. This broad measure of income also includes noncash benefits, such as health insurance provided by an employer, and increases in the value of stock and other assets. While the base of an income tax is the increase in *potential* consumption (i.e., income), a consumption tax applies only to the portion of income that individuals *actually* consume.

Tax reform proposals generally follow either the principle of taxing consumption or the principle of reforming the existing system to conform more closely to a pure income tax. In thinking about this distinction, it is important to note that the current system already has many features of a consumption tax: investment income is exempt from tax when it is saved in certain forms, such as IRAs; unrealized capital gains are not taxed; and small businesses can immediately deduct the cost of a certain amount of new investment, as would be the case under a consumption tax. Thus, characterizing the current system as an income tax is something of a misnomer; it is more of a hybrid between an income tax and a consumption tax.

Before turning to the main prototypes in the following section, this section examines the choice between income and consumption taxation from the standpoint of key criteria for evaluating a tax system: fairness, growth, and simplification.

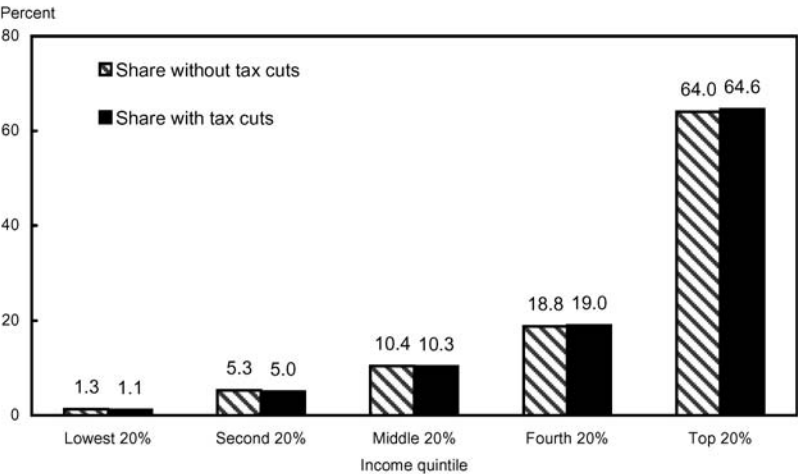
Fairness

A traditional standard for fairness is that taxes should be levied according to individuals’ ability to pay. Thus, proponents of income taxation argue that it is fair because income best reflects the ability to pay taxes. In addition, a common view is that individuals with higher incomes should pay a greater proportion of their income in taxes—the tax system should be progressive. As shown in Box 3-3, the current income tax system is highly progressive.

Box 3-3: What Is the Current Distribution of the Tax Burden?

A major criterion for judging a tax system is whether it is fair. One way to examine this question is to look at the shares of the tax burden borne by taxpayers in various parts of the income distribution. Nearly two-thirds of the total Federal tax burden is borne by the top 20 percent of taxpayers. This includes individual and corporate income taxes, payroll taxes, and excise taxes, but not the effects of temporary economic stimulus provisions that expired at the end of 2004. As shown in Chart 3-1, the share of taxes of the top 20 percent increased as a result of the tax cuts enacted since 2001.

Chart 3-1 **Share of Federal Taxes With and Without Tax Cuts, 2004**
The share of taxes of the top 20 percent increased as a result of the tax cuts enacted since 2001.



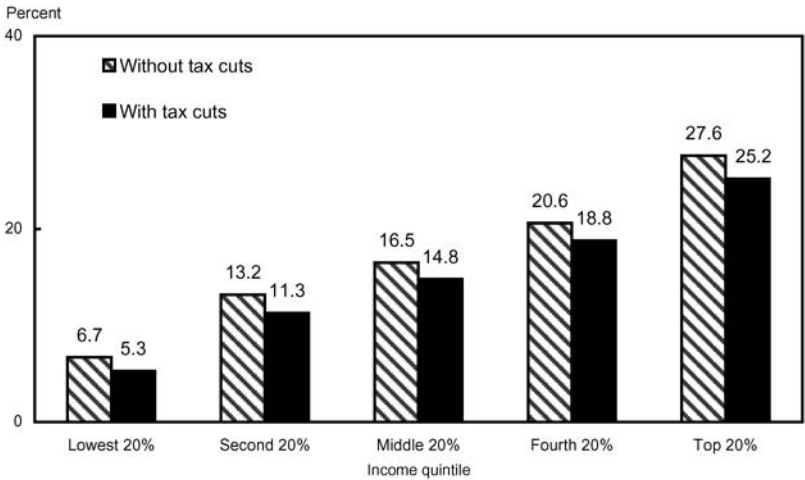
Source: Congressional Budget Office, “Effective Federal Tax Rates Under Current Law, 2001 to 2014,” August 2004.

Another way to look at fairness is in terms of taxes as a percent of income. As shown in Chart 3-2, Federal taxes take a larger share of income for higher-income groups, both before and after the tax cuts.

Box 3-3 — continued

Chart 3-2 Effective Federal Tax Rates With and Without Tax Cuts, 2004

Effective tax rates are higher for higher income groups, both with and without tax cuts.



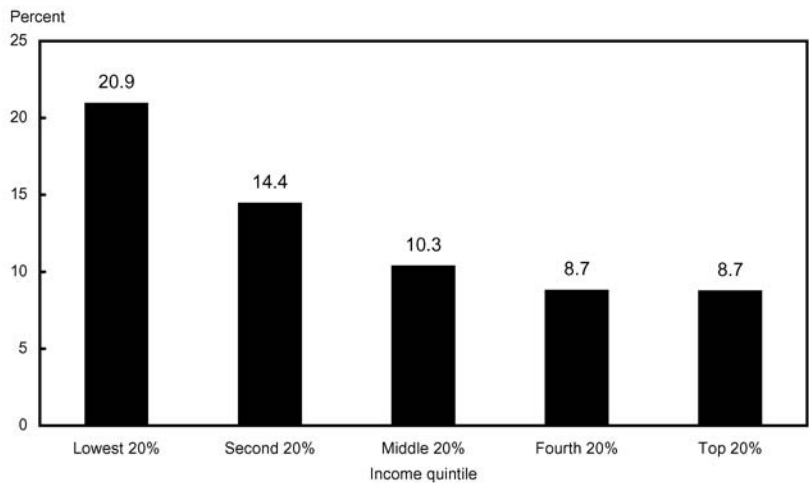
Source: Congressional Budget Office, "Effective Federal Tax Rates Under Current Law, 2001 to 2014," August 2004.

The bottom 40 percent of the population received the largest percentage reductions in total Federal taxes (Chart 3-3). After the tax cuts, the bottom 40 percent of the population paid no income taxes, and, on balance, received money back from the income tax system.

In summary, the tax relief passed during the President's first term increased the overall progressivity of the Federal tax system.

Chart 3-3 Percent Reductions in Total Federal Taxes, 2004

The bottom two income quintiles received the largest percent reductions in total federal taxes.



Source: Congressional Budget Office, "Effective Federal Tax Rates Under Current Law, 2001 to 2014," August 2004.

Critics of consumption taxes often argue that they are *regressive*, that is, they represent a higher proportion of the income of lower-income families. Conventional analyses use an annual measure of income as a measure of ability to pay and assume that the burden is borne by consumers. They generally show that a proportional tax on consumption would be highly regressive. Annual incomes, however, often vary substantially from year to year, so one year's income may not be a good indicator of ability to pay. When a lifetime measure of income is used, the regressivity of consumption taxes appears less pronounced.

Some studies question whether income is the most appropriate basis for measuring fairness. One reason for taxing consumption is the belief that it is a better measure of lifetime ability to pay than annual income. If so, progressivity should be measured with respect to consumption rather than income, and an inclusive flat rate consumption tax would be proportional by definition. In addition, as discussed below, there are ways to tax consumption while addressing concerns about distributional fairness. Furthermore, increased economic activity from a more efficient tax system could be sufficient to improve the economic welfare of all income groups.

Finally, when considering the fairness of taxes, it is important to keep in mind that the ultimate burden of a tax is not necessarily borne by the taxpayer who writes the check to the government. In particular, the burden of taxes paid by corporations is ultimately borne by individuals in their roles as stockholders, workers, and consumers. A common view of economists is that in the short run, before there is time for economic adjustments, the burden of increases in corporate income taxes is borne entirely by shareholders. Thus, under this view, most of the corporate income tax burden is borne in the short run by high-income households, because the ownership of corporate stock is highly concentrated in high-income households. Over time, however, at least part of the burden of corporate taxes is likely to be shifted to owners of noncorporate businesses, workers, and consumers. Such shifting of tax burdens can significantly affect perceptions of the fairness of particular taxes. For example, the corporate income tax might be viewed as less fair if the burden is seen as resulting in lower long-run wages for workers rather than being incurred by well-to-do corporate shareholders.

Effects on Growth of the Economy

Increasing economic efficiency and promoting growth of the economy are important goals for tax reform. A tax system that inflicts fewer distortions on economic decisions would improve the efficiency of the use of resources in the economy and thus improve the general welfare. One source of inefficiency is *tax preferences*, that is, provisions that provide more generous tax treatment of certain types of income and expenditures than would be accorded under a

more uniform or pure version of the tax. Such preferences cause investment funds to flow to tax-favored lines of business at the expense of potentially more productive investment and thus reduce the overall output of the economy.

Consumption tax proponents argue that a consumption tax would be more conducive to growth than an income tax even in the absence of tax preferences. A consumption tax would be more neutral with respect to investment decisions since new investments would be immediately deductible (expensed). As noted above, the current income tax is not neutral among investments, and it is inherently more difficult to achieve neutrality under an income tax. By removing the tax on the returns to saving and investment, a consumption tax would increase saving and investment. Over time, this would increase the stock of capital. With a larger stock of capital, workers would be more productive, and output and wages would rise. Some recent research estimates that changing to a tax on consumption could increase the net national saving rate by 16 to 43 percent after a year and by 12 to 31 percent after 14 years, depending on the type of tax adopted. National output per capita would decrease by 0.5 percent or increase by up to 4.4 percent after a year and increase by 0.5 to 6.3 percent after 14 years. The research suggests that wages would increase by 0.8 to 1.4 percent after 14 years.

Reform of the income tax could also promote economic growth. Income tax reform could lead to a more uniform, broad-based, low-rate income tax that would reduce distortions in economic decisions. The above research suggests that such an income tax reform would increase the saving rate by 10 percent after one year and by 6 percent after 14 years and that national output per capita would increase by 3.8 percent after one year and by 4.4 percent after 14 years.

However, even if there are long-run economic gains from a tax reform proposal, these must be weighed against the costs of transition from the current tax system to the new one. Taxpayers would incur costs adjusting to compliance under a new system and the IRS would incur start-up costs developing rules, forms, and administrative procedures. In addition, major tax reform could result in significant gains or losses for some taxpayers when the prices of assets change. If losers were to be fully compensated for their losses, the potential gains from reform would be reduced. None of the preceding analysis implies that tax reform should not be undertaken. Rather, the key point is that transition issues need to be taken into account when assessing the costs and benefits of the various reform proposals.

Finally, tax reform could impose large transition costs on state and local governments. Some tax reform proposals call for repeal of Federal income taxes. Since most state income taxes rely on the Federal tax as a starting point, states would either have to find another source of revenue or administer their income taxes on their own. Other proposals would impinge on the traditional state reliance on sales taxes by adding a Federal tax on this base.

Simplification

Proponents of consumption taxes argue that they would be simpler than income taxes. Some consumption tax prototypes, such as a national retail sales tax or a value added tax, would be simpler for individuals because the point of collection would be shifted from individuals to businesses. This feature is not unique to consumption taxes, however, because it would be possible to design a comprehensive income tax that could be collected at the business level. Consumption taxes would also be simpler because allowing immediate deduction for all purchases would eliminate the need to keep track of depreciation deductions over time and to make distinctions among various types of property. In addition, the complexities associated with taxing capital gains would be eliminated, since capital gains are not part of a consumption tax base.

Proponents of income taxes point out that the current income tax system could be greatly simplified, and that starting from scratch, one could design a much simpler system. They also note that it is unfair to compare an idealized consumption tax with the current system. Thus, either a consumption tax or a reformed income tax could be much simpler than current law, but there may be some additional simplification potential under a consumption tax.

Tax Reform Prototypes

The previous section examined some general issues of tax reform. This section considers the most prominent consumption tax prototypes and potential reforms of the current system. The President has not endorsed any specific proposal, and this chapter does not advocate the adoption of any particular prototype for reform.

Consumption Tax Prototypes

If tax reform takes the path of taxing consumption rather than income, there are four basic types of consumption taxes to consider: the retail sales tax, the value added tax (VAT), the flat tax, and the consumed income tax. This section begins with a brief description of the four taxes and then discusses each in more detail.

The simplest consumption tax to understand is the *retail sales tax*, which imposes tax liability when an individual purchases goods or services for consumption. Retail sales taxes are levied by most states and many local governments.

The starting point for thinking about *value added taxes* is to note that most goods are produced in stages. For example, a farmer grows wheat and sells it to a miller, who grinds it into flour and sells it to a baker, and so on until a loaf of bread is delivered to a grocery store to be sold to consumers. Instead

of being collected all at once at the final sale to consumers, the value added tax is levied on the value added to the good or service at each stage of its production. At each stage, the tax base is receipts for the sale of goods and services less purchases of goods and services from other firms (Box 3-4).

Box 3-4: The Equivalence of Sales Taxes and Value Added Taxes

The retail sales tax and value added tax provide different methods of taxing the consumption of goods and services. Consider a simple example of bread produced and sold to households. A farmer grows wheat and sells it to a miller for \$300. The miller grinds the wheat into flour and sells it to a baker for \$600. The baker transforms the flour into bread and sells it to the grocer for \$800. The grocer sells the bread to consumers for \$1,000.

Business	Purchases	Sales	Value added	20% value added tax	20% sales tax
Farmer.....	\$0	\$300	\$300	\$60	\$0
Miller.....	300	600	300	60	0
Baker.....	600	800	200	40	0
Grocer.....	800	1,000	200	40	200
Total.....	1,700	2,700	1,000	200	200

Now consider a 20 percent tax on consumption. Under the retail sales tax, the grocer would compute the tax as 20 percent of sales and owe \$200 to the government. The farmer, miller, and baker would not pay sales tax because they sold only to other businesses for resale.

A 20 percent value added tax collects the same total revenue one step at a time as value is added to the product at each stage. The miller pays a VAT of \$60, calculated by subtracting purchases of \$300 from \$600 of sales and paying the 20 percent tax rate on the difference of \$300. The other businesses would compute their tax in the same way. The total tax would add up to \$200, the same amount as under the retail sales tax.

A European VAT (called a credit-invoice VAT) is calculated by imposing the tax on the full value and then giving a credit for VAT paid at the previous stages. The grocer would compute the \$40 VAT as 20 percent of sales of \$1,000 (or \$200) less tax credits of \$160 shown on the receipts for purchases of \$800 from the baker. The other businesses would compute their tax in the same way.

Consider what happens if the grocer fails to file and pay the amount of tax that is owed. Under the sales tax, the full amount of tax is lost to evasion. But under the VAT, only the tax on the last stage would be lost. In addition, the invoices at each stage provide a paper trail that helps improve compliance.

Because the sum of value added at each stage equals the value of the final product, taxing value added at each stage gives the same overall result as taxing final products at the retail level. Therefore, the VAT is just another way of taxing the same base as the retail sales tax. From an economic standpoint, they are equivalent.

The *flat tax* consists of a business tax and an individual level tax, both of which use a single flat tax rate. Calculation of the business tax base begins with a computation like that of the VAT, receipts less purchases from other firms. Next, wages are deducted from the business tax base. If wages are then taxed at the same flat rate under the individual tax, the result is the same as the VAT and retail sales tax. Therefore the key difference is that wages are taxed at the individual level rather than being included in the business tax base. This difference allows for building progressivity into the system by providing an exemption of, say, \$40,000 for a family of four.

Under a *consumed income tax*, taxpayers would first calculate their income as they do under the current income tax. Then they would be allowed a deduction for any saving during the year. Since consumption is equal to income minus saving, this too is a consumption tax.

These seemingly quite different taxes are equivalent ways of taxing the same base: consumption. As discussed in the following sections, the choice among them is affected by various administrative and compliance issues as well as the availability of mechanisms for obtaining distributional fairness.

National Retail Sales Tax

Sales taxes are levied by all but five states, and provide nearly 38 percent of state tax revenues. Most state sales taxes are levied at rates between 4 percent and 6 percent. Many states, however, exempt or apply a lower rate to food purchases, prescription drugs, and certain other “necessities” to improve the perceived fairness of the tax and also exempt most services.

Under a retail sales tax, individuals would no longer have to file tax returns because taxes are remitted to the government only by retail businesses. This is an important feature of retail sales taxes and other transactions-based taxes, which shift the burden of complying with the tax system from individuals to businesses. Since there would be many fewer tax filers, proponents argue that total compliance costs would be much lower than under the current system.

Under a retail sales tax, only final sales to consumers should be taxed since the intent is to tax consumption. Taxing business-to-business sales can result in cascading, a situation in which the tax is imposed multiple times before the consumer level. Nevertheless, states currently obtain about 40 percent of their sales tax revenues from business-to-business sales, although many business-to-business sales are exempted. The economic distortions associated with cascading can be severe at higher tax rates, and thus a national retail sales tax

would have to differ from state taxes by not taxing such sales. A related problem is that it is sometimes difficult to distinguish final sales for consumption from sales for use in production. For example, how would a store selling a computer know for certain whether it is being purchased for resale (exempt), for use in another business (exempt), or for home entertainment (taxable)? This issue would arise with many dual-use products and services.

To replace a significant portion of Federal tax revenues, tax rates for a national retail sales tax would have to be much higher than current state and local rates. The exact rate would depend on which Federal taxes were to be replaced and on whether education expenses, prescription drugs, medical expenses, and other necessary goods and services would be taxed. Some recent research suggests that to replace revenues from the individual and corporate income taxes, a national sales tax rate would have to be at least 30 percent if the tax base were that of a “typical state” and business-to-business sales were exempt. Such high rates could create strong incentives for tax evasion and avoidance. Some tax economists believe that sales tax rates over 10 percent could be problematic because of the incentive for evasion and avoidance.

Concerns about the impact of sales taxes on lower-income households could be addressed by exempting certain necessary goods and services or by providing a refundable tax credit sufficient to cover a certain amount of tax. Exemptions and preferential rates to address equity concerns, however, increase the complexity of sales taxes and lead to uneven taxation of consumption. Refundable credits could require the filing of some type of tax return by lower income households. However, this would defeat one of the main goals of the retail sales tax, which is reducing administrative burdens on households. In any case, both solutions would require higher tax rates to achieve a given amount of revenue. Uneven taxation and high tax rates would undermine a principal potential benefit of this type of reform: reducing economic distortions and promoting growth.

Value Added Tax (VAT)

Value added taxes are used in all European Union countries and in more than 100 countries around the world. European countries, which generally adopted VATs in the 1960s or early 1970s, typically impose a standard rate of 16 to 20 percent and a lower 5 to 10 percent or zero rate on products such as food and drugs. It is important to note that countries adopting VATs have not used them to replace income taxes; they are in addition to individual and corporate income taxes.

VATs avoid the problem of cascading taxes by allowing credit for the VAT paid on purchases. European VATs also create a paper trail that is believed to improve compliance. In spite of these advantages, VATs have not received serious consideration in the United States. Similar to the sales tax, VATs are

viewed as regressive, at least when annual income is used as the measure of ability to pay. Critics of the VAT are not mollified by the fact that it is possible to impose lower VAT rates on commodities such as food. Another concern is that VAT tax rates would tend to increase over time as has occurred in Europe because the VAT is such an efficient and largely hidden tax.

The Flat Tax

Reducing the tax burden for low-income households is cumbersome under the sales tax and VAT because they are collected at the business level. One of the advantages of the flat tax is that it allows for progressivity by providing a personal exemption based on family size.

The exemption leads to a fundamental trade-off in designing a flat tax. A higher exemption level means more families at the bottom of the income scale pay no tax and the distribution of the tax burden is more progressive. But the higher the exemption, the higher the tax rate required to raise any given amount of revenue. A higher rate reduces the anticipated gains in economic efficiency. The Treasury Department estimated in 1996 that a 22.9 percent tax rate would be required to raise as much revenue as the individual and corporate taxes, while keeping the Earned Income Tax Credit and exempting \$40,700 income (at 2003 levels) for a family of four.

The flat tax would be simpler than the current tax system. The individual tax is simple because it applies only to compensation for labor services and tax liability varies only with family size. The business level tax is simpler than the current corporate income tax. For example, since all purchases are deductible immediately, there is no need to keep track of depreciation deductions over a period of years or to distinguish between current expenses and capital costs. The flat tax would also reduce the costs of tax planning. Applying the same tax rate to all types of businesses and to both individual and business income is important because it eliminates many opportunities for avoiding taxes by changing the organizational form of a business or by shifting income to entities subject to lower tax rates and deductions to entities with higher rates. The double tax on corporate income and the associated distortions would also be eliminated.

A pure flat tax would eliminate many popular deductions, including those for home mortgage interest and charitable contributions. Retaining these deductions would require a higher tax rate and more complicated tax forms, and thus lose some of the gains in economic efficiency and simplification. In addition, some critics argue that even with a large exemption, the flat tax is likely to shift tax payments away from the highest income groups and toward lower- and middle-income groups. Finally, there would still be many complexities and opportunities for tax avoidance and evasion. Suppose, for example, that a business owner bought a computer for personal use. If the

owner claimed it was for business, he or she could deduct the entire cost of the computer.

There are many variants of the basic flat tax idea. For example, some proposals would allow for greater progressivity by using multiple tax rates in the individual tax. Other proposals would retain some deductions, such as those for charitable contributions or mortgage interest. Each variation sacrifices some of the efficiency gains and basic simplicity of the flat tax to achieve other goals.

Consumed Income Tax

Under a consumed income tax, taxpayers first compute income as they do under the income tax. Then taxpayers are allowed an unlimited deduction for net saving during the year. A consumed income tax is comparable to a traditional IRA for which contributions are deductible and withdrawals are subject to tax, but would have no limits on contributions or penalties on withdrawals. To prevent taxpayers from simply borrowing money and claiming a deduction for putting the proceeds into a savings account, any borrowing would be added to income and thus be taxable.

The consumed income tax offers more flexibility than the flat tax in allocating the burden among income classes because the individual tax base is broader and most proposals include a progressive rate structure. The primary disadvantage is complexity. It retains the complexity of the current system because taxpayers start by computing income as they would under current law. Then a second procedure to compute saving net of borrowing adds an additional layer of complexity.

Reform Within the Current System

A change to any of the consumption tax proposals would scrap the current tax system and replace much or all of it with a new one. Businesses and individuals would have to learn how to comply with and best arrange their affairs under the new system. A new administrative apparatus would be required for some proposals. While sales taxes have long been used in this country and VATs in many other countries, these are imposed at lower rates than would be required to replace all Federal revenues and are used along with, rather than as replacements for, income taxes.

Given the costs of transition to an entirely new tax system, some proposals focus on reform within the current structure. Starting from the current system would reduce transition and adjustment costs and considerable benefits could be obtained by simplifying and rationalizing tax provisions that overlap or are otherwise overly complex. Advantages of the prototypes and the tax principles discussed above could guide the direction of reform.

The Administration's tax program has already achieved significant reforms within the current system. Achievements include lowering marginal tax rates, reducing the double tax on corporate income, simplification, and improved fairness for families. This section discusses possible additional reforms that would provide simplification, improve fairness, or promote economic growth.

Lower Tax Rates and Broader Base

The principle behind the Reagan Administration's major tax reform in 1986 was to reduce tax rates and broaden the tax base by eliminating deductions and tax credits. The Tax Reform Act of 1986 was largely successful in this effort. Individual income tax rates were collapsed into two rates, 15 percent and 28 percent, with the top rate falling from 50 percent to 28 percent. The corporate tax rate was reduced, from 46 percent to 34 percent. Lowering rates reduced the distortions of the tax system and is often credited with increasing work effort and entrepreneurial activity and reducing tax avoidance activities. The overall reform was revenue neutral and slightly progressive. Even though the top marginal tax rates were reduced, progressivity was enhanced because high-income taxpayers lost many tax preferences.

While the achievements of the 1986 reform have eroded over time, the basic principles of lower rates and a broader base benefited the economy and could be useful in guiding reform within the current system.

Rationalizing Saving Incentives

Income taxes create a bias against saving because taxpayers who choose to save for later consumption have a larger total lifetime tax burden than those who do not save. To offset this bias, current law includes a variety of provisions that promote saving. Some are targeted at individual saving for retirement, some at employer plans for employee retirement, and some at saving for specific purposes, such as education and medical expenses.

The multitude of special purpose saving options encourages taxpayers to establish small pools of savings that can only be used for one purpose. Taxpayers have less flexibility since saving intended for one purpose cannot be used for another (except by paying a penalty). Taxpayers are likely to be unaware of all the options available, frustrated trying to decide which options are best for them, and confused by the detailed requirements. Since many incentives are available only to certain taxpayers, the multitude of options may add to perceptions that the tax system is unfair because some taxpayers are eligible, but others are not. Moreover, the large number of special accounts may be an impediment for lower-income and less sophisticated taxpayers concerned about making the wrong choices, which can have sizable penalties associated with them.

The current set of saving incentives could be combined into a simpler system with one type of account for individual retirement saving, one for employer-sponsored retirement saving, and one for lifetime saving for anticipated future education, health, home purchases, or other expenses. The President's budgets have included proposals for Retirement Savings Accounts (RSAs), Employer Retirement Savings Accounts (ERSAs), and Lifetime Savings Accounts (LSAs). Under these proposals and after a transition period, the savings incentives of over 90 percent of households would no longer be adversely affected by the tax system.

Double Taxation of Corporate Income

Corporate income is taxed first at the corporate level and then a second time under the individual income tax as dividends or capital gains. The tax relief enacted in 2003 reduced the double tax by lowering individual income tax rates for both dividends and capital gains. The current provisions expire after 2008, however. Thus, tax reform could include a permanent extension of current provisions or go further and completely eliminate double taxation of corporate income.

Depreciation Rules

As discussed above, the logic of an income tax requires that firms be able to deduct the amount by which their physical investments depreciate in value each year. Current law allows deductions for different types of equipment and buildings over nine recovery periods from 3 to 39 years. A 2000 Treasury Department report on depreciation concluded that the current system is based on outdated recovery periods, does not account for new industries and technologies, and favors some assets while penalizing others. As a result, the system distorts investment decisions and results in an inefficient allocation of capital in the economy.

There are several approaches that reform could take. One option is to rationalize the current depreciation system to make it more neutral in its effects on investment decisions. An effort to bring depreciation rules closer to economic depreciation would raise a number of difficult measurement issues, however. Another approach would simplify the current system by reducing the number of recovery periods and grouping investments into broader categories.

A third approach is to increase investment incentives and move part way toward a consumption tax by increasing the generosity of depreciation allowances. For example, a temporary bonus depreciation provision in the 2002 tax bill allowed taxpayers to deduct 30 percent of the cost of an investment in the first year with the remaining 70 percent of the cost to be deducted over the life of the investment. That is, 30 percent of the cost was deducted immediately as under a consumption tax, while 70 percent was

depreciated as under an income tax. First-year bonus depreciation was increased to 50 percent in 2003 and 2004.

These approaches have the potential to improve the allocation of capital and increase incentives for investment. The cost of increased incentives would have to be balanced against other objectives, such as keeping income tax rates low.

The Alternative Minimum Tax (AMT)

The AMT is a separate tax system requiring taxpayers to compute their income tax liability a second time under different rules and then pay the AMT if it is higher than the regular tax. As a result, the AMT adds considerable complexity, and dealing with it must be an important element of any tax reform. The predecessor to the current AMT was enacted in 1969 to ensure that high-income taxpayers with substantial amounts of tax preferences would at least pay a moderate sum in taxes. Unlike many income tax provisions, Congress did not index the AMT for inflation. Later, Congress increased AMT tax rates from 21 percent to 24 percent in 1991 and to 26 percent and 28 percent in 1993. With higher rates and no indexing for inflation, it was only a matter of time before large numbers of taxpayers would be affected. During the last several years, Congress has passed several temporary measures to keep the number of AMT taxpayers from growing too rapidly. However, under current law, the number of taxpayers paying the AMT is expected to grow rapidly from 3 million in 2004 to 38 million by 2010. Most of the newly-affected taxpayers will not be those with the highest incomes. One study projects that under current law, over half of all taxpayers with incomes of \$75,000 to \$100,000 (in \$2003) and 94 percent of married taxpayers with two children in that income range will be subject to the AMT by 2010.

Because taxpayers have to compute their taxes twice to see if they have to pay the AMT, it is a major source of complexity. Further, the lowest rate under the AMT is 26 percent, a higher rate than would otherwise be faced by middle-income families. Finally, while some tax preferences are added back into the tax base, many features of the AMT are inconsistent with sensible tax principles. For example, some costs of earning income are not deductible and personal exemptions are treated as a tax preference under the AMT.

Alternatives for AMT reform include repeal or limiting its effect to high-income taxpayers by increasing exemption levels and lowering AMT tax rates. Significant changes to the AMT would be costly, however, as various estimates suggest that the 10-year cost of full repeal would be nearly \$1 trillion.

Simplification

Many provisions in the current tax system overlap, conflict, or are otherwise overly complex. The Congressional Joint Committee on Taxation and others have produced lists of such provisions. Elimination or simplification of such provisions could substantially reduce compliance burdens and distortions of

the current system. In addition, some would broaden the tax base thus allowing for further reductions in tax rates.

An example of the potential for simplification was provided when Congress recently enacted legislation similar to an Administration proposal for a single definition of a dependent child in determining when taxpayers can claim several widely-used tax benefits. Previously, five different standards for a dependent child applied under different tax provisions, leading to confusion and inadvertent errors. This reform will benefit many lower- and middle-income households by providing a single set of rules and reducing burdensome record-keeping requirements.

While there are many complex provisions, among the prime candidates for simplification are the capital gains rates affecting certain special types of gains, taxes on dependent children with small amounts of investment income, and provisions that phase out certain tax benefits at higher income levels.

Conclusion

This chapter has examined problems of the current tax system and examined some of the major options for tax reform. The President has not endorsed any specific proposal. Well-designed reforms, however, should be able to simplify the system and enhance both fairness and economic efficiency.

Although tax reform has been discussed for many years, it is a particularly pressing need at the current time. Increasing numbers of taxpayers will be affected by the alternative minimum tax, which will be a major source of frustration and complexity. In addition, the tax reductions enacted since 2001 will expire in a few years unless they are extended or a new, reformed tax system is adopted. If these provisions are allowed to expire, the result will be substantial increases in taxes on taxpayers in all income groups, with the largest percentage increases being imposed on lower- and middle-income households. Taken together, these looming problems provide a natural opportunity to rethink the entire system of taxation.