Time To Change the Tax System

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ST. LOUIS-- There's a consensus among economists that the U.S. federal income tax system needs an overhaul, said Kevin Kliesen, an economist with the Federal Reserve Bank of St. Louis. They think the current tax structure has too few incentives to save and invest, is too costly to comply with and is too complex.

"That's why tax reform proposals are popular," Kliesen said. "And predicting the short-term economic effects of any of them would be difficult. But if tax reform favors saving over consumption that is, if it favors the future rather than the present it will eventually boost the growth rate of the economy and enhance our living standards."

Kliesen's analysis of tax reform appears in "Tax Man, Heal Thyself," the lead article in the July 1996 issue of The Regional Economist, the St. Louis Fed's quarterly review of economic and business issues.

At last count, said Kliesen, there were some 13 major proposals to change the federal income tax code. The two getting the most attention are the Hall-Rabushka flat tax (H-R) and the Unlimited Savings Allowance (USA) plan. Proponents of each claim that U.S. investment would rise substantially over time by boosting incentives to save and would simplify the tax code while keeping its progressive nature.

The basic premise behind the H-R version is to tax income only once: where it's earned. Under H-R:

- Income at the individual level is defined as wages and salaries, plus pension and retirement contributions, with a flat 19 percent (marginal) tax rate applying to incomes above a certain level.

- Deductions for mortgage interest, charities and alimony are eliminated.

- The corporate tax would drop from the current 35 percent to 19 percent. "Probably the most dramatic corporate tax change in H-R," said Kliesen, "is one allowing capital equipment to be expensed rather than depreciated. This gives firms incentives to add to their productivity-enhancing stock of durable assets."

One study suggests that the average family with annual wages and income between $10,000 and $30,000 would see a net reduction in taxes. Those with incomes between $30,000 and $100,000, however, would likely experience a slight increase in their taxes.

The Unlimited Savings Allowance (USA) is a "consumed income tax," Kliesen said, meaning that it effectively taxes income used to buy goods and services by not taxing income that's saved. It shares many of the same features of H-R, but differs in many important ways. Under USA:

- The definition of gross income is expanded to include financial income such as dividends and interest payments, and income from the sale of stocks and bonds.

- To offset the above, USA allows a taxpayer to take a credit for the amount of payroll tax (Social Security and Medicare) that he pays.

- Deductions for mortgage interest, charities and alimony would be kept, but deductions for property taxes, and state and local taxes, would be scrapped.

- A number of deductions for businesses would be curtailed, but, to compensate for this, the corporate tax rate would be lowered to 11 percent.

Proponents of the USA plan believe that families with incomes between $10,000 and $50,000 would enjoy an average tax cut of just over 9 percent. Those with incomes between $50,000 and $100,000 would see no change in tax liability, while those with incomes greater than $100,000 could see an increase of as much as 4 percent. Although the USA plan is not as simple as the flat tax, it would probably be a vast improvement over the current system in terms of boosting the incentives to save and invest.

Tax reform would not only encourage saving and investing; it would also reduce the costs of complying with a system that's become complex and confusing over the years. "In the past 17 years," said Kliesen, "the U.S. tax system has been modified no less than eight times. And today, we have a total of 586 tax forms and schedules. Although the burden of complying with the system is difficult to determine, estimates range from $100 billion to $600 billion per year, with nearly five billion man-hours required."

Most economists, even those who criticize current tax reform efforts, acknowledge that the existing system is a drag on economic growth and efficiency, Kliesen said. "In an era when the economy's potential output growth has slowed markedly from the pace it enjoyed before the early 1970s, the likely positive effects on saving and investment coming from an improved tax system shouldn't be taken lightly," he adds. "Fundamental tax reform, however it plays out, will probably be a boon to future generations."

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