

Example 14.3

Tax Reform

The U.S. federal government makes use of four main taxes to raise its revenues: the personal or individual income tax (\$1,163.5 billion); the payroll tax (\$869.6 billion), which is earmarked to finance the Social Security System; the corporation income tax (\$370.2 billion); and the gift and estate tax (\$26.0 billion) (fiscal year 2007 revenues in parentheses).¹ No one appears to be entirely happy with this system of taxes, and many people are quite unhappy. Congress responds continually to the dissatisfactions with the tax system, but more by way of fiddling with the tax laws than by enacting major tax reforms. There have been 15,000 changes in the federal tax laws since the passage of the Tax Reform Act of 1986 (TRA86), which was the last major tax reform, primarily a restructuring of the personal income tax base.² The most dramatic changes since 1986 have been to the tax rates rather than to the tax bases, such as the increase in the personal income tax rates under the Clinton administration, the cutting of those same rates during the George W. Bush administration, and the lowering of the corporation income tax rates.

Many people believe that the time has come for another major reform of the federal tax bases. The calls for reform run the gamut from reform of the personal and corporation income tax bases, to substituting a wage tax for the personal income tax, to scrapping all four federal taxes in favor of a national retail sales tax. Many of the suggestions for reform have made their way into legislative proposals in the House and Senate, but so far none of the proposals have been put forward for a vote.

President Bush was one of the foremost advocates of tax reform. He established an Advisory Panel on Federal Tax Reform in January 2005 to design an overhaul of the current tax system that would be simpler, fairer, and more pro-growth while at the same time being revenue neutral, that is, raise the same amount of revenue as the current tax

¹ *Budget of the United States Government, Fiscal Year 2009, Supplement* (Washington, D.C.: U.S. Government Printing Office, 2008), Historical Tables, Tables 2.1 and 2.5.

² Simple, Fair, and Pro-Growth: Proposal to Fix America's Tax System, *Report of the President's Advisory Panel on Federal Tax Reform*, November 2005. The 15,000 figure appears in the Panel's cover letter to the Report, p. 2. www.taxreformpanel.gov.

system. The leading economists on the Panel were Edward Lazear, the Chairman of the Council of Economic Advisers and James Poterba, MIT's foremost public sector economist.

The Panel issued their report in November 2005. The report noted that the panelists considered a number of fairly radical reforms, such as replacing the personal income tax with a personal consumption tax, and instituting a value added tax (VAT) or a national retail sales tax to replace some or all of the current taxes. But the panelists were unable to reach a consensus on any of these options. Instead, they proposed a restructuring of the existing personal income and corporation income taxes. They offered two different options, one that they called the Simplified Income Tax Plan and the other the Growth and Investment Tax Plan. The proposed restructuring under either plan was fairly substantial. The Panel offered a list of specific reforms that ran for an entire typewritten page, single-spaced. The majority of the reforms were common to both plans, especially those designed to promote simplicity and fairness. The plans differed mostly with respect to the pro-growth goal; saving and investment were taxed somewhat less under the Growth and Investment Tax Plan.³

Reproducing the entire list of proposals is not of much interest because Congress never considered either tax plan. More relevant is the set of principles that the Panel espoused regarding each of the President's goals, and the more important reform proposals in support of those principles. In many instances, the specific proposals promoted more than one of the goals. Here is a sampling of the main principles and proposals.

Simplicity: The Panel sought a tax form that would be half as long for the average taxpayer. A major reform to this end related to the incentives to promote saving. The current personal income tax has fifteen separate provisions to promote saving for retirement, for medical expenses, and for education. The Panel proposed combining these into three plans: a Save at Work plan that simplifies the current 401k plans (see Example 14.1), a Save for Retirement Account that replaces all the individual IRA-type accounts (also described in Example 14.1), and a Save for Family Account that replaces all the current savings incentives for education and health. Another major simplification was to replace the personal exemptions, standard deduction, and child tax credit with one family credit, which included a credit for full time students.

Fairness: The Panel endorsed the progressivity of the personal income tax. They retained the graduated rate structure, but reduced the number of brackets to four: 15%, 25%, 30%, and 33% under the Simplified Tax Plan. They also changed a number of current deductions to credits. Most notable was replacing the deduction for mortgage interest to a home credit equal to 15% of the interest paid, with a limit on the principal to which the interest credit applies equal to the average of the housing prices in the taxpayer's geographic region. As noted in Chapter 14 of the textbook, deductions reduce

³ For a list of the proposed reforms under the two options see the President's Advisory Panel Report, op. cit., Executive Summary, pp. XVI and XVII.

the progressivity of the tax by giving proportionally larger tax breaks to higher income taxpayers, those facing higher marginal tax rates. In contrast, a tax credit applies the same percentage reduction to the tax liabilities of all taxpayers regardless of their income. The Panel also recommended that low-income taxpayers receive a special savers credit.

Growth: Both tax plans attempted to increase the incentives for saving and investment. As already noted, they retained the tax incentives for saving for various purposes – retirement, health, and education – while simplifying and streamlining them. The top marginal tax rate was reduced, from the current 35% to 33% under the Simplified Income Tax Plan and to 30% under the Growth and Investment Tax Plan. Additionally, the Simplified Tax Plan reduced the double taxation of capital income under the personal and corporation income taxes by allowing corporations to exclude 100% of dividends from the corporation income tax base, the same treatment as for interest payments, and by excluding 75% of capital gains from taxation under the personal income tax. The Growth and Investment Tax Plan went further in promoting saving and investment. It moved the personal income tax closer to a personal consumption tax by taxing all income from capital – capital gains, dividends, and interest income – at a 15% rate. It also allowed corporations to expense their investments, that is, deduct the entire amount of their investments each year from the corporation income tax base (see Example 15.2).

In summary, the Panel concluded that the changes to the personal and corporation income taxes that they proposed, all of which could be easily enacted, would sufficiently promote the President’s three goals. They saw no need for a radical restructuring of the federal tax system.

The FairTax (National Retail Sales Tax)

Other people disagree with the Panel. Boston University’s Larry Kotlikoff and David Rapson believe that the goals of simplicity, fairness, and growth would be far better served by replacing all four of the existing federal taxes with a national retail sales tax, which they call the FairTax. They calculate that a broad-based sales tax covering virtually all goods and services would raise the same amount of revenue as the four existing taxes with a tax rate of 30%. Moreover, the 30% tax rate would finance all federal expenditures providing the government reduced real non-Social Security spending by 3%. Their proposal includes a separate rebate (transfer) to all taxpayers, adjusted for family size, equal to the average consumption of individuals and families who have the poverty-line level of income.⁴

Kotlikoff and Rapson have simulated the effects of their proposal relative to the current federal taxes for 42 representative individuals and families who vary by age (30, 45, and 60), marital status, number of children for the married couples, and income (from \$10,000 to \$250,000 for individuals and from \$20,000 to \$500,000 for married couples).

⁴ Kotlikoff, L. and Rapson, D. (2005) Comparing Average and Marginal Tax Rates Under the FairTax and the Current System of Federal Taxation, *Working Paper 11831*, NBER Working Paper Series, December. Their proposal and the data reported in this example can be found in the Executive Summary, pp. 2–5, unless otherwise noted. www.nber.org/papers/w11831.

They find that virtually everyone faces lower average and marginal tax rates under the FairTax. First, the marginal tax rates on income from their savings (capital income) fall from a range of 22.6%–54.2% to zero, since capital income is untaxed. Second, they all experience a decrease in the effective marginal tax rates on their labor income, often a dramatic decrease. For example, the effective marginal tax rate on the labor income of a married couple with two children and earnings of \$30,000 decreases from 47.6% to 23%. The current high marginal tax on their wage income is due in large part to the 21% phase-out rate under the Earned Income Tax Credit (EITC).⁵ Under the FairTax proposal, the EITC would disappear along with the personal income tax. Finally, Kotlikoff and Rapson calculate the difference in the average burden of taxation for each family for the remaining years of their lives under the current tax system and the FairTax and find that it decreases for all but three of the individuals and families: single taxpayers aged 30 earning either \$10,000 or \$15,000, and a childless married couple, age 30, earning \$20,000. The increased lifetime burden on these individuals and couples is quite small, however.⁶

How can (virtually) everyone face lower marginal and average tax rates from changing to a national sales tax if it is revenue neutral relative to the four existing federal taxes? The answer is that a national retail sales tax, which is a tax on consumption, represents a considerable broadening of the tax base relative to the existing taxes, so that the tax rates can be lower. The broadening occurs because, absent any taxes, the present value of all current and future consumption must equal the present value of current and future labor income plus the value of existing wealth.^{7,8} This is true whether the current wealth holders consume their wealth or pass it on to heirs through bequests and the heirs eventually consume it. Either way, there is no other source of income to finance current and future consumption. Therefore, a national sales tax on all consumption is equivalent to a tax on labor income plus all existing wealth. In contrast, the current tax system taxes only a portion of existing wealth. In addition, assume that the FairTax is passed on fully in the prices of goods and services. Therefore, it would take \$1.30 of income to purchase a good or service that used to cost \$1.00 under the existing federal taxes. Equivalently, a dollar of income now buys only \$.77 worth of consumption ($$.77 = \$1/\$1.30$). Therefore, a 30% sales tax is equivalent to a 23% tax on labor income and existing wealth ($.23 = 1.00 - .77$). Almost all labor income is taxed at greater than 23% under the existing federal taxes.⁹

In summary, Kotlikoff and Rapson see the following advantages for the FairTax:

⁵ The structure of the EITC is presented in Chapter 11 of the textbook.

⁶ Kotlikoff and Rapson, *op. cit.*, Table 5.

⁷ The present value of income and consumption computes the value of all future income and consumption in today's dollars so that dollars earned or spent over time are comparable. See the first part of Chapter 20 in the textbook if you are unfamiliar with the concept of the present value of future dollars.

⁸ In a world without taxes, the income earned on savings out of existing wealth grows at the same rate of interest used to discount future income to present value. Therefore, the present value of wealth does not change over time, on average, throughout the economy.

⁹ Notice that in the example of the married couple above, their marginal tax rate under the FairTax is 23%.

- *Fairness*: Virtually everyone's marginal and average tax rates would be decreased. Moreover the FairTax is progressive: The rebate protects low-income individuals and families and the relative burden is shifted towards the rich because they own most of the existing wealth.
- *Simplicity*: The FairTax would be relatively simple to implement because 45 states now levy their own sales taxes. Either the states or the federal government could collect both the national and state taxes.
- *Growth*: Herein lies the greatest advantage of the FairTax relative to the existing taxes. Because the FairTax lowers the marginal tax rate on labor income for virtually all taxpayers and the marginal tax rate on savings is zero, it would lead to a big increase in saving and investment, which would increase the future productivity of the economy. Kotlikoff and Rapson estimate that real wages would eventually rise by 19% under the FairTax.

The President's Advisory Panel knew of the simulations and arguments in favor of the FairTax but were unconvinced by them. They see the following difficulties with a national retail sales tax.

In the first place, the Panel do not trust the Kotlikoff/Rapson simulations. Kotlikoff and Rapson use a highly sophisticated computer program that assumes individuals and families smooth their consumption optimally over time to maximize their lifetime utility. If the current system were replaced by a national retail sales tax, taxpayers would reoptimize their lifetime consumption patterns, including bequests. Kotlikoff and Rapson compare effective average tax rates and marginal tax rates on labor of the two tax systems under these optimization assumptions.¹⁰ Although conceding that changes in tax laws have both current and future effects, and that the Kotlikoff/Rapson approach is a perfectly reasonable way to capture them in principle, the Panel note that their simulations require a huge set of assumptions – about preferences, the path of future wages, prices, and interest rates, and people's expectations about future wages, prices, and interest rates. Unfortunately, these assumptions are all highly problematic. Consequently, the Panel chose to rely on more limited and heuristic short- and medium-term calculations that suggest that the FairTax, along with the rebate, would redistribute the tax burden from the lower and upper classes to the middle class. There is also the concern, discussed in Chapters 14 and 19 of the textbook, that the current elderly bear a disproportionate burden when switching from an income to a consumption tax base.

More narrowly, the Panel believe that Kotlikoff and Rapson underestimate the size of the rebate. Their calculations suggest it would be on the order of \$600 billion, and would require a sales tax rate of 34% to achieve revenue neutrality with the existing taxes. They also believe that instituting a broad-based national sales tax would be administratively difficult because most state sales taxes have much narrower tax bases. Finally, they point to evidence that tax evasion under sales taxes increases substantially

¹⁰ See Kotlikoff and Rapson, op. cit., parts II and III, pp. 10–17 for the particular way that they make the comparisons. The technique is quite complex.

when sales taxes reach 30% and more. For all these reasons, the Panel respectfully disagreed with Kotlikoff and Rapson that the FairTax would better meet the President's three goals than their proposed reforms of the personal and corporation income taxes.

The Hall-Rabushka Flat Tax

Another radical tax reform that has gained some support is a long-standing proposal by Stanford University's Robert Hall and Alvin Rabushka to replace the federal personal income tax with a personal tax on labor income only.¹¹ The tax on wages and salaries would be levied at a single rate, which is why it is commonly referred to as the Flat Tax. The tax would include a high personal exemption, varying by family size, to protect low-income individuals and families from taxation. A legislative proposal of the Hall-Rabushka Flat Tax by Dick Armey to the 106th Congress set the tax rate at 19%, to decrease to 17% once the tax was fully phased in, with personal exemptions ranging from \$11,600 for a single taxpayer to \$23,000 for married couples filing jointly. There was also a \$5,000 exemption for each dependent.¹²

In addition, Hall and Rabushka would replace the corporation income tax with a cash-flow tax applicable to all businesses that allows them to expense their investments. This part of their proposal is the same as the Advisory Panel's proposal under their Growth and Investment Tax Plan.

The Hall-Rabushka Flat Tax shares with the FairTax the property that investment (and therefore saving) and income from capital is untaxed, which goes as far as a tax system can possibly go in promoting long-run economic growth. It is also much simpler to administer than either the FairTax or the current tax system. At the corporate level, the ability to expense investment removes all the tricky administrative issues that arise with the current tax regarding the depreciation of assets. And a cash-flow tax would be much simpler for firms to adjust to than would a new national sales tax.

At the personal level, a tax on wage and salary income is the only way to levy a truly simple tax on individuals and households. As noted in Chapter 14 of the textbook, taxpayers still have to keep track of their assets and income from capital under a personal consumption tax so that they can properly distinguish between their saving and consumption during the year. In contrast, Hall and Rabushka point out that a tax on wage and salary income can be filed on a single postcard containing the following four to six lines: 1. Total wage and salary income; 2. The personal exemption; 3. Taxable wage and salary income (line 1 – line 2); 4. Tax liability, equal to the flat rate times the taxable wage and salary income on line 3; 5. Amount of tax withheld by employer, if relevant; 6. Additional tax owed or amount of refund due (line 4 – line 5). This is about as simple as a personal tax can be.

¹¹ Their proposal first appeared in Hall, R. and Rabushka, A. (1983) *Low Tax, Simple Tax, Flat Tax* (New York: McGraw-Hill, Inc.). See also Hall, R. and Rabushka, A. (1995) *The Flat Tax*, 2nd edn (Stanford, CA: Hoover Institution Press, Stanford University).

¹² Bickley, J. (2000) Flat Tax Proposals and Fundamental Tax Reform: An Overview, *Report IB95060*, Government and Finance Division, Congressional Research Service, November 17, The Armey Proposal.

The one disadvantage of the Hall–Rabushka Flat Tax relative to the FairTax is that income from capital escapes taxation entirely. The tax base does not include existing wealth. This opens the Flat Tax to the charge that it is unfair relative to the FairTax or the existing tax system because the ownership of wealth is highly concentrated among the rich. For this reason alone, one suspects that a radical change in the existing federal taxes, if it were to occur, would more likely be some form of consumption tax – a national sales tax, an EU-style VAT, or a personal consumption tax – than a wage tax.