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Tax Policy Solutions

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Taxes play a central role in long-term fiscal issues. The *level* of revenue collected must ultimately be sufficient to finance the chosen level of spending. Likewise, the *structure* of tax policy has far-ranging effects on the economy, similar to the structure of spending programs. This chapter is a guide to reforms that, in our view, could improve the structure of taxes and could align revenue levels with different chosen levels of spending.¹

The fundamental goals of tax policy appear to be widely accepted: taxes should be simple, transparent, stable, and fair; encourage economic prosperity; impose minimal costs on the economy; raise the revenue needed to finance chosen spending levels; yet respect individuals' freedom and privacy. Nevertheless, this broad consensus barely scratches the surface of real tax issues. People often have different ideas of what each goal means: fairness, for example, is in the eyes of the beholder. They may disagree on the best way to achieve a goal. Is the most effective way to increase growth to reduce the budget deficit, to cut tax rates, or to invest in education and health? Most important, they may disagree about what

to do when the goals are in conflict with each other—for example, what to do if a particular proposal raises the progressivity of the tax system but also reduces work effort.

As a result of these differences, changes in tax policy tend to be controversial. Nonetheless, the nation has no option but to align revenue and spending levels in the long run, and we believe that tax structure could be durably improved at any given revenue level.

Background

The federal government raises revenue from four main sources: the personal income tax, payroll taxes, the corporate income tax, and estate and gift taxes. Over the past fifty years, the personal income tax has been the workhorse, in terms of raising revenues and providing progressivity. Payroll taxes have risen substantially over the last several decades and are now the second largest revenue source. Most households pay more in payroll taxes than in income taxes. Payroll taxes are earmarked to pay for social insurance benefits; the taxes themselves are regressive, but the overall effect of the programs, including taxes and benefits, is progressive. Corporate tax revenues have fallen sharply as a share of GDP over the past fifty years. The estate and gift taxes raise small amounts of revenues but are a key element of the progressivity of the federal tax system.

As described in chapter 1, the personal income tax and estate tax are currently in a state of flux because since 2001 numerous tax provisions have been passed on a temporary basis. Under current law, all of these recent tax cuts will expire by the end of 2010.

In 2004 the federal government collected revenues of \$1.9 trillion. At 16.3 percent of GDP, revenues were at their lowest share of the economy since 1951. As shown in chapter 1, under the baseline that would make almost all of the recent tax cuts permanent and avoid big tax increases due to an alternative minimum tax (AMT), revenues in 2015 are projected to be only 17 percent of GDP, less than the average of 18.2 percent between 1960 and 2000. Thus as the nation heads into a lengthy period of expanded budgetary pressures, revenues are likely to be running well below their historical share of GDP.

After 2015, the revenue picture improves only slightly. The adjusted baseline implies revenues of 20 percent of GDP by 2030. Although this would be close to the highest revenue level since World War II, it would still be far below projected spending equal to about 27 percent of GDP in 2030 under current policies (see chapter 2). This suggests the need either for very large cuts in spending, very large tax increases, or some of both, relative to the adjusted baseline.

How to distribute such taxes equitably among households—within and across generations—is both controversial and laden with judgment. There is widespread agreement that a fair tax should provide “equal treatment”; that is, households or individuals that are in equivalent economic situations should be treated equivalently. In practice, however, it is sometimes difficult to reach agreement on what constitutes an equivalent economic situation.

Most people also believe a fair tax should be progressive, though there is sharp disagreement about *how* progressive taxes should be. Progressivity refers to the extent to which the ratio of taxes paid to income (or some other measure of economic capacity or well-being) rises as income (or another measure of capacity) rises. The overall progressivity of government policy, however, is determined by both taxes and expenditures. For low- and moderate-income households, the redistribution achieved through government spending may swamp tax-induced redistributions. Thus the current and projected budget deficits, which are crimping federal spending for low- and middle-income families, threaten to make the overall system more regressive.

In general, the tax system should do as little damage as possible to the level and composition of economic activity.² Uneven rates across activities or assets encourage people to choose projects with inferior economic returns but favorable tax treatment over projects with stronger economic returns but less favorable tax rules. This leads to a misallocation of resources and an unambiguous decline in economic well-being. Several areas of the federal tax code stand out in this regard, in particular the favorable treatment of housing and the varying treatment of different forms of business income.

Changes in tax levels and rates have two sets of effects on the economy. First, they directly affect economic decisions. Lower marginal tax rates,

for example, can stimulate work, saving, investment, and risk taking. (On the other hand, to the extent that tax cuts reduce tax liabilities without affecting marginal rates, people will feel richer and are likely to reduce work effort and similar economic activity.) Available evidence suggests that although these effects can be large when tax rates are very high, in general the broad impacts on labor supply, saving, investment, or risk taking are modest when the rates themselves are lower.

Second, tax cuts have indirect effects on the economy. Without offsetting reductions in spending, tax cuts raise the budget deficit, which reduces public saving. When national saving—the sum of private and public saving—falls, the future income of American households is reduced. In many cases the negative effect from increasing the budget deficit outweighs the positive direct effect of a tax cut.³ In short, whether tax increases support or hamper economic growth depends on how they are designed and financed. The evidence suggests that as long as tax rates remain in a moderate range, small differences in marginal tax rates by themselves exert only modest influences on work, saving, and entrepreneurship, while sustained budget deficits reduce growth.

Currently, the highest marginal rates are faced by poor and middle-income households, especially when children are present. The reason is that benefits from many government programs phase out quite sharply as income increases, and hence effectively “tax” any increase in income earned by such families.

Besides affecting incentives to work and save, high tax rates also give taxpayers incentives to avoid (legally) and evade (illegally) taxes. Thus, lower rates can encourage taxpayers to report more of their income and to restructure their activities to include more taxable activity and less untaxed activity. The magnitude of these effects is open to question, but their importance is heightened by an estimated “tax gap”—taxes that should be paid but are not—in excess of \$300 billion per year.

Although there is near-unanimous agreement that the federal tax system is too complex, taxes seem to become more complicated every year. Some complexity is an unavoidable by-product of trying to achieve other policy goals, such as greater equity or better enforcement. Nevertheless, we believe that much of it could be eliminated without loss of important social policy objectives. The political process, however, often ignores the

costs of complexity in new legislation and then constrains simplification efforts for fear of creating losers.

Replacing the Current System

One approach to dealing with the problems described above is to jettison most of the current tax code and start over with a completely new system. Advocates of fundamental tax reform claim that it could boost growth, slash tax burdens, simplify compliance, and eliminate the Internal Revenue Service. Unfortunately, a more realistic assessment of the problem must acknowledge that all taxes involve some complexity and require a government agency to handle returns, audit taxpayers, and deter cheating—and no tax will satisfy all taxpayers.

In recent years, several consumption-based taxes have been proposed as alternatives to the existing system. Under a national retail sales tax (NRST), a single tax rate would apply to all sales by businesses to households. (Sales between businesses and between households would not be taxed.) Under a value added tax (VAT), each business would pay tax on the difference between its total sales, whether to consumers or to other businesses, and its purchases from other businesses, including investment. Thus the incremental value at each stage of production is 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, it is the same, in theory, as under an NRST.

The flat tax, whose name was 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 be allowed deductions not only for purchases from other businesses but also for cash wage and salary payments and employer pension contributions.⁴ Individuals would then pay tax on wages, salaries, and pension income that exceeded personal and dependent exemptions. Businesses and individuals would be taxed at a single flat rate. Under the “jettison the income tax” approach, the NRST, the VAT, and the flat tax would replace the current convoluted income tax base with a consumption base, replace the current graduated rate structure with a single tax

rate (or at least a single positive rate), and eliminate almost all tax credits and deductions.⁵

As replacements for the current system, the consumption tax proposals made to date are unlikely to function all that simply or to be politically acceptable, although they might sound appealing relative to an unreformed income tax. In the national retail sales tax, the tax rate required to replace income and payroll taxes and maintain current government programs would be on the order of 40 or 50 percent. Likewise, realistic versions of the flat tax—including measures of transition relief; allowances for individual deductions for charity, large health payments, and state taxes; and business deductions for health insurance and taxes—would require rates of over 30 percent just to replace the personal and corporate income taxes.

In addition, both systems would provide large tax cuts for the wealthiest households and make up the revenue with tax increases for low- and middle-income households. Finally, international experience suggests that retail sales tax rates above 10 percent stretch the limits of enforcement. The flat tax would also face significant avoidance problems at the business level, both because it treats some cash flows (such as interest and dividend payments) differently from others (such as purchases of goods and services) and because firms and tax advisers have devised very clever ways to “relabel” such flows to gain tax advantages.

Piecemeal Moves toward Flat Consumption Taxes

Completely replacing the existing system would entail enormous administrative, legislative, and economic upheavals. This has led some to advocate step-by-step replacement of particular features of the tax code, with the goal of converting progressive taxes on income and wealth into a flat tax on consumption. Such 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 changes are reflected in the Bush 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 proposed vast expansions in the contribution limits for tax-free savings accounts.

The problem is that these changes do not add up to a well-defined tax system. In theory, an efficient 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 reduce 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 the piecemeal proposals and legislative changes of recent years fail all four tests. They (a) reduce government saving, and likely national saving; (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 advocates of piecemeal reform downplay such concerns, arguing that the perfect is the enemy of the good. But our underlying point is that the system that emerges has many of the worst features of *both* the earlier tax system and a fundamentally reformed system. First, the administration’s tax cuts accompanied an expansion in expenditure, 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, efficiency is reduced because windfall gains—for example, from cuts in taxes on dividends and capital gains—raise the return to old investments without inducing more saving. Fourth, there will be efficiency losses from increases in taxpayers’ ability to shelter income without saving more if differences between the taxation of capital income and capital expense become larger—that is, if tax preferences for deposits to accounts are expanded but interest deductions are retained.

By excluding returns to capital from taxation but not returns to labor, this system shifts the burden of taxation to low- and moderate-income households, which receive the bulk of their income in the form of wages. And the system would also allow interest deductions, which would allow high-income taxpayers to shelter some of their wages, so that the tax burden would fall even more heavily on the wages of low- and middle-income households.

Reforming the Current System

There are numerous areas where the current tax system could be changed. This section discusses some of the major possibilities.

Deal with the Expiring Tax Cuts

The most immediate tax questions facing the country are to what extent the administration's recent tax cuts, including some not yet implemented, are to be made permanent, and if so, how they would be financed. Ultimately, tax cuts must be paid for either with spending cuts or other tax increases. To date, however, no leader in either political party has indicated how these and other recent deficit-increasing measures will be paid for. The administration has actually proposed budget rules that would allow Congress to pass legislation to make the tax cuts permanent without showing any cost relative to a "current law baseline." In fact, making the tax cuts permanent would reduce revenues after 2011 by about 2 percent of GDP.

If these tax cuts were financed with spending cuts, the required reductions in spending would be enormous. In 2015, for example, if Social Security, Medicare, Medicaid, homeland security, defense, and net interest were all off limits, a 50 percent reduction in all other government spending would be required to cover the revenue loss from having made the tax cuts permanent. For the tax cuts to be financed by tax increases, a majority in Congress and the president would have to commit themselves to tax reform that increased net revenues rather than reform that is revenue neutral. To the extent that insufficient tax increases or spending cuts occur, the tax cuts would be temporarily financed by borrowing. This postpones, but does not avoid, the ultimate need to cut spending or raise taxes. Moreover, borrowing to finance tax cuts that have not been paid for will reduce long-term growth, according to studies by a variety of experts and also the Congressional Budget Office. Slower growth would eventually create an even bigger gap to fill. In short, whether the tax cuts are made permanent is as much a first-order economic issue as are the very large scheduled increases in spending discussed in previous chapters.

nothing. Anyone whose entitlement exceeded the threshold would receive this amount in cash. Such a program would be decried as wasteful and a sop to the rich. Yet it works in much the same way as the mortgage interest deduction. Similarly, additional amounts spent each year on the major health tax subsidy—the exclusion of employer-provided insurance from taxable earnings—likely increase health expenditures, which in turn leads to an increase in the number of uninsured, which in turn leads to higher Medicaid costs.

Exclusions, deductions, and exemptions provide different subsidies to taxpayers in different brackets. This makes sense if the purpose of the deduction is to adjust the measure of income for ability to pay or to net expenses against gross income. But if the goal is to subsidize some group or activity, this design often makes less sense. A tax credit (or a deduction at a common rate) would provide the same marginal incentive for each household. Proposals along these lines could be designed to minimize revenue loss, dampen regressivity, and improve other aspects of existing subsidies.

Reform Incentives for Saving

Similar arguments apply to the current structure of tax incentives for saving. The revenue loss from retirement saving incentives alone is greater than personal saving in the United States, and although both these measures—lost revenues and personal saving—have limitations, the comparison reveals how little net saving such tax breaks are creating. As a result, the enormous (and expensive) efforts over the past twenty-five years to stimulate private saving by providing numerous tax incentives for *contributions* to particular accounts (which is quite different from new “saving”) appear not 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.

Part of the problem is that the accounts do not subsidize saving, which requires a reduction in consumption spending and current living standards. Instead, they merely subsidize deposits (or contributions) into an account. These contributions can be made in many “painless” ways that do not involve reducing one’s standard of living. High-income, high-

wealth households are the most able to make such painless contributions, drawing from income they would have saved anyway, assets they already have saved, or borrowed money. As a result, limiting deductions for deposits when interest deductions are taken would help solve part of the problem. Another part of the problem is that the immediate incentive to contribute—as measured by the tax deductions that are allowed—is largest for these same high-income households.

The best way to raise saving may lie in using existing accounts better, rather than in raising contribution limits to IRAs or creating new accounts. Encouraging automatic enrollment and automatic escalation of contributions over time in existing 401(k) accounts is a primary example. The evidence suggests this would raise contribution rates among low- and moderate-income workers who are less likely to be using the accounts as tax shelters. Encouraging people to save their tax refunds or allowing automatic payroll deductions for individual retirement accounts would have similar effects. We believe that these moves—which are probably legal now but could be facilitated by legislative clarification—would have a much more positive impact on saving and well-being in retirement than piecemeal and inconsistent moves toward a consumption tax.

Along the same lines, expanding and making permanent the saver's credit would be an effective way to raise contributions among low- and middle-income taxpayers, who often have very little in the way of financial assets for retirement. The saver's credit provides a nonrefundable government matching contribution for individual contributions to 401(k) and IRA plans. The match rate declines as individual income rises. This tends to reverse the upside-down structure of existing saving incentives, which give larger deductions to higher-income households. Although expanding the saver's credit would entail a revenue cost, we believe that, per dollar of cost, it could do more to raise both private and national saving.

Fix the Alternative Minimum Tax

Under current law, roughly 30 million households will face the AMT by 2010; 42 million taxpayers will face the tax by 2015 if the 2001 and 2003 tax cuts are made permanent. As a result of this expansion, the efficiency, equity, transparency, and simplicity of the tax system are all

threatened. Simply repealing the AMT, however, would dramatically reduce federal revenues and would encourage tax sheltering.

A better solution would be to fold the features of the AMT that are desirable, specifically those that close down aggressive tax sheltering, into the regular income tax and do away with the other provisions. For instance, it is not appropriate to treat the dependent exemption like a tax shelter, whereas it is appropriate to limit the use of private-purpose state and local bonds. There is no reason not to prohibit the exclusion of interest on these bonds within the regular income tax. Another way to keep the AMT in check over time is to raise its top rate and grant exemptions high enough to exclude most or all lower-, middle-, and upper-middle-income taxpayers. One way or the other, AMT reform as a whole is going to require a significant increase in either income tax rates or the tax base to keep revenues constant.

Tax All Capital Income Once

The notion that the combined corporate and individual income tax should tax all income once, and only once, at regular income tax rates, is sound. Once integrated, the corporate tax rate should be made equal to the top rate paid by individuals. In that way, most capital owners would not be led to choose the form of business, form of financing, and level of dividend payments on the basis of the tax system.⁸

Currently, a portion of corporate income is taxed at both the individual and the corporate levels (but at a maximum rate of 15 percent at the personal level), another portion is taxed at either the corporate or the individual level, and a final portion escapes taxation completely. Corporate income escapes taxation at the corporate level through shelters. It escapes taxation at the individual level to the extent that it accrues to nonprofits and pension funds. While the emphasis and public discussion has been on the so-called double-taxation of corporate income, the non-taxation—or sheltering—of corporate income is also a big problem.

Integrating the individual and corporate income taxes involves achieving several objectives that should be dealt with *simultaneously*. First, the creation of windfall gains should be minimized. Second, individual-level

taxation of corporate dividends and capital gains should be waived only if the full tax has been paid on income at the corporate level.⁹ If corporate taxes have not been paid, corporate dividends and real 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 substantially strengthened. Broadly defined, corporate sheltering occurs when firms engage in transactions that make sense only for tax reasons and do not have an underlying business purpose. Several examples involving the creative use of financial instruments have been well publicized in recent years. Although it is arguable whether such transactions are legal under current rules, our view is that the rules should be changed to either make such transactions illegal or make them unprofitable. This could be accomplished through increased enforcement as well as through the implementation of accounting procedures that require more conformity between book and taxable income. Fourth, corporate tax expenditures should be sharply curtailed. Corporate tax expenditures provide subsidies for investments in particular industries or activities, such as energy, manufacturing, and insurance. This package of changes would likely raise net federal revenues from corporate source income.¹⁰

Tax Labor Income Once

For about 75 percent of all households and virtually all wage earners 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.¹¹ 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 could be done in a way that would make the burden of payroll taxes less regressive. This would be particularly important if a consumption tax either were added to the system or replaced part of the system, in order to offset some of the regressivity of such a tax.

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. Movement toward return-free filing, or IRS completion of tax returns, could be achieved for as many as 50 million taxpayers in the United States, but would require some adjustments in the tax code. 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. Other areas ripe for simplification via consolidation involve education subsidies and retirement saving programs.

Improve Administration and Enforcement

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 the taxes they owe. Providing the IRS with additional resources to better enforce current tax rules would likely boost revenues by more than the cost of the additional resources. At the same time, one can only go so far in this direction before the costs exceed the benefits.

Raise Revenue Levels to Meet Government Spending Needs

Under plausible projections and with no significant entitlement reform, federal spending will rise to about 27 percent of GDP in the not-too-distant future (as described in chapter 2). Historically, revenues have stayed below 20 percent of GDP. If outlays are allowed to rise to such levels, or even to somewhat lower levels, serious thought needs to be given to how best to structure a tax system not only at current revenue levels, but also at the levels that those expenditures might require. To be clear, this is an argument for paying honestly for any chosen size of government, not an argument about what that size should be. If higher spending requires additional revenues, it will be even more important than it is now to keep rates as low as possible and the base as broad as possible, for purposes of achieving both efficiency and equity.

One possibility—at least, there is strong evidence that it can be administered—is a value added tax. A broad-based VAT, one with only a few exclusions, would generate revenue of about 0.6 percent of GDP for each percentage point of tax.¹² It would also affect prices, and thus 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 percentage point of tax. On balance, then, a 10 percent VAT could raise an additional 4 to 5 percent of GDP in revenue, if its tax base were 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 used 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 has certain features that allow it to effectively tax services as well as goods. Furthermore, 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 suppliers have not paid them. Administrative concerns make the NRST a much more questionable proposition, even as a supplement to the existing system.

Another avenue of approach is to impose a tax on carbon emissions or establish a market in rights to emit carbon. These options would deal with a major environmental problem as well as contribute to revenues. Such taxes, however, are likely to raise far less in revenues than a moderate value added tax and also raise significant issues of environmental policy that are beyond the scope of this chapter.

Revenue Packages

Table 5-1 shows alternative ways of combining the ideas above to both meet various possible revenue goals and restructure taxes.

Structural Reforms

At any level of revenue, structural reforms would be desirable, including a no-return system for many households, restructured saving incentives, integration of corporate and individual income taxes, consolidation of

Table 5-1. *Financing Options for 2030*
Percent of GDP

<i>Item</i>	<i>Smaller government scenario</i>		<i>Two intermediate government scenarios</i>				<i>Larger government scenario</i>	
	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>	<i>7</i>	<i>8</i>
Spending	18	18	24	24	24	24	28	28
Revenue ^a	20	20	20	20	20	20	20	20
Repeal AMT	-0.5	-0.5						
Cut rates	-1.5	-3.5						
Allow tax cuts								
to expire			2	2			2	
Aggressively reduce tax expenditures		2	2		2		2	
5% VAT				2	2			
10% VAT						4	4	
20% VAT								8
Total revenue	18	18	24	24	24	24	28	28

Source: Authors' calculations, as discussed in text.

a. In adjusted baseline.

existing programs for education and for saving, and consolidation of the earned income, child credit, and personal exemption. In addition, a thorough cleaning of the tax base, featuring a substantial trimming of tax expenditures, would be in order. Whether the revenues obtained from base broadening or other measures are used to raise overall revenues or reduce tax rates across the board will depend on the level of government spending.

Revenues to Finance the Smaller Government Scenario

The adjusted baseline makes the 2001 and 2003 tax cuts permanent, indexes the AMT for inflation, and no longer treats the dependent exemption like a tax shelter for AMT purposes. Under the smaller government scenario described in chapter 2, federal spending is 18.2 percent of GDP by 2030. Still, this is *lower* than revenues under the adjusted baseline, which would be 20 percent of GDP in that year.¹³ The “excess” revenue would allow policymakers to move the antisheltering provisions of the AMT into the regular income tax and then repeal the AMT altogether. It would also allow additional rate cuts.

Revenues to Finance the Two Intermediate Scenarios

Under the two intermediate scenarios discussed in chapter 2, investing in the future and maintaining the social contract, spending is about 24 percent of GDP by 2030, roughly 4 percent of GDP above the adjusted revenue baseline. This difference could be closed through several changes. Allowing the tax cuts to expire would raise 2 percent of GDP in revenue. A 5 (or 10) percent VAT would raise about 2 (or 4) percent of GDP in revenue. Aggressive closing of tax expenditures could raise another 1 to 2 percent of GDP in revenue (if the revenues were not used to reduce rates). Note that the cost of making the 2001 and 2003 tax cuts permanent is roughly equivalent to an extra 5 percentage points on the value added tax.

Another possibility—that we do not pursue here—would be an additional mandate on individuals to pay for health and retirement programs, which could be assessed in ways other than a Social Security tax or a VAT. For example, individuals could be required to make deposits into retirement accounts and contribute toward their own retirement health insurance.

Revenues to Finance the Larger Government Scenario

In the larger government plan, spending would equal 28 percent of GDP in 2030, 8 percentage points above the adjusted revenue baseline. Under this scenario, allowing the tax cuts to expire, trimming a net of 2 percent of GDP in tax expenditures (using any excess to reduce tax rates), and implementing a value added tax of 10 percent would all be required to match the increase in government spending. If tax expenditures could not be trimmed and the tax cuts were made permanent, a 20 percent VAT would be required to balance the budget.

Conclusion

The structure of the tax system should be improved regardless of the level of government spending. Cutting back on tax subsidies performs the same economic function as cutting back on direct expenditures and permits a

lowering of the tax rates required to support government. But revenue increases will also be required, unless policymakers are willing to keep spending below the adjusted baseline, particularly in the areas of health and retirement.

Notes

1. Due to length restrictions, we necessarily omit many important issues that a fuller treatment would permit. For more detailed discussions of our views, see Henry J. Aaron, William Gale, and James Sly, "The Rocky Road to Tax Reform," in *Setting National Priorities: The 2000 Election and Beyond*, edited by Henry J. Aaron and Robert D. Reischauer (Brookings, 1999), pp. 211–66; William Gale and Janet Holtzblatt, "The Role of Administrative Issues in Tax Reform: Simplicity, Compliance, and Administration," in *United States Tax Reform in the Twenty-First Century*, edited by George R. Zodrow and Peter Mieszkowski (Cambridge University Press, 2002), pp. 179–214; and C. Eugene Steuerle, "Tax Reform: Prospects and Possibilities," statement before the Committee on the Budget, U.S. House of Representatives, October 6, 2004.

2. A key exception to this statement is the case of "externalities," such as pollution, where the activity of one person or group imposes costs for other groups that are not borne by the original group.

3. For a recent analysis, see Robert Dennis and others, "Macroeconomic Analysis of a 10% Cut in Income Tax Rates," Technical Paper Series (Washington: Congressional Budget Office, May 2004). Similar analysis applies to federal spending programs as well. The programs have direct effects on household and business income and incentives, and if they are not financed by other spending cuts or tax increases they increase budget deficits, which exerts a drag on long-term economic activity.

4. Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Stanford, Calif.: Hoover Institution Press, 1995).

5. Another consumption tax alternative is the USA (unified saving account) tax; see Laurence S. Seidman, *The USA Tax: A Progressive Consumption Tax* (MIT Press, 1997). This proposal would combine 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 large administrative problems, partly because of the attempt to retain the existing progressivity of the income tax.

6. Official estimates of many subsidies are contained in a tax expenditure budget prepared each year by the Tax Department. See Office of Management and

Budget, “Tax Expenditures,” in *Fiscal Year 2006, Analytical Perspectives, Budget of the U.S. Government* (Government Printing Office, 2005).

7. A similar story could be also told about many direct spending programs—farm subsidies come to mind.

8. Similarly, with this integration, there should be only one corporate tax rate. We see no reason to assess lower taxes on rich owners of corporate capital than more modest owners simply because the latter’s shares happen to be in a larger corporation.

9. If corporate taxes had been paid, an alternative to taxing corporate source income at a zero rate at the personal level would be to provide a credit at the personal level. This would allow corporate source income to be taxed on a personalized basis, so that low-income households do not bear the full 35 percent rate.

10. The comprehensive business income tax (CBIT) proposal offered by the Treasury Department in 1992 would eliminate interest deductions for firms and exclude dividends and interest from individual taxation, and would apply to unincorporated businesses as well as corporations. This proposal also affects the returns to old capital, however, not just new capital.

11. The available evidence suggests that workers bear the burden, via reduced wages, of both their own payroll tax payments and those made by their employer. See Harvey S. Rosen, *Public Finance*, 6th ed. (New York: McGraw-Hill/Irwin, 2001), pp. 265–66.

12. Henry J. Aaron, William G. Gale, and Peter R. Orszag, “Meeting the Revenue Challenge,” in *Restoring Fiscal Sanity: How to Balance the Budget*, edited by Alice M. Rivlin and Isabel Sawhill (Brookings, 2004), p. 122.

13. The main reason revenues rise as a share of GDP in the adjusted baseline is that under current law, brackets in the regular income tax and the AMT are not indexed for real wage growth (only for inflation), so that over time productivity growth would push people into higher tax brackets.

