Special Reports

THE KEMP COMMISSION AND THE FUTURE OF TAX REFORM.

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Special Reports

Tax Policy

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In this report, he examines the Kemp Commission's proposals and relates them to several issues in the debate over fundamental tax reform. The first section describes what the report did and did not do. The second section analyzes the major recommendations one at a time. The third section analyzes the recommendations as a package. Assuming that the personal exemption levels the commission had in mind are roughly as large as those in current Republican tax proposals, adopting the commission's proposals would require an estimated tax rate of about 27.5 percent to achieve revenue neutrality. If the tax rate were set at 20 percent, the proposals would raise the first-year deficit by $100 billion to $150 billion or more, even if there were very large behavioral responses. The fourth section evaluates the effects of the commission's proposals on simplicity, equity, and growth. The fifth section raises two issues concerning the business tax, a critical feature of tax reform that has received little analysis to date. The next section discusses some "myths" of tax reform. The final section is a short conclusion.

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I. Introduction

On January 17, 1996, the National Commission on Economic Growth and Tax Reform (the Kemp Commission) released its report on overhauling the tax system. /1/ The commission is a private organization set up by Robert Dole and Newt Gingrich to report to them (not to the Congress) on ways to encourage economic growth by making the tax system "fairer, flatter, and simpler."

The report first lays out several "working principles" for any tax reform geared to economic growth: fairness, simplicity, neutrality, visibility, and stability. Taken individually and at an abstract level, each of these principles commands widespread support. Disagreement on tax reform is focused on differences over

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how to implement these principles and how to trade off the principles against each other.

The report advocates repeal of the entire Internal Revenue Code, and makes several "core recommendations" for the design of a new tax policy:

- provide a single, low tax rate;
- provide a "generous" personal exemption to remove the tax burden on those least able to pay;
- reduce the tax burden on working families;
- end biases against work, saving, and investment;
- allow full deductibility of the payroll tax; and
- make the new system difficult to change.

The commission waffled on deductions for mortgage interest and charitable contributions, noting the important role each has played in advancing social goals, but ultimately suggesting only that it would be appropriate to have a national discussion on the best way to continue to encourage such activity. The commission also noted that policymakers must take care to protect existing assets during a transition to a new tax system.

The report is also notable for what it excluded. The report was in many ways "the dog that didn't bark." The report fell far short of earlier expectations that the commission would endorse "the" flat tax (i.e., the Hall-Rabushka/Armey/Forbes proposal). This is both surprising and relevant because the commission's members seem largely united on principles of reform, but still were either unable or unwilling to reach agreement on specifics. For whatever reasons, the commission shied away from endorsing any particular proposal. The report did not even indicate at what level the "single, low tax rate" should be set, nor did it indicate what dollar amount qualified as a "generous" personal exemption.

The report did not construct a tent big enough to include all existing tax proposals with Republican sponsors. The recommendation to remove existing biases against saving and investment rules out the proposals by Phil Gramm and Pat Buchanan, which would tax interest and dividend income at the household as well as the business level. The report does not appear to support a national retail sales tax. And the report cannot be construed as support for the Nunn-Domenici USA tax.

The report does not emphasize border adjustability as a crucial element of tax reform. And it does not emphasize capturing revenues from the underground economy as an important criterion by which to distinguish reform proposals (perhaps due to the realization that none of

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the proposals would do much better than the existing system).

Overall, the report makes an interesting and relevant contribution to the debate. This article presents a preliminary analysis of the commission's recommendations and places them in the broader context of fundamental tax reform.

II. The Recommendations One at a Time

A. Single, Low Tax Rate

There are several benefits of a pure single rate system: elimination of the marriage penalty, elimination of tax timing and shifting considerations, better incentives for high-income households, etc. But the Kemp Commission proposal is not a pure single-rate system: the personal exemptions introduce a second-rate (zero), and deductions for payroll taxes introduce a third effective tax rate, as discussed below. These features can reintroduce tax- timing considerations and the marriage tax. /2/ Thus, there is nothing sacrosanct about a single rate, once exemptions and deductions have been admitted. For example, relative to the commission's proposal, one could reduce tax rates for middle-income households and raise rates for higher-income households and still raise the same amount of revenue. The effects of such a change on equity, efficiency, and simplicity are worth considering (see Bradford 1988, for example).

B. Generous Personal Exemption

A large personal exemption has many advantages in terms of equity and simplicity and has received support from a wide range of analysts, independent of their views of the flat tax (see, for example, Pechman 1987). But the report is misleading about its plans to "relieve the burden" on the poor. The report does not endorse retaining the earned income tax credit (EITC). The EITC provides an incentive for lower-income people to enter the workforce and to expand their work hours up to a particular level. A family of four can receive over $3,000 in benefits per year from the EITC and pay no income tax. The report should have been clear that if the EITC is not retained, the tax burden on low-income families will rise as a proportion of their income.

Moreover, the report claims its recommendations would "help remove the barriers that keep low-income Americans from reaching their full potential," but it is unclear how this would occur. Most of the high marginal (effective) tax rates imposed on low-income households are due to phase-out provisions of spending programs -- which are not affected by the commission report -- not to high explicit income tax rates. Deductions for employee payroll taxes have no bene-

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ficial impact on low-income households because their income is below the exemption level.

The bottom line is that the poor will not be assisted in any direct way by this proposal. It is possible that a rising economic tide due to tax reform would raise all boats sufficiently to offset this effect, but the commission presents no evidence on this point.

C. Reduce the Tax Burden on Working Families

The implications of this statement are vague. It could mean that the tax reform will be revenue-neutral and therefore that taxes on businesses, retirees, students, and the unemployed will have to rise. Alternatively, the statement could mean that total tax revenues will fall and therefore that expenditures will have to fall. If so, the commission, by neglecting to note which expenditures should fall and by how much, is providing incomplete information on the nature of its proposal.

D. End Biases Against Work, Saving, Investment

The report advocates the elimination of the double taxation of saving and of all taxation of capital gains. These recommendations strike the core of the difference between a consumption tax and income tax and show clearly that the flat tax and related proposals represent consumption taxes. (If transitional protection is granted to existing assets, the base converts to a wage tax rather than a consumption tax, as discussed below.) The report also advocates eliminating the estate tax.

The report encourages ending biases against work in the tax code. But this is an impossible task: A consumption tax cannot remove the bias against work. Leisure time (time not spent working) is a form of consumption that is not taxed under any of these proposals. At least at first, consumption taxes may increase the bias against work relative to an income tax if a new tax base is smaller than the current base and hence requires a higher rate to raise the same revenue.

E. Full Deductibility of the Payroll Tax

Currently, employers can deduct their payroll tax payments, but workers cannot. The report supports adding payroll tax deductions for workers. The justification is twofold: to avoid having people pay taxes on top of other (payroll) taxes; and to reduce the combined marginal tax rate imposed on the wages of middle-income households. The first justification seems to suggest that other taxes paid -- such as state and local income taxes and property taxes -- should be deductible. I return to this point below. The second justification may not be well-served by a deduction. Holding the "flat" tax rate constant, the deduction would reduce effective marginal tax rates for middle-income taxpayers by less than two percentage points. /3/ But allowing the deduction would require a higher tax rate to raise the same amount of revenue

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as without the deduction. The net effect on combined marginal tax rates is estimated in the next section to be less than one percentage point.

Moreover, the deduction for employee payroll taxes would be worthless to taxpayers earning less than their family exemption. Thus, deductibility of payroll taxes would have the interesting side effect of making the social security and Medicare systems less progressive on a lifetime basis.

Despite these concerns, integrating the payroll tax and the "income" tax is an important consideration as most households currently pay more in payroll taxes (counting the employer share -- which most analysts believe is borne by workers -- as well as the employee share) than in income taxes. For example, the Nunn-Domenici USA tax contains a proposal for a payroll tax credit. Holding the "flat" tax rate constant, the credit would reduce the effective taxation of labor income by the full amount of the payroll tax. If the credit were refundable, it would be quite valuable to lower- income as well as middle- and upper-income households. But a credit would also cost significantly more than a deduction and therefore would require a higher "flat" rate to keep revenues constant.

F. Stability

The report proposes that a two-thirds vote be required in Congress to change tax rates (after the other recommendations are adopted). Everyone would like a stable system, but I am not sure that the best time to impose this requirement is immediately after enacting a policy change that (a) has never been tried anywhere in the history of the world, and (b) would be the largest tax policy change in U.S. history. It does not seem out of the realm of possibilities that any new tax system would get installed with some unforeseen problems. Technical corrections bills are not uncommon even for changes within an existing system. But to repeal the entire tax code and replace it with a new one seems almost certain to require subsequent corrective measures. At the very least, it would be prudent to have a several-year waiting period before this provision took effect. In addition, whether the rule could be overturned by simple majority is unclear.

G. Mortgage Interest and Charitable Contribution Deductions

The commission did not rule out either option and it seems unlikely that the political process will either. For most lower- and middle-income homeowners, the reduction in house value due to eliminating the mortgage interest deduction would probably far outweigh any direct tax reduction they might obtain under a flat tax. But retaining the mortgage interest deduction raises some serious economic issues. If interest income

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is not taxed, there is little justification for deducting interest payments. The combination of untaxed interest income and deductible interest payments creates exactly the type of tax-distorted ways to game the tax system that tax reform should seek to eliminate, not enhance. /4/

While theoretical purity might call for eliminating the charitable contributions deduction, the commission may have found this a difficult stance to maintain in light of the fact that the commission itself filed for tax-exempt status, so that contributions to the commission could be tax-deductible. /5/

H. Transitional Protection

The commission recommended, without further elaboration, that "policymakers must take care to protect the existing savings, investment, and other assets" during a "transition to a new tax system." This seemingly innocuous statement has important implications for tax reform. First, it turns a consumption tax into a wage tax. Future consumption can be financed only by existing assets or future wages. Exempting the consumption tax on existing assets leaves only future wages as the tax base.

Second, it raises fundamental fairness issues. People have purchased homes expecting to receive mortgage interest deductions; businesses have borrowed money and made investments expecting to take write-offs for interest payments and depreciation. A cold-turkey switch to a pure consumption tax would end these deductions on old investments. That is, it would penalize people for having done things (like saving, buying a house, or borrowing and investing) that are not only perfectly legal but in many cases encouraged by the tax system. It would thus seem eminently fair to allow transitional relief. This is consistent with the commission's recommendations.

Third, transition raises a fundamental trade-off between equity and efficiency. The catch-22 is that allowing transitional relief reduces the potential gains in economic growth and efficiency from tax reform. Several studies even show that consumption taxes can produce significant gains in efficiency if transitional rules are not allowed, but provide no gain if transitional relief is allowed (Auerbach and Kotlikoff 1987, Gravelle 1991). To see why this trade- off occurs, consider elderly households. Elderly households have more wealth than younger households due to standard life-cycle considerations. Granting special transition rules to existing assets, therefore, would reduce the effective tax rate on elderly households and -- since a revenue target would need to be met -- would require recovering the money by taxing younger households at a higher rate. This would reduce the incentive of younger households to work, save, and invest and would reduce economic growth.

Therefore, the transition to a new tax system presents policymakers with a very difficult

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choice between (i) having transitional relief and getting a less efficient tax system and (ii) not having transitional relief, but getting a more efficient tax system. The commission's report shows no indication that a trade-off might exist and suggests, perhaps unintentionally, a willingness to give up on many of the potential efficiency gains from a well- designed tax reform. /6/ This seems like an odd conclusion for a commission devoted to economic growth as well as tax reform.

III. The Recommendations Taken as a Whole

An essential element of tax reform is how particular policies combine to create a tax system. In particular, many interesting implications of the recommendations cannot be understood in isolation. The commission was clearly interested in these issues, noting their belief that "we can achieve these goals within the context of budget equilibrium." But the report presents no estimates of the interaction between the tax rate, the personal exemptions, the generosity of deductions, and overall revenue.

To partially remedy this gap, I present below some estimates of the impact of what I consider to be plausible assumptions about the parameters and details of possible tax reform proposals. These assumptions are based on the commission's reports and the details of existing proposals. At the outset, however, I emphasize that this is a very preliminary exercise; it is designed to obtain a rough sense - - rather than a precise estimate -- of the implications of various proposals.

The starting point for the estimates is the Hall-Rabushka (1995) tax proposal. The tax system consists of a business tax and an individual tax that together completely replace the current individual and corporate income taxes. The business tax applies to all businesses. The tax base is the difference between (i) receipts from sales of goods and services and (ii) the sum of wage and pension payments, material costs, and new investments. A flat rate is applied to the tax base. Under the individual tax, the base would include wages and pension benefits, less an allowance for personal and dependent exemptions. All wages and pension benefits above the ex-

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emption would be taxed at the same rate as the business tax. Exemption levels (in 1996 dollars) are those in the Armey/Shelby plans (H.R. 2060/S. 1050): $21,400 for married couples, $10,700 for singles, $14,000 for single heads of households, $5,000 for each dependent exemption. (For a married couple with two dependents, the exempt level would be $31,400.) There is assumed to be no earned income tax credit.

The following modifications are considered: A deduction in the individual tax for employee payroll tax payments, and a deduction in the business tax for employer payroll tax payments; a

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deduction for mortgage interest; a deduction for charitable contributions; a deduction for state and local income and property taxes; and transitional protection for existing assets.

In the press conference announcing the release of the commission's report, Jack Kemp suggested that the single tax rate be no higher than 20 percent. Therefore, two types of estimates are presented: the tax rate that would be needed to raise the same amount of revenue as the current system; and the revenue shortfall, relative to the current tax system, of imposing a 20 percent tax rate. Details of these calculations are presented in the appendix.

The basic results are presented in Table 1. With no deductions, the proposal under consideration is the Armey/Shelby proposal. The estimated 20.8 percent tax rate required for revenue neutrality is taken from a recent Treasury study (Treasury 1996) and is shown in the first row. (If the exemption levels were reduced by one-third, the break-even tax rate would be 18.4 percent.) The subsequent rows in the table estimate the implications of various proposals put forth or suggested by the Kemp Commission. Allowing employers and employees to deduct payroll taxes would raise the required flat tax rate to 23.5 percent. Thus, with no deductions, the combined tax rate on workers would be 36.1 percent (=0.153 + 0.208). Allowing deductions, but adjusting the tax rate to raise the same amount of revenue leads to an effective combined rate of 35.2 percent (=0.153 + (1- 0.153)*0.235). Therefore, after accounting for how payroll tax deductions require an increased basic tax rate, the change in the effective tax rate on labor income would be less than one percentage point. /7/

Table 1

Trade-Offs in Tax Reform

Tax Base	Tax Rate That Yields the Same Revenue as the Current System	Revenue Shortfall with a 20 Percent Tax Rate (Billions of 1996 dollars)
No deductions	20.8	29

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Deduct payroll taxes	23.5	113
Deduct mortgage interest	24.8	143
Deduct charitable contributions	25.2	156
Protect existing assets in transition		
paid for over 20 years	29.2	237
paid for over 30 years	27.5	205
Deduct state and local income and property taxes		
20-year transition	30.9	265
30-year transition	29.0	233

Adding a mortgage interest deduction would raise the required rate to 24.8 percent. Adding a deduction for charitable contributions would raise the required rate to 25.2 percent. Protecting existing assets during the transition is a more complex issue, as discussed in the appendix. Under favorable assumptions about economic growth, transitional protection is estimated to raise the required tax rate to 27.5 percent if the transition occurs over 30 years, and to 29.2 percent if the transition occurs over 20 years. The revenue loss, holding the tax rate at 20 percent, would be on the order of $200 billion in the first year. Finally, although the commission did not discuss deductions for state and local income and property taxes, the report did come out against forcing taxpayers to pay taxes on taxes. Allowing deductions for these items would raise the required tax rate to 28.9 percent in a 30-year transition and to 30.8 percent in a 20- year transition.

Some caveats should be noted. The estimates do not include behavioral effects beyond what is included in the Treasury analysis. As shown below, including such effects would reduce

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the required tax rate and the estimated revenue shortfall at a tax rate of 20 percent. On the other hand, the estimates understate the amount of deductions that would be taken for two reasons: (i) some nonitemizers currently pay mortgage interest, make charitable contributions, and pay state and local income and property taxes. These taxpayers' payments are not recorded on current tax forms (from which the estimates were made) but some of the payments would be deductible under the proposal envisioned above; /8/ (ii) if mortgage interest deductions are permitted in a system that does not tax interest income, it would be reasonable to expect that mortgage interest deductions might rise fairly

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dramatically. Including these effects would raise the required tax rate and revenue shortfall at 20 percent.

A. Revenue Estimates With Incentive Effects

Modelling behavioral responses explicitly is beyond the scope of this report, but the impact of such responses on revenue can be estimated by adjusting the size of the tax base. Two such experiments are undertaken here. In the first, wages and salaries and taxable business income were raised by 5 percent; in the second, wages, salaries, and taxable business income were raised by 10 percent.

Table 2

Revenue Estimates for the Kemp

Commission Proposals With Behavioral Effects

	Break-Even Tax Rate			Revenue Shortfall at 20 Percent Tax Rate (Billions of 1996 dollars)		
	Behavioral Response			Behavioral Response		
Tax Base	0%	+5%	+10%	0%	+5%	+10%

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No deductions	20.8	19.5	18.4	29	-19	-66
Add deductions for payroll tax mortgage interest, charitable contri- butions; protect existing assets*	27.5	25.5	23.5	205	162	112
Add deductions for state and local income and property taxes	29.0	26.8	24.6	233	190	140

*Transition relief is assumed to be financed over a 30-year period.

Table 2 shows the results. If tax reform raised labor and business income by 5 percent, the suggestions in the Kemp report would require a 25.5 percent tax rate to raise the same revenue as the current system in the first year. If the tax rate were set at 20 percent, the revenue shortfall -- relative to the current tax system -- would be about $162 billion. (If the tax rate were 17 percent, the revenue shortfall would be $251 billion.) Raising labor and business income by 10 percent would require a 23.5 percent tax rate to raise the same revenue as the current system. If the tax rate were set at 20 percent, the revenue shortfall -- relative to the current tax system -- would be $112 billion. (If the tax rate were 17 percent, the revenue shortfall would be $210 billion.)

B. The Forbes Plan

Republican presidential candidate Steve Forbes has advocated a flat tax plan of his own. A family of four would receive exemptions worth $36,000 and would face a tax rate of 17 percent on wage income above that amount. Pension benefits do not appear to be in the tax base. I could not find detailed specifications of the rest of the system, and so made the following assumptions: the exemptions are $24,000 for a married couple, $12,000 for singles or single heads of households, and $6,000 per dependent; the business tax would be the same as in the Armey/Shelby proposal. Forbes makes clear that his plan is not intended to be revenue-neutral, but does not provide estimates of the likely revenue cost.

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Table 3

Revenue Estimates for the Forbes Plan

with Behavioral Effects

	Break-Even Tax Rate			Revenue Shortfall at 17 Percent Tax Rate (Billions of 1996 dollars)		
	Behavioral Response			Behavioral Response		
Tax Base	0%	+5%	+10%	0%	+5%	+10%
No deductions	22.5	21.1	19.8	185	145	105

Table 3 provides rough estimates of these figures, under alternative behavioral assumptions. The break-even tax rate under the Forbes plan is even higher than under Armey/Shelby because the exemption levels are higher and because pensions are not in the tax base. The revenue shortfall at a 17 percent rate exceeds $100 billion, even with a 10 percent rise in wages and business income.

In any case, the figures above are not meant to be definitive, but do give a sense of the trade-offs that exist in constructing a new tax system. The two provisions with by far the largest revenue cost appear to be the payroll tax deduction and transitional protection for existing assets. To be clear, I am not suggesting that either set of behavioral responses is likely; I believe both are probably much too large. Rather, the point of the examples is that even with very large behavioral responses, tax reform proposals modelled along the lines of the Kemp Commission report will either (a) require relatively high flat tax rates, or (b) create large revenue shortfalls at tax rates of 20 percent or less.

A study by Coopers & Lybrand reaches similar estimates of the effects of added deductions on required tax rates, but does not appear to estimate the effects of transitional

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protection of assets (see Chandler 1996).

IV. Simplicity, Efficiency, and Fairness Revisited

The commission appears confident that its recommendations will lead to substantial improvements in the simplicity, fairness, and growth effects of our tax system. I find these claims less convincing.

A. Simplicity

Making the tax system simpler is feasible and could reap substantial gains. But the system may not stay simple. A flat tax will not end lobbying activity, it will just start the game over at a new starting point; zero is not a lower bound for the effective tax rate on capital. Transition issues could add a substantial amount of complexity. Some pesky design issues will have to be dealt with at some point. For example, the flat tax

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would essentially renegotiate every alimony agreement in the country. Currently, alimony payments are deductible and alimony received is taxable. Under the flat tax and other reform proposals, this would change: alimony payments would no longer be deductible and receipts would no longer be taxable. Changing every alimony agreement seems like an unnecessary and undesirable feature of tax reform. A brand new tax system will inevitably generate unintended loopholes that will need to be corrected. These could relate to the fundamental structure of the tax (an example is given in the section below on the business tax) or could merely relate to the effective definitions used in the new law. Even a simple statement such as "a business may deduct purchases of a business asset" requires potentially difficult legal definitions of several terms (see Feld 1995). In short, any actual tax system will be more complex than any ideal or idealized tax system; the actual system will be subject to the political process, will have to deal with a whole series of technical details, and will be required to patch loopholes to raise revenue.

B. Fairness

The commission believes that its proposal is fair because (a) there is an exemption for low-income households and (b) everyone pays the same rate above the exemption level. Although fairness is obviously a subjective issue, several points can be made. The debate on tax reform is taking place against a backdrop of 20 years of increasing inequality. Taxes were not a major influence in generating this trend, but that does not imply that tax policy should exacerbate the inequality. In addition, tax reform is occurring at the same time that spending programs on the poor seem likely to cut real spending per beneficiary. These factors -- combined with the proposed repeal of the EITC, the proposed exemption of taxes on old capital via transitional relief, the proposed exemption of taxes on the ordinary return from new

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capital, and the proposed elimination of the estate tax -- suggest that equity issues need to be considered in a broader context. Moreover, there is nothing inherently fair (or unfair) about having just a single rate. A case can be made that consumption represents a fairer base than income, but this case depends on people being able to borrow and lend as much as they would like at the same, fixed interest rate. When borrowing constraints bind, it is less clear that consumption is a fairer base.

C. Efficiency/Growth

The commission "operated under the premise that an economic growth rate of 2.5 percent is unacceptable to the American people" and suggested that fundamental tax reform could double the economic growth rate for a decade. This prospect would be welcome, but seems unlikely.

Table 4

GDP Growth Rates

	Average annual growth rates of		
Years	GDP	GDP per capita	Population
1985-94	2.6	1.6	1.0
1975-84	2.5	1.5	1.0
1965-74	3.3	2.2	1.0
1955-64	3.4	1.8	1.6
1870-1913	4.3	2.2	2.1

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Sources: Economic Report of the President, Historical Statistics of the United States: Colonial Times to 1970.

Table 4 presents growth rates of GDP and other items for different periods. Assuming that the rate of population growth does not change, doubling the most recent 10-year growth rate to 5.2 percent would require raising the growth rate of GDP per capita to 4.2 percent from its recent 1.6 percent. This is a much higher growth rate of GDP per capita than is suggested by recent years' data. Moreover, it is almost twice as high as the growth rate of GDP per capita in the most recent period when the U.S. had no income tax, 1870-1913. In those years, despite double the population growth of today, GDP growth did not average 5 percent. Even the longest peacetime expansion in post-war history -- 1982 to 1989 -- generated only one year of growth above 5 percent. The growth rate of GDP has exceeded 5 percent 11 times since World War II, but these expansions have largely been cyclical in nature: the capacity utilization rate in manufacturing rose an average of 4.5 percentage points in the years when growth exceeded 5 percent. In 1994, the capacity utilization rate in manufacturing stood at 83.4, its highest level in 15 years. Therefore, further growth will have to be done the hard way: by raising capacity, rather than using more of existing capacity.

Much of the alleged effect of tax reform on growth is supposed to occur through a rapid increase in saving. For several reasons, however, this may be unlikely to occur. A very large percentage of U.S. saving occurs through tax-preferred vehicles, such as IRAs, 401(k) plans, Keoghs, and pensions. Funds in these accounts already receive the same tax treatment that they would under a consumption tax. Moreover, pensions would lose their tax-advantaged status relative to other forms of saving, but may still find themselves saddled with expensive regulations, which could lead to a fall in pension coverage. Allowing transitional relief would also reduce the impact on saving. Put differently, not allowing transitional relief would make asset holders worse off and therefore would reduce their consumption (raise their saving). Finally, allowing a mortgage interest deduction would retain a tax-deductible conduit for borrowing, which could reduce further the impact on saving.

V. The Business Tax

Both the Kemp Commission report and the tax policy debate in general pay little attention to the busi-

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ness tax in the reform proposals. (The commission did endorse expensing of new investment, but was largely silent on other business issues.) This is a significant oversight.

Although the corporate income tax currently raises only about 20 percent of total income tax revenues, Treasury (1996) estimates that the business tax would raise 42 percent of

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revenues under a flat tax, if there is no transitional relief. Many of the gains from tax simplification could come from the business side. The impact of the business tax on investment and efficiency is a crucial part of how tax reform might raise economic growth. And the distributional burden of the business tax is crucial to understanding incidence of a radical tax reform.

By allowing expensing of new investment, the business tax would set the tax rate on the ordinary return to new investment equal to zero. That is, the present value of the deduction would equal the present value of tax payments for this investment. For particular investors or projects that generate returns that are higher than the normal return (adjusting for risk), the business tax would impose a positive net tax burden. That is, the present value of depreciation deduction would be less than the present value of the tax payments flowing from the project's income.

Two issues are raised here. The first concerns a potentially important loophole in the business tax base. The business tax is not a cash flow tax. Receipts from sales of goods and services are taxable, but receipt of interest income is not taxable. This creates an obvious incentive in transactions between businesses subject to the flat tax and entities not subject to the business tax (households, governments, foreigners): the business would like to relabel as "interest income" as much cash inflow as possible. The other party (not subject to the business tax) is indifferent to such labeling. The same possibility occurs for cash outflows. Outflows that are labeled purchases of goods and services or capital goods are deductible, while outflows that are labeled interest payments are not deductible. This creates obvious incentives for businesses to label as "purchases" as much of their cash outflow as possible. It may be possible to fix some of these problems by moving to a cash flow tax at the business level that includes financial flows. But (i) the issue is a problem in the business tax in current proposals, and (ii) a cash flow tax is a very different tax system, which raises a host of additional issues. /9/

The second issue is that revenues from the business tax may be countercyclical. Under the current income tax, revenues are procyclical -- they rise during booms and fall during recessions. This automatic stabilizer feature is almost universally considered a virtue of the income tax. Under the flat tax, however, the business tax may work as an automatic destabilizer. The business tax base is sales less investments and less other items. The relevant point is that investment tends to be highly volatile over the business cycle. Thus, in a recession, if investment drops more than sales, tax payments will rise, rather than falling as they would under the income tax. The difference, of course, is that under the income tax, depreciation is calculated as more or less a weighted average of previous years' investments and so is more stable than investment. In the business tax, new investments would be depreciated completely in the first year, so that deductions would equal -- and be as volatile -- as investment (see Merrill, Wertz, and Shah, 1995). For all of these reasons, the business tax merits closer scrutiny.

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VI. Myths of Tax Reform

One disservice the Kemp Commission provided was furthering several myths about tax reform.

(a) JOHN F. KENNEDY WAS A SUPPLY SIDER. The report contains several lyrical passages claiming intellectual ancestry in the words and writings of President Kennedy. Let it be noted, however, that the Kennedy tax cuts reduced the highest rate all the way to...70 percent! The Kennedy plan retained what would today be regarded as a steeply progressive system with numerous rates. There was an investment tax credit, but it applied only to corporate investments, and there were fewer sheltering vehicles available. Virtually every economist today would agree to rate cuts if the top rate were 91 percent, as it was in early 1960s.

(b) FEDERAL TAX REVENUES ARE ALWAYS AROUND 19 PERCENT OF GDP, REGARDLESS OF WHAT THE TOP RATE IS. This proves that raising rates does not raise revenue and that revenues would not fall under a flat tax. It is not a myth that federal tax revenues have hovered around 19 percent of GDP. This is shown in the top line of Figure 1. But this seemingly constant number hides some important dynamics. The main sources of federal revenue are the payroll tax, the personal income tax, and the corporate income tax. Figure 1 [see page 728] shows that the composition of federal revenues has changed substantially. Relative to GDP, payroll tax revenue has increased over time, while income tax revenue has declined. Figure 2 [see page 728] shows payroll tax rates and payroll tax revenues. Both have risen over time, as has the payroll tax base. Clearly, though, for the payroll tax, higher tax rates do mean higher revenues.

The corporate and personal income taxes are shown in Figure 3 [see page 729]. Several comments are

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merited here. Since there are several tax rates, looking only at the highest individual rate (which may only affect a small minority of taxpayers) may not be a very strong test of the effects of tax rates on revenues. Moreover, changes in tax rates often are accompanied by changes in the tax base. These considerations make it difficult to develop clean tests. Nonetheless some observations are relevant. First, the broad trend in both taxes is reduced tax rates and reduced tax revenues. Second, the income tax surcharge in the late 1960s clearly raised revenues. Third, the 1981 tax act, which combined rate cuts and base cuts, severely reduced income tax revenues. Corporate revenues fell from 2.1 percent of GDP in 1981 to 1.5 percent in 1984 and did not rise to 2.1 percent again until 1994. Individual income tax revenues fell from 9.6 percent of GDP in 1981 to 8.1 percent in 1984 and have never exceeded 9 percent of GDP since 1982. Fourth, the 1986 tax act, which was designed to be revenue

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neutral, by combining a tax cut with a base expansion, by and large was neutral: income tax revenues have been a relatively constant proportion of GDP since then. Therefore, the fact that revenues stayed roughly constant after 1986 when tax rates fell is not evidence that rates have no impact on revenues, because the base was changing, too.

These findings suggest that the relatively constant ratio of aggregate revenue to GDP provides little information about how individual taxes respond to tax rates. The evidence for both the payroll tax and the income tax is consistent with the view that -- holding the tax base constant -- increases in tax rates raise revenue. This is not to deny the existence of incentive effects -- such effects clearly exist. But the result says that even after adjusting for those effects, aggregate revenues and rates typically move in the same direction, if the base is held constant.

(c) TAX CUTS IN THE PAST HAVE RAISED THE REVENUES PAID BY THE RICH SO THE FLAT TAX WOULD, TOO. Flat tax advocates often point out that tax cuts in the 1920s, 1960s, and 1980s led to increases in the tax payments made by the rich and suggest that similar effects would occur if the nation adopted a variant of their proposal (see Hall and Rabushka 1995, for example). There are two major differences between those tax cuts and the proposed flat tax. First, the percentage increase in the rate of return was much higher for the earlier changes: in the 1920s, the top rate fell to 25 percent from 73 percent; this change therefore more than doubled the after-tax payoff to 75 percent (1 - 25 percent) from 27 percent (1 - 73 percent). In the 1960s, the top rate fell to 70 percent from 91 percent. This more than tripled the after-tax payoff for the highest income taxpayers, to 30 percent from 9 percent. In contrast, a Kemp Commission style proposal might reduce the top rate to roughly 25 percent from 40 percent. This represents a one-quarter increase in the after-tax payoff to 75 percent from 60 percent. Hence, the increased payoff rates would be much lower than in previous changes, suggesting a much smaller revenue response.

The second and more important difference is that the flat tax would exempt the ordinary return to new saving and investment from any taxation. Since the highest income groups also have the highest wealth, this would reduce substantially a part of their tax base. (Of those with adjusted gross income of $100,000 or more, about 41 percent of AGI is something other than wages and salaries or pension benefits and therefore would not be included directly in the individual tax base; for the rest of the population, about 11 percent of AGI would not be included.) If transitional relief of existing assets is allowed, then the wealthiest taxpayers would have their tax payments reduced further because they have the most assets to protect. Hence, for the highest income households, moving to a flat tax would imply a small increase in after-tax returns (relative to earlier historical episodes) but a relatively large reduction in the tax base, particularly if transitional relief is allowed. For both of these reasons, the experience in earlier historical tax cuts need not be relevant, and the share of tax revenues paid by the wealthy would likely fall, or rise by much less than in the past.

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VII. Conclusion

One effect of the Kemp Commission report may be to reduce consideration of the retail sales tax. This would be a useful outcome. The European experience suggests that compliance and evasion problems make sales taxes unworkable at the rates that would be needed to generate sufficient revenues (see OECD 1993, Bartlett 1995). A VAT would work better than a retail sales tax, and a Hall- Rabushka flat tax would work better than a VAT (see Gale 1995.) The flat tax is a clever idea in principle. Whether it, or some other fundamental reform proposal such as the Nunn-Domenici USA tax (or some combination), can be made to work in practice is a different question and the answer is not obvious.

More broadly, the report is symptomatic of the whole debate on tax reform: there is widespread agreement on the principles of tax reform, much less agreement on what those principles mean in practice, and perhaps very little on how to trade off one principle against another. But the revenue estimates provided above suggest that all of the stated goals of the commission cannot be achieved simultaneously: choices will have to be made between desirable features of the rate structure, the tax base, and extent and direction of social policy.

It is ironic that the commission report seeking unity on some basic principles of tax reform was issued just as attacks on the basic flat tax proposal have sprung

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up from Republican presidential candidates. To a large extent, the attacks reflect political motives, but if they had not occurred now, they would have to occur later as they embody the natural evolution of the debate to the next level: a more focused discussion of particular design issues and trade-offs.

Appendix: Estimating the Implications of the Kemp Commission Proposals

The data analysis was based largely on tabulations from the 1992 Public Use IRS files. The Public Use files provide tax returns for approximately 93,000 taxpayers along with weights that can be used to replicate aggregate tax return totals. The data were "aged" to 1994 levels to allow for population changes and income growth.

The next step was to calculate the tax base under the individual tax for each of the various provisions. The underlying tax base was taken to be the sum of wages and salaries, pension benefits (not including social security) and IRA distributions. From this total, personal and dependent exemptions were subtracted. The exemption levels are reported in the text and were adjusted to 1994 levels by deflating by 4.17 percent, to account for (an estimate of inflation) between 1994 and 1996. Subtracting the exemptions from the underlying base yielded taxable "income" with no other deductions. If taxable income was negative, it was set to zero.

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Payroll taxes were set at 7.65 percent of wages and salaries up to the 1994 earnings limit for one person: $60,600. This may overstate the deduction for payroll taxes if the deduction were meant to apply only to social security taxes. But it understates the deduction because it does not account for two-earner families that pay social security taxes on combined husband's and wife's earnings that exceed $60,600. It also omits all Medicare taxes on earnings above $60,600. Estimated employee payroll taxes were then deducted from the tax base and the tax base was recalculated, again with the provision that deductions were not allowed for any taxpayer whose taxable base reached zero.

The deductions for mortgage interest, charitable contributions, and state and local income taxes paid were simply taken off of the tax forms. Each deduction was subtracted from a base that had already accounted for each previous deduction.

With these calculations, the analysis builds on the Treasury (1996) analysis of the Armey/Shelby proposal. Treasury estimated the following revenue figures, assuming a 17 percent tax rate:

TAX ON	REVENUES*	IMPLIED BASE*
Individuals	335.8	1,975
Nonprofits	16.3	96
Noncorporate business	91.2	536
Corporate business	172.2	1,013
Total	615.5	3,620

* Billions of 1996 dollars.

Total tax revenue in 1996 is estimated to be $753 billion, so at a 17 percent rate, the Armey/Shelby proposal is estimated to generate a shortfall of $137.5 billion. Applying a 20.8 percent tax to the overall tax base would generate the same revenue as the current system.

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The estimated individual tax base using the 1992 Public Use files was $1,716 billion (in 1994 dollars). Even after adjusting for inflation, this is well below the imputed Treasury base. Using this lower base estimate would result in substantially higher tax rate estimates, so my analysis uses the higher Treasury base as a starting point and reduces the base by the figures implied by the 1992 Public Use files.

The calculation of the base under various proposals is as follows:

Tax System	Taxable Base*	Source
No deductions	3,620	Treasury (1996)
Deduct payroll taxes		
Employer	-242	see below
Employee	-176	Public Use files
Remaining Base	3,202	
Deduct mortgage interest	-166	Public Use files
Remaining Base	3,036	
Deduct charitable contributions	-53	Public Use files
Remaining Base	2,983	
Allow transition protection		
paid for over 20 years	-406	see below

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paid for over 30 years	-243	see below
Remaining Base		
20 year transition	2,577	
30 year transition	2,740	
Deduct state and local income and property taxes**	-140	Public Use files
Remaining Base		
20 year transition	2,437	
30 year transition	2,600	

*Billions of 1996 dollars

**This accounts only for these deductions on the individual tax. Business deductions are not included.

The figures above are used to generate the results in Table 1. The tax rate figures in Table 1 are determined by dividing estimated 1996 revenues, $753 billion, by the tax bases listed above. The revenue shortfall of a 20 percent tax rate is generated by comparing 20 percent of the tax bases listed above with $753 billion.

Other details on the above table are as follows. The deduction for employer payroll tax is determined by noting that estimated 1994 payroll taxes are $461 billion (Economic Report of the President, 1995, Table B-80). Half of this figure was applied to employers in 1994, for a 1994 total of $230 billion. This was grossed up by 5 percent to (conservatively) account for inflation and growth from 1994 to 1996. All of the other changes in the tax base due to deductions were also grossed up by 5 percent: for example, in the 1994 estimates, adding

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the mortgage interest deduction reduced the tax base by $158 billion. This was raised to $166 billion to reflect 1996 conditions.

Estimates of the revenue impact of protecting assets during transition are based on the following calculations: Let U = the current value of untaxed basis, t = the tax rate, g = real growth rate of the economy, r = real after-tax rate of return on government debt, and H = the horizon over which the revenues lost from transitional relief are recaptured. Then U*t is the present value of revenue losses from transitional relief. (If assets appreciate at rate r*>>r then U*t is an underestimate of the revenue loss.) This loss in the present value of revenues over H years can be converted to an annual measure by noting that it is equivalent (in present value) to a revenue loss of x(1+g) /h in years h=1...H, where x is determined such that the present value of such losses = U*t:

[EQUATION OMITTED]

The initial year revenue loss, x, can be written as B*t, where B is the initial year reduction in tax base caused by allowing transitional relief. Making the substitution and solving the equation implies that

[EQUATION OMITTED]

Thus, the initial year loss of tax base due to protecting existing assets in transition depends on the growth rate of the economy, the government after-tax borrowing rate, the number of years over which the revenue will be recaptured, and the original untaxed basis. The Treasury Department, based on Federal Reserve Board data, has estimated current untaxed basis to be on the order of $10 trillion (Toder, 1995). Based on that estimate of U, alternative values of B (in billions of 1996 dollars) are given below:

g-r	H=20	H=30
.02	406	243
.02	451	285
.00	500	333

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[FIGURES 1, 2, AND 3, ON PAGES 728 AND 729 ARE OMITTED]

FOOTNOTES:

/1/ "Unleashing America's Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century," The National Commission on Economic Growth and Tax Reform, January 1996.

/2/ For example, under the Armey/Shelby flat tax proposal described below, the exemption levels are $14,000 for single heads of households, $10,700 for singles, and $21,400 for couples. Therefore, two people with children could obtain $24,700 in exemptions if they are not married, but only $21,400 if they are married. At a tax rate of 20 percent, these features impose a marriage tax of $660 (=0.20*(24,70021,400)). Unlike the current system under which many households face little marriage tax or subsidy, the Armey/Shelby proposal would impose the $660 marriage tax on every couple that earns more than $24,700 and has children.

/3/ Suppose the basic flat tax rate were 20 percent. If payroll taxes were not deductible, a worker would pay 7.65 percent in employee payroll taxes plus 20 percent in "flat" taxes for a total of 27.65 percent. With deductibility, the effective tax rate would be 0.0765 + (1-0.0765)*0.20 = 26.12 percent, a reduction of 1.53 percentage points. If the basic tax rate were 25 percent, the saving would be 1.9 percentage points.

/4/ Because of various sheltering provisions, similar problems arise in the current tax system

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as well. See Engen and Gale (1995), for one example.

/5/ See Kirchheimer (1995).

/6/ There are other transition issues as well: removal of future capital gains taxes and corporate taxes implies windfall gains. If people receiving windfall gains are not asked to compensate the government for those gains, it will not be immediately obvious why those with windfall losses should be compensated.

/7/ Having a refundable payroll tax credit, rather than a deduction, would require a 32 percent flat tax rate.

/8/ For example, aggregate charitable contributions are roughly twice as large as reported charitable deductions (see Andreoni, Gale, and Scholz 1995, Table 6).

/9/ For further discussion of these issues, see Charles McLure and George Zodrow (1995), who conclude (page 25) that the method of taxing business income in the flat tax "contains unacceptable opportunities for abuse."

END OF FOOTNOTES

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Special Reports

Tax Reform

Musgrave, Richard A.

Richard A. Musgrave is H.H. Burbank Professor of Political Economy, Emeritus, Harvard University and Adjunct Professor of Economics, University of California, Santa Cruz. He is a member of the Tax Analysts Advisory Board.

He wishes to thank David M. Cutler, Alvin C. Warren, and George R. Zodrow for helpful suggestions, though the views expressed are his own.

As a first issue in the current tax reform debate, Musgrave addresses the proposed replacement of progressive rates with a single bracket or flat rate system. He rejects the claim of flat rate proponents that substitution of a flat rate by itself will greatly ease the taxpayer's task. Given the

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availability of IRS tables, liabilities are derived just as readily under a multiple bracket system. Using a flat rate offers massive simplification only if combined with transition to an impersonal form of taxation, as under income- or consumption-type value added or sales taxes, taxes that are collected at the business level. This, however, would involve a heavy cost in both equity and transparency. If personal taxation is maintained instead, as under the Hall-Rabushka-Armey plan, the major effect of its transition to a single rate would be a downward shift in the tax burden, not simplification. Combined with an increase in the personal exemption so as to reduce the number of taxpayers, this would be bound to increase the burden over the middle-income range. This, Musgrave concludes, is the crucial issue in the flat rate debate, and not exaggerated claims of simplification.

The second major issue Musgrave addresses is whether to retain and improve income as the personal tax base by resumption of an '86 type reform, or to replace it by a tax on wage income or consumption. Following the Hall-Rabushka and Armey plans, use of a flat rate has misleadingly come to be associated with switching to wage income as base, but this need not be the base. Any of the bases under consideration -- total income, consumption, or wage income -- can be taxed either under a flat or progressive schedule. The two key issues -- what rates to use and what base to apply -- should be kept apart, he argues.

The traditional concept of total income as tax base, which has guided federal tax policy for half a century or more, is now questioned. It is faulted for "double taxing" interest income, an outcome that can be avoided either by taxing current consumption as under the USA plan, or wage income as proposed by Armey. Musgrave writes that while critique of the income base has some merit, the case for replacing it with a consumption or wage base is by no means clearcut, be it as a matter of tax equity or economic effects.

A stronger case for replacing the income base, he believes, exists on grounds of simplification. The difficulties of measuring taxable income, especially under conditions of inflation, are bypassed by the other two bases so that replacement may well yield simplification. At the same time, it remains to be seen what new problems would develop and it would be naive to assume that the forces of loophole creation will vanish with such a change.

As a further source of confusion, Musgrave points to the mistaken claim, advanced by the "flat tax" plan, that it would reach all income equally. By allowing for expensing, the normal return to capital is in fact exempted from tax so that capital and wage income are treated quite unequally. A similar misleading claim is advanced in support of the USA plan. Musgrave emphasizes that one cannot abandon the income base while claiming to maintain its merits, and this should be made clear to the public.

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Recent years have generated a wide range of proposals to overhaul the federal tax system, proposals that differ fundamentally from the reform aims of past decades. The income tax age, which began with the finance of World War II, is to come to an end. The goal is no longer to improve the income tax by broadening its base but to replace it, fully or partly, with a new model. Some call for substitution of an old-fashioned retail sales tax or its equivalent, a consumption-type value added tax. Others would introduce new constructs, claiming great advantages over the income tax. Offered under the labels of "flat tax," "USA (unlimited savings allowance) tax," "consumed income tax," "prepayment tax," and many more, these proposals leave the public in a state of confusion. /1/ Unfortunately so, since no intelligent choice can be

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made unless it is understood just what the various plans would actually do. My purpose here is not to choose among them but to clarify some key issues.

To simplify, this will be done with reference to two prototypes, the "flat tax," first proposed by Robert Hall and Alvin Rabushka, and supported by Rep. Dick Armey, R-Texas, and the "USA tax" offered by Sens. Pete Domenici, R-N.M., and Sam Nunn, D-Ga. /2/ Both are designed to replace the personal income and corporation profits taxes while holding revenue constant. Both would tax at the business and personal levels, but their tax bases and rates would differ. The flat tax would apply a 17 percent rate at both the business and individual levels, while the USA tax would combine an 11 percent rate at the business level with rates ranging from 10 to 40 percent at the individual level. The base of the business tax under the flat tax plan would be that of a consumption-type value added tax minus payroll, while that under the USA tax would include the full value added base. The base of the individual tax under the flat tax plan would equal wage payments and pensions, while that under USA would equal income minus saving, i.e. consumption. Net saving would be determined as the difference between additions to and withdrawals from regulated financial accounts. In both cases an ample exemption would be allowed at the individual level, but other deductions and credits now granted under the income tax would largely be dropped. Other proposals differ in detail, but key issues may be examined by viewing these two prototypes.

I. The Flat Rate Quandary

Public imagination has been captured by the vision of a flat tax, with personal returns reduced to postcard form, symbolizing a greatly simplified system. Closer consideration shows that the simplification case for the flat rate tends to be overstated. Gains from simplification will largely be the result of base-broadening and the removal of capital income from the base; this can be achieved just as well if combined with progressive rates at the personal level. The essence of the flat rate lies not in simplification but in the resulting redistribution of the tax burden.

Suppose that the five bracket rates of the income tax were replaced by a flat rate of equal revenue, at say, 30 percent. Revenue would be the same but taxpayers would no longer have to compute their liability from a schedule of multiple rates. At first sight this suggests a major simplification but the gain is largely fictitious since such computation is in fact unnecessary for the large majority of taxpayers. Given the availability of the IRS tax tables, determination of tax liability, once taxable income is given, is no more difficult under a multiple-rate than under a single-rate system.

Simplicity of computation aside, moving to a single rate would void the shuffling of incomes between family members to avoid higher bracket rates and source withholding would come to account for a larger part of total revenue. A much larger gain in simplification would result only

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if the flat rate were combined with radical base- broadening, including elimination of personal exemptions as well as of deductions and removal of capital income from the base. It would then become possible to administer the tax in impersonal form (similar to the business tax component of our two plans) and taxation at the personal level could be abandoned in favor of a value added tax. Taxation would be at the business level only. The individual taxpayer would disappear from the scene and the number of taxpayers would be vastly reduced.

The flat rate would then win on grounds of simplification, but at a severe cost. Moving to a wholly depersonalized system would reduce taxpayer awareness of the fiscal process and thereby dilute responsible fiscal citizenship. Removal of legitimate deductions would be inequitable. Most important, removal of the personal exemption would shift the burden to the bottom of the scale. Allowance for a personal exemption in effect constitutes a zero-rate bracket, so that a flat rate imposed on income above the exemption generates a rising ratio of tax to income and hence a rising effective rate. For the vast majority of taxpayers, this rise in effective rate is set largely by the personal exemption, with rising bracket rates becoming important only for, say, the top 7 percent of taxpayers, those with AGI of above $70,000. While the use of progressive bracket rates higher up is controversial, the need for relief at the lower end of the scale is widely accepted. The principle of a tax-free minimum is thus retained by even

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the "flat rate" plan. Even that plan's tax, with its single rate, is not assessed entirely at the business level; and even though the same rate applies, wages are taxed at the individual level so as to permit an exemption or initial zero-rate bracket. Adding to semantic confusion, it is now offered as the "progressive flat rate tax." /3/

As has been suggested in some reform plans, the principle of a tax-free minimum could conceivably be retained by combining a depersonalized value added tax with cash payments to low-income individuals to serve as a refund or substitute for the personal exemption, but this would be cumbersome especially when making allowance for family size. This then explains why these plans retain a personalized component. But once a personal tax component is retained, much of the simplification case for the flat rate is lost. Adding further brackets to the consumption base of the USA tax does not add significantly to compliance cost, nor would it do so if applied to the wage base of the flat tax. Replacing multiple rates with a flat rate, therefore, has little to do with simplification and should not be sold under that label.

The real significance of the flat rate, rather, is in its effect on the share of the burden carried by higher incomes. Though the number of high-income taxpayers is relatively small, the distribution of the tax base is highly skewed and consequently their share in the base is substantial. The top 10 percent of taxable returns, those with AGI above $200,000, contribute

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about 40 percent of taxable income and the top 1 percent contribute about 17 percent. Substituting a flat rate, therefore, would push a substantial part of the burden down the income scale, shifting it to the low- and middle- income range. The merits of such a shift will not be discussed here, but with simplification set aside as largely a red herring, this is what the debate over flat versus multiple rates should be about.

II. What Base?

What has been said here regarding the flat rate issue applies independently of base, be it income, wages, or consumption. Both the wage and income bases may be combined with either a single- or multiple-rate system. This leaves the choice of base a distinct and separate problem.

The term "income," as commonly understood and aimed at by advocates of the income tax, refers to a person's "incomings," independent of their sources or uses. Seen from the sources side, capital and wage income are treated alike and the cost of earning them is to be deducted. Seen from the uses side, both consumption and saving are to be included. The flat tax proposes to narrow the base by excluding capital income from the sources side while the USA tax proposes to narrow it from the uses side by excluding saving.

Which of the three formulations should be chosen -- income, wages, or consumption? The question is not a new one. A century and a half ago, John Stuart Mill first faulted the income tax for involving "double taxation" of interest income. Consider C and S, both receiving an initial wage income of $100 in period I. With a 10 percent tax, both pay $10 and have $90 left. Now let C consume $90 in period I and pay no further tax. S saves, invests, and with an interest rate of 10 percent, earns an additional $9 in period II. On this S pays an additional tax of $0.90 in period II, or $0.81 in terms of period I value. This is considered unfair and inefficient.

A correction may be applied in two ways. One is to tax consumption when it occurs. C will then consume $100 and pay $10 in period I. S consumes $110 and pays $11 in period II, equal in present value terms to C's payment of $10. The other is to exempt interest income from tax, leaving both C and S with a payment of $10 in period I. Seen in this simple illustration, a tax on consumption and a tax on wage income are thus equivalent procedures, and both differ from a tax on income. /4/

A. Equity

In choosing among the three bases, considerations of equity, efficiency, and feasibility may be distinguished, and special transition problems need be addressed. As a matter of "horizontal equity," it is generally agreed that people in equal positions should pay the same tax. From the income tax perspective, this was seen to call for imposing the same tax on all people with equal

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"incomings," thus leaving them with the same options. From the consumption perspective, the income base is said to fail the test because S pays more, even though both S and C begin with the same position. The argument has merit but the case is not clear cut.

For one thing, allowance must be made for the fact that not all income saved will be consumed later on. It may be transferred in gifts or bequests. Under the USA tax, such transfers will escape taxation until and if consumed later on. Since the donor has the option to choose between consumption and transfer, a good case can be made for the inclusion of transfers in the donor's consumption base, and similarly so for their inclusion in the wage base of the recipient. For another, the reasoning assumes that consumption, current or fu-

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ture, is the only benefit that income provides. This overlooks the benefits derived from the accumulation and holding of wealth, whether in terms of security, power, or social standing. /5/ To account for these gains, fairness calls for a supplementary tax on wealth, a suggestion made in the literature but not included in the major plans now under consideration. /6/ Determination of the wealth tax base, however,would reintroduce many of the difficulties now encountered in the treatment of capital income under the income tax.

A further consideration may be added. Whereas the case for a consumption base seems appealing, that for a wage tax seems less attractive. Why should income derived from work effort and the surrender of leisure be taxed, while that earned from saving and investment is left tax-free? The very use of the terms "earned" and "unearned" income suggests that, if anything, there may be a reverse conclusion. If it is unfair to discriminate against savers, may it not also be unfair to discriminate against wage earners? Equity is a complex concept and much depends on how the problem is viewed.

Turning to considerations of "vertical equity," a drastic change in perspective should be noted. Whereas the use of the consumption base has traditionally been linked to indirect and regressive taxation of the VAT type, such need no longer be the case. As shown by the USA tax plan, the consumption base may be applied in the context of personal taxation and progressive rates; and though the flat tax uses a single rate only, progressive rates have been applied to the wage base in other plans. /7/ It may be added, however, that to obtain the same distributional results, faster rising marginal rates would be needed under the consumption and wage than under the income base. Such would be the case because the savings rate rises and the wage share in income falls when moving up the income scale.

B. Efficiency

The "double taxation" of interest under the income tax is criticized on efficiency as well as equity grounds. Efficient choice is interfered with by inserting a tax wedge between present and future

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consumption. Saving is discouraged and economic growth is retarded. The case again has merit, but the qualifications noted in the equity context reapply. Much also depends on the responsiveness of saving to the rate of interest, a much debated but still highly controversial issue.

C. Simplicity

It remains to consider the feasibility of implementing the various bases and the resulting gains in simplicity, a concern that has been at the center of the discussion. The income tax has increasingly been subject to criticism for many shortcomings, including defects that could be avoided such as inappropriate deductions and exclusions, as well as complications inherent in the measurement of capital income, particularly in the context of inflation. By treating real investment on a cash flow basis, these difficulties are largely bypassed by both the flat and USA taxes, thereby achieving substantial simplification. Further simplification is to be achieved by eliminating uncalled for deductions and exclusions.

Such gains would result, but new problems will arise as well. Simplifications arising from base-broadening may not last, and the retention of tax-exempt interest and deduction of mortgage interest in the USA tax plan does not bode well in this respect. Differentiation between outlays that constitute consumption and investment will gain in importance under the USA tax and the monitoring of transactions in financial accounts, needed to measure saving under the USA tax, will not be easy. /8/ The difficulty does not arise under a wage tax, which therefore may prove the simpler procedure. However, there would be the further problem of distinguishing between what constitutes wage and what constitutes capital income.

Outcomes, especially during the transition, will differ under the two plans. Replacement of the income tax by the wage-based flat tax will relieve consumers of the old (prechange) capital stock from taxation and thus redistribute in favor of the older generation. Substitution of the consumption-based USA tax, in turn will benefit new savers and thus redistribute in favor of the younger generation. Problems of intergeneration equity, efficiency, and growth effects arise.

In all, both the flat tax and USA tax would yield major simplification and efficiency gains in bypassing the determination of capital income. At the same time, it remains to be seen what new problems would appear and how well the issue of simplification can be separated from the struggle over progressivity and burden distribution. Uncertainties created by a major overhaul of the tax system, finally, also have their own cost. Overhaul, to be sure, offers a challenge, especially to a new generation of tax analysts, but the alternative of returning to income tax reform in the spirit of 1986 should not be overlooked.

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III. Treating Incomes Equally?

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We now turn to a brief look at just what is being taxed by the combined business and personal tax packages under the flat and USA plans, and to their claim of imposing equal taxation on all income.

A. Flat Tax

The flat tax, as noted above, would impose an 17 percent tax at both the business and personal levels. The base of the business tax would be defined as sales minus purchases from other business, minus investment, and minus wage payments. Wages, when received, would then constitute the base of the personal tax, along with an allowance for personal exemption. The package would thus be similar to that of a subtraction-type, consumption-based value added tax collected partly at the business and partly at the wage-earner level, with a higher rate of tax needed to refund wage earners an amount equal to wage tax saving due to the personal exemption.

How does the base appear when viewed from the sources side of the account? Here it is claimed that the package, as one of its chief merits, will provide for "equal taxation of all income." /9/ Business income, defined as what is left after deducting costs of doing business, purchase of equipment and payroll is taxed at the business level, while wage income paid to workers is taxed at the personal level, all at the same rate of 17 percent. Thus all income is said to be taxed equally; but is it?

The key problem lies with the role of expensing and the concept of "business income." Business income as defined by the flat tax fits the context of cash flow analysis, but does not offer a measure of personal income or national income share comparable to wages. Yet this is the concept of income, analogous to income shares in national income, that is relevant when viewing equal treatment of incomes as needed to secure equity among individuals. Business income, in that context, should be defined as the net return to capital, as is attempted (if imperfectly) under the corporation tax. /10/ To measure that net return, business must be allowed to recover its investment cost, but only over the course of the asset's useful life and not at the outset as provided by expensing.

The basic point, passed over in the exposition of the flat tax plan, is that expensing exempts the normal return to capital from taxation. By allowing immediate deduction of the investment cost against other income, the government in effect renders an interest- free loan to the investor. In the course of continuous reinvestment, this loan will generate an income stream the present value of which, after tax, equals the tax on the normal return on the initial investment. /11/ The only returns that remain in the tax base are rent, monopoly profits, compensation for risk, and reward for superior entrepreneurial effort. Retention of rent and monopoly profits is to the good, taxation of risk tends to be cushioned by loss offset where possible; but entrepreneurial reward, ironically so for this supply-side age, is retained while the normal return drops out.

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Once the correct income concept is applied, the claim that all income is treated equally becomes invalid. The very term "business tax," suggesting an analogy to the corporation income tax, becomes misleading. By using incompatible income concepts and offering the package as an equal tax on all income, its true nature is misrepresented. As viewed from the sources side, income taxation under the flat tax should be described as a tax on wages, with capital income largely exempted and the two sources treated quite unequally. Compared with an "equal tax on all income," this offers a less appealing image.

The crucial role of expensing, that it serves to exempt the normal return to capital, is not revealed in the plan's presentation. The reader is told, correctly if rather cryptically, that there is a deeper rationale for expensing than mere simplification. Investment is preceded by saving, exemption of investment means exemption of saving, and exemption of saving in turn means taxation of consumption. /12/ Well and good, but this does not support the claim that a tax which permits expensing, will also result in an equal tax treatment of capital and wage income. On the contrary, it shows that the two sources of income, defined as factor shares or incomings, are not treated alike.

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B. USA Tax

Similar problems arise in the presentation of the USA tax system. The plan once more includes two parts, a tax on "gross profits" imposed on business and a tax on consumption at the personal level. Beginning with the 10 percent business tax, the base now equals sales minus purchases from other business, including current inputs and capital equipment. Wage payments now remain in the base. Interest received is not included and interest paid is not deducted. The base of the business tax thus defined is that of a consumption- type, subtraction method value added tax pure and simple. To this is added a personal tax on consumption at rates of 19 to 40 percent. In combination, the package amounts to a progressive consumption tax with a first bracket rate of 11 percent applied without exemption, followed by higher bracket rates (applicable to consumption in excess of exemption) from 29 to 50 percent.

Once more, the authors also view their package from the sources side. After declaring that the USA system is designed to "cut through the thicket of labels, biases and in some cases confusion," /13/ that very confusion is compounded by presenting what in effect constitutes a progressive consumption tax as an unlimited savings allowance "income" tax system. The business and personal tax components of the plan are seen as consistent parts, contained in the same base and drawing on different points in the process by which "income" is created. "The tax base first emerges when businesses create income by producing and selling goods and services. That is when the business tax applies. Next, the tax base reappears when individuals actually receive that income, net of business tax, in the form of wages, salaries, interest and

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dividends and similar distributions to the owners of business. It is at that point where the individual tax applies." In all, "the business tax is even-handed in the amount of tax it imposes on the labor and capital income produced by a business." /14/ With the rate of business tax set so as to match the revenue now obtained from the corporation tax, the impression is left that just one form of business tax is swapped for another.

The trouble once more lies in failing to note the fundamental role of expensing in the treatment of capital income and its difference from economic depreciation. As depreciation over the useful life of the asset is replaced by expensing, the normal return to capital, as noted before, is exempted with only residual profits left in the base. Notwithstanding the detailed exposition of the USA tax plan, this crucial difference is again not put on the table. The reader is not advised that with expensing the normal return to capital is left tax-free. Hence the analogy of "business income" to wage income no longer holds, with wage and capital income treated quite unequally. As in the flat tax case, this sounds less attractive, but once more the public should be told what goes on.

FOOTNOTES:

/1/ For a brief overview of various approaches, see Charles E. McLure Jr. and George R. Zodrow, "A Hybrid Approach to the Taxation of Consumption," forthcoming in Handbook of Tax Reform, M.J. Boskin, ed., Stanford: Hoover Institution Press.

/2/ See Robert E. Hall, and Alvin Rabushka, 1995, The Flat Tax, second edition, Stanford: Hoover Institution Press, reprinted in Special Supplement, Tax Notes, Aug. 4, 1995, and "USA Tax System, Description and Explanation of the Unlimited Savings Allowance Income Tax System," Special Supplement, Tax Notes, Mar. 10, 1995.

/3/ See Robert E. Hall and Alvin Rabushka, "The Flat Tax: A Simple Progressive Consumption Tax," Hoover Institution Conference Paper, Frontiers of Tax Reform, May 11, 1995, National Press Club, Washington, D.C.

/4/ It does not follow that for any one individual the wage base, in any given year, must equal the consumption base. The two will differ if, during that year, non-wage income is received or net saving occurs. What it does mean is that for any one individual the present value of his/her lifetime tax will be the same whether imposed on wage income or consumption, provided that (1) all income will be consumed during his/her lifetime, (2) no assets are held at the beginning and consumed during the period, (3) no transfers are made or received, (4) tax rates do not change, and (5) the return to capital equals the rate of interest.

/5/ See Henry C. Simons, Personal Income Taxation, The University of Chicago Press, (1938) p. 96.

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/6/ Allowance for a supplementary wealth tax is made in George R. Zodrow and Charles E. McLure Jr., "Implementing Direct Consumption Taxes in Developing Countries," Tax Law Review, Vol. 47, No. 4, New York University School of Law.

/7/ See note 1 supra.

/8/ See Alvin C. Warren Jr., "The Proposal for an 'Unlimited Savings Allowance,'" Tax Notes, Aug. 28, 1995, p. 1103.

/9/ Hall and Rabushka, note 2 supra, p. 55.

/10/ It may be noted here that under a correct income tax approach, seen in the context of domestic taxation, there would be no absolute corporation tax, with all net income, whether distributed or retained, imputed to shareholders.

/11/ To illustrate, suppose that an investment of $100,000 is made. No income has been earned as yet but under the expensing rule, that amount may be immediately charged as a cost against past earnings or income from other investment. With a 34 percent tax, a tax saving of $34,000 results. Investment and expensing of that amount gives rise to a further saving of $11,560, and so forth. The total amount available for investment then sums to equal $151,500. The investment of $151,500 yields a return 1.515 times as large as the earnings obtained in the absence of tax. But a tax of 34 percent must now be paid thereon. The investor is thus left with 0.66 (1.515) = 1.0 times his earnings in absence of tax. The increase in earnings by a factor of 1.515 and the introduction of a 34 percent tax wash out. If the initial amount was borrowed, this result holds provided that interest paid is not deductible from the base. If deductible, expensing leaves the investor with a subsidy.

The above outcome, with its result of zero tax, however, holds only when the rate of return on the investment equals the normal or market rate of interest. When the return exceeds the market rate the above normal return remains subject to tax. See Joseph E. Stiglitz, Economics of the Public Sector, New York: Norton, p. 455 (1986), and A.B. Atkinson and J. Stiglitz, Lectures on Public Economics, New York: McGraw-Hill, p. 146 (1980).

/12/ See note 2 supra.

/13/ USA tax system, note 2 supra, p. 1525.

/14/ USA tax system, note 2 supra, p. 1489.

END OF FOOTNOTES.

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