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The Rocky Road to Tax Reform

FROM THE BOSTON Tea Party through recent revelations of Internal Revenue Service abuses, paying taxes has aroused public passions in the United States. Every president in the past four decades has proposed significant tax changes, and successive Congresses have enacted many tax bills, major and minor. Seemingly endless tinkering has not, alas, bred satisfaction. Almost everyone concurs that the tax system could be improved. But agreement on the nature and severity of the problems and how to resolve them remains elusive.

The basic goals of tax reform seem clear. Taxes should be simple and fair. They should be conducive to economic prosperity and market efficiency. And, not least, they should raise sufficient revenue to cover the "appropriate" level of government spending without unduly compromising freedom and privacy.[1]

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1. Taking exception to these statements is a group of economists who believe that an inefficient, unfair, or complex tax system makes it more difficult politically to raise revenues, which helps hold down the size of government. They argue that, on balance, a smaller government with a more cumbersome tax system is better for the economy than a larger government with a more efficient tax system. Friedman (1993); and Becker and Mulligan (1998).

Despite the motherhood and apple pie quality of these goals, tax policy remains controversial. First, the goals are imprecise: views of what constitutes a fair tax, for example, vary widely. Second, controversy arises over how to achieve each goal. Supporters of increased growth may disagree over whether across-the-board income tax cuts, targeted tax cuts for saving and investment, or paying down public debt will do most for the economy. The most important source of controversy, however, is differing value judgments concerning the relative importance of the goals coupled with the fact that the goals sometimes conflict with one another. Research and data may answer technical questions, but they cannot resolve disagreements based on divergent values and preferences.

This chapter first summarizes the main features of federal taxes and explains the sources of tax complexity, distribution of tax burdens, and effects of taxes on economic growth. It then describes and evaluates proposals to reduce the level of tax revenues via across-the-board cuts in income tax rates and other options. Subsequent sections examine strategies and specific options for modifying the structure of the current system, including the general tax base, rates, and special provisions. Finally, the chapter examines proposals for fundamental tax reform—replacing existing taxes with a whole new system.

Federal Taxes: An Overview

One of the most fundamental decisions in any tax system is what to tax—wages, income, wealth, or consumption?[2] The federal government taxes all four but taxes consumption lightly compared with other countries. About half of federal tax revenue comes from personal income taxes and another third from payroll taxes (table 7-1). The corporation income tax, estate and gift taxes, and excise taxes supply most of the rest. The composition of revenues has changed dramatically over the past fifty years. In 1952 about 10 percent of revenues came from payroll taxes and one-third from corporate taxes. By 1998 those pro-

2. Throughout this section numbers have been calculated by the authors using data from various sources, including Bureau of Economic Analysis, Internal Revenue Service, Office of Management and Budget, Joint Committee on Taxation, and Commerce Clearing House.

Table 7-1. *Federal Tax Revenues, 1999*

Type of Tax	*Billions of dollars*	*Percent of GDP*	*Percent of revenues*
Individual income tax	887	10.0	48.7
Corporate income tax	178	2.0	9.8
Social insurance taxes	607	6.9	33.3
Estate and gift taxes	28	0.3	1.5
Other	121	1.4	6.6
Total	1,821	20.6	100.0

Source: Authors' calculations based on data from Congressional Budget Office (1999a).

portions had reversed. The overall level of revenues hovered between 16 and 19 percent of GDP from 1951 to 1995 but has risen in recent years to 20.5 percent of GDP in 1998, the largest share since 1944.

Personal Income Tax

The modern personal income tax was established in 1913 after ratification of the Sixteenth Amendment to the Constitution eliminated the requirement that taxes be apportioned across the states solely on the basis of population. Until 1940 the tax fell only on the relatively wealthy and never yielded more than 1.5 percent of GDP in revenue. The revenue demands for World War II, however, led to the transformation of the income tax from a "class" tax to a "mass" tax. By 1952 the tax collected 8 percent of GDP in revenues. After remaining relatively flat through 1995, revenues rose to 9.9 percent of GDP by 1999.

TAX BASE. In principle an income tax should fall on *all* net additions to individual spending power during the tax period and *only* on these net additions. In practice the combination of personal and corporate income taxes varies significantly from this norm: some income is taxed once—either when it is earned or consumed—some income is taxed more than once, some not at all, and some flows that are not income are taxed.[3]

3. The justification for taxing income as opposed to, say, consumption, is examined later in the chapter in the section on fundamental tax reform.

The personal income tax is levied annually on the worldwide nominal income of U.S. residents, including wages and salaries, interest, dividends, rents, royalties, net business income, unemployment insurance and part of social security benefits, pension and annuity income, and realized capital gains. Wages account for most of adjusted gross income, but the composition of income varies dramatically at different income levels. Capital gains, dividends, interest, and business incomes account for more of the incomes of high-income households than those of low-income households (table 7-2).

Some forms of income are excluded from federal taxation, including noncash income (such as employer-financed health insurance premiums and imputed rent from housing), part of social security benefits, and interest from state or local government bonds. Taxes on deposits and investment earnings in pensions, Individual Retirement Accounts, and 401(k) plans are deferred until the income is realized. Taxes on capital gains—the increase in value of assets over time—are deferred until the asset is sold and are not levied at all if the asset is held until the owner dies.[4] Up to $500,000 in capital gains from the sale of owner-occupied housing by couples ($250,000 by single persons) are also excluded from income tax.[5]

EXEMPTIONS AND DEDUCTIONS. After determining their gross income, tax filers may subtract personal exemptions; in 1999 the exemption is $2,750 for the filer, spouse, and each dependent. Filers may also claim a standard deduction: $7,200 for couples filing joint returns and $4,300 for single filers in 1999. The combination of exemptions and the standard deductions relieves almost all households with income below the poverty line from paying federal income tax. Personal exemptions are phased out for high-income taxpayers.[6]

4. There are some important exceptions to this rule. The accruing value on zero-coupon bonds is imputed and taxed annually. Futures contracts are "marked to market," and the change in value is subject to taxation each year.

5. This exemption is available every two years provided that the filer has resided in the house for two of the preceding five years.

6. Joint Committee on Taxation (1999). The phaseout of personal exemptions begins for single filers, heads of household, and couples filing jointly at $126,600, $158,300, and $189,950, respectively. The reduction is 2 percent for each $2,500 or

Table 7-2. *Composition of Income by Income Level, 1996*
Percent

		Adjusted gross income	
Type of income	*All filers*	*\$10,000–\$20,000*	*\$200,000 or more*
Wages	74.4	75.2	45.5
Interest and dividends	7.0	7.3	12.0
Realized capital gains	5.6	1.0	21.1
Business and partnership income	7.1	4.7	19.4
Pension and social security income	11.5	19.2	4.3
Other	–5.6	–7.4	–2.3

Source: Authors' calculations based on data from Internal Revenue Service (Fall 1998).

Instead of using the standard deduction, households may itemize deductions for expenditures on state and local taxes, mortgage interest, business or personal investment expenses, charitable contributions, some medical expenses, and other items. Mortgage interest, charity, and state and local taxes account for more than 90 percent of all itemized deductions. In recent years, about 29 percent of tax filers have taken itemized deductions, but the proportion varied in 1996 from less than 9 percent among filers with adjusted gross incomes below \$30,000 to 88 percent among filers with incomes of \$75,000 or more. Itemized deductions are reduced by formula for high-income tax filers.[7]

TAX RATES. Income is subject to six statutory tax rates. The rate is zero if exemptions and deductions exceed adjusted gross income. Taxable income—the excess of adjusted gross income over exemptions and deductions—is subject to rates of 15, 28, 31, 36, or 39.6 percent that rise

fraction thereof above the beginning of the phaseout. The phaseout is complete at incomes of more than \$249,100, \$280,800, and \$312,450, respectively.

7. For single taxpayers and couples filing jointly; itemized deductions other than those for medical expenses, gambling losses, investment interest, and nonbusiness casualty or theft losses are reduced by 3 percent of income over \$126,600 but never by more than 80 percent of their original amount.

with income.[8] The brackets to which these rates apply, as well as personal exemptions and the standard deduction, are adjusted annually to offset the effects of inflation. Most filing units are in low tax brackets. In 1998 some 30 percent had no taxable income and therefore were in the zero bracket, 46 percent were in the 15 percent bracket, and 20 percent were in the 28 percent bracket. Only 3.5 percent faced rates higher than 28 percent, and only 0.5 percent faced the highest rate of 39.6 percent. Tax legislation in 1981 and 1986 sharply lowered statutory marginal tax rates for all income groups. Legislation in 1990 and 1993 raised marginal rates for high-income taxpayers, but even so, marginal rates on high incomes are substantially lower than they were twenty years ago.[9] Capital gains on assets held more than one year are taxed at lower rates than other income with the rate depending on the type of property, when it was purchased, how long it is held, and the taxpayer's income.

TAX CREDITS. Tax credits directly reduce tax liability. A $100 credit reduces taxes by $100 (or the taxpayer's liability, whichever is less). In contrast, a $100 exemption or deduction reduces taxable income and thereby reduces tax liabilities by $0 to $39.60 depending on the taxpayer's marginal tax rate. Credits are provided for families with children, for low earned income, and for expenses relating to child and dependent care, higher education, and adoption. All credits are phased out as income rises, except for the child care credit, which is phased down. The earned income credit is refundable and thus can reduce tax payments below zero, generating net payments from the government to the filer. Most other credits are not refundable and therefore are of no value to filers with no taxable income.

8. For example, a couple filing jointly in 1999 would pay a rate of 15 percent on taxable income up to $43,050, 28 percent on income from $43,050 up to $104,050, 31 percent on income from $104,050 up to $158,550, 36 percent income from $158,550 up to $283,150, and 39.6 percent on income above $283,150. Different income ranges apply to single persons, heads of households, and married persons filing separately. Approximately 25 percent of tax payers face effective marginal tax rates that differ, sometimes considerably, from their statutory tax rates because of the phaseouts of tax credits, personal exemptions, and itemized deductions.

9. Burman, Gale, and Weiner (1998a).

ALTERNATIVE MINIMUM TAX. Besides the regular income tax, there is also a personal alternative minimum tax (AMT), a parallel tax system that applies to gross income less an exemption ($45,000 for married couples) and a very restricted menu of deductions. Taxpayers whose AMT liability exceeds their regular income tax liability must pay the AMT. The AMT is one of several methods Congress has used to limit tax avoidance, but it is very complex. In recent years about 0.4 percent of households paid the personal AMT. By 2009, about 6.3 percent of filers are projected to have to pay minimum tax because the AMT exemption is not indexed for inflation or rising incomes.

ADMINISTRATION AND EVASION. The overall rate of evasion of income tax is estimated to be about 20 percent of actual tax revenues, but the evasion rate varies dramatically by type of income. The compliance rate is about 99 percent for income and payroll taxes that employers withhold and remit to the government. Withholding not only minimizes evasion but also reduces compliance costs. The compliance rate for taxes on interest, dividends, pensions, and social security, which are reported to the government by the payer but for which no taxes are withheld, is 92–98 percent. The compliance rate by sole proprietors (small businesses) and farms, whose income is neither withheld nor reported by a third party, is about 70 percent.[10]

SUMMING UP. The two most notable features of the personal income tax are graduated tax rates and a narrow tax base. Graduated tax rates are a primary means of collecting proportionately more tax from high- than from middle- and low-income filers. The narrow tax base, created by the exclusions, deferrals, deductions, exemptions, and credits already noted, reduces taxable income. In 1996, taxable income was 68 percent of adjusted gross income and 48 percent of personal income in the national income accounts. The narrow tax base generates complexity and equity problems explained later and raises the tax rates needed to generate a given amount of revenue.

10. All data in the paragraph are based on U.S. Department of the Treasury (1996); and Gale and Holtzblatt (1999, p. 20 and table 3).

Corporation Income Tax

All income, whether earned by individuals or businesses, eventually accrues to people. Income from sole proprietorships and partnerships is taxed under the personal income tax, but corporations face a separate tax.[11] Corporations are legal entities that limit the liabilities of their owners to the amounts they have invested. The primary reason to place a tax on corporate income is to discourage people from using corporations to avoid taxes.

The corporation income tax base includes receipts from sales of goods and services and from investments, less deductions for costs used to produce revenue, including wages and fringe benefit payments, the cost of purchased goods and services used as inputs, interest payments, and the depreciation—loss of value—of plant, equipment, and other capital. Depreciation deductions are typically set by formula based on the estimated economic life of the asset. Additional corporate deductions and credits target exports, foreign investment, research and development, charitable contributions, and small businesses in general. A variety of industry-specific provisions, often derided as "corporate welfare," favor insurance, energy, natural resources, agriculture, shipping, and finance. In recent years, increased attention has also been given to corporate shelters. Generally, these are complex tax arrangements, designed primarily to avoid taxes, that often depend on aggressive interpretation of existing law and, when discovered by the Internal Revenue Service, are often disallowed.[12]

The personal and corporation income taxes are not integrated. As explained later, some—but certainly not all—corporate source income is taxed twice: once at the corporate level through the corporation tax and again at the personal level, through taxes on dividends and capital gains. The legitimate reasons for taxing corporations once do not justify taxing corporate income twice.

The basic corporate tax rate is 35 percent on profits exceeding $18,333,333, but corporations with lower profits pay marginal rates as

11. Corporations with fewer than seventy-five shareholders are an exception. They may organize as "S corporations" and be taxed as partnerships, imputing the business income to the individual shareholders.

12. U.S. Department of Treasury (1999).

low as 15 percent. Low rates on low profits are rationalized as a spur to small business, but the rationale is weak because large businesses may earn few profits and small businesses may earn large ones. As with the personal income tax, there exists a parallel corporate alternative minimum tax, levied at a 20 percent rate on a complex and broader tax base than that of the regular corporation income tax. Companies that pay the AMT receive a credit applicable against ordinary corporation tax they may owe in later years.

Estate and Gift Taxes

The estate, gift, and generation-skipping transfer taxes form an integrated tax on transfers of assets from one person to another. Transfer taxes have several aims: to tax previously untaxed income, such as unrealized capital gains; reduce the concentration of wealth; and increase the progressivity of the overall tax and transfer system.

The estate tax is levied on taxable estates above a floor, which will rise from $650,000 in 1999 to $1 million after 2005. Owners of family businesses and farms enjoy additional exclusions that effectively exempt estates worth up to $1.3 million. The taxable estate consists of net assets less charitable contributions and transfers to one's spouse. Every person may also give up to $10,000 a year each to as many other people as he or she wishes without paying gift tax or affecting subsequent estate tax liability. Because of these provisions, the estate tax applies only to about 2.1 percent of decedents.[13]

Marginal rates rise from 37 percent on the smallest taxable estate to 55 percent for taxable estates in excess of $3 million. For estates valued between $10 million and $21.04 million, an additional 5 percent tax is effectively added, boosting the average rate on large estates to 55 percent. Credits are provided for state-level estate tax payments. As a result of high marginal tax rates, a significant number of loopholes, and plenty of time to anticipate the tax, estate taxes engender a large amount of tax avoidance and planning activity, and estate tax revenues have made up only about 10 percent of gross estates in recent years.

Between 1988 and 1998 estate tax revenues grew much faster than other revenue sources because of the rapid appreciation of the asset val-

13. Davenport and Soled (1999, p. 594).

ues of the 1990s, because limits on transfers between spouses removed in 1981 had led to the deferral of taxes that began to come due as the second spouses died, and because provisions to limit avoidance, such as a tax on generation-skipping trusts, were beginning to have a major effect on revenues. The graduated increases in the estate tax credit will retard revenue growth through 2006, but unless Congress raises the threshold at which it takes effect, the estate tax will continue to grow as a share of federal revenues.

Payroll Taxes

Unlike income and estate taxes, which flow into general revenues, payroll taxes are earmarked to pay for social insurance benefits—social security, medicare, and unemployment insurance. The social security tax is 12.4 percent of earnings up to a wage ceiling, $72,600 in 1999, divided equally between levies on employees and employers and imposed fully on the self-employed. The medicare tax is 2.9 percent of all earnings, again divided equally between employees and employers. The unemployment insurance tax, 6.2 percent of earnings up to $7,000, is levied only on employers. The employer taxes are deductible in computing business income subject to corporation or personal income tax but employee contributions are not.

Most analysts believe the employer tax depresses wages and that workers therefore bear most or all of the burden of payroll taxes. If this assumption is correct, 74 percent of taxed households pay more in payroll taxes than in income taxes.[14] The reason is that payroll taxes are due on the first dollar of earnings while income taxes are due only when income exceeds personal exemptions and deductions. Even then, the first positive income tax rate of 15 percent is lower than the combined social security and medicare payroll tax rate of 15.3 percent, and income taxes are further reduced by the earned income credit and other credits.

Effects of Federal Taxes

Three of the primary goals of tax policy are to make taxes simple, fair, and conducive to economic growth. How does the federal system measure up?

14. Congressional Budget Office (1998a, p. 32).

Complexity

Perhaps the most vexing aspect of taxes for many people is actual or perceived complexity. The Internal Revenue Code contains more than 1 million words, and regulations contain 5 million more. Business owners must keep track of inventory and compute depreciation, a particular problem for small companies. Accounting for international income and the alternative minimum tax creates additional problems. Low-income households must deal with child and dependent care credits and the earned income credit. Itemized deductions, the treatment of capital income (particularly capital gains, interest deductions, and passive losses), and the alternative minimum tax bedevil higher-income filers. Just over half of individual filers hire tax professionals to prepare their tax returns.

Yet compliance costs can easily be overblown or distorted. Many people go to preparers to expedite refunds or because they would rather pay a professional to complete their returns than spend their own time on this chore. For many people, the tax system is not complicated. In recent years about 38 percent of filers have used the simplified 1040A or 1040EZ forms and another 18 percent have filed the standard 1040 but did not have itemized deductions or business income. According to one study, 45 percent of taxpayers spent fewer than ten hours preparing their income tax returns, and 30 percent spent fewer than five hours. About half had no out-of-pocket expenses for tax preparation, and another 17 percent paid less than $50. But for some households, taxes can be quite complex. The same study showed that about 11 percent of filers spent fifty to one hundred hours on taxes and 5 percent spent more than one hundred hours. Expenditures of time and money were highest among high-income and self-employed taxpayers.[15]

Some tax complexity is an unavoidable by-product of trying to achieve other policy goals. For example, basing tax liabilities on individuals' characteristics—marital status, number of dependents, and income and expenditures—may be fair, but it requires reporting and documentation. Giving tax breaks to meritorious activities—home ownership, charitable gifts, the purchase of health insurance, post-

15. Blumenthal and Slemrod (1992, p. 189).

secondary education, child care, retirement saving, or entrepreneurial activity—may be worthwhile, but it adds paperwork, reporting, and auditing requirements. Preventing abusive use of deductions and credits also increases complexity. If the child care credit, for example, is not intended to subsidize children's ski lessons in Aspen, rules are necessary to specify which expenditures are acceptable and which are not. Simply preventing evasion—the illegal failure to pay taxes—may necessitate complex rules.[16]

The political process is another wellspring of complexity. Private groups lobby for targeted tax-reducing provisions, which inevitably complicate taxes. There is no organized lobby for simplicity.[17] So long as complex provisions reduce their taxes, filers tend not to object to them. But such provisions do not lower the cost of government. As special provisions proliferate, the population is ultimately left with the same tax bill collected through an increasingly burdensome system.

Reasonable estimates of the costs of complying with and running the individual and corporation income taxes, based on 1995 data, range between \$75 billion and \$130 billion, or 10–17 percent of income tax revenue. Even at \$75 billion, or \$634 per income tax return per year, the administrative costs of compliance are significant.[18]

The real question is not the size of compliance costs, but whether the United States gets good value for tax complexity. Generally, it does not. The many base-narrowing special provisions raise the tax rates on other activities necessary to meet any given revenue target, and incentives to avoid or evade taxes increase as rates rise. Many complicating tax provisions embody social policy that would be difficult to defend if cast as a direct expenditure. A government expenditure program that gave each wealthy donor a 39.6 cent rebate for every dollar given to qualifying charities, but gave middle-class donors only a 15 cent rebate for each dollar given by the middle class, and gave nothing at all to low-

16. The choice to tax income rather than consumption also has implications for tax complexity, but as shown in the section on fundamental tax reform, it is probably not the central determinant of the complexity of a tax system.

17. A well-designed campaign finance reform might reduce these problems but is difficult to achieve (see chapter 14).

18. Calculations based on data from Gale and Holtzblatt (1999, p. 11).

income donors would be regarded as outrageous. Yet the charitable contributions deduction has just such an effect and is widely supported.

The Distribution of Tax Burdens

Tax policy affects the distribution of income among living members of the population and across generations. Intergenerational effects arise, for example, from tax policies that affect economic growth, the budget surplus, or future tax revenues. In this section we focus on the distribution of tax burdens among living households. Several factors complicate this task. First, those who remit taxes to the government may not be made worse off by the tax. For example, taxes on business eventually burden some person—customers, owners, workers, or suppliers. To estimate total tax burdens, these taxes must be assigned to particular people.

The second problem is how to classify households. Annual income is a standard measure of a household's well-being, and we use it in this chapter. But many analysts prefer to classify households by annual consumption or lifetime income. This choice bears on whether income or consumption is the better base for a personal tax, an issue we examine later.

The typical household paid about 18.9 percent of its income in all federal taxes in 1999 (table 7-3 and figure 7-1).[19] Average tax burdens increase with income, which means that taxes are progressive. Most of the progressivity comes from the personal income tax with its gradu-

19. The Congressional Budget Office (1998a, p. 32) reports estimates of effective federal taxes as a percentage of adjusted family income for selected years. It assumes that income and payroll taxes are borne by the households on whose income and earnings they are levied. Excise taxes are borne by those who purchase the taxed commodities. Corporate income taxes are assigned to capital income recipients. Adjusted family income equals total cash income plus the employer share of social security and federal unemployment insurance payroll taxes and the corporation income tax, adjusted for differences in family size by the equivalence scale implicit in the official federal poverty thresholds. The income measure excludes all income received in kind, such as health insurance, and unrealized capital gains.

Some tax cut advocates claim that the typical household pays almost 40 percent of its income in federal, state, and local taxes. This claim, however, is flawed. It misrepresents a study by the Tax Foundation, and the study itself is dated, overstates taxes, and understates income (see Auerbach and Gale, 1999).

Table 7-3. *Average Effective Federal Tax Rates, by Tax and Income Group, 1999*[a]

All families	*Individual income taxes*	*Social insurance taxes*	*Corporate income taxes*	*Excise taxes*	*All federal taxes*
Lowest quintile	–6.8	7.9	0.5	2.9	4.6
Second quintile	0.9	10.0	1.0	1.8	13.7
Middle quintile	5.4	10.8	1.3	1.3	18.9
Fourth quintile	8.4	11.4	1.3	1.1	22.2
Highest quintile	16.1	7.7	4.6	0.6	29.1
Overall	11.1	9.2	3.0	1.0	24.2
Top 10 percent	18.0	6.4	5.7	0.5	30.6
Top 5 percent	19.6	5.0	6.8	0.4	31.8
Top 1 percent	22.2	2.7	9.2	0.3	34.4

Source: Congressional Budget Office (1998a).

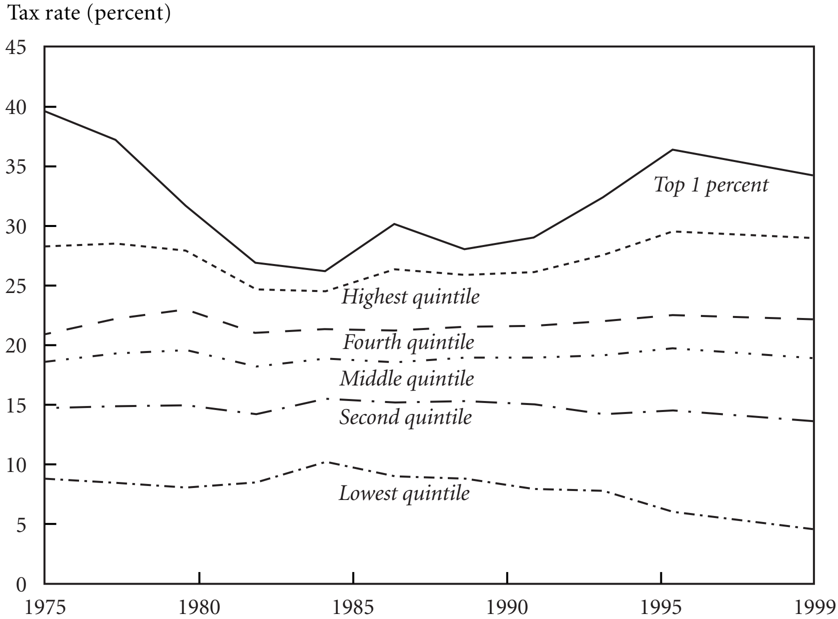
a. The average tax rate is defined as the ratio of the taxes listed divided by adjusted family income.

ated statutory tax rates and exemptions, deductions, and credits. Because of personal exemptions, standard deductions, the earned income credit, and the child credit, in 1999 a family of four with all income from earnings owed no income tax unless it earned more than $28,200. The family would, however, owe payroll taxes on the first dollar of earnings.

Official statistics show that federal tax revenues as a share of GDP are near all-time highs. Paradoxically, the 1999 average tax rates of families at most points of the income distribution are light relative to what they have been over the past twenty to thirty years. Overall tax payments have risen because the incomes of high-income households have risen sharply and because Congress raised taxes in 1990 and 1993 on high-income taxpayers.

Federal taxes are a lower portion of income in 1999 than at any time since at least 1977 for households in the bottom 40 percent of the income distribution because 1981 legislation lowered marginal tax rates, 1986 legislation increased personal exemptions, the earned income credit was expanded several times, and a child credit was introduced in 1997 (figure 7-1).

Figure 7-1. *Average Effective Federal Tax Burdens, by Income Percentile, 1977–99*



Source: Congressional Budget Office (1999b).

For households in the middle 20 percent, taxes in 1999 are at their average level over the past twenty years, while families in the 60th to 80th percentiles are facing tax burdens slightly greater—by less than 0.5 percentage point—than average. Only among the top 20 percent of households have tax burdens increased significantly since the 1980s, and even for these families, the burdens are smaller now than in the 1970s. Moreover, real growth of pretax and after-tax income for the top 20 percent of households far outpaced growth in other quintiles (table 7-4). Among the top 1 percent of filers, real after-tax incomes rose 120 percent.[20]

20. Congressional Budget Office (1999b). Furthermore, the CBO data understate income growth among high-income households in recent years by omitting unrealized capital gains, which have been enormous (Gale and Sabelhaus, 1999).

Table 7-4. *Average Real Income Levels and Growth, by Income Group, Selected Periods, 1977–99*[a]

Percent unless otherwise specified

	Pretax income				*After-tax income*			
Income	*Income level*	*Growth*			*Income level*	*Growth*		
groups	*1999*	*1977–99*	*1985–99*	*1995–99*	*1999*	*1977–99*	*1985–99*	*1995–99*
Lowest quintile	8,400	–16	–3	4	8,014	–12	3	5
Second quintile	21,200	–11	0	5	18,296	–9	2	7
Middle quintile	35,400	–3	4	6	28,709	–3	3	7
Fourth quintile	53,000	8	7	7	41,234	6	6	7
Highest quintile	132,000	40	21	10	93,588	38	14	11
Overall	49,500	15	11	8	37,521	13	8	9
Top 10 percent	188,000	50	27	12	130,472	51	18	13
Top 5 percent	276,000	66	33	13	188,232	70	22	15
Top 1 percent	719,000	102	37	9	471,664	120	22	13

Sources: Authors' calculations based on data from Congressional Budget Office (1999b).

a. All incomes are in 1995 dollars.

Americans also pay a smaller share of their incomes in taxes than do citizens of any other developed nation except Japan. Of the twenty-nine countries in the Organization for Economic Cooperation and Development (OECD) in 1996, the United States had the twenty-fifth lowest ratio of taxes to GDP, almost tied with Japan and higher only than Mexico, Turkey, and Korea.[21]

Whether the level and distribution of taxes among income classes is satisfactory is a matter of judgment. Certainly, it would be hard to claim that the haphazard and politically motivated tax reforms of the past twenty years have led to the ideal distribution of tax burdens. But two facts are clear. First, the distribution of income, before or after taxes, has become dramatically less equal in the United States than it was as recently as two decades ago. Second, tax burdens vary widely *within* income brackets because not all taxpayers are equally able to avail themselves of itemized deductions, credits, and allowances and because taxpayers derive varying fractions of their income from capital gains, which are taxed at much lower rates than apply to other income. Many of the provisions that cause tax rates to vary were introduced to recognize tax-relevant variations in ability to pay that are not well measured by ordinary income. But there is no doubt that tax burdens vary even among similarly situated filers, a situation known as "horizontal inequity."

Economic Growth

Critics charge that the income tax reduces economic growth because rates are too high and too uneven. High rates, it is alleged, discourage work, saving, investment, and entrepreneurship. Uneven rates encourage investors to choose activities with relatively low economic returns but favorable tax treatment instead of projects with superior economic returns but less favorable tax treatment. The overall effects of taxation on economic growth, however, are far from clear. Estimates from a symposium sponsored by the Joint Committee on Taxation in 1997 suggest that the combined effects of integrating the corporate and individual income taxes, broadening the tax base to smooth out the variation in tax rates across uses, and flattening income tax rates would

21. Organization for Economic Cooperation and Development (1998).

change the size of the economy between –3 and 4 percent in the long run. If the taxation of all capital income were eliminated, including transition relief for income from existing assets, the economy would expand in the long run by 1–5 percent.[22]

WORK. Evidence suggests that taxes depress the labor supply of men and single women only slightly but have a larger impact on the labor supply of married women. Taxes on work can be surprisingly high. If workers bear the full 15.3 percent payroll tax for social security and medicare, the combined federal marginal tax rate on a worker in the 15 or 28 percent income tax bracket is 28.1 or 40.2 percent.[23] This calculation wholly ignores the increased social security benefits that higher earnings will generate later on. Taking these benefits into account lowers the tax rate. For similar reasons, pension contributions are not considered a tax because they are correlated with future pension benefits. Because the social security payroll tax does not apply to earnings higher than the payroll tax ceiling, the effective marginal tax rate on labor income may decline when earnings rise above the ceiling.

PERSONAL SAVING. Most of the evidence indicates that taxes have small effects on the level of saving. The taxation of returns to personal saving is enormously varied. Deposits in ordinary bank accounts generate no deductions, and income earned on such accounts is taxed when earned. But most personal saving occurs in tax-sheltered accounts such as ordinary or Roth Individual Retirement Accounts, Keogh plans, and 401(k) plans and employer contributions to pension plans.[24] Personal income

22. Joint Committee on Taxation (1997, table 1). Mroz (1987), Hausman (1985), Eissa (1996), Eissa and Liebman (1996), and Bosworth and Burtless (1992) examine the impact of taxes on labor supply. For the impact of taxes on saving, see Bernheim (1999). Cummins, Hassett, and Hubbard (1994) and Clark (1993) examine taxes and investment.

23. The money wage cost to the employer of hiring the worker is 1.0765 times stated pay because the employer must pay 7.65 percent of the wage in payroll tax. The effective tax rate is the sum of the income tax (15 percent) and the payroll tax (15.3 percent) divided by the total money wage: (0.15 + 0.153)/1.0765 = 0.281. This calculation ignores the earned income tax credit, which lowers rates over the income range in which it is increasing and raises rates in the range over which it is being phased out.

24. Gale and Sabelhaus (1999).

taxes on deposits and all investment earnings in most such accounts are deferred until the funds are withdrawn. Deferral conveys large tax benefits. Saving faces a zero net tax rate when the tax rate applicable to deductions of contributions is the same as that applied to withdrawals. When the rate on withdrawals is lower than that on contributions, the overall tax rate on saving is negative in the sense that the return to the saver is higher than it would be if the tax system disregarded the deposits, investment income, and withdrawals.[25]

As noted earlier, capital gains on assets held outside of tax-preferred accounts receive many tax benefits: deferral of taxes until realization, exclusion of taxes if held until death, application of lower tax rates than would apply to other forms of income, and a large exclusion if earned on owner-occupied housing. The effective tax rates on capital gains are much lower than those on earnings or other forms of capital income.[26]

BUSINESS INVESTMENTS. Taxes discourage investment, but how much is subject to controversy. Taxes inhibit growth if they treat different forms of income differently. For example, investors would choose a project yielding 15 percent that is taxed at an average rate of 40 percent over an alternative project that yields 20 percent but is taxed at a 60 percent rate. And they would jettison both projects in favor of one that generates

25. See Burman, Gale, and Weiner (1998b). The tax treatment of ordinary and Roth IRAs is equivalent if people face the same marginal tax rate throughout their lives. Under ordinary IRAs, people earn Y, save it, receive investment returns of rY, and pay tax at the rate, t, on withdrawals. At the end of the day, they have $Y(1+ r)(1\ t)$. Under Roth IRAs, people earn Y, pay tax at the rate, t, on the income and then pay no further tax on investment earnings and withdrawals. At the end of the day, they also have$Y(1+ r)(1\ t)$.

26. A simple example illustrates the size of this differential. Suppose that a person in the 28 percent bracket invests $1,000 in a thirty-year bond yielding 10 percent annually in taxable interest and invests the interest earnings in bonds also yielding 10 percent. At the end of thirty years the investment will have grown to $8,051. Suppose instead that the investor buys an appreciating asset that grows at an annual rate of 10 percent, sells the asset after thirty years, and pays the capital gains tax of 20 percent on the appreciation. The investor will realize $14,160 after paying tax, a value 76 percent larger than on the bond. The annual tax rate equivalent of the capital gains tax is only 7.6 percent.

economywide returns of only 8 percent but had a 25 percent subsidy attached to it.

In practice, tax rates on investments differ widely, depending on the type of investment, the form of income generated, the form of the financing, and the identity of the investor. Special rules favor certain investments—for example, those promoting historic preservation or research and development. Small businesses receive significant tax benefits. Some investments can be structured so that tax rates levied on the project as a whole are negative. This situation can occur when the project generates fully deductible expenses (interest payments, for example) and lightly taxed capital gains in roughly equal amounts. Effective tax rates are negative because the tax reduction from the expenses will exceed the tax payments from the capital gains income. The effect is magnified when deductions can be packaged and sold to high-bracket filers while income flows to low-bracket filers.

The fact that corporate source income may be taxed twice can raise tax burdens and increase disparities in taxes across assets. But it is unclear how much corporate income is doubly taxed. Rather than paying dividends, some corporations distribute profits to shareholders by repurchasing shares, which does not generate individual-level taxes. A significant portion of all dividends accrues either to tax-exempt shareholders—foundations, universities, churches, or hospitals—or to pension funds, IRAs, or 401(k) plans, which typically face zero or negative effective tax rates. None of these dividends faces double tax burdens. A significant portion of capital gains on corporate stock accrues either to individuals who hold the gains until they die, to tax-exempt shareholders, or to pension funds broadly defined, and so also escapes the burden of double taxation. Finally, shareholders escape the burden of the corporation tax if the market price they pay for the shares is reduced by the value of future corporation taxes.[27] To the extent that taxes are capitalized into profits, only the person who holds the stock at the time

27. Suppose an investor would be willing to pay $1,000 to own stock that promises annual earnings of $100, a price/earnings ratio of ten. If a tax of 35 percent is now imposed on the company, the after-tax earnings will become $65. The investor who insists on a ratio of price to *net* earnings of ten would now pay only $650 for the stock.

the tax is announced (or, for new issues, when the stock is issued) bears a burden from the tax.

Economists and tax lawyers have produced a small library of proposals to eliminate double taxation by integrating the personal and corporation income taxes, typically by imputing to shareholders part or all of corporate profits and permitting individuals to claim credits for part or all of corporate tax payments.[28] Despite extensive academic analysis, integration plans that did not invite massive tax avoidance would be complex and expensive, and generate little political support.

Another reason tax rates vary across investments and over time is that neither the personal nor corporate income tax adjusts the tax base for inflation. Depreciation deductions are based on historical cost, not replacement cost. Parts of interest income and deductions represent inflationary erosion of fixed nominal obligations. And part of capital gains during inflationary periods represents a general increase in price, not an increase in the relative value of the asset. The failure to adjust these items for inflation leads to an overstatement of income and taxes for recipients of interest, realized capital gains, and those claiming depreciation deductions, and an understatement of income and taxes for people taking deductions for interest payments, including homeowners.

Indexing all capital income and expenses for inflation would be administratively complex, expensive, and politically difficult. But making only some of these adjustments—for example, indexing only capital gains for inflation—would widen opportunities for tax avoidance. Fortunately, the waning of inflation has reduced the importance of the failure to index the tax base.

These myriad provisions produce widely varying effective tax rates. The largest practical issues arise with respect to the relative treatment of owner-occupied housing versus business investment, and within business categories between corporate and noncorporate entities. Taxes on housing are low or even negative because homeowners may deduct mortgage interest and property tax payments but need not report as income the imputed rent on the house that generates those deductions. Homeowners also escape tax on almost all capital gains on their resi-

28. U.S. Department of Treasury (1992).

dences. One study reports marginal effective tax rates of 26–31 percent on new corporate investment, 18 percent on noncorporate, nonresidential investment, and 5 percent or less on owner-occupied housing. The economywide effective marginal tax rate on new investment income was about 16 percent.[29]

Does the Budget Surplus Justify Large Tax Cuts?

Projections of large future budget surpluses burst upon the economic scene in 1998 and promise to influence debate for the next several years, just as large and stubborn deficits dominated economic debate during the 1980s. Do the projected surpluses justify tax cuts? And if so, what form should the cuts take?

At least four reasons have been advanced for tax cuts. The first is that government is taking in more revenue than it needs to pay for current obligations. This argument is invalid. To be sure, the Congressional Budget Office in July 1999 estimated that the ten-year unified budget surplus will total about \$2.9 trillion. But \$1.9 trillion of that amount comes from the social security trust fund.[30] Leaders of both parties agree that the trust fund should be preserved for social security, which has significant unfunded liabilities. More than \$500 billion of the remaining \$1 trillion consists of surpluses in the military and civilian pensions and medicare (part A) programs that will be needed to meet future benefit commitments. Thus the same logic that establishes the imprudence of basing tax cuts on social security surpluses applies equally to accumulations in these trust funds. The remaining projected surplus exists only because of highly restrictive and unrealistic assumptions regarding cuts in real discretionary spending for national defense and domestic programs (see chapter 1). Under more plausible assump-

29. Auerbach (1996, p. 42 and table 2-1). Gravelle (1994, p. 294) finds higher rates: 33 percent for all capital income, 22 percent for noncorporate investment, and 43 percent for corporate investment. The differences stem from different treatment of pensions and differences in the modeling of the burden of the corporate tax. Two other studies concluded that average rates of tax on capital income in the 1980s were negative (Gordon and Slemrod, 1988; and Shoven, 1991), but this result is controversial (Gravelle, 1994).

30. Congressional Budget Office (1999a).

tions about discretionary spending and the preservation of pension and health reserves, there would be no surplus available for tax cuts.

The second possible justification for cutting taxes is that burdens are too great. While nobody likes high taxes, we have shown that current burdens for most filers are actually as small as or smaller than they have been in two decades.

The third reason advanced in support of tax cuts is to promote economic growth. Advocates claim an across-the-board tax cut would boost personal saving and labor supply enough to raise national output by about 0.3 percent after ten years.[31] But reducing taxes could actually lower growth by lowering national saving. A tax cut would reduce budget surpluses nearly dollar for dollar, but almost all of the increase in household disposable income that is the counterpart to lower government revenues would be consumed, not saved. And, with the economy booming, if consumer spending rises, the Federal Reserve would probably feel compelled to tighten monetary policy.

The final argument for tax cuts is that they will help reduce the size of government. There is ample room for political disagreement over the proper role of government. Recent history suggests that cutting taxes is a poor instrument for reducing the size of government, but a very effective device for producing large government budget deficits. In the decade after the massive tax cuts of 1981 took effect, federal government spending actually rose from 22.3 percent to 22.6 percent of GDP. During this period the national debt in the hands of the public skyrocketed from $785 billion (25.8 percent of GDP) to $2.7 trillion (45.9 percent of GDP). Government spending as a share of GDP has come down since 1991. The prospects for major additional cuts seem poor because of the need to maintain national defense and the imminent onset of pension and health care costs for retiring baby boomers.

Although the economic case for tax cuts is weak, both houses of Congress passed tax cut bills that would reduce revenues by $800 billion in the next ten years and by triple the amount in the succeeding ten.[32]

31. Beach and others (1999, p. 1864).

32. The conference agreement contained the odd provision that the entire tax cut would be abolished after ten years to conform with Senate budgetary rules, but no one expects this provision to be sustained.

The conference agreement, which the president had not signed as this book went to press, would reduce all income tax rates by 1 percentage point, reduce capital gains tax rates, index capital gains for inflation, expand Individual Retirement Accounts, abolish the estate tax, provide dozens of tax breaks for corporations, and subsidize education and health care. The agreement would also reduce the marriage penalty by expanding the standard deductions for couples to double that for singles and by extending the 15 percent tax bracket for couples.

Whatever the political appeal of such proposals, both would significantly reduce national saving, which is the sum of private and government saving. Furthermore, the income tax cuts would go mostly to the well-to-do. When fully phased in, they would deliver an average of $31,768 a year to each of the top 1 percent of households, but an average of only $353 a year to each household in the middle 20 percent of the income distribution, and a paltry $22 a year to the average household in the bottom 20 percent. Cuts in capital gains taxes and estate taxes, which are not included in these distributional estimates, are even more heavily skewed toward the nation's wealthiest households. In view of the sharp recent increase in income inequality, such tax cuts seem poorly targeted.

If tax cuts prove irresistible despite long-term revenue needs, better designs exist than were embodied in either the House or the Senate bills in 1999. A refundable income tax credit for payroll tax payments would distribute benefits more equally than would an across-the-board proportional tax cut. It would be even more desirable to use tax reductions to help ease the way to tax reforms that would simplify the system and reduce distortions. Tax cuts can compensate the losers from reforms that withdraw provisions that complicate the code or inhibit growth.

However, now is not the time for large tax cuts. The economy is strong, and most households already face tax burdens that are low relative to burdens in the past twenty years. Although the budget is in surplus, these surpluses are mostly needed to meet pension and health care obligations. After these problems are resolved, it would be appropriate to debate whether any remaining surpluses should be used for tax cuts, spending increases, or debt repayment.

Strategies for Modifying the Current Tax System

Proposals to modify the current tax system abound. Most fall into one of three categories: proposals to create additional incentives for promoting specific activities, such as saving, investment, education, charity, or child care; proposals to simplify taxes by curbing or eliminating special tax provisions and reducing rates; and proposals to place limits on taxes.

Additional Targeted Provisions

Whether they are trying to help low-income households, improve education or health, or encourage saving and investment, elected officials often turn to the tax code rather than to direct government spending. As noted, provisions that would be derided if described as expenditures often seem sensible to lawmakers as tax provisions. In addition, most tax provisions do not expire, while most expenditure programs require periodic reauthorization and appropriations. Furthermore, tax provisions sometimes have genuine administrative advantages over government expenditures. The earned income credit, for example, is probably less costly to administer than an equivalent expenditure program to subsidize low earners because most who claim the credit would file tax returns anyway and are spared the need to fill out additional forms in the office of some agency charged with administering identically distributed direct subsidies.

Despite their political appeal, targeted tax provisions are usually poor public policy. Many are unfair. Congress has generally been unwilling to make tax deductions or credits refundable. Households with incomes too low to generate positive tax liability receive no benefit from nonrefundable credits, and households whose liability is smaller than the credits, receive only partial benefit from them. For example, about two-fifths of children live in families with income too low to benefit from the child credit enacted in 1997.[33]

33. Greenstein and Shapiro (1997). Nonrefundable credits designed to achieve social objectives include the credit for child and dependent care expenses, the credit for the elderly or for the permanently and totally disabled, the child tax credit, education credits, and the adoption credit.

Targeted provisions add complexity to the tax return. They also reduce revenues, thereby requiring higher tax rates on income that is not favored. These two problems are related. A credit available to all is very costly. But limiting eligibility requires rules or phaseouts, which increase effective marginal tax rates. The reduction in the child tax credit by $50 for every $1,000 of income is equivalent to adding 5 percentage points to the filer's marginal tax rate. Without a phaseout, however, the credit would be available to high-income households, necessitating higher tax rates on other income to raise the same revenue. Because tax-induced distortions in economic behavior increase with the marginal tax rate, legislators face a dilemma: they must either impose significantly higher marginal tax rates on households affected by the phaseout or slightly higher tax rates on everyone. Tax preferences also typically make the economy less efficient by diverting investment and economic activity from their best economic uses toward their best tax-motivated uses.

Furthermore, tax incentives breed more tax incentives. For example, President Clinton proposed and Congress enacted tax credits to encourage the first two years of postsecondary education. But why not also give credits for kindergarten through twelfth-grade schooling costs, home schooling, and adult education? Where and by what criteria should future Congresses draw the line? Lawmakers who have just persuaded their colleagues of the merits of one particular targeted provision may find it hard to oppose the next similar provision. But as the number of tax-favored activities grows, complexity increases and the special advantage of each tax-favored activity gradually diminishes. In the end the nation is stuck with the same tax liability raised through an ever more complicated tax system.

Targeted tax provisions also provide opportunities to game the tax system. The clearest example is the preferential treatment of capital gains, which lies behind many tax avoidance schemes. To prevent avoidance from getting out of hand, Congress is driven to further complicate the tax system with such provisions as the alternative minimum taxes.

Despite these drawbacks, targeted tax provisions might be worthwhile if they worked well. Usually, they do not. Current proposals to use tax credits to reduce the number of people who are without health insurance illustrate some of the problems. Most of the tax relief would go to people whose behavior is unaffected by the provision. Providing tax credits across the board to make certain that the 16 percent of nonelderly adults who currently lack health insurance receive the credit means that 84 percent of the credit is "wasted." Large credits would entail lengthy or steep phaseout ranges. Small or nonrefundable credits would do little to help make health insurance affordable for low-income households, many of whom have no tax liability. Limiting the credit to households with low incomes would improve the efficiency of the credit, but even among households with incomes below $25,000, three-quarters already have health insurance. Furthermore, the credits might cause some employers to stop offering health insurance as a fringe benefit.

The increasing use of targeted tax provisions is deceptive and dangerous. It fools people into thinking that they are the beneficiaries of reduced taxes, it complicates taxes for everyone, and the net impact is usually tiny compared with the overall costs. It would usually be far better to run subsidies the old-fashioned way—as spending programs. The tax base would be broader. The tax form would be shorter. And tax rates would be lower and clearer, permitting taxpayers and their representatives to understand better the costs and benefits of policy choices.

Fewer Targeted Tax Provisions

The second approach to the reform of the current system would curtail special incentive provisions and lower statutory tax rates. The 1986 Tax Reform Act embodied this approach. It eliminated enough special deductions and loopholes to reduce the top individual income tax rate from 50 percent to 28 percent and to reduce the top corporation rate from 46 percent to 34 percent without lowering revenues or significantly changing the distribution of tax burdens across income classes. It simplified taxes and contributed to growth by reducing and equalizing rates.[34]

The 1986 act was the high-water mark for base broadening, however. Since then targeted tax provisions have proliferated. To broaden the tax base more than was done in 1986 will prove difficult, not only

34. Mark Hankerson, "History of Recent Tax Bills," *Congressional Quarterly*, July 17, 1999.

because successive Congresses and presidents have displayed a penchant for tax incentives, but also because the deductions remaining after the 1986 act involve core social policies relating to owner-occupied housing, retirement saving, charitable contributions, health insurance premiums, state and local taxes, education, and children.[35] Nonetheless, we believe that some progress can be made through a limited reduction in the value of these tax incentives in one or both of two ways.

The first would convert some major itemized deductions to 15 percent tax credits.[36] The change would reduce the number of households that itemize, which would simplify taxes. It would not affect any of the three-quarters of tax filers in the zero or 15 percent tax bracket but, holding tax rates constant, would raise an estimated $60 billion a year from taxpayers in the 28 percent and higher tax brackets.[37] The revenue could be used to reduce tax rates in those brackets significantly. The result would be a simpler tax system with the same revenue. This reform could be structured to maintain the distribution of taxes by income bracket with reduced marginal rates. However, the proposal would inflict some economic harm on the sectors that generate the current deductions.

A related policy would be to greatly increase the standard deduction. Unlike the conversion of deductions into credits, raising the

35. Congressman Richard Gephardt introduced a proposal in 1996 that would have eliminated deductions for state and local taxes, charity, and pension contributions and eliminated exemptions of municipal bond income. Income tax rates would have been reduced 10 to 34 percent.

36. Whether taxpayers should receive a deduction or a credit for what are now itemized deductions depends on whether one sees the deduction as an incentive for particular kinds of expenditures or as a way of computing the filer's properly taxable income. Some current deductions—charitable contributions, for example—are seen most naturally as pure incentives because people may choose whether to consume their incomes directly or donate them to others. If the charitable contributions deduction is seen as a tax incentive to encourage people to give to meritorious organizations, it is hard to see why some people should receive an incentive of 39.6 cents in reduced taxes for each dollar they give while others receive only 15 cents. From this perspective a credit seems fairer than a deduction. Other deductions—for state and local taxes, large medical expenses, or casualty losses, for example—may be seen as involuntary payments that reduce the filer's ability to pay taxes. In those instances a deduction rather than a credit seems fairer.

37. Congressional Budget Office (1997a, p. 344).

standard deduction would reduce revenues. For this reason it would have most appeal as part of a tax reduction package. Increases in the standard deduction would raise the income level at which filers first owe taxes, reduce the number of filers who need to itemize deductions, and lower the total net value of deductions for those who continue to itemize. For example, raising the standard deduction by $1,000 would simplify taxes by reducing the number of itemizers by about 6.5 percent and would provide progressive tax cuts of $50 billion. If instead the number of personal exemptions each tax return was granted was reduced by one, and the standard deduction was raised by $4,000, the number of itemizers would decline by more than one-third, revenues would be maintained, and progressivity would be increased.[38]

Tax Limits

Rather than reforming the tax system, some analysts have advocated establishing a parallel system with no deductions and flat rates, while others have proposed limits on the maximum share of each filer's income that taxes could claim. The idea of a parallel tax system dates back to at least 1964, when Senator Russell Long suggested that taxpayers be permitted to file under an alternative tax system with fewer deductions and a tax rate well below the maximum rate under the regular personal income tax. In 1998 Stephen Moore of the Cato Institute proposed to allow people to pay a flat 25 percent of their gross income in tax instead of the current personal income tax and employer and employee payroll taxes. This idea—The Freedom to Choose Flat Tax—is embodied in bills introduced by Senator Spencer Abraham and Representative Vince Snowbarger.[39]

This approach suffers from critical flaws. Creating a parallel tax system does nothing to simplify the measurement of income, the major

38. Calculations based on data from Treasury tax file.

39. A striking indicator of how much personal income tax rates have been reduced is that the capped rate under Senator Long's alternative tax was 50 percent, well below the maximum personal rate then in effect of 77 percent but well above current rates. Pechman (1966); *Congressional Record*—Senate, vol. 110, pt. 18, September 29–October 3, 1964, p. 23653; and Stephen Moore, "The Freedom to Choose Flat Tax" (http://www.cato.org/dailys/6-09-98.html [August 11, 1999]).

source of complexity. And many taxpayers would have to compute tax under both the current system and the new one to determine which generates the lower tax. Even in the absence of changes in taxpayer behavior, the plan would reduce revenues dramatically—by an estimated $108 billion had it been enacted in 1996—with tax cuts averaging more than $30,000 for taxpayers in the top 1 percent of the distribution and $80 for taxpayers with incomes of $30,000 or less. The parallel tax would also create major opportunities for tax avoidance.[40]

Others have proposed legislated or even constitutional limits on the proportion of individual or aggregate income that can be collected in taxes. Such limits carry significant dangers, particularly if embedded in the Constitution, because revenue requirements may rise suddenly to meet national emergencies. Furthermore, neither "tax" nor "income" have clear definitions. Were such limits in effect, one could anticipate the creative use of "user charges" instead of "taxes" and other efforts to skirt the rules.

Specific Reforms

Many specific issues persistently appear on the tax reform agenda. We examine five here: simplification, the marriage penalty, saving incentives, capital gains, and reform of the Internal Revenue Service.

40. For example, an individual on January 1 could "invest" $1 million in a corporation. Proceeds from sale of stock are not taxable income to the corporation. The corporation on January 2 could pay the individual $1.5 million in wages, which is a deductible expense and therefore costs a corporation subject to a 35 percent tax rate only $975,000. The individual pays 25 percent tax on the $1.5 million in wage income and keeps $1,125,000. At the end of the day the corporation has made $25,000 and the individual has made $125,000. And there are 363 more days in the year. Such chicanery could be avoided under the new system if the corporation income tax were also reduced to 25 percent, but that step would reduce revenues by about $50 billion. It is probably possible to prohibit such obvious manipulations in other ways, but as long as the tax rate differential existed, clever accountants, attorneys, and tax planners would be able to invent very complex, hidden schemes that would go undetected. Gale (1999a).

Simplification

Several reforms could simplify the tax system without materially changing the level or distribution of taxes.

THE AMT EXEMPTION. The personal AMT currently raises little revenue but threatens to become a major nuisance for millions of filers because the exemption above which the AMT applies is not indexed for inflation. Significantly raising the personal AMT exemption and indexing it for inflation would simplify the tax system and prevent the imposition of this parallel tax on millions of filers, but would still prevent people from making so-called excessive use of otherwise legal provisions. In addition, not allowing items such as personal exemptions, state and local tax deductions, or tax credits to affect a taxpayer's AMT status would make the AMT simpler and better targeted at those who exploit tax shelters.

ELIMINATE PHASEOUTS OF PERSONAL EXEMPTIONS AND ITEMIZED DEDUCTIONS. The phaseouts of itemized deductions and personal exemptions for high-income filers raise effective marginal tax rates, add complexity, and yield little revenue. These phaseouts should be repealed and marginal tax rates should be increased (very slightly) to maintain tax burdens by income class. This change would make effective tax rates more transparent and simplify tax filing. Phaseouts for the various nonrefundable credits occur at different income levels and create a panoply of effective taxes. It would cost little to unify the phaseouts and save taxpayers from having to fill out several worksheets.

CONSOLIDATE SAVING INCENTIVES. The tax code contains many saving incentives, which we examine in more detail in the next section. The rules are varied and confusing. Replacing all with one set of simple rules would simplify record keeping and investment and withdrawal decisions.

CAPITAL GAINS. Currently, capital gains are taxed at twelve different rates, depending on the asset, the owner's income, when the asset was purchased, and how long it was held. If capital gains are to be taxed at reduced rates, excluding a fixed proportion of capital gains from taxation would achieve this objective more simply. A distinction for long-term and short-term gains could be retained, if desired. It would be easy to design a revenue-neutral reform of this sort.

DEPRECIATION DEDUCTIONS. Calculating depreciation is one of the most complex features of the tax code, especially for small and medium-sized businesses. Permitting businesses to deduct the present value of all depreciation deductions for an asset in the year of purchase could dramatically simplify this element of the tax code without reducing revenues in the long run.[41]

SIMPLIFIED FILING. Filing burdens could be reduced in two ways. The Internal Revenue Service could accelerate the conversion from paper returns to electronic filing, a procedure that encourages filers to use computer software and thereby reduces error rates. The IRS Restructuring and Reform Act of 1998 established a goal that 80 percent of all tax returns should be filed electronically by 2007.

Some simplification could also be achieved by instituting a "return-free" system for filers with simple returns under which the taxpayer or the taxpayer's employer supplies a few information items to the Internal Revenue Service, which calculates the tax due and bills the taxpayer. Up to 52 million taxpayers (more if the standard deduction were significantly increased) could be placed on a return-free system with relatively minor changes in the structure of the income tax. These include filers with income only from wages, pensions, IRA distributions, interest, dividends, and unemployment compensation who do not take itemized deductions or credits other than the EITC and are in the zero or 15 percent tax bracket. A return-free system would spare these taxpayers, most of whom already file the relatively simple 1040EZ or 1040A forms, much or all of the costs of preparing the final return and the fear or aggravation of filing. They would still have to grapple with state income taxes, however.[42]

41. Auerbach and Jorgenson (1980) originated this proposal.
42. Gale and Holtzblatt (1997, p. 750).

The Marriage Penalty

The idea that two people should be taxed more heavily just because they are married seems absurd. Yet many married couples do face a tax penalty, not because tax legislators oppose marriage, but because tax penalties for being married or for being single are inescapable unless one is prepared to abandon either of two other principles: that families with the same income should pay the same taxes or that tax rates should rise with income. Consider two couples facing hypothetical tax rates of 10 percent on the first $30,000 of income and 20 percent on all income above $30,000. In couple A one spouse earns $60,000 and the other earns nothing. In couple B, both spouses earn $30,000. If couples are taxed as a unit, both pay $9,000 in tax, 10 percent on the first $30,000 and 20 percent on the next $30,000. Couple B, who faces this marriage penalty of $3,000, could reduce its tax to $6,000 by getting a divorce, so that each (former) spouse would face a 10 percent rate. Couple A would not reduce its taxes by divorcing and so faces no marriage penalty. Giving these couples tax brackets twice as wide as those of single persons—10 percent on the first $60,000 of income and 20 percent on all higher income—would end the marriage tax on couple B, which would pay $6,000 in taxes whether married or not. But it would create a marriage bonus for couple A: if married, their taxes would be $6,000; if divorced, their taxes would rise to $9,000.

Many provisions of the personal income tax cause marriage penalties and bonuses, including tax brackets and the standard deduction (which are about 1.66 times as large for couples as for single filers), the earned income tax credit, phaseouts of personal exemptions and itemized deductions (which affect high-income filers), and floors on certain deductions expressed as a percentage of income. Marriage penalties under medicaid, food stamps, and income-tested cash assistance affect low-income households. They are not currently politically active issues.

The personal income tax system in 1996 provided 42 percent of married couples with a marriage penalty and 51 percent with a marriage bonus. Among filers with incomes greater than $50,000, penalties outnumbered bonuses. The value of bonuses exceeded the value of penalties by $4 billion overall and by $2 billion for filers with incomes higher than $50,000.[43]

Marriage penalties or bonuses have little effect on whether people marry, but may influence when.[44] Joint filing, which produces both marriage penalties and rewards, affects marginal tax rates, and tax rates do affect labor supply. When two people get married, the higher earner (usually the man) ordinarily faces marginal tax rates equal to or lower than when single, because the tax brackets are wider for couples, while the lower earner (usually the woman) often gets pushed into a higher tax bracket by the additional earnings of the spouse. Because the labor supply decisions of married women tend to be more sensitive to marginal tax rates, the higher tax rates on the lower earner have a larger effect than the lower tax rates on the higher earner.[45] One simulation estimated that this feature of the tax system reduces the labor supply of married couples by about 1 percent relative to a system under which marriage did not affect tax rates.[46]

Because the sources of marriage penalties are several, the proposed reforms are many and diverse. These include increasing the width of tax brackets and the size of the standard deduction for couples to twice those of single people, various changes in the earned income tax credit to make it more generous for couples, tax credits for second earners, and providing couples the choice of filing jointly or as two single people. The plans differ in costs, the proportion of tax reduction that flows to low-income filers, and the extent to which they raise marriage bonuses instead of just eliminating marriage penalties.

Several countries avoid marriage penalties by requiring individual filing. Under this approach, each spouse would be taxed on his or her own earnings. Capital income would be taxed to the person who owns

43. Congressional Budget Office (1997b, p. xiv).

44. Alm and Whittington (1995); and Sjoquist and Walker (1995).

45. Mroz (1987); Hausman (1985); Eissa (1996); and Bosworth and Burtless (1992).

46. Congressional Budget Office (1997b, p. 12). This section ignores the separate category "head of household," which receives treatment intermediate between the treatments of singles and couples filing jointly. Marriage penalties can be calculated in many ways, depending on how children or deductions are assumed to be distributed between couples when computing their taxes as singles.

the asset. This reform could create large marriage bonuses for couples with substantial capital income if they were able to arrange their affairs so that capital income could be allocated to the spouse facing the lower marginal tax rates, and deductions could be allocated to the spouse facing higher tax rates.[47]

Saving Incentives

Congress has adopted many tax provisions over the years to encourage saving. The incentive comes through the exemption from current tax of investment income as it accumulates in the sheltered account. Roth IRAs also exempt withdrawals. Individual Retirement Accounts, 401(k) plans, Keogh plans, Savings Incentive Match Plan for Employees (SIMPLE plans), simplified employee pensions (SEPs), and defined contribution and defined benefit pensions allow tax-deductible ontributions.

A critical flaw in these saving incentives is that taxpayers do not need to save—that is, reduce their consumption—to benefit from them. Taxpayers can shift funds from ordinary saving accounts, run up credit card balances, increase home loans, or borrow to finance the contributions that generate the tax benefits. Limits on current tax sheltered savings vehicles curtail, even if they do not prevent, such avoidance. Relaxing contribution limits would be unwise. The success of these incentives in promoting saving is in considerable doubt; personal saving rates have fallen since most of these provisions were introduced.[48] Furthermore, they create new opportunities for tax avoidance, especially by the wealthy, who can shift assets or exploit borrowing strategies.

Raising deposit limits on Roth IRAs would be particularly imprudent. Deposits in Roth IRAs do not reduce current taxes, but withdrawals are wholly tax free. As a result, deposits reduce revenues little in the first few years but massively later on. Offering such incentives may

47. In some of the countries that tax on an individual basis, capital income is taxed at a separate rate, independent of the taxpayer's total income.

48. Econometric analysis of saving incentives has focused on microeconomic evidence. See Engen, Gale, and Scholz (1996) and Poterba, Venti, and Wise (1996) for opposing viewpoints.

appear costless to elected officials whose terms in office will have ended long before the bill comes due.

The Clinton administration recently proposed a new saving incentive, Universal Savings Accounts, which could be described as progressive, government-sponsored 401(k) accounts. This plan is described in detail in chapter 6.

Tinkering with tax-based saving incentives diverts attention from potentially more effective ways to increase saving. The surest way to raise national saving is to maintain budget surpluses. In addition, several options to expand private saving are worth exploring. The most obvious is financial education. The households that do not use currently available saving incentives tend to be the ones with few other assets, and thus the ones who are least able to manage the accounts. Improved education would also help prepare American households for the move from private, defined-benefit pension plans to defined-contribution plans, which place more responsibility on workers to manage their own funds.

Capital Gains

Lower capital gains tax rates, advocates claim, would stimulate economic growth, raise tax revenues, and give a big boost to middle-income households. The data suggest that these claims are false. Capital gains already receive highly preferential treatment under the income tax: they are taxed on a deferred basis, they are not taxed at all if held until death, and they face lower rates than apply to other income if and when they are taxed. Cutting capital gains taxes further would widen the tax differential between capital gains and other income, encourage additional costly and complicated sheltering arrangements, and reduce revenue. Even if a cut in capital gains led to higher revenues from the capital gains tax itself, which is doubtful, it would lead to larger cuts in revenues from other sources as other forms of income were converted into capital gains. Furthermore, capital gains tax cuts provide large windfalls for the wealthy and little for anyone else. The 8 percent of taxpayers with income above $100,000 account for 88 percent of all long-term gains.

Capital gains tax cuts might stimulate private saving and investment, but they would lower national saving by reducing federal revenues more than they increase private saving.[49] Nor would a cut in capital gain taxes increase venture capital very much. Capital gains on small new ventures are already taxed at half the rate of other capital gains. In addition, a significant portion of funds for venture capital comes from sources that do not pay capital gains taxes and so would not be affected by cuts. Taxing realized capital gains at the same rate as other income has significant appeal: it would simplify taxes and increase national saving and investment.

The Internal Revenue Service: Freddy Krueger or Mr. Rogers?

Popularity may be impossible for an organization such as the Internal Revenue Service that is charged with making sure that people regularly surrender a sizable fraction of their incomes. But at least grudging acceptance of the IRS's legitimacy is essential because effective tax collection is possible only if the vast majority of citizens voluntarily comply with the laws. To achieve and sustain such compliance, filers must feel they are paying taxes for a government they fundamentally support under a tax system that is reasonably fair and is perceived as basically efficient. That sense of efficiency and justice requires that the IRS have the capacity to identify and come down hard on cheaters without needlessly harassing honest filers.

An external commission and congressional investigations have revealed serious shortcomings in IRS administration that call efficiency and justice into question. Because of these revelations, legislation and internal management reforms are now under way that address such problems as a lack of long-term planning (arising in part from the brief tenure of successive IRS commissioners), poor customer service (arising from inadequate internal training and supervision and insufficient use of computer technology), and abuse of taxpayers by IRS officials.

On July 22, 1998, the president signed into law the IRS Reform and Restructuring Act of 1998 that institutes various corrective measures. The law gives the commissioner of the IRS, its chief executive, a fixed

49. Even the effect on private saving is estimated to be minuscule. The Congressional Budget Office estimated that reducing the capital gains rate from 20 percent to 15 percent would raise the return to private saving by only 0.03 percentage point, which would have a negligible effect on private saving. Congressional Budget Office (1998b, pp. iv, 4).

five-year term and broadened the commissioner's powers to replace top management. It established an external supervisory board, consisting of private and public members, to oversee the work of the IRS. It extended a Taxpayer Bill of Rights that proscribes revenue quotas for auditors, limits the authority of the IRS to seize property, and protects people from being held responsible for the tax liabilities of former spouses.

The reform of the IRS raises fundamental and difficult questions about the proper managerial stance for the nation's revenue agency. Abusive practices create public anger and can erode voluntary compliance. But so too can administrative laxity that permits people to cheat with impunity. If the IRS is unduly draconian, it courts the first risk. Procedural hurdles that prevent it from aggressively pursuing evaders raise the second risk. Although there can be no doubt that the IRS needed administrative modernization and that some overly zealous revenue agents abused their power, recent legislation will need careful monitoring to make sure that the agency retains the power to do an inherently unpopular job.

Fundamental Tax Reform

Rather than modify the existing tax system, another option would be to junk it and start over. Although fundamental reform has been the subject of academic analysis for years, it achieved a politically higher profile after Republicans became the majority party in Congress in 1995 and during the presidential primaries in 1996. The furor has since died down, but fundamental tax reform merits careful attention because it continues to resonate among many experts and laypersons and because it raises important issues for tax policy. Advocates have claimed that fundamental tax reform could boost growth, slash burdens, simplify tax compliance, and eliminate the IRS. Unfortunately, a new tax system would not be exempt from the nagging trade-offs or the political constraints that plague less radical tax policies.

Options for Reform

Four different taxes have been put forth as alternatives to the existing system: a national retail sales tax (NRST), value-added tax (VAT), flat tax, and an "unlimited saving account" (or USA) tax. Under an NRST, a single tax rate would apply to all sales by businesses to households. Sales between business and between households would be untaxed. Government would pay sales tax to itself on all government purchases of labor, materials, services, and capital, thereby taxing personal consumption of government-produced goods and services.

Under a VAT, each business would pay tax on the difference between its total sales to consumers and other businesses less its purchases from other businesses, including investment. Thus, the increment in value of a product 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, the same as in an NRST.

The flat tax, 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.[50] Individuals would 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.

The USA tax would combine a VAT on businesses with a personal consumption tax. Under the personal tax, people would report all income from earnings and investments, but they would be allowed a new deduction for all net saving. 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.

Our analysis focuses on the NRST and the flat tax. We exclude the USA tax because tax lawyers and economists have argued that it would be unduly complex and difficult to administer.[51] We exclude the value-added tax because it exists now in many countries and would pose few novel issues for the United States.

In their pure forms the NRST and the flat tax would replace the current tax base—a convoluted concept of income—with consumption,

50. Hall and Rabushka (1985).
51. Ginsburg (1995); Slemrod (1996); and Graetz (1997).

replace the current graduated rate structure with a single tax rate, and eliminate all tax credits and deductions.[52]

Tax Rates

To make sensible comparisons across tax systems, it is important to distinguish between two ways to express tax rates. Suppose a good has a sticker price of $100, excluding taxes, and that a $30 sales tax is placed on the good. The "tax-exclusive" sales tax rate is 30 percent, calculated as T/P, where T is the tax payment and P is the pretax price of the good. The "tax-inclusive" sales tax rate is about 23 percent, calculated as $T/(P+T)$. The tax-inclusive rate is always lower than the tax-exclusive rate. At low rates there is little difference. But a 100 percent tax-exclusive rate corresponds to a 50 percent tax-inclusive rate. Sales taxes are usually quoted in tax-exclusive terms. Income taxes are usually quoted in tax-inclusive terms. Neither method is superior, but they must be distinguished to avoid confusion.

NATIONAL RETAIL SALES TAX. Representatives Dan Schaefer and Billy Tauzin have proposed to replace the $1,174 billion raised by individual and corporation income taxes, the estate tax, and federal excise taxes in 2000 with a 15 percent tax-inclusive (17.6 percent tax-exclusive) retail sales tax. Americans for Fair Taxation (AFT), a private lobbying group, proposes a 23 percent tax-inclusive (30 percent tax-exclusive) retail sales tax to replace the estimated $1,748 billion that the individual and corporation income taxes, the estate tax and the payroll tax will yield in 2000. The AFT plan would include a cash payment or *demogrant* calculated to offset taxes for low-income families. Each family—rich and poor alike—would receive a cash payment equal to the sales tax rate multiplied by the official poverty threshold. For a four-person family, the payment in 1999 would equal an estimated $3,841.

52. The distinction between pure income and pure consumption taxes is often exaggerated. Under the typical consumption tax—a VAT or a flat tax, for example—businesses are allowed immediate deductions for investments. If businesses were permitted only to deduct depreciation over the life of the investment, the VAT would be levied on income rather than consumption. See Bradford (1996). Slemrod (1997) describes the changes needed to convert the current income tax into a flat-rate consumption tax.

The actual rates in both proposals would be far higher than acknowledged by their supporters. First, the plans fail to allow for the increase in the cost of maintaining government services. The problem is easiest to see if it is assumed that producer prices (not including sales taxes) stay constant after conversion to a sales tax. In that event, consumer prices—producer prices *plus the new tax*—would rise by the full amount of the sales tax. The plans stipulate that government will pay sales taxes on its own purchases, but the revenue estimates do not recognize this added cost. Furthermore, to maintain their real value, federal transfer payments would have to be increased by the amount of the new tax, but the proposals make no allowance for this cost, either.[53]

Second, the rate estimates for the NRST assume no tax avoidance or evasion, although the higher rates under a national sales tax would produce larger incentives to avoid or evade tax than do current state sales taxes, which taxpayers do avoid and evade to some degree.[54] Third, the estimated rates presume that a very broad base of personal consumption would be taxed with virtually no exclusions, despite the fact that states now exclude about half of consumption, including health insurance premiums and hospital bills, rents, and most other services. At the rates under an NRST required to sustain revenues, political pressure to exempt or subsidize additional consumption would intensify.

Under relatively optimistic assumptions about these factors, the rates needed to maintain government skyrocket. If the evasion rate under a NRST were 15 percent, tax avoidance reduced the effective sales tax base by 5 percent, and political and administrative concerns reduced the starting tax base by only 10 percent—not the 50 percent typical of current retail sales taxes—the Schaefer-Tauzin proposal would require a tax-exclusive rate of 60 percent and the AFT proposal would require a tax-exclusive rate of 101 percent (table 7-5). Higher rates could easily be

53. Gale and others (1998). Alternatively, if producer prices (not including sales tax) fall after switching to a sales tax, the problem still arises but in another guise. In this case the government does not need to raise its nominal revenue target. But the nominal sales tax base (producer prices times quantities of goods sold) would shrink, so that the sales tax would raise less revenue than the proposals assume it would.

54. Gale and Holtzblatt (1999, p. 481).

Table 7-5. *Required National Sales Tax Rates*
Percent

Plan	*Tax inclusive*	*Tax exclusive*
To replace income, payroll, and estate taxes		
AFT proposal	22.8	29.6
Plus adjusted to hold government constant	34.9	53.6
Plus allowing for 5 percent avoidance rate, 15 percent evasion rate, and 10 percent statutory base erosion	50.4	101.4
To replace income, estate, and excise taxes		
Schaefer-Tauzin proposal	14.9	17.5
Plus adjusted to hold government constant	24.0	31.6
Plus allowing for 5 percent avoidance rate, 15 percent evasion rate, and 10 percent statutory base erosion	37.4	59.8

Sources: Gale (1999a).

required to maintain revenues if avoidance and evasion rates are higher or if Congress spared more than 10 percent of the potential base from tax.

THE FLAT TAX. The Treasury Department has estimated that a pure flat tax with a 20.8 percent rate would have generated as much revenue as the personal and corporation income taxes and the estate tax in 1996.[55] Unlike the advocates' estimates for the sales tax, the flat tax estimates include tax evasion and are based on logically consistent assumptions about price level changes. Nevertheless, in practice, rates would likely be higher for several reasons.

Congress would face intense pressure to offer transition relief to businesses that would be treated less generously under the new rules than under current rules. Repeal of the income tax would destroy remaining depreciation deductions for businesses that own capital at the time of transition. Owners of such "old capital" would be at a disadvantage in competition with owners of "new capital" purchased after the implementation of the new tax, which could be expensed. Similarly,

55. U.S. Department of Treasury (1996, p. 451). This includes personal exemptions of $10,700 (single), $21,400 (married), and $14,000 (head of household), and child exemptions of $5,000.

companies that have borrowed funds would lose deductions for interest payments and would have a disadvantage in competition with companies that have not borrowed. The flat tax would also eliminate carry-forwards relating to net operating losses, alternative minimum tax payments, and other items that business can currently use to reduce future taxes. Business owners would doubtless seek relief.[56]

More generally, taxes are deeply embedded in the structure of existing contracts and other transactions. Moving to a flat tax could upset these arrangements. For example, the flat tax would change the substance of every alimony agreement, because alimony payments are currently deductible and alimony receipts are taxable, but under the flat tax, those treatments would reverse. Likewise, the flat tax would alter every loan repayment plan because interest payments are currently deductible and interest receipts are taxable, but neither activity would affect tax liabilities under the flat tax.

These problems would create a dilemma. Most of the gains in economic efficiency and much of the political appeal of the flat tax derive from low rates made possible by a broad tax base. But providing transition relief would raise rates and would reduce gains in economic efficiency. Transition rules would also erode gains in simplicity.

Beyond transitional concerns, the permanent elimination of existing deductions and credits would prove difficult. Removing deductions for mortgage interest and property taxes would raise tax burdens for about 29 million homeowners who itemize, reduce the real value of homes, and possibly increase mortgage defaults.[57] Terminating deductions for charitable donations under the personal, corporation, and

56. Perlman (1996).

57. The impact on housing prices is controversial. Capozza, Green, and Hendershott (1996, p. 201) estimated that the flat tax would reduce the price of owner-occupied housing (the structure plus the land) by an average of 29 percent if interest rates were constant. If the flat tax led to a fall in interest rates of 2 percentage points, the estimated average fall in housing prices would be 9 percent (p. 190). Bruce and Holtz-Eakin (1998) estimate that nominal house structure prices would rise by 10 percent in the short run and 17 percent in the long run. However, Gale (1999b, pp. 6–7) shows that under consistent assumptions about price-level effects, and including land in the analysis, the Bruce and Holtz-Eakin model suggests that real housing prices would fall by 7–10 percent in the short run and by 2–6 percent in the long run, depending on how interest rates adjust.

estate and gift taxes would reduce contributions by about 11–23 percent.[58] Eliminating deductions for health insurance premiums employers pay for workers would have increased the number of uninsured in 1994 by between 5.5 million and 14.3 million, about 14 to 36 percent.[59] Removing the deduction for state and local taxes would increase the effective burden of subfederal government on taxpayers who currently itemize. Deductions for casualty losses would end, meaning that a victim whose earnings were stolen would still have to pay taxes on them. Businesses would lose more than $300 billion in deductions for payroll taxes. The flat tax would also eliminate the earned income credit, which raises the labor supply of, and redistributes income to, low earners.[60]

If Congress provided limited transition relief; retained individual deductions for mortgage interest, charitable contributions, and state and local income and property taxes; continued business deductions for health insurance premiums and payroll taxes; and kept the earned income tax credit the revenue-neutral rate would rise from 20.8 percent to 31.9 percent (table 7-6).[61]

Regardless of the economic wisdom of retaining these aspects of the current income tax under a flat tax, political support for them will be powerful. Even flat-tax designers now acknowledge that transition relief will be inescapable in practice.[62] And some recent proposals, termed

58. Clotfelter and Schmalbeck (1996, pp. 229, 232, 234) estimate that the end of the charitable contributions deduction would reduce individual giving by 10 percent to 22 percent, corporate giving by 15 percent to 21 percent, and testamentary gifts by 24 percent to 44 percent.

59. Gruber and Poterba (1996, p. 142).

60. Dickert, Houser, and Scholz (1995); and Eissa and Liebman (1995).

61. This estimate understates the increase in rates that would be necessary because it is based on itemized deductions claimed under the personal income tax. But many taxpayers who use the standard deduction and therefore do not explicitly list such outlays as mortgage interest or charitable contributions also incur these expenses and would claim them under a flat tax if such itemized deductions were retained. Furthermore, if political pressure or policy consideration led Congress to retain itemized deductions, similar considerations might lead to the retention of such provisions as child care or education credits.

62. Representative Richard Armey and Professors Robert Hall and Alvin Rabushka, for example, have already acknowledged the need for transition relief. A commission studying tax reform chaired by former Representative Jack Kemp blandly remarked that “policymakers must take care to protect the existing savings, invest-

Table 7-6. *Required Tax Rates under the Flat Tax*
Percent

Adjustment	*Flat rate if only one adjustment is made*	*Flat rate if all adjustments up to this point are made*
Armey-Shelby flat tax (no adjustments)	20.8	20.8
Allow transition relief	23.1	23.1
Retain mortgage interest, health insurance, charitable contribution, state and local income, and property tax deductions	25.0	28.4
Retain earned income tax credit	21.1	27.5
Retain payroll tax deduction (businesses)	22.3	31.9

Sources: Authors' calculations.

"McFlat" taxes, would allow the flat tax to include deductions for mortgage interest and charitable contributions.[63] These cracks in the armor, which have appeared long before any serious legislative consideration has occurred, suggest that more would open in the political horse-trading surrounding actual legislation.

Simplicity, Compliance, and Administration

The appeal of fundamental tax reform stems in no small measure from claims that it would greatly simplify taxes, reducing compliance costs for households and businesses and defanging or even eliminating the IRS. However, while the NRST and flat tax clearly have some advantages over the existing system, they also create new problems. And responsible observers on all sides agree that an IRS-like agency is here to stay.

ment, and other assets" during a transition to a new tax system. Although the Kemp Commission did not elaborate on this seemingly innocuous statement, it has far-reaching implications for tax reform. Kemp Commission Report; http://www.flattax.house.gov/reptoc.htm [August 13, 1999].

63. See Specter (S. 488, 1995); and the Kemp Commission Report.

THE RETAIL SALES TAX. The fact that state sales taxes are generally thought to be simple casts an aura of simplicity over the NRST. Under a sales tax, few households would need to keep federal tax records, know federal tax law, or file federal returns. Filing the NRST for businesses would generally be relatively easy.

Few savings in compliance costs would be achieved, however, unless states also abandoned their personal and corporation income taxes. And if they replaced their income taxes with sales taxes, the combined rates would be astronomical, compounding the administrative difficulties that high federal rates would cause. Furthermore, experience with the state sales taxes provides no guidance on how to administer a demogrant to over 270 million people. Payments would be based on family size, a design feature that necessitates filing by all families and raises problems of enforcement because two separate one-person families would receive larger grants than would one two-person family.[64]

In addition, almost all states collect a significant share of their sales tax revenue from business-to-business sales. Inputs may pass through many stages before reaching consumers, and taxes can accumulate. This situation is tolerable when rates are low, but not when rates are high. Distinguishing sales to businesses from sales to consumers will require detailed audits of retailers and other businesses, because incentives for households to masquerade as businesses to evade the tax will increase with the increases in the tax rate.

Almost all states exempt a large number of difficult-to-tax consumer goods or services. At low rates these gaps in coverage matter little, but when rates are high, distortions and inefficiencies would become serious. No state, for example, taxes financial services, and only a handful tax services generally, yet the NRST proposals would tax all services.

A threshold administrative question regarding a national retail sales tax is whether it could be enforced at rates necessary to sustain revenues.[65] Retail sales tax rates in foreign countries are typically in the range of 4–6 percent, although a few countries have had higher rates.

64. For the same reason, the sales tax would create a sizable marriage penalty for all couples. See Gale (1998); and Gale and Holtzblatt (1999).

65. For a detailed analysis, see Gale and Hotlzblatt (1999). Mastromarco (1998) presents an opposing view.

No country has run a sales tax at anywhere near the rates that would be required to sustain revenues in the United States.[66] Although implementation of the sales tax at the rates shown in table 7-5 might not prove impossible, extreme caution would be appropriate.

THE FLAT TAX. The alleged simplicity of the flat tax, symbolized by a post-card-sized return, is one of its great selling points. A pure flat tax would be simpler than the current income tax, but some problems would carry over to the new system. These include distinguishing independent contractors from employees, determining who are qualified dependents, enforcing tax withholding for domestic help, limiting home office deductions, determining and collecting taxes from the self-employed, reconciling state and federal taxes, and distinguishing travel and food expenses incurred while doing business, which should be deductible, from other travel and food expenses, which should not be deductible.[67]

Several problems for tax administration could actually intensify, including the sheltering of personal consumption as a business expense, the tax treatment of mixed business and personal use property, rules regarding how taxes or losses may be allocated among different taxpayers, and distinctions between financial and real transactions.

The flat tax would also create new opportunities for avoidance and evasion. For example, wages and salaries would be deductible business expenses but fringe benefits would not. Businesses might find it desirable to hire physicians and nurses directly rather than purchase health

66. The OECD has stated that "Governments have gone on record as saying that a retail sales tax of more than 10 to 12 percent is too fragile to tax evasion possibilities." Vito Tanzi, director of Fiscal Studies at the International Monetary Fund has said, "The general view among experts, a view obviously shared by most governments, is that 10 percent may well be the maximum rate feasible under an RST" (Tanzi, 1995, pp. 50–51). British fiscal expert Alan Tait expressed a similar view: "At 5 percent, the incentive to evade [the retail sales tax] is probably not worth the penalties of prosecution; at 10 percent, evasion is more attractive, and at 15–20 percent, becomes extremely tempting" (quoted in Tanzi, 1995, p. 51). Slemrod (1996) and others have expressed similar sentiments.

67. Graetz (1997) describes numerous problems in the current system that will not disappear with the flat tax.

insurance for their employees. Because sales proceeds are taxable to businesses but interest income is not, businesses would find it profitable to discount prices for installment purchasers who accepted high interest rates. One author concluded that the flat tax would create a dilemma—either a complicated tax law would be necessary to reduce the evasion possibilities or complicated business transactions would arise to game the law or both.[68] After a careful review of estimates of the costs of administering the income tax, another study concluded that administrative costs for a pure flat tax would be about half those of the corporation and individual income taxes.[69] If Congress retained some itemized deductions and the earned income tax credit and granted transition relief, however, these savings would shrink.

Fairness and the Distribution of Tax Burdens

The debate over whether consumption or income is a better measure of ability to pay taxes has been going on for centuries. Proponents of consumption taxes argue that consumption usually approximates lifetime income because few people inherit or bequeath more than a small fraction of their lifetime earnings. For that reason, taxing consumption is equivalent to taxing households on the basis of their ability to pay taxes over long periods of time. However, advocates of the income tax counter that current income may be a better measure of ability to pay because few households can borrow much against future income and the prospect of having a large future income may not prove much help.

Fundamental tax reform would redistribute tax burdens. The shift from an income base to the consumption base of the NRST or the flat tax would tend to reduce the burden on high-income filers because they consume a smaller than average share of their income. The shift from graduated rates to a flat rate would also tend to reduce their burden. Ending double taxation of corporate income and the estate tax and providing transition relief would have similar effects.

As a simple matter of arithmetic, if wealthy households pay less in taxes, others have to pay more, assuming revenues are held constant.

68. Feld (1995, p. 615).
69. Slemrod (1996, p. 375).

Both the NRST and the flat tax would eliminate the earned income credit and thus make poor working households worse off. And middle-class households would have to bear a higher burden of taxation.

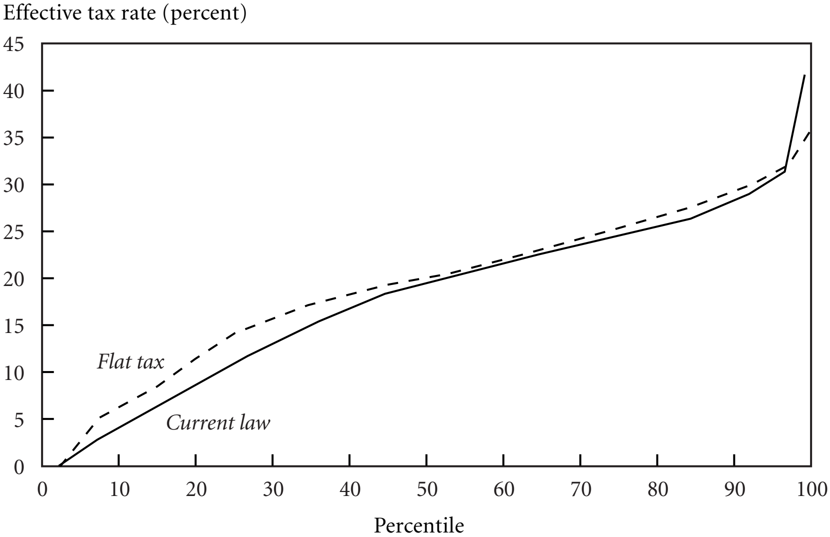
Figure 7-2 shows the estimated distributional effects of moving to the flat tax. Households in the top 1 percent of the income distribution would receive average tax cuts of $38,000.[70] These tax cuts would be financed by tax increases of $350 per household in the bottom 50 percent of the income distribution, and about $700 per household in the 75th–99th percentiles of the distribution. Taxes on households in the 50th–75th percentiles would be largely unaffected.

In examining the distributional effects of fundamental tax reform, it is important to keep in mind that people eventually bear the burden of business taxes. For this reason the practices of some advocates of fundamental tax reform of comparing individual tax liabilities under the flat tax with those under the current income tax are extremely misleading. The reason is that most flat taxes would sharply increase the proportion of taxes collected directly from business. Furthermore, even if one limits one's attention to personal liabilities, the likely curtailment of health insurance fringe benefits that would result from repeal of business deductions for health insurance and the effects on house prices of repeal of deductions for mortgage interest and property taxes could easily swamp changes in direct personal tax liabilities.

A second claim, that fundamental tax reform would be profamily because of the demogrant in the sales tax and the large personal and child exemptions in the flat tax, is also misleading. Families with children would be hurt by the elimination of current deductions for health insurance, mortgage interest, state and local income and property taxes (which finance schools and other services), the earned income credit, child care credits, education credits, and child credits. Switching to a consumption tax would put families with children at a disadvantage because at each income level they tend to have higher consumption requirements than do couples without children. One recent study found that a broad-based, flat-rate consumption tax would have hurt low-income families with children and helped families with incomes

70. This estimate does not include the effects of eliminating the estate tax or of providing transition relief.

Figure 7-2. *Effective Tax Rates under Current Law and Flat Tax*



Source: Gale, Houser, and Scholz (1996).

over $200,000.[71] This analysis was based on pre-1997 tax law. Including the child and education credits enacted in 1997 would imply even larger losses for families with incomes below $200,000.

Effects on Economic Growth

Many of the problems and trade-offs created by fundamental tax reform could be reduced if reform boosted growth dramatically. Fundamental tax reform could increase growth by reducing marginal tax rates on capital and labor income, reducing the disparity in taxation of different types of capital and labor income, and imposing a lump-sum tax on old capital by not providing transition relief. But the impact on growth depends critically on the "purity" of the reform.[72]

71. McIntyre and Steuerle (1996, p. 15).

72. Estimates of the effects on growth also depend on how the current system is characterized. Engen and Gale (1996) document that most private saving and growth now occurs in tax sheltered forms. If one recognizes this fact, the impact on saving and growth of switching to a consumption tax will be smaller than it would be if one assumes that the current system is a pure income tax.

A pure consumption tax with no personal exemptions or product exemptions and no deductions, credits, or transition relief could increase the size of the economy by 9 percent in the ninth year after reform and would require a tax-inclusive rate of 14 percent (table 7-7). Compared with the estimated impacts of other policies, these are enormous. Unfortunately, the growth effect shrinks rapidly as the pure reform is made more realistic. Adding modest personal exemptions (smaller than in the flat tax proposed by Representatives Richard Armey and Richard Shelby)[73] and providing transition relief for existing depreciation deductions (but not interest deductions) reduces the growth impact by 80 percent, leaving increased growth of only 1.8 percent in the ninth year, and requires a tax-inclusive rate of 24 percent. Allowing for additional deductions, credits, and child exemptions or other forms of transition relief would raise the tax rate considerably, as shown in table 7-6. There are no estimates of the growth impacts of these changes, but the data in table 7-7 suggest that at the required rates shown in table 7-6, the growth effect would likely be near or below zero.[74]

Conclusion

The U.S. tax system collects nearly $2 trillion from a public that dislikes taxes but for the most part complies voluntarily. However, taxes have become encrusted with provisions that confuse filers, distort economic decisions, and necessitate higher marginal tax rates than would be required if the provisions were curbed or eliminated. Impatience with this system has led some to call for its complete replacement. At first glance, starting afresh may sound attractive, but the idea raises formidable problems of redistribution and transition and would create major uncertainties. Incremental reform is more promising, if less dramatic. Specific steps could make taxes easier to comply with and to

73. H.R. 2060 and S. 1050, The Freedom and Fairness Restoration Act of 1995.

74. Other models, reported in Joint Committee on Taxation (1997) generate a range of results that, dropping the high and low estimates, are fairly close to the results reported in the text. See also Auerbach (1996); Engen and Gale (1996); and Fullerton and Rogers (1996).

Table 7-7. *Economic Growth, Alternative Versions of the Flat Tax*

Percent

	Increase in the size of the economy in			*Revenue-neutral tax rate in*		
Alternative	*2 years*	*9 years*	*Steady-state*	*2 years*	*9 years*	*Steady-state*
Pure consumption base	6.9	9.0	10.9	14.7	13.9	12.5
Add limited personal exemptions[a]	2.5	4.0	6.1	22.1	21.2	19.4
Add limited transition relief[a,b]	0.6	1.8	3.6	24.4	23.5	22.0

Source: Altig and others (1997).

a. In these simulations, personal exemptions are set at $9,000, and child exemptions are set at zero. In the Armey-Shelby flat tax, these exemptions are set at $10,700 and $5,000 respectively.

b. Transition relief is provided only for existing depreciation deductions, not for interest payments.

enforce, permit rates to be cut, and promote economic growth. In taking these steps, selective tax reductions would help smooth the way to achieving these goals because every tax reform creates losers as well as winners. For that reason as well as for reasons of fiscal prudence, massive tax cuts now would be massively unwise. The nation should instead husband its resources, not only to meet looming problems of an aging population, but also to accumulate a down payment on tax reform.

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