Federal Revenue Options

Testimony submitted to
United States House of Representatives
Committee on the Budget

October 6, 2004

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Chairman Nussle, Ranking Member Spratt, and Members of the Committee:

Thank you for inviting me to testify today on federal revenue options. 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. First, taxes should be simple. Second, taxes should be fair. Third, taxes should be conducive to economic prosperity and market efficiency. Fourth, they should raise sufficient revenue to cover the "appropriate" level of government. Fifth, to the greatest extent possible, tax rules should respect people's freedom and privacy.[2]

Despite the "motherhood and apple pie" quality of these goals, tax policy remains controversial. One problem is that controversy arises over how to achieve each goal. Supporters of increased growth 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. Another obstacle to consensus is that the goals are imprecise: views of what constitutes a fair tax, for example, vary widely. 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.

One strategy for reform is to improve the performance of the existing tax system. A second strategy, so-called fundamental tax reform, would toss out the current system and install

[1] Arjay and Frances Fearing Miller Chair, Economic Studies Program, and Co-Director, Tax Policy Center. The views presented are my own and should not be taken to represent the views of the Brookings Institution or the Tax Policy Center.

[2] 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).

an entirely new set of taxes. These approaches can also be combined in a hybrid reform -- which improves some parts of the current system, throws out other parts, and installs new taxes.

The most important issue in analyzing tax reform options is to compare the current system to *realistic* alternatives. Anyone can write down a simple tax system on paper. Whether that tax system can survive the legislative process, the scrutiny of the tax shelter industry, and public notions of equity, and still raise sufficient revenue and remain simple is open to question. I have not yet seen a fundamental tax reform proposal that meets that test.

The focus on realistic options has at least three implications. First, it implies that almost all of the claimed benefits of various proposed systems have to be taken with an enormous grain of salt. Most of these benefits disappear when more realistic versions of the taxes are considered. Second, it implies that policymakers and the public won't be able to "have it all" in tax reform. That is, we won't be able to come up with a whole new system that everyone finds simple, fair, and more conducive to economic growth. We will have to make trade-offs. Third, it is possible to do worse than the current system.

A second key issue is whether the new taxes are considered to be add-ons or replacements for the current system. Given the current long-term fiscal imbalance, either revenues will have to be raised substantially, or spending cut, or both. This observation also changes the nature of tax reform debates. In the past, analysts debated revenue-neutral reforms. Now, however, unless policy makers intend to cut future spending by about 20 percent of GDP, revenue-neutral reforms are no longer sufficient, and serious thought needs to be given to the best way to structure taxes designed to raise *additional* revenues.

Proposals like a national retail sales tax, a flat tax, and a value-added tax have several common features. They are all consumption taxes, would tax at a flat rate, and would allow few or no deductions or credits. They would be regressive relative to the current system. In their pure form, they could have positive effects on economic growth, but once subjected to the realistic considerations noted above (legislative processes, tax shelters, public views of fairness), they would likely provide little net growth effect. The potential to simplify exists with each of these taxes, but it is likely to be overstated substantially. In particular, avoidance and evasion would continue under each of the plans, and could even increase in certain areas.

My estimates suggest that a sales tax that marked up the price of goods and services by at least 26 percent would be required to replace the income tax, and one that marked up the price of goods and services by at least 60 percent would be required to replace all federal taxes.

The rest of my testimony provides more discussion of the national retail sales tax, the flat tax, and the relation between recent tax policy and fundamental tax reform.

National Retail Sales Tax[3]

One proposal for fundamental tax reform is to replace part or all of the current tax system with a national retail sales tax (NRST). The NRST is one potential form of a consumption tax. Retail sales occur when businesses sell goods or services to households. Neither business-to-business nor household-to-household transactions are retail sales. For example, the sale of a newly constructed home to a family that will occupy it is a retail sale. But the sale of that same newly constructed home to a business that is planning on renting it to others is not a retail sale. Nor is a sale of an already existing home from one occupant to another.

Typically, proposed NRSTs would aim to tax all goods or services purchased or used in the United States. Exemptions would be provided for business purchases and education (both considered investments). Domestic purchases by foreigners would be taxed; foreign purchases by domestic would not. To ensure that no family in poverty has to pay the sales tax, the sales tax proposals typically also offer equal per-household payments called "demogrants" and equal to the sales tax rate times the poverty line.

A national retail sales tax structured along these lines would represent a sharp break from the current tax system. The tax base would shift to consumption. Rates would be flat. All exemptions, deductions, and preferences would be eliminated. Tax administration, enforcement, and point of collection would altered radically.

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.

Required Rate

To determine the revenue- and budget-neutral tax rate in a national sales tax requires estimating the rates of evasion, avoidance, the extent to which deductions, exemptions and credit would be re-introduced, and the impact on economic growth. With extremely conservative assumptions about the magnitude of evasion, avoidance, and statutory base erosion, it would require a 60 percent tax-exclusive (38 percent tax-inclusive) tax rate to replace existing federal taxes, and a 26 percent tax-exclusive (21 percent tax-inclusive) tax rate to replace the existing personal income tax. These estimates do not include any allowance for economic growth, but even if the economy grew by 5 percent, which would be an enormous effect relative to existing estimates, the tax-exclusive tax rates would only come down to 57 percent and 25 percent to replace all federal taxes, or the income tax, respectively.

[3] For additional information, see Gale (1999) and Gale and Hotlzblatt (2002).

Note that the eventual sales tax rate that households would face would likely be significantly higher because existing state sales tax would be added. In addition, most or all state income taxes would probably be abolished in the absence of a federal income tax system (since the states depend on the federal income tax system for reporting purposes) and converted to sales taxes. These would add considerably to the combined sales tax rate. Any transition relief provided to households would reduce the tax base and raise the required rate further. And if major consumption items like food, housing, or health care were exempted from the base (the assumption above do not allow for such large exemptions), the tax-exclusive rate could rise to over 100 percent. In short, any realistic plan for a national retail sales tax that replaced the bulk of the federal tax system would require extremely high combined federal-state tax rates. Sales taxes at such high rates raise crucial questions about enforceability.

Advocates and sponsors of sales tax proposals have suggested that much lower rates, on the order of 23-30 percent would be sufficient to replace the entire federal system. These estimates are lower than the ones above for three reasons. First, they are quoted in tax-inclusive terms. Second, they assume that there is no evasion, no avoidance, and no statutory base erosion due to political pressures or hard-to-tax items.

Third, quite simply, the advocates made a mathematical mistake in calculating their required tax rate. An analysis of the required rate in a sales tax requires some assumption about what happens to the level of the producer prices (the prices that consumers see before sales taxes are imposed) in the transition to a sales tax. Producer prices could (a) remain constant in nominal terms, (b) fall by the entire amount of the previously embedded taxes, or (c) fall by an amount between the first two benchmarks. In calculating their required rate, the NRST advocates assumed that producer prices would remain constant when they calculated the amount of revenue the government would obtain from a sales tax, but assumed that producer prices would fall when calculating the amount of spending the government would have to do to maintain current programs. These assumptions are obviously inconsistent, and they either understate government spending needs, overstate the revenue likely to be obtained, or both. Making a consistent assumption about producer prices – regardless of whether the assumption is (a), (b) or (c), leads to a higher rate than the advocates have assumed.

Enforceability and Avoidance

The results above suggest that even with rates of evasion much lower than in the existing income tax system, the required national retail sales tax would be well into the 30's and possibly even higher (on a tax-inclusive basis). Governments have gone on record noting that at rates of more than 12 percent, sales taxes are too easy to evade. Thus, the most optimistic assessment would be that there is no historical precedent for a country to enact a high-rate, enforceable, national sales tax. That does not mean it is impossible, but extreme caution would be appropriate.

Sales tax advocates admit that evasion would be a certainty, yet make no account for it in their estimates and hope that sentiments of fairness will induce taxpayers not to cheat. They also point to low marginal tax rates as an inducement not to cheat, but as shown above, the tax rate would not likely be low. Another claim is that detection of cheating would rise dramatically

since only retailers would have to be audited, but this is misleading. Under the sales tax, businesses that make retail sales would be responsible for sending tax payments to the government, unless the buyer used a business exemption certificate, in which case no tax would be due. But the buyer would have the legal responsibility for determining whether the good is used as a business input or a consumption item. This means that auditing and enforcement would have to focus not just on retailers, but also on all businesses that purchase from retailers, to ensure that business exemption certificates were used appropriately.

Most importantly, the sales tax would generate tremendous opportunities for evasion. For example, in the income tax, the rate of evasion is around 15 percent. But income where taxes are withheld and reported to government by a third party has evasion rates of around 5 percent. For income where taxes are not withheld and there is no cross-reporting, evasion is around 50 percent. Since the sales tax would feature no withholding and no cross-reporting, the possibility of high evasion rates needs to be taken quite seriously.

Advocates also assert that the sales tax would be more effective than the current system at raising revenue from the underground economy. The classic example is that of a drug dealer who currently does not pay income tax on the money he earns, but would be forced to pay taxes under a sales tax if he took the drug money and bought, for example, a Mercedes. The problem with this argument is laid out best by Rep. Richard Armey (R-Texas): "If there is an income tax in place, he [the drug dealer] won't report his income. If there is a sales tax in place, he won't collect taxes from his customers" and send the taxes to government. In the end, neither system taxes the drug trade. Many other countries have attempted to implement a retail sales tax, or variants, and almost all have abandoned the tax and moved to a value-added tax.

Finally, some sales tax advocates would eliminate the IRS and have the states administer the tax. Even though the states would keep 1 percent of the revenue they collect, they would have poor incentive to collect federal taxes adequately. Even the Wall Street Journal, no fan of big government, notes that "it is fantasy to think of 'getting rid of the IRS.'"

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. 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.[4] Retail sales tax rates in foreign countries are typically in the range of 4–6 percent, although a few countries have had higher rates.

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

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.

The NRST would significantly redistribute tax burdens. The shift from an income base to the consumption base of the NRST 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. It is also likely that avoidance options would be more available to high-income than to low-income households. As a simple matter of arithmetic, if wealthy households pay less in taxes, others have to pay more, assuming revenues are held constant.

If households are classified by annual income, the sales tax is sharply regressive. Under the AFT proposal, taxes would rise for households in the bottom 90 percent of the income distribution, while households in the top 1 percent would receive an average tax cut of over $75,000. If households are classified by consumption level, a somewhat different pattern emerges. Households in the bottom two-thirds of the distribution would pay less than currently, households in the top third would pay more. Still, households at the very top would pay much less, again receiving a tax cut of about $75,000. There appears to be little sound motivation for

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

[5] 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.

heaping huge tax cuts on precisely the groups whose income and wealth have benefited the most from recent events, and raising burdens significantly on others (Feenberg, Mitrusi and Poterba 1997).

Advocates like to assert that sales taxes are pro-family relative to the income tax. But children and families benefit disproportionately from numerous features of the current system, including dependent exemptions, child credits, child care credits, earned income credits and education credits. And the preferential treatment of housing, health insurance, and state and local tax payments also plausibly helps families, since they consume relatively more housing, medical services, and government-provided services such as education. All of these preferences would be eliminated under a sales tax. Moreover, compared to childless couples, families with kids generally have high consumption relative to income, so switching from income tax to a consumption tax would further raise tax burdens during years when family needs were highest. Based on 1996 data, a recent study found that enactment of a broad-based, flat-rate consumption tax like the sales tax or flat tax would hurt families with incomes less than $200,000, because of the loss of tax preferences, but would help families with income above $200,000, due to the dramatic reduction in the top tax rate. Incorporating the 1997 and 2001 tax changes—especially the child and education credits-—would only exacerbate these results.

The Flat Tax[6]

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.[7] 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. This implies that the flat tax is a consumption tax.

Required Rates

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.[8] Unlike the advocates' estimates for the sales tax, the flat tax estimates include tax

[6] For additional information, see Aaron and Gale (2000) and Gale and Holtzblatt (2002).

[7] Hall and Rabushka (1985).

[8] 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.

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, 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 carryforwards 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.[9]

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.[10] Terminating deductions for charitable donations under the personal, corporation, and estate and gift taxes would reduce contributions by about 11–23 percent.[11]

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[9] Perlman (1996).

[10] 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.

[11] 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.

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.[12] 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.[13] 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.[14]

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.[15] And some recent proposals, termed "McFlat" taxes, would allow the flat tax to include deductions for mortgage interest and charitable contributions.[16] These cracks in the armor, which have appeared long before any serious legislative consideration has occurred, suggest that more would open in the political horsetrading surrounding actual legislation.

Administration and Enforcement

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

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[12] Gruber and Poterba (1996, p. 142).

[13] Dickert, Houser, and Scholz (1995); and Eissa and Liebman (1995).

[14] 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.

[15] 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, investment, 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].

[16] See Specter (S. 488, 1995); and the Kemp Commission Report.

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.[17]

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 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.[18] 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.[19] If Congress retained some itemized deductions and the earned income tax credit and granted transition relief, however, these savings would shrink.

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.[20]

A pure consumption tax--like the flat 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. 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

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

[18] Feld (1995, p. 615).

[19] Slemrod (1996, p. 375).

[20] 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.

Shelby)[21] 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. There are no estimates of the growth impacts of these changes, but the available data suggest that at the required rates, the growth effect would likely be near or below zero.[22]

Recent tax policies and tax reform

Some advocates of moving to a consumption tax have shifted to trying to achieve fundamental tax reform in several steps, rather than in one fell swoop, and defend the Bush tax cuts as effecting such a piece-meal move toward a consumption tax. Indeed, as Bartlett (2003) argues, "By Bush's second term, it is possible that we will have made enough incremental progress toward a flat rate consumption tax that we may finally see fundamental tax reform fully enacted into law."

Although they bear a superficial and partial resemblance to broader tax reform measures, the recent tax cuts create new structural flaws in the tax system, have the opposite effect of well-designed fundamental tax reform in key areas like saving and growth, and will actually make fundamental reform more rather than less difficult.

The recent tax cuts and consumption taxes: comparing rules and effects

The recent tax cuts share several features with fundamental reform plans. They reduce the top marginal individual income tax rates, reduce tax rates on capital income (dividends and capital gains) even further, and eliminate the estate tax. The bonus depreciation rules move toward a system where investments are expensed in the first year, albeit on a temporary basis.

Recent regulatory changes also push in the same direction. For example, in January 2002, the IRS published a notice of proposed rule-making to clarify its interpretation of the 1992 Supreme Court decision in *INDOPCO, Inc. v. Commissioner*. In INDOPCO, the Court ruled that expenses incurred by firms preparing for a friendly take-over had to be capitalized rather than expensed. The IRS rules put forward categories of safe harbors under which intangible assets could be expensed rather capitalized. Many practitioners are concerned that under the IRS rules, firms are given too much leeway to expense investments rather than depreciate them over time.[23]

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[21] H.R. 2060 and S. 1050, The Freedom and Fairness Restoration Act of 1995.

[22] 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).

[23] See, for example, Jack Taylor, "Tax Deductibility of Business Expenses," CRS Report for Congress, RS21194, April 2002.

Moreover, proposals for greatly expanded tax-free saving accounts would push even further toward elimination of tax on capital income. The Administration has proposed two new types of individual accounts—called Lifetime Saving Accounts (LSAs) and Retirement Saving Accounts (RSAs). LSAs would allow annual contributions of $5,000 per person per year. Although contributions would not be deductible, account earnings and withdrawals would be tax-free. Anyone could make a contribution to their own account or anyone else's with no income, age, or other restrictions. Withdrawals could be made at any time for any purpose. RSAs are basically Roth IRAs, but with no income limit for contributions. They would have similar features to LSAs, except that contributions could not exceed earnings and withdrawals made before age 58 (or the death and disability of the owner) would be subject to a small penalty. Over time, these proposals would allow an increasing share of the returns to wealth to be sheltered from taxation (Burman, Gale, and Orszag 2003).

Despite these similarities, the tax cuts differ from fundamental reform in both their rules and their effects. A key difference in rules between the recent tax cuts and fundamental reform involves the tax treatment of interest payments. A well-designed income tax would tax interest income and allow deductions for interest payments. A well-designed consumption tax could treat interest the same way, or it could allow for nontaxation of interest income *coupled with nondeductibility of interest payments*. The key point is that *any* well-designed tax system would treat capital income and capital expenses in a consistent manner. Yet although it is embracing proposals that reduce or eliminate the tax on interest income, the Administration has not endorsed or proposed any such restrictions on deductions for interest borrowing.

Without such restrictions, cuts in the taxation of capital income expand the opportunities for tax sheltering. For example, consider someone who borrows $100 and deposits the money in a tax-free savings account. If the individual borrows the money in a tax-deductible form (for example, through a home equity loan), the net effect is to create a tax shelter. The investment returns on the account would be free from taxation, so no tax would be owed on the income, but the individual would still enjoy a deduction for the borrowing costs. Note also that there is no net investment in the example -- simply a tax-motivated asset purchase financed with debt. Gordon, Kalambokidis, Rohaly, and Slemrod (2004) argue that if "the ultimate destination of this set [i.e., the Bush Administration's] of tax reforms is a consumption tax base, then the most glaring omission from the discussion to date concerns interest deductibility."

The recent tax cuts and fundamental reform also differ in their effects. Perhaps the central reason to consider a consumption tax is the potential to raise national saving and thereby raise economic growth (Aaron and Gale 1996). It is therefore instructive to understand why many studies show that a well-designed consumption tax could raise national saving and growth while the analysis in earlier sections shows that the recent tax cuts will reduce national saving and growth.

One difference arises because the studies that show that consumption taxes raise growth examine revenue-neutral shifts in the structure of taxes (see the papers in Aaron and Gale 1996 and Zodrow and Mieszkowski 2002), whereas recent tax policies significantly reduced revenues. National saving is equal to private saving minus the government's budget deficit. A revenue-neutral switch to a consumption tax leaves the deficit unaffected and thus only needs to increase

private saving in order to raise national saving. Most studies suggest that positive, albeit modest, increases in private saving would occur under a well-designed consumption tax. Thus, the deficit-financed nature of the recent tax cuts reveals one flaw in the argument that the tax cuts are helping the nation evolve in steps toward a well-designed consumption tax. The revenue costs and the limited private saving response discussed above imply that the recent tax cuts reduce national saving, exactly the opposite of a fundamental goal of a consumption tax.

A second difference is that the recent tax cuts move the nation more toward a wage tax than a consumption tax. The fundamental difference between wage and consumption taxes involves the treatment of people who own assets at the time the new tax system is enacted.[24] A wage tax does not tax assets held at the time of the transition. A consumption tax does; it provides a tax break only for new saving, not for income or consumption out of existing capital. As a result, a consumption tax actually *reduces* the value of existing assets to their owners.[25]

Research indicates the taxation of assets held at the time of transition to a consumption tax is the source of almost all the increase in economic growth from such taxes.[26] Thus, a wage tax, which exempts from taxation the assets held at the time of the transition, does not provide the macroeconomic benefits that a consumption tax would.

By way of comparison, the 2001 and 2003 tax cuts not only do not impose a new tax on existing capital, they reduce taxes on existing capital. The reductions in capital gains and dividends taxes, for example, provide large benefits to owners of existing stocks and hence are not well-targeted toward exempting just new saving.

In effect, from the standpoint of economic growth, a major attraction of a consumption tax is the ability to place an additional tax on existing assets at the time of the transition. Yet the 2001 and 2003 tax cuts do exactly the opposite, reducing such taxes, and hence omitting much of the potential economic gains from a consumption tax.

Will the recent tax cuts make fundamental reform more likely?

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[24] Intuitively, this result stems from the fact that, under some simplifying assumptions, future consumption can be financed from existing assets or future wages. Thus, both items are taxed under a consumption tax. If existing assets are exempted, the result is a tax on wages.

[25] To see why, think of someone with $100 in the bank at the time a consumption tax is adopted. Under an income tax, the owner of the bank account could withdraw the money and spend it without being taxed. Under a consumption tax, though, the $100 would be taxed when it is withdrawn and spent. Since the $100 bank account does not buy as much, after tax, its value is reduced under a consumption tax.

[26] For example, Altig et al (2001) show that a standard flat tax with a personal exemption of $9,500 would raise the size of the economy by 2.2 percent after 14 years if assets held at the time of transition were subject to the tax, as they would be under a consumption tax. But if at least partial transition relief were granted for assets held at the time of transition (by continuing to allow depreciation allowances on such assets), the economy would only be 0.5 percent larger after 14 years.

From a political economy perspective, tax reform always combines gain and pain. The 2001 and 2003 tax cuts do the easy part of tax reform, but ignore the difficult part. Consider the 2003 dividend tax cut. Even before the dividend tax reduction, most corporate income in the United States was not taxed twice. A substantial share was not taxed at the corporate level due to shelters, corporate tax subsidies, and other factors. And half or more of dividends were effectively untaxed at the individual level because they flow to pension funds, 401(k) plans, and non-profits (Gale 2002). The problem is that the dividend tax cut undermines the political viability of true corporate tax reform. Any such reform would have to combine the carrot of addressing the "double taxation" of dividends with the stick of closing corporate loopholes and preferential tax provisions, to ensure that corporate income is taxed once and only once – but at least once. The dividend tax cut instead just gave the carrot away.

The same problem has occurred in the taxation of capital income generally. Enacting meaningful reform will require conforming the treatment of capital income and interest deductions. Yet by reducing the taxation of capital income without also restricting the ability to deduct interest payments, legislators gave away the easy part of reform and now have little to bargain with to make the treatment of interest income and expense compatible.

Summary

Tax cuts that reduce national saving, reward owners of existing capital, and retain deductions for borrowing costs while reducing the taxation of new capital income are not consistent with any sensible tax system – whether based on income, consumption, or wages. Taken to their logical conclusion, these tax cuts will not lead to a consumption tax, but rather to a system in which capital is actually subsidized (i.e., faces a negative tax rate on average) and labor income ends up bearing the full weight of supporting government services and more.

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