taxanalysts tax break

By William G. Gale and Peter R. Orszag

Bush Administration Tax Policy: Down Payment on Tax Reform?

William G. Gale is the Arjay and Frances Fearing Miller chair in federal economic policy at the Brookings Institution and codirector of the Tax Policy Center. Peter R. Orszag is the Joseph A. Pechman Senior Fellow at Brookings and codirector of the Tax Policy Center. The authors thank Matt Hall, Brennan Kelly, and Emil Apostolov for outstanding assistance. The views expressed are the authors' and should not be attributed to the trustees, officers, or staff of the Brookings Institution or the Tax Policy Center.

I. Introduction

This is the sixth installment in a series that summarizes and evaluates tax policy in the Bush administration.[1] This report examines the relationship between the proposed and enacted tax cuts and fundamental tax reform.

In think-tank circles and academic conferences, former top administration officials and other tax cut supporters sometimes defend the tax cuts as a piecemeal approach to fundamental tax reform and a way to move the nation toward a consumption tax. Those defenses are clever, since reform seems a more noble goal than merely slashing taxes. But the defense is flawed in several important ways:

- Consistent with fundamental reform, the recent tax cuts and Bush administration proposals have reduced marginal tax rates on capital income and flattened the rate structure. But the similarities end there.
- Studies show that a well-designed consumption tax can modestly raise national saving and economic growth. To obtain that result, though, the consumption needs to (a) be revenue-neutral; (b) broaden the base; (c) tax existing capital — that is, not provide transition relief; and (d) treat interest income and expense in a consistent manner. But the recent tax cuts (a) lose substantial amounts of revenue; (b) do not broaden the base; (c) reduce taxes on existing capital; and (d) increase the difference in the tax treatment of interest income and expense.
- Some tax cut supporters downplay those concerns, arguing that the criticisms represent the perfect being the enemy of the good. But the underlying point is that the system that emerges from the Bush tax cuts has many of the worst features of *both* the previously existing tax system and a fundamentally reformed system. The tax cuts will generate none of the potential growth effects of fundamental reform, and in fact will reduce long-term economic growth (Gale and Orszag 2004d). There will be no efficiency gains from broadening the base, because no base-broadening has occurred. There will be efficiency losses from increasing taxpayers' ability to shelter income, because of the enlarged difference between the taxation of capital income and capital expense. One feature that the current tax system now shares with fundamental reform, compared to the tax system before 2001, is increased regressivity (Gale and Orszag 2004b).
- Recent tax cuts and current proposals do not move the system toward a well-designed consumption tax or a well-designed wage tax. Instead, tax policy and proposals in the Bush administration move the tax system toward a wage tax that is imposed only on low- and middle-income households, because upper-income households would be able to take disproportionate advantage of the fact that capital income would be increasingly exempt from taxation, but interest payments would still be tax-deductible.
- By cutting revenue and rates without implementing any of the necessarily painful steps that real reform would necessarily entail, the tax cuts have probably also diminished the political possibilities of enacting a well-designed tax reform.

Section II discusses the key features of fundamental tax reform plans. Section III compares the rules and effects of recent tax cuts to the rules and effects of fundamental tax reform. Section IV discusses the ''five easy pieces'' approach to tax cuts. Section V discusses prospects for fundamental tax reform in light of the recent tax cuts. Section VI is a short conclusion.

II. Fundamental Tax Reform

The U.S. ''income'' tax features graduated tax rates and a narrow tax base that is a complex hybrid between consumption and income, with some features that are inconsistent with income or consumption taxation (Economic Report of the President 2003). Proposals for so-called fundamental tax reform — such as the flat tax (Hall and Rabushka 1995) or a national retail sales tax — aim to replace the current income tax, and sometimes other taxes as well, with a broad-based, flat-rate tax on consumption.

[1] The earlier contributions are Gale and Orszag (2004a, b, c, d, e).

A. Consumption Taxes

The theoretical case for a consumption tax is easy to understand: The goal is to raise national saving. Higher national saving would boost long-term economic growth and living standards, because it would provide more machines, computers, and other productivity-increasing equipment over time. Workers would enjoy higher earnings because, with the extra equipment, they would be able to produce more per hour.

All studies find that shifting to a *well-designed* consumption tax would generate at least modest increases in national saving and economic growth.[2] To be ''well-designed'' — that is, to generate an increase in national saving — a consumption tax needs to contain at least four features: (a) it should raise (at least) the same amount of revenue as the taxes it replaces; (b) it should broaden the tax base; (c) it should not provide transition relief to existing capital; and (d) it should treat capital income and expense consistently. Although the literature is unanimous in showing that a well-designed consumption tax raises national saving and long-term economic growth, the four features above are essential to obtaining that result. It is by no means clear that a consumption tax change that omits those features has positive economic effects.

It is clear why each of those design features matters. First, a consumption tax that raises the same amount of revenue as the taxes it replaces does not increase the federal deficit and thus does not reduce federal saving.[3] That makes it easier to raise national saving, the sum of private and public saving. The more public saving falls, the greater the increase in private saving needed to raise national saving.

Second, a broader tax base allows for lower tax rates, holding revenue constant. Even though consumption is smaller than income, a consumption tax could in principle have a broader base than the current ''income'' tax if the former taxes major consumption items like housing and healthcare that are subsidized in the current system. But that can not happen if a move to a consumption tax is achieved simply by eliminating the taxation of saving.

Third, a well-designed consumption tax reduces the taxation on new saving but not on the return to, or principal on, existing capital. In fact, it imposes an extra tax on existing capital. 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. Because the $100 bank account does not buy as much, after tax, its value is reduced under a consumption tax.[4]

As a result, the shift to a well-designed consumption tax would actually *reduce* the value of existing assets to their owners. A key finding in academic analysis is that almost all of the economic benefit from moving to a consumption tax derives from the one-time tax it places on existing assets.[5] In contrast, consumption taxes that provide transition relief to existing capital — even if they are well-designed in the other ways described above — generate little or no positive effect on long-term growth.

Fourth, a well-designed consumption tax would eliminate the ability of taxpayers to deduct interest costs if they are not required to pay tax on interest or other capital income.[6] Without such a restriction, large tax sheltering opportunities could be created. Imagine, for example, 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.

The principal downside to even a well-designed flat-rate consumption tax is that it is likely to be regressive relative to the current system. Moving from a pure income tax base to a pure consumption tax base, holding the rate structure constant, is regressive because lower-income families tend to consume a larger share of their income than higher-income families. Moving from a graduated rate structure to flat rates, holding the tax base constant, is also regressive, because it reduces the taxation of more affluent families relative to the less affluent. As a result, the combined shift in base and rates involved in moving from a progressive income tax to a flat-rate consumption tax is regressive.[7]

---

[2]For example, see the studies in Aaron and Gale (1996) and Joint Committee on Taxation (1997), and by Altig *et al.* (2001) and Judd (2001).

[3]To be clear, to obtain that result, the tax has to be budget neutral as well as revenue neutral. That is, the tax has to raise sufficient revenue to maintain the existing level of government programs. *See* Gale (1999) for further discussion of this issue in the context of a national retail sales tax.

[4]If the pretax price level falls after transition to a consumption tax, the issue is somewhat more complex but the basic result holds. *See* Bradford (1996).

[5]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 be only 0.5 percent larger after 14 years. If interest deductions on preexisting loans were grandfathered as well, the net effects on growth would be smaller and possibly negative. *See also* Auerbach (1996) and Engen and Gale (1996).

[6]More generally, it would treat capital income and capital expenses consistently. If interest income were taxed, interest expenses should be fully deductible.

[7]As a theoretical matter, the claim that moving from an income to a consumption base is regressive is not as simple to maintain if base broadening occurs at the same time, but studies confirm that a shift to a broad-based flat-rate consumption tax would be regressive compared to the current system (*see* Gale, Houser, and Scholz 1996, Gentry and Hubbard 1997, and Feenberg *et al.* 1997).

B. Wage Taxes

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. Intuitively, this result stems from the fact that, under some simplifying assumptions, future consumption can be financed from either (a) existing assets or (b) future wages. Both items are taxed under a consumption tax. But if existing assets are exempted, the result is a tax on wages.

Thus, a consumption tax imposes a tax on assets held at the time of the transition; future consumption that is financed out of existing assets is fully taxable. As a result, a consumption tax actually *reduces* the value of existing assets to their owners, as discussed above. In contrast, a wage tax does not impose any tax on existing capital. In short, the key difference between the two systems is whether "transition relief" is provided.

As noted above, the absence of transition relief is what generates most of the economic growth effects of consumption taxes. Accordingly, a wage tax has a smaller effect on economic growth than does a consumption tax. Moreover, it requires higher marginal tax rates, because wages are substantially smaller than consumption. Finally, a wage tax is significantly more regressive than a consumption tax, because ownership of assets is highly skewed toward high-income households.

III. The Recent Tax Cuts

This section describes the recent tax cuts, shows how they differ in rules and effects from well-designed consumption taxes, and concludes that the recent tax cuts move the system in the direction of what would effectively be a wage tax imposed only on low- and middle-income households.

A. Structural Features

The recent tax cuts share several features with fundamental reform plans. They reduce the top marginal individual income tax rates, reduce tax rates of capital income (dividends and capital gains) even further, and eliminate the estate tax. The bonus depreciation rules move toward a system in which 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 rulemaking to clarify its interpretation of the 1992 Supreme Court decision in *INDOPCO Inc. v. Commissioner*, 503 U.S. 79, *Doc 92-1849, 92 TNT 44-1* (1992). In *INDOPCO,* the Court ruled that expenses incurred by firms preparing for a friendly takeover had to be capitalized rather than expensed. The IRS rules put forward categories of safe harbors under which intangible assets could be expensed rather than 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.[8]

Moreover, proposals for greatly expanded tax-free saving accounts would push even further towards the 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).

As noted above, well-designed consumption taxes should have at least four features. They should be revenue-neutral. They should broaden the base. They should not subsidize old capital. They should eliminate disparities between the treatment of capital income and capital expense. The recent tax cuts fail all four of those tests.

Well-designed consumption taxes should have at least four features. The recent tax cuts fail all four tests.

First, the tax cuts are clearly not revenue-neutral. Over the 2001-2014 period, the enacted tax cuts, plus the costs of making the 2001 and 2003 tax cuts permanent, would represent a revenue decline of $3.3 trillion, and an increase in the budget deficit of $4.5 trillion (Gale and Orszag 2004c). The revenue cost of the administration's tax cuts should provide a telling warning that they do not even move in the right direction relative to the underlying goal of a well-designed consumption tax. The key objective of such a tax is to raise national saving. It is completely implausible, however, that any increase in private saving in response to the tax breaks would offset their revenue loss. The administration's deficit-financed tax cuts thus *reduce* national saving and economic growth rather than increase it — exactly the opposite of the fundamental goal of a consumption tax (Gale and Orszag 2004d). Rather than potentially trading off some increase in growth against more inequality in after-tax income, as under academic versions of a consumption tax, the tax cuts give us both lower growth and more inequality.

Second, while a well-designed consumption tax would broaden the base, the administration's proposals contain no significant movement in that direction. Third, the recent tax cuts *subsidize* old capital, exactly the opposite of what a consumption tax would do. The 2001 and 2003 tax cuts not only do not impose a new tax on existing capital, they reduce taxes on that capital. The reductions in capital gains and dividends taxes, for example, provide large benefits to owners of existing

[8]*See, e.g.,* Jack Taylor, "Tax Deductibility of Business Expenses," CRS Report for Congress, RS21194, April 2002.

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 those taxes, and hence omitting much of the potential economic gains from a consumption tax.

Fourth, 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 and other capital income, the administration has neither endorsed nor proposed any such restrictions on deductions for interest payments. As a result, the recent tax cuts increase the disparity in the treatment of capital income and expense. Proposals for RSAs and LSAs would move the system substantially farther in that direction. As explained above, without those restrictions, cuts in the taxation of capital income expand the opportunities for tax sheltering, as long as interest payments are deductible. Gordon, Kalambokidis, Rohaly, and Slemrod (2004) argue that if "the ultimate destination of this set [that is, 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."

B. A Wage Tax on Low-Income Households?

Households can always borrow and invest the funds. In a well-designed tax system, that set of transactions would generate no net gain, and of course it never generates net investment. Under the reforms advocated by the Bush administration, that set of transactions would generate no taxable capital income (if the funds were invested, say, in RSAs and LSAs), but would generate deductions for interest payments that could be used to reduce taxes on wage income. Because it seems likely that high-income households are either more financially sophisticated or can better afford financial advice, it also seems likely that the proposals advocated by the Bush administration would lead not just toward a wage tax, but toward a wage tax that was paid only by low- and middle-income households. These changes would imply that capital is subsidized and labor income bears both the full weight of supporting government services and of paying for the subsidies to capital income. That would be both extremely regressive and detrimental to economic growth.

IV. Five Easy Pieces

Policymakers have generally been reluctant to embrace the notion of replacing the current system with a broad-based, flat-rate consumption tax. Some advocates of moving to a consumption tax believe that this is just a political economy problem. They have therefore 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 piecemeal move toward a consumption tax. The strategy is embodied in the "five easy pieces" delineated by Christian and Robbins (2002). According to one formulation those five easy pieces would:

- reduce marginal income-tax rates, especially at the top;
- increase contribution limits for tax-preferred savings accounts;
- expense (write-off immediately) business investment;
- repeal the estate tax; and
- reduce dividend and capital gains taxes.

These five easy pieces are, presumably not by coincidence, reflected in the administration's recent tax cuts: The 2001 tax act reduced marginal tax rates and eventually repeal the estate tax. It also expanded contribution limits to IRAs and 401(k)s. The 2002 and 2003 tax acts included "bonus depreciation" provisions for expensing business investment, albeit only for part of capital outlays. The 2003 tax legislation reduced capital gains and dividends taxes. The administration has also promoted vastly expanded tax-free savings accounts.

The claim, according to Christian and Robbins and others, is that this package of steps would move the nation very close to a consumption tax with a flat rate of taxation. At first, that claim seems plausible. The expansion in tax-free savings accounts, reduction in dividends and capital gains taxes, and repeal of the estate tax, for example, would reduce or eliminate any tax on saving, as would also occur under a consumption tax. Indeed, as Bruce Bartlett, a leading conservative commentator, noted in early 2003, "we can now see that Bush has had a strategy all along that conforms exactly to the five easy pieces. . . . 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."

> ***The bottom line is that the five easy pieces are really just five, large, regressive tax cuts.***

First impressions, however, can be quite misleading. The five easy pieces fail all four tests of a well-designed consumption tax noted above. They are not revenue-neutral; instead, they reduce revenues substantially. There is no base-broadening. They do not impose any new burden on the owners of existing assets, as would occur under a consumption tax; indeed, they subsidize the return to old capital. And they increase the disparity between the tax treatment of interest income and interest deductions. The bottom line is that the five easy pieces are really just five, large, regressive tax cuts.

V. Prospects for Fundamental Reform

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 they ignore the difficult part, and in so doing, will make reform harder, not easier, to achieve.

For example, a well-enshrined principle of tax reform is to broaden the base and lower the rates. Broadening the base involves painful adjustments, because it removes a variety of subsidies or special exemptions. Normally, those adjustments are made possible, politically, by a reduction in tax rates (such as in 1986). But the 2001 and 2003 tax cuts reduced regular income tax rates without any effort to broaden the base. Thus, a chance at reform was squandered, and the ability to use those rate reductions as fodder to induce a well-defined reform has been lost.

The 2003 dividend tax cut provides a second example. 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 nonprofits (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 substantially less to bargain with to make the treatment of interest income and expense compatible.

Broadening the base is always a difficult sell politically, because it creates losers. It is especially difficult, perhaps impossible, as a stand-alone policy because President Bush and almost all Republicans in Congress have signed the ''no new taxes'' pledge (Gale and Kelly 2004).

VI. Conclusion

The Bush tax cuts enacted to date, and the proposed additional policies, would reduce national saving, reward owners of existing capital, and create new shelters by substantially reducing the taxation of capital income, while retaining deductions for borrowing costs. Those features are not consistent with *any* sensible tax system — whether based on income, consumption, or wages. Moreover, the changes will prove regressive and will make the changes associated with serious tax reform more difficult to establish in the future. That hardly amounts to an agenda for fundamental tax reform.

References

Aaron, Henry J., and William G. Gale. 1996. *Economic Effects of Fundamental Tax Reform*. Brookings Institution Press.

Altig, David E., Alan J. Auerbach, Lawrence J. Kotlikoff, Kent Smetters, and Jan Walliser. 2001. ''Simulating Fundamental Tax Reform in the United States.'' *American Economic Review* 91(3): 574-95. June.

Auerbach, Alan J. 1996. ''Tax Reform, Capital Allocation, Efficiency and Growth.'' In Henry J. Aaron and William G. Gale, eds., *Economic Effects of Fundamental Tax Reform*, 29-81.

Bartlett, Bruce. 2003. ''Bush's High Five.'' *National Review Online*. February 10. http://www.nationalreview.com/nrof_bartlett/bartlett021003.asp

Bradford, David F. 1996. ''Consumption Taxes: Some Fundamental Transition Issues.'' In Michael J. Boskin, ed. *Frontiers of Tax Reform*. Stanford, CA: Hoover Institution Press, 123-150.

Burman, Leonard E., William G. Gale, and Peter R. Orszag. 2003. ''The Administration's Savings Proposals: Preliminary Analysis.'' *Tax Notes* 98(10): 1423-46. March 3.

Christian, Ernest S., and Gary A. Robbins. 2002. ''Stealth Approach to Tax Reform.'' *The Washington Times*. November 1.

Economic Report of the President. 2003. Washington, DC: US Government Printing Office.

Engen, Eric M., and William G. Gale. 1996. ''The Effects of Fundamental Tax Reform on Saving.'' In *Economic Effects of Fundamental Tax Reform*. Henry J. Aaron and William G. Gale, eds. Brookings Institution Press. 83-111.

Feenberg, Daniel R., et al. 1997. ''Distributional Effects of Adopting a National Retail Sales Tax,'' *Tax Policy and the Economy* 11: pp. 49-90.

Gale, William G. 1999. ''The Required Tax Rate in a National Retail Sales Tax.'' *National Tax Journal.* 52 (3): 443-57. September.

Gale, William G. 2002. ''About Half of Dividend Payments Do Not Face Double Taxation.'' *Tax Notes* 97(6): 839. November 11.

Gale, William G., Scott Houser and John Karl Scholz. 1996. ''Distributional Effects of Fundamental Tax Reform.'' In *Economic Effects of Fundamental Tax Reform*. Henry J. Aaron and William G. Gale, eds. Brookings Institution Press. 281-315.

Gale, William G. and Brennan Kelly. 2004. ''The No New Taxes Pledge.'' *Tax Notes* 104(2): 197-209. July 12.

Gale, William G., and Peter R. Orszag. 2004a. ''Tax Policy in the Bush Administration: Introduction and Background.'' *Tax Notes* 104(12): 1291-1300. September 13.

Gale, William G., and Peter R. Orszag. 2004b. ''Tax Policy in the Bush Administration: Distributional Effects.'' *Tax Notes* 104(14): 1559-1566. September 27.

Gale, William G., and Peter R. Orszag. 2004c. ''Tax Policy in the Bush Administration: Revenue and Budget Effects.'' *Tax Notes* 105(1): 105-118. October 4.

Gale, William G., and Peter R. Orszag. 2004d. "Tax Policy in the Bush Administration: Effects on Long-Term Growth." *Tax Notes* 105(3): 415-423. October 18.

Gale, William G., and Peter R. Orszag. 2004e. "Tax Policy in the Bush Administration: Short-Term Stimulus." *Tax Notes*. 105(6): 747-756. November 1.

Gentry, William M., and R. Glenn Hubbard. 1997. "Distributional Implications of Introducing a Broad-Based Consumption Tax." In *Tax Policy and the Economy*. James M. Poterba, ed. volume 11, Cambridge: MIT Press.

Gordon, Roger, Laura Kalambokidis, Jeffrey Rohaly, and Joel Slemrod. 2004. "Toward a Consumption Tax and Beyond," Presented at American Economic Association annual meetings. January.

Hall, Robert, and Alvin Rabushka. 1995. *The Flat Tax*. Stanford: Hoover Institution Press.

Joint Committee on Taxation. 1997. "Joint Committee on Taxation Tax Modeling Project and 1997 Tax Symposium Papers." November 20.

Judd, Kenneth. 2001. "The Impact of Tax Reform in Modern Dynamic Economies" in Kevin A. Hassett and R. Glenn Hubbard (eds.): *Transition Costs of Fundamental Tax Reform*, Washington, D.C.: AEI Press, pp. 5-53.

Zodrow, George R., and Peter M. Mieszkowski. 2002. *United States Tax Reform in the 21st Century.* Cambridge University Press.