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Tax Reform Options in the Real World

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Introduction

The basic description of a desirable tax system is broadly accepted: It should raise the revenues needed to finance government spending in a manner that is as simple, equitable, stable, and conducive to economic growth as possible. Although people agree that the current system clearly falls short of at least some of these goals, it is not easy to point to examples around the world that work much better. In addition, how the system should be reformed is subject to enormous controversy. People define the underlying goals differently—notions of fairness, for example, are clearly "in the eyes of the beholder." People disagree on the most effective policies for attaining a particular goal, such as more economic growth. And most importantly, people have differing value judgments, which make agreement on policy almost impossible in the nearly ubiquitous case where there are tradeoffs among the goals.

In addition, although all of us are attracted to well-designed tax reforms, the real challenge is changing the system in a way that will work not only on paper, but also in the real world. In practice, the changes needed to make idealistic tax proposals acceptable in a world populated by politicians, lobbyists, tax shelter experts, and taxpayers who want their own individual taxes cut and who have strong, but malleable views on equity and enforcement almost always make taxes more complex, less fair, and less consistent with economic prosperity. Nevertheless, there is currently a real opportunity for tax reform that should be taken seriously.

Driving Forces for Reform

In addition to ongoing concerns about the complexity, inequity, and inefficiency of the current system, at least three factors imply a pressing need for significant changes to the tax system.

First, the central tax question facing the country currently is not tax reform, but the extent to which the Bush administration's tax cuts—all of which expire between now and 2010—should be made permanent and, if so, how they would be financed. The loss in revenues from making the tax cuts permanent would be enormous: equal to several times the resources needed to repair the entire Social Security problem, which the president has declared a "crisis" (Gale and Orszag 2004a). We do not know how this fiscal hole would be filled because, despite advocating basically the same tax policy since 1999, the administration has never proposed a way to pay for the cuts and, in each of the last two years, actually proposed to change the accounting rules in a way that would have let the tax cuts be made permanent without even showing a cost in the budget baseline. In fact, the tax cuts can only be paid for with increases in other taxes or lower spending. The required changes, though, would be enormous. For example, in 2015, if reductions for Social Security, Medicare, Medicaid, defense, homeland security, and net interest were off limits, the rest of federal spending would have to be cut by almost half, just to pay for the revenue loss from the tax cuts. Alternatively, a roughly 120 percent increase in corporate tax revenues would cover the revenue loss. To the extent that tax increases or spending cuts do not occur soon—and they do not seem likely—the revenue losses would have to be financed by borrowing, which merely postpones the ultimate payment. Moreover, the net effect of the tax cuts plus borrowing would be to reduce long-term economic growth, according to studies by academics and the Congressional Budget Office (Gale and Orszag 2004b), which would put the nation in a weaker long-term economic situation.

The second problem is the alternative minimum tax (AMT). Taxpayers pay the AMT when their AMT liability exceeds their regular income tax liability. Designed in the late 1960s and strengthened in 1986, the AMT operates parallel to the regular tax system and was originally intended to capture tax on excessive sheltering activity. The tax has evolved, however, so that it does not tax many shelters and it does tax a variety of items—like having

children, being married, or paying state taxes—that most people do not consider shelters. Moreover, the number of taxpayers facing the AMT is slated to grow exponentially, from about 3 million today to 30 million by 2010, under current law, both because regular taxes are slated to fall and because the AMT is not indexed for inflation. This expansion will increase the inequity and complexity of the tax system (Burman, Gale, and Rohaly 2003).

The third issue is the expected increase in government spending over the next several decades. Since 1950, tax revenues have hovered between 16 and 20 percent of GDP. Under current projections, however, government spending is expected to rise to about 27 percent of GDP by 2030 (Rivlin and Sawhill 2005). This increase is fueled mainly by rising entitlement spending for Social Security and especially Medicare and Medicaid, trends which are fueled in turn by increases in the number of elderly households and in health-care expenditures per capita. Unless the country is willing to make truly massive cuts in such expenditures relative to their projected values, a significant increase in revenues above 20 percent of GDP will be required. Revenues in 2004 were at their lowest share of GDP since 1959. If the tax cuts are made permanent and the AMT reduced to manageable levels, revenues would be a smaller share of GDP when the baby boomers begin retiring en masse in about five to seven years than the average revenue share over the past thirty years. This would leave the country unprepared for addressing the coming budget problems.

All of these issues will play out against the backdrop of a political system that features both houses of Congress and the White House held by a majority party whose members have overwhelmingly signed the "no new taxes" pledge, yet who also voted overwhelmingly for the largest entitlement increase in recent history (the Medicare prescription drug benefit), cut taxes four times in four years (Gale and Kelly 2004), and in 2004 passed one of the most loophole-laden tax acts in recent memory.

Fundamental Reform

The most radical approach to tax reform would be to junk the whole system and start over. Under a national retail sales tax (NRST), for example, a single tax rate would apply to all sales by businesses to households.

Sales between business and between households would be untaxed. Under a value-added tax (VAT), each business would pay tax on the sum of its total sales to consumers and to other businesses, less its purchases from other businesses, including investments. Thus, the increment in value of a product at each stage of production would be 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 in theory as in an NRST. The flat tax, originally developed by Hoover Institution scholars Robert Hall and Alvin Rabushka (1995), is simply a two-part VAT: The business tax base would be exactly like the VAT except that businesses would also be allowed deductions for wage payments and pension contributions. Individuals would pay tax on wages and pension income that exceeded personal and dependent exemptions. Businesses and individuals would be taxed at a single positive flat rate.

The NRST, the VAT, and the flat tax are all flat-rate, broad-based consumption taxes. Advocates claim that fundamental tax reform could boost growth significantly, slash tax burdens, simplify compliance, and eliminate the IRS. Unfortunately, however, a more realistic assessment is less sanguine.

The required tax rate in the national retail sales tax to replace almost all existing federal taxes and maintain government programs would be at least 40 percent and probably significantly higher—not the 23 percent rate advertised by its supporters (Gale 1999).

The pure flat tax could replace the existing income and corporate tax with a rate of about 21 percent if there were no serious avoidance problems (but see below). But doing so would cause significant relocation in the economy, and declines in charitable contributions, real housing prices, and the number of households with health insurance. Businesses' tax liability would vary dramatically relative to the current system, and they would find taxes were no longer based on profits. Realistic versions of the flat tax—which smoothed out these problems by allowing transition relief; individual deductions for mortgage interest, charity, and state taxes; and business deductions for health insurance and taxes—would require tax rates of 30 percent or higher (Aaron and Gale 1996).

These rate estimates assume there is little or no (legal) avoidance or (illegal) evasion of taxes. But experience in other countries shows that a national retail sales tax would have difficulty controlling tax evasion if

rates went much above 10 percent. Under the flat tax or X tax, firms could easily relabel cash flows and reduce their taxes substantially (McLure and Zodrow 1996).

Both the NRST and the flat tax would provide large tax cuts for the wealthiest households and make up the revenue with tax increases on low- and middle-income households. The X tax is a variant of the flat tax that would introduce graduated taxation of wages and has the potential to be somewhat more progressive than the flat tax.

Many of the problems and tradeoffs created by fundamental tax reform could be mitigated if reform boosted growth dramatically. In their pure form, the NRST and flat tax could have positive effects on economic growth, but when the taxes were subjected to the realistic considerations noted above and the higher tax rates such considerations would require, studies suggest that the taxes would likely generate little if any net growth and could actually reduce growth (Aaron, Gale, and Sly 1999).

An alternative fundamental reform plan, the USA tax, would replace the existing tax system with a VAT on businesses with a personal consumption tax. Under the personal tax, people would report all income from earnings, investments, and receipt of loans, but they would be allowed a new deduction for all net saving and repayment of loans. Thus, the personal tax falls on the difference between income and saving, which is consumption. In addition, the USA tax would retain some of the deductions and credits allowed under the current personal income tax and would have progressive rates. The USA tax has been judged to have substantial administrative problems.

Five Easy Pieces

Completely replacing the existing system would create enormous administrative, legislative, and economic upheavals. This has led some to advocate piecemeal or partial replacement of the income tax system.

The basic notion is that by making changes one at a time, progressive taxes on income and wealth can be transformed into a flat consumption tax. The changes typically include: reductions in marginal income-tax rates, especially for high-income households; increases in contribution

limits for tax-preferred savings accounts; expensing (immediate write-offs) of business investment, rather than depreciation over time; repeal of the estate tax; and a reduction in dividends and capital gains taxes. Many of these items are reflected in the administration's recent rate cuts, dividend and capital gains tax cuts, expansions of contribution limits to IRAs and 401(k)s, and temporary "bonus depreciation" provisions. The administration has also promoted expanded tax-free savings accounts.

The problem is that these changes do not add up to a well-defined tax system. First, a well-designed consumption tax would (a) collect adequate revenues to cover expenditures over time and avoid reducing national saving through higher government deficits; (b) broaden the base to lessen interference in the economy; (c) tax already-existing capital—that is, concentrate any revenue relief on new saving or investment; and (d) treat interest income and expense in a consistent manner. But the recent changes and the piecemeal proposals fail all four tests. In combination, they (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 overhaulers downplay such concerns, arguing that the criticisms represent the perfect being the enemy of the good. But the underlying point is that the system that emerges has many of the worst features of *both* the previously existing tax system and a fundamentally reformed system. First, the tax cuts accompanied expenditure expansion, leading to deficits that may reduce long-term economic growth. Second, there will be no efficiency gains from broadening the base if no base-broadening occurs. Third, there will be efficiency losses from increasing taxpayers' ability to shelter income if there are enlarged differences between the taxation of capital income and capital expense. Particularly important here is 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 tax borrowing and allow deductions for lending (saving), 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 symmetric, consistent manner. Proposals for expanded tax-preferred saving accounts would move the

system even further toward treating the two sides of the ledger inconsistently and increase opportunities for tax sheltering.

Finally, since it seems likely that high-income households are more financially sophisticated and can better afford financial advice, proposals simply to expand nontaxable saving deposit vehicles could lead not just toward a wage tax, but toward a wage tax that was only paid by low- and moderate-income households (who could not so easily reduce their tax base even below wages paid through the use of interest deductions).

"Back to the Future"

Yale University Law Professor Michael Graetz has a proposal he describes as "Back to the Future" (Graetz 2004). He would, among other things, raise the income tax exemption to about $100,000, tax income above that level at a flat 25 percent tax rate, remove some shelters from the income tax, and cut the corporate tax rate in half. This would cut revenues from these taxes in half, and the lost revenue would be replaced by a broad-based VAT.

This proposal has significant advantages. It would reduce the number of income tax returns filed by roughly 100 million. Transition problems would be reduced relative to fundamental reform because the income tax and corporate tax would not be abolished.

But there are also a number of concerns. The main issue is that the proposal has not been specified in sufficiently detailed manner to gauge its effects. Relevant details include what would be excluded from the VAT base; which low-income credits would be retained, and what mechanism would be used to provide those credits (since these households would not file income tax returns); and how the income tax base would be structured. Although the proposal is intended to be neutral with respect to revenue and distribution, in the absence of additional details it is unclear what the implications of those constraints are for the required tax rates and relevant tax bases. My own estimates suggest that a VAT rate of about 15–20 percent would be required, which would make it difficult to maintain distributional neutrality. Also, if states did not abolish their income tax or raise their exemptions to $100,000, there would be little saving in tax complexity.

Real-World Reforms

The following options may be less ambitious than the ones discussed above, but may in turn prove more enactable and indicate ways that the existing system could be made simpler, fairer, more conducive to economic growth, and consistent with spending needs.

Integrate the Corporate and Individual Income Taxes. Only about a quarter of corporate income appears to be taxed at both the individual and corporate level, and all of that is now taxed at a maximum rate of 15 percent at the personal level. Corporate income can avoid taxes at the corporate level through shelters. It can avoid taxation at the individual level to the extent that it accrues to nonprofits and pensions. About one quarter of corporate income is taxed at the individual level, but not the corporate level; one quarter is taxed at the corporate level, but not the individual level; and one quarter appears never to be taxed (Gale and Orszag 2003). While the emphasis and public discussion has been on the so-called double taxation of corporate income, the nontaxation of corporate income is probably an even bigger problem.

Reforming, or integrating, the individual income tax and corporate income tax should involve several features that need to be dealt with *simultaneously*. First, the integration should occur only for income stemming from new corporate investment. There is no reason to give tax breaks on the income stemming from old investments; those tax breaks would be windfall gains. Second, individual-level taxation of corporate dividends and capital gains (on new investments) should be removed only if the full tax has been paid on the income at the corporate level. If corporate taxes were not paid, then corporate dividends and capital gains should be taxed at the *full* individual rate (not capped at 15 percent). Third, efforts to shut down corporate tax sheltering need to be beefed up substantially. This could include both increased enforcement as well as altered accounting procedures that require more conformity between book and taxable income. Fourth, a wholesale attack on corporate tax expenditures would be a final, key element in this package. To be clear, my sense is that this package of changes would likely raise net federal revenues from corporate source income.

Integrate the Payroll and Individual Income Taxes. For about 70 percent of all households, and virtually all filers in the bottom 40 percent of the income distribution, payroll tax burdens exceed income tax payments (Tax Policy Center 2003). The payroll tax imposes a burden of roughly 15 percent on the very first dollar of earnings. In contrast, a family of four does not fall into the 15 percent marginal income tax bracket until its income exceeds $36,000, and it does not pay an average 15 percent income tax rate until its income is $120,000, which is actually higher than the payroll tax cap for Social Security. Integrating the payroll tax and the income tax could take different forms, but each would make the burden of payroll taxes more progressive. This would be particularly important if a consumption tax were either added to the system or replaced part of the system, to offset some of the regressivity of that tax.

Simplify. There are a number of ways to simplify the system, even without enacting fundamental reform. The administration's efforts to unify the definition of a child in the tax code are one such example. Return-free filing could be achieved for as many as 50 million taxpayers with relatively minor changes in the tax code. Return-free filing is in existence in dozens of countries around the world and would relieve the hassles of filing and compliance for the households least able to address such issues. The number of households who could avoid filing would be greatly enhanced, and other simplifications would occur, if the personal exemption, the child credit, and the earned income credit were consolidated into a single program, and if the standard deduction were increased. Likewise, increasing the standard deduction by the value of a personal exemption and reducing the number of personal exemptions by one would simplify taxes further by reducing the number of people who itemize. In addition, education subsidies could be consolidated and streamlined, as could retirement saving programs.

Restructure Deductions into Credits. On simplicity, equity, revenue, and possibly efficiency grounds, the itemized deductions should be converted to refundable, flat-rate, capped credit. Although they are immensely popular and subsidize activities thought of as "good," itemized deductions create numerous problems. They largely subsidize activity that would have occurred anyway. They complicate tax filing and enforcement. They erode

the tax base and are regressive, giving bigger benefits to high-income than low-income filers. Finally, the deductions hide subsidies that would be obvious if they were spending programs. Imagine that instead of a mortgage interest deduction, we had a program called "homeowner welfare," in which taxpayers earned a "welfare entitlement" equal to their annual mortgage interest payment times their tax rate. Anyone whose entitlement was below a certain threshold, say $6,000, would receive nothing. Anyone whose entitlement exceeded the threshold would receive the entitlement in cash. This program would be decried as wasteful and a sop to the rich. Yet it is not dissimilar to the way the mortgage interest deduction works. Items that represent true reductions in ability to pay taxes should be deducted in full, but none of the itemized deductions completely meets that standard. Relative to current law, converting the deductions to 15 percent credits would reduce revenue loss, dampen regressivity, minimize the other unfair aspects of deductions, and simplify tax filing. At the same time, it would continue to allow a subsidy for activities that society may deem as "preferred" for one reason or another.

Fix the Alternative Minimum Tax. The alternative minimum tax should be abolished, if—and these are some big ifs—(a) the anti-tax-sheltering provisions of the AMT are brought into the income tax, (b) dividends and capital gains are taxed as described above, and (c) the revenue is made up by adjusting income tax rates. Alternatively, the AMT could be retained, but reformed in a revenue-neutral manner that would raise the AMT exemption substantially, to remove the middle class from the tax, and would include dividend and capital gains as preference items, to restore the AMT's goal of closing shelters.

Raise Private and National Saving. The enormous efforts over the past twenty-five years to stimulate private saving by providing tax incentives for *contributions* to particular accounts (which is quite different from "saving") do not appear to have been very successful in raising overall private saving, and they have been even less successful in raising national saving, the sum of private and public saving. Currently, federal tax expenditures for pensions and other saving incentives are larger than the entire level of personal saving.

Part of the problem is that the accounts do not subsidize saving, which requires a reduction in consumption spending and living standards. Instead, they merely subsidize contributions into an account. These contributions can be made in many "painless" ways that do not involve reducing one's living standard. High-income, high-wealth households are the most able to make such painless contributions, drawing from income they would have saved anyway or assets they already have saved. Another part of the problem is that the immediate incentive to contribute—as measured by the tax deductions that are allowed—is largest for the same high-income households. Finally, the ability to finance the contributions to such accounts with interest deductions creates tax shelter opportunities and should be restricted, as the chapters in this volume by Hall, Pearlman, and Slemrod point out.

Studies that acknowledge the role of precautionary needs for saving and the extent of saving incentives already in the current system generally find that a consumption tax would have a very small impact on the national saving rate (Engen and Gale 1996; Samwick 1998). In short, if increasing saving is the problem, tax reform is unlikely to be the answer.

A much more effective, less expensive, and simple approach to encouraging national saving—and the economic growth it can generate—is to improve the operation of existing accounts by encouraging automatic enrollment and automatic escalation of contributions over time in existing 401(k) accounts. This would raise contribution rates among low- and moderate-income workers who are less likely to be using the accounts as tax shelters. Likewise, encouraging people to save their tax refunds or allowing automatic payroll deductions for individual retirement accounts would have similar effects. Relative to increasing contribution limits for tax-preferred saving or moving to a consumption tax, these options would raise national saving as much or more, and would be more progressive (Gale, Iwry, and Orszag 2005).

Improve Administration. An intelligent tax reform would equip the Internal Revenue Service with the resources it needs to enforce and administer the system. Many taxpayers simply do not pay taxes they actually owe, while the IRS lacks the resources to enforce payment. Providing

the IRS with additional resources generally would boost revenues, provided the money is put to enforcement. At the same time, one can only go so far in this direction, as the additional manpower used reduces net product in the economy as a price for producing a fairer distribution of the tax burden.

Meet Government Spending Needs. Given the spending trends noted above, serious thought needs to be given to the best way to structure taxes designed to raise *additional* revenues. Note that higher revenue needs make it even more important to keep rates as low as possible and the base as broad as possible. I do not think we can extract another 5 to 10 percent of GDP in revenues out of the current individual and corporate income tax system. The needed changes would raise rates too high to be economically sound.

One possibility for added revenue, especially if income tax rates are held at 35 percent, would be to apply a Social Security tax at 3 percent on all earnings above the current earnings cap, similar to Medicare's 2.9 percent rate.

Other options involve new taxes. One possibility here—at least one where there is very strong evidence that it can be administered—is a VAT. A broad-based VAT, one with only a few exclusions, would generate revenue of about 0.6 percent of gross domestic product for each 1 percentage point of tax. It would also increase the cost of government purchases and reduce the income tax base. The net contribution to deficit reduction, therefore, would be about 0.4 percent of GDP for each 1 percentage point of tax. On net a 10 percent VAT, then, could raise an additional 4 to 5 percent of GDP in revenue if the VAT tax base were kept fairly broad. The great advantage of a VAT over a national retail sales tax is that the VAT is a proven collection system in force in more than one hundred countries around the world. Exporters could follow established procedures for getting rebates at the border. Unlike the retail sales tax, the VAT does not have great difficulty in taxing services, as opposed to goods. One form of VAT uses credits that effectively reduce the amount of cheating by requiring users of inputs to make up for missing VAT if their input suppliers have not paid them. Administrative concerns make the NRST a much more iffy proposition, even as a supplement to the existing system.

The VAT could even be earmarked to cover Medicare and Medicaid costs, offering the public a natural way to check its own enthusiasm for ever-higher health-care spending.

Another option would be a tax on, or market in, carbon emissions, which would likely raise significantly less revenue than a VAT. It raises issues in environmental policy that are well beyond the scope of this chapter, but merits serious consideration.

Conclusion

Tax reform is an opportunity to focus on several broader issues that tend to get lost in everyday discussions and politicking. First, the *level* of revenues society is willing to collect should be consistent with the level of government services society would like to provide. Second, the *structure* of revenues should be more consistent in the way it treats assets and debt. Third, a major tax reform is perhaps the only opportunity society will have for a long period of time to make simplification a guiding focus of policy changes and to clean special provisions out of the code. A reform consistent with these three items and not unduly regressive or progressive would not only command substantial political support, but it would also improve the operation of the tax system and the economy.

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