

## Fixing the Tax System

### Support Fairer, Simpler, and More Adequate Taxation

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#### Summary

A good tax system raises the revenues needed to finance government spending in a manner that is as simple, equitable, stable, and conducive to economic growth as possible. But the challenge for the next President will be to make reform work not just in the abstract, but in the real world, where special interests often rule the roost. The next President should support reforms that would tax all income once (only) at the full tax rate, simplify and streamline the tax code, and, of course, raise sufficient revenues. To achieve these goals, the package of specific reforms proposed in this paper would:

- tax all new corporate investment income only once
- remove all corporate subsidies in the Code and strengthen corporate anti-sheltering provisions
- integrate payroll and income taxes for individuals
- introduce return-free filing for many taxpayers
- consolidate and streamline tax subsidies for education, retirement and families
- eliminate or revise various tax deductions
- create a value-added tax that would, eventually, raise 5 percent of the gross domestic product (GDP) in revenues



## Context

In the next few years, several factors will push tax issues to the forefront of policy discussions. First, under current law, almost all of the Bush administration's tax cuts will expire at the end of 2010. The loss in revenues from making the tax cuts permanent would be enormous—equal to several times the resources needed to repair Social Security—and economic growth is unlikely to come anywhere close to covering that loss. As a result, the required spending reductions would be enormous, too. For example, if certain key programs—Social Security, Medicare, Medicaid, defense, homeland security, and net interest—were off-limits, all other federal spending would have to be cut by *almost half*.

A second factor is the rapid growth in the alternative minimum tax (AMT), which will increase the inequity and complexity of the tax system. Tax filers 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, because the AMT is not indexed for inflation and because some temporary AMT tax cuts are about to expire.

A third issue—which may not require immediate action, but should nevertheless help frame the current debate—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 projected to rise to about 27 percent of GDP by 2030. This increase is fueled mainly by increased entitlement spending for Social Security and especially Medicare and Medicaid. Unless candidates are willing to suggest truly massive cuts in such programs,

they will have to come to terms with the need for an increase in revenues to above 20 percent of GDP.

Despite these pressures on the system, tax changes are not inevitable, and achieving meaningful reform—that is, with substantial design improvements—will require strong political leadership.

## **Why Junking the Income Tax Isn't the Answer**

Discarding the nation's existing Byzantine tax system and instituting "simple" flat-rate taxes have visceral appeal, and some candidates have endorsed reform proposals using this approach. However, when real-world implementation issues are considered, each of these proposals has significant drawbacks. The three primary flat-rate reforms are:

- A national retail sales tax (NRST), under which a single tax rate would apply to all sales by businesses to households. Sales between businesses and between households would be untaxed.
- A value-added tax (VAT), requiring each business to 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—in theory, 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 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 flat rate.

These three models are all flat-rate, broad-based consumption taxes. Some people would like to use such taxes to *replace* our current graduated-rate, narrowly-based

income tax. Advocates claim that such fundamental reforms could boost economic growth significantly, slash tax burdens, simplify compliance, and eliminate the IRS. Unfortunately, a more realistic assessment is less optimistic.

In order to replace almost all existing federal taxes and maintain government programs, a national retail sales tax would require mark-ups at the cash register of *more than 40 percent*, not the 23 percent rate advertised by plan supporters.<sup>1</sup> This assumes there is little or no legal avoidance or illegal evasion of taxes. Experience in other countries, however, shows that a national retail sales tax would have difficulty controlling tax evasion if rates went much above 10 percent. Higher evasion, in turn, would require even higher tax rates to raise the necessary revenue.

The pure flat tax could theoretically replace the existing income and corporate tax with a rate of about 21 percent (and all federal taxes with a rate of about 32 percent) but could result in significant dislocation in the economy and declines in charitable contributions, real housing prices, and the number of households with health insurance. Businesses would find their tax liability varied dramatically from the current system and would no longer be based on profits. For example, Hall and Rabushka show that under their flat tax, General Motors' 1993 tax liability would have risen by a factor of 25, from \$110 million to \$2.7 billion. In contrast, Intel's would have fallen by three-quarters.

More realistic versions of the flat tax—which would smooth out these problems by allowing transition relief; individual deductions for mortgage interest, charitable contributions, and state taxes; and business deductions for health insurance and taxes—would require flat tax rates of 30 percent or higher just to replace individual and corporate income taxes. In addition, under the flat tax, which has never been

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<sup>1</sup> The advocates of the sales tax made a simple logical error in calculating the required tax rate. When they estimated government revenues that a sales tax would generate, they implicitly assumed that, relative to the current economy, consumer prices (what consumers pay, including taxes) would rise by the full amount of the sales tax. But when they estimated the amount of government spending that would be needed under a sales tax to maintain government programs, they implicitly assumed that consumer prices (including the sales tax) would remain unchanged from the current system. This inconsistency led to a systematic and substantial understatement of the required tax rate (Gale, 2005; President's Advisory Panel on Tax Reform, 2005).

tried as a stand-alone system anywhere in the world, it appears that firms could re-label cash flows and shelter significant amounts of income, which would require even higher tax rates to make up the difference.

Junking the current system and moving to a NRST, VAT or flat tax would provide massive tax cuts for the wealthiest households and increase the tax burden on low- and middle-income households. (The so called “X-tax” is a variant of the flat tax that would introduce graduated taxation of earned income. The X-tax would be more progressive than the flat tax and would reduce, but not eliminate, the distributional disparities.)

Many of the problems and tradeoffs created by these types of tax reform could be mitigated if they boosted economic growth dramatically. In their pure forms, the NRST and flat tax could have positive effects on economic growth, but when the taxes are subjected to the realistic considerations noted above, studies indicate that they would likely generate little if any net growth in the economy and actually could retard it.

## **Five Essential Reforms**

The next administration can propose a number of reforms that would make taxes significantly simpler, fairer, more conducive to economic prosperity, and responsive to likely government spending increases.

### **Tax All Capital Income Once and Only Once At the Full Income Tax Rate**

The taxation of capital income—the return from saving—in the current system is, in plain terms, a mess. A family’s saving is the difference between its income and what it spends on consumption. Thus, the difference between an income tax and a consumption tax hinges on the treatment of saving. The current tax system’s treatment of saving has features of both types of tax. In some cases—notably the treatment of 401(k) plan investments—the system operates like a consumption tax; in others, it operates like an income tax—for example, the interest income on a saving account is subject to tax every year. Unfortunately, by combining features of an

income and a consumption tax, the system creates the opportunity to shelter income.<sup>2</sup>

Now consider the complexities of corporate taxation. The issue of “double taxation” of corporate income has received some public attention. This occurs when earnings are taxed at the corporate level and then paid to individuals as dividends, where they are taxed again. But today, no corporate income is fully double-taxed, since dividends are now taxed at only 15 percent. Corporate income can avoid taxes at the corporate level through shelters and at the individual level to the extent that the income accrues to nonprofits and pensions. As a result, only about a quarter of corporate income appears to be taxed at both the individual and corporate levels, whereas 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 at all.

The bottom line is that capital income is taxed at greatly different rates depending on the organizational form, the type of activity where the investment is deployed, the type of asset, the type of financing, and so on. This is inequitable, inefficient, and complicated. As a result of taxpayers’ ability to use these conflicting rules to their advantage, some analysts conclude that the country collects little if any net revenue from capital income taxes. *The solution is to tax all capital income once and only once at the full income tax rate.* Reforming this part of the system would require policymakers to address several issues *simultaneously*.

- First, the integration of corporate and individual capital taxation 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. To the extent that corporate taxes were not

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<sup>2</sup> For example, if families borrow money by taking out a second mortgage, the interest payment is tax-deductible. But if they use the money to invest in a 401(k) plan, the tax on the interest is deferred until the withdrawal occurs. As a result, the effective tax rate on the investment is negative—investors can make money without risking any of their own capital simply by taking out a tax-deductible loan and investing in a tax-deferred asset.

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 income reported to shareholders (book income) and income reported to the IRS (taxable income).
- Fourth, a wholesale attack on corporate subsidies – for example, in agriculture, mining, oil, timber and so on -- would be a final, key element in this package.

If a new administration successfully promoted this entire package of changes, it can expect to increase net federal revenues from corporate and capital income.

### **Tax Labor Income Once and Only Once At the Full Income Tax Rate**

Although much of the attention in tax policy debates is devoted to capital income taxes, wages and salaries represent the largest share of income for most people. Labor earnings are taxed under two separate systems: the personal income tax and the payroll tax. The liability for payroll taxes is, in legal terms, split equally between the employer and the employee. In practice, though, workers bear all or almost all of the burden of such taxes through reduced take-home wages. Payroll taxes are levied for Social Security contributions (12.4 percent of wages up to \$94,200) and Medicare contributions (2.9 percent of wages without limit). Thus, net burdens are about 15 percent of wages up to the Social Security earnings limit and 3 percent on additional earnings. For about 70 percent of all households, and virtually all filers in the bottom 40 percent of the income distribution, these payroll tax burdens exceed income tax payments.

The payroll tax and the income tax could be integrated by providing a refundable income tax credit or abolishing the payroll tax on the first \$5,000 of earnings or on all earnings, with the revenue loss made up by an across-the-board increase in income

tax rates. Alternatively, the earnings ceiling on Social Security taxes could be raised or eliminated, or a tax on earnings above the Social Security earnings cap could be created, in which case an across-the-board reduction in the income tax rate could occur. Any of these changes would make the tax system more progressive and reduce the burden on low-income earners.

## **Rationalize the Structure of Deductions, Exclusions and Credits**

The tax system subsidizes literally scores of economic activities through a variety of mechanisms. Exclusions, exemptions, and deductions reduce taxable income on a dollar-for-dollar basis. As a result, a \$1 deduction is worth more to a high-income household with a high income tax rate than it is to a low-income household with a low or zero income tax rate. By contrast, credits reduce tax liability directly, so that a \$1 credit reduces each household's tax liability by a dollar. For very low-income households, credits that are "refundable" can generate a negative tax liability and be paid back in cash, whereas "nonrefundable" credits merely reduce tax liability to zero. Clearly, nonrefundable credits are useless for households that do not have tax liability to begin with. On simplicity, equity, and possibly efficiency grounds, credits that are aimed at meeting social policy objectives should be made refundable, so that they provide benefits to the households who need the funds most.

Expenses that truly reduce taxpayers' ability to pay taxes should be deductible in full, but very few of the currently allowable "itemized deductions" completely meet that standard. Although they are immensely popular and subsidize activities thought of as "good," for the most part they subsidize activity that would have occurred anyway, as well as create numerous problems. They complicate tax filing and enforcement. They erode the tax base and are regressive, giving bigger benefits to high-income filers.

Finally, they 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. Such a program is not dissimilar to the way the mortgage interest deduction actually works.

The best solution would address each of the current deduction categories directly. *Charitable contributions* should be fully deductible; this preserves the largest incentive for giving for the highest-income households and it ensures that those who give away all of their income would not owe tax. The *mortgage interest* deduction should be converted to a refundable first-time home buyers' tax credit. This would generate revenue, would improve homeownership rates, and eliminate incentives to buy ever-bigger houses with ever-bigger mortgages. Deductions for *state and local taxes* could be eliminated as part of alternative minimum tax (AMT) reform; if the AMT is allowed to grow as under current law, very few taxpayers will have access to the state and local deduction anyway. Tax subsidies for *health insurance* should be handled in the context of a broader health care reform effort, but there is no question that they need to be restricted. Under the current system, where health insurance payments are tax-deductible, consumers do not face the full price of the health care benefits they demand.

## **Simplify Taxes and Improve Administration**

Although Presidential candidates consistently say they would support a simpler tax system, every year taxes seem to become more complex. Some of the complexity is the by-product of using the tax system to achieve other policy goals, such as greater equity, but much complexity could be eliminated without any serious dent in other objectives. As a prime 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 already exists in dozens of countries around the world and would eliminate the hassles of filing and compliance for the households least able to cope with them.

The number of households that could avoid filing would be further increased and other simplifications would occur if the personal exemption, the child credit, and the earned

income credit were consolidated and if the standard deduction were increased. Increasing the standard deduction by the value of a personal exemption and reducing the number of personal exemptions by one would be revenue-neutral, and would greatly reduce the number of people who must itemize. Similarly, education subsidies and retirement saving programs could be consolidated and streamlined.

The alternative minimum tax should be abolished, if—and these are some big ifs—the anti-tax-sheltering provisions of the AMT are brought into the income tax rules, dividends and capital gains are taxed as described above, and the revenue from AMT repeal is made up by adjusting income tax rates upward. Alternatively, the AMT could be retained, but reformed in a revenue-neutral manner that would 1) raise the AMT exemption substantially, in order to remove the middle class from the tax, and 2) tax dividend and capital gains at regular tax rates, so as to restore the AMT's goal of closing shelters.

An intelligent tax reform also 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. Providing the IRS with additional resources for enforcement generally would boost revenues and produce a fairer distribution of the tax burden.

## **Pay for Long-Term Government Spending**

Given the increased government spending trends noted earlier, Presidential candidates must give serious thought to the best ways to raise *additional* revenues over the next decade. Extracting another 5 to 10 percent of GDP in revenues out of the current individual and corporate income tax system—with its narrow base and ubiquitous deductions—would be extremely difficult, because the increases in tax rates that would be required would generate significant avoidance and evasion activities.

The need for higher revenue makes it even more important to reform the current system to keep tax rates as low as possible and the tax base as broad as possible.

This would increase the chances of raising significant new revenue from the individual and corporate income tax systems or payroll taxes if tax rates were increased in the future.

Alternatively, new revenue sources could be explored. The best bet here—and one where there is very strong evidence that it can be administered—is a VAT – as a complement to the current system, not a replacement.<sup>3</sup> A 10 percent VAT could raise an additional 4 to 5 percent of GDP in revenue if the 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.

“Green” taxes—levies on pollution or resource extraction—also could be considered. Besides raising revenues, these taxes can contribute to a cleaner, healthier environment by providing price signals to those who pollute. They have foreign policy benefits as well, as they plausibly reduce U.S. demand for oil and dependence on oil-producing nations.

## Concluding Observations

Nobody likes to pay taxes. But the U.S. tax system does not have to be as complex and unfair as it currently is. Candidates should consider that the reforms proposed above would not only simplify the system from the taxpayer’s point of view, they would make taxes more equitable and, importantly, they would provide the long-term financial resources for the government spending that the public demands.

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<sup>3</sup> Yale University Law Professor Michael Graetz (2004) also has proposed a VAT, but he would use the revenues gained to cut the income tax substantially—raising the exemption to about \$100,000 and taxing income above that level at a flat 25 percent—and to halve the corporate tax rate. A significant concern with this proposal is that it leaves the government with virtually no options for funding what is likely to be a significant increase in future government spending.

## About the Author and the Project

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William G. Gale is a Brookings vice president and director of the Economic Studies Program. He also is co-director of the Urban-Brookings Tax Policy Center and director of the Retirement Security Project. Gale is an expert on tax policy, budget and fiscal policy; and public and private pensions. He served as a senior staff economist for the Council of Economic Advisers under President George H.W. Bush.

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## Additional Resources

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