Blueprint for America

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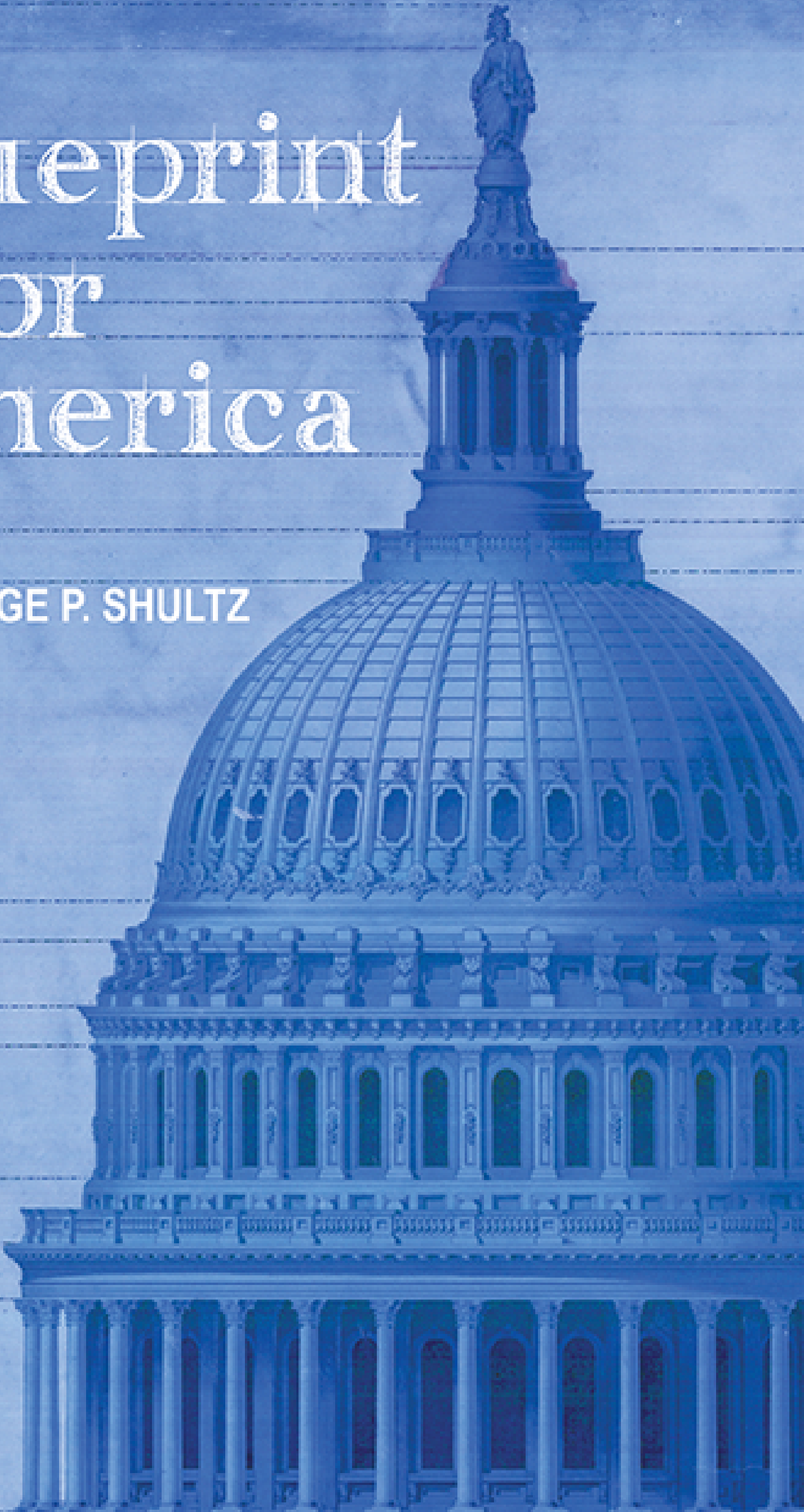

CHAPTER 3

A BLUEPRINT FOR TAX REFORM

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The primary purpose of taxation should be to raise the revenue necessary to finance government spending. Federal spending is projected to grow rapidly in coming decades. The primary drivers are the increased costs of entitlements such as Social Security and Medicare (due primarily to rising real outlays per beneficiary—demography plays an important but minority role) and higher interest costs on the growing debt.

In order to cover the cost of projected spending, say, in 2040, income and/or payroll tax rates would have to rise so much that many middle-income families would face marginal tax rates over 60 percent. That would make most American workers minority partners in their own (marginal) labor, a recipe for stagnation. So reforming the current tax system must be complemented by spending control; otherwise, even a more efficient reformed tax system will eventually be undone.

The borders between taxation, spending, and regulation are blurry. A regulatory requirement on a business or household usually imposes costs and requires some compliance. For example, a regulation requiring car companies to install airbags in cars drives up the cost of the car. It may well have benefits that exceed the costs, but the costs show up as part of private auto sales, thereby making the government appear smaller, even though the regulation is quite similar to the government collecting a tax and paying companies to install the airbags. The mandate requiring companies to provide health insurance for full-time employees, likewise, is like a tax used to pay for health insurance. Estimates of the annual cost of federal regulations substantially exceed $1 trillion per year.

As negative taxes in the form of refundable credits have proliferated and grown, the dividing line between taxes and spending can be elusive. The convention used in the federal budget is that the part of the credit that reduces a positive tax liability is a reduction in taxes, whereas any negative net refund component is considered an outlay.

We all know that the tax code is riddled with special features—deductions, credits, and the like—which greatly reduce revenue while promoting, or at least appearing to promote, various activities, some quite popular. These so-called tax expenditures—such as the mortgage interest deduction or the electric car credit—severely erode the tax base and reduce tax revenue by over $1 trillion per year. So it is useful to keep spending and regulation in mind in any discussion of taxation.

Finally, while governments may also borrow, the debt must be repaid or refinanced, and in either case will require higher future taxes for any given level of spending.

Taxes distort many important economic decisions. For example, taxes lower economic growth, because our tax system reduces incentives to save and invest; to work and acquire skills; and to engage in entrepreneurship. Taxes also distort the allocation of capital and labor among uses of differing productivity. While other policies—regulatory, trade, educational, training, immigration, and monetary—affect growth, our tax and spending, and therefore debt, policies are likely to be the most important.

By reducing after-tax wages and returns to saving, the income tax decreases work and saving. The corporate income tax discourages capital formation, encourages excessive leverage by companies and banks, and reallocates capital by industry and sector with its numerous special provisions. These biases assure that overall capital formation runs steeply uphill, while some investments run more, some less uphill. It would be comical if the deleterious consequences weren't so severe. Every introductory economics student learns that the harm from these distortions rises with the square of the tax rate (this derives from the area under supply and demand curves). Doubling the rate quadruples the harm. Thus, the primary goal of taxation should be to raise the revenue to finance the necessary functions of government in the least distortionary manner possible.

These economic distortions depend on the combined overall rate of taxation for each activity. The same activity may be taxed multiple times. For example, wages may be taxed under the federal personal income tax, the Social Security payroll tax, the Medicare payroll tax, and state income taxes; when the wages are spent, sales taxes might be levied. Saving is generally taxed twice under the income tax, first when the income out of which the saving occurs is earned and saved, and then again when it earns a return in the form of interest or dividends. The corporate tax is an additional tax on capital income. For those with sizable estates, the estate tax adds yet another tax on saving.

Most states add another layer of personal and corporate income taxation. While this discussion of tax reform focuses on the federal personal and corporate income taxes, as do most reform proposals, it is necessary to keep these other taxes in mind. For example, for the most productive California citizens and successful small businesses (which are taxed at personal rates), marginal tax rates exceed 50 percent, not just the 39.6 percent federal rate.

As a result of these distortions, a dollar of additional revenue costs the economy about $1.40. Reducing the harm from these tax distortions is the main reason to keep marginal tax rates as low as possible while raising sufficient revenue to fund the necessary functions of government. Thus, tax systems with low rates and broad bases are the most effective foundation for an efficient, growing economy.

The United States has the highest corporate tax rate of any advanced economy—39 percent including state taxes, or 50 percent higher than the OECD (Organisation for Economic Co-operation and Development) average. Of course, various credits and deductions—such as for depreciation and interest—reduce the effective corporate tax rate, but it is still out of line with our global competitors. Corporate income is taxed a second time at the personal level as dividends, or capital gains if the company retains and reinvests the earnings. It is important that the corporate rate and the top personal rate be quite similar, if not identical. When even a modest gap arises, huge volumes of capital will shift in or out of the corporate organizational form, depending on which rate is lowest, in order to legally avoid the higher tax.

Corporations do not pay taxes; people do. The corporations remit them, but in the final analysis, it is people who pay them, as consumers in higher prices, workers in lower wages, or investors in lower returns. In a static economy with no international trade, the corporate tax would likely be borne by shareholders or owners of capital more generally. The US economy is neither static nor closed, and taxes tend to be borne by the least mobile (elastic) factor of production. Capital is much more globally mobile than labor, and the part of the corporate tax that is above that of our lowest-tax major competitors will eventually be borne by American workers. That burden is larger in a growing economy, as the lower investment slows productivity growth and future wage increases.

There is considerable evidence that high corporate taxes are economically dangerous. The OECD concludes that "corporate taxes are found to be most harmful for growth, followed by personal income tax, and then consumption taxes." Many of the problems of our tax system result from the attempt to tax income, including investment returns, rather than consumption. Income taxes are inevitably far more complex and easier to avoid or evade.

So it is not surprising that virtually every major tax reform proposal in recent decades has centered on lowering tax rates and moving toward a broad-based, low-rates tax primarily on consumption. Consumption can be taxed directly, as in a sales or value-added tax, or by deducting saving and investment from income in determining the tax base, a consumed income tax. There are numerous ways this can be accomplished, for example, by junking the separate corporate income tax, integrating it with the personal income tax by attributing corporate income and taxes to shareholders, or eliminating personal taxes on corporate distributions, and allowing an immediate tax deduction, so-called expensing, for investment (net of interest), which cancels the tax at the margin on new investment.

Four decades of Treasury proposals, the 2005 President's Tax Commission Proposals, and the Simpson-Bowles Commission, appointed and subsequently ignored by President Obama, all moved in that direction. Proposals such as the Hall-Rabushka flat tax; Bradford's progressive consumption tax, a version of which was introduced some years ago by senators Sam Nunn and Pete Domenici; a value-added tax (VAT); and the "FairTax" retail sales tax are pure consumption taxes. There is considerable research showing that moving toward a broad-based, integrated progressive consumption tax would significantly increase real GDP and future wages. Replacing both the corporate and personal income taxes with a broad, revenue-neutral consumption or consumed income tax would produce even larger gains. In his presidential address to the American Economic Association, Nobel Laureate Robert Lucas concluded that implementing such reforms would deliver great benefits, raising income 7 percent to 15 percent, at little cost, making it "the largest genuinely true free lunch I have seen."

The main danger of a broad-based consumption tax is that it will be added on top of other taxes, with the additional revenue used to grow government substantially. That risks serious erosion of our long-run standard of living. The VAT, for example, has been used for that purpose in Europe; and, while better than still-higher income taxes, the larger-size governments it has enabled are the prime reason European living standards are 30 percent or more lower than ours. Trading a good tax reform for a much larger government is beyond foolish. No tax reform can offset losses that large. Hence, new tax devices should only be on the table if they are not only revenue-neutral to start, but also accompanied by rigorous, enforceable spending controls.

The current personal and corporate income taxes have bases which are hybrids of income and consumption, given partial "consumption tax" features such as accelerated depreciation deductions and tax-deferred saving in individual retirement accounts and 401(k) accounts. But various limits, exclusions, and other features leave high rates on some types of saving and investment, low rates on others. I personally prefer a progressive, broad-based consumed income tax, but that raises the question of how to broaden the base. As noted above, tax expenditures cost the Treasury over $1 trillion per year. Removing or capping most would allow economically beneficial lower marginal tax rates. The difficulty of removing deductions and credits one by one is that each is backed by a powerful entrenched vested interest, and many are widely popular. As former Senate Finance Chair Russell Long famously put it, to most people tax reform means, "Don't tax you, don't tax me, tax the fellow behind the tree."

The 1986 Tax Reform Act demonstrated that sweeping reform with lower rates and a broader base is possible. Other important criteria for a good tax system include limiting its administrative and compliance costs and need for a phalanx of tax lawyers, accountants, and lobbyists that accompany complex tax rules. The President's Advisory Panel on Federal Tax Reform estimated in 2005 that the administrative and compliance costs exceeded $140 billion per year, and it is undoubtedly considerably larger now. A broader-based, lower-rate consumed income tax would considerably reduce this burden. A pure flat tax, a pure retail sales tax, and a pure VAT would do even better, but only if enacted as a replacement for current taxes. If added on, these costs would increase.

In addition to raising revenues to pay for government spending, the tax system also redistributes income. The current income tax system is very progressive. The top 1 percent of taxpayers, with 20 percent of income, pays 38 percent of all federal income taxes collected; the bottom 50 percent pays 2 to 3 percent of total income tax collections. Indeed, the OECD declares the US tax system the most progressive of any OECD nation. That is because most other nations rely on the slightly regressive value-added tax for a large share of their larger revenue as a share of GDP. Consumption-type tax reforms can be designed to maintain considerable progressivity, most easily in the consumed income tax, which can be levied at more than one rate, while providing a personal exemption. For example, an archetypical plan might have a few rates ranging from 5 percent to 25 percent on (consumed) income above the poverty rate, combined with a corporate rate of 25 percent.

In addition to the effects on efficiency, equity, and growth, it is also worth asking political economy questions. Will tax reform affect the size of government or its nature? As noted above, the value-added tax has been a prime enabler of larger government. Will the reform affect federalism? Some reforms risk encroaching on state and local revenue sources, of which the retail sales tax is often the largest.

Will the reform likely endure? We have had more than a dozen major, and many more minor, tax law changes since the landmark 1986 tax reform, many eroding the base or raising the rates. We should be concerned that we might move to a better tax system only to undo it shortly thereafter. Simplicity, transparency, and a common rate or rates are more promising than high rates, which breed tax avoidance or even outright evasion and undermine public confidence. The tax system not only changes often, but is riddled with dozens of temporary features which need to be debated and renewed every year. Congresses (and presidents) seem unable to avoid continually tinkering with the tax code. A tax reform that is filled with special features would lose much of its economic benefit. We need a stable tax system that changes much less frequently, so families and firms can more reliably plan for the future.

Finally, will the reform contribute to a prosperous, stable democracy? Will it help increase American wages and the living standards of the majority of the population? We need a larger fraction of economic activity paying taxes on a broader base that would enable lower rates. And we need a larger fraction of people participating in and benefiting from the economy and the financing of the necessary functions of government. Toward that end, a modest minimum income tax, payable by all, might be desirable. Reforming the personal and corporate income taxes into an integrated, progressive consumed income tax could contribute substantially to achieving these goals. A dramatic simplification of the tax code along these lines would also help reassure citizens that the system is not engineered so that special interests and the well-connected can avoid taxes. A tax system reliant on voluntary compliance must be, and must appear to be, fair and reasonable, not a vehicle for crony capitalism, to support a healthy democracy.