

Tax System Challenges in the 21st Century

American taxpayers paid about \$1.9 trillion in combined federal taxes, including income, payroll, and excise taxes, in fiscal year 2004. These taxes, along with over \$400 billion in deficit borrowing, funded the federal government. The tax revenue raised represented about 16 percent of gross domestic product—at the low end of the range of federal taxes as a share of GDP for the last 40 years.

Beyond funding government, any tax system, including the current one, has profound effects on the economy as a whole and on individual taxpayers, both for today and tomorrow. Taxes affect decisionmaking throughout the economy, including decisions concerning how much and where to work, save, and invest. These decisions, in turn, affect economic growth and future income, and thus future tax revenues.

Concerns about the tax system's effect on future economic performance are one driver of the current debate about the future of that system. The U.S. position in the worldwide economy has fundamentally changed and the structure and composition of our economy has shifted. U.S. workers and firms must now succeed in a world of fast-paced technological change and constantly evolving global competition. Also, as noted in section 1, the imbalance between federal revenues and expenditures, if allowed to persist long term, will affect economic growth. Addressing the imbalance will require greater scrutiny of both tax revenues and expenditures.

The following challenges and illustrative questions provide a framework for thinking about these issues in the future.

The success of our tax system hinges very much on the public's perception of its fairness and understandability. Fairness is ultimately a matter of personal judgment about issues such as how progressive tax rates should be and what constitutes ability to pay. Fairness also depends on the extent to which taxpayers believe their friends, neighbors, and business competitors are complying with the tax laws and actually paying their taxes. Compliance is influenced by the effectiveness of the Internal Revenue Service's (IRS) enforcement efforts but also by Americans' attitudes about the tax system and government. Disturbing recent polls indicate that about 1 in 5 respondents say it is acceptable to cheat on their taxes.

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- ▶ *Given our current tax system, what tax rate structure is most likely to raise sufficient revenue to fund government and satisfy the public's perception of reasonableness and fairness?*
- ▶ *How can we best strengthen enforcement of tax laws to give taxpayers confidence that their friends, neighbors, and business competitors are paying their fair share? For example, can we increase compliance with the tax laws and reduce the need for IRS enforcement activities through greater use of withholding and information reporting? Would improved compliance data allow IRS to better allocate its enforcement resources? Could increased penalties and disclosure reduce the use of abusive tax shelters?*

Over the years the federal tax system and especially the federal income tax has become more complex, less transparent, and subject to frequent revision. Some complexity is understandable in an economy as diverse and sophisticated as ours. However, tax system complexity and frequent revisions make it more difficult and costly for taxpayers who want to comply to do so and for IRS to explain and enforce the tax laws. Many argue that complexity creates opportunities for tax evasion, through vehicles such as tax shelters, which in turn motivate further changes in tax laws and regulations and perhaps more complexity. A lack of transparency also risks creating disrespect for the tax system and the government.

- ▶ *What opportunities exist to streamline and simplify the current tax system and thereby make it more transparent to taxpayers, reduce opportunities for tax evasion, and decrease the compliance burden on taxpayers? For example, can the Alternative Minimum Tax be eliminated? Can the Earned Income Tax Credit eligibility rules be simplified? Could the measurement of income be simplified?*

The growing complexity of the tax system stems in part from the extensive use of tax incentives to promote social and economic objectives. The tax system includes hundreds of billions of dollars of such incentives—the same magnitude as total discretionary spending. For instance, the Low Income Housing Tax Credit is the federal government's largest program for creating new affordable housing units and the Earned Income Credit is its largest cash assistance program for low-income families. However, tax

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incentives do not compete in the annual budget process and effectively are “fully funded” before any discretionary spending is considered. Further, relatively little is known about the effectiveness of tax incentives in achieving the objectives intended by the Congress. As far back as 1994, GAO concluded these incentives deserved more scrutiny.

► *Which tax incentives need to be reconsidered because they fail to achieve the objectives intended by the Congress, their costs outweigh their benefits, they duplicate other programs, or other more cost-effective means exist for achieving their objectives? For example, could health-related tax incentives, including the treatment of employer-provided health insurance, which has been estimated to be over \$180 billion in both income and certain payroll taxes, be better used to promote broader health care access, more efficient health care delivery, and more effectively control costs?*

► *Rather than reconsider specific types of tax incentives, is it time to consider another 1986-style tax reform (broadening and simplifying the tax base by eliminating many tax preferences thus allowing tax rates to be minimized)?*

Incentives for savings are a particular concern. Private sector savings are near historical lows and government savings, due to federal budget deficits, are negative. Low rates of domestic saving force the nation to rely on foreign lenders to finance new investment. The tax code includes many incentives intended to increase savings to finance retirement, health care, higher education, and so on. These savings incentives, which exempt some income from tax, have moved the current tax system in the direction of a consumption base. These incentives, however, are complex and, although not completely settled, researchers have raised questions about how much, if any, net new savings they stimulate.

► *How effective are existing tax incentives at increasing savings for their targeted purposes? How effective are they at increasing overall national savings? Could the myriad savings incentives (IRAs, health savings accounts, several education savings incentives, etc.) that complicate the current tax system be consolidated and simplified while promoting increased savings?*

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The debate about the future tax system is partly about whether the goals for the nation's tax system can be best achieved using the current structure, which is heavily dependent on income taxes, or a fundamentally reformed structure, which might include more dependence on consumption taxes, a flatter rate schedule, and fewer tax incentives. Increasing globalization, which makes it easier to move assets, income, and jobs across international borders, is another motivator for the debate. As policymakers grapple with such issues, they will have to balance multiple objectives such as economic growth, equity, simplicity, transparency, and administrability while raising the needed revenue. The appropriate balance among these objectives may also be affected by (1) how, if at all, to take into account that, including both the employer and the employee share, an estimated two-thirds of taxpayers would pay more in 2004 in payroll taxes—which are levied to fund social security and Medicare benefits—than they pay in income taxes and (2) whether and how to tax wealth.

- ▶ *Is the federal income-based tax system sustainable and administrable in a global economy? How should we tax the income of U.S. multinational corporations that is earned outside of the U.S.?*
- ▶ *Should the basis of the existing system or any new reforms be changed from an income to a consumption base (today we actually have a hybrid system)? Would such a change help respond to challenges posed by demographic, economic, and technological changes? How would such a change affect savings and work incentives?*
- ▶ *Regardless of whether a consumption tax is created, the current income tax is revised, or other fundamental tax system changes are made, how should the burden be allocated among taxpayers? Who should pay more and who should pay less? How can burden be distributed according to policymakers' decisions while minimizing complexity and preserving the desired benefits of any fundamental tax policy changes?*

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▶ *How would the interrelationships between the federal and state and local tax systems and with the payroll tax system be taken into account when changing the federal tax system? How should wealth be taxed, if at all, in either an income or consumption based tax system and in any conversion to a consumption tax? How should transfers of wealth be taxed, if at all?*

