Tax Reform: Is the Time Right for a New Approach?

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In the eyes of many Americans, our income tax system is overly complex, basically unfair and—in short—fatally flawed. At least half the citizens surveyed in recent public opinion polls would support radical reform.

They have a point. Although length is not necessarily synonymous with complexity, the U.S. income tax code now has more than 700 times as many words as the U.S. Constitution. Furthermore, the costs of complying with the individual income tax code are high and rising (*Chart 1*). Estimates of the compliance costs associated with the corporate income tax are even higher, ranging from about 50 percent to more than 100 percent of the revenue collected. In other words, the sum the average firm pays to keep track of tax-related information may exceed what it pays in taxes.

The complexity of the tax code feeds public suspicion that the tax system is unfair. Many taxpayers would agree with Nobel Prize winning economists Milton Friedman and James Buchanan that much of the system's complexity results from politicians' trading tax preferences for campaign contributions.

Economists' training leads them to focus more on the tax system's inefficiencies than its complexity and unfairness (though the three problems are closely related). Here too, the U.S. income tax code falls short. A striking example of inefficiency in the income tax code is its unequal treatment of income from different sources. Under current law, wage and interest income is taxed only once—at the individual level. Meanwhile, profits are taxed twice—first at the corporate level then again at the individual level. For profits that are distributed as dividends, the top combined marginal tax rate can exceed 65 percent. This heavy taxation of dividends and capital gains discourages saving and entrepreneurship; it encourages firms to use debt finance rather than equity finance, making them more vulnerable to economic downturns; it slows economic growth.

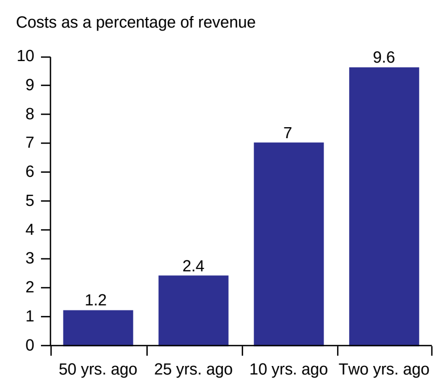
The Consumption Tax

The principal alternative to an income tax is a consumption tax. Consumption taxes encourage saving and investment by deferring taxes on income until that income is spent. They make moot a host of complex issues concerning depreciation schedules and the timing of capital gains. Furthermore, a household's wealth and well-being are more directly tied to its consumption spending than to its income.

Three alternative versions of the consumption tax have been proposed. Two of the proposals can be described as direct taxes on consumer purchases—the national sales tax and the flat tax. The third proposal, known as the unlimited savings allowance (USA) tax, exploits the principle that income must either be saved or consumed by taxing the difference between income and savings.

Although equivalent in spirit, the proposals differ in important details. Before discussing the likely economic consequences of replacing the income tax with a consumption tax, it may therefore be helpful to review the distinguishing characteristics of the alternative plans.

Chart 1
The Rising Cost of
Complying with U.S. Tax Codes



NOTE: Compliance costs include the resources that the Internal Revenue Service expends in enforcing the tax laws as well as the costs that taxpayers incur in filling out tax forms.

SOURCES: Joel B. Slemrod, as quoted in *Business Week*, January 9, 1995, and James L. Payne, *Costly Returns*, (Lanham, Md.: Institute of Contemporary Studies Press, 1993).

> *"Once enacted, any of these three proposals would likely have a positive effect on saving and investment."*

The National Sales Tax. Representative Bill Archer (R-Texas) and Senator Richard Lugar (R-Indiana) argue that consumption spending should be taxed directly. A national sales tax on retail purchases would be one such strategy. An equivalent measure would be to impose a tax at each stage of production on the difference between sales revenue and payments made to other businesses for materials, equipment and supplies. Such a sales tax is called a value-added tax, or VAT. Most sales tax proposals would exempt food and medicine to reduce the burden of taxation on the poor. All other goods and services would be taxed. Economists estimate that the sales tax rate would have to be at least 21 percent to raise as much revenue as the current income tax.

An attractive feature of a national sales tax is that even those with illegal sources of income would pay taxes with every purchase. In the same vein, a sales tax is anonymous: no one need know how much money the taxpayer makes or where it comes from. Another advantage is that the sales tax concept is familiar and easy to understand.

The proposal does have drawbacks, however. A 21-percent sales tax levied at the retail level would invite widespread under-the-counter sales. The VAT approach would reduce the incentive to cheat by taking many small bites instead of one large one. However, the costs of complying with a VAT would be extremely burdensome to small businesses. Moreover, because taxes would be hidden in the prices consumers pay rather than transparent as with the sales tax, a VAT could be an invitation to tax increases.

The Flat Tax. Representative Richard Armey (R-Texas) proposes a modified VAT known as the flat tax. Under a VAT, firms pay tax on their sales less the sum of their purchases from other businesses. The flat tax would work in exactly the same way, except each firm's employees would be paid with pre-tax dollars, and employees would write checks to the government for the taxes due on the wage component of value added. In effect, the flat tax treats each worker as an independent contractor. This difference in the treatment of wages has two important benefits. First, taxes wouldn't be hidden, as they are under a standard VAT. Second, the flat tax approach would allow a certain amount of each individual's wages to be exempted from taxation ($13,000 for singles, $26,000 for couples, plus $5,300 per dependent under the Armey proposal), making it easy to limit the tax burden on the poor.

On the negative side, flat tax opponents claim that people without labor income would pay no tax. The statement is only superficially true: nonwage income would be taxed before it is distributed, at the same rate as wage income.

Representative Armey proposes that the initial tax rate be 20 percent. Most economists think the rate would need to be closer to 23 percent to replace the revenue from the current income tax.

The USA Tax. Senators Sam Nunn (D-Georgia), Pete V. Domenici (R-New Mexico) and Bob Kerrey (D-Nebraska) propose a consumption tax disguised as an income tax. The key difference between the current income tax and their USA tax is that under the USA plan net new saving would be fully deductible from income for tax purposes. Households would continue to report wage, dividend, interest and capital gains income on their tax returns. They would continue to deduct home mortgage interest and charitable contributions. A modest deduction for higher education expenses would be introduced. The value of fringe benefits such as employer-provided health insurance would be included in household taxable income for the first time. Tax rates on personal income would be graduated—rising from 19 percent to 40 percent—while the corporate income tax would be scrapped and replaced with an 11-percent

VAT. Tax rates would be higher than under the other reform proposals, partly because the USA tax would retain more deductions than the other proposals and partly because Social Security benefits, in effect, would be financed from general revenue under the USA plan.

Of the three reform proposals, the USA tax is the only one that uses the tax code to stimulate investment in education as well as in plant and equipment. It is also the only reform proposal that incorporates Social Security taxes.

On the minus side, the USA tax would do little to simplify the tax code. It would continue the current subsidy to home ownership and actually would increase the incentive for home ownership by not counting new home equity loans as taxable dissaving. Additionally, households would be able to accumulate up to $35,000 in nonmortgage debt without tax liability. Consequently, the USA tax would provide less overall stimulus to saving and investment than the other tax reform proposals reviewed here.

Likely Effects of Switching To a Consumption Tax

Once enacted, any of these three proposals would likely have a positive effect on saving and investment, for two reasons. First, because they are consumption taxes, each proposal defers the taxation of income until the income is spent. Second, each proposal eliminates the current system's punitive taxation of dividends and capital gains. As shown in the right-hand column of Table 1, increased saving and investment will eventually pay off in a higher capital stock, higher real wages and greater consumption. Laurence Kotlikoff of Boston University has estimated that switching to a consumption tax would boost the nation's stock of plant and equipment by nearly 27 percent after 20 years. A 27-percent increase in the capital stock would mean nearly 10-percent increases in real wages and real output, relative to their level under an income tax.

In the near term—described in the left-hand column of Table 1—greater investment can be achieved only at the expense of consumption. So, in the years immediately following tax reform, consumption would be lower than it would have been under the current system.

On a cautionary note, the prospect of tax reform may have a perverse effect on the economy in the prereform period. Knowing that investment would soon be receiving more favorable tax treatment, people would be likely to spend more on consumption and defer investment in the months before the new tax law takes effect.

The Effects on Interest Rates. The real yield on short-term bonds moves opposite from the capital stock, all else being constant. Since the capital stock would gradually *increase* under a consumption tax, relative to its level under an income tax, the real yields on short-term corporate and Treasury debt would gradually *decline* after tax reform, eventually stabilizing at about three-fourths their current levels.

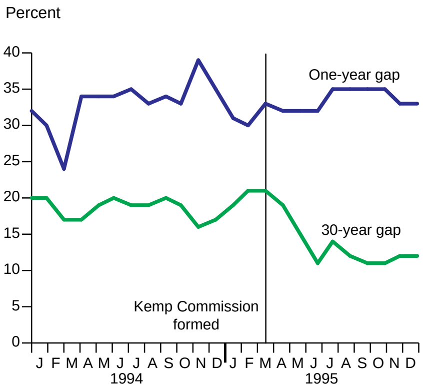
The time path of short-term municipal bond yields would be quite different. Municipal bonds currently have an advantage relative to corporate and Treasury bonds because they are tax-exempt. Under either a national sales tax or the Armey flat tax, this advantage would disappear: all bonds would be treated the same. After the implementation of tax reform, the yield on municipal bonds would jump upward to match the yield on other bonds. Thereafter, the yields on all short-term bonds would move in tandem.

Table 1
Likely Effects of the Switch To a Consumption Tax

	Near term	Long term
Investment	+	+
Capital stock	0	+
Wages and benefits	0	+
Consumption	–	+

"While there's room for disagreement on exactly which options package is right, there can be little doubt that the consumption tax is an idea whose time has come."

Chart 2
Treasury–Municipal Percentage Yield Gaps: Behaving as Predicted



SOURCES: Board of Governors of the Federal Reserve System, Bloomberg and authors' calculations.

The current return on a 30-year bond is an average of the one-year returns expected over the next 30 years. Therefore, if people think that either a national sales tax or the Armey flat tax is coming, a gradual closing of the gap between long-term Treasury and long-term municipal bond yields should already be apparent. There should be no corresponding closure of the gap between short-term Treasury and short-term municipal bond yields until reform is imminent.

The behavior of municipal bond yields relative to Treasury bond yields suggests that traders began taking the possibility of comprehensive tax reform seriously following the appointment of Jack Kemp (R-New York) to chair a reform commision (*Chart 2*). At the long end of the maturity spectrum, recent months have seen the percentage gap between 30-year Treasury bond yields and 30-year municipal bond yields cut in half, from 20 percent to 10 percent. However, no change in tax regime is expected until after the 1996 elections: no shrinkage of the yield gap is yet apparent for bonds that mature before November 1996.

The Politics of Tax Reform: Winners and Losers. The vast majority of people would gain from the switch to a consumption tax. But the gains would not be distributed evenly, and—especially in the years immediately following reform—some people would suffer net losses. Risky new businesses in high-growth, capital-intensive industries would be clear winners from tax reform. These firms would benefit from the more favorable treatment of equity finance and the increased flow of savings provided by a consumption tax. Holders of existing municipal bonds would be short-term losers under the national sales tax or Armey flat tax because these plans remove current tax preferences for municipal bonds. (The USA tax plan would remove the tax preference for new municipal bonds but retain it for existing bonds.) People who live in high-tax areas—like New England and the Great Lakes region—are also hurt by tax reform in the short run because they lose their ability to deduct state and local income and property taxes. Similarly, homeowners would likely find that the fall in long-term interest rates caused by tax reform would not, at first, fully offset the elimination of the mortgage interest and property tax deductions.

Conclusion

The choice between the current U.S. income tax and a consumption tax is like the choice a family makes when deciding whether to trade in its 5-year-old car for a new model in its first year of production. The new model has no track record. Its handling might take some getting used to, and buying it would mean pulling together a down payment. On the other hand, it has an engine that is more powerful, more efficient, and easier to repair and maintain. The performance of the older vehicle has been slowly deteriorating, and the car needs more and more repair. While there's room for disagreement on exactly which options package is right, there can be little doubt that the consumption tax is an idea whose time has come.

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