Introduction

“The tax code today is nothing more than a cesspool of legalized corruption and special interest legislation. We should replace this monstrosity with a simple flat tax for all Americans.”

Steve Forbes, during his 1996 presidential campaign.

His platform reflects some of the widespread dissatisfaction with the current tax system.

Introduction

At certain times, this dissatisfaction has led to action.

The 1986 Tax Reform Act reduced 15 tax brackets ranging from 11% to 50% to just three ranging from 15% to 33%.

It lowered rates and taxed a broader base of income.

Subsequent legislation has added complexity to the tax code, and greater opportunity for tax avoidance and evasion.

Why fundamental tax reform?

Improving tax compliance

The first motivation for fundamental tax reform relates to compliance.

Tax compliance are efforts to reduce the evasion of taxes.

Tax evasion is illegal nonpayment of taxation.

This differs from tax avoidance, which are legal means (such as giving to charity) to lower one’s tax bill.

There are three major arguments for fundamental tax reform:

Increase tax compliance

Make the code simpler

Improve efficiency
The distinction between evasion and avoidance is sometimes a fine one, but it is not always the rich who evade taxes. For example, for many years taxpayers wanting to claim tax exemptions for dependents were only required to fill in their name on the tax form. TRA 1986 also required the Social Security number for dependents over age five. 6 million dependents suddenly disappeared.

In 1988, the tax law started requiring that the Social Security numbers of child care providers be listed before a worker could claim the child care credit. 2.6 million child care providers disappeared.

Why fundamental tax reform? Improving tax compliance

The simplest theory of evasion weighs the marginal benefits from underreporting $1 income (evasion) against the marginal costs.

The marginal benefit is the saved tax.

The marginal cost is the marginal penalty per dollar evaded, multiplied by the probability of getting caught.

Figure 1 illustrates this.

In this case, as the marginal tax rate rises, the marginal benefit curve shifts upward and more evasion occurs.

As the expected penalty rises (either the penalty per dollar or the probability of getting caught), the marginal cost curve shifts upward and less evasion occurs.

The most recent evidence in the U.S. suggests that the “tax gap” is $280 billion, or 16.3% of tax revenue.

In an interesting experiment, Slemrod, Blumenthal, and Christian (2001) randomly sent letters to taxpayers before taxes were due, either threatening audit or appealing to people’s consciences to be honest.

The audit threats increased reported income for low and middle income taxpayers.

They lowered reported income among upper class families, who perhaps believed the letter was an opening round in a negotiation, and their reported income was a “first offer.”
The 1997 IRS hearings and their fallout for tax collection

In September 1997, the Senate Finance Committee held a week of hearings to investigate IRS abuses.

The committee heard all sorts of damning testimony, much of which actually painted a skewed picture of the IRS operations.

In 1998, President Clinton signed the “Taxpayer Bill of Rights” which created some protections for taxpayers.

As a result of this legislation, the IRS’s enforcement capabilities have been severely impaired.

Number of field examiners fell by two-thirds.

Number of collection cases fell by one-half.

Number of evasion cases pursued fell by two-thirds.

Audit rates for self-employed fell from 4% to 2%.

IRS has identified $30 billion in underpayments, but does not have the resources to pursue them.

Sentiment may now be turning in the opposite direction, perhaps as a result of corporate scandals.

The latest IRS commissioner has vowed to make enforcement a priority.

The damage may be done, because 17% of Americans believe cheating on their taxes is acceptable, up from 11% in 1999.

Why fundamental tax reform?

Making the tax code simpler

The second motivation for fundamental tax reform relates to simplicity.

The IRS estimates that it takes 13-14 hours to complete Form 1040, assuming most income came from wages and there were no complicated investment activities or itemized deductions.

Itemizing takes another 6 hours, and reporting small business activity takes 11 hours.

Reporting capital gains is estimated to take 8 hours.

This complication motivates a simpler tax plan, such as Steve Forbes’s flat-tax proposal.

This is illustrated in Table 1.

Why should we care about tax evasion? Couldn’t we raise taxes to offset this evasion?

First, such a policy would lower efficiency. Efficiency is increased by broadening the base and lowering the rates. Moreover, since cheating rises with higher rates, it is partially self-defeating.

Second, evasion harms vertical equity, because upper income households have greater scope for evasion.

Third, evasion is a very clear violation of horizontal equity.

Forbes’s flat tax gets rid of the tax deductions (“loopholes”) in the current system, and lowers the tax rate on self-employment income.

Table 1

<table>
<thead>
<tr>
<th>Current tax system</th>
<th>Forbes’s flat tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income (wages, interest, etc.) minus Deductions</td>
<td>Wage income minus Exemptions</td>
</tr>
<tr>
<td>Adjusted gross income (AGI) minus Exemptions minus Itemized (or standard) deduction</td>
<td>Taxable income</td>
</tr>
<tr>
<td>Taxable income Use income tax schedule minus Credits</td>
<td>Multiply by 20%</td>
</tr>
<tr>
<td>Total tax payment minus Withholding</td>
<td>Total tax payment</td>
</tr>
<tr>
<td>Final payment (refund) due</td>
<td></td>
</tr>
</tbody>
</table>
Why fundamental tax reform? Making the tax code simpler

- Simplicity is an admirable goal, and often consistent with other efficiency and equity goals.
- Yet, some worthwhile goals are inconsistent with such simplification.
- For example, including employer-provided health insurance or pension contributions is consistent with the Haig-Simons definition.
- They substantially increase the reporting burden of employers.

Why fundamental tax reform? Improving tax efficiency

- The third motivation for fundamental tax reform relates to improving tax efficiency.
- The cost of raising tax rates includes an entire array of behavioral responses.
- These include labor supply, savings, risk-taking, child care use, and charitable giving.
- The key question becomes how does changing the tax rate change tax revenue? There are both direct and indirect effects.
- **Direct effect of tax changes** means a higher tax rate raises revenues on a fixed base of taxation.
- **Indirect effects of tax changes** mean a higher rate lowers the size of the revenue base on which taxes are levied.
- These effects include:
  - **Gross Income effect**: The distortions discussed with respect to labor supply, savings, etc.
  - **Reporting effect**: The incentives to reclassify income in ways that are not subject to tax, such as providing employer health insurance.
  - **Income exclusion effect**: The incentives to take greater advantage of exclusions from gross income in defining taxable income, such as 401(k) contributions.
  - **Compliance effect**: The increase in evasion.
- **Figure 2** shows an example of how tax revenue can be affected by raising the tax rates.

**Figure 2**

Before tax increase, taxable income = $50,000 (tax rate = 10% flat rate)

After tax increase, taxable income = $50,000 (tax rate = 25% flat rate)

- Gross Income: $45,000
- Health benefits: $2,000
- Charity: $2,000

Wage income $45,000

Revenue: $5,000 (5% of $50,000)

Lawn mowing income $5,000

Revenue: $0 (0% of $5,000)

- Income included in tax base
- Income not included in tax base
- Tax revenue
- Decrease in wage earnings

Under the lower tax rate, the individual takes all of his income, which consists of $45,000 of wage income and $5,000 of additional income from lawn mowing.

- He pays $5,000 in taxes.
- When the tax rate rises, the person evades taxation by not reporting the lawn mowing income, and avoids taxation by substituting health insurance for wages, and giving to charity.
- His taxable income is now $35,000, and he pays $7,000 in taxes.

Empirical work suggests that the elasticity of tax revenue with respect to tax rates is approximately -0.5 – a response that implies significant deadweight loss.

- The indirect effects of reporting, income exclusion, and compliance, not gross income earning, drive this response.
- Most of the response comes from the rich, who are better able to take advantage of these features of the tax code.
- Fundamental tax reform could help with the goals of compliance, simplicity, and efficiency.
- Yet it is difficult to achieve this reform, for various political and economic reasons.
TRA 1986 moved the U.S. toward a simpler tax code, but it was largely undone by subsequent legislation.

Why is it so hard to maintain a simple, broad-based tax code?
- There are both political and economic explanations.

The politics and economics of tax reform

Political pressures for a complicated tax code
- There are political pressures for policy changes when:
  - The winners of such changes are concentrated, well organized, and have much to gain, and,
  - The losers are diffuse and don’t lose much per person.
- There is also a perception of politicians that voters oppose new government spending, but will support the same goal when financed through tax expenditure.

For example, President Clinton came into office promising to shift federal spending to education and job training, but ended up using “targeted tax cuts.”

“The minute we proposed any kind of tax cut, everybody started salivating.” – Adviser to President Clinton.

Economic pressures against broadening the tax base
- Economic considerations also come into play.
- Tax shelters are activities whose sole reason for existence is tax minimization.
- These were popular in the mid-1980s, where some assets received very favorable tax treatment (e.g., through depreciation, etc.).
- Some tax shelters generated paper losses while actually turning a profit for their investors.
- An example of this is illustrated in Table 2.

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**Table 2:** Tax shelters

<table>
<thead>
<tr>
<th>Action</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Invest $100,000 in oil venture</td>
<td>Lose $10,000 in value</td>
</tr>
<tr>
<td>Sell oil venture for $90,000</td>
<td>Save $30,000 on taxes</td>
</tr>
<tr>
<td>Deduct $60,000 from this year’s income</td>
<td>Save $5,000 on taxes</td>
</tr>
<tr>
<td>Deduct $10,000 loss from next year’s income</td>
<td>Make $25,000</td>
</tr>
</tbody>
</table>

Even a bad investment – buying an asset for $100,000 and selling it a year later for $90,000 turns profitable under this tax shelter.

This occurs because of a 60% ITC, and offsetting the capital loss against the following year’s income.

The existence of tax shelters runs in opposition to the three benefits of fundamental tax reform: they make evasion easier, make the code more complicated, and reduce efficiency.

Yet the value of such tax shelters is capitalized into an asset’s value.

Tax capitalization is the change in asset prices that occurs due to a change in the tax on the stream of returns from that asset.

Thus, eliminating tax shelters can severely punish their owners and can cause large horizontal inequities.
The politics and economics of tax reform
Economic pressures against broadening the tax base

- To illustrate this horizontal inequity, consider two apartment complexes – one worth $100,000 in a low-income neighborhood because it cannot cover its costs with rent, and the other worth $200,000 because it can.
- Suppose an ITC or special depreciation schedule allowed the first owner substantial tax benefits, raising the market value from $100,000 to $200,000. That is, the pretax value of the stream of tax benefits is equal to $100,000.

If a person buys the apartment in the low income neighborhood at $200,000, expecting the stream of tax benefits, that person will suffer if the breaks are eliminated.
- Eliminating the tax shelter immediately lowers the market value of the apartment back down to $100,000.

Transitional inequities from tax reform are changes in the treatment of similar individuals who have made different decisions in the past and are therefore differentially treated by tax reform.
- These inequities are a natural feature of any tax reform, which by definition will create winners and losers.
- Feldstein (1976) suggested that such tax reforms be infrequent and slowly phased in, to minimize sudden changes in asset prices.

One solution is grandfathering – letting those who made decisions under the old tax rules to continue to benefit from those rules.
- This is often inequitable (well-off individuals usually benefit from such grandfathering rules) and inefficient.
- But such compensation may be necessary to implement tax reform.

**Grandfathering in Virginia**
- One recent example of such a grandfathering rule is in the state of Virginia.
- The state income tax system gave a $12,000 annual deduction to everyone over the age of 65, regardless of income or wealth.
- In eliminating the deduction, Governor Mark Warner allowed seniors currently over 65 to keep the deduction.
- The legislation passed in April 2004.

**TRA '86 and tax shelters**
- TRA 1986 closed many of the most egregious tax shelters that had emerged as a result of the 1981 tax reform.
- Removing the tax shelters outright would have angered many powerful constituents. Instead, TRA 1986 created three groups of income – ordinary (earned) income, investment income, and passive income.
- The shelter income was “passive income.”
- Income losses in one group could not offset income in another group.
- The AMT rules for income also excluded many of the tax shelter rules.
- The tax shelters were eliminated, but at the cost of a more complicated tax code.
CONSUMPTION TAXATION

A more radical reform, favored by many economists, is moving from an income tax to a consumption tax.

Taxing consumption means taxing individuals based not on what they earn but on what they consume (such as through a sales tax).

Figure 3 shows that taxing consumption is relatively small in the U.S. compared with other countries.

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Consumption taxation

Why might consumption make a better tax base?

Consider a national sales tax at, say, 35% of all purchases rather than an income tax. What are the advantages of moving to a consumption tax base?

- Efficiency
- More savings and fairer treatment of savers
- Simplicity

Such a tax would improve efficiency because most of the elasticity of the tax base with respect to tax revenue arises because of “holes” in the tax system.

For example, the nontaxation of income paid in the form of fringe benefits. Such tax avoidance activities disappear with a national sales tax.

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Table 3

Income Tax versus Consumption Tax

<table>
<thead>
<tr>
<th></th>
<th>Homer</th>
<th>Ned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income in Period 1</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Taxes in Period 1</td>
<td>$50</td>
<td>$50</td>
</tr>
<tr>
<td>Consumption in Period 1</td>
<td>$50</td>
<td>$25.61</td>
</tr>
<tr>
<td>Savings in Period 1</td>
<td>$0</td>
<td>$24.39</td>
</tr>
<tr>
<td>Interest Earnings in Period 2</td>
<td>$0</td>
<td>$2.44</td>
</tr>
<tr>
<td>Taxes in Period 2</td>
<td>$0</td>
<td>$2.22</td>
</tr>
<tr>
<td>Consumption in Period 2</td>
<td>$0</td>
<td>$25.61</td>
</tr>
<tr>
<td>PDV of Taxes</td>
<td>$50</td>
<td>$51.10</td>
</tr>
</tbody>
</table>

With an income tax, Ned is penalized for saving by paying more in taxes.

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Consumption taxation

Why might consumption make a better tax base?

A consumption tax would also remove the “pro-consumption” bias in the current system, and potentially increase savings.

Consider Homer and Ned in Table 3.

Under an income tax, Ned, who is more patient and saves for the next period, pays more in taxes than Homer even though their incomes are the same.

Ned’s income is taxed both as labor income and interest income.

That is, he is taxed $50 on his $100 of earnings, and taxed $1.22 on his $2.44 of interest income.

Homer, who consumes all of his income in the first period, does not have interest income and avoids that part of the income tax.

Thus, there is a “pro-consumption” bias in the income tax code.
Table 3

<table>
<thead>
<tr>
<th>Income Tax versus Consumption Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales tax of 100% of purchases</strong></td>
</tr>
<tr>
<td>Income in Period 1</td>
</tr>
<tr>
<td>Taxes in Period 1</td>
</tr>
<tr>
<td>Consumption in Period 1</td>
</tr>
<tr>
<td>Savings in Period 1</td>
</tr>
<tr>
<td>Interest Earnings in Period 2</td>
</tr>
<tr>
<td>Taxes in Period 2</td>
</tr>
<tr>
<td>Consumption in Period 2</td>
</tr>
<tr>
<td>PDV of Taxes</td>
</tr>
</tbody>
</table>

With a consumption tax, both savers and non-savers pay the same amount.

### Consumption taxation

#### Why might consumption make a better tax base?

- Under a consumption tax, their tax payments are the same.
- Interest income is not taxed, only consumption.
- Ned saves more in this example, but in reality, lower taxes could lead to either an increase or decrease in savings.
- The switch to consumption taxation removes the pro-consumption bias in the tax system, and removes the horizontally inequitable treatment of those who choose to save.
- It may lead to higher savings as well, and a more productive economy.

#### Why might consumption be a worse tax base?

- Smaller tax base: A tax on consumption is essentially a tax on lifetime labor income.
- It therefore removes the tax on savings, shrinking the tax base.
- Thus, the consumption tax rate would have to be higher than the income tax rate.

### Consumption taxation

#### Why might consumption be a worse tax base?

- **Vertical equity**: A central fact about consumption is that the share of income devoted to consumption falls with income.
- That is, the rich save a larger proportion of their income throughout their lives.
- Consumption taxes are therefore regressive.
- Policy prescriptions – like taxing staple goods at lower rates – goes in the opposite direction of the Ramsey model.

- **Transition issues**: The current middle-aged and elderly are major losers from such a transition.
- They have already paid most of their income taxes during their working years, and now get hit with a high tax on their purchases that come from accumulated savings.
- Politically, there would almost certainly have to be some compensation for seniors, yet this might use up the entire efficiency gain from the transition.
Consumption taxation

Why might consumption be a worse tax base?

- **Compliance**: Such a high sales tax might create a thriving "black market" to evade the sales tax.
- It is much harder to track consumption expenditures than it is to track income earned.
- **Cascading**: There is also a problem with taxing business inputs.
- In principle, the sales tax should only be on retail sales, not business inputs. In practice, many businesses buy their inputs at the retail level.
- Businesses often pay sales taxes when they buy inputs, and then again when they sell output.

Different forms of consumption taxation can address the concerns raised by the sales tax approach. These include:

- The value-added tax
- An expenditure tax

**The value-added tax (VAT)** is a consumption tax levied on each stage of a good's production on the increase in value of the good at that stage of production.

Table 4 illustrates the VAT in practice.

<table>
<thead>
<tr>
<th>Table 4</th>
<th>Each firm pays a tax on the &quot;value added&quot; only.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Value Added Tax in Practice</strong></td>
<td>Purchase price</td>
</tr>
<tr>
<td>Logger</td>
<td>$0</td>
</tr>
<tr>
<td>Manufacturer</td>
<td>25</td>
</tr>
<tr>
<td>Retailer</td>
<td>75</td>
</tr>
<tr>
<td><strong>Total taxes paid:</strong></td>
<td></td>
</tr>
</tbody>
</table>

It is self-policing, because you need a receipt to deduct the "value added" rather than the sales price.

Consumption taxation

Designing a consumption tax

- In practice, the VAT is not quite as simple.
- Multiple rates
- Complicated exemptions
- Costly to administer
- Exemptions for businesses doing less than $80,000 in commerce

An **expenditure tax** is a consumption tax levied on yearly consumption rather than on specific sales.

Thus, it can be used to meet the progressivity needs in a way a sales tax cannot.

There are still compliance problems and complex informational requirements. It is difficult to track expenditures.

Consumption taxation

Designing a consumption tax

- The VAT addresses both the compliance and cascading problems.
- The tax is self-policing, with each participant in the production chain having a strong incentive to make sure that the other participants report correctly.
- An attempt to reduce the value of a transaction raises the tax bills of other participants.
- It also allows firms to deduct from taxation the price they pay for inputs.

Consumption taxation

Backing into consumption taxation: Cash-flow taxation

- Taxing consumption at the point of production leads to progressivity concerns, while taxing expenditure is administratively infeasible.
- A **cash-flow tax** is a tax on the difference between cash income and savings.
- This would require the least change to our current system of taxation. The main difficulty would be verifying savings.
THE FLAT TAX

The flat tax was first popularized by economists Robert Hall and Alvin Rabushka in 1981. Its features include:
- Corporations pay a flat-rate VAT on sales, minus purchases from other firms, minus wage payments to workers.
- Individuals pay a tax on labor income only at the same flat rate.
- All tax expenditures would be eliminated (like the exemption for employer health insurance) and replaced with a family-level exemption.

Although this is similar to a VAT, by taxing wage income and offering a family deduction, we can introduce progressivity into the tax system.
- Hall and Rabushka proposed a 19% flat rate, and a $25,000 exemption.
- The advantages of a flat tax include:
  - Efficiency gains from having one flat rate on a broad definition of income
  - Simplicity and improved compliance

The flat tax

Problems with a flat tax

- The key problem with the flat tax still is progressivity.
- Although it can be made fairly progressive for low- and middle-income earners, it is much less progressive for high-income earners than the current system.
- See Table 5.

<table>
<thead>
<tr>
<th>Household income (married couple with two children)</th>
<th>$25,000</th>
<th>$50,000</th>
<th>$100,000</th>
<th>$300,000</th>
<th>$1,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current tax code (2004)</td>
<td>1.2%</td>
<td>6.9%</td>
<td>13.0%</td>
<td>24.2%</td>
<td>31.7%</td>
</tr>
<tr>
<td>Hall-Rabushka flat tax</td>
<td>0%</td>
<td>9.3%</td>
<td>14.3%</td>
<td>17.4%</td>
<td>18.5%</td>
</tr>
</tbody>
</table>

The rich would be the big winner under the Hall-Rabushka flat tax plan.

The sizable reduction in vertical equity would be problematic for many voters.
- In addition, there are transition issues with a flat tax.
- Horizontal inequities would arise, for example, removing the tax-subsidy to homeownership. This could lead to a large drop in home values.
- There would also be disruption to the health insurance market – as many as 20 million people could lose their health insurance if the exclusion from income was eliminated.