

Buchanan, Neil H.

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## A Critique of Competing Plans for Radical Tax Restructuring

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A Critique of Competing Plans  
for Radical Tax Restructuring

by

Neil H. Buchanan\*

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\*The Jerome Levy Economics Institute of Bard College

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## **I. Introduction**

As long as there are elections, there will be proposals to change the tax system. As the 1996 elections demonstrate yet again, there is nothing so certain to generate interest in a candidate than a dramatic plan to change the taxes that people pay.

This truism of American politics is a useful reminder to those who would offer the Perfect Tax System: No matter what you do, it will be changed very quickly. While it is always good to look for ways to improve the tax code, it is the height of arrogance to claim that there is a way to change the tax code once and for all. Nothing is permanent. Even a candidate like Bob Dole, who claims that he wants a simpler tax system, cannot resist offering baubles like a \$500-per-child tax credit, adding several more pages of rules and interpretations to the U.S. tax code.

Moreover, while the Dole plan became the centerpiece of political discussion in late 1996, replacing the earlier fevered discussions of Steve Forbes's flat tax plan, the next President and Congress will deal with the more fundamental question underlying Forbes's short-lived popularity: Should the tax system be changed completely? At some point, the discussion will return to that central issue.

Probably the most basic reason for this is that taxes evoke not only strong but contradictory feelings. People feel a basic conflict between the desire to keep as much money as possible and the sense that they should

contribute to the good of society; between the respect for privacy and the need to be sure that others are paying their share; between the dislike of complexity and the desire to be responsive to unique situations.

Given those and many other conflicting feelings, it is not surprising that the current system has been decried from every point on the political spectrum, being variously described as "broken," "unsalvageable," and even "a disgrace." Hoping to capitalize on these emotions, growing numbers of politicians have taken up the cause of tax "reform"—not just of the income tax system, which is certainly the focus of voter discontent, but of the entire federal tax system itself. In many cases, the plans being proffered are hardly new.<sup>1</sup> The common element in each case, however, is the fundamental nature of the changes being sought. The plans are, in the truest sense of the word, radical.

The marketers of these radical plans have developed a group of ideas and buzz-words that have been repeated so often that they have almost lost their meaning. Terms like "confiscatory tax rates," "punishing success," and "a penalty on the creation of wealth" are typical descriptions of the problems with the tax system (even though such descriptions are not actually attacks on the U.S. tax system specifically, but are instead arguments against progressivity in even the simplest tax code), in addition to attacks on specific aspects of the U.S system, which are often referred to as "social engineering," "picking winners and losers," or "micro-managing the economy."

While each of the proposals<sup>2</sup> discussed below has its distinguishing

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<sup>1</sup> For example, Tobin [1949], almost a half-century ago, referred to savings-exempt taxes as having "a long history."

<sup>2</sup> Some of the plans described below have already been submitted as bills in

features, it is possible to group the proposals into four classifications: simplified income taxes, value-added taxes (of which sales taxes are but one type), saving-exempt taxes, and labor-income taxes.

Each of the plans, no matter its basic type, is being promoted by stressing its greater simplicity relative to the current system. The last three are also claimed to increase the rate of national saving. Both of these goals are intended to lead to greater investment, higher levels of long-term economic growth, higher standards of living, and greater international competitiveness.

Many of the plans, moreover, have been designed to be "revenue-neutral," that is, neither to raise nor lower total tax revenues for the U.S. Treasury, while others are designed to cut taxes as a supply-side measure, in the belief that such cuts will act as a spur to productivity and innovation.

This paper will assess the basic tax proposals and analyze their likely impacts, arguing that most (if not all) of the possible benefits of radical change can be achieved through extensive reform of the current structure. Most important, it will be argued that we should *not* switch from a system of taxing income to one taxing consumption (or one taxing only labor income). Our tax system is certainly flawed (as any real-world tax system would be), but our basic approach to taxation is sound.

A special note: One of the most important issues in any tax reform proposal is its degree of progressivity or regressivity, i.e., its impact on the distribution of income. That issue is discussed extensively in a companion

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Congress, while others are still in the public discussion stages (and thus have not been described in similar detail by their sponsors).

paper [Buchanan 1996] to the present essay. While the issue is mentioned in passing below, the bulk of this analysis is designed to evaluate the various elements of pending tax proposals from the standpoint of their technical and efficiency aspects. This should not, however, be viewed as an indication that the author believes progressivity to be an unimportant issue.

Before discussing the particular plans, however, it will be important to dispense with three commonly-heard arguments regarding these tax plans: first, the argument that capital should be taxed less than it is now (or not at all); second, arguments about how to estimate the revenue effects of a new tax system; and third, arguments against “double-taxation.”

### **A. Cutting Taxes on Capital (Entirely?)**

One of the basic arguments advanced by those who would abandon the current tax system entirely is that we are over-taxing capital income. In some cases, the argument is that we should reduce taxes on capital income, while others would exempt all income from capital from being taxed at all. This is based on the conclusions from a simple “neo-classical” approach to understanding the economy, i.e., the method of analysis which says that government intervention can only move a free-market economy away from its preferred position.

There are two ways to analyze such claims: to attack the neo-classical approach itself, or to show that even the neo-classical approach can reach different conclusions if it starts from more realistic conclusions. The latter approach is preferred here, simply because it avoids unnecessarily fundamental paradigmatic arguments. It is sufficient to show that the logic does not support the conclusions. This can be done both empirically and theoretically.

On the empirical level, some interesting work has been done by economists who have attempted to apply the neo-classical model to actual U.S. data, testing whether cuts in taxes on capital will have the purported benefits. The central statistical conclusion of Fazzari and Herzon [1996], in a Levy Institute *Public Policy Brief*, is particularly devastating in this regard.

Looking at the consequences of cutting capital gains taxes from 28% to 19.8%, Fazzari and Herzon found that this would increase the level of GDP by the amount that it is currently growing in about 25-50 *days*. This can be put into perspective by noting three things: 1) This is a one-time effect on GDP, not a permanent increase in the GDP growth *rate*; so the economy is not going to be growing any faster in the long-run after cutting capital gains taxes than it was before they were cut; 2) even this trivial effect would take about ten years to show up in the economy; and 3) even these tiny effects are based on highly generous estimates of the response of investment to a drop in the cost of capital, i.e., the study uses an estimate that a 1% drop in the cost of capital will cause a 0.5% increase in the long-term level of the capital stock.

As the authors note (p. 29), this is on the high side of the estimates reported in other economists work. In fact, that other work indicates that the response of investment to declines in the cost of capital is probably zero, i.e., that the capital stock does not respond at all to the cost of capital. Therefore, the range of estimates for this effect is not between, say, 0.4 and 0.5, so that Fazzari and Herzon's choice of the higher estimate could be argued to be unimportant; instead, the range is between 0.5 and 0.0. The conclusion that there will be a one-time increase in GDP of 25-50 days growth, therefore, should be seen as an extreme upper-bound, rather than as the mid-point of a range.

Empirical evidence also argues for extreme skepticism about other



proposals to reduce the tax rate on capital. For example, the Investment Tax Credit, which is often used as an alternative to capital gains tax cuts, is equally unproven in creating more investment, as demonstrated in a Levy Institute *Public Policy Brief* [Karier, 1994]. The common theme between the Fazzari/Herzon and Karier conclusions is that they are both looking at ways to reduce the cost of capital; and since investment is not responsive to the cost of capital, it should not be surprising that the different methods of lowering the cost of capital are similarly ineffective.

Moreover, it is not at all clear that capital is over-taxed in the U.S., relative either to our own past or to other industrialized countries. Gravelle [1994], for example, argues that aggregate effective tax rates on capital have *not* gone up since the enactment of the 1986 tax act. She writes (p. 24): "Thus, the claim for a need to lower capital income tax burdens on the grounds that increases in the 1986 Tax Reform Act were excessive is not supported by this measure of the effective rate." Earlier, she notes that rates of capital income taxation are now as low as they have ever been in the United States, and in particular, as low as they were in the prosperous 1960's.

For international comparisons, Jorgenson and Landau [1993] present estimates of effective tax rates for 1980, 1985, and 1990 in the major industrialized countries. Interestingly, these estimates show that the effective tax rates on individual assets in the U.S. (as elsewhere) went up and down dramatically over that decade. For example, the effective marginal tax rate on tax-exempt institutions went from 4.2% to -1.2% to 16.9% in the three time periods noted. Also, most types of capital had a lower effective tax rate in the U.S. in 1985 than in 1980 or 1990, without any demonstrable jump in investment in the 1985-89 period, relative to the other two periods. Finally,

the effective tax rate in the U.S. on key assets is comparable to the rates for our two major competitors. For example, the effective marginal tax rate on machinery is (using similar assumptions to produce estimates for each country) 33.5% in Japan, 39.8% in Germany, and 38.9% in the U.S. The U.S. is hardly non-competitive.

The fact that empirical studies have failed to find an impact of changing the tax treatment of capital on rates of investment is easier to understand if one looks more carefully at the theoretical work that has been done. A great deal of effort has gone into making the assumptions of neo-classical tax theory more realistic. For example, it is possible to extend the simple model to investigate the effects of recognizing people's differing preferences with regard to present versus future consumption, or to introduce the concept of risk and uncertainty into the models.

Studies of this type have shown that, even in theory, the effect of lowering taxes on capital is ambiguous in terms of its effects on economic efficiency. Gravelle [1994] notes that any change in the tax system which favors capital income will simultaneously result in changes in other taxes, spending, and deficit levels. How these other changes will effect the economy is entirely ambiguous. In fact, Gravelle shows several theoretical specifications in which efficiency is *increased* by raising capital taxes.

Given this, it is not at all clear that moving to a supposedly capital-friendly approach will have the desired positive effects—quite aside from the many negative effects of the various proposals. Therefore, the remainder of this analysis will emphasize the effects of the various tax plans on the budget deficit, on various groups of taxpayers, and on taxpaying households as a group.

## B. Revenue Estimates and Revenue Neutrality

In the charged anti-deficit, anti-tax atmosphere of Washington, anyone with a plan to change the tax system must claim either that their plan neither decreases *nor increases*<sup>3</sup> government revenue, that their plan will lead to so much growth that eventually revenue will return to its current level, or that there will be cuts in spending to offset the losses in revenue entailed by the tax cut. Several of the plans under discussion, therefore, has been quite deliberately designed to be "revenue neutral," with rates and levels of deductions chosen to ensure that the new system raises the same amount of revenue that the current system would collect.

For those plans that are claimed to be revenue-neutral, how can one meaningfully analyze the plans on the basis of revenue effects? One can do two things: 1) consider what goes into the basic process of making any revenue estimate; and 2) analyze whether the revenue neutrality masks distributional effects of the tax plan.

Any change in the tax law will generate both direct and indirect effects on tax revenues. Even a simple change in a very specific tax can have multiple effects throughout the economy. For example, if the federal excise tax on airplane tickets were to be increased, this would directly increase the tax revenue per ticket sold. However, it would also be likely to decrease the total number of tickets sold, so that estimating the revenue effect of such a change would necessarily involve a guess as to the size of the ensuing change

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<sup>3</sup> Indeed, even more than the risk of raising the deficit, the risk of creating new and bountiful revenue sources for the government has become a major concern for many libertarians on the political right [see, for example, Mitchell, 1995].

in ticket sales.

One can add to this uncertainty, moreover, several "spillover" effects: for example, the decrease in ticket sales could decrease total flights by the airlines, which would decrease tax revenues from airline fuel taxes and from any laid-off airline employees' income and payroll taxes. The decreased use of airplanes, however, is likely to be accompanied by increases in driving and train trips, which will increase revenues from fuel taxes, tolls, Amtrak receipts, etc.

Obviously, the possibilities are virtually endless. In the case of something as simple as a tax on one item, if one believes that the spillover effects are likely to be small, one can simply look at the immediate effect and—perhaps—also at the direct behavioral response to the price rise.

Indeed, this approach is currently mandated by law. When analyzing the net change in tax revenue due to any change in the tax code, the relevant government agency may estimate only the static revenue impact plus-or-minus the most direct behavioral impact of the change. This is the basis of the recent debate over "dynamic scoring," which revolved around the potential importance of the spillover effects of a tax change, as it works its way through the economy. In the case of a fundamental change in the entire structure of the tax system, the size and composition of the spillover effects is central to the debate.

To use as an example a national sales tax, one could adopt the simple method of multiplying a tax rate (say, 17%) by the current total annual consumption expenditures in the country (almost \$5 trillion currently, including imputed consumption of owner-occupied housing) to get an estimate for tax revenue of \$850 billion, which is about \$100 billion less than is currently being collected. However, because the very act of taxing

consumption is supposed to reduce consumption, one would then assume that even this estimate is too high. On the other hand, if the tax change makes the economy much more prosperous, it might raise total consumption (even as it raises saving by a proportionately larger amount) and thus raise total tax revenue.

The list of factors that are potentially important—but operationally difficult to measure—is seemingly endless. For example: How much tax evasion would a 17% (or 32% or 50%) sales tax rate engender? How much income that is currently hidden will be declared if the tax system is simpler? What are the international implications of the new tax system: for example, the tax treatment of imports and exports, and the further effects on the value of the dollar? These are questions to which there are no clear answers. It is by no means certain, moreover, that the changes will conveniently cancel each other out. The total revenue changes are potentially substantial.

One of the great pitfalls in analyzing these tax plans, indeed, is caused by the multitude of potential effects that might be brought into any analysis. For example, in examining the effects of their plan on the real estate sector, Hall and Rabushka [1995] claim that their flat-tax plan will lower long-term interest rates by three points. This, along with a smaller effect, allows them to claim that the negative effects on the housing market from eliminating mortgage interest deductions will be exactly offset by these positive effects, leaving homeowners equally well-off as they were under the current tax system.

Such claims might best be called "selective general equilibrium," in that they claim to look at equilibrium effects that are beyond the initial effects of a tax change; but they are not based on an exhaustive analysis of the macroeconomic interactions caused by such a fundamental change.

Moreover, since large-scale macroeconometric models are reliable only within the range of economic changes that are included in their databases (i.e., they would not be useful in predicting the effects of changes never before seen, such as interest rates of 40% or, more relevant to this analysis, the elimination of all tax deductions), even they would not produce reliable estimates when modeling a fundamental change in the tax system.

Finally, there are very likely to be important short-term effects associated with the change to a new system. For example, if consumption will be directly taxed as of a certain date, people are apt to accelerate their purchases of consumption items to precede that date. After that date, then, there will be a period of artificially low sales and thus low tax revenue as people use up the surplus consumption goods that they have purchased. This effect is virtually certain to spill over into greater general economic uncertainty, as businesses attempt to anticipate and respond to unusual sales volatility with changes in their purchases of inputs and hiring of workers. This possibility has been noted by officials at the Federal Reserve as being likely to make their lives much more difficult, at least in the short term, since they would try to counter-act any unusual movements in the economy with changes in interest rates.

The only certainty when making revenue estimates, therefore, is that bigger changes entail bigger uncertainties. Keeping the basic system while eliminating many deductions is very similar to the approach taken with the 1986 Tax Reform Act. We have evidence, based on experience following 1986, that the revenue changes were relatively small; so one can have reasonable confidence in the reliability of those revenue guesses. On the other hand, changing to a flat tax would involve much more uncertainty, while changing to a VAT or a national sales tax would be still more uncertain—not least

because it is not currently even clear what would be included and excluded from tax treatment in those systems. Thus, it is quite possible that these plans would not turn out to be revenue neutral.

In a recent assessment of dynamic scoring, Auerbach [1996] lists all of the ways that the current method of producing revenue estimates could be “enhanced,” from incentive effects to demand-side effects to intertemporal effects (from Real Business Cycle models), and more. He also points out that these new estimates would have to rely on further assumptions regarding offsetting policy changes, and (in order to be truly exhaustive) they would also need to make assumptions about legal and social effects of policy changes.

In the abstract, these considerations are potentially amenable to modeling, with the only concern being the cost-benefit ratio involved. For example, if the inclusion of the effect of a fiscal policy change on church donations takes \$1 million worth of government economists’ time, only to improve the revenue estimates by 0.0000001%, one might well decide that not every behavioral response is worth estimating. One might argue (again, in the abstract) that some dynamic factors should be taken into account, but only those that are “big” in a meaningful sense.

However, Auerbach argues against that conclusion, pointing out that the abstract world implied by such technical analysis is irrelevant to the real issues at hand today: “... [I]n the intense political environment in which estimates are produced and used, and given the unavoidable uncertainties of compiling such forecasts, it seems likely that fully dynamic forecasts may end up being even more biased and inaccurate than the forecasts of the last few years.” [p. 157]

Therefore, the three possibilities (that revenues would go up, that revenues would go down, and that revenues would remain the same) must at

least be considered in any analysis of the macroeconomic effects of radical tax restructuring.<sup>4</sup>

### **C. Double-Taxation**

The term "double-taxation" has become a central point of concern for many tax analysts [see Hall and Rabushka for a description]. In its most limited form, this term describes the levying of a corporate income tax at the level of the firm followed by a personal income tax if the remaining profits are paid out as dividends. The term has now become, however, a much more broad complaint about the entire tax system [see, e.g., Mitchell, 1995].

A genuine concern with double taxation should be separated into two parts. First, there is the question of the total effective tax on any particular flow of money. Second, one should also be concerned with whether any particular method of collecting taxes creates unwanted inefficiencies. When dealing with the first question, it should be clear that in most cases what matters is not how many times something is taxed but rather how much total tax is collected.

Most people would, no doubt, rather pay \$50 in tax four times than pay \$1000 in tax once. Much more important are the efficiency effects of double-taxation, which have been the subject of an extensive literature [reviewed very well in Gravelle, 1994]. While there is little agreement on the overall efficiency effects (especially the size of any effects) of these tax artifacts, it is undeniably true that there are some inefficiencies of this sort caused by the tax system. Those inefficiencies, however, need to be weighed against the costs of changing the entire tax system. Using them as an excuse to change

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<sup>4</sup> For an argument in favor of using dynamic scoring, see Mitchell [1996].



the entire system is simply inappropriate.

It is also true that multiple taxation is not limited to capital income. Currently, labor income is taxed by the Federal government twice, once by the Social Security system, and once by the income tax. (One could even argue that there is triple-taxation, if one includes the employers' contributions to Social Security.) Eliminating this was part of the Dole tax plan in its early stages of discussion, but it was dropped from the final campaign proposal.

Even the transition to a consumption tax would create a severe case of double-taxation. In the years when there is still an income tax, people pay tax on their incomes. However, anyone who puts some of their remaining money into a mutual fund, then withdraws the proceeds and spends them after the changeover to the consumption tax, would pay tax on that money again. Double taxation would be part of the system so long as anyone had money on deposit from before the tax regime changed. (See below for further discussion of issues relevant to the transition from one tax system to the other.)

The problem with the language of double taxation is that it is possible to extend it to virtually any situation. Since the economy is a system of flows—incomes flowing to households and businesses, deposits and withdrawals flowing into and out of financial institutions—one can describe nearly anything as multiple taxation by looking at the history of the transaction. A business can claim that any business tax amounts to double taxation, for example, because the money flowing in as revenues was previously subject to sales tax and, prior to that, income tax.

A strong version of such disingenuous reasoning is found in the Kemp Commission's report [National Commission on Economic Growth and Tax

Reform, 1996], which tries to describe the current tax code's "Bias Against Saving and Investment." Describing a family which has earned \$1000, paid \$280 of that in federal income taxes, and decided to invest the \$720 remaining, the report describes four levels of tax: "**First**, they already had to pay income taxes to have the \$720 to invest. **Second**, the company in which they invest will generally pay tax at a 35 percent rate on the returns on the amount invested. **Third**, if the company pays dividends, the family will pay a 28 percent tax on the dividends they receive. Alternatively, if the company retains the after tax income for reinvestment or finds other ways to boost future earnings, the stock price will rise. The future earnings will be taxed, and if the family sells the stock, it will pay a capital gains tax at a 28 percent rate. ... **Fourth**, if they hold the proceeds of the sale until death, they will be subject to an estate tax that can go as high as 55 percent." [Bold-face in original.]

This "quadruple taxation" is contrasted with the single taxation that would result if the family had decided to spend the \$720 on a trip to Disneyland rather than to save it. What is not stated is that one could just as easily follow the path of money spent on consumption and claim multiple taxation through similar reasoning: Disney uses the money to pay its employees, who pay social security tax and income tax, spending the remainder on clothes, paying (in most states) sales tax, with the clothing company paying profits taxes and paying its employees, etc. Using this method of counting, it is possible to claim that any flow of money is taxed an infinite number of times.

What makes that type of reasoning wrong, of course, is that the different taxes are being levied due to different economic events. The second and third levels of tax noted above, for example, are not taxes on the \$720 but

on the gains created by the investment of the \$720. The investment itself is not being re-taxed.

This logic has reached an extreme in the case of the estate and gift tax, which is the fourth level of tax described by the Kemp report. Several plans exclude estates and gifts entirely from taxation on the basis that this, too, is double taxation. Since the term double-taxation is so difficult to pin down, however, it is difficult to argue with the logic on these grounds: whatever money went into an estate or a gift probably was taxed at some point, and maybe even at more than one point. The inheritance tax, however, can be defended not as a continuation of taxation on a flow of income but as a way to recapture part of a stock of wealth that would otherwise be passed to heirs who have done nothing—"entrepreneurial" or otherwise—to benefit the economy.

Moreover, most specialists in taxation consider the current estate and gift taxes to be too low rather than too high. As one of the country's most prominent tax experts has noted: "Although tax theorists almost unanimously agree that taxation of wealth transfers [estate and gift taxes] should play a larger role in the revenue system, they have not been successful in convincing Congress." [Pechman, 1986] More estate and gift taxation should be the preferred direction, not less.

The issue of double taxation has an important, though limited, role to play in tax debates. However, the issue is currently being over-used to the point of abuse. The appropriate questions remain the total amount of taxes levied and the efficiency effects that they cause.

## **II. Outlines of the Major Plans**

As noted above, there are four classifications for the types of tax plans

that have been proposed: simplified income taxes, value-added taxes, saving-exempt taxes, and labor-income taxes. These will be described in turn.

### **A. The 10% Tax (or: Sweeping Out the Stables)**

The only detailed plan for fundamental change in the tax code that maintains an emphasis on income taxation (as opposed to consumption taxation) offered thus far is from House Minority Leader Richard Gephardt. His plan, which he labels (in something of a misnomer, since it has more than one tax bracket) the "10% Tax Plan," is an attempt to remove the complexity from the current tax code, thus expanding the tax base and lowering tax rates—while maintaining a progressive rate structure.

Under this plan, all income, both earned and unearned, is taxable for a majority of taxpayers at a flat ten percent rate; at relatively high incomes (\$40,200 of taxable income for a family of four, after subtracting \$19,350 in exemptions, i.e., a gross income of \$59,550) the marginal tax rate rises progressively, to 20, 26, 32, and finally 34 percent for taxable income over \$264,450. The only deduction that would be maintained would be the mortgage interest deduction. The Gephardt plan is relatively mute when it comes to business taxes, with the exception of a few smaller items like personal deductions for job-related expenses (which are re-classified as adjustments to income).

The Gephardt plan is generally not implicated in the discussions about raising national saving, since it is explicitly not attempting to punish consumption or encourage saving (except inasmuch as greater simplification might affect people's overall behavior). The Gephardt plan will be featured, however, in the discussions of simplicity and political reality in Section III.

## **B. Taxes on Consumption**

Value-Added Taxes (VAT's), common in Europe, are business taxes which are levied at each stage of the production process. A simple example would be the production of bread, where each stage of the bread's production adds value to the basic product: seed becomes wheat, wheat becomes flour, flour becomes bread, bread is packaged, the packaged bread is sold to the wholesaler, the wholesaler sells to the retailer, and the retailer sells to the customer. Each of those steps turns something that was worth relatively little into something worth more. The VAT system taxes each participant in the process a certain percentage of the difference between the cost of their inputs and the revenue from their outputs.

In a pure VAT, the tax would be levied on all products, including products that end up as investment goods (bulldozers, buildings, etc.). In that sense, therefore, the VAT is not a tax on consumption. Since most proponents of the VAT intend to have it work as a tax on consumption, however, they must make sure that the tax is not levied on the items that they wish to favor (i.e., investment goods). The only way to make the VAT "investment friendly" is to create an Exemptions List, which determines which items will not be subject to tax or which will be subject to preferential tax rates. In practice in Europe, this has resulted in a bewilderingly complex system, the complexity of which is effectively hidden from the consumer.

Unlike sales taxes, VAT's are not added on to the sales price at the cash register, but are already included in it; so a consumer does not know whether an item is tax-preferred or not. Deciding what is and is not taxable is an important part of any tax system, including the other types of tax plans discussed here. The advantage of the VAT is that it makes these choices

explicit.

A major problem with the concept of the value-added tax, however, is that the term is too broad to be useful. It can be used in terms so general that many tax systems that are seemingly unrelated to the VAT can, nevertheless, be called a VAT. For example, the flat tax (discussed below) can fairly be described as “precisely a value-added tax, plus a rebate of taxes to families based on their labor income and family size.” [Slemrod, 1995] A broad-based income tax, similarly, could be described as a VAT, plus a supplemental tax on saving. Most people think of a VAT as a national sales tax, when in fact a national sales tax is merely one type of VAT. Therefore, even using the term VAT is ill-advised. For the purposes of this analysis, therefore, VAT will not be used as a descriptive category, with the analysis centered on the only type of VAT that has been seriously proposed for the U.S.—a national sales tax.

Other than the income tax, perhaps the most familiar tax to most Americans is the sales tax. Repealing the entire tax code and replacing it with a national sales tax has become a goal of several prominent politicians, including former Republican Presidential candidate Senator Richard Lugar of Indiana and House Ways and Means Committee Chairman Bill Archer (R-Tex.) (who has refused to endorse any particular approach to tax reform, except to say that he favors any kind of consumption tax scheme). Senator Lugar's plan would have imposed a national rate of 17% on all final purchases, meaning that all saved income would be exempt from taxation.

National sales taxes have been attacked on several grounds. One of the most basic problems is the claim that the sales tax can be collected by existing state-level agencies, allowing a complete shut-down the Internal Revenue Service (certainly a crowd-pleasing notion). Since the IRS also

collects Social Security (FICA) contributions, however, Senator Connie Mack (R-Fla.) and the staff of the Joint Economic Committee have calculated that it would be necessary to have a sales tax rate of between 32 and 50 percent to make up for all of the tax revenue lost by eliminating all other types of taxes. Moreover, five states that currently levy no sales tax would be forced to create their own tax-collection bureaucracies from scratch. Without a funding mechanism, however, this would be tantamount to an "unfunded mandate," which Congress overwhelmingly voted to discontinue in 1995).

A final concern with a national sales tax is that, once again, the difficult political decisions (and the complexity) will come when the tax base is defined. Should educational expenses be taxed as consumption or exempted as investment in human capital. What about preventive personal health maintenance? These decisions would be the grist of future tax debates for future elections, just as discussions of personal exemptions and exclusions dominate elections today.

### **C. Saving-Exempt Taxes**

A plan which is much more directly "pro-saving" is the USA Tax plan, proposed by Senators Sam Nunn (D-Ga.) and Pete Domenici (R-N.M.). This plan is essentially a "universal IRA" plan, in that it allows people to put as much money as they want into a saving vehicle and not pay taxes on that money until they withdraw the money at a later date. If a person earns \$20,000 and saves none of it, therefore, they would pay the same in current taxes as a person who earns \$50,000 and saves \$30,000 of it. The rate structure would include three rates: 15, 20, and 40 percent. On the business tax side, the USA Tax would, like the two flat tax plans, levy a flat tax rate on net cash flow. In the Nunn/Domenici plan, the flat rate would be 11%,

with a few other technical differences in the plans.

The USA Tax retains the deductions for mortgage interest and charitable contributions, but it eliminates the deductions for state and local taxes. Significantly, however, it introduces a “higher education” deduction, treating expenditures for tuition at colleges and universities, junior colleges, and various technical training schools as an expensable investment rather than consumption. If for no other reason, therefore, the USA Tax is significant in including such a straightforward incentive to invest in human capital, a feature that is sadly lacking from the current tax code and in all of the other proposals.

The rate structure for personal taxes is actually less steep than it appears, since the USA Tax would allow deductions for payroll taxes (Social Security and Medicare). With these credits included, the three rates are reduced to 11% (for taxable income up to \$5,400 for married filers), 19% (\$5,400–\$24,000), and 32% (\$24,000 and over). With the cutoff points as low as they are, moreover, the progressivity of the system would be much less than even the top rate of 32% would imply, since larger and larger portions of income would be saved (and thus untaxed) as personal income rises.

Look, for example, at a person with \$50,000 in gross income with \$25,000 in taxable income (after subtracting family exemptions, savings, college tuition, mortgage interest, and charitable contributions). If that person earned and consumed another \$1,000, their tax bill would rise by \$320, because their marginal tax rate is 32%. On the other hand, if a higher income person earned an extra \$1000, it is much more likely that they would save much or all of it, meaning that they face a lower tax burden on marginal income. The difference in tax burden implies that the middle-income person would face a higher tax rate merely because they have not reached the point



where their consumption spending has leveled off. By supply-side logic, then, that implies a relative work *disincentive* for the person whose consumption needs are the most immediate, since their effective tax rate is higher.

Finally, the USA Tax is unique in that it has already been written! It is a fully detailed document, including transition rules from the current system. While this makes the bill nearly 300 pages long, it also makes it a more serious effort at dealing with the complexity of the economy. While it will most likely never be adopted in its current form, it provides many useful ideas and details that can be adapted to other proposals.

#### **D. The Flat Tax**

House Majority Leader Dick Armey (R-Tex.) and Senator Shelby (R-Ala.) have proposed a flat tax plan that eliminates all deductions and replaces them with high personal exemptions (roughly \$37,000 for a family of four) and which then taxes the result at a rate of 17% (although the rate is 20% for the first year of the plan). Significantly, the Armey/Shelby plan only taxes labor income (wages and salaries) and does not tax income from property (interest, dividends, or capital gains). On the business side, taxes are levied (also at 17%) on net cash flow, i.e., business revenue after subtracting all expenses for wages, benefits, and investment. This will effectively mean that all investment spending is fully expensed, that is, 100% depreciated in the year that it is incurred.

Most flat-tax plans are based on the proposal by Professors Robert Hall and Alvin Rabushka of the Hoover Institution [see Hall and Rabushka, 1995]. Some proponents would maintain the deductions for mortgage interest and charitable contributions —although the only apparent reason for keeping these deductions is to make the plan more politically acceptable. To pay for

those deductions, a revenue-neutral plan must offer a combination of lower exemptions and/or a higher flat rate on all taxable income.

A flat tax does not overtly reward saving; only the income one earns from saving and investment is exempted from tax. Thus, the "cost of saving" is decreased (or, equivalently, the cost of consumption is increased) at the individual level, as one can earn a greater after-tax rate of return on any amount of saving at a particular interest rate. (That the plan itself would lower interest rates is a claim also made by Hall and Rabushka, as noted above.)

The sponsors of the Flat Tax plans claim that the overall effect of their systems would be progressive despite their flat rate structure—due to the generous exemptions which reduce the proportion of income subject to tax. Nevertheless, it is worth remembering that these plans are still committed to the notion that the maximum tax rate on any income should be no more than a certain percentage—in Armev/Shelby's case, 17%. This means that the country would be moving to a system in which a person with a million dollars in annual income would find their next dollar of labor income taxed at a maximum of 17% instead of the current 39.6%.<sup>5</sup> While this is a choice that people might prefer, it is by no means certain that it would be the popular choice. It is at least important, however, to be clear on this basic fact.

Finally, the flat tax, despite the claims of its proponents that it is a completely worked-out plan, still has one major gap. Even after years of analysis and discussion, proponents of the flat tax do not know how they would tax financial services. That is, how does one tax "net cash flow" when

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<sup>5</sup> Their next dollar of *capital income*, of course, would not be taxed at all—or, to put it in Hall and Rabushka's terms, it would be taxed before it was received as income.

it is unclear what should be included as revenues for companies whose business it is to turn over large flows of cash? Certainly, a bank's revenues could not include all of its deposits, since it is merely holding that money for someone else. Therefore, it is not at all clear how the flat-taxers would tax banks or other financial corporations. This is, to say the least, a matter of some concern for anyone who would suggest that the country should rewrite its entire tax code in favor of a flat tax.

### The Kemp Commission

As part of an early attempt to deal with intra-party disputes regarding tax reform, House Speaker Gingrich and former Senate Majority Leader Dole appointed a committee to study and to make recommendations on overhauling the federal income tax system. While its official title, the National Commission on Economic Growth and Tax Reform, might make it appear that this was a panel of technical experts hired by the government to make recommendations, the panel was entirely a creation of the Republican Congressional leadership.

As soon as former Congressman Jack Kemp (who, obviously, did not know at the time that he was later to become the Vice Presidential nominee) was designated its chairman, it was widely expected that the Commission would endorse the flat tax, long a political project of Mr. Kemp. When the report was finally released, the only surprise was that the Commission supplied no numbers for its flat tax plans. It did, however, explicitly endorse the framework of a flat tax, from the single rate provision to the large personal exemptions to the labor income base (and companion business cash flow tax).

Moreover, the commission effectively abandoned any pretext of

impartiality throughout. For example, the report refers to those who might disagree with the conclusions of the commission as “defenders of the status quo” and later as “complainers.” Also, the report was issued along with ten companion papers which discussed various aspects of the current tax code and the commission’s recommendations, none of which was written by an academic economist of national reputation—not even one with well-established conservative credentials, such as Martin Feldstein or Michael Boskin. Instead, the four authors (each of whom wrote more than one of the companion pieces) are affiliated with conservative think-tanks whose views on tax policy were already widely known to be congenial to the leanings of the commission.

The report, in fact, could easily be mistaken for an excerpt from any of Mr. Kemp’s previous writings on the subject, in which he has fervently laid out a case for a flat tax. With chapter titles like “Imagine an America...” and “At the Boiling Point,” this was an uncritical advertisement for supply-side economics—e.g., assertions that the economy will grow faster due to tax cuts on business, not because of the spending that such cuts will create, but because the creative impulses of entrepreneurs will be “unleashed” by the lower tax rates. Arguments for “dynamic scoring” also received prominent play in the final report.

As a political document, therefore, the Kemp group’s report is an interesting repetition of the state of thinking of the sub-group of the Republican party that is currently dominating economic policy discussions. As a balanced and exhaustive analysis of the strengths and weaknesses of the current tax system (or of the many proposals for reform), however, it is irrelevant.

### **III. The Myth of Economic Neutrality**

Perhaps the most striking facts about the proponents of the various tax plans described above are their failures on two counts: first, to recognize that there is more to the U.S. fiscal system than just the federal income tax system, and second, that it is not possible to build a tax system which does not “distort” the economy.

#### **A. The *Entire* Tax System is Complicated and Extensive**

Perhaps the most under-appreciated fact in the current debate over restructuring the tax system is that the federal income tax is only one part of the federal tax system, and the federal tax system is only one part of the entire tax system. There are over 83,000 entities in this country with the legal power to tax. Designing a federal income tax or even an entire tax system for the federal government to achieve some ideal level of simplicity and efficiency is made much more difficult when one must consider interactions among taxing jurisdictions.

At the federal level, the part of the tax system that is left largely untouched by virtually all current proposals is the Social Security tax contributions by individuals and businesses. Since the Social Security tax is, by design, regressive,<sup>6</sup> the rest of the federal system must be designed with

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<sup>6</sup> This is true for two reasons: first, this tax is only levied on earned income, and second, it is a single-rate tax on all earned income up to roughly \$60,000 in income, at which point the marginal rate becomes zero and the average rate approaches zero as income rises. The latter point is no longer true for Medicare contributions, which do not have an upper cutoff for income.

this in mind.

At the non-federal level, most taxes are levied as sales taxes, which are by their very nature regressive. In addition, most anti-externality taxes are regressive (e.g., taxes on cigarettes, alcohol, and gasoline), despite the positive social goals which they are designed to achieve. Since the rest of the tax system is already regressive, therefore, changing the federal tax system in a way that leaves it any less progressive will turn the whole system into an even more regressive method of raising revenue.

The goal, therefore, should be to make the Federal tax system as or more progressive than it is today. Simply meeting the goal of being, on its own, progressive is inadequate, since even a range of effective tax rates starting at 10% and rising to 10.1% meets the dictionary definition of progressivity. To couple that type of federal system with the rest of the tax system, therefore, is to guarantee a net increase in regressivity.

## **B. Incentives and Social Engineering**

One aspect of the "perfect tax code" notion that underlies much of the current debate is the idea that the tax code could be made neutral, i.e., that people could make decisions not on the basis of tax considerations but on the basis of their personal desires and the possibilities of a free marketplace. Once again, however, this notion is not grounded in economic reality. How could the U.S. government have collected over \$1.4 trillion dollars in 1995 (over one-fifth of personal income) without affecting people's behavior? It is simply not possible.

Economics is the study of human responses to incentives. As such, every institutional structure is analyzed to find the incentives and disincentives that it embodies. This is particularly true of the tax system—

perhaps the most extensively-studied incentive system in the entire economy. The key fact which emerges from all such analyses is that it is not possible to construct a tax system without incentives and disincentives.

This is why economists have invented the concept of the "lump-sum tax"—a hypothetical construction that is based on the acknowledged impossibility of raising tax revenue without altering (or, as it is more commonly described, distorting) human behavior. This invention was necessary because it allows economists to analyze other questions without having to consider the behavioral responses to taxes, as in, "Suppose that we have an increase in government spending on public highways, financed by a lump-sum tax..." No one could seriously claim that a non-distorting tax exists or could be invented; the point is simply to say that the question under discussion is the effects of the highway expenditures, with the responses to taxes assumed away for simplicity.

It is, therefore, impossible to claim that any tax system will be "neutral" with regard to the economy. No system will allow the economy to move to some state of nature in which all human decisions are led by the invisible hand. Even the simplest of tax systems, the "head tax" (where every person pays exactly the same number of dollars per year, no matter what their situation—or what the British call a "poll tax"), creates incentives and disincentives. For example, some people might respond to such a tax by legally "disappearing," that is, by altering their behavior in ways that allow them to pay no tax. This involves making choices to give up some activities that are more likely to result in discovery.

Moreover, this tax system would create a clear disincentive to having children (although, as always, the magnitude and effect of that disincentive is unclear), since every child would create a tax liability without being able to

work for quite a number of years. (Similarly, an exemption for children below a certain age would create other behavioral distortions—lying about the ages of one's children, artificial incentives to throw children out of the household on a certain date, etc.)

The dream of the non-distorting tax is, therefore, forever to remain unrealized. Of course, this is not to deny that some tax systems are more transparent than others in how they alter behavior. Even if it is not possible to be perfectly neutral, it is at least possible to be simpler than the current tax code. Increased transparency should not be automatically equated with decreased distortion, however. For example, a perfectly transparent tax that would levy a 100% rate on all commercial transactions in the state of Texas would hardly lead to small distortions.

The argument against the current tax code is often made on the basis of its supposed built-in disincentives to save. For example, until 1986, the tax code allowed interest on consumer borrowing to be deducted from taxable income, which created a clear incentive (in theory) to spend rather than to save. This is one reason why, for example, the tax-preferred treatment of IRA's and pensions is broadly popular among politicians of both parties. It is also why the tax deduction for interest on consumer debt was phased out—with no discernible impact on the saving rate, which continued to decline.

The crucial point, however, is that the more radical tax reform proposals wipe out the existing tax code, including all of its disincentives (and incentives) regarding saving. Then, starting from a blank slate, they tax consumption only. This is, therefore, quite clearly "social engineering," with the self-appointed tax engineers making the judgment that the economy would be better off with a larger amount of saving than the private economy would naturally produce.



While it might be possible to claim that the years of artificially-low saving need to be followed by years of artificially-high saving (an arguable proposition, at best), that would imply that there would be some point at which consumption should no longer be penalized. This is not part of any of the tax proposals, however, and the rhetoric is rather overwhelmingly anti-consumption in general—not just anti-consumption as a short-term corrective.

This leads to the key unasked question of this debate: How much saving is enough? Since the supposed link is from saving to investment to growth, the real question is: How much growth is enough? Since it is not possible to design a tax code which is neutral, we cannot simply say that the free market will produce the "right" amount of saving. We must, therefore, have some idea of what a reasonable ultimate goal should be. The answer, "More than we have now," is simply inadequate.

The current broad consensus on how fast the economy can grow—independent of cyclical fluctuations—is between 2.5% and 3% per year. Changing the tax system is not designed to allow the economy to stay closer to that long-term trend; it is explicitly supposed to raise the trend. But to what? Without an undistorted standard of comparison, it is impossible to say. Comparing to our past (for example, the high-growth sixties) is hardly appropriate, since we have had an income tax for nearly our entire industrial history (and marginal personal tax rates on upper incomes in the that decade were historically quite high, topping out at 91%). Comparing to other countries is tempting, but they have their own tax systems (generally based on the income tax) with their own incentives and disincentives—not to mention much more complete versions of the welfare state. They do not presumptively have it right.

When it comes to social engineering, of course, it is notable that the one deduction that is allowed in many of the proposed tax systems is the dependent-child exemption. Rep. Armey, indeed, specifically refers to the importance of making the tax system more fair for "families." If we believe that people respond to financial incentives, might we not conclude that this incentive to have children is an attempt at social engineering? After all, many state welfare systems have been changed recently to prevent a minuscule financial incentive from inducing a population explosion among the poor. Why should that not be a similar concern in the general tax code?

Is there still a way to design a tax code which does not change any relative trade-offs in the prices of any set of goods? This is the claim of the Flat Tax, which claims to tax everything once and only once at exactly the same rate. This is quite distinct from the explicit consumption taxes (and the USA tax), since the claim is that all goods, services, and activities would be taxed at a uniform rate—erasing the existing bias against consumption rather than creating a new bias in favor of saving. (The details of the Flat Tax proposals do leave several items untaxed; but for the sake of argument, one can take the assertion at face value.)

For example, if—in an imaginary non-tax world—a Ford Taurus would cost \$20,000, a weekend vacation \$1,000, and course at a *private* Junior College \$2,000, then one can take twenty vacations for the same price as one Taurus and two vacations for the same price as one course. Any single-rate tax that applies equally to all three goods would preserve those trade-offs. For example, a 10% tax would make the three goods cost \$22,000, \$1,100, and \$2,200, respectively. The 20:1 and 1:2 (and, of course the 10:1) price ratios would remain.

However, maintaining the same relative price structure does not, except

under very restrictive assumptions, leave behavior unchanged. Say a person has an annual budget of \$30,000, and they have responded to the non-tax price structure by buying one Taurus, four vacations, and three courses. (There is, of course, no reason why the ratio among goods purchased must reflect the ratios of their prices.) Even assuming that it makes sense to talk about fractions of these goods, can we be sure that the same person would buy the same proportion of goods after the tax is imposed—i.e., 0.91 of a Taurus, 3.64 vacations, and 2.73 college courses?

The general answer is no, because of “income effects,” i.e., the fact that people feel poorer due to the decreased buying power of their budgets, which can make them alter their proportional choices. For example, the person in the examples above might respond to the new situation by deciding that they really need to get their advanced degree sooner, so that they can raise their income in the future. They might now buy five college courses, cutting back on both fractional Tauruses and vacations. Another person might just give up on earning more (a supply-side effect, as their labor choices decrease with higher taxes), in which case they might buy no courses and take a series of weekend vacations.

The technical term for this is that people do not have “homothetic preferences,” or that they do not have a “linear income expansion path.” Whatever the terminology, however, it is clear that a tax system such as that in the United States, where the federal government collects over 20% of personal income in total taxes (including Social Security contributions), must affect people’s choices. Cutting it to 10%, or 5%, would not change the basic fact: Taxes are never neutral.

This is true even if, as mentioned earlier, one could design a tax system which taxed everything equally. It is worth discussing in some detail just

how difficult that would be, however. Taxing all goods at the same rate (which would certainly imply taxing all capital goods—housing as well as plant and equipment investment and even inventories—at the same rate as consumer goods) is difficult enough, given the existence of non-traded and non-priced goods and the difficulty of even measuring the “goods and services” provided by the financial sector.

More intractable, however, is the built-in problem that taxes on goods and services favor leisure over labor. That is, if a person sees a 10% tax on all goods and services, this means that they lose less by not working than before. In the example above, making \$30,000 does not buy all that it used to; so choosing not to work is “cheaper” than it used to be.<sup>7</sup> How to tax leisure, then, becomes a major problem if one really wants to eliminate all biases in the tax code.

It is possible, of course, to accept the “unpleasant” fact that taxation moves people’s behavior away from the Invisible Hand’s optima but still believe that these distortions should not consciously be considered when designing tax policy. When a tax happens to distort behavior in one direction or another is one thing; but when Congress deliberately decides to favor one activity over another, that is “social engineering.” This “see no evil” approach, which says that distortions are fine so long as we do not know what they are, is bizarre at best. If the economy is not going to be where the non-taxed free market would have it anyway, why not use our analytical powers

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<sup>7</sup> It is not guaranteed, of course, that all people would respond to that change in relative prices by working less; many might work more hours. In the aggregate, it appears that the change in labor hours worked in response to changes in net taxes is zero, i.e., those who work more are exactly balanced by those who work less.

to see if we can improve on what is currently happening? This is no longer a matter of moving away from a state of grace, but rather of moving from one creation of fallible humans to another.

Therefore, rather than imagining that we can build a non-distorting tax system, the best criteria to evaluate a tax system are: 1) What goals are you trying to promote? and 2) Are you succeeding? This requires a discussion of what the tax system should do, beyond just raising revenue. Some discussion of those issues can be found below and in Buchanan [1996].

#### **IV. Making Future Change More Difficult**

One of the principle goals of economic policy is to create prosperity, preferably in both the immediate and longer-term senses. Part of the approach to achieving that goal should be to maintain maximum flexibility in policy-making, i.e., to keep all policy options open. It is virtually certain that circumstances will change over time, so forsaking certain policy options ahead of time should not be acceptable.

##### **A. Super-Majorities and Referenda**

Flexibility in policy-making, therefore, should be preserved. This means that the enactment of so-called super-majority requirements in changing the tax code should be copiously avoided. The Gephardt Plan, for example, proposes that a national referendum be held before any tax rate could be increased, while the Kemp Commission proposed super-majority requirements in both houses of Congress before taxes could be raised.

In response to downturns in the economy, it should be easier rather than more difficult to lower taxes, since the key to such situations is timeliness. What is less obvious is that this need for flexibility must apply in

an upward direction as well. Since many in Congress and elsewhere are extremely concerned about a balanced federal budget, it will not be acceptable to cut taxes in a downturn if it will be too difficult to increase them again when the economy strengthens.

Indeed, the various proposals are silent on this, but it is not necessarily clear that one could even pass a law with a “sunset” clause in it (e.g., “taxes will be decreased tomorrow and increased back to their current level at a specified point in the future”) by less than a super-majority, since there might be a legal challenge to the ability to “raise taxes” in the future, even if taxes are only to be raised back up to a previous level.

Moreover, this logic does not apply solely to cyclical changes in the economy. If the economy were to start growing faster in a sustained way (even assuming that we could distinguish that from a cyclical upturn), the logic would normally be to believe that the higher-than-expected tax revenues should either be spent on previously-ignored projects or reduced by cutting taxes. Should there be a super-majority requirement, however, any deficit-hating member of Congress would not want to cut taxes, because the seeming improvement in the economy could prove to be short-lived.

The only remaining response would be either to allow excess tax revenues to be a drag on the economy, or to spend the excess on whatever projects might be handy (since spending would not be required to fall under a super-majority rule—at least, not yet). Ironically, therefore, the result of a super-majority rule would be to decrease the likelihood of tax cuts in both good times and bad, and to increase the level of government spending.

The final problem with the super-majority proposals revolves around the definition of what type of tax law change is covered by the super-majority requirement. The proposal by the Kemp Commission was to require a two-

thirds majority vote in both the House and the Senate, but only for proposals to raise the single tax rate itself.

This should hardly be comforting to anyone concerned about rampant taxation, however, since the whole method of creating progressivity in a flat tax is the standard deduction, which can be lowered to bring more people at the bottom into the system without raising the rate. In fact, the higher is one's income, the less one is hurt by this maneuver, and thus the more beneficial is the brake on rate increases. The entire method is biased toward future regressivity. Compared to the current system, moreover, in which over 96% of all taxpayers pay less than 17% of their gross income in total federal income taxes, this change is hardly a guarantee of a tax cut.

This has encouraged efforts to create "loophole-free" tax limitation plans. One constitutional amendment, proposed by Sen. Kyl and defeated in early 1996 (followed by promises to re-file the bill), would put a super-majority requirement on "any law that will have as its effect to increase federal tax revenue." As proposed, such an amendment would not even allow balancing provisions (two or more proposals which, on net, leave tax revenue unchanged) to be passed by a simple majority. This means that any tax proposal that would raise revenue, whether it be a direct rate increase or an obscure definitional change that would broaden the tax base, could only be passed by a super-majority vote.

Beyond the nightmarish details involved with such a broad proposal, and setting aside the tendency that this will have to prevent change in either direction (as noted above), there is a much broader problem with such a plan. Dynamic scoring, as discussed earlier, is based on the fact that the flow of tax receipts depends not just on the details of the tax legislation but also on the decisions that people make following the tax change. If an increase in the

cigarette tax decreases the quantity of cigarettes purchased, for example, that implies lower tax revenues than one would have guessed using a static analysis.

The reason that dynamic scoring is so controversial, however, is that it brings into question not just the size of the changes in tax revenue but the actual direction of the change. The famous “Laffer Curve” was designed to demonstrate that the government could receive more tax revenue by lowering the tax rate. Whether or not one believes that particular assertion, the concept comes up again and again, from debates about capital gains taxation at the national level to arguments over property tax rates at the local level. It is very often the case that one can find forecasts from different analysts of both increases and decreases in tax revenue due to any proposed change in tax law.

If a cut in the capital gains tax rate will, as many proponents claim, increase tax revenue, then that proposal would require a super-majority vote. The obvious response to this would be for proponents of various changes in the tax code to present evidence that these changes will be revenue-losers, which would allow them to be passed by simple majorities. The current debates would be turned upside down, with proponents of higher tax rates adopting Laffer Curve-style analyses to ease passage of these proposals.

## **B. Interactions with Budget Rules**

If a super-majority requirement were enforced in conjunction with a constitutional amendment requiring a balanced budget, the situation becomes murkier still. If the Balanced-Budget Amendment requires a super-majority vote to set aside the requirement of a balanced budget (as recent versions of the amendment, which have very nearly passed in the Senate,



would do), then the tax law changes that forecast a *decrease* in tax revenue will require a super-majority vote. The super-majority requirements in the tax bills would require the same thing for an *increase* in revenue.

The result of this must certainly be increased paralysis of the political system. Anyone who wants to change anything to do with fiscal policy must do so with a super-majority vote. Anyone opposed to any change need only show that the change has *some* effect on the federal fiscal system. For those who believe that a perfect fiscal system (so perfect that it will never need to be changed) can be put in place before these proposals become part of the Constitution, this might be the desired result. For others, however, the prospects are disheartening at best.

It is even possible that, rather than experiencing increased paralysis, the system could completely break down. If the result of *not* changing the tax laws is to increase revenues, that too could be challenged as a “tax increase” that needs to be subjected to a super-majority vote. Thus, given the lack of ability to forecast revenues with any precision, there would be no “default” position. Any chosen alternative, including the choice not to change at all, would be open to the attack that it either increases tax revenue or increases the deficit.

The only technical alternative to this would be to designate a particular agency that would make definitive forecasts for every policy initiative—forecasts which would have to be legally immune from challenge. This would move the decision-making power further away from elected representatives, and the agency would be forced to institutionalize a single model of the economy. This would certainly be controversial among both economists and politicians, no matter which approach was chosen, since the economics profession is extremely split in its opinions about various approaches to

modeling. Which version of Keynesianism or Classicism will be the “official” arbiter of economic policy? The possibilities for dispute and conflict are seemingly endless.

The overall conclusions regarding super-majority requirements are: 1) If they apply only to changing the tax rate in a single-rate system, the result is inherently regressive, 2) If they apply only to changing the tax rates in a graduated-rate system, they are easily side-stepped by changing the base, 3) If they apply to the base as well as the rate(s), it is extremely difficult to define what a “tax increase” is, leading to more gamesmanship, and 4) In conjunction with a balanced-budget amendment (or a binding balanced-budget requirement), the super-majority requirement for tax increases is likely to lead to legislative stasis.

## **V. Important Administrative Questions**

### **A. Transitional Issues**

One of the issues that will prove most vexing if the current tax debate moves from the theory phase to the implementation phase will be the problem of changing from the old tax system to the new one. A few serious considerations should be noted here, as an indication of the depth of the issues involved.

Prior knowledge of the “rules of the game” in any situation has an enormous impact on an individual's financial plans. A crucial part of that prior knowledge is the relevant tax treatment of alternative strategies. The more abrupt the change in the tax system, therefore, the more likely it is that people will be arbitrarily helped or harmed by a tax law change.

One area where this is most relevant to middle-income taxpayers is in

residential real estate. Most people have purchased their largest asset, secured by a thirty-year financial obligation, on the basis of the current tax code. While any change in the tax code is going to have some impact on people's assets, removing the most popular deduction (or making any other change that affects the tax value of the deduction) has potentially disastrous effects on people's financial situations. The National Association of Realtors, for example, estimates that the elimination of the mortgage interest deduction would reduce the value of real estate in the U.S. by over \$1 trillion, or almost one-fifth of its current total value. DRI/McGraw-Hill puts the loss at 15% of the aggregate value of residential real estate.

Not only does this mean that the average homeowner's primary asset would lose one-fifth of its value, it means that any homeowner whose equity in the house was less than twenty percent would see their entire accumulated equity disappear. For example, a person whose home is worth \$150,000 before the change who owes \$130,000 on the mortgage loan would see their house's value drop to \$120,000, such that their equity would become negative and their \$20,000 nest egg disappears.

Another transitional problem has to do with generational fairness. Moving from an income tax system to a consumption tax system has a very perverse effect on people who have retired or are near retirement, in that it involves taking people who have spent their entire working lives paying income tax, and then changing over to a consumption tax—just when they will become heavy consumers. This problem would eventually go away, but not for at least thirty years.

As Gravelle [1994] explains, the problem of transition is so profound that it means that it is better to stay with the system that is currently being used. If we had always had a consumption tax system, then switching to an

income tax system would be unacceptably inefficient. Since we have an income tax system, though, we are better off improving it rather than going through the pain and unfairness of a transition.

## **B. Complexity and Simplicity**

The public debate about changing the tax system is, as noted earlier, typically not being waged over issues like economic efficiency and super-majority requirements. More often, one hears speeches about the complexity of the current tax code and the pervasive influence of lobbyists on the system. While these and other issues are important in their own right, they are simply arguments for "some kind of change" rather than arguments for any specific alternative.

One of the effects of this atmosphere has been the emergence of a "fetishism of numbers." The current system is chastised for having so many pages of instructions that, "Placed end to end, these pages would stretch 694,000 miles, or about twenty-eight times around the earth. The IRS despoils the environment, chopping down about 293,760 trees to print all of this paper." [Hall and Rabushka, 1995]<sup>8</sup>

Estimates of the costs of compliance with the system are similarly without serious content, with the often-heard estimate of \$300 billion reached through calculations (again from Hall and Rabushka) that—despite protestations to being "conservative estimates"—stretch credulity. The fact is that the system is complex, but calculations like this create the false impression that the country will be \$300 billion richer if the current system is

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<sup>8</sup> The Nunn/Domenici plan's length, 290 pages, is also considered a public-relations liability.

scrapped.

One response to the understandable desire for greater simplicity is the promotion of the "post-card-sized form" for filling out taxes. Examples of this form typically have about ten lines. However, one indication of how arbitrary this type of "simplicity" is can be seen in the following line (from a card produced in conjunction with a proposal by Sen. Arlen Specter): "Number of dependents, not including spouse, multiplied by \$4500." For general use, that line would be broken into at least two lines (one for the number of dependents, and one for the calculation)—not because tax forms have to be complex, but to prevent errors. The IRS, in fact, already has the equivalent of the post-card-sized form, the 1040EZ, which has only 12 lines (including lines for taxable interest income, unemployment compensation, and the Earned-Income Credit, none of which would exist under most of the plans described above) and—with much larger type—fits on the front of one page of typing paper.

Moreover, even if one believes that fewer and shorter forms is the appropriate goal for tax policy, this is not an argument for any of the substance of the various tax plans. It does not argue for exempting saving, since that is actually more complicated than simply computing and taxing income. It does not argue for eliminating tax brackets (as all but the Nunn/Domenici and Gephardt plans would do), since those calculations can be done either on separate pages or (if one wants to save trees) by the taxpayers themselves on one extra line. In short, arguments for simplicity are not arguments for flatness nor for abandoning the concept of income taxation.

Another area where the political rhetoric has gone beyond of reality is the question of the role of lobbyists. The idea seems to be that making the

system simpler will eliminate the opportunity for lobbyists to influence legislation. Rep. Gephardt's plan comes with literature that goes so far as to say: "The 10% Tax takes away the lobbyist's seat at the table." The sad reality is that, even if any of these plans were to be adopted, the lobbying to change them would begin immediately after they were enacted.

It could be argued that the highest-priced lobbyists would have nothing left to lobby for, since some of these tax plans give their clients what they have wanted for years. This is not what the rhetoric is meant to imply, though, as Rep. Gephardt's literature also says: "Average taxpayers will know that everyone else is paying their fair share: high-priced lawyers and accountants will not help the privileged reduce their tax bill." Reducing the amount of lobbying for the privileged by giving the privileged what they want in the first place is hardly a victory for the average American. (This criticism is least true of the Gephardt plan, however.)

The presumption in the debate about simplifying taxes seems to be that there *is* a universally-desirable, pure system of taxation with which every reasonable person would be happy. Presumably, then, that perfect system will only become bad if it gets corrupted by "special interests" and high-priced lawyers. Neither of these presumptions is demonstrably true, given that the world is a complex place, and the tax system largely reflects that complexity.

That said, there is definitely virtue in the idea of simplifying the tax system. The Gephardt plan does so, but without making any of the other, more radical, changes that the other plans would make. Even so, the notion of "cleaning out the stables"—or, eliminating the accumulated complexity of the tax code—should be mindful of the other implication of that metaphor: the stables will not stay clean. The 1986 tax reform eliminated many of the most abused tax shelters; but only ten years later, there is already an

accumulation of rules and tax shelters (created by both parties) that should arguably be shoveled out. The process will continue.

Even in the most simplified tax system, moreover, the most fundamental attack on simplicity (and opening for political lobbying) will be in defining what is taxable and what is not. A system that is designed to tax “consumption” will be confronted with thousands of purchases that can be viewed as either consumption or investment (e.g., a personal computer). How such decisions are made would be the bread-and-butter of congressional tax-writing committees for years to come.

Finally, it should be noted that there is an important scientific benefit that arises from the complexity of the tax code. Economists rely heavily on the data provided by tax returns and tax receipts in studying the economy. This information (which includes obscure items like the amount deducted for business travel, in addition to the obvious items like income and filing status) would otherwise be very expensive to collect, which implies that one way to characterize at least a fraction of the IRS budget is for economic data collection, similar to the Census Bureau or the Bureau of Labor Statistics.

Moreover, these data are qualitatively different from survey data in that they are provided by virtually everyone in the economy with copious attention to accuracy. (How much deliberately *in*accuracy goes into these data is an interesting question as well.) This benefit, peripheral though it may be, should not be overlooked. If we lose these data, we will either have to spend money to collect similar data, or we will not be able to understand the economy as well in the future.

## **VI. Conclusions**

The debate over changing the tax system has brought forth both useful

proposals and irrelevant side-issues. This analysis has attempted to separate the two, and to clarify the benefits and harms of the various plans for radical tax restructuring.

Virtually all of the plans under consideration to replace the current tax system suffer from significant shortcomings. Their revenue effects are speculative at best, most would abandon income taxation entirely, and they are based on a flawed ideal of a neutral tax code. Moreover, many of the proposals include unworkable and unwise limitations on future fiscal policy (some in the form of constitutional amendments) that would make the nation worse off.

The transition to any new system would create significant complexity, uncertainty, and intergenerational fairness. The better policy would be to make the current system work better. Among the plans proposed, by far the most judicious and sensible is the Gephardt plan.

No matter the results of this round of the tax debate, however, when the day is done we can be sure of one thing: someone will have a new proposal the next day. It might even be better than anything we have now.



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