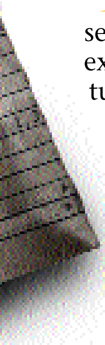
> The income tax has made more liars out of the American people than golf has.
>
> —Humorist Will Rogers

Tax Man, Heal Thyself

by Kevin L. Kliesen



There seems to be a general consensus among economists that the existing federal income tax structure in the United States: 1) is complex; 2) hobbles economic growth by creating disincentives to save and invest; and 3) creates a substantial compliance cost burden for individuals and businesses. It also appears that a large number of Americans and their political representatives concur with this assessment given the large number of tax reform proposals advanced recently. Most of the proposals put forth are not only a significant departure from the current framework, but, in many cases, also differ markedly from each other.

The Economics of Taxation

Some form of tax collection apparatus is necessary to fund the myriad governmental entities and the responsibilities they are charged with. From an economic point of view, however, most taxes introduce distortions in an economy. A sales tax, for instance, creates a "wedge" between the price a consumer pays for a good and the price the seller receives. A tax wedge also results from a tax on income. In this case, the tax affects economic activity by altering people's incentives to work or not to work (leisure).

At its core, the current federal income tax structure is a system built on progressive tax rates, which means that the more money you make, the higher your tax rate. For example, up to a certain income level, taxpayers pay 15 percent in taxes for every additional (or marginal) dollar they make; the highest income taxpayers, by contrast, pay up to a federal marginal tax rate of 39.6 percent. Marginal tax rates, most economists believe, are important from an economic standpoint because they influence decisions to work, save and invest.

To see this, consider an increase in George's payroll tax rate, which lowers his after-tax income. Because George now works the same amount of hours for less income, he may instead choose to work less. In other words, he might substitute a certain amount of leisure for work because the opportunity cost of an hour of his leisure has declined: In this case, George's supply of labor falls in response to an increase in his tax rate. This is called the substitution effect.

But another effect—the income effect—works in the opposite direction. A reduction in George's after-tax income causes him to consume less than before, whether it's meals eaten away from home, videos rented or leisure time "consumed." By definition, fewer hours of leisure time consumed means more hours devoted to work. Thus, under this equally plausible scenario, an increase in George's tax rate may actually cause him to supply more labor, not less.

In general, how individuals respond to changes in after-tax income depends on factors such as their age, sex and marital status. The consensus among economists seems to be that the largest effects occur at the extensive margin, which means that changes in after-tax income have the largest effects on decisions to enter or leave the labor force.[1] For example, consider George's wife, Martha, who decides to enter the labor force and get a job. Unless they file separate returns, the marginal tax rate paid by Martha will be the same as that of her husband. Thus, her decision to enter the labor force may differ markedly if her marginal tax rate is 15 percent as opposed to 28 percent or nearly 40 percent. In this way, higher marginal tax rates induce larger distortions on economic activity and decisions to work.

What's Wrong with the Current System?

The U.S. federal income tax is a byproduct of the 16th Constitutional Amendment, which was ratified in 1913. Since then, the U.S. tax system has been continually modified. In the past 17 years, major changes in the tax code took place in 1978, 1981, 1982, 1983, 1985, 1986, 1990 and 1993. Moreover, there also has been a trend toward fewer rates. For example, in 1965 there were 25 different rate schedules; in 1995, there were just five.

A Riddle Wrapped Inside a Mystery

A central criticism of the current federal tax system is its complexity. A total of 585 tax forms and schedules currently exist. Although the compliance burden on individuals and businesses is difficult to ascertain, the estimates range from $100 billion to $600 billion per year, with nearly five billion man-hours required.[2] This burden has been one of the main issues raised by tax reform advocates, who believe that economic resources devoted to tax preparation and recordkeeping activities could instead be used to purchase capital equipment, hire additional workers or implement programs designed to boost skill levels.

Another criticism is that the current structure has become an inefficient and costly way to promote outcomes that policymakers have deemed as favorable to certain social causes or industries. In other words, because of the numerous exemptions and deductions that are currently in place, some activity is taxed and some is not. The tax code, for example, is used to subsidize home ownership through the mortgage interest deduction and employer-provided health care coverage through the ability to pay insurance premiums with pre-tax dollars. Consequently, about a third of the individual income tax base is not subject to taxation. Similar incentives, such as deductibility of labor costs and interest paid, exist on the business side. Tax reform proponents want to simplify the tax code and reduce tax rates by broadening the tax base. Both of these would go a long way toward reducing the distortions mentioned earlier.

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Penalizing Future Generations

Although the complexity of the federal tax system certainly raises economic efficiency concerns, probably the most trenchant indictment that one can make against it is that it provides too few incentives to save and invest. This is a serious problem because low saving rates translate into low investment rates, which, most economists agree, eventually show up in reduced productivity growth rates and smaller increases in living standards over time. Reforming the tax code so that it favors saving relative to consumption—that is, so that it favors the future rather than the present—will inevitably boost the growth rate of the economy and enhance U.S. living standards.

The current system does, however, encourage some form of saving through such instruments as individual retirement accounts and 401(k) plans. At the same time, the system heavily penalizes savings and investment by taxing interest payments received by individuals and by taxing corporate dividends twice—sometimes even three times. The tax structure further penalizes saving because it is not entirely insulated from the effects of inflation: The income derived from interest payments or the sale of assets (capital gains) is not adjusted for inflation, nor are business depreciation schedules, which affect corporate profits.

The most obvious way of making the federal tax system more saving-friendly is by taxing consumption more heavily. On the face of it, this would be a substantial departure from the existing system, which taxes individuals on the basis of their current income. As a general proposition, there are two ways of taxing consumption at the individual level. One method would be some form of a federal sales tax, which would append directly to the price of most goods and services. This type of tax tends to be regressive, making some type of rebate or tax credit required as an offset for low income individuals. The second method of taxing consumption is to exempt savings from taxation. The easiest way to see this is to define total income as the sum of what is spent and what is saved. By exempting income that is saved from taxation, that part of income that is consumed, by definition, will be taxed. Taxing consumption at the individual level this way essentially entails imposing a tax on wages and salaries and foregoing taxes on interest or investment income, which would be taxed as income at the corporate level only. Although the latter method is probably preferable to the former, either would significantly improve the incentives to save and invest.

Two Well-Known Tax Reform Measures

At last count, there were 13 major proposals to change the existing federal tax code.[3] Two of these proposals have received the greatest amount of attention and have been fleshed out the most: the Hall-Rabushka flat tax (H-R) and the Unlimited Savings Allowance (USA). Proponents of each claim that the U.S. investment rate would rise substantially over time by enhancing the incentives to save. Moreover, each would—to a differing degree—simplify the existing tax code and retain its progressive nature.

The Flat Tax

Perhaps the best known of the recent reform measures—thanks in large part to former Republican presidential candidate Steve Forbes—is the flat tax. Proposed by Stanford professor Robert Hall and Hoover Institution senior fellow Alvin Rabushka, the flat tax has been around in some form or another since biblical times.[4]

The basic premise behind the Hall-Rabushka (H-R) version is to tax income exactly once: where it is earned, not where it ends up. In the H-R framework, income at the individual level is defined as wages and salaries plus pension and retirement benefits, with a flat 19 percent (marginal) tax rate applying to incomes above a certain level.[5]

Under the current system, a family of four that did not itemize would escape taxation if its adjusted gross income was $16,550 or less. The Hall-Rabushka flat tax would allow the same family of four a $16,500 personal allowance, plus a $4,500 deduction per child (dependent). This means that a family of four with an income level of $25,500 or less would not be taxed. Hall and Rabushka argue that the average family with wage income between $10,000 and $30,000 would see a net reduction in taxes under their proposal, as would those with incomes above $100,000. Those with incomes between $30,000 and $100,000, however, would likely experience a slight increase in tax liability.

A Treasury Department study, however, contends that the Armey-Shelby version of Hall-Rabushka (see Footnote 5) would actually increase the tax liability for all taxpayers, except those with wage incomes above $200,000.[6] The Treasury Department's tax analysis has been criticized by some for not sufficiently incorporating the dynamic effects of a tax proposal's positive economic effects—that is, any positive labor supply response to reduced marginal tax rates and increased incentives to save and invest.

One reason that upper income taxpayers would probably see a reduction in their tax liability under the flat tax is that financial income such as stock dividends or capital gains would no longer be taxed at the individual level but only at the corporate level. Although this feature removes a key disincentive to save, namely, the double-taxation of interest and investment income, some policymakers have objected to this provision because it would likely provide a windfall to upper income taxpayers. Another controversial aspect of H-R is that homeowners would no longer be able to deduct mortgage interest payments or property taxes from their income (see sidebar, Page 8).

The corporate tax rate under H-R would drop from the current 35 percent to 19 percent. The H-R corporate tax proposal also differs from the existing system in that only income from domestic operations would be counted toward the corporation's gross income; by contrast, the current system taxes foreign profits of domestic firms.

As far as deductions go, firms could deduct only wages and salaries and not fringe benefits, whereas the current law allows firms to deduct both. In addition, under current law, individuals are not taxed on the value of their fringe benefits, such as paid vacations or their employer's contribution to their health insurance premium. Many economists believe that the current system provides an incentive for firms and their employees to shift an increasing percentage of their compensation to fringe benefits rather than cash wages. The H-R proposal would eliminate this by taxing the value of fringe benefits at the corporate level.

Probably the most dramatic corporate income tax change included in H-R is the treatment of capital equipment and structures (investment). The Hall-Rabushka flat tax simplifies the corporate tax code significantly by allowing capital equipment to be expensed rather than depreciated.[7] This feature gives firms an incentive to add to their productivity enhancing stock of durable assets, which, with the elimination of the double-taxation of investment income, would substantially improve capital formation. Essentially, the H-R business tax is a value-added tax that operates by taxing firms on the difference between the gross revenue of their sales and the price of their inputs, such as wages and salaries and intermediate goods.

So, what are the likely effects on interest rates and financial markets if the H-R flat tax would become law?

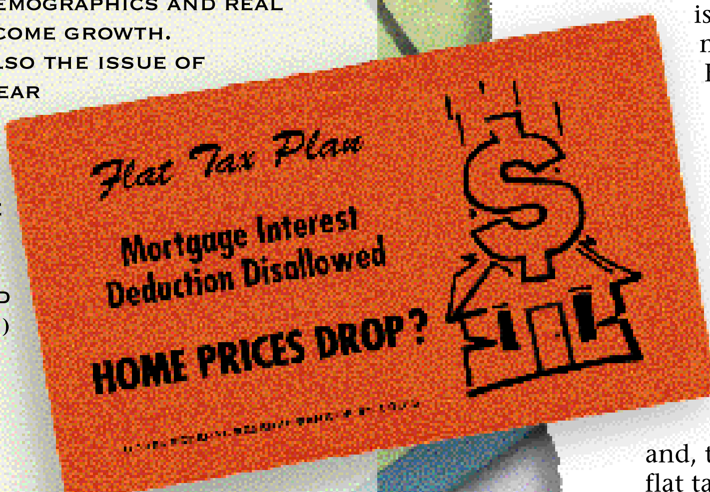
The flat tax proposal, like any tax reform plan, would create winners and losers.

Falling Home Prices?

The aspect of the flat tax that has received the single greatest scrutiny is the proposal to disallow mortgage interest deductions. Overall, ending the mortgage interest deduction would have some negative effect on home prices simply because this deduction has been capitalized into the value of houses. Economists disagree as to how large the likely drop in average home prices would be, or whether it would be temporary or permanent. If, on the other hand, interest rates decline as predicted under the flat tax format, then home prices would be expected to surge.

Nevertheless, some economists forecast that the expected decline in interest rates would not be enough to fully offset the expected fall in home prices. A study by Data Resources Inc. suggests that home prices could fall by as much as 15 percent.[1] Other economists are not so sure, believing that the effect would be mildly negative in the short run and potentially positive or neutral in the long run. In this vein, Gravelle (1995) notes that previous tax changes that were predicted to have significant effects on home prices have failed to materialize to the degree expected. This is possibly because the demand for housing is relatively insensitive to interest rates over the long run and instead reflects factors like changes in demographics and real per capita income growth.

There is also the issue of who would bear the largest burden of repealing the mortgage interest deduction. Cecchetti and Rupert (1996) argue that those who would be the most harmed are upper income taxpayers, who disproportionately itemize and take the mortgage interest deduction. However, because a relatively small percentage of their household wealth lies in the value of their houses, an expected rise in the value of their other assets, which would be expected to occur as a result of the flat tax, could offset any such declines.



[1] See Wyss (1995).

In general, the demand for credit would decrease because interest paid would no longer be deductible by either individuals or businesses. At the same time, the supply of credit would increase (the result of enhanced incentives to increase saving) because interest income would no longer be taxable—in other words, lending money would be more attractive.[8] All other things equal, removing this tax distortion would cause interest rates to fall. Some economists have estimated that interest rates could decline by as much as 150 basis points, while other economists speculate that rates may actually rise because of an expected increase in economic activity that would boost the demand for credit.[9]

When it comes to the broader macroeconomic effects on growth and living standards, the H-R proposal, like any tax reform plan, would create winners and losers. If the winners could more than compensate the losers and still remain better off than before the tax reform was enacted, then, from an economic perspective, it is a good idea. Although the economic effects are always difficult to predict, let alone estimate accurately, the flat tax is probably a substantial improvement over the current system on economic grounds alone.

The Unlimited Savings Allowance (USA)

Introduced as Congressional legislation by Senators Pete Domenici (R-N.M.) and Sam Nunn (D-Ga.), the USA proposal is a consumed income tax, which means that it effectively taxes income that is used to consume goods and services by not taxing income that is saved. The USA proposal shares many of the same features as the Hall-Rabushka flat tax on the business side, but differs in many important ways on the individual side.

For the individual, the USA proposal expands the H-R definition of gross income to include financial income, such as dividends and interest payments or the sale of stocks or bonds (capital gains). This feature of the proposal maintains the double-taxing of investment income and, thus, is not as saving-friendly as the flat tax. To offset this disincentive to save, the USA proposal allows the taxpayer to take a credit for the amount of payroll tax he pays (Social Security and Medicare). Also unlike the H-R flat tax proposal, the USA tax would keep the deductions for mortgage interest, charities and alimony, but would scrap the deductions for property taxes and state and local taxes.

A key saving feature of the USA reform is that it would allow an individual to deduct the net amount saved during the year from the taxpayer's gross income; this could be accomplished through annual increases in a savings account, purchases of stocks and bonds or start-up capital used to finance a small business. In principle, this feature could offset the double taxation of investment income because, if saved, the entire amount would be deducted from the taxable gross income. However, if a taxpayer ended up with a net dissaving for the year (meaning that money is taken away from savings to finance consumption), then that amount would be taxable and effectively added to the person's tax base. The USA plan has three rates, ranging from 19 percent to 40 percent—although the marginal taxes would drop to between 11 percent to 32 percent because of the payroll tax deduction feature.

On the business side, the USA proposal is a value-added tax very similar to the H-R proposal in that outlays for capital equipment are immediately expensed rather than depreciated. But unlike the flat tax, firms in a USA framework could not deduct wages and salaries or pensions. Firms would, however, receive a credit for the portion of the federal payroll tax they pay (currently a little less than 8 percent). To compensate firms for the curtailment of deductions, the corporate tax rate would be lowered to 11 percent.

Proponents of the USA proposal believe that families with incomes between $10,000 and $50,000 would enjoy a tax cut averaging a little more than 9 percent. Those with incomes between $50,000 and $100,000 would see no change in tax liability, and those with incomes greater than $100,000 could see an increase of as much as 4 percent.[10] Other economists are more skeptical. Boskin (1996), for example, argues that the highest effective marginal tax rate under the USA plan would be about 51 percent, which is much higher than now and could actually exacerbate some of the known labor supply distortions discussed earlier. Although it is not as simple as the flat tax, the USA tax would also probably be a vast improvement over the current system in terms of enhancing the incentives to save and invest.

Making the Switch

Changes to the tax system of the nature proposed under the flat tax or USA plan raise numerous transition issues. Probably the most noteworthy is that significant distortions would arise as investments and activities undertaken under one set of tax rules would no longer apply under a new set of rules. In addition to the housing issue discussed earlier, there is also the issue of physical capital investment made under the pretext of depreciation rules. For example, the immediate expensing of capital equipment would penalize firms that made investment decisions on the basis of cost recovery under the old system (depreciation). Because the profitability of these investments would likely be diminished, some transition rules would be required.[11] The USA proposal includes such rules.

Another issue that policymakers would have to contend with is the potentially detrimental effect on nonprofit organizations if charitable contributions were not able to be deducted. Likewise, state and local governments may face increased uncertainty if municipal bond issues no longer had their tax-exempt status, or if state and local taxes were no longer deductible at the federal level. Generally speaking, removing the favorable tax treatment on state and local bonds would reduce the demand for them, causing their prices to fall and thus their yield (interest rate) to rise. Finally, as previous tax reform measures have shown, dramatic changes in the tax code have the potential to affect aggregate prices, interest rates, stock prices, wages and the return to capital. In an economy of the size and complexity of the United States, these effects are not easily pinned down, nor are they ever entirely anticipated.

Net Gain

Any change in the current federal tax system will engender some form of distortion, result in some economic cost borne by a percentage of the population and produce some unexpected outcomes. Few economists would quarrel with this. By the same token, most economists, even those who criticize current tax reform efforts, acknowledge that the existing tax system is a drag on economic growth and efficiency. In an era when the economy's potential output growth has slowed markedly from the pace it enjoyed before the early 1970s, the likely positive effects to saving and investment arising from an improved tax system should not be taken lightly. Although some short-term transitional issues still need to be ironed out, fundamental tax reform, however it plays out, will probably be a boon to future generations.

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ENDNOTES

1. See Heckman (1993) and Rosen (1995).
2. See Boskin (1996).
3. See Bickley (1996).
4. See Hall and Rabushka (1996).
5. Although several exist, the best known of the flat tax bills is sponsored by House Majority Leader Richard Armey (R-Texas) and Senator Richard Shelby (R-Ala.). See Bickley (1996).
6. See Bickley (1996).
7. Expensing means that 100 percent of the purchase price of the equipment would be written off in the tax year in which it is purchased. Existing law permits capital to be depreciated over the life of the asset using three possible depreciation schedules.
8. See Golob (1995).
9. See Feldstein (1995).
10. See Weidenbaum (1996).
11. See Rosen (1995).

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