

Fundamental Tax Reform: Understanding the Options

Alan D. Viard
(with Jason L. Saving)

Understanding the options

- Income tax v. consumption tax
- Four consumption tax designs
- Proposals by President's Panel

Timing of work, consumption

- Income tax distorts timing
 - Taxes saving (consuming later than working)
 - Punishes early work, late consumption
- Consumption tax need not distort
 - Neutral with respect to timing of work (exception noted later)
 - *If tax rate is constant*, neutral with respect to timing of consumption

Numerical example

- Jane and Sally earn \$100 wages today
- 100 percent before-tax rate of return
- No-tax world
 - Jane consumes \$100 today, nothing later
 - Sally consumes nothing today, \$200 later

20 percent income tax

- Jane bears 20% tax burden
 - Pays \$20 wage tax
 - Consumes \$80 today (was \$100 with no tax)
- Sally bears 28% tax burden
 - Pays \$20 wage tax, saves \$80
 - Earns \$80 return, pays \$16 tax, clears \$64
 - Consumes \$144 later (was \$200 with no tax)

Consumption tax: 20 percent tax-inclusive rate (25 percent tax-exclusive)

- Jane bears 20% tax burden
 - Consumes \$80 today, pays \$20 tax
- Sally bears 20% tax burden
 - No tax today, saves \$100, \$100 return
 - Consumes \$160 later, pays \$40 tax

Consumption tax simpler

- Income = consumption + (increase in wealth)
- Increase in wealth difficult to measure
 - Accrued gains, original issue discount, etc.
 - Capital v. current inputs, depreciation
 - Inflation
- Consumption tax needn't measure wealth

Drawbacks of consumption taxation

- Can distort behavior if rates vary over time
- May shift tax burden from rich to poor
- Transition

Transitional burden on existing assets

- Assets accumulated before reform, consumed after get worst of both worlds
 - Principal taxed again
- Transition relief reduces economic gains

Size of potential gains

- Auerbach (1996) estimates long-run gains for one reform
 - GDP 8.4% higher, wage rate 5.3% higher
- Reform reduces consumption during early decades

Actual gains may be smaller

- Assumes “pure” consumption tax
- Assumes no transition relief
- Assumes reduction in progressivity
- Assumes all savings for retirement

Personal expenditures tax (PET)

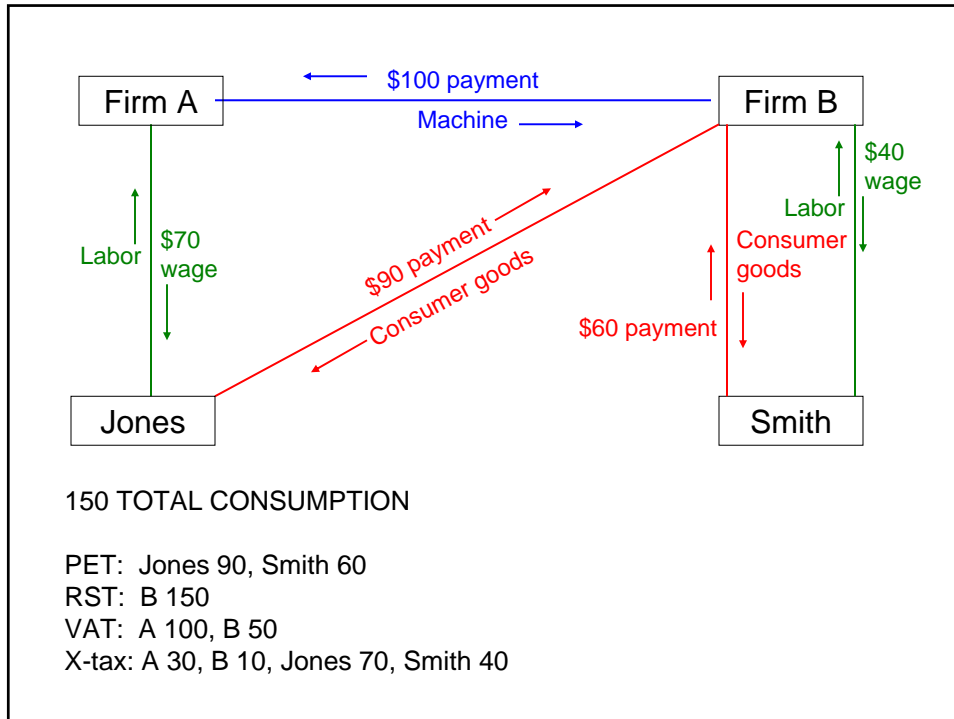
- Households file returns, computing income less net saving
 - Borrowing is negative net saving, must be added to income
- Can have progressive rates

Drawbacks of PET

- Complexity of individual returns retained
- Timing of consumption distorted as households move between brackets
- Taxing borrowing may be politically infeasible, exempting it is distortionary

Three other consumption taxes

- Retail sales tax (RST)
 - Firms taxed on sales to consumers
- Value added tax (VAT)
 - Firms taxed on sales minus purchases (value added)
- X-tax
 - Firms taxed on value added minus wage costs (business cash flow) at flat rate
 - Households taxed on wages at progressive rates, top rate matches firm's tax rate



Underground-economy fallacy

- Drug dealers taxed by RST/VAT when they spend profits
- But, dealers' customers don't pay RST/VAT
- Underground economy still escapes tax

Trade fallacy

- Imports taxed, exports exempted under RST, VAT, PET
- But, dollar strengthens in equilibrium
- No competitive advantage in world markets

RST, VAT

- Two are similar, except for administration
 - RST: Fewer filers, but probably more evasion
- Simpler than PET
 - Collected from firms, no household returns
- But, less visible – especially VAT
 - May be money machine for government

Distributional concerns

- Unlike PET, can't have progressive rates
- Possible distributional relief
 - Different rates on different goods (inefficient)
 - Rebates, cash grants
 - Add-on to income tax
- But, this relief detracts from simplicity

X-tax tries to resolve simplicity-distribution conflict

- Simpler than PET
 - Business cash flow taxed at firm level
- More progressive than RST/VAT
 - Wages taxed at progressive rates, business cash flow taxed at top rate

Drawbacks of X-tax

- Poor people living on business cash flow
- Must distinguish wages from business cash flow (hard for small businesses)
- Timing of work distorted as workers move among brackets
- Tax base negative for some firms

Difference between income, consumption

- Net Income = $GDP - \text{Depreciation} = \text{Wages} + (\text{Gross Capital Income}) - \text{Depreciation}$
- Consumption = $GDP - (\text{Gross Investment}) = \text{Wages} + (\text{Gross Capital Income}) - (\text{Gross Investment})$

Comparing X-tax, income tax

- Stylized two-part income tax
 - Tax firms on (gross capital income) – depreciation, households on wages
- X-tax
 - Tax firms on (gross capital income) – (gross investment), households on wages
- “Only” difference: treatment of investment
 - Depreciate under income tax, immediately deduct (expense) under X tax

The consumption tax that dares not speak its name

- “X-tax”?
- Called “flat tax” if wage tax does *not* have progressive rates
 - Hall & Rabushka originally proposed that
 - Flat tax often confused with flat *income* tax

Revenue-neutral rates

- Around 25% (tax-exclusive) VAT to replace individual, corporate income tax
 - Rebate equal to tax rate times poverty level
- Around 35% if payroll taxes also replaced
- RST rates higher if more evasion
- Large revenue losses in some groups' proposals

President's Advisory Panel on Federal Tax Reform

- January 2005 executive order
 - Revenue-neutral, appropriately progressive
 - Homeownership, charity
- Two reform options in November 2005 report, www.taxreformpanel.gov
- Legislative action unlikely

Simplified Income Tax Plan

- Lower top rate to 33%, repeal AMT
- Work and Family credits
- Repeal state and local tax deduction, limit health insurance exclusion
- Limit charity, mortgage interest deductions, but extend to non-itemizers
- Simplify corporate tax, repeal AMT, exempt dividends from individual tax
- Simplify, expand tax-free saving accounts

Growth and Investment Plan

- X-tax, with 30% top rate
 - Credits, mortgage interest, charity, state and local taxes similar to Simplified Income Tax
- Separate 15% tax on interest, dividends, capital gains
- Income/consumption tax hybrid

Conclusion

- Consumption tax likely to be simpler, more efficient than income tax
- Four consumption tax designs – each has strengths, weaknesses
- Panel rejected pure consumption tax