

The Multiple Goals Of Tax Reformers

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One of the great difficulties in attempting to achieve any new tax reform is that the potential goals are multiple and often in conflict with each other. Dissatisfaction with the existing income tax may be a unifying factor, but it is not enough of a base on which to design a new system. In the end, any major transformation requires compromises that are agreeable across a broad spectrum of the population and the political community.

If there is one goal on which there is widespread agreement, it is that the current tax system should be simplified. Interestingly, however, both Congress and the Executive Branch for years have been unable to undertake major simplification projects. Although the current budget process is liable to lead to a tax bill with some important minor simplifications, for instance, almost all are of the type that create few "losers"--those taxpayers whose options might be further restricted or who might pay more taxes rather than less. At the same time, many proposals currently under consideration would add significantly to complexity -- e.g., optional, back-loaded, individual retirement accounts. Most importantly, no one has yet attempted to achieve simplification by going through the thousands of provisions built into the current system and suggesting how to modify, delete, make more uniform, or otherwise reform many of them.

Some reformers would achieve simplification simply by trying to abandon the current system. The notion is that all this complexity will go away with adoption of some new replacement tax. Some flat tax proponents tend to take this tack, whereas other consumption tax proponents, such as those who worked on the Nunn-Domenici plan, seem more ready to accept that complications and compromises will be made. Others seek simplification mainly in the taxation of capital income. Thus, the expensing of assets would eliminate the requirement to report depreciation of assets. Still others want to achieve simplification by getting business essentially to pay over tax on behalf of individuals, with little or no further filing requirements at the individual level. Here flat taxes, whether on income or consumption, as well as value added taxes and social security taxes stand out as examples.

Another goal of some reformers is to increase saving in society. The hope is that a lower rate of tax on capital income will induce individuals to save more. The economic literature casts some doubt on how much saving would increase. At least initially, such a move also requires an increase in tax rates on wages, at least those that are consumed currently. Theoretically, however, some economists argue that the current system distorts the decision to save regardless of whether or not saving in the aggregate would increase in society.

Some proponents of a consumption tax simply want to lower taxes on capital income, in particular, returns from physical assets. The consumption tax is merely the latest of the vehicles that would be used. For example, expensing of purchases of capital equipment has been proposed for years now, whether or not an income tax is maintained.

Progressivity is a matter on which there is little unity. Many flat tax proponents would remove some of the progressivity of the existing system. Some consumption tax proposals, on the other hand, attempt to achieve the same degree of progressivity as the current income tax. Whether the Nunn-Domenici proposal really achieves this goal or not is unknown, as advocates have not released data indicating exactly what rates would be required at very high income levels. The Nunn-Domenici proposal already allows rates to go as high as 46.6 percent for middle-income families.

A not-so-hidden goal of some reformers is to lower tax rates for higher-income individuals. Some flat tax advocates, however, do not want to shift that burden, or shift it very much toward middle-income or lower-income taxpayers. This combined goal and constraint can put them into a box where their proposals fall short of revenue neutrality. Thus, if tax rates are lowered at higher-income levels, then taxes are liable to fall there if not enough base broadening can be found. If taxes are not to be raised at other income levels, then

the proposal as a whole would lose revenue. Losing revenue then means higher deficits or expenditure reductions. Thus, the tax package starts having implications far beyond the tax system.

Concern over efficiency is one reason for trying to lower rates. At higher rates, economic theory tends to hold that some efficiency costs are higher per dollar of revenue raised. As an example, individuals are more likely to change their behavior when their tax rates are raised, say, from 40 to 41 percent than from 20 to 21 percent. With fewer distortions, greater growth may also be possible.

The efficiency issue, however, arises in many forms. One argument used to support a consumption tax is that the income tax distorts the choice between current and future consumption by taxing the rate of return to capital. A wage earner who saves to consume tomorrow pays a higher total tax than one who consumes today out of wages, although the saver may also ultimately have more resources.

Still another efficiency issue arises simply from the differential treatment of different types of consumption and of different returns from saving. Broadening the tax base--for example, by removing exclusions for labor compensation paid in the form of health benefits--would make more neutral the treatment of health care consumption and other forms of consumption. Similarly, treating all capital income alike--for example, by taxing all of it effectively at a zero rate under a consumption tax--would eliminate many of the distortions arising from distinguishing the tax treatment of one asset from another. A consumption tax ideally would make more equal the taxation of returns from housing, which are favored under current law, and the returns from other forms of capital income.

Fairness, defined as the equal treatment of those in equal circumstances, is a goal common to most proposals and proponents. They may, however, define equals differently. Traditional base-broadening measures, for instance, attempt to tax all forms of income more equally. In a consumption tax, the argument is extended to say that two wage earners earning the same income should be taxed the same. Thus, the one who saves and later consumes should not pay more tax than the one who does not. Note the close relationship between this argument and the efficiency argument that present consumption is favored over future consumption. Still another issue arises with respect to inheritances, and the treatment of those with and without this source of potential consumption.

Different proposals and proponents have widely varying goals with respect to flows across international borders. Many forms of value added tax and consumption tax would allow a tax rebate on exports and a collection of tax on imports. Such a "destination" rule, however, works against some of the simplification sought in the type of flat tax that would tax all income at "source" and try to be done with it.

Note that movement along many of these paths can be made independently. Many types of simplification, for instance, are possible without adopting a flat tax or a consumption tax. Increases in saving can be sought through deficit reduction or retirement policy or even saving incentives, although separate types of incentives have been difficult to design in ways that prevent game playing and tax reduction through portfolio shifts. Tax rates or taxes, of course, can be lowered without other changes, while progressivity can be sought or eliminated through a multitude of changes in taxes or expenditures.

As a practical political matter, compromising among goals requires finding a base acceptable to a significant portion of the population. In the tax reform efforts of 1984 and 1986, for instance, individuals seemed willing to accept lower rates in exchange for a cutback in tax shelters, and an increase in the personal exemption as both a pro-family and anti-poverty measure. Similar political tradeoffs are likely to be required before a new round of tax reform gets very far. Simplification does seem to be the one common goal today, but most proposals go far beyond that goal. In many ways, however, compromises among principles form the base around which a design could be attempted, and my guess is that tax reform is not likely to go very far until that base becomes well-established.

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