Strengthening the Progressive Income Tax:

The Responsible Answer To America's Budget Problem

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Executive Summary

We cannot resolve the Federal budget crisis without raising taxes. There is not enough scope for responsible program cuts while paying for the Savings and Loan bailout and beginning to address the growing backlog of unmet needs in education, childcare, the environment, and public infrastructure. Increased revenue ***is*** needed and should be drawn from the personal income tax.

Though much maligned, the income tax has the advantages of directness, flexibility and fairness which its alternatives do not offer. Two steps should be taken to obtain the needed revenue from this source. First, the base-broadening of 1986 should be extended by restricting tax expenditures such as the deduction of mortgage interest, failure to include capital gains at death, and exemption of interest on state-local debt. Second, we should return to a set of rising bracket rates over the middle-upper income range with a top rate of 40 percent. Both measures would provide substantial revenue gains while improving the equity of the tax.

The traditional alternative of increased excise taxation, with the exception of higher gasoline taxes, is seriously flawed. The burden impact would be mostly regressive and the revenue gain would be insufficient. Introduction of a general consumption or value added tax (VAT) would offer a large revenue potential but would not be adapted to ability to pay Regressivity over the lower income range might be dampened, but there could be no allowance for family size. The impact over the middle to upper income range would be regressive, thus continuing the process of flattening the burden distribution. Traditional state reliance on sales taxation would be interfered with as the VAT differs only in its method of collection. An expensive new administrative apparatus would also be needed and this would delay meeting the deficit problem.

A much superior general consumption taxation might eventually take the form of an expenditure or so-called “cash-flow” tax, with application of personal exemptions and progressive rates. But this tax is still novel and would be essentially similar to an income tax on wage income only. Thus, new issues of equity in burden distribution would arise.

Reliance on a strengthened and progressive income tax is the best solution.

Introduction

The Reagan Administration, in its massive tax cut of 1981, reduced income tax rates by over 20 percent. This was to herald a decade of rapid economic growth, with speedy revenue recoupment and balanced budgets. Such was not to be the case. While initially helpful in overcoming the recession, the tax cut did not produce what then Vice President Bush called a "voodoo" solution. Employment rose and consumption boomed, but were accompanied by a near decade of massive deficits. Current prosperity was gained in the process, but at the cost of massive foreign indebtedness, trade deficits, and slowed growth. These costs could have been avoided by a change in policy mix, calling for a tighter budget and easier money. However, this course correction was barred by the Administration's overriding commitment to tax reduction. Moreover, the deficit generated pressure to reduce spending on civilian programs, another high ranking Administration policy objective.

Certainly the 7991 target is out of reach without dramatic policy changes. The "flexible freeze" will not be flexible enough.

Much the same scenario holds today. President Bush has reaffirmed his pledge not to raise taxes and Congress chooses to play a cagey game of "you first." Despite the recent compromise between the Congress and the White House, there remains a good chance that the Gramm-Rudman fiscal year 1990 target of $100 million will not be met. Certainly the 1991 target is out of reach without dramatic policy changes. The "flexible freeze" will not be flexible enough. While revenues will rise with a growing economy, the indexing of the income tax has reduced the built-in flexibility of the system; and as revenues rise, so will expenditure needs. Progress in the international climate may come to permit large cuts in the defense budget, but reducing defense spending takes time because much of the spending is locked in with troop commitments and multi-year procurement programs. After defense, interest, welfare, and Social Security commitments are met, less than one-third of the budget remains, leaving little scope for substantial savings. Some programs might. be cut but others will have to be expanded, and new needs will arise.

A backlog of [spending] needs has to be faced and cannot be bypassed by wishing upon a flexible freeze, or by appeal to volunteerism and privatization.

Recognizing new needs should not be reserved for bailing out Savings and Loans. The rise of poverty in the midst of plenty which has marred the 1980s should be addressed, as should low-cost housing, and the deterioration of the nation's schools and large parts of the public infrastructure. A backlog of needs has to be faced and cannot be bypassed by wishing upon a flexible freeze, or by appeal to volunteerism and privatization.

Given this setting, the hopes for eventual deficit resolution by a do-nothing policy primarily rest -with the emergence of surplus on the Social Security account. This surplus is expected to rise from $46 billion in 1989 to $98 billion by 1994, and to $451 billion by 2020. It may come to outweigh the deficit in the remaining budget by the late 1990s, but this hardly offers a responsible solution. As provided by the legislation of 1983, the Social Security surplus was designed to lower the burden on future workers from the retirement of the baby boom

generation. The surplus can only do so if it is used to bolster the nation's capital stock, either public or private, rather than simply finance ongoing programs. Therefore the deficit target should be set exclusive of Social Security.' Its surplus should not serve as an excuse for postponing action on the remainder of the budget. A shift in policy toward easier money and increased tax revenue is needed.? How to obtain this while improving rather than worsening the quality of our revenue system is the theme of this paper.

Why Not Rely on the Income Tax?

A shift in policy toward easier money and increased tax revenue is needed. How to obtain, this while improving rather than worsening the quality of our revenue system is the theme of this paper.

Since its expansion to a mass tax in World War II, the individual income tax has steadily contributed over 40 percent of federal tax revenue, or some 70 percent if payroll taxes are excluded. This key role is not accidental. Federal reliance on the income tax offered a division of labor, with state reliance on the sales tax and local reliance on the property tax. Most important, the income tax came to be widely regarded as the best and most equitable form of central finance. Recently, the merit of the income tax has been increasingly (and I think excessively) questioned, both by its friends who aim to improve it, and by its opponents who aim to displace it. Improvements were made by the reform of 1986 but gaps remain and further correction is called for. Nevertheless, the income tax remains superior to other proven taxes, and preferable to most alternatives which have been proposed. Already in place and capable of yielding a substantial revenue gain, it surely should be the major revenue source for deficit reduction.

Advantages of the Income Tax

Several key advantages of the income tax should be noted.

The income tax as a direct *tax is highly* visible ***to*** *the taxpayer and. .. as a direct and* personal *tax permits tax liabilities to be adjusted to the taxpayer's ability to pay.*

1. The income tax as a *direct* tax is highly *visible* to the taxpayer and hence a steady reminder of the quality of public service that should be provided in return, It thus promotes an efficient public sector, unlike "invisible" product taxes such as a value added tax. What is an advantage as viewed from this perspective may also be seen as a disadvantage in other contexts. Appealing to short-sighted voter behavior, invisible taxes may serve a budget policy which aims at program expansion, just as obnoxious taxes may serve as an aid in budget restriction. The income tax as a fair and visible tax offers a constructively neutral solution.

2. The income tax as a direct and *personal* tax permits tax liabilities to be adjusted to the taxpayer's ability to pay. That ability is fairly measured by a comprehensive definition of income."

3. Ability to pay varies with the size of income and the income ta.x permits tax liability to be adjusted accordingly By granting a personal exemption and a minimum deduction, a zero-rate bracket is established, and low incomes may be kept tax free. By then applying rising bracket rates, the effective rate (tax as percent of income) may be made

to rise with income. The income tax thereby permits distributing the tax burden in line with ability to pay, a concern which excise taxes, a retail sales or a value added tax do not meet, Thus, hidden behind the debate over the role of the income tax is a debate over how the tax burden should be distributed. Only a personal tax such as the income tax can offer a satisfactory solution.

4. The income tax as a personal tax offers a further advantage of permitting adjustment for family size. By varying the number of exemptions, the same income may be taxed more or less according to family size, another advantage which the indirect and impersonal taxes do not have.

For the income tax to be equitable, taxable income must be defined in a comprehensive way, so as to fairly represent the recipient's ability to pay.

5. For the income tax to be equitable, taxable income must be defined in a comprehensive way, so as to fairly represent the recipient's ability to pay, That is, taxable income should include all accretions to wealth, independent of the form in which they are derived and how they are used. Failure to comply with this comprehensive definition causes "horizontal inequities," with people of similar incomes (if comprehensively measured) paying (different amounts of tax. Imperfections in tax-base definition, moreover, cause economic inefficiency by directing activities into tax-preferred channels. The 1986 reform removed many such preferences or loopholes by broadening the tax base; but much remains to be done and substantial revenue may be obtained in the process.

Failure to comply with this comprehensive definition causes "horizontal inequities," with people of similar incomes (if comprehensively measured) paying different amounts of tax.

What the 1986 Reform Has Accomplished

The income tax reform of 1986 consisted of three major parts: (1) low income relief by raising the floor of taxable income, (2) base broadening with focus on removal of upper-income shelters, and (3) reduction in upper bracket rates. A comparison of pre- and post-reform patterns of effective rates (tax as percent of AGI) is given in columns 1 and 2 of Table 1. Post-reform rates are sornewhat lower throughout as the reform provided for a modest (ten percent) revenue loss. The reduction was substantial at the lower end of the scale, reflecting the raising of the floor of taxable income. At the same time, patterns of effective rates remained essentially unchanged over the middle and upper ranges. As noted further below, such was the case because the base broadening and rate reduction tended to offset each other over this income range.

Table 1

Effective Income Tax Rates, Pre- and Post-Reform

(1988, Joint Return, One Dependent)

AGI Patterns (Pre-reform law)	Tax as % of AGI Pre-reform Law 1	Reform Law 2	Alternative 3
0- 10,000	0 %	0 %	0 %
10,000- 20,000	5.2	4.3	1.6
20,000- 30,000	8.8	8.3	5.6
30,000- 50,000	12.3	11.0	9.8
50,000- 100.000	16.5	16.0	15.5
1 00,000- 200,000	23.8	21.8	26.2
200,000- 500,000	29.6	25.0	34.8
500,000-1,000,000	29.8	26.8	37.6
1,000,000 +	27.9	26.6	41.6
Total	14.5	13.4	13.4

Source: R.A. Musgrave, "Short of Euphoria," The *Journal of Economic Perspectives.* Vol. 1, No. 1.1987, p.66.

*Substantial low end relief was granted both by raising the personal exeniption... and by increasing the **standard** deduction.*

■ **Low End Relief.** Substantial low end relief was granted both by raising the personal exemption from $1,080 to $2,000 and by increasing the standard deduction from $3,670 to 65,000. Thereby some 6.8 million taxpayers were dropped from the rolls and another 3.7 million found their liabilities cut by over one-half. While substantial, these adjustments only served to restore the real value of low end allowances to their pre-inflation levels of ten years before. In terms of 1978 prices, the exemption for a single return had fallen from $1,000 in 1978 to $595 in 1986, with the reform restoring it to a 1978 equivalent of $1,098. Also of major importance to the lower end, the earned income credit, which gives a tax refund to low income earners, was raised substantially

■ **Base Broadening.** Base broadening under the 1986 reform reversed the growth of high income shelters which had developed in recent years. Thus the deductibility of interest on debt used to finance tax-free or tax-postponed investments was limited. The carryover of losses from passive partnership investments was restricted, as was the transfer of income to minor children. Preferential pension arrangements for executives were tightened.

Capital gains were fully included in taxable income. Unfortunately, reversal is now sought by President Bush, while letting the rate cut stand.

Capital gains were fully included in taxable income, evidently a concession traded for a more drastic cut in upper bracket rates. This was a key reform, since preferential treatment of capital gains had played a central role in many other tax shelters. Unfortunately, reversal of this very feature is now sought by President Bush, while letting the rate cut stand. Taxation of unrealized gains at death, another potential reform, was passed over in 1986.

Extending into the middle range, the reform severely limited deductible contributions to IRAs and other pension plans. It also disallowed deduction of interest on consumer debt and repealed deductibility of state and local sales tax payments. A major shelter of special importance over the middle range-deductibility of mortgage interest-was re-

tained. Even a modest limitation of such deductibility on second residences did not pass.

Nevertheless, substantial progress toward base broadening was made by the 1986 reform, with perhaps one-third of all tax preferences closed. Much is left to be done to address certain remaining preferences.

The potential revenue from base broadening would be roughly comparable to a 20 percent increase in the level of rates.

Table 2

Selected Tax Expenditures*

	$ billion
Deduction of mortgage interest without inclusion of imputed rent	35
Exclusion of tax exempt interest	10
Deduction of charitable contributions	12
Carryover of capital gains at death	13
Total	70

*Revenue cost at present rates of tax and 1990 levels of income.

Source: *Special Analysis of the Budget for the United States Government, Fiscal Year 1990.* Special Analysis G.

The additional revenue thus available might readily be raised to $100 billion by fuller coverage of other items such as fringe benefits and further limitations of certain deductions such as business meals.[4] The potential revenue from base broadening would be roughly comparable to a 20 percent increase in the level of rates. In addition, it would improve the tax base and the degree of horizontal equity To be realistic, perfect solutions are not available but even partial steps could bring a substantial gain. The homeowner preference, for instance, is by now a well-entrenched part of our tax mores, but some limitation regarding the eligible residences and the amount of deductible interest should be achievable. The permissible amount of tax-exempt interest might be limited and a tighter view might be taken on what passes as business expenses.

A further and major problem area lies in the treatment of pension contributions and benefits. The ideal rule would be to disallow deduction of contributions (be they by employers or employees) when made, and to tax that part of the benefits which reflect earning on prior contributions. As it stands, neither the treatment of Social Security nor that of private pension schemes meets this criterion, and adjustments would yield a substantial amount of additional revenue.

These changes in turn would need to be part of a larger package which restored a basic structure of progressive rates, calling upon the upper income groups to bear their share of the deficit reduction burden.

The 1986 reform made substantial progress towards closing certain high bracket tax shelters, but it was by no means complete. Important items, especially those applicable to the middle income range, were left untouched. Even a partial step towards further base broadening could make a major contribution to revenue and do so while improving the quality of the income tax. These changes in turn would need to be part of a larger package which restored a basic structure of progressive rates, calling upon the upper income groups to bear their share of the deficit reduction burden.

Rate Reform

Rate adjustments, the third major step of the 1986 reform, featured an increase in the first bracket rate from 11 to 15 percent, a modest rate reduction in the mid-range rates, and a slashing of bracket rates higher up, reducing the top rate from 50 to 28 percent.

These changes were combined with a sharp reduction in the number of rate brackets. Thus the pre-I986 schedule of 14 rates ranging from 11 to 50 percent was replaced by an essentially two-rate schedule of 15 and 28 percent, strangely broken (see below) by a middle bracket of 33 percent. Without the increase in exemptions and base broadening over the upper range, this downward revision of upper bracket rates would have resulted in a drastic reduction in the progressivity of the income tax. However, the net effect of all three changes (see again Table 1, columns 1 and 2) was to lower effective rates substantially at the bottom while keeping them essentially unchanged over the middle and upper range. For the distributional effect of the tax bill among income groups, it is the change in this pattern of effective rates (tax as percent of AGI) that matters, as it reflects the combined impact of exemptions, rates, and base definition.

Top rates were cut by over one-half in the 1980s, and the middle range rates were cut by a quarter. .. [Tax] coverage still reaches further down than it did in the early 1960s.

But the changing pattern of bracket rates is also of interest in its own right. Bracket or marginal rates are important when it comes to economic effects and they may also be taken to reflect the distributive intent of the Congress. As shown in Table 2, top rates were cut by over one-half in the 1980s, and middle range rates were cut by a quarter. Bottom rates remained fairly stable and the level of exemptions (similar to a zero rate bracket) declined sharply relative to average income in the 1970s. A reversal followed in 1986, but coverage still reaches further down than it did in the early 1960s. All this against a background of a fairly stable overall average income tax rate, as shown in line 5. With indexing of exemptions and bracket limits under the 1986 reform, the impact of inflation on the income tax will henceforth be neutralized.

The 1986 reform, viewed against these trends, may be interpreted in different ways. From one perspective, it is a move toward honesty in tax legislation because the pre-reform bracket rates were fictitious from the start and were never meant to be applied to a broadly defined tax base. By matching base broadening with rate reduction, Congress merely chose to repeal a rate pattern which it did not intend to apply. From this view, "coming clean" and improving the tax base while flattening rates was thus a step forward. From another perspective, the move was to ratify retreat from progressive taxation which, though largely ineffective, had once been intended by the Congress. To be sure, base broadening without rate reduction would have been incompatible with the reform's goal of revenue neutrality. But instead of flattening bracket rates at the top, the cut could have been in line with the old pattern of rates.

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Table 3

Flattening of Income Tax Rates

	1963	1978	1982	1987
1. Top Rate	71%	70%	50%	28%
2. Marginal Rate on Average Income'	20	22	16	15
3. Bottom Rate	20	14	12	15
4. Exemptions as % of Average Income"	40	15	18	25
5. Tax as % of Personal Income	10	10	9	11

*Bracket rate applicable to top income slice for joint return with average personal income.

.. Exemptions for a joint return as a percent of average personal income.

Source: R.A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice, 5th ed. New York: McGraw-Hill, 1999, p.357.

The reform took a long step towards a flat fate tax, continuing the process which was begun in 1981 and before.

Returning to Table 1, suppose that the reform had combined its base broadening with an across the board ten percent cut of pre-reform bracket rates. This would have called for bracket rates from 9.8 to 45 percent, and resulted in a pattern of effective rates as shown in column 3 of Table 1. As a result, there would have been an increase in the progressivity of effective rates as compared with the pre-reform setting. (Alternatively, there could have been an in-between solution with lower top rates than in column 3, but still an increase in progressivity from column 2.) By failing to do so, the reform took a long step towards a flat rate tax, continuing the process which was begun in 1981 and before.

As a further sales device, the reduction in brackets has been presented as a great step towards simplification, but this claim is without substance. Taxpayers do not compute their tax liabilities by applying bracket rates but by reference to rate tables. Multiple brackets do not complicate the system but are needed to generate a smooth progression of effective rates.

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While the 1986 reform did indeed move towards a flat rate tax with regard to bracket rates, even a one bracket schedule still leaves progressivity of effective rates over the lower to middle range of the income scale. This is the case since the exemption works as a zero rate bracket, and further progressivity is given by the standard deduction and the earned-income credit. An important feature of income tax progression, i.e., low income relief, is thus preserved under a flat rate tax. Some progressivity also remains over the middle range, but declines sharply above that level and becomes negligible over the upper range. Introduction of a 33 percent hump rate under the 1986 reform also served the goal of flat rate taxation, as did reduction in the number of rate brackets.[5]

What constitutes the correct distribution of the tax burden among income groups is not a simple question. Few would argue that a person with an income of $10,000 should pay the same *amount* of tax as another with an income of $100,000 or $1,000,000. The debate, rather, is whether the same or a rising *percent* should be paid as income increases. Since most people would agree to a zero-rate bracket, the debate narrows further to whether a flat or rising percentage should

apply over the middle to upper and top income ranges. Rising bracket rates are needed to secure a rising effective rate and this, as economists have stressed, involves an efficiency cost and potential disincentive effects on work effort and saving. These considerations matter and will be noted further below, but they are not the only concern. The answer also depends on how one views issues of distributive justice and how one assesses the social consequences of concentration of income and wealth.

The distribution of family income has been skewed traditionally towards the upper end of the scale, as tends to be normal for a market system and, for that matter, any other working economic order. But there are differences in degree and trends matter. Thus, the share of family income (before paying income taxes, but including transfers) received by the lower half of US families declined from 20 percent in 1977 to 18.2 percent in 1988, while that received by the upper half rose from 80 to 81.8 percent. Over the same period, the share received by the top ten percent rose from 31.9 to 35.7 percent, and that received by the top one percent rose from 9.2 percent to 12.5 percent.[6] While the income share of the top one percent rose from 1977 to 1988, its effective tax rate declined from 39 to 29.4 percent.’ This trend towards inequality is expected to continue. If the distribution of wealth is considered, roughly reflecting the distribution of capital income, the degree of inequality is raised further, with the top one percent holding 36 percent of personal wealth.[8]

*The cuts in the top rate from 70 to **50** percent in 1981 and from 50 to 28 in 1986 have overshot the mark.*

Given this pattern, and with due allowance for economic costs of rate progression,. the cuts in the top rate from 70 to 50 percent in 1981 and from 50 to 28 in 1986 have overshot the mark. “Prices must be right” for a market economy to function, but so must there be a social concern for fairness if the market is to flourish in a democratic society. Therefore I have not been able to share in the extravagant praise with which the 1986 legislation was greeted by most tax reformers.’ As I see it, a modest increase in the top rate with a sliding adjustment towards the middle should contribute to closing the revenue gap. This may imply an increase to only 35 percent as had been proposed in the President’s *Tax Report of 1986*, to 37 percent as had been proposed in the Gephardt-Bradley plan of 1984, or to 40 percent as I would suggest. The precise level does not matter but, it should be stressed, the increase should not be traded for return to only partial inclusion of capital gains.

*As **I** see it, a modest increase in the top rate with a sliding adjustment towards the middle should contribute to closing the revenue gap. This may imply an increase to only 35 **percent** . . . or to 40 percent as I would suggest.*

The magnitude of the revenue gain to be generated by such changes is significant. The Congressional Budget Office estimates that simply leveling the top rate at 33 percent generates a five year -revenue stream of $42.9 billion. A 40 percent bracket would more than double that amount and additional brackets below the top rate would capture even more.

Conclusion

The proposition that the income tax “must not be touched” because it has been the subject of recent reform has political appeal but little substance. On the contrary: the need to provide for additional revenue

and to do so promptly should make use of the improved tax, rather than worsen the tax system by resorting to inferior revenue sources or the addition of a new and complex tax.

Corporation Tax

The proposition that the income tax "must not be touched" because it has been the subject of recent reform has political appeal but little substance.

Before leaving income as a revenue source, a brief word need be added regarding the role of the corporation tax. Its weight in the federal revenue system has receded during recent decades but the 1986 reform halted this trend. The changes included: (1) a major revenue gain from repeal of the investment credit, (2) a further revenue gain from base broadening together with a tightened minimum tax, (3) a major revenue loss from reduction in the top rate from 46 to 34 percent, and (4) a further largely revenue-neutral reform in depreciation rates. Together, these changes provided for a revenue gain of about 25 percent. Nevertheless, problems of reform remain and reliance on accelerated depreciation as an incentive device rather than on the investment tax credit may be questioned.

Beyond this, there remains the question of the appropriate role of the corporation tax in the income tax system. Economists, viewing a model tax system, have long argued that the tax treatment of corporate-source income should be integrated with that of personal income, thus calling for inclusion of retained earnings in taxable income under the income tax. With corporate source income thus integrated into the individual income tax base, the corporation tax as a separate tax would be discontinued. An absolute corporation tax might make sense if directed at monopoly profits (or as in war time at excess profits), but not on ability to pay grounds. Such ability is carried by the corporation's shareholders and not by the corporate entity as such. As a decision-making unit, the corporation is properly subjected to regulations as by the antitrust laws, but that is a different matter.

The need to provide' for additional revenue and to do so promptly should make use of the improved tax, rather than worsen the tax system by resorting to inferior revenue sources or the addition of a new and complex tax.

Viewing the shareholder as owner of the corporation, horizontal equity would be served by eliminating discrimination against dividend income. This would also remove preferential treatment of debt finance now granted under the corporation tax by deductibility of interest but not of dividends paid. Financial rigidity in the corporate structure would be reduced. Such a reform would leave a revenue loss, as the gain at the individual level would fall short of the loss at the corporation level. The benefit would accrue largely to upper income brackets and should be linked with an offsetting rate increase therein.

More recently, concern with the prevailing tax preference for debt finance and its impact on the takeover movement has led to the suggestion that the treatment of debt and equity finance be equalized, not by exempting dividend payments from the corporation tax but by removing deductibility of debt interest. This approach to neutralization would yield a revenue gain and might thus be a preferred solution. However, such a move would consolidate the role of the corporation tax as an "absolute tax," a development not in line with the concept of an equitable and neutral view of personal income taxation.

Indirect Taxes on Consumption

We now turn to taxes on consumer goods as an alternative source of additional revenue. These include: (1) selected excises on certain items of consumption, and (2) a broad-based consumption tax, be it in retail sales or VAT form. All these taxes differ from the income tax, not only by resting on consumption rather than on income but also by being indirect and impersonal in nature. As such they cannot be adapted easily or adequately to individual ability to pay, with regard to levels of consumption (or consumer income) and especially with regard to family size.

Selected Excises

Revenue from selective excises totaled **$35** billion in fiscal **1989, or** about four percent of federal tax revenue. The amounts drawn from some of the major items are shown in line 1 of Table 3. Considering the size of the budget, these contributions are low and it is evident that very substantial increases in tax rates would be needed to secure even a modest contribution to resolving the deficit problem. There may be a good case for an increased tax on gasoline as a matter of resource conservation or even for increased "sin taxes" as a matter of public health policy.[10] Charges also offer a constructive approach to deal with environmental protection, but their revenue potential is again limited. More likely, resort to the excise route would involve an *ad hoc* selection of inferior tax bases.

*Resort to the excise route **would** involve an* ad hoc *selection of inferior tax bases.,*

Moreover, as shown in lines 2 to **6,** liabilities as a percent of income typically fall when moving up the income scale, pointing to the regressive nature of most excise taxes. Liabilities tend to be closer to proportional when related to an expenditure base, but even then no relief is given at low income levels. Not only is the burden distribution of excises typically inverse to ability to pay, but no allowance can be made

*Not only is the burden distribution of excises **typically** inverse to ability to pay, **but** no allowance can be made for family size. In both **respects** such taxes are inferior to the income tax.*

Table 4

Revenue and Burden Distribution from Excise Taxes

	Gasoline	Beer	Liquor	Tobacco	Telephone	Air Fare
1. Revenue, 1989 (billion $)	9.2	1.7	4.3	4.6	1.6	3.2
Expenditures as % of Income						
1. Less than $5,000	17.0	6.9	3.8	7.9	12.3	2.9
2. 5,000–9,999	6.1	2.1	1.2	3.3	4.1	0.9
3. 10,000–19,999	5.4	1.8	1.0	2.2	2.6	0.9
4. 20,000–29,999	4.9	1.4	0.8	1.6	1.8	0.7
5. 30,000–39,999	3.8	1.2	0.7	1.3	1.4	0.6
6. 40,000–49,999	3.3	0.9	0.6	1.0	1.2	0.7
7. 50,000 or more	2.3	0.7	0.5	0.5	0.9	0.8
Total	3.7	1.2	0.7	1.3	1.6	0.8

Source: *The Distributional Effects of An Increase in Selected Federal Excise Taxes,* Staff Working Paper, **CBO,** July 1987.

for family size. In both respects such taxes are inferior to the income tax. Dallying with the deficit problem by upping excise taxes might offer a politically attractive way of pretending that the deficit problem is being dealt with, but little would be accomplished and the quality of the tax system would be impaired.

Retail Sales Tax or VAT

Establishing a broad-based consumption tax such as a retail sales or value added tax, unlike resort to excise taxes, would have the potential of making a very substantial contribution to deficit closing. Depending on how broadly the base is defined, a five percent rate may be expected to yield from $75 to $100 billion or more. Beyond this, it would open a new perspective on the very structure of federal finance.

Upping excise taxes might offer a politically attractive way of pretending that the deficit problem is being dealt with, but little would be accomplished and the quality of the tax system would be impaired.

If a step towards a broad based consumption tax were to be taken, it must be decided whether it should take the form of a retail sales or value added tax. Except for administrative procedures, the two taxes are similar. A retail sales tax of five percent raises the price of the finished product at its retail value by five percent. The value added tax imposes a five percent tax on the successive increments of value added, thus adding up to the same total when the retail level is reached. Since the retail value of a product is simply the sum of the value added at each stage of production, their revenue and impact among consumers is essentially the same. Following the European example, current discussion among US economists tends to assume that a federal consumption tax should take the VAT, rather than retail sales form, but this is by no means obvious. In Europe, common market countries have gone the value added tax route because: it could be seen as a replacement of existing turnover taxes and because effective administration of a retail sales tax would not have been feasible in some member countries. In the United States, this difficulty would not arise. Here the case has been made that the federal government, by choosing the VAT form, would respect the traditional assignment of retail sales taxation to the states. Though politically appealing, this is a dubious argument since the two taxes and their bases are in fact the same. On the contrary, since the states already have retail sales taxes, there would be a great gain in administrative efficiency to have the federal government adopt the same, thereby permitting its joint administration with that of the states. This would save administration cost, while leaving the states free to set their own rates. The retail sales tax has the further advantage of being clearly recognizable as a consumer tax. The VAT, on the other hand, may be misunderstood as being, a "business tax," and thus akin to and a possible "substitute" for the corporation tax.

The choice between' a retail sales or. VAT approach is not a fundamental issue since the two taxes are essentially the same.

However, the choice between a retail sales or VAT approach is not a fundamental issue since the two taxes are essentially the same. The more basic question is whether an indirect, broad based consumption tax, in either form, should be adopted. This involves two issues: (1) whether consumption rather than income is indeed the appropriate tax base, and (2) whether a broad based consumption tax of the impersonal type will generate a fair burden distribution. Leaving the

former question for consideration in the following section, we proceed directly to the latter.

As shown in Table 5, the burden distribution under VAT is regressive throughout the income scale, reflecting the fact that consumption as a percentage of income declines as income increases. The resulting regressivity differs sharply from the progressive pattern of the income tax especially over the lower-middle range. Some adjustment may be made to dampen this defect at the lower end of the scale by excluding items which weigh heavily in low income budgets. This may be seen from Table 5, showing the effective rates of tax which result as a ten percent VAT is imposed on a broad and narrow base respectively. Narrowing the base reduces rates at the lower end substantially with little effect higher up. An alternative correction could be applied by rendering offsetting transfer payments to low income consumers. Though potentially powerful, such a correction is difficult to apply, as has been seen to be the case where attempted at the state level.

The burden distribution under VAT is regressive throughout the income scale.

Table 5

Effective Rates of VAT Yielding $75 Billion

	Broad Based	Narrow Based
Consumption Base	$2.5 tr.	$1.5 tr.
Tax rate on Consumption Base	10%	10%
Revenue	$250 b.	$250 b.
Family Economic Income Class	Tax as % of Income	
O-10	14.2	8.9
10-15	9.2	5.9
15-20	7.5	4.8
20-30	6.1	4.1
30-50	5.0	3.3
50-100	3.9	2.7
100-200	3.0	2.3
200 and over	1.8	1.7

Source: Charles McLure, Jr. The Value *Added Tax.* Washington: American Enterprise Institute, 1997. p. 33. Table 4, lines 1 and 4.

Even if low income regressivity can be avoided, two defects remain. For one, the mere exclusion of low income items does not adequately allow for family size as does the use of exemptions under the income tax. Secondly, exclusion of mass consumption items from the tax base only serves to remove regressivity at the lower end of the scale, but not. over the middle to upper range.

[A new federal consumption tax] would interfere with the reliance of states on consumption-based taxes and, if in VAT form, would require the development of an altogether new administration.

In conclusion, resort to a broad based consumption tax would open a new and very substantial source of revenue, but would also call for greatly expanded administration. It would hardly be worthwhile unless a considerable amount, say $75 billion, were to be raised from this source. There would be serious disadvantages as well. Whether adopted in retail sales or VAT form, it would interfere with the reliance of states on consumption-based taxes and, if in VAT form, would. require the development of an altogether new administration. This

would take time and delay dealing with the deficit problem. Moreover, the burden distribution would be less equitable than what can be accomplished under the income tax. Tinkering with excises or resorting to a value added tax may be preferable to no revenue gain, but we should be able to do better.

A Personal Consumption Tax

Tinkering with excises or resorting to a value added tax may be preferable to no revenue gain, but we should be able to do better.

It remains to consider a further option which has received wide and favorable attention among tax economists in recent years. This is a personal consumption based tax, similar to the income tax in that it can be adapted to the taxpayer's capacity to pay, but now related to his/her total consumption, with a personal exemption and rising bracket rates. The preceding objections applicable to impersonal consumption taxes, such as the retail sales tax or value added tax, would thus no longer apply, or would need to be modified substantially

Income vs. Consumption as Base

The case thus rests on the fundamental question of which is the better tax base, income or consumption. The traditional view has been that a person's economic capacity depends on his/her income, however it is used and from whatever source it is derived. Therefore, income was seen as the best measure of economic capacity.

Another perspective holds that the purpose of income is, after all, consumption. Therefore economic capacity is best measured by the level of consumption. Which of the two perspectives is the "correct" one?

To simplify matters, suppose first that there are no bequests or gifts, so that people will consume their entire income during their lifetimes. Even then, there remains an important difference between the two taxes. Under the consumption tax, no tax is paid when income is received. The tax is paid only when consumption occurs, including the addition to consumption which has been derived from preceding earnings on the taxpayer's saving. Under the income tax, a tax is paid when income is received, and a further tax is paid on the interest income derived from postponing consumption. The income tax thus discriminates against the late consumer who saves. As economists from John Stuart Mill on have argued, this is unfair and inefficient, since it interferes with the timing of consumption. This "double taxation of saving" may be avoided by taxing consumption only when it occurs or by excluding interest from the base of the income tax.

*While ... the tax system should not penalize future **consumption,** the case for the consumption as against the income base is not as evident as may appear at first sight.*

Suppose that the consumption base can be determined readily by asking the taxpayers to add their grocery bills and applying tax rates thereto. Would this be a good tax? While there is merit to the proposition that the tax system should not penalize future consumption, the case for the consumption as against the income base is not as evident as may appear at first sight. For one thing, benefits derived from the receipt of income do not accrue only in terms of consumption, be it

present or future. Capital accumulation provides security, social status and power to its owner. These benefits are substantial and accrue quite apart from resulting claims to future consumption. It is thus appropriate that there should be some charge which reflects these benefits. The proper tax base, therefore, falls somewhere in between that given by income and consumption. Alternatively, the consumption tax might be supplemented by a tax on wealth. In either case, the advantages of simplification are largely lost.

Also, not all income is consumed during the recipient's lifetime. A substantial part thereof, especially over the higher income range, is passed on as gifts or bequests. Since taxable capacity reflects disposition over income during the recipient's lifetime, rather than across generations, gifts or bequests should be included in computing the base of the consumption tax.[11] Nor should such inclusion be viewed as a substitute for the estate and gift tax, because they are meant to derive a public share in transfers. This is especially relevant since these federal taxes were reduced drastically in 1981 and 1984, and attempts to tax unrealized gains at the time of transfer under the income tax have remained unsuccessful.

Progressive rates may be applied to a personal consumption tax as they are to the income tax, but differences remain. Under the income tax, the horizon within which the tax base is viewed is essentially short-term. Progressive rates may thus be applied in relation to annual income. Inequities which arise from short-term swings in income may be dampened by permitting the tax base to be averaged over a number of years. Under a consumption base, swings would be larger and a short-term perspective is less appropriate. Since long-term averaging or assessment on the basis of lifetime consumption becomes impracticable, the consumption base would be less hospitable to progressive taxation. Major proposals to base taxation on consumption are indeed linked to a flat-rate approach."

Since taxable capacity reflects disposition over income during the recipient's lifetime, rather than across generations, gifts or bequests should be included in computing the base of the consumption tax.

Major proposals to base taxation on consumption are indeed linked to a flat-rate approach.

Implementation

Taking a realistic view, the taxpayer cannot simply be required to add his/her grocery bills in order to determine the taxable base. An indirect approach is needed. The outcome has been presented by its various proponents as a "simple flat tax," a "cash flow tax," a "cash flow income tax," and a "simplified alternative tax." The observer is left perplexed as to the actual base, and references to withholding at the corporate level as a "business tax" add to the confusion.

Cutting through the details, the essential idea is to determine taxable consumption as the difference between (1) total cash proceeds, including those from sales, wages, dividends, and interest as well as those from sale of assets, borrowing, or withdrawal from financial accounts, and (2) total non-consumption uses, including costs of doing business, such as costs of materials and wage payments, acquisition of depreciable and other assets, debt repayment, and addition to financial accounts. The difference between the two is the tax base from which a personal exemption is subtracted and to which bracket rates are ap-

plied. To expedite administration, part of the tax is collected at the corporate level and part at the household level. The tax collection at the corporate level serves as withholding against the final tax to households. (Various implementation plans offer variations on this theme, but need not be considered here.)

Many tax experts believe that the administration of such a tax would be simpler than that of the income tax, and some of the major income tax difficulties (such as the determination of annual depreciation charges and of capital gains) would indeed be avoided. But other pressures for exclusion from the base, as in the preferential treatment of owner-occupied housing, would surely reappear. New and unforeseen difficulties may also be expected to emerge with practical experience. Tax preferences have nine lives and a habit of adapting themselves to changing circumstances.

The cash flow tax. . . goes a long way towards transforming the income tax into one on wage income only.

Towards a Wage-Income Tax

Focusing on the uses side, the tax base of a cash flow tax is arrived at by beginning with all gross receipts and deducting all uses other than those for consumption. Consider now what happens to various income sources in the process. Among the uses that are deducted is the cost of depreciable assets that are acquired in the process of investment. Investment costs are thus expensed when made, as distinct from being depreciated over time as under the income tax. As a result, the return to capital earned in a competitive market, unlike that of the wage earner, is not affected by the tax. This is because expensing reduces the investor's own cost of investment by the rate of the tax which offsets his/her loss of cash flow at the same rate.[13] Moreover, capital income under the cash flow tax will contribute to revenue only to the extent that its return exceeds the market rate of interest. This is because only then will the Treasury's tax revenue exceed its cost of borrowing to finance the initial advance under expensing.[14] Unlike our simple model, this does not mean that capital income goes scot free. Rent of land, return to risk, monopoly profit, and entrepreneurial wages remain included. Nevertheless, the cash flow tax, from the sources side, goes a long way towards transforming the income tax into one on wage income only.

Wage income as a share of total income falls when moving up the income scale, thus rendering even a proportional wage tax regressive with regard to total income.

Going back to the traditional critique of the income tax-that it double taxes interest and thus discriminates against savings and postponed consumption-there is nothing wrong with this outcome. According to this view, removing this bias by taking interest out of the tax base is just as it should be. But Congress, confronted with a proposal to move the income tax toward a tax on wage income only, might well be startled by such a plan. Wage income as a share of total income falls when moving up the income scale, thus rendering even a proportional wage tax regressive with regard to total income. In addition, excluding capital income runs counter to a long tradition of regarding wage or "earned" income as more, not less "deserved" than capital income. Surrendering leisure, after all, involves a cost to the worker, which may be more, not less, significant than the saver's cost of postponing consumption, an act which might be advantageous even without a return.

Looked at from the sources side as approaching a tax on wage income, the cash flow approach is thus less attractive than if viewed from the uses side as approaching a consumption tax; and while it may simplify administration, the cash flow approach hardly simplifies an understanding of what is being taxed.

A purported advantage of the cash flow approach is that it avoids taxing the return to capital at the margin, while including intra-marginal or rent-type income only[15] Detrimental effects on investment would thus be avoided. This, however, is questionable. The part of capital income that remains included is "extra" marginal and not "intra" marginal in nature. It involves capital income which exceeds that of the competitive market rate of return, and not the gain which investors may derive because they would be willing to undertake earlier units of investment at a lower rate of return. Indeed, some of the items that remain included may be particularly elastic in supply.[16]

Personal saving as a percent of disposable income, which stood at 6.5, 6.7, and 7.9 percent in the 1950s, 1960s, and 1970s, respectively, has plummeted to three percent in 1988.

Conclusion

In conclusion, it is evident that a personal type consumption tax, implemented in its cash-flow form, is superior to an impersonal retail sales or value added tax, because it permits exemptions and progressive rates, whereas the latter, at best, does so only at the lower end. Since the VAT or retail approaches are similar in application, the case for the cash flow tax is thus strengthened greatly if combined with progressive rates. Provided that bequests are included in the base, the cash flow tax also becomes an acceptable alternative to the income tax, although less so when viewed as moving the latter toward a tax on wage income only.

However this may be, introduction of a cash-flow tax would hardly begin with a complete replacement of the income tax. Adequate experience would be needed, a transition during which the revenue would be divided between the two bases, using integrated tax forms and withholding. Since the weight of saving and hence the difference between the two bases becomes important only over the upper-income ranges, the sensible way to begin would be with respect to higher incomes.

Taxation effects surely were not a major factor. The personal savings rate dropped precisely when tax rates declined.

Effects on Saving

As noted at the outset, the declining rate of net national saving in the US is a major problem to be faced in addressing the future of the American economy. The role of the federal deficit in dissaving has been paramount in this decline, but personal saving has dropped as well. Personal saving as a percent of disposable income, which stood at 6.5, 6.7, and 7.9 percent in the 1950s, 1960s, and 1970s, respectively, has plummeted to three percent in 1988. Whatever the reasons, such as consumer appetites and changes in pension financing, taxation effects surely were not a major factor. The personal savings rate dropped precisely when tax rates declined. Nevertheless, taxation effects on saving and the need for savings incentives are paid much attention.

Consider first the impact of the income tax on saving. As the tax is imposed or increased, the taxpayer is left with less income and part of this loss may well be reflected in reduced saving. Also, as the tax is imposed, the net rate of return on investment is reduced, which makes it less worthwhile to save. Both these effects suggest that the tax will reduce saving.

A further presumption that the income tax deters saving arises from its progressive. nature. Since the savings rate tends to rise with the level of income, a progressive income tax will tend to bear more heavily on saving than a flat rate tax. But though this appears to be the case in the context of annual behavior, it need not follow in a lifetime context. Since most income is consumed during one's lifetime, differences in saving behavior matter less if considered on the basis of a lifetime consumption function. Other factors that effect savings behavior are treatment of durable consumer goods, the structure of credit markets, historical and social consumption patterns, accumulations of wealth, pension systems, and demographics. The problem is more complex than appears at first sight.

Empirical attempts to measure [the impact of income taxes on saving] have yielded quite diverse results and, on the whole, have been inconclusive.

It is not surprising, therefore, that empirical attempts to measure this impact have yielded quite diverse results and, on the whole, have been inconclusive.[17]

A similar lack of consensus prevails regarding the savings effects obtained by replacing an income tax with a consumption tax. There is a presumption that such a substitution would favor saving since the income tax penalty on interest is removed. But the difference appears to be slight. A recent estimate by the Congressional Research Service compares the effect of substituting a $60 billion value added tax for an equal reduction in the income tax.[18] The study concludes that such a substitution would in 50 years cause the capital stock to increase by 1.4 percent over present levels and that the long-run level of consumption would rise by a mere onequarter of one percent.

Income tax, through further base broadening and moderately progressive rates, remains the best instrument to achieve the needed revenue for deficit reduction and for meeting other public needs.

The one clear-cut conclusion that may be drawn from all this is that the savings effects of changes in tax structure are swamped by those obtained with a reduction in the level of deficit. Towards this, no substantial progress can be made without a tax increase.

After consideration of available alternatives, and guided by the normative standard of ability to pay, I conclude that the income tax, through further base broadening and a recommitment to moderately progressive rates, remains the best instrument to achieve the needed revenue for deficit reduction and for meeting other public needs.

Endnotes

[1] On the one hand, the Social Security surplus is committed for future use and therefore deficit goals should be set exclusive of it. On the other hand, the deficit or surplus inclusive of Social Security must be in line with sound macroeconomic policy both in the short term and the long term. In the short run, this may mean not closing the deficit so fast as to threaten a recession. In the long run, it means taking account of how current contributors will respond as savers and consumers. For further discussion, see Henry J. Aaron, Barry I?. Bosworth, and G. Burtless, Can ***America Afford to Grow Old?,*** Brookings Institution, 1989.

[2] Our conclusion rests on the premise that the economy will continue in sufficient strength to sustain such policy change while maintaining an adequate level of employment. Reconsideration will be called for should the economy weaken substantially.

[3] Another comprehensive concept of ability to pay as defined by consumption arises in the context of a personal consumption tax and is discussed below.

[4] Repeal of state income tax deductability would add another $18 billion of revenue to the federal income tax, most of it borne by the middle and upper income range. But it would also lead states to increase their reliance on sales taxation. As a result, the combined liabilities may shift towards the lower end of the scale. Similar considerations also apply to the deductability of the property tax.

[5] The hump rate of 33 percent is designed to phase out the relief granted by the personal exemption and the first bracket rate of 15 percent, so as to yield a flat tax (tax as a percent of income before exemption) of 28 percent over the upper ranges.

[6] See ***The Changing Distribution of Federal** Taxes:* 19 75-1990. Congressional Budget Office, Washington, DC, October 1987, p. 37.

[7] See CBO, op. cit., p. 47.

[8] See CBO, op. cit., p. 65.

[9] See R.A. Musgrave, "Short of Euphoria,"***Economic Perspectives,*** Vol. 1, No. 1, Summer 1987.

[10] But, of course, these goals could be furthered by means other than the tax system. For example, proponents of these goals have advocated mandatory mileage requirements and restrictions on smoking and drinking.

[11] Positions differ on this crucial point. Our position calling for inclusion is shared by Aaron and Galper, Assessing *Tax Reform,* Brookings Institution, 1985, p. 77 and by McClure, Mutti, Thuronyi and Zadrow, *The Taxation of Income and Capital in Colombia,* Ministerio de Hacienda, Colombia, 1988, p. 295. Inclusion is not allowed for by Hall and Rabushka, op. cit., and by D. Bradford, *Blueprints for Basic Tax Reform,* Tax Analysts, 1984.

[12] Along these lines, see R. Hall and A. Rabushka, Low *Tax, Simple Tax, Flat Tax,* McGraw-Hill, 1986.

[13] Suppose Jones invests $10,000 in a depreciable asset and thereby obtains an annual cash flow of $1,672, or 16 percent of cost, for ten years. His yield or rate of return is ten percent since when discounted at that rate, the present value of his cash flow equals his investment cost of $10,000. Now a cash flow tax of 32 percent is introduced and two things happen. Jones at once gains $3,200. This amount—received by way of reducing other tax liabilities or in cash-is what the Treasury owes him as expensing is applied. But he must also pay an annual tax of $535 or 32 percent of his cash flow for five years. This reduces his after tax flow to $1,137, still 16.7 percent of his reduced investment cost. His net return similarly remains at ten percent since the present value of the reduced cash flow, when discounted at ten percent, again equals the reduced investment cost. With own cost and cash flow both reduced by the rate of tax, the Treasury has entered as a partner and the investor's rate of return is unaffected.

[14] As the investment is made, the Treasury at once suffers a loss of $3,200 to compensate for expensing and it must finance this amount by borrowing. It also obtains a ten year revenue flow of $5,311. Discounted at ten percent, this equals its cost of $3,200. The Treasury thus strikes even if the present value of that flow equals the present value of its borrowing cost. Such will be the case if the market rate at which the Treasury borrows just equals the investment yield of ten percent. This equality will hold in a purely competitive economy without risk, in which case the cash flow tax is revenue neutral with regard to capital income. But in practice, the investment yield will tend to be higher, so that some positive yield is obtained from this source. By the same token, an investment which results in a lower than market rate of return results in a loss to the Treasury (For further discussion, see Henry J. Aaron and Harvey Galper, *Addressing Tax Reform,* Brookings Institution, Washington, DC, 1985.)

[15] See McLure et al, op. cit., p. 282, and Aaron and Galper, op. cit., p. 82.

[16] Note however that the Treasury, by entering as a partner also reduces the investor's own cost and thereby the amount which he must place at risk. With amount at risk and cash flow reduced at the same rate, his rate of return on risk taking is unchanged, leaving open how total risk taking will be affected. As was noted long ago, a similar result may be obtained by assuring full loss offset under the income tax.

[17] For example, the following comments are found in H.J. Aaron, H. Galper and J. Pechman, eds., *Uneasy Compromise: Problems of* a *Hybrid Income-consumption Tax.* Brookings Institution, Washington, DC, 1988, pp. 268, 265, 259.

Barry Bosworth, Brookings Institution:

> To date the empirical evidence has been quite conclusive in discounting any substantial effects on overall private saving rates of changes in the return to capital ... I do not understand the current focus on incentives for private saving at a time when two-thirds of net private saving is required to finance the budget deficit ... At the present time, tax policy should be a minor element in the debate over how to increase the national savings rate.

Lawrence Summers, Harvard University:

> 1 remain persuaded that permanent tax measures that raise the return to savings are likely to increase private savings. But at this point, the magnitude of the effect is difficult to gauge ... The data speak clearly to one point, however. Changes in public saving that occur as the government runs budget deficits have a direct and large impact on national saving. The most potent and reliable way to increase national savings is to reduce government deficits. Any adverse effect that tax increases may have on private saving is almost surely dwarfed by their favorable effect on national saving.

David Starret, University of Minnesota:

> Economists know little about long-run savings responses or short-run adjustments to many potential policy changes.

[18] See Jane C. Gravelle, *Effects of a Value-Added Tax on Capital Formation,* CRS, Nov. 15, 1988.