

Observations on Tax Reform

Testimony before the President's Advisory Panel on
Federal Tax Reform



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Groundhog Day

- Similar calls for reform have been made over the last four decades
 - Friedman -- early 1960s
 - Hall and Rabushka - early 1980s
 - Tax Reform Act of 1986
 - Armey/Archer --1990s
 - Kemp Commission -- 1996



Reprise

- Similar complaints over the decades
 - Too complex
 - Discourages hard work, saving and risk-taking needed for growth
 - Not fair
 - Difficult to comply with and administer



Senator Moynihan during SFC Hearing regarding Kemp Commission report:

- *"The thought of a new set of simple rules is always appealing. However, any time a change of this magnitude is under consideration, with huge potential risks to the economy and shifts of fortune in the balance, we must approach proponents' claims with caution and healthy skepticism..."*



Issues central to reform

- Complexity
- Equity
- Effect on savings and growth



Too Complex?

- Millions of low-income households do not file returns
- 17% of tax filers file 1040EZ
- 22% of tax filers file 1040A
- About 70% do not itemize deductions
- 45% spend less than 10 hours on compliance
- However, over half of all taxpayers hire professional assistance



Major sources of complexity

- Taxation of business income
 - Treatment of passthroughs
 - Depreciation allowances
 - Cross-border income
- Capital gains
 - Tracking basis; holding period
 - Different rates
- Income phase-outs
- Structural extenders/uncertainty
 - Impact of budget rules
- Myriad of savings vehicles
- Certain itemized deductions (e.g., recordkeeping for charitable contributions)
- Alternative minimum tax
- Earned income tax credit
- Taxation of financial instruments



Is the Grass Really Greener?

- “We have been concerned for some time about the seemingly inexorable and exponential increase in the complexity of the tax system [VAT], especially in so far as it affects ordinary people and small businesses.” (The Chartered Institute of Taxation).
- “The majority of people who do not deal with VAT on a day-to-day basis seem to find the tax almost unintelligible...” (Sinyor, Tax Advisor, December 2004).
- English VAT criticized as a stealth tax, because of lack of transparency.
- 16% evasion rate in English VAT (British Auditor General).



Examples of VAT complexity

- Children's clothing -- zero rated
 - Fur clothing is excepted
- Is a roller coaster public transport, which is zero-rated?
- Is Jaffa Cake a biscuit or a cake, which is treated more favorably?
- At times, the amount of VAT may depend on quantities purchased. (e.g., a single supply of 100 bricks or two supplies of 50 bricks).
- Six doughnut rule -- whether eating on premises or off premises.



Potential VAT complexities

- Exemptions
- Multiple rates
- Sourcing rules -- distinguish taxable domestic sales from zero-rated exports
- Treatment of financial services
- Retention of tax expenditures
- Related-party transactions
- Excluded transactions
- Small business exceptions
- Re-negotiation of tax treaties
- Piggyback of state taxes
- Other forms of income reporting (e.g., financial aid)



Tax expenditures

- Much complexity has been caused by over 100 special provisions added by Congress over the years.
 - Employer provided health insurance
 - Retirement benefits
 - Mortgage interest deduction
 - Research credit
- Will these really be eliminated; if so, what are the consequences?



Our current tax system

- \$2.9 trillion in total taxes in 2002
- Federal taxes - \$1.9 trillion
(18.2 % of GDP)
 - personal income tax -- 44%
 - social insurance taxes -- 39%
 - corporate income tax -- 9.5%
 - excise taxes -- 4.7%
 - estate taxes -- 1.3%



Current tax system (cont.)

- State taxes -- \$1 trillion (9.6% of GDP)
 - Sales taxes -- 33%
 - Property taxes -- 26.5%
 - Personal income taxes -- 20%
 - Corporate income taxes -- 3%
 - Estate and gift taxes -- .7%
- Most state tax systems are regressive
 - Over the last decade, regressivity has increased.



Comparison to Foreign Systems

- U.S. has a lower tax burden than virtually all of our trading partners.
- Income taxes and social insurance taxes are close to the OECD average.
- Big difference is consumption taxes
 - U.S. (4.2% of GDP); OECD average (11.1% of GDP).
 - Most use VATs, rather than sales taxes
 - No major industrialized nation uses only consumption tax.



Equity

- Vertical equity
 - the ability to pay
 - Potential social benefits vs. economic disincentives/complexity
 - 63% believe upper income pay too little (USA Today). Impression that middle income taxpayers pay more.
 - Hite study – two-thirds chose system as progressive or more progressive than current system.
 - Wage income vs. capital income
 - benefit principle



Equity (cont.)

- Horizontal equity
 - Personal exemptions/child credits
 - Casualty or extraordinary health costs
 - Marriage penalties and bonuses
- Intergenerational equity
 - Rate of consumption changes over lifetime
- Transitional equity



Ability to pay

- “To secure least aggregate sacrifice, taxes should be so distributed that the marginal utility of the money paid in taxation is equal to all the payers.” (A.C. Pigou).
- Regarding the flat tax: “Now for some bad news...it is an obvious mathematical law that lower taxes on the successful will have to be made up by higher taxes on average people.” (Hall and Rabushka).
- Polling indicates that much support for a consumption tax comes from the misinformed belief that it will be more progressive than the current system (Slemrod 2003).



Hybrid nature of our system

- Imperfect income tax/piecemeal consumption tax.
- Many forms of capital income are exempt.
 - About 4/5ths of all interest income is excluded thru pensions, life insurance policies, and tax-exempt bonds.
 - Almost half of all dividend payments were exempt; those that are included are taxed at reduced rates.
 - Taxation of capital gains is a mish-mash (not-indexed; taxed at realization; special rates, etc.)
 - Small business expensing
- Myriad of tax-favored investment vehicles
 - Retirement savings (defined benefit plans, defined contribution plans, traditional IRAs, Roth IRAs).
 - Others (education savings, insurance, etc.)



Savings and economic growth

- Affected by many factors other than taxes
 - Technological advances (1950s and 1990s)
 - Oil prices (1970s recession)
 - Very difficult to isolate
- Efficiency gains, if any, will depend on the rate
 - Could exceed 30% tax rate
- International evidence ambiguous
- Effect on savings also ambiguous
 - Hybrid system already
 - Taxpayers with greater returns to savings may spend more.
- Neutrality
 - Tax expenditures– will they really be eliminated



Reform of current system

- 1986 style reform
- Simplify existing incentives
 - Education incentives
 - Family incentives
 - Rationalize savings incentives
- AMT reform or repeal
- Business tax reform
- Stability
 - Effect of sunsets, phase-ins and other budget gimmicks.