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EVEN THE OECD CRITICIZES THE U.S. TAX SYSTEM'S INEFFICIENCY

A recent study from the Organisation for Economic Co-operation and Development (OECD) concludes that the U.S. tax system is unnecessarily inefficient and complicated.[1] The study recommends that the United States reduce its heavy tax burden on capital income, praises major elements of the 2001 tax act for cutting high marginal tax rates, and deplores the alternative minimum tax and many income-based phase-outs. Given the OECD's generally pro-tax attitude, these findings are especially noteworthy and credible.

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OECD economists Richard Herd and Chiara Bronchi explain in "Increasing Efficiency And Reducing Complexity In The Tax System In The United States," that while taxes in the United States are low compared to those in most other OECD members, features in the U.S. system generate excessive distortions and too much paperwork for the amount of revenue collected.[2] One example they cite is the Alternative Minimum Tax (AMT). They describe it as "a very unusual levy" that is found in "no other OECD Member country" and which "adds substantially to complexity without achieving its original goals."[3] The OECD economists repeat a number of their recommendations more explicitly and concisely in a short follow-up article, "Improving The U.S. Tax System."[4]

The U.S. Income Tax's Treatment of Saving and Investment Is Particularly Distortionary

The OECD study is critical mainly of the income tax, especially its treatment of saving and investment. "The current system is not designed in a way that minimises the excess burden of taxation. The most noticeable inefficiencies come in the area of capital income taxation."[5] The study recognizes that a tax system will be biased against saving and investment if a tax is imposed on both the amounts saved and the returns to the saving. The income tax subjects earnings used for saving to repeated taxation, while earnings used for immediate consumption are subject to income tax only once. This, Herd and Bronchi explain, "favours present over future consumption with a negative impact on savings and capital accumulation."[6] This is of concern because reduced capital formation slows productivity gains and reduces employment and income growth.

The OECD economists also point out that saving is subject to "large variations" in tax treatment "depending on the sector in which it is invested and the financing instruments that are used."[7] For instance, C corporations, whose earnings are subject to both corporate and individual income taxes, fare worse than S corporations,

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partnerships, and sole proprietorships, whose earnings are taxed only at the individual level. Furthermore, among C corporations, "[t]here is a bias in favour of debt finance" and against equity finance because the former is deductible under the corporate income tax while the latter is not.[8] These peculiarities of the U.S. income tax explain an apparent contradiction. On the one hand, "[t]he top statutory rate for federal corporate taxation [in the United States] is in the middle range of OECD rates."[9] On the other hand, because the corporate income tax is an *additional* income tax that the U.S. government levies on some investments, "[m]arginal effective tax wedges across various financing vehicles exhibit more variability than [in] other OECD Member countries, while the level of the tax wedge for equity is amongst the highest in the area."[10] Other OECD member countries, to a greater extent than the United States, reduce the double tax on corporate equity income through provisions such as decreased tax rates on dividends and capital gains or credits on the shareholders' tax returns for corporate taxes paid on earnings distributed as dividends.

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The basic income tax bias against saving and the additional penalty on corporate income produce a double-whammy. The basic bias reduces the amount of saving, and the secondary tax biases among types of saving mean that the reduced amounts of saving "are not always allocated to the area where they have the highest return..."[11] The problems would be even worse, judges the study, except that "many of the most adverse effects of taxation [in the United States] have been reduced with the progressive reduction of marginal income tax rates..."[12]

Multiple Layers of Income Tax on Saving and Investment Should Be Cut Back or Eliminated

A ploy often used by those who seek higher tax rates is to note the harmful economic distortions caused by taxing various economic activities unequally, and then demanding that the variations in tax rates be eliminated by raising the lowest rates to match the highest (never reducing the highest to the lowest). In years past, this was a favorite technique of the U.S. Treasury staff, as well as other elements within the OECD and its member states' taxing authorities. By contrast, this OECD study advocates correcting the income tax bias against saving and investment by eliminating the additional layers of tax on saving.

If replacing the income tax with a consumption tax is too big a change ... the OECD study suggests ... "reducing corporate tax rates, integrating the taxation of corporations and individuals and cutting the capital gains tax rate. Efficiency gains might also flow from lowering the top marginal tax rates on income and extending the scope of saving schemes that allow tax-free accumulation of income until the money is spent..."

It advises that "replacing the income tax with a consumption tax ... in many ways ... would be the best approach..."[13] This substitution would eliminate the primary income tax bias and probably many of the secondary tax biases among assets. It should be noted here that although the study's authors are most familiar with European-style value added taxes (VATs), saving-neutral taxes can take other forms that might have more appeal in this country. Among the options are a simple cash flow tax, the USA tax originally

proposed by Senators Nunn and Domenici and now sponsored by Representative Philip English (R-PA), the flat tax proposed by Representative Dick Armey (R-TX), and a national sales tax.

If replacing the income tax with a consumption tax is too big a change to be politically feasible at this time, the OECD study suggests a number of ways to reform the current system that "could also generate benefits..."[14] These include "reducing corporate tax rates, integrating the taxation of corporations and individuals and cutting the capital gains tax rate. Efficiency gains might also flow from lowering the top marginal tax rates on income and extending the scope of saving schemes that allow tax-free accumulation of income until the money is spent [e.g., tax-deferred IRAs and retirement pensions]."[15] The study notes approvingly, for instance, that Iceland has "a flat capital income tax rate of only 10 per cent"[16] and that the tax codes in many other countries have similar provisions that provide some relief from the income tax's basic anti-saving bias.

While the OECD study does not explicitly refer to the debate between the Bush Administration and those who would prefer not to cut taxes, its recommendations are much closer to those of the Bush Administration — except they go farther in emphasizing permanent changes, business tax reforms, and other cuts in the highest marginal tax rates.

The 2001 Tax Cut

The OECD study is generally favorable toward the 2001 tax act. "The cuts do move ... in a direction that is likely to improve efficiency."[17] The OECD economists specifically cite the reductions in statutory rates, the eventual elimination of the phase-outs on itemized deductions and personal exemptions, the eventual repeal of the estate tax, and the expansion of tax-neutral retirement saving plans. Whereas opponents of the legislation claim that it was fiscally irresponsible to cut taxes, Herd and Bronchi explain that the tax cut, which will gradually reduce marginal tax rates over the next decade, will simply "ensure that the overall tax ratio [taxes as a percent of GDP] does not remain at its recent high level permanently."[18] Although the study does not say so explicitly, taxes as a share of GDP will remain well above their historical average even with the legislation.

The OECD economists observe that income tax complexity at the business level usually receives short shrift politically in this country. They conclude that it deserves much more attention, stating ... "But it is in the area of corporate taxation where most simplification is required, as compliance [there] is particularly expensive."

Some advocates of increased income redistribution complain that the rate cuts scheduled for 2004 and 2006 for people in the three highest tax brackets should be repealed. The OECD study, however, says that these rate cuts will benefit the U.S. economy because, when they finally become fully effective, they will go largely to the extremely productive workers, savers, and investors in the highest marginal tax brackets, many of whom are entrepreneurs. Further, the study calls it "an anomaly ... generated by procedural problems," that the tax act sunsets at the end of 2010, and says "[p]utting the changes onto a permanent basis should be a priority."[19] Because the OECD is not known for being hostile to big government and high taxes, its findings regarding the 2001 tax cut are all the more compelling.

Second earners in two-earner households are another group that often experience high marginal tax rates because their combined income spills into the higher brackets. Because second earners tend to have relatively elastic labor supplies, the large marginal tax wedges they face can impose a "significant deadweight cost" on the economy by driving productive people from the workforce.[20] The study praises the second-earner exemption permitted in the early 1980s and proposed again by President Bush as particularly "well targeted ... [for] reducing marriage penalties". It notes that Congress chose instead to legislate an eventual increase in the standard deduction and rate brackets for couples to twice those for singles.[21]

The OECD study does not approve of the entire 2001 tax act. It gives poor marks to the portions of the package that are "essentially distributed on a flat-rate basis to all taxpayers" because they have "little incentive effect".[22] This includes the $300/$600 rebate, which was not part of the President's initial proposal but was added at the insistence of Senate Democrats and some Republicans. If one reads between the lines, it may also be critical of Congress for not dealing with the marriage penalty by means of a second-earner exemption.

Early in the paper, the OECD economists ... explain concisely what is right about tax competition among jurisdictions and what is wrong with collusion among governments to keep taxes high. "[S]ignificant tax competi-tion between local areas ... helps limit the burden of taxation... [I]ndividuals can always move if the burden from sub-federal taxation becomes too high, relative to benefits."

While the OECD study does not explicitly refer to the debate between the Bush Administration and those who would prefer not to cut taxes, its recommendations are much closer to those of the Bush Administration — except they go farther in emphasizing permanent changes, business tax reforms, and other cuts in the highest marginal tax rates. The study's logic is that tax reforms can best improve the economy if they concentrate on removing some of the income tax's worst biases against productive efforts. A bonus is that because many distortionary tax provisions are also very complicated, well designed tax reforms can simultaneously simplify the tax system.

Some might object to the OECD study because it concentrates on the long run. But that time frame is actually an advantage because it avoids the flawed theorizing and disappointing practical results of Keynesian economics. The OECD study relies on neoclassical — incentive based — economics. In the neoclassical model, the way to help the economy in the short run, as well as the long run, is to enact sound economic policies. That means permanent tax reforms, not temporary "stimulus" measures that are gone after a few months, leaving the initial tax biases that hurt the economy in place. The benefits of lasting reforms begin strengthening the economy in the near term and they grow over time.

At one point the study implicitly criticizes distribution tables as short-sighted because of the dynamic effects they ignore. If taxes were lowered on "businesses, capital gains and capital income" relative to consumption-based income, the "move would be likely to initially increase the income share of the richest groups in US society." But over time the tax reforms would enrich society as a whole because the tax reforms "should eventually also increase output and real incomes more generally."[23]

Income Tax Complexity

As most Americans know from personal experience, the U.S. income tax is too complicated.

The OECD economists agree. Their disapproval of the AMT was mentioned above. They are also critical of phase-outs, which refer to deductions, exemptions, and credits taken away from taxpayers as their incomes increase. Phase-outs add to tax complexity because they entail complicated special rules and additional tax calculations. In addition, phase-outs worsen tax distortions because they have the effect of boosting marginal tax rates. (For example, suppose a taxpayer makes an extra $100, is in the 30% statutory rate bracket, and has $5 of tax credits phased out due to the extra income. The result is that the taxpayer's tax bill rises by $35 on the added income of $100, for an effective marginal tax rate of 35%.) The OECD study recommends "the elimination of tax increases introduced by phase-outs. The elimination of a number of phase-outs would provide simplification for up to 30 million filers."[24]

The OECD economists observe that income tax complexity at the business level usually receives short shrift politically in this country. They conclude that it deserves much more attention, stating succinctly in a short follow-up paper: "But it is in the area of corporate taxation where most simplification is required, as compliance [there] is particularly expensive. In fact, costs are perhaps as high as half the yield of the tax due to the cost of the professionals needed to ensure compliance, to minimise payments and to apply the different rules of financial and tax accounting."[25]

Shortcomings of the OECD Study

To be sure, the OECD report has faults. It calls for abolishing the state income tax deduction without asking why people should pay federal income tax on money already taken away from them by state and local governments. The report is too accepting of externality arguments and other rationales for raising U.S. energy and tobacco taxes.[26] The report also leaps to the conclusion that because state and local retail sales taxes often mismeasure the correct tax base (exempting many retail sales of services while taxing many inter-business supply purchases), the solution is to replace the retail sales taxes with VATs. A less radical approach would be to reform state and local retail sales taxes so that their tax bases conform more closely to true retail sales.

The OECD study finds that relative to the revenues raised, the U.S. tax system, particularly the income tax, is extremely damaging to productivity and growth and much too complicated... [It] argues strongly that the most economic improvement will come from lowering high marginal rates and lessening biases against saving and investment.

The report could also be improved if it related the overtaxation of saving and investment income more explicitly to a faulty statutory tax base; that is, present U.S. tax law overstates saving and investment income compared to a tax base that provides for full and immediate expensing of investment and acknowledges saving as a cost of earning future income in the determination of taxable income. Such systems are sometimes referred to as consumption-based or consumed-income taxes, but they are really taxes on a more accurate view of what truly constitutes income. By contrast, the current income tax overstates income by delaying or denying legitimate deductions for various costs of generating income, and by taxing the saving stream at multiple points, in effect counting the same income several times.

Tax Competition as a Check on Government

Another reason the OECD study is interesting is that its discussion of sub-federal taxation opens a revealing window on the OECD's "tax harmonization" drive. States in this country set

their own tax rules, which differ from state to state. Taxpayers react to those differences. They sometimes decide to locate a business or establish residence in one state rather than another because the first has lower corporate or individual taxes. As consumers, they sometimes decide to buy from merchants in other states where retail sales taxes are low. In fact, although the study does not mention this specifically, some of the fastest growing states in recent years have been those with no state income tax.

The responsiveness of taxpayers to interstate tax differentials creates tax competition among the states. The threat of losing businesses, residents, and consumers to lower-tax states deters some states from raising taxes as high as they would otherwise. The tax competition that occurs among the states is analogous to that which occurs at the national level among sovereign countries. Taxation among nations is an area where the Paris-based OECD has been active in recent years. Its "tax harmonization" initiative is an attempt to restrain tax competition between low-tax and high-tax nations by forcing low-tax countries (especially those without much political and economic clout) to increase their taxes.

Maybe because the United States is the most powerful member of the OECD economically and militarily, the OECD is not demanding that the United States increase its relatively low taxes. But it is pressuring the United States to tell foreign governments more about the investments foreign citizens make here. That would make it easier for foreign governments to tax their citizens on U.S. investments, and would diminish or remove the tax incentive for foreigners to invest in the United States. The resulting decline in foreign investment would hurt the U.S. economy.

The OECD finds that the best reform, if politics were not a consideration, would be to scrap the income tax entirely and replace it with a tax that is neutral between saving and consumption.

Early in the paper, the OECD economists, perhaps inadvertently, explain concisely what is *right* about tax competition among jurisdictions and what is *wrong* with collusion among governments to keep taxes high. "[S]ignificant tax competition between local areas ... helps limit the burden of taxation... [I]ndividuals can always move if the burden from sub-federal taxation becomes too high, relative to benefits."[27] What this says is that a jurisdiction can readily charge high taxes *if* taxpayers receive good value for their money, just as a producer can successfully charge premium prices if he or she sells a product worth the extra cost. High taxes only cause an exodus of economic activity if the value of the extra services to taxpayers falls short of the extra taxes they pay. As such, tax competition reins in government power and helps keep governments on their toes; it makes them more responsive to taxpayers than otherwise and less able to treat taxpayers like cash cows.

Later, however, the study offers the conventional OECD argument for restraining tax competition. Looking at state corporate taxes, it depicts tax competition as a foolish policy that imposes a net loss on state governments. "In recent years every state has either enacted or significantly expanded one or more tax incentives with respect to business location... Incentives cause other states to adopt retaliatory incentive measures, imposing high costs and further shrinking the aggregate tax base." It claims that state governments "might improve welfare in the nation as a whole" if they competed less over taxes.[28]

The two passages appear at first glance to be contradictory. However, the complaint about tax competition could be read not as a complaint

against a jurisdiction's having a low tax rate uniformly applied to all businesses, and high enough to cover the government services provided to the firms, but rather, as a caution against targeted tax favors for incoming or expanding businesses that are not available to other business taxpayers, or taxes lower than the state services provided. If this is the intent, the point is well taken. If it is a reversion to the OECD's general disapproval of low-tax jurisdictions, it is misplaced. In particular, if a state were to forgo taxing business income entirely, except as it is received as proprietors' or shareholders' income, the state would merely be eliminating what would otherwise be a form of double taxation. Meanwhile, state and local services provided directly to the businesses would best be covered by user fees, as for water and trash pick-up, or by local property taxes.

Conclusion

What constitutes good tax policy is sometimes obscured in this country by the different positions that the major political parties have taken. A virtue of the OECD study is that it is largely removed from those political considerations. The OECD study finds that relative to the revenues raised, the U.S. tax system, particularly the income tax, is extremely damaging to productivity and growth and much too complicated.

Will tax reform do more to increase jobs, wages, and GDP if it targets those with low incomes or if it reduces tax biases against saving and investment and lowers the highest marginal tax rates? The OECD study, which recognizes the importance of incentives, argues strongly that the most economic improvement will come from lowering high marginal rates and lessening biases against saving and investment. Should relief be enacted on only a temporary basis, with the tax system maintained in the long run pretty much as it was prior to the 2001 tax cut, or should relief be permanent? The OECD study concludes that permanent tax reforms will be far more beneficial than temporary ones. The OECD finds that the best reform, if politics were not a consideration, would be to scrap the income tax entirely and replace it with a tax that is neutral between saving and consumption.

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Endnotes

1. The way the organization spells its name is retained. Also retained are the OECD study's British spelling conventions, when appearing in direct quotations.

2. Richard Herd and Chiara Bronchi, "Increasing Efficiency And Reducing Complexity In The Tax System In The United States," Organisation for Economic Co-operation and Development, December 17, 2001, accessed at http://appli1.oecd.org/olis/2001doc.nsf/linkto/eco-wkp(2001)39/$FILE/JT00118568.pdf. The study was prepared for the *OECD Economic Survey Of The United States*, November 2001.

3. *Ibid.*, p. 13.

4. Chiara Bronchi and Richard Herd, "Improving The U.S. Tax System," OECD Observer, March 29, 2002, accessed at www.oecdobserver.org/news/printpage.php/aid/665/Improving_the_U.S._tax_system.html.

5. Herd and Bronchi, "Increasing Efficiency And Reducing Complexity In The Tax System In The United States," p. 49.

6. *Ibid.*, p. 2.

7. *Ibid.*, p. 2.

8. *Ibid.*, p. 34.

9. *Ibid.*, p. 31.

10. *Ibid.*, pp. 31 and 34.

11. *Ibid.*, p. 2.

12. *Ibid.*, p. 8.

13. *Ibid.*, p. 2.

14. *Ibid.*, p. 2.

15. *Ibid.*, p. 2.

16. *Ibid.*, p. 49.

17. *Ibid.*, p. 48.

18. *Ibid.*, p. 48.

19. *Ibid.*, pp. 48-49.

20. *Ibid.*, p. 21.

21. *Ibid.*, p. 22.

22. *Ibid.*, p. 48.

23. *Ibid.*,p. 51.

24. *Ibid.*, p. 12.

25. Bronchi and Herd, "Improving The U.S. Tax System."

26. For an analysis of why steeper tobacco taxes are not justified, see Stephen J. Entin, "There's No Economic Excuse for a Higher Cigarette Tax," *IRET Economic Policy Bulletin*, No. 72, April 1998. For a discussion of why externality arguments fail, see Roy E. Cordato, "Global Warming, Kyoto, and Tradeable Emissions Permits: The Myth of Efficient Central Planning," *Studies in Social Cost, Regulation, and the Environment*: No. 1, Institute for Research on the Economics of Taxation, September 1999; and Roy E. Cordato, *Social Costs, Public Policy, and Freedom of Choice*, *IRET Fiscal Issues*, No. 7, 1992.

27. *Ibid.*, p. 6.

28. Herd and Bronchi, "Increasing Efficiency And Reducing Complexity In The Tax System In The United States," p. 37.

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.