IRET
Institute For Research On
The Economics Of Taxation

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REFORMING TAXATION: ADVANTAGES OF A SAVING-CONSUMPTION NEUTRAL TAX BASE, AND PRINCIPLES TO GUIDE REFORM

Statement to
The President's Advisory Panel on Federal Tax Reform
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President Bush has called for wide-ranging tax reform and simplification. He is asking for a tax system that is more pro-growth, that is simpler, and that is fairer than the current system. The possibility of real tax reform is higher now than at any time since 1986. Consequently, it is an honor and a privilege to be asked to testify before the Commission, and I thank you for the opportunity.

I have been asked to discuss the advantages of a tax system that is neutral in its treatment of income used for saving and for consumption, sometimes referred to as a consumption-based tax. A neutral tax treats all economic activity alike, and avoids the anti-saving biases in the broad-based income tax. A neutral tax would be simpler, more pro-growth, and, in my view, more uniform and fairer than the current tax system.

IRET <www.iret.org> has published several papers on the advantages of neutral tax systems and their economic impact which would be useful for the Commission to review.

• ***The Inflow-Outflow Tax***[1] <ftp://ftp.iret.org/pub/InflowOutflowSum.PDF>, which we view as the optimal neutral tax system.

• ***The Economics of Taxation and the Issue of Tax Reform***[2] <ftp://ftp.iret.org/pub/EntinNewOrl-2003.PDF>, a handbook on the way in which taxes affect the economy, the concept of marginal tax rates and a non-distorting tax base, the anti-saving, anti-investment features of the current income tax, and the advantages of neutral taxation.

• ***Reforming Taxation: Attributes of a Good Tax System and Principles to Guide Reform***[3] <ftp://ftp.iret.org/pub/ADVS-183.PDF>, some basic facts on the purposes of taxation, and the nature of income, fairness, and efficiency that should be understood in order to develop a good tax system.

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• ***Renew Bonus Expensing To Keep Recovery Strong***[4] <ftp://ftp.iret.org/pub/ADVS-173.PDF>, showing the sensitivity of investment to tax treatment.

• ***The End of Tax Expenditures As We Know Them?***[5] <ftp://ftp.iret.org/pub/BLTN-84.PDF>, which warns that what is an anomaly under the income tax, and may have been branded a tax expenditure, may be the highly desirable norm under a consumed-income or consumption tax (example, all pension and retirement plans).

• ***Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays the Tax?***[6] <ftp://ftp.iret.org/pub/BLTN-88.PDF> which demonstrates that all taxes are paid by individuals, that taxes on corporations and capital income in general are largely shifted to labor by depressing saving, investment, productivity, and wages, and that graduated tax rates on the upper income result in lower incomes across the board.

• ***Phase-outs Increase Tax Rates and Tax Complexity***[7] <ftp://ftp.iret.org/pub/BLTN-71.PDF> which calculates the adverse impact on marginal tax rates of many tax provisions that means test deductions, credits, and exclusions.

• ***Taxes and the Good Society***[8] <ftp://ftp.iret.org/pub/TaxesGoodSoc.PDF>, which is a discussion by the late Dr. Norman B. Ture, one of the country's leading tax experts, on the basic concepts of tax fairness, neutrality, and the purpose of taxation in a democratic society.

What is the current system?

The current federal income tax system is a hybrid. It begins as a broad-based income tax, which is a type of tax that falls more heavily on income used for saving and investment than on income used for consumption, chiefly by subjecting saving and investment to multiple layers of tax. However, the current system contains provisions that treat a portion of saving and investment as they would be treated under a saving-consumption neutral system (or consumption-based system), in order to moderate the damage that would otherwise be done.

The current system taxes the world-wide income of U.S. residents (a global system), requiring offsetting credits for foreign taxes paid to avoid double taxation. The simpler alternative would focus on activity within the United States (a territorial system). These fumblings and compromises have added greatly to the complexity of the tax system. A clean and simple neutral territorial tax system would achieve these objectives much more easily.

Why tax reform? Income, growth, and jobs.

The current tax system distorts economic activity and reduces income and employment. It does so to the degree that it is closer to a broad-based income tax than to a neutral or consumed-income tax. It hides much of the cost of government from the taxpayer-voters. It is complex, making it expensive and confusing to comply with, and hard to enforce. It is subject to abuse by taxpayers and the IRS. It breeds suspicion, because people do not see clearly who is paying the tax, and is widely viewed as unfair, although definitions of fairness vary.

We could end most of these distortions, complications, and suspicions by moving to a saving-consumption neutral tax. Such a move would improve the economy, raise incomes, and promote employment. The shift would have the added benefits of simplifying compliance and enforcement, enhancing transparency and confidence in the system, and reassuring people as to the fairness of the tax system.

Any of the several types of neutral tax system would be more conducive to capital formation than current law. They would all allow the economy to operate more efficiently and to gain, over about a decade, the investment that the current biased tax system has suppressed. I estimate that they would add about 10 percent to the GDP, or about $4,000 to $6,000 to average family income. The various neutral taxes take different approaches to eliminating the biases in current law, and provide differing degrees of simplification and transparency. They may differ in transition issues. But all would raise incomes and employment.

Other things equal, each time in the past that the United State has moved its tax system away from the income base toward the consumption base, it has seen, as of the dates when the changes became effective, improved levels of saving and investment, productivity, and wages. Each time that tax policy has shifted back toward the income base, with higher taxes on capital and steeper tax rates on those who produce the most, economic performance has deteriorated. The Tax Acts of 2001, 2002, and 2003, which reduced marginal tax rates and reduced the double taxation of corporate income, moved the United States toward a consumption base, and have greatly strengthened the recovery from the last recession. The Tax Reform Act of 1986 was a shift toward the income tax. It raised taxes on capital and was followed by a major stock market and real estate collapse. That "reform", plus two subsequent payroll tax increases, paved the way for the subsequent recession.[9] The same phenomena have been observed internationally. Japan mimicked the 1986 U.S. reform in 1988, curtailing tax-neutral saving plans, instituting a capital gains tax, and raising property taxes soon after. As a result, Japan has been in a virtually non-stop recession for over 15 years. By contrast, lower corporate tax rates in Ireland and Eastern Europe, and flatter individual tax rates in Eastern Europe and Russia, have greatly improved economic performance.

Correcting flaws and avoiding errors.

Understanding the advantages of a neutral tax may require people to learn some new terminology, and to rethink some ideas about taxes that have been taken for granted over the past 80 years. We are used to thinking in terms of the current tax system. Its definitions of income and its structure of taxes seem normal, even though they are often at odds with reality, logic, and sound economics.

The Commission would perform a real public service by using its position to improve the public's understanding of the nature of income, what constitutes a sound tax system in a democratic society, and the advantages of making significant changes.

The Commission should start by taking stock of the purposes and attributes of a good tax system, to give itself a standard against which to judge the many proposals it will consider.

The Commission should consider how a revised tax system could promote good government by making the tax system more transparent to the voters and less susceptible to manipulation by special interests, either commercial or political.

The Commission must make an explicit choice early on about what it considers to be the right type of tax base. Until the appropriate concept of a tax base is selected, no decision about specific deductions, credits, exclusions, inclusions, or points of collection can be made in any sensible, consistent manner. A deduction or exclusion that may be natural under one tax base may be incorrect or distorting under another. If someone tells you that something is a "tax expenditure", ask him, "In which tax system?"[10]

The Commission should make sure that the steps it recommends would improve the functioning of the economy and raise the level of employment, output, and income. Otherwise, there is not much point.

In particular, the Commission must be aware of whether or not the reforms that it is considering would move in the direction of a more neutral tax base and lower the "hurdle rate" or cost of capital compared to current law. A neutral tax with a lower cost of capital would increase capital formation, productivity, and per capita output and income. If it does not take this precaution, it may stumble into recommendations that would reduce growth and job creation.[11]

The Commission must consider how the tax is to be collected and administered. There are trade-offs between a tax that is highly visible and transparent to the voters, and one that is simpler to comply with but less informative of the cost of government.

The Commission should also review the basic concepts of fairness and efficiency in taxation, to ensure that they reflect the nature of production and income. The Commission should think though these fundamental issues before making decisions on the details and minutia of the new tax code.

Toward that end, I offer the following framework to guide the development of alternatives to the current tax system.[12]

Framework for thinking about tax reform.

What are the two main purposes of a sound tax system?

1. Raising revenue to pay for government goods, services and activities; and

2. "Pricing" government to let people know how much they are being charged for government goods and services so that, as taxpayers and voters, they may decide in an informed manner how much government activity they wish to support with their votes.

The current federal tax code fails to accomplish these purposes in an effective and efficient manner.

What Is Income? Income is earned. Income is the reward for supplying labor and capital services to the market to create goods and services of value to others. Except in rare instances, income closely matches the value of the effort and services provided by individuals to produce additional output. Supplying labor and capital means giving up leisure and deferring consumption. These sacrifices are the cost of earning income. These attributes of income have important implications for the concept of fairness and the design of the tax system.

Income is a net concept: revenues less the cost of generating those revenues. Just as a business cannot reasonably be said to have a profit until its revenues exceed its costs of production, neither can a worker or saver be said to have income until his revenues exceed the amounts spent on acquiring the skills (through education) or purchasing the assets (through saving and investing) that generate the revenues. To obtain a realistic measure of a person's income, the full value of all costs of earning revenues (including education expenses, saving, and investment outlays) should be subtracted from revenues. All returns from such efforts that exceed these costs (including withdrawals of deferred principal and its earnings) should be added to revenues.

Who Pays Taxes, and With What? In reality, only people pay taxes, and all taxes are paid out of income. Goods and services do not pay taxes; businesses do not pay taxes. Taxes collected by businesses fall in reality on the income of the businesses' shareholders or other owners, lenders, workers, or customers in the form of lower returns, lower wages and/or higher prices. This insight has implications for the design of the tax system, and who is responsible for collecting and sending taxes to the Government.

Four key criteria for tax reform.

Tax reform should be approached with four criteria in mind: neutrality, visibility, fairness, and simplicity. Fortunately, to a great extent, simplicity, neutrality, and fairness (properly defined) can all be achieved at once by means of saving-consumption neutral tax systems.

Neutrality. Neutrality is essential if the economy is to operate at peak efficiency, and if incomes are to be as high as possible. Strict neutrality requires that income be calculated correctly and then taxed at a uniform rate.

The tax system should be even-handed or neutral across various types of saving and investment, and between saving and investment and consumption. That can be achieved by treating saving and investment as costs of earning income. All saving must receive the sort of tax treatment currently afforded pensions, various types of IRAs, 401(k), Keough, SEPs, and other saving-deferred plans currently in the tax code. Investment outlays, research and development expenses, and purchases of inventories must be deducted in the year the outlay is made (expensed), rather than depreciated over time. Failure to do so, as in the income tax, raises the cost of saving more than it raises the cost of consumption.[13]

Neutrality also means that multiple layers of tax on capital must be avoided. In particular, the dual taxation of Schedule C corporate income at the corporate and individual level must be eliminated. The transfer tax on estates and gifts must also be removed, because an estate is saving that has already been taxed or will be subjected to the heirs' income tax.

Visibility. Visibility means a tax system is transparent to the taxpayers so it is clear how much government costs and who is paying for it. Visibility is necessary for voters to determine when the benefits of government spending are sufficient to match its costs. Visibility is a key element in holding government accountable to voter-taxpayers.

Visibility is best achieved by a tax levied as openly as possible with some form of annual accounting that confronts individuals with the full amount of taxes they have paid over the course of the year. Visibility suggests that revenues not be collected from taxes buried in businesses transactions.

Visibility also requires that as many people as possible be subject to tax, excepting only the very poor, so that they can see that government is not a free good. It should not be possible for a majority of voters to shift a disproportionate share of the tax burden onto a minority of taxpayers.

Visibility can reassure people about the fairness of the tax system. If everyone were filling out the same simple tax forms, and people could understand what was on them, then people would be far more certain that they and their neighbors were paying their fair share of taxes. The mystery and the suspicion would be gone.

Fairness. Fairness means equal treatment under the law, and respect for the people who produce goods and services. Income is the earned reward for contributing to the production of goods and services. This fact, combined with the principle of equal treatment under the law, strongly urges that a proportional (single-rate) tax on income is the fairest.

Compassion requires that the very poor be relieved of the burden of paying for the protections afforded by government and for the public goods and services provided by government that they and their families consume. But insofar as possible, it is fair that everyone should contribute something toward these communal efforts.

Allowing all individuals, regardless of income, an equal personal exemption is consistent with this concept of fairness. It would provide that persons of higher income pay a higher fraction of their income in tax than persons of lower income, but not in a greatly disproportionate manner.

Simplicity. The complexity of the current tax system imposes enormous compliance costs on taxpayers and enforcement costs on the government. Most of the complexity in the current tax code stems from its arbitrary definition of taxable income,

its effort to impose non-neutral taxation of income from capital, and its taxation of income from foreign sources offset by a tax credit for foreign taxes paid.

There is no conflict between simplicity and neutrality. Neutral tax systems that are not biased against saving and investment are inherently simpler and fairer than non-neutral ones. Systems that restrict taxation to income earned domestically are likewise simpler than systems that tax global income with a credit against foreign taxes paid. For simplicity, the tax system should be territorial, levied on income earned within the country.

However, the very simplest tax systems, those that would have businesses collect all taxes without income earners or consumers seeing what is taken or having to do any work would be a violation of visibility.

Simplicity should not be an excuse to remove large numbers of people from the tax rolls or to eliminate periodic tax filing. Some small amount of effort by the citizens in paying tax is a fundamental requirement of a tax system that informs the citizen-voters about what government is doing, enabling them to fulfill their civic responsibility in a democratic society.

The current tax code fails all four tests.

The current tax code violates neutrality by taxing some income at higher rates than other income, in particular by falling more heavily on income used for saving and investment than on income used for consumption. It hides significant revenues from the voters in business taxes, and it exempts tens of millions of people from the income tax rolls. It masks the cost of government. It encourages people to attempt to shift the cost of government goods and services to others. It is enormously complicated. It punishes real economic effort and treats many taxpayers very badly.

Let me take a moment to make clear what the income tax biases against saving and investment consist of. At the federal level, there is usually one layer of tax on income that is used for consumption, but there are at least four layers of possible tax on income that is saved (Chart 1).

1) Income is taxed when first earned (the initial layer of tax). If one uses the after-tax income to buy food, clothing, or a television, one can generally eat, stay warm, and enjoy the entertainment with no additional federal tax (except for a few federal excise taxes).

2) But if one buys a bond or stock or invest in a small business with that after-tax income there is another layer of personal income tax on the stream of interest, dividends, profits or capital gains received on the saving (which is a tax on the "enjoyment" that one "buys" when one saves). The added layer of tax on these purchased income streams is the ***basic income tax bias against saving***.

Chart 1 Multiple Taxation of Saving
One Tax on Consumption, Four Taxes on Saving

Layer 1– Tax on Earnings

Income is taxed when earned. If it is used for consumption, there is usually no further federal tax.

Layer 2 – Personal Income Tax on Returns

If the income is saved, the returns are taxed as interest, dividends, capital gains, or non-corporate business profits.

Layer 3 – Corporate Income Tax

If the saving is in corporate stock, the corporate tax hits the income before it is either paid out to shareholders or reinvested to boost future earnings.

Layer 4 – Transfer (Estate and Gift) Tax

Another tax on already taxed assets.

(Similar taxes at the state and local levels increase the multiple taxation.)

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Chart 2 Multiple Taxation of Corporate Income

	(a) Retained Earnings, Pre 2003 Act	(b) Dividend Payout, Pre 2001 Act	(c) Retained Earnings and Dividends, 2003 Act
1) Corporate Income	$1.00	$1.00	$1.00
2) Corporate tax at top rate	$0.35	$0.35	$0.35
3) After-tax corporate income: Either retained, raising stock price (columns (a), (c)), or paid as dividend (col. (b), (c))	$0.65	$0.65	$0.65
4) Individual income tax at top rate (dividends as ordinary income, retained earnings as capital gain)*	$0.13 (tax rate 20%)	$0.2574 (tax rate 39.6%)	$0.0975 (tax rate 15%)
5) Total tax	$0.48	$0.6074	$0.4475
6) Total tax rate	48%	60.74%	44.75%
7) Income left to shareholder	$0.52	$0.3926	$0.5525

** Top corporate rate excludes corporate surtaxes, and top individual rate ignores phase-outs of exemptions and deductions and taxation of Social Security, which may push effective top tax rates higher than statutory rates. Retained earnings are assumed to trigger a long-term capital gain with a maximum rate of 20% or 15%. Short-term gains are taxed at ordinary tax rates.*

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3) If the saving is in corporate stock, there is also the corporate tax to be paid before any distribution to the shareholder, or any reinvestment of retained after-tax earnings to increase the value of the business. Whether the after-tax corporate income is paid as a dividend, or reinvested to raise the value of the business and create a capital gain, corporate income is taxed twice — ***the double taxation of corporate income***.

4) If a modest amount is left at death (beyond an exempt amount that is barely enough to keep a couple in an assisted living facility for a decade), it is taxed again by ***the estate and gift tax (the "death tax")***.

State taxes compound these biases.

The anti-saving and anti-investment biases in the income tax retard growth. The maximum combined federal corporate and individual income tax rates on dividends could exceed 60 percent before the 2003 tax reductions, and they are still are nearly 45 percent today (Chart 2). That is before state and local taxes, and is on top of the tax on the income that was used for the saving. Estate taxes and the generation skipping tax can still raise the total tax burden on income going into a taxable estate to between 80 and 85 percent. The tax disincentives to save and invest, and to work, train, and take risks, lead people to under-save and over-consume, and to work less and play more.

It has long been assumed that high graduated tax rates and added layers of tax on income used for capital formation would do little economic damage, would harm only the wealthy, and would provide significant income redistribution. In fact, income redistribution was the main justification for the "Haig-Simons" definition of income that inspired the concept of taxable income in the current income tax. Professor Simons, at least, admitted that the tax was not economically optimal, and that it would damage saving and reduce output. His disciples seem to have forgotten that consequence, and are living in a state of denial.[14]

It has become apparent, however, that most of the taxes that seem to fall on those who supply physical capital, intellectual capital, or special talents to the production process may actually be shifted to ordinary workers and lower income retirees in the form of reduced pre-tax and after-tax incomes. Even for labor, the optimal (additional) tax on the normal returns to capital is zero.[15]

Capital is far more sensitive to taxation than is labor (Charts 3 and 4). Savers can easily switch to consumption, a satisfying alternative, or send capital abroad. Many workers, by contrast, have to work to make ends meet, or work hours that are set by their employers. (The self-employed or the upper income, who can afford to retire or take time off, have somewhat more flexibility as to hours worked.) Therefore, a given tax rate imposed on labor and capital has a far greater impact on the quantity of capital than the quantity of labor offered to the market. The relatively large reduction in the in the stock of capital depresses productivity and demand for labor, which lowers wages and employment. The work force bears the economic burden of taxes on capital (Chart 5).

Chart 3 Effect of Tax On Desired Capital Stock

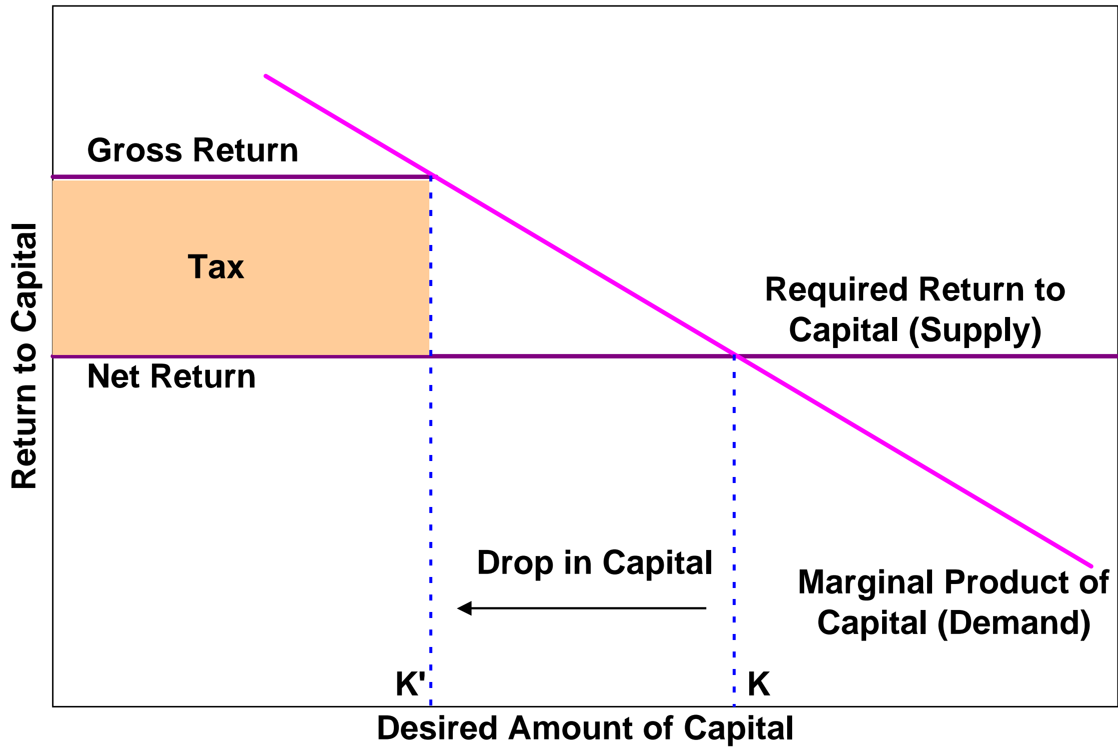


Chart 4 Effect of Tax On Labor

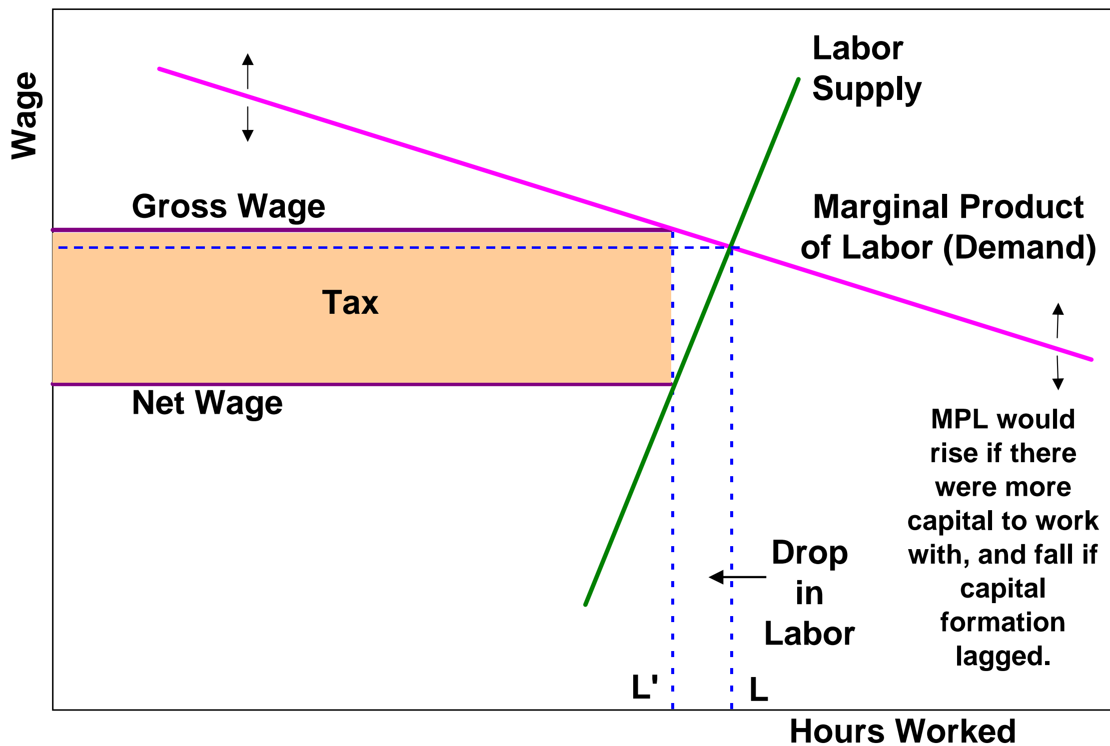
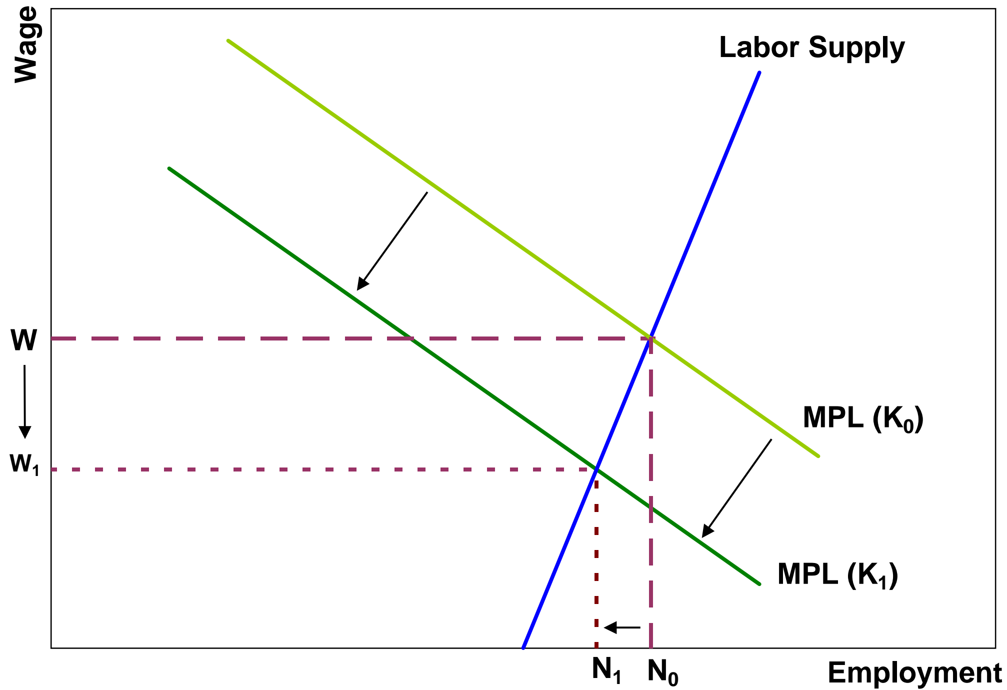


Chart 5   A Smaller Stock Of Capital Reduces Wages



Consider a small trucking company with five vehicles. Suppose that the rules for depreciating trucks for tax purposes change, with the government demanding that the trucks be written off over five years instead of three. The owner has had enough business to run four trucks flat out, and a fifth part time. He is barely breaking even on the fifth truck under old law. It is now time to replace one of the trucks. Under the new tax regime, it does not quite pay to maintain the fifth truck. The owner decides not to replace it, and his income is only slightly affected. But what happens to the wages of the fifth truck driver? If he is laid off, who bears the burden of the tax increase on the capital?

Consider another example, involving human capital, specifically, medical training. Suppose the imposition of a progressive income tax were to discourage the supply of physicians by inducing some doctors to retire, by causing others to work fewer weeks per year, and by dissuading people from applying to medical school. One result would be fewer jobs available and lower levels of productivity and incomes for nurses and support staff in medical offices and hospitals. Another would be a rise in the price of health care for consumers (including the government).

Neutral taxes can be best at satisfying the four key criteria for a good tax system.

Neutrality and Growth. Neutral taxes are, by their nature, more favorable toward growth than income taxes. Neutral taxes eliminate the income tax biases against saving and investment, and have flatter tax rates to avoid punishing people who work, save, and produce more output and income. Eliminating the estate and gift tax removes one layer

of tax bias. Another layer is removed by taxing corporate income either at the corporate level or at the shareholder level, but not both.[16] For full neutrality, the basic income tax bias against saving and investment must be corrected by granting all saving the same treatment as is given to pensions or IRAs, either by deferring tax on saving until the money is withdrawn for consumption (as in a regular IRA), or by taxing income before it is saved and not taxing the subsequent returns (as in a Roth IRA). The two methods are equivalent if the tax rate is the same over time (Chart 6). Either method is a boon to savers. Putting away $1,000 a year from age 20 to 70 at historical stock market yields is a saving deferred account yields $400,000, but less than $250,000 under ordinary income tax treatment (Chart 7).

President Bush's 2001 and 2003 tax reforms have gone a long way toward achieving the goal of tax neutrality. They provide for elimination of the estate and gift tax in 2010. They reduce the double taxation of corporate income by taxing dividends and capital gains at a reduced rate of 15 percent. However, the death tax returns in 2011, and the tax relief for dividends an capital gains expires at the end of 2008. At the very least, these steps should be made permanent.

The President's proposed expansion of the neutral treatment of saving in his lifetime saving accounts and pension reforms is a step in the right direction. The analogous treatment of investment is to allow immediate expensing of investment instead of lengthy depreciation. Depreciation understates business costs, overstates income, and overtaxes investment. Chart 8 shows, for example, that the value of the depreciation allowance on a seven year asset at three percent inflation is only 85 cents. The allowed tax cost of a building that must be written of over 39 years is only 37 cents. The erosion of the value of the allowed claims for cost by time and inflation greatly understates business costs, and the damage is worse the higher the rate of inflation. Assets have to be able to earn more to cover the added tax. Those that cannot never get built. Workers never get to work with these assets, and their wages suffer.[17] It was a mistake to allow the 50 percent expensing provision in the 2003 Tax Act to expire at the end of 2004. The next chart shows the effect of the 30 percent and 50 percent expensing provisions in the 2002 and 2003 tax cuts. They were the major reason why equipment spending and economic output bottomed out and then took off in 2003 and 2004 (Chart 9).[18]

There are several types of neutral tax systems. They include a cash flow or saving deferred income tax[19], a national retail sales tax, a value added tax (VAT)[20], a returns exempt Flat Tax[21], or some combination. They all either defer taxes on saving or exempt the returns to arrive at a saving-consumption neutral tax base. They all eliminate multiple taxation of corporate and individual income and of estates.

An individual cash-flow tax is collected from individuals based on their earnings less their saving, which equals their spending on consumption goods and services. The Flat Tax uses the Roth IRA method to achieve the same end result. A retail sales tax is collected by retailers based on the consumption spending of individuals, which is that part of their earnings not devoted to saving. Value added taxes are collected in increments throughout the production process by businesses based on sales less investment expenses;

Chart 6 Equivalence Of Saving Deferred And Returns Exempt Tax On Saving; Contrast With Ordinary Income Tax

Tax Treatment	Saving Deferred	Returns Exempt	Ordinary Income Tax
Pretax earnings to be saved	$100	$100	$100
Tax on saving	0	20	20
Amount saved	100	80	80
Is interest on inside build-up taxed?	No, 7.2% reinvested	No, 7.2% reinvested	Yes, 5.76% reinvested
Account after 10 years	200	160	140
Tax due on withdrawal	40	0	0
After-tax spendable balance	160	160	140
Cost to saver of ordinary tax treatment			20 (= 160 – 140) (a third of the interest)

Illustration assumes 7.2% pre-tax interest rate, 20% tax rate, and 10-year investment.

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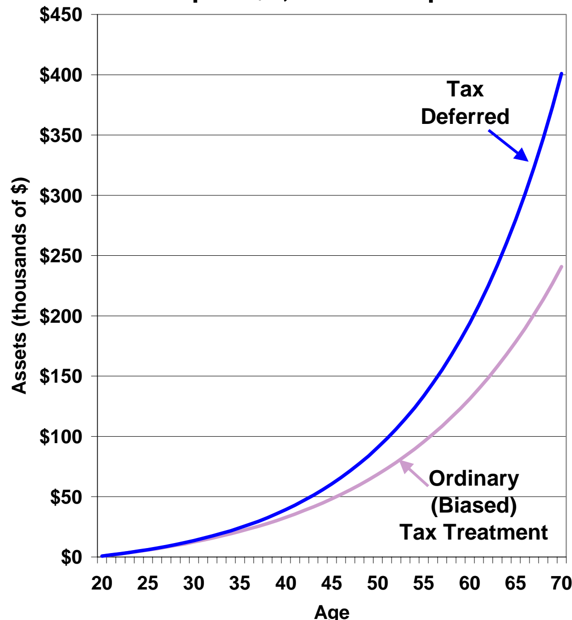
Chart 7 Advantage Of Tax Deferred Saving Over Ordinary (Biased) Tax Treatment; Build-up Of $1,000 Saved per Year



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Saving from age 20 onward, under tax-deferred system and ordinary "double taxation" (assume 7.2% interest rate, 20% tax rate).

Chart 8 Present Value of Current Law Capital Consumption Allowances per Dollar of Investment Compared to Expensing (First-Year Write-Off)

Asset lives:		3 Yrs	5 yrs	7 yrs	10 yrs	15 yrs	20 yrs	27.5 yrs	39 yrs
Present value of first-year write-off of $1 of investment:		$1.00	$1.00	$1.00	$1.00	$1.00	$1.00	$1.00	$1.00
Present value of current law write-off of $1 if inflation rate is:	0%	$0.96	$0.94	$0.91	$0.88	$0.80	$0.74	$0.65	$0.55
	3%	$0.94	$0.89	$0.85	$0.79	$0.67	$0.59	$0.47	$0.37
	5%	$0.92	$0.86	$0.81	$0.74	$0.60	$0.52	$0.39	$0.30

Assumes a 3.5 percent real discount rate, 3-20 year assets placed in service in first quarter of the year, 27.5 - 39 year assets placed in service in January.

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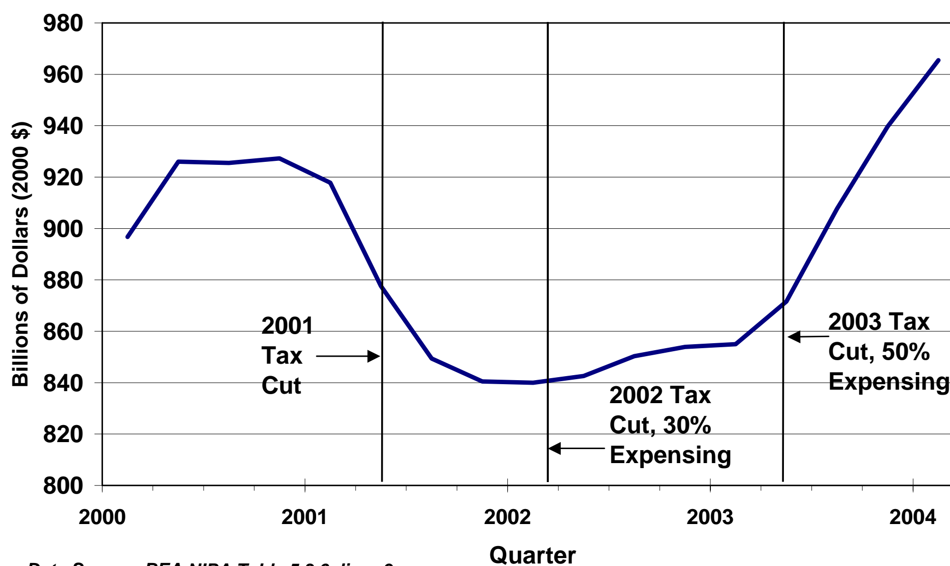
Chart 9
Real Private Investment - Equipment And Software And 2001, 2002, and 2003 Tax Cuts



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sales less investment equals national income less saving, which again equals the amount spent on consumption of final goods and services. (The Flat Tax may also be thought of as taxing capital income at the business level with expensing, like the VAT.) In other words, these taxes all have the same fundamental tax base.

Some writers make artificial distinctions among saving-consumption neutral taxes, referring to them as consumption taxes if they are of the sales tax or VAT variety, and as saving-deferred or saving-exempt income taxes if they are of the cash flow type or Flat Tax, as if to imply that they generate different incentives to save or consume. In fact, the point of collection of the taxes does not change their common nature; they are all saving-consumption neutral taxes on people's incomes (properly defined).

Each of the types of neutral taxes has the potential to accommodate a single low tax rate on income, and to eliminate the alternative minimum tax and the estate tax. The systems all have expensing instead of depreciation (or equivalent non-taxation of investment outlays), and no separate taxation of capital gains. Each is territorial, and can substantially reduce the confusing treatment of foreign source income that cripples American businesses operating abroad.[22] Many of the major sources of complexity in the current tax code would be gone.

Under all of the neutral tax systems, the costs of buying and operating equipment, factories, commercial buildings, and residential real estate, would all be lower. With a lower tax hurdle, several trillion dollars of capital investment that is just not sustainable under current tax law would become possible. Investment would boom for a decade or more, productivity would rise at a rapid clip, and wages would match the gains.

If the GDP were to be ten percent higher under the new tax regime, it would raise incomes for middle income families by about $4,000 to $6,000 a year. Everyone would gain. Labor would gain most of all. Capital formation boosts productivity and wages. Every dollar of additional GDP made possible by additional capital formation yields about 50 cents in higher after-tax wages, about 30 cents in higher federal, state, or local tax revenue, requires about 15 cents to replace the capital as it wears out, and returns about a nickel to the savers and investors.

The United States would be a magnet for capital intensive industries furnishing higher paying jobs. Starting a new business would be far easier, because one could concentrate on running the business instead of figuring out tax forms. One could put one's money to work expanding a business instead of paying insurance premiums to keep the business in the family in the event of one's death.

Neutral taxes and visibility. Visibility means that the voting public is well aware of how much the government is costing them. Among the various neutral taxes, those collected from individuals are more visible, and those collected by businesses are less visible. Some neutral tax plans have recommended very large exempt amounts. Visibility requires that, excepting the very poor, as many people as possible pay tax so that, as voters and consumers of government services, they will be aware of what government

costs, and realize that government is not a free good. Neither simplicity nor fairness should be used as an excuse for exempting tens of millions of people from tax.

Neutral taxes and simplicity. Neutral taxes are inherently simpler than income taxes. Picture the current stacks and stacks of tax forms that a parent, a small business owner, a saver, a retiree, or a low income worker receiving the EITC must fill out. Think of the worksheets that govern the taxation of Social Security benefits and the phase-outs of deductions, exemptions, and credits. Think of Schedule D, and of having to list dozens or hundreds of stock trades. Think of the dozens of depreciation schedules and the complexity of recapture on Schedule C.

Think about the rules relating to how much you can put into what kind of pension plan or IRA or education account, when and how much you have to start withdrawing, and what happens to you if you miscalculate. Try to figure out the foreign tax credit form without computer assistance. Picture doing it all over again if you run afoul of the alternative minimum tax (either the individual AMT, or, if you are a corporate tax officer, the corporate AMT, which taxes corporations more heavily when they are suffering reduced earnings in a recession, or trying to grow rapidly and increase employment). Try to plan sensibly for the estate and gift taxes without a tax attorney on your payroll and an insurance broker on call.

Now picture throwing that all into the waste basket. Under neutral taxes, even those that are collected from individuals, the filing would be a relative snap. There would be no vast array of credits and exemptions phased in or phased out. There would be no list of stock trades, no Schedule D, no separate calculation or peculiar taxation of capital gains. There would not be dozens of different pension arrangements; all saving would either be tax deferred without rules and limits, or would have been done after-tax with no taxation of the subsequent earnings.

There would be no depreciation schedules and no keeping track of different rules for different machines and buildings over many years; investment in machinery, buildings, land, resources and research would be deducted dollar for dollar in the year it was made. There would be no foreign income and foreign tax credit offset to compute, and less need for the IRS to rely on information from foreign banks or businesses to enforce U.S. tax law. Tax treaties would relate only to the accurate allocation of costs between parts of a multinational business.

Picture a tax system in which the individual tax forms fit on two sides of a sheet of paper, nearly all the numbers were provided by one's employer, bank, broker, or credit card company, and it only took a day to do.[23] Alternatively, picture a Fortune 500 business sending in a tax form that weighed one pound instead of one hundred. Picture fifty thousand tax accountants and IRS agents lining up to teach math in grade schools across the country.

Neutral taxes and fairness. It is clear that neutral taxes are fairer than income taxes, if one understands the nature of income. Income is the payments that people

receive for contributing to the production of goods and services by working or making capital available. Except in rare cases, people are paid in proportion to how much they add to the value of output. If income is proportional to effort and one's contribution to the economy, then a flat rate proportional tax, with no tripling up of taxes on saving and investment, is arguably the fairest tax.

Kindness and charity urge that the poorest citizens be relieved of the requirement to share in the cost of government. Neutral taxes can be made progressive via rebates (if the tax is levied on businesses) or by a personal exempt amount or even multiple tax rates (if levied on individuals), but that should not be carried to excess. Income support programs are best handled outside the tax system as explicit payments by federal and state agencies other than the Treasury.

Nonetheless, neutral or "consumption-based" taxes can be made progressive to the degree that is deemed desirable. It is not necessary to double or triple tax saving and investment to have a progressive tax. That was the main rationale for the income tax in the 1930s, but we know better today. We can have a fair and charitable neutral tax and still enjoy the added growth of jobs and income that the correct treatment of saving and investment creates.

Neutral taxes encourage investment in education, and encourage highly skilled people to keep working and to keep employing others. Spending a hundred thousand dollars on schooling, and losing four to eight years of paychecks, is a major sacrifice. The reward is a higher level of skill and income, compressed into a shorter working life. Graduated tax rates and the lack of a deduction for investment in education penalize such people. A flat or flatter rate neutral tax system would end that discrimination.

Bear in mind that growth generates a higher level of income across the board, and is a good thing for everyone. It is hardly fair if a misguided effort to redistribute the pie causes the pie to shrink, and it is worse than a crime, it is a blunder if such efforts hurt the poor the most.

Budget and distributional concerns.

Count the gains from growth in determining the budget impact of tax reform. The potential for faster growth of jobs and incomes should allay concerns that tax reform might force a choice between higher short-term budget deficits and tax increases for some taxpayers.

As saving and investment increase, productivity and the taxpayer's income will grow faster for a decade or more and be higher by increasing amounts over time. When we look at how tax reform affects a family or individual worker or taxpayer, it is not enough to apply the new tax code to last year's income because neither the economy nor the taxpayer will behave the same way after tax reform as before.

The taxpayer will enjoy lower interest rates on mortgages and student loans as the tax burden on saving is reduced. Although reduced taxes on saving may not instantly lower the tax of a twenty-year-old who has not yet begun to save, it will lower taxes on that worker as he or she accumulates assets over a working lifetime, and leave that worker many tens of thousands or even hundreds of thousands of dollars better off by age 65, and far more secure in retirement. Whatever happens the first year, people will enjoy a lifetime of benefits from a pro-grow tax reform, and it is the lifetime benefits that matter.

As for the federal budget, there are many benefits, short term and long term. People would immediately have less incentive to shelter their existing income from tax, and the Treasury would see some revenue offset to any net tax reduction even before any rise in economic activity and income. In addition, of course, national income would grow faster, right from the start. An extra point on the growth rate would add a cumulative extra half trillion dollars to federal revenues over seven years.

There would also be gains on the spending side of the budget. More people working, and working at higher paying jobs, would men a natural reduction in claims for income support payments. In light of the great benefits of reform to the economy, the population, and the budget, it would be wise to forge ahead, regardless of the transitory budget consequences. If the transitory costs to the Treasury are of real concern to lawmakers, they can best be addressed by restraining the growth of federal spending to accommodate the tax reform.

Conclusion

Tax reform is not about shifting the tax burden to someone else, eliminating individual tax filing or making it painless, eliminating millions from the tax rolls, eliminating all deductions, eliminating the IRS, or eliminating competition from foreign companies or countries.

Tax reform is not just an indiscriminate "broadening the base and lowering the rate."[24] It is about getting the tax base right and setting rates that cover the amount of government that people want to have.

Tax reform is about raising revenue in a manner that does less damage to the economy than current law, and that better informs the public what it is paying for government so that voters can make informed decisions about how much government activity they wish to support. Get tax reform right, and we will have a better economy and a better government.

Endnotes

1. Stephen J. Entin and Norman B. Ture, "The Inflow Outflow Tax: A Savings Deferred Neutral Tax System," 1998, <ftp://ftp.iret.org/pub/InflowOutflowSum.PDF>.

2. Stephen J. Entin, "The Economics of Taxation and The Issue of Tax Reform," IRET Paper, April 24-27, 2003, <ftp://ftp.iret.org/pub/EntinNewOrl-2003.PDF>.

3. Stephen J. Entin and Lawrence A. Hunter, "Reforming Taxation: Attributes Of A Good Tax System And Principles To Guide Reform," *IRET Congressional Advisory*, No. 183, January 19, 2005, <ftp://ftp.iret.org/pub/ADVS-183.PDF>.

4. Stephen J. Entin, "Renew Bonus Expensing To Keep Recovery Strong," *IRET Congressional Advisory*, No. 173, May 6, 2004, <ftp://ftp.iret.org/pub/ADVS-173.PDF>.

5. Bruce Bartlett, "The End of Tax Expenditures As We Know Them?" *IRET Policy Bulletin*, No. 84, June 13, 2001, <ftp://ftp.iret.org/pub/BLTN-84.PDF>.

6. Stephen J. Entin, "Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax? " *IRET Policy Bulletin*, No 88, September 10, 2004, <ftp://ftp.iret.org/pub/BLTN-88.PDF>.

7. Michael Schuyler, "Phase-Outs Are Bad Tax Policy," *IRET Policy Bulletin*, No. 71, January 16, 1998, <ftp://ftp.iret.org/pub/BLTN-71.PDF>.

8. Norman B. Ture, "Taxes and the Good Society," Lecture by Norman B. Ture, Delivered at Center for Economic and Policy Education, Saint Vincent College, September 13, 1995, <ftp://ftp.iret.org/pub/TaxesGoodSoc.PDF>.

9. See note 11.

10. Bruce Bartlett, *The End of Tax Expenditures As We Know Them?, op. cit.*

11. Such issues were not considered in 1986, and the results were not good. The Tax Reform Act of 1986 was often described as "broadening the base and lowering the rates." Although this is sometimes offered as a definition of a sound tax reform, it misses many basic points. In fact, the 1986 Act was a major disappointment. It lowered personal tax rates at the margin, which was a good step toward economic efficiency. However, it sharply raised tax rates, at the margin, on new saving and investment, which increased the income tax bias against those activities. It did so, in the guise of base broadening, by removing provisions that mitigated the multiple layers of tax imposed on income from saving and investment. The Act eliminated the investment tax credit, lengthened asset lives for cost recovery purposes, ended the capital gains differential, imposed or tightened income and contribution limits on tax deferred retirement savings plans, and introduced passive loss rules on real estate that depressed returns in that sector for investors who were not active managers of their properties. The minor efficiency gains that came from canceling a few peculiar tax breaks for certain other activities in no way made up for these across-the-board increases in the taxation of capital.

In effect, the Tax Reform Act of 1986 moved the hybrid tax system in the direction of a purer broad-based income tax. The Act paved the way for the stock market crash of October 1987, and led to weakness in investment in plant, equipment, and real estate that, along with two payroll tax increases in 1988 and 1990, set the stage for the recession of 1991-92. The 1986 Act also removed several million

people from the income tax rolls, making them less concerned about the cost of government and less interested in controlling federal spending and tax rates in the future.

12. This framework owes much to the work of IRET's founder, the late Norman B. Ture. See his papers: "Taxes and the Good Society," *op. cit.*; "Restructuring The Federal Tax System" *IRET Policy Bulletin*, No. 65, December 15, 1995, <ftp://ftp.iret.org/pub/ BLTN-65.PDF>; and "Federal Tax Policy and the U.S. Economy: Policy Options for Improving Both," March 13, 1997, <ftp://ftp.iret.org/pub/FedTaxPol-Improv.PDF>. For an overview of a model tax system that Dr. Ture proposed based on these principles, see Stephen J. Entin and Norman B. Ture, "The Inflow Outflow Tax — A Saving-Deferred Neutral Tax System," *op. cit.*.

13. For more on the biases against saving in the current income tax, see Stephen J. Entin, "The Economics of Taxation and the Issue of Tax Reform," <ftp://ftp.iret.org/pub/EntinNewOrl-2003.PDF>; Stephen J. Entin, "Fixing The Saving Problem: How The Tax System Depresses Saving, And What To Do About It," *IRET Policy Bulletin*, No. 85, August 6, 2001, p. 15 ff, <ftp://ftp.iret.org/pub/BLTN-85.PDF>. Also see David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, 2nd ed., revised (Arlington, VA: Tax Analysts, 1985).

14. Any justification of the comprehensive or broad-based income tax and the additional corporate and death duties must rely on significant non-economic social benefits, because these taxes impose high economic costs, including reduced incomes across the board. The usual social benefit assumed for the income tax is that it may be used to reduce income inequality. However, redistribution lowers total income, especially labor income, and the process can hurt those it is designed to help. Early advocates of using the broad-based income tax for redistribution, such as Professor Henry C. Simons, acknowledged some of the costs.

Simons admitted that the income tax is not economically ideal. He reasoned that, since the rich save more than the poor, taxing saving more heavily than consumption would be "progressive". Simons also favored making the marginal tax rate structure graduated (higher tax rates imposed on incremental taxable income as it exceeds specified levels) to further increase the progressivity of the system. The pure Simons definition of income did not allow for a corporate tax in addition to the individual income tax, however, because that would have been an additional layer of double taxation.

Professor Simons was well aware that the twin distortions of the tax base and the rate structure inherent in the income tax could lead to a drop in saving, investment, and national income. In his magnum opus, *Personal Income Taxation*, (Chicago, IL: University of Chicago Press, 1938), Simons wrote:

> The case for drastic progression in taxation must be rested on the case against inequality — on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely...
>
> The degree of progression in a tax system may also affect production and the size of the national income available for distribution. In fact, it is reasonable to expect that every gain, through taxation, in better distribution will be accompanied by some loss in production...
>
> [I]f reduction in the degree of inequality is a good, then the optimum degree of progression must involve a distinctly adverse effect upon the size of the national income... (Simons, pp. 18-20.)

Simons took seriously the possibility that saving and investment would suffer from his policy prescription:

> With respect to capital accumulation, ...the consequences are certain to be significantly adverse... [I]t is hardly questionable that increasing progression is inimical to saving and accumulation... That the net effect will be increased consumption ... hardly admits of doubt." (Simons, pp. 21-23.)

Simons's remedy was not to do away with progressivity, but to offset its effect on saving by running federal budget surpluses. The assumption that the government virtuously would run large budget surpluses to make up for the anti-growth consequences of a biased and progressive tax system has proven to be utterly naive. Furthermore, a budget surplus cannot make up for the adverse effects that high corporate or individual tax rates and unfriendly capital cost recovery allowances have on the present value of after-tax cash flow from an investment, a calculation that any business school graduate will undertake in deciding on the feasibility of an investment project. Thus, even an offsetting budget surplus would not prevent a reduction in the equilibrium capital stock from a reduction in the marginal return on investment.

Professor Alfred Marshall, who bowed to the general acceptance of progressivity, nonetheless favored a more neutral graduated tax on consumption over a graduated tax on income: "[T]here is a general agreement that a system of taxation should be adjusted, in more or less steep graduation, to people's incomes: or better still to their expenditures. For that part of a man's income, which he saves, contributes again to the Exchequer until it is consumed by expenditure." (Alfred Marshall, *Principles of Economics*, Eighth Edition (1920), Philadelphia, PA, Porcupine Press, reprinted 1982, p. 661.)

As Marshall pointed out, one does not need to adopt a non-neutral income tax to achieve progressivity. Saving-consumption neutral taxes can be made progressive as well. In fact, it is not necessary to have graduated tax rates to achieve progressivity. A tax which exempts some amount of income at the bottom, and imposes a flat marginal tax rate on income above that amount, is progressive, because the average tax rate will rise with income. A graduated consumption-based tax is not as economically efficient as a flat rate consumption-based tax, because it increases the tax penalty at the margin the more productive an individual becomes and the more effort he or she makes. Nonetheless, it is far more efficient than a graduated income tax.

15. Several studies in the economic literature illustrate that neutral treatment of capital income would raise the after-tax income of labor, in present value terms, even if labor must pick up the tab for the lost tax revenue. That is, a tax on capital is effectively shifted to labor. For a further discussion of tax shifting and the literature on optimal taxation of capital, see Stephen J. Entin, *Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax?, op. cit.*

16. The Treasury issued a report on corporate individual tax integration in 1991, and there is a long literature on these mechanisms. Most other developed countries use one approach or another to mitigate double taxation of corporate income, and have lower corporate tax rates as well.

17. For a further discussion of the merits of expensing, see Entin, *The Economics of Taxation and the Issue of Tax Reform*, *op. cit.*, <ftp://ftp.iret.org/pub/ EntinNewOrl-2003.PDF>. Also David Bradford, *Blueprints for Basic Tax Reform*, *op. cit.*.

18. See Stephen J. Entin, "Renew Bonus Expensing To Keep Recovery Strong," *IRET Congressional Advisory*, No.173, May 6, 2004, <ftp://ftp.iret.org/pub/ADVS-173.PDF>.

19. A tax on income less net saving, in which all saving is tax deferred in the manner that current law allows for limited amounts of saving in an ordinary IRA, 401(k), or pension. This type of tax is also called an inflow-outflow tax, a consumed income tax, an individual cash flow tax, or an expenditure tax.

For a full description, see *The Inflow-Outflow Tax*, *op. cit.*, <ftp://ftp.iret.org/pub/InflowOutflowSum.PDF>.

20. Value added taxes include European style credit invoice method VATs, goods and services taxes or GSTs (as in Canada and Australia), subtraction method VATs, and business transfer taxes.

21. A returns exempt tax does not allow a deduction for or deferral of current saving, which must be done on an after-tax basis, but it does not subsequently tax the returns on that after-tax saving. It is the method used for Roth IRAs.

22. All the major saving-consumption neutral taxes would lead to international tax simplification because all are territorial. That is, they are imposed on economic activity within the United States, and not on economic activity conducted by U.S. residents elsewhere in the world. The present global income tax requires U.S. residents to report income from around the world, and then to file for a foreign tax credit to avoid double taxation. Moving to a territorial system, not only for businesses but for individuals as well, would provide great simplification for taxpayers and would reduce administrative and enforcement costs for the IRS with little revenue consequence. It would also greatly enhance the competitiveness of U.S.-based multinational firms that must compete with foreign firms whose home countries have territorial regimes and lower corporate tax rates than the United States. It would be expected to raise exports of intermediate goods and services of multinational businesses to their affiliates abroad, and lead to more demand for the research and management functions of the U.S. parents.

Sales taxes and VATs are generally imposed on imports and remitted or not levied on exports. This feature is called border adjustability. The border-adjustable form is natural because sales taxes (and the final layer of the VAT) are collected at the point of final sale to consumers. With border adjustment, any purchase, whether domestic or foreign in origin, triggers the same tax at the cash register. Consumed-income taxes and the Flat Tax are not explicitly border adjustable, because they are collected from individuals as they earn. However, these taxes fall on income before it is used for consumption, and so the tax falls on income used to buy a domestic good or an import. The tax is not levied on foreigners buying U.S. exports. These taxes may be thought of as implicitly border adjustable. Border adjustment and territoriality are different concepts.

23. A simple neutral individual cash flow tax might arguably be considered the optimal tax system. An example is the Inflow-Outflow Tax expounded by the late Norman B. Ture at the Institute for Research on the Economics of Taxation. It is levied only on individuals, and is therefore the most visible tax system. In it, people would defer tax on saving and investment (including tuition invested in human capital), and deduct any income they transfer to others (as gifts or as taxes). Thus, charitable gifts, payroll taxes, and taxes paid to state and local governments would be deductible (and recipients of transfers would report the receipts as taxable income if it exceeded exempt amounts).

Saving would be deducted from taxable income. Withdrawals from saving would be added to income. One's bank or broker would give one the required amount to enter on the tax form. There would be an exempt amount to protect the poor, and, ideally, a single (flat) marginal tax rate on all other income, which would minimize all other distortions of economic activity. Investment in inventories, equipment, and buildings for one's business would simply be expensed. The I-O tax would fall on virtually the same tax base as a national retail sales tax, but would be more visible to the taxpayer/voter, and would do a better job of "costing out" government. See *The Inflow-Outflow Tax*, *op. cit.*, <ftp://ftp.iret.org/pub/InflowOutflowSum.PDF>.

24. We do not want another Tax Reform Act of 1986. See note 11 and *Reforming Taxation: Attributes of a Good Tax System and Principles to Guide Reform* op. cit., <ftp://ftp.iret.org/pub/ADVS-183.PDF>,