INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

THE INFLOW OUTFLOW TAX — A SAVING-DEFERRED NEUTRAL TAX SYSTEM

Introduction

The tax system presented in this paper was the last major work of Dr. Norman B. Ture before his death in August, 1997. It describes his view of an ideal, highly visible, and reasonably simple income tax that is neutral in its treatment of saving and consumption uses of income. It is a simple cash flow tax imposed on individual income. The cash flow accounting used in the proposal makes it a saving-deferred tax. The multiple layers of tax on estates, gifts, and corporations are eliminated. Together, these changes eliminate the current income tax bias against saving and investment and lead to substantial tax simplification. Dr. Ture developed this tax proposal in recent years with the help of his staff at IRET.

Two purposes of a good tax system — raising revenue and "pricing" government

Any restructuring of the nation's tax system should be based on a set of clear tax principles, which should be uniformly applied to the exercise. Those who would redo the tax system should start by recognizing the two key purposes of a tax system, 1) to obtain revenue to pay for government goods, services, and activities, and 2) to let the citizen-taxpayers know how much they are paying for government, so that they may decide in an informed manner how much government activity they wish to support with their votes.

Four principles or attributes of a good tax system — neutrality, visibility, fairness, and simplicity

A good tax system should fulfill its first objective, raising revenue, in a manner that does the least damage to the economy. The attribute required to achieve that objective is "neutrality." A neutral tax must be unbiased across economic activities, and, especially, not overly penalize work in favor of leisure, nor tax income used for saving and investment more heavily than income used for consumption.

The second objective, letting voters know the cost of government, may be achieved by a tax system with the attribute of "visibility" or transparency to the taxpayers. A very large segment of the population must be made keenly aware that government costs money if government spending is to be held to levels at which its benefits match its costs. Toward that end, taxes should be paid by individuals, not hidden away at the business level or buried in the prices of products. Additional principles or attributes of a good tax system include fairness (properly defined), and reasonable simplicity and clarity. Simplicity and clarity, in turn should lead to easy, low cost administration and enforcement of the tax rules by the government and low cost of compliance for taxpayers.

<u>Neutrality.</u> Neutrality means measuring income correctly and then levying taxes evenly on all uses of income by all income producers, without bias, to avoid distorting economic activity.

A neutral, unbiased tax system would begin with a sensible definition of income subject to tax. 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 (properly measured), neither can a worker or saver be said to have income until his or her revenues exceed the amounts spent on acquiring the skills or assets that will generate the revenues. The full value of all costs of earning revenues should be subtracted from revenues before any tax is imposed.

Once income has been accurately measured and allocated among taxpayers, it should be taxed even-handedly. Neutral treatment requires that all income be taxed at the same rate. It is improper to tax some income at a higher rate than other income, either through graduated tax rates or by imposing multiple layers of tax on some types of income but not on other types of income.

No tax system can easily avoid penalizing labor relative to leisure. However, keeping tax rates as low as possible and avoiding graduation avoids the worst of this distortion.

Making the tax system even-handed or neutral across various types of saving and investment, and between saving and investment and consumption, requires several steps. Multiple layers of tax on capital must be avoided, and the basic income tax bias against saving and investment must be eliminated by correctly treating saving and investment as costs of earning income. (For greater detail, see Appendix.) In particular:

• The transfer tax on estates and gifts must be eliminated.

Most of an estate is saving that has already been taxed. Any parts of an estate that was tax deferred saving should remain tax deferred so long as the heirs continue to save it.

• The dual taxation of Schedule C corporate income at the corporate and individual level must be eliminated.

The extra layer of tax on corporations can be eliminated either through "integration" of the individual and corporate income taxes or the substitution of a non-income type of tax system. Integration means that corporate income is recognized as belonging to the shareholders, and is taxed either on individual tax returns or corporate tax returns, but not both. This puts it on a par with income generated in proprietorships, partnerships, and sub-Chapter S corporations.

• The tax system must either allow savers to deduct saving or to exclude the returns on saving from taxable income.

The income tax, by taxing both income that is saved and the returns on that income, taxes saving and investment more heavily than consumption. (See Appendix.) There are two ways to restore neutrality. One approach is to exclude all saving from taxable income while taxing all returns on the saving — a saving-deferred tax. This is the treatment currently allowed to a limited degree with pensions and deductible IRAs. The other is to include saving in taxable income but impose no tax on any of the returns — a yield-exempt tax. This is the treatment currently accorded Roth IRAs and tax exempt bonds. Other costs of earning income must also be expensed as occurred. Investment outlays must be deducted in the year the outlay is made (expensed), rather than depreciated over time, or otherwise delayed or ignored. (See Appendix.)

Several types of tax systems would serve to exclude saving and investment or their returns from tax, end the bias against saving and investment, and simplify the tax system. These "neutral" taxes include the unbiased income taxes (saving-deferred and yield-exempt) described above, retail sales taxes that exempt investment goods and business supplies from tax, and value added taxes that allow expensing of investment goods and other intermediate products and services purchased from other businesses at each stage of production.

Since several types of taxes are equally "neutral", choosing among them requires an assessment of their other characteristics and how well they stack up against other important attributes of a good tax system.

<u>Visibility</u>. Visibility requires that the tax system reveal clearly to the citizen/taxpayer what he or she must pay for government goods, services, and activities. Taxes are the "price" we pay for government; taxes "cost out" government for the taxpayer.

Compassion dictates that the very poor should not be subject to tax. Excepting the very poor, however, all citizens should pay something to help fund the outlays of the federal government in order that they understand that the resources used by the government are not free or costless. Taxes should be levied on the largest number of people consistent with compassionate treatment of those who cannot afford to pay.

At what stage in the flow of income should taxes be collected? At the business level, after it has made its payments to other firms but before its remaining revenues are paid out to its workers, savers, and investors? When the revenues are received by the workers and owners of the capital as earnings? Or when some portion of their income is spent on consumption?

Goods and services do not pay taxes. Businesses do not pay taxes. Only people pay taxes. All taxes, in fact, are taxes on income. Sales and excise taxes either depress sales of the taxed products, reducing the incomes of the people who provide the labor and capital used to make them, or they reduce the purchasing power of that income when the workers and savers attempt to spend it. 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 or wages or higher prices.

Since taxes are really paid by people out of income, they should be collected from people out of income. People see their tax liability most clearly when they pay an individual tax on the (properly defined) income that they have received, with a clear accounting, annually, at tax time. Taxes should not be hidden from taxpayers by being imposed on businesses as either corporate taxes, manufacturers excise taxes, or value added taxes. Similarly, taxes should not be hidden by being collected in bits and pieces over the course of a year as the taxpayer goes shopping, as either sales taxes or value added taxes.

<u>Fairness</u>. Fairness is often stated as making the rich pay a higher share of their income in taxes than the poor. Most people would agree that there should be some amount of income exempt from tax to shelter the very poorest citizens. Such an exempt amount imparts progressivity to the tax system. However, imposing further progressivity by means of graduated rates above the exempt amount is not consistent with fairness. Income is correctly understood to be the earned reward for supplying labor and capital services to the market. Except in rare cases, income closely matches the contribution of the effort and services provided by individuals to additional output. That fact, and the notion of equal treatment under the law, strongly urge that a proportional (single rate) tax on income (above the modest exempt amount) is the fairest.

Simplicity. Much complexity in the current tax code stems from its ad hoc approach to defining taxable income. The code is not based on any clear understanding of what constitutes income, nor accurate measurement of income, nor any set of coherent principles regarding the imposition of tax. This lack of guiding principles and resulting chaotic definition of income make for difficulties in administration and compliance, because neither the IRS nor the taxpayer can figure out clearly what is in or out of the tax base.

Most complexity is found at the business level or with respect to specialized investments of individuals. Taxation of wages and ordinary individual interest and dividends is fairly straightforward. Simplification should not go so far as to eliminate tax filing by individuals, as with a sales tax or VAT; that would sacrifice visibility to an unacceptable degree, and is not necessary to achieve significant simplification.

Ideally, a tax system should be easy for the government to administer and enforce, and be easy and inexpensive for taxpayers to comply with. Simplicity and clarity are the keys to achieving these goals. A clear definition of income and elimination of multiple layers of tax would create a system that is much simpler and easier to administer, enforce, and comply with than current law.

A tax proposal that conforms to the attributes and principles of a good tax system.

As mentioned, there are several types of (largely) neutral tax systems. Most achieve varying degrees of tax simplification. Unfortunately, most fail to do a good job with respect to visibility, which is one of the most critical attributes of a good tax system. (See Appendix for a comparison of these systems.)

The following is a tax proposal that conforms to all the attributes and principles of a good tax system. It is called the inflow-outflow (I-O) tax.

<u>Overview.</u> The I-O tax system is an individual-based saving-deferred tax with a number of additional deductions from revenue necessary to properly measure and allocate the income for tax purposes.

Inflows — an individual's revenues from work, saving, and transfer payments received — would be taxable. Outflows associated with earning the revenues (such as net saving, investment, and some education outlays), and income transferred to others (either voluntarily by gift or as mandatory tax payments) would be deductible. Net taxable income would, in effect, consist of revenues utilized for the individual's own consumption.

For neutrality and visibility, the net labor and capital income would be taxed once and only once on individual tax returns. For fairness, there would be personal allowances to shelter the poor from tax. For neutrality and fairness, there would be a single tax rate imposed on income above the exempt amount. The single rate would eliminate the graduated tax rate bias against work, education, risk taking, and success, and would treat all individuals alike under the law.

Income must be attributed to the correct taxpayer. For visibility, income should be taxable to the final recipient of the income. People should be taxed only on the income over which they retain control and of which they enjoy the benefit. If one taxpayer gives revenue to another, either voluntarily (as by gift or charitable donation), or due to legal obligation or government coercion (alimony, fines, taxes), the donor should deduct that revenue from his or her taxable income, and the recipient should add that revenue to his or her taxable income.

Income must be defined properly. Income is a net concept, revenues less the cost of generating those revenues. Among the costs of generating income are: training and education in the case of labor income; the cost of acquiring income earning assets (saving and investment) in the case of income from capital. Costs of generating income must be deductible in full — expensed, not deferred (unless compensated by payment of interest to maintain present value).

Details of the I-O system follow. An illustrative sample tax form is on page 8.

<u>Labor income</u>. Individuals would pay tax on labor income (wages, salaries, selfemployment income, and the value of non-pension fringe benefits) and pension receipts. The employer would report the total to the taxpayer on a W-2 form, as it does for cash wages and pension withdrawals under current law.

<u>Transfers received.</u> Individuals would pay tax on the taxable portion of social security. (All payroll taxes would become deductible in this tax system; therefore, over a phase-in period equal to a full working lifetime, all social security benefits would eventually become taxable.) Individuals would also pay tax on welfare and other transfer payments received from state and local governments and charities, insofar as they exceed the exempt amounts. (In practice, those who receive charity would usually be too poor to owe tax, and would not have to file a return.)

Income from saving and the net saving deduction. Individuals would deduct their saving (a cost of earning future income) from taxable revenues, and pay tax on all returns on saving (whether principal or earnings on the principal or earnings of an unincorporated business) when withdrawn. Reinvested returns would be tax deferred.

In effect, all saving would be treated like current-law pensions or IRAs. All income individuals transfer to financial intermediaries or other businesses through lending or the purchase of shares would be deductible by the savers. Only those earnings withdrawn or received by lenders, shareholders, or owners of an unincorporated business (and not reinvested) would be taxable, and would be reported on the individual tax returns. The "inside build-up" of the saving in saving accounts, brokerage accounts, mutual funds, corporate shares, or unincorporated businesses would not be taxable. There would be no separate calculation of capital gains; they would be covered in the proceeds from the sale of assets (whose full cost was deducted at the time of purchase). The proceeds would remain tax deferred if reinvested. For example, trades within a brokerage account would not be reportable unless money was withdrawn from the account.

Pension contributions by employers and employees currently excluded from employees' incomes would remain deductible saving. Since all saving could be deducted in this system, all current-law restrictions on the amounts allowed as contributions and withdrawals under employer-sponsored pension plans would be eliminated.

The deduction for saving would be for net saving. Borrowing would be considered "dissaving" and be considered taxable revenue to be netted against amounts saved. However, borrowing would result in an immediate tax liability only if used for consumption. Borrowing used to buy assets such as stocks or a machine for one's business would not result in more taxable income because the investment outlays would be deductible saving. Also, repayment of debt and interest paid on debt would be part of deductible saving. (But see alternative treatments of home purchases, below.) Each financial institution with which the taxpayer had dealings would report the taxpayer's net saving or dissaving for the year as a single number on a 1099 form, like those currently in use to report interest or dividends on Schedule B. There would be no need for the taxpayer to track all of his or her deposits and withdrawals over the year to calculate the net amount. There would be no separate Schedule D for capital gains.

<u>Deductions of transfers paid.</u> Charitable contributions would be deductible by the donor. (As indicated above, the charitable gifts would be taxable to the ultimate recipient, who would seldom have sufficient income to owe tax. Current law simply allows the charitable deduction and ignores the other side of the calculation.)

All payroll and state and local taxes would be deductible as income over which the taxpayer has lost control and transferred to others. State and local taxes are involuntary outflows. They largely fund welfare and other aid to the poor (income transfers akin to charitable contributions to persons below taxable levels of income) or education (a transfer that pays for the cost of the recipient's acquisition of human capital), all of which could be considered to be reasonable deductions. Law enforcement and fire protection are services to the taxpayer, but constitute remedies for or protection from casualty losses, and ought not to be considered beneficial income. There are some local government services that accrue to the individual taxpayer or homeowner, such as water, sewer, and trash pick-up, but these are often billed separately, in which case they would not be deductible.

<u>Deductions of cost of acquiring human capital.</u> Individuals would deduct some portion of the cost of training and education. Tuition and other training costs are already largely deductible in the form of property taxes at the local level that pay for primary education, and state income taxes that assist state universities. Tuition paid directly by the student could be considered for similar treatment. However, there is also a "consumption" or general living element of education; it is not all a cost of earning future income. Some rough adjustment must be made in what will always be a gray area.

<u>Treatment of home ownership.</u> We do not recommend "pure" inflow-outflow treatment of the owner-occupied home, which would be to treat it (as in the national GDP accounts) as an investment yielding income in the form of shelter. Pure treatment would include the imputed rent from the owner-occupied home in taxable income, plus the mortgage borrowing that financed the home; it would allow a deduction for the purchase price of the home, the repayment of mortgage principal and interest, and outlays on maintenance.

This pure approach to the treatment of owner-occupied homes is far too difficult to calculate. The alternative approach to neutral treatment of saving — no deduction for the purchase of the asset, but no tax on the returns, is an easier alternative, and the I-O tax would adopt it in this instance. Neither the imputed rent nor the mortgage borrowing would be taken into the homeowner's income. In exchange, there would be no deduction of the purchase of the home, outlays for maintenance, nor repayment of mortgage principal and mortgage interest.

Form 1040: Individual Tax Form, Inflow Outflow Tax	
1. Sum of: Labor compensation, Pension receipts, Taxable social security, Transfer payments (from W-2 forms)	\$33,000
2. Net saving (+) or net withdrawals from saving (-) (from Schedule B)	\$3,000
3. If line 2 is net saving (+), subtract the dollar amount from line 1; if line 2 is net withdrawal from saving (-), add the dollar amount to line 1.	\$30,000
4. Other itemized deductions from Schedule A	\$10,000
5. Subtract line 4 from line 3.	\$20,000
6. Personal allowance times number of taxpayers and dependents: <u>\$5,000</u> x <u>2</u> =	\$10,000
7. Subtract line 6 from line 5. This is your taxable income.	\$10,000
8. Tax from table (or, line 7 times 20%).	\$ 2,000
9. Amount withheld, from W-2, plus estimated tax payments.	\$ 2,100
10. Amount due (+) or amount overpaid (-) (line 8 less line 9). If amount is due, pay Internal Revenue Service.	- \$ 100
11. If overpaid, fill in: Amount to be refunded <u>\$100</u> ; or Amount to be applied to estimated tax	

Schedule A, Itemized Deductions	
1. Sum of individual payroll tax (from W-2), state and local income tax withheld (from W-2) and estimated state and local tax less refunds from previous year, and local property taxes.	\$ 5,000
2. Gifts, contributions.	\$ 1,000
3. Qualified tuition, training expenses.	\$ 4,000
4. Total. Enter on Form 1040, line 4.	\$10,000

Schedule B, Saving	
List net saving (+) or withdrawals (-) from financial institutions reported on 1099 forms.	
First National Bank	-\$1,000
Merrill Paine Schwab	+\$4,000
Total (if greater than zero, this is net saving; if less than zero, this is a net withdrawal). Enter on Form 1040, line 2.	\$3,000

<u>Treatment of businesses.</u> There would be no separate taxation of businesses in a saving-deferred tax. As discussed above, businesses would be treated like pensions or IRAs owned by the savers: all income individuals transfer to businesses through lending or the purchase of shares would be deductible by the savers; only those business earnings distributed to lenders and shareholders (and not reinvested) would be taxable, and would be reported on the individual tax returns. The "inside build-up" of the saving in the business would not be taxable.

The non-tax status of business in the inflow-outflow tax is not just by fiat. The normal rules of the inflow-outflow tax automatically render a business a non-taxable entity. Businesses would not be taxable because their deductible outflows would always equal their inflows.

Business inflows include the revenues from sales of goods and services and income on financial investments, plus borrowing from lenders and sales of new shares to stockholders. Business outflows include operating costs — wages, purchases of materials, inventory, outlays on research and development, rent and royalties paid, and all outlays for investment in plant and equipment, structures, and (unlike current law) land — plus state and local taxes and federal payroll taxes, interest payments to lenders and dividend payments to shareholders. These outflows are all costs of earning income or transfers of capital income to lenders and shareholders for taxation on their returns. Any left-over revenues saved by the business should be considered tax-deferred saving by the shareholders. Nothing would remain to be taxed at the business level. Consequently, there would be no need for businesses to file an income tax return, eliminating most of the accounting, auditing, and costs of enforcement and compliance in the current tax system.

In this system, the deduction for business investment would effectively be passed along to the savers who lend money to, buy shares in, or otherwise invest in the business. Savers would fully deduct their purchases of stocks and bonds. These proceeds of stock and bond issues, plus what we now call retained earnings, would just equal the operating costs and (deductible) capital investment and net saving of the business, eliminating taxable business income. This pass-through of the deduction for investment would be an advantage for start-up businesses that have little income as yet from previous investments against which to take a deduction. It effectively eliminates the problem of net operating loss carry forwards that delay and reduce the value of deductions for investment and raise the cost of capital under current law.

<u>Territoriality</u>. The tax would be territorial, imposed on income generated within the United States, not on income earned abroad. There would be no deduction for saving invested abroad, and no tax on the returns. There would be no credit for foreign taxes paid on foreign income repatriated to the United States. Territorial taxation would substantially reduce the confusing treatment of foreign source income that cripples American firms attempting to compete abroad. The tax would not be "border-adjustable", that is, it would not

be forgiven on exports and imposed on imports, because the producers of the exports worked and earned their income in the United States, and should be taxed just as all other U.S. producers, while the producers of imports worked and earned their income abroad, where it is subject to foreign taxes.

Conclusion

The inflow-outflow tax is a neutral, highly visible tax system. It correctly measures income, providing revenue to the government with minimal disruption to the economy. It allocates income for tax purposes, appropriately, to the final recipients of the income, thereby informing the citizen-taxpayer of the tax cost of government. The I-O tax also achieves a significant degree of tax simplification compared to current law, and reduced costs of administration and compliance. The I-O tax achieves these results in a superior fashion compared to most other major tax reform proposals. It is deserving of serious consideration by policy makers and students of political economy.

Stephen J. Entin President and Executive Director

APPENDIX^{*}

TAX BIASES AGAINST SAVING AND INVESTMENT AND HOW TO FIX THEM

Tax biases on income that is saved: four layers of tax.

The income tax hits income that is saved and invested much harder than income used for consumption. The income tax is imposed on income that is saved and again on the income produced by the saving. In contrast, the income tax falls on income used for consumption but does not fall again on the consumption spending and the services and enjoyment it provides.

For example, if one uses after-tax income to buy a bond, the stream of interest payments is also taxed. If one uses after-tax income to buy a television, there is no additional tax on the purchase of the TV or the stream of entertainment it provides.

In fact, people who save and invest find their income subject to four layers of federal tax (versus one layer for consumption).

Layer 1 — tax on earnings. The income is taxed when first earned.

Layer 2 — tax on interest and business income. When the after-tax income is saved, the returns on the saving are taxed — double taxation. If the saver puts his or her income into a bond or bank account, the interest earned is taxed. If the saver invests directly in a small business, his or her investment income from the proprietorship or partnership is taxed. If the saver buys a share of corporate stock, he or she is in fact buying a share of the company, a claim to a share of its income, and his or her share of the corporate income tax on the corporate earnings.

<u>Layer 3 — taxes on dividends and capital gains.</u> Shareholders face triple taxation. In addition to the original tax on the saving and the tax paid by the corporation, shareholders must pay personal income tax on any dividends that the corporation distributes out of its after-tax income. (This is sometimes called "the double taxation of dividends", but it is really the third layer of tax because the income used to buy the shares was taxed before it was saved.)

There is a third layer of income tax even if the corporation does not pay a dividend. If a corporation (or other business) retains its after-tax earnings for reinvestment, the earning power and the value of the business will increase. If the owner or shareholder sells the business or the shares, the increase in value is taxed as a capital gain.

^{*} Appendix material modified from the author's background papers contained in "Unleashing America's Potential", the Report of the National Commission on Economic Growth and Tax Reform, January, 1996.

Capital gains can arise whenever a business's prospects improve, not just because of reinvestment of previously-taxed earnings. The development of a successful new product, or a discovery such as a new wonder drug or a new oil field, can the boost the after-tax earnings outlook of a business and increase its current market value. *The current market value of a business (and its stock) is the present (discounted) value of its expected future after tax earnings.* If the higher expected business earnings come to pass, they will be taxed as corporate income and/or unincorporated business or personal income. To tax as well the increase in the business's current value if the business or the shares are sold is to double-tax the future income of the business before it even occurs, and to triple-tax the initial saving. The current law income tax treatment of capital gains, whatever their source, is multiple taxation of saving.

<u>Layer 4</u> — estate and gift taxes. If the saving outlives the saver, and the remaining unspent assets exceed a modest exempt amount, the federal unified transfer (estate and gift) tax imposes another layer of federal tax on the already multiply-taxed saving. This is an added layer of tax even for tax-deferred saving (as in IRAs, 401(k) plans, 403(b) plans, SEPs, and Keogh plans), which is subject to the estate tax and is taxed again as income to the heir (if not a spouse).

Cost of the tax biases against saving and investment

These tax biases are real and they have serious consequences. Savers and investors expect a reasonable after-tax return on their assets. Because of these biases, saving and investment must earn substantially higher returns to cover the added taxes and still be worthwhile substitutes for consumption. Saving and investment earn higher returns only if the quantity of capital is significantly reduced, making the value of each additional unit's output that much greater. The current biases in the tax treatment of capital have cost the economy several trillion dollars in saving and investment, considerably retarding the growth of productivity, wages, and employment, and retarding the growth of individual income and wealth.

It is no exaggeration to suggest that the level of income in the United States could be at least 15% to 20% higher than it is today if these biases did not exist. That missing income has simply been thrown away to no good purpose. These losses could amount to as much as \$4,000 to \$6,000 per year for typical middle income families. The current system also cripples people's ability and incentive to save for retirement, leaving people with less retirement income than they need to be financially secure, and increasing their dependence on government programs or their children in old age.

Ending the tax bias: neutral treatment of income used for saving and consumption

Making the tax system even-handed or neutral between saving and investment, on the one hand, and consumption on the other, requires several steps. First, excess layers of tax on capital income must be ended. The transfer tax on estates and gifts must be eliminated. Corporate income must be taxed either on individual tax returns or corporate tax returns, but not both.

Second, to measure income correctly, the basic tax treatment of saving and investment must be changed. The tax system must either allow savers to deduct saving from taxable income, while including the returns, or to exclude the returns on saving from taxable income. There must be no separate, additional taxation of capital gains. Investment outlays must be deducted in the year the outlay is made (expensed) rather than depreciated over time.

<u>Deduct saving, tax returns method.</u> Excluding (or deducting) saving and investment from taxable income is called "expensing". In the case of saving, expensing is akin to the tax-deferred treatment allowed limited amounts of retirement saving today (as with current IRAs, 401(k) plans, 403(b) plans, SEPs, and Keogh plans), but with no restrictions on the amount of saving that could be deducted, no penalty tax on withdrawal at any age, and no forced distribution at any age. In effect, the purchase of a bond, bank account, or share of stock would be recognized as a cost of earning income. When the outlay is made, it would be deducted. When the returns come in, they would be taxed (including interest, dividends, the return of the principal when the bond matures, or the proceeds from the sale of the stock at a later date).

<u>Tax saving, exempt returns method.</u> The other route to neutrality is to tax the income that is to be saved, but exempt interest, dividends, capital gains, and other returns on the saving from tax. This is akin to the tax treatment accorded Roth IRAs and state and local tax exempt bonds. No deduction for buying the asset is allowed, but the returns are not taxed.

Both methods of dealing with saving eliminate the excess tax on income that is saved compared to income that is used for consumption. A tax increases the cost of whatever item or activity it is imposed upon. The income tax is biased because it raises the cost of saving and investment more than it raises the cost of consumption. Look at how much more a person must earn to support a given level of consumption after a tax is imposed, compared to how much more must be earned to buy an asset that delivers a given amount of after-tax income.

Suppose that, if there were no income tax, one could buy \$100 of consumption goods or a \$100 bond paying 4% interest, or \$4 a year. Now impose a 20% income tax. One would have to earn \$125, and give up \$25 in tax, to have \$100 of after-tax income to consume. The pre-tax cost of \$100 of consumption has risen 25%. To get a \$4 interest stream, after taxes, one would have to earn \$5 in interest, pre-tax. But \$5 in interest requires a \$125 bond. To buy a \$125 bond, one would have to earn \$156.25 and pay \$31.25 in tax. The cost of the after-tax interest stream has gone up 56.25%, more than twice the increase in the cost of consumption. (See table.) Put another way, if there were no income tax, obtaining a \$1 stream of interest would cost the saver \$25 in current consumption (\$100/\$4). After the income tax, it would take \$156.25 to buy a \$4 interest stream or \$125 of consumption. Each \$1 interest stream would cost \$31.25 in foregone consumption (\$125/\$4), 25% more than in the no-tax situation.

There are two ways to restore neutrality. One is to exempt interest from tax, as with state and local tax exempt bonds. One would then have to earn \$125 to buy a \$100 bond, earning \$4 with no further tax. The other method is to allow a deduction for income that is saved, while taxing the returns, as with a deductible IRA. One would have to earn \$125 to buy a \$125 bond, earning \$5 in interest pre-tax, and, after paying \$1 in tax on the interest, have \$4 left.

Income Tax Bias Against Saving and Two Cures

Pre-tax income needed to have \$100 for consumption after taxes or a \$100 bond paying \$4 in interest after taxes under ordinary income tax treatment, IRA-type treatment, or tax exempt bond treatment								
		Pre-tax income	Тах	After-tax income	Interest on saving	Tax on interest	After-tax interest	% increase in cost of activity due to tax
No income tax exists	Income consumed	\$100	\$0	\$100				
	Income saved	\$100	\$0	\$100	\$4	\$0	\$4	
Ordinary income tax levied at 20% rate	Income consumed	\$125	\$25	\$100				25%
	Income saved	\$156.25	\$31.25	\$125	\$5	\$1	\$4	56.25%
IRA-type treatment: amounts saved tax deductible, returns on saving taxed		\$125	\$0	\$125	\$5	\$1	\$4	25%
Tax exempt bond treatment: no deduc- tion of saving, returns not taxed		\$125	\$25	\$100	\$4	\$0	\$4	25%

The 20% income tax, by taxing income when first earned and taxing the return on saving, raises the cost of consumption by 25% and the cost of obtaining additional future income by 56.25%, more than twice the increase in the cost of consumption. Under IRA or tax exempt bond treatment, the tax raises the cost of obtaining additional future income by 25%, the same penalty as on consumption.

Equivalence and importance of the two methods of treating of saving. The two methods are equivalent in their treatment of saving (if savers face the same tax rate over time), and better than current law. Using another example, suppose that interest rates are 7 percent. At that rate of interest, \$1 saved would grow, with interest, to \$2 in ten years. (Alternatively, suppose that reinvested earnings caused the price of a share of stock to double in ten years, and that the stock is sold and the capital gain is realized at that time.) Suppose also that the income tax rate is 20%.

Under the saving-deductible method, an individual could earn \$100, save it without paying tax up front on the deposit or on the annual interest build-up (or on the stock purchase and accruing gain), and withdraw \$200 ten years later. After paying a 20% tax on the withdrawal (or the proceeds of the stock sale), the saver would have \$160 to spend.

Under the exempt-returns method, an individual could earn \$100, pay a 20% tax, and save the remaining \$80. Without owing any further tax on the returns, he could withdraw \$160 ten years later, and, here too, would have \$160 to spend.

Either neutral method is better than current law. Under the current tax system, an individual earning \$100 would have to pay a 20% tax, save \$80, and owe tax annually on the interest, reducing the 7% percent interest rate to an after-tax rate of 5.6%. With less interest left to build up after taxes, the saver would accumulate only \$138 to withdraw and spend after ten years. The \$22 difference (\$160-\$138) between current law and the neutral systems (about 14% over 10 years) is a measure of the double taxation imposed by current law on income that is saved.

The penalty on saving under current law sharply retards the build up of retirement saving that is not protected from double taxation by a pension plan. (See graph.)

The enhanced ability to save for education, home ownership, and retirement would be an important feature of a restructured tax code. Retirement saving is a subject of great importance as the baby boom approaches old age. The Social Security System faces enormous deficits. Eliminating those deficits by means of large increases in the payroll tax would cost several million jobs.

<u>Treatment of capital gains.</u> As the example above shows, the two methods produce the same after-tax returns on saving involving capital gains. In fact, under either the saving-deferred or returns-exempt approach to ending the tax bias, capital gains would cease to be a tax issue, greatly simplifying tax forms for individual and business taxpayers and reducing disputes with the IRS. Under the return-exempt approach, there would obviously be no tax on capital gains, because no returns on saving would be taxable. In the deductible-saving case, the purchase of the assets would be expensed (resulting in no basis for tax purposes), and all the proceeds of asset sales would be properly included in taxable income. Any gain or loss embedded in the numbers would be automatically calculated correctly for tax purposes, without any special calculations required. If the proceeds of asset sales were reinvested, any embedded gains could be rolled over, and would remain tax deferred until withdrawn for consumption.

Ending the tax bias: neutral treatment of investment through expensing

Expensing is the simplest and most sensible way provide unbiased to tax treatment of direct investment in physical capital. Just as neutral treatment of saving can be accomplished by deducting saving and taxing the returns, neutral treatment of investment can be achieved by expensing investment and taxing the Expensing means returns. writing off the investment in the year it is purchased rather than the current practice of stretching out capital consumption (depreciation) allowances over an extended period of time, which reduces their value. The stretch-out constitutes an interest-free loan to the Treasury of the taxes that would otherwise have been



saved by the deduction. Outlays for plant, equipment, buildings and other structures, land, inventory, and research and development should all be deductible in the year the outlays are made, just as for any other production input. Subsequently, all the returns on these investments, including sales of goods and services, rents, and royalties (all net of other costs), and sales of assets, should be taxed.

Under current law, purchases of equipment are written off over periods of time ranging from 3 to 20 years. Most structures are written off over a 39 year period. Stretching out the write-off period reduces the present value of the deductions due to lost interest and inflation. The result is that the business deducts an amount that is less in present value than the value of the equipment. The under-depreciation overstates taxable income, resulting in a higher-than-statutory tax rate on the real earnings of the asset. The table illustrates the difference in the value of the deductions between expensing and one of the set of depreciation schedules commonly used in current law. For example, the present value of deductions for the 7 year asset at 3% inflation and a 3.5% real discount rate is only 84.6% of the cost of the asset. The present value falls short of expensing by \$15.40 on a \$100 piece of equipment, costing the firm an extra \$5.39 in tax in present value terms, assuming a 35% corporate tax rate. The longer the life of the asset, the

greater is the loss of value of the write-off. The deduction for a building written off over 39 years at 3% inflation is worth less than 37 cents on the dollar; at 5% inflation, less than 30 cents on the dollar.

Present Value of Current Law Capital Consumption Allowances per Dollar of Investmen Compared to Expensing (First-year Write-off).							t	
Asset lives:		3 yrs	5 yrs	7 yrs	10 yrs	15 yrs	20 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
Present value of current law write-off of \$1 if inflation rate is:	0%	\$0.964	\$0.937	\$0.912	\$0.877	\$0.796	\$0.742	\$0.550
	3%	\$0.935	\$0.888	\$0.846	\$0.789	\$0.667	\$0.592	\$0.367
	5%	\$0.917	\$0.859	\$0.807	\$0.739	\$0.599	\$0.519	\$0.295
Assumes a 3.5 percent real discount rate, 3-20 year assets placed in service in first quarter of the year, 39 year assets								

placed in service in January.

It must be understood that, in reality, revenues are not income until they exceed the cost of producing the income. By holding deductible costs below actual costs, depreciation schedules overstate businesses' and individuals' real incomes. When income is overstated for tax purposes, the tax is a bigger percent of the taxpayer's true income than the statutory tax rate. The overstatement of income sometimes turns a real loss into an apparent profit and forces a tax payment when none should be due.

A tax system that does not allow full and immediate write offs for capital costs is biased against investment relative to consumption and against investment in long lived assets relative to short lived assets. The current tax treatment of depreciation diverts economic activity in the United States away from capital intensive industries such as manufacturing, especially heavy industry, and into services and less capital intensive production. In the process, many high value added jobs have been lost.

Accountants and tax officials often argue for delaying write-offs to correspond with the gradual decline in an asset's future earning power as the asset wears out. This so-called "economic depreciation" is fine for measuring the size of the country's capital stock and the level of economic capacity, but it has nothing to do with appropriately measuring the taxable income of an individual or business, which is revenues less costs. When a business (or its lenders and shareholders) buys a machine or other asset, it gives up the resources to pay for it at the moment

the payment is made, not several years later. It must immediately forego all other possible uses of the money, including earning interest, hiring labor, buying inventory, or distributing dividends to shareholders to save or consume as they see fit. Furthermore, the seller of the machine must take the sales revenue into taxable income immediately. The asymmetrical treatment by the Treasury of the buyer and the seller — partial write-off for the buyer, full taxation of the purchase price for the seller — is clearly arbitrary, inappropriate, and anti-investment. Only expensing measures income correctly, and imposes the correct amount of tax.

GROWTH-FRIENDLY TAX SYSTEMS

Comparison of neutral tax systems

There are several types of tax systems that successfully exclude saving and investment or their returns from tax, eliminate the bias against saving and investment, and simplify the tax system. These include two types of unbiased income taxes, various types of sales taxes, such as the retail sales tax and manufacturers' excise tax, and the value added tax (VAT). Except for a few idiosyncracies, they are all unbiased taxes on labor and capital income, properly measured, either when earned or when spent. Whatever direction the tax restructuring movement takes, it is important to remember that all these approaches have this great common advantage over current law. All of the serious tax reform proposals that are being widely discussed around the country and in Washington employ one or more of these approaches in some form.

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

While sharing many advantages, some of these tax systems do better than others when measured against the other important tax policy considerations. Among these are simplicity, visibility, and fairness, and treating all taxpayers equally before the law.

<u>Saving-deferred income tax.</u> The distinctive feature of this system (also called a cash flow tax) is that individuals would exclude their saving (including interest and principal payments) from taxable income; they would include the returns on their saving — interest, dividends, and sales of assets, plus borrowing — in taxable income, but only if the returns were withdrawn for consumption, and not reinvested. There would be personal allowances and a tax rate structure that could be flat or graduated.

Under the cash flow tax, all income would be taxed as close to the final recipient of the income as possible, for maximum visibility. In its pure form, all inflows (all receipts) would be taxable, and all outflows (all outlays associated with earning the income, or any income given away to others, either voluntarily or as a tax) would be deductible. 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).

Under the pure saving-deferred income tax, all labor income (including fringe benefits) and capital income would be taxed once and only once on individual tax returns. There would be no business tax. Businesses would deduct their dividend payments as well as their interest payments, passing them on to shareholders and lenders for tax purposes. Any remaining capital earnings retained by the business for reinvestment would be tax deferred on behalf of the shareholders, and investment would be expensed. Since all taxable capital income would be reported on individual tax returns, businesses would not need to file.

The pure cash flow tax, levied only on individuals, is the most visible tax system. The "inflow-outflow tax" proposed by Norman B. Ture at the Institute for Research on the Economics of Taxation, is a pure version of the saving-deferred individual tax with a flat rate and no taxation of businesses. There would be no taxation of foreign source income, and no foreign tax credit; there would be no deduction for saving flowing abroad, and no tax on the returns.

The "USA Tax" (universal saving allowance tax) proposed by Senators Nunn and Domenici has a saving-deferred tax for individuals, with a graduated rate. The USA tax adds a variation of the VAT on businesses to collect a portion of the total tax take. This gives the appearance of taxing businesses (which reduces visibility) and permits border adjustment of some of the total tax bill (which may not be desirable).

<u>Returns-exempt income tax.</u> The best known example of a returns-exempt income tax is the single-rate individual income tax (the "Flat Tax") proposed by professors Robert Hall and Alvin Rabushka. It has been introduced by Representative Dick Armey (R-TX) and Senator Richard Shelby (R-AL). In its pure form it would have only one tax rate applicable to income over a large exempt amount, with no other deductions permitted. Only labor and pension income would be taxed on individual tax returns. In general, individuals would not deduct their saving, but would not be taxed on the earnings of the saving. (In legislative variations of this proposal, contributions to pensions and other retirement plans would remain deductible, and the withdrawals taxable, as under current law.)

Under the Flat Tax, all income from capital would be taxed once and only once on business tax returns; so would fringe benefits. There would be no need for businesses, individuals, or the IRS to track the payments of capital income from businesses to taxpayers. These provisions hide some of the tax burden from savers and workers. The business returns would follow the saving deferred method: businesses would expense investment outlays and other costs, and pay tax on all the returns. There would be no taxation of foreign source income, and no foreign tax credit.

The Flat Tax takes some short-cuts in the allocation of income among taxpayers. For simplicity and a lower tax rate, it taxes donors, not recipients of charitable contributions, disallows deductions for state and local taxes and payroll taxes to individuals and businesses, and disallows interest deductions (such as mortgage interest) while not taxing interest received. Loss of the interest deduction for mortgagees and businesses would be offset by elimination of the tax on interest received by lenders. Interest rates would be expected to fall to current after-tax levels, compensating borrowers for the loss of the deduction, and leaving lenders with the same after-tax return as under current law.

These steps make for a simpler individual tax form, but a more complicated business tax form, and lead to some mismeasurement of income. Furthermore, the system cannot deal well with financial institutions that earn their income from the spread between interest rates on borrowing and lending interest rates, and must use the normal cash flow treatment of interest for such businesses. (It is difficult to deal with banks, S&Ls, brokerage houses, and other financial intermediaries in any tax system in which interest is not generally deductible by borrowers and taxable to lenders. This is true of the returns-exempt tax, sales taxes, or value added taxes. A separate tax, based on cash flow would have to be used for these businesses.)

Variations on this system are possible. One variation, introduced by Senator Arlan Specter (R-PA) would allow the retention of the charitable deduction and retention of the home mortgage interest deduction for borrowers. (Retention of the mortgage interest deduction for borrowers would have little revenue effect, because the lenders would be taxed on the interest as under current law.)

<u>Sales tax or value added tax.</u> Taxes imposed on the sales of goods and services, such as a retail sales tax, a manufacturers excise tax, or a VAT, allow individuals to defer tax on their saving until the saving is withdrawn for consumption. A VAT, and a national retail sales tax if it were to exclude investment goods from the sales tax base, would be neutral as between income used for saving and investment and income used for consumption.

Sales taxes and VATs tend to be hidden in the cost of goods and services, making the cost of government less visible, and the taxes the easiest to raise. They are the easiest taxes for individuals to comply with — individuals are totally divorced from the collection process — but they may go too far in that regard. Sales taxes also pose some problems with respect to easing their burden on low income taxpayers.

Sales taxes and VAT's have serious compliance cost for businesses, which could be made worse by the development of Internet commerce. Sellers generally only collect sales taxes for the jurisdiction in which they are located. The states are upset that they are losing sales tax revenue on purchases made by their residents out of state, and require "use taxes" on out of state items, which most citizens fail to pay. The states would like businesses to collect taxes for all jurisdictions to which they ship retail products or provide services. However, there are 30,000 potential taxing jurisdictions in the United States. Compliance would be a nightmare. Jurisdictions have different sales tax rates and different definitions of what is or is not a taxable item, and cannot agree on where the electronic services provided over the internet (which may involve parties in several states and nations) are produced or consumed. The danger of multiple taxation of the same income is serious. In the case of national sales taxes or VATs, businesses would face corresponding international compliance issues as they sell to or buy from many nations.

Sales taxes may be imposed on imports and remitted or not levied on exports. This feature is called border adjustability, or being "destination-based". These taxes may also be set up without border adjustability, in which case they are called "origin-based". The question of border adjustability, in which case they are called "origin-based". The question of border adjustment should not be the determining consideration in choosing which tax system to adopt. Border adjustability is often cited as an advantage of a national sales tax or a VAT. Most economists, however, are skeptical that border adjustability would benefit the U.S. economy as a whole. It would not, by itself, increase total U.S. output or employment. We would produce more for export and less for our own use, importing more to make up the difference. The balance of payments would be largely unaffected. Jobs gained in producing exports would be at the expense of jobs aimed at producing for the domestic market. Destination based taxes are generally rationalized as "taxing the consumption where it occurs". But it should be remembered (see below) that consumption-based taxes are not taxes on consumption per se. They are taxes on labor and capital income earned in producing goods and services. The U.S. tax on workers and capital employed in the United States ought not to vary depending on where their products are sold.

The nature of the taxes

The nature of consumption or consumption-based taxes must be clearly understood. One point of clarification is in order. Various types of sales taxes and excise taxes are often referred to as "consumption taxes", rather than income taxes, because they are collected when products are produced or sold. A broadly-imposed national retail sales tax would fall on an amount of GNP that equals total consumption. Nonetheless, these are not taxes on the act of consumption or on the goods and services consumed. Goods and services do not pay taxes. Only people pay taxes. All taxes, in fact, are taxes on income. Sales and excise taxes and VATs either depress sales of the taxed products, reducing the incomes of the people who provide the labor and capital used to make them, or they reduce the purchasing power of that income when the workers and savers attempt to spend it.

The two neutral income-style taxes are imposed on income as it is earned, with the amount saved and invested excluded (or the earnings of saving excluded). Saving and investment are outlays that people make to earn income. There is no real income or profit from saving and investment until the returns exceed the outlays. Consequently, taxing that part of the payments to labor and capital left over after saving and investment is the correct

amount of income from labor and capital to tax. (Alternatively, the saving should be taxed, and the returns exempted.) These systems are sometimes called "consumption-based income taxes" or "saving-deferred income taxes". Excluding from total income the amount that is saved and used to finance investment leaves an amount equal in a given time period to total consumption. This does not convert the tax into a "tax on consumption", however; it is merely a means of avoiding multiple taxation of income used for saving, and the returns on the saving will be taxed when earned, unless reinvested in turn. It bears repeating that all taxes are paid out of income by people, not by businesses, and not by goods and services.

Growth and job creation

Any of the saving/consumption neutral tax systems would be far more conducive to growth than current law. They would allow the economy to gain, over about a decade, the investment and growth that the current biased tax system has suppressed. They take different approaches to eliminating the biases in current law. They have different transition problems, but none of these are unsolvable. The sooner that one of these approaches is adopted, the sooner the gains can be realized.

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. In particular, 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. 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. 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-yearold 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 in the first year, people will enjoy a lifetime of benefits from a pro-grow tax reform, and it is the lifetime benefit that should be looked at.

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. Even before total income rises, Treasury would see some revenue offset to any net tax reduction. National income would begin to 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 enormous benefits of reform to the economy, the population, and the budget, it would be wise to restrain the growth of federal spending to accommodate the tax reform.