SOME UNDERLYING PRINCIPLES OF TAX POLICY

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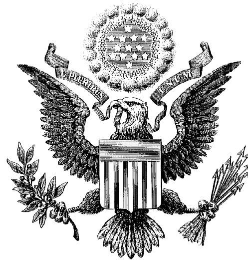

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Executive Summary

A new direction in tax policy is needed to reduce the complexity of the existing system, lower administrative costs, and reduce the biases and inequities endemic in the federal income tax. The resulting tax system should feature greater uniformity of treatment between different types of income, avoiding the multiple taxation of saving. An examination of tax neutrality, economic growth and fairness suggests that the basis of taxation should be shifted from income to consumption.

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There is a high level of unhappiness about the American federal system of taxation. Public outcries about Internal Revenue Service (IRS) abuses have prompted calls for changes in tax administration, and legislators in both political parties have advocated significant changes in the Internal Revenue Code. Calls for reform have intensified, with some calling for either a national sales tax to replace the existing individual income tax or for a flat rate simplified income tax that would likewise represent a significant departure from the existing system.

While such substantial reforms in the tax code may not happen in this Congress, it is highly unlikely that more than a few years will pass without some significant changes in the tax code. Significant changes in income taxation occurred in 1981, 1986, 1990, 1993, and 1997, for example, with smaller changes in several other years. During the past two decades, we have never gone more than five years without a fairly significant revision in the tax code. With that in mind, it is appropriate to reflect on some guiding principles that should govern the nature and direction of tax change.

ALTERNATIVES TO TAXATION

Taxes are a device to enable governments to take command over or redistribute resources. They are not, however, the only device. Two other major means — borrowing and printing money — have been used historically to achieve the same objective as taxes, as well as several minor methods. All of them, however, seem inferior to taxes for a variety of reasons, which is why most governmental activity is tax financed.

Borrowing is the most important alternative method of financing. For 28 consecutive fiscal years from 1970 through 1997, the federal government financed at least part of its expenditures through budget deficits, meaning the government borrowed to meet its obligations. At no time, however, did borrowing account for as much as 25 percent of all federal financing of spending, and in most years the proportion was 10 percent or less.

Whenever government takes command over resources, this will crowd out private sector spending, whether it is financed by taxes, borrowing, or printing money. With taxation, the mechanism by which resource transfer occurs is transparent, so the persons responsible for new tax-financed government spending are accountable to the public through the political process. With

borrowing or with the printing of money (or its modern equivalent, Federal Reserve monetizing of debt through purchases of Treasury obligations), the burden on the private sector is largely disguised, avoiding the accountability desirable in a democratic society. Borrowing reduces private spending because of increases in interest rates and/or an increase in the rate of inflation induced by deficit financing. With printing money or debt monetization, rising prices reduce real incomes and wealth to holders of obligations with fixed principal or interest payments.

Additionally, there is an argument that is sometimes used that debt financed spending imposes a burden on future generations that is morally untenable, particularly if the debt is issued to finance governmental consumption expenditures, such as income transfers, crowding out private capital formation. It is no doubt true that future generations face the need to finance the payment of interest on public debt incurred through deficit financing. A good case can be made, however, that taxes also burden future generations, inasmuch as there is an abundance of literature that suggests that they tend to lower the rate of economic growth, reducing the incomes of our children.[1] *Borrowing imposes a hidden burden upon taxpayers in the short run and an explicit burden in the long run, while taxes impose an explicit short-run burden and a more hidden burden in the long run.*

To the extent government is financed through inflationary finance (especially debt monetization by the Federal Reserve), this has additional negative effects on the economy. Positive and variable rates of inflation reduce the clarity of the signals that the pricing system gives with respect to the allocation of resources. It leads to unproductive activity, such as individuals becoming obsessed with buying precious metals or land rather than creating wealth by capital formation financed by paper securities. It increases investment uncertainty, particularly among foreigners as the dollar declines in value relative to other currencies. The inflation problem also applies to borrowing. Often, the upward pressure on interest rates from substantial federal borrowing leads to political pressure being placed on the Federal Reserve to monetize debt, for example.[2]

INEVITABLE ECONOMIC COSTS OF TAXATION

With all the problems with debt and inflationary financing techniques, taxation is the least objectionable major form of paying for government. There are inherent problems with taxation as

[1] See Richard K. Vedder, *State and Local Taxes and Economic Growth: Lessons for Federal Tax Reform*, Joint Economic Committee of Congress, December 1995; Bruce L. Benson and Ronald N. Johnson, "The Lagged Impact of State and Local Taxes on Economic Activity and Political Behavior," *Economic Inquiry*, July 1986; Aladdin Mofidi and Joe A. Stone, "Do State and Local Taxes Affect Economic Growth?" *Review of Economics and Statistics,* November 1990.

[2] Government can also take command over resources by regulation. Unfunded mandates and other restraints on private or local government behavior are estimated by Milton Friedman to exceed 10 percent of national income. See Milton Friedman in "Let's Revamp the Tax Code - but How?," *Wall Street Journal*, April 15, 1998, p. A22.

well, however, that deserve mentioning. Basically, taxation reduces spending on private sector goods and services traded in markets. The benefits from exchange – to both the purchaser and seller – are reduced when trade is restrained by taxation. The way that taxes restrain private trade varies. Income and property taxes reduce incomes to taxpayers, lowering their demand for goods and services. Sales and excise taxes increase costs to suppliers, reducing their willingness to provide goods at any given price. In any case, taxes reduce private trade.

Alfred Marshall popularized the concept of "consumer's surplus" to measure the gains to consumers from trade.[3] Suppose some consumer is willing to pay 65 cents a can for a popular soft drink. Suppose, however, she can purchase that drink for only 50 cents. In that situation, she derives 15 cents consumer's surplus (65 cents minus 50 cents) – the value associated with getting the soft drink for less than she is willing to pay for it. Suppose that now a government trying to raise money and reduce roadside litter decides to put a five cents a can tax on soft drinks and that the tax is passed on to consumers, raising the price to 55 cents.[4] The consumer's surplus falls to 10 cents (65 cents minus 55 cents). The accumulated consumer's surplus to all customers likewise falls.

Trade is mutually beneficial to consumers (or buyers) and producers (or sellers). The gains to trade to producers are often called "producer's surplus." If a soft drink maker is willing to sell a can of its product at 45 cents, but the market price is 50 cents, the manufacturer derives five cents (50 cents minus 45 cents) of producer surplus. In the tax example above, it is assumed that the price goes to 55 cents, with the producer then paying five cents a can to the government for the tax. The after-tax revenues to producers per can are unchanged. Even in this case, however, there is some loss in producer's surplus, as the volume of sales will decline as the retail price of the product goes up. While per unit producer surplus remains unchanged, total producer surplus falls.[5]

Economists refer to the "deadweight loss" associated with reduced consumer's and producer's surplus that accompanies a decline in private exchanges when taxes are increased. Alternatively, they speak of the "excess burden" of taxation. That burden is believed to be rather substantial. One oft-cited study, for example, estimates that the loss in welfare to consumers and producers from taxation may equal perhaps 40 or 50 cents of each one dollar in taxes raised.[6]

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[3] See Alfred Marshall, *Principles of Economics*, 9th ed. (London: Macmillan, 1961).

[4] The extent to which the tax is passed on to consumers immediately depends on several factors, most notably the elasticity of demand - the extent to which people are sensitive to price in making consumer decisions. In the long run, however, typically all costs will be absorbed by consumers.

[5] Where, as is typical, some of the short-term incidence of the tax is borne by producers, there is even greater loss in producer surplus, and smaller loss in consumer surplus, than in the example above.

[6] See Charles L. Ballard, John B. Shoven and John Whalley, "General Equilibrium Computations of the Marginal-Welfare Costs of Taxes in the United States," *American Economic Review*, March 1985.

WHAT MAKES A "GOOD" TAX?

Taxes, then, lower economic welfare. Yet other means of financing lower economic welfare as well, and are on balance worse. Thus, we can paraphrase a famous Winston Churchill assessment of democracy in discussing taxation: "Taxation is the worst form of financing government – except all others."

While taxes in general impose some burden on society in the form of lost individual economic welfare, some taxes are better than others. Policymakers should try to minimize the economic and social problems that taxation imposes. What criteria should be used in evaluating whether a tax minimizes harm to the members of society? While several have been suggested, only three criteria are universally accepted by experts in public finance. A good tax is:

1. Not costly for either government or taxpayers to calculate or administer; on the other hand, tax avoidance is difficult and risky.

2. Neutral in its impact on resource allocation decisions, minimizing negative effects on economic growth; it does not lead to unproductive economic activity that is tax-induced.

3. Fair; people believe that the tax burden is equitably distributed amongst the tax-paying population.

While there is less than universal agreement on a fourth principle, basic principles of representative democracy would suggest that:

4. A good tax is one that is transparent; people are aware of its existence and know the burden that it imposes; one objection to deficit financing is that it imposes disguised or stealth taxation; this should be avoided in using tax financing.

Some experts in public finance suggest other criteria that might be applicable. Joseph Stiglitz, for example, has suggested that a good tax is one whose revenues demonstrate flexibility. As he puts it, "Changes in economic circumstances require changes in tax rates."[7] Yet this criterion is highly debatable. It is true, for example, that a tax whose revenue is highly "elastic" with respect to the growth in real incomes will grow constantly in revenues over time, alleviating the need of legislative bodies to approve new taxes. Yet many would consider this a *defect* and a violation of the fourth principle above: tax revenues are increased without the approval of the people's representatives, a

[7] Joseph E. Stiglitz, *Economics of the Public Sector* (New York: W.W. Norton, 1986), p. 332.

form of taxation without representation.[8] Many politicians looked favorably on the hidden tax increases that accompanied the "bracket creep" associated with high inflation and progressive federal marginal income tax rates in the era before the mid-1980s, as they reduced the political costs to themselves of financing growing government. There is, however, good evidence that the high and partially unvoted tax rates on middle-class Americans slowed down economic growth and subverted the workings of the democratic process.[9]

Tax Administration

Resources are needed to administer a tax system. Some of those resources are explicit costs to the government, such as the $8 billion annual budget of the IRS. Others are explicit costs to taxpayers, such as the monies spent on tax preparation services such as H & R Block. Many of the costs, however, are implicit or hidden costs. The billions of hours spent annually in gathering tax records, filling out forms, etc., are a cost to society. These costs are hard to measure but nonetheless real. Americans would spend tens of billions of dollars, conservatively, to avoid the time spent, the frustrations, and the anger associated with preparing their income tax.

Other things equal, then, a tax is better the lower these explicit and implicit costs are - both to government and to taxpayers. Another dimension of the tax administration problem relates to evasion and tax avoidance. A tax is "good," other things equal, if it is difficult to evade – that is to say where the costs to evaders (criminals) are high, and the costs to tax enforcers are low. Not only do uncollected taxes lower tax revenues forcing higher tax rates to raise any given amount of money, there is an extreme inequity associated with increased tax burdens to honest persons imposed by dishonest individuals who evade their fiscal responsibilities.

Neutrality and Economic Growth

By their human actions in demanding and supplying goods, individuals in a market economy decide on how resources will be allocated among alternative uses. That allocation reflects the desires and constraints facing consumers and producers. Thus it is usually bad for the tax system to distort resource allocation, because that will tend to lead to a below-optimal use of our material bounty. Only

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[8] Stiglitz agrees that a good tax should be politically responsive. See *ibid*., p. 335.

[9] There is considerable evidence that incremental taxation induces new federal spending. See, for example, Richard Vedder, Lowell Gallaway and Christopher Frenze, *Taxes and Deficits: New Evidence*, prepared for Senator William V. Roth and Representative Richard K. Armey of the Joint Economic Committee, October 30, 1991. At some point, higher government spending has negative effects on economic growth. We have explored this in several studies prepared for the Joint Economic Committee. See, also, Richard Vedder and Lowell Gallaway, "The Laffer Curve, Government and Economic Growth," published in the *National Conference on the Innovative Application of the Laffer Curve: Paper and Proceedings* (Chattanooga, TN, 1998), pp. 63-72. For the negative impact of state and local taxation on economic growth, see footnote 1.

where activities have spillover effects – impacting on persons other than the buyers and sellers involved – does it make any sense to distort the way people want resources allocated in a market economy.

Yet we have a highly complex tax code that favors some activities over others. The tax code favors people who have strangers take care of their children rather than close relatives (the child care tax credit). We tax returns to capital resources much higher than returns to labor, leading to a lower level of capital formation than is desirable. We favor real estate investment over investment in machines. All of these things violate the basic principle of neutrality. Moreover, as Browning and Browning put it: "In addition to distorting the way taxpayers receive or spend their incomes, tax preferences may be responsible for other types of welfare costs. A multitude of special tax provisions adds greatly to the complexity of the tax law. This probably increases ...administrative costs..."[10]

These concerns make most tax experts hesitant about most fiscal policies that alter human behavior. Excise taxes are levies on specific items - like telephone service or cigarette smoking. Unless there is a compelling "spillover" argument, most economists would argue against these specific, non-general forms of consumption taxation. Why, for example, tax long distance telephone calls but not tax other forms of long distance communications, such as postal services, fax messages, or e-mail? Similar arguments apply for tax credits. For example, while tax credits to support education sound nice, why should the government subsidize individuals who take courses from a local school, while actually taxing (through sales taxes) those who learn about the world from purchasing serious books to read at home? Why should the federal government tax the consumption of red wine, while it does not tax cola drinks, particularly in light of empirical evidence that suggests that moderate wine drinking is actually beneficial?

Other things equal, a good tax minimizes the negative effects on economic growth – the increase in incomes and output over time. Empirical evidence suggests that taxation in most modern industrialized societies tends to have negative effects on output.[11] Not only do taxes replace private sector with public sector activity, but they typically reduce the overall amount of activity. Yet some taxes seem to have a less inimical impact than others. Care should be taken to try to have a menu of taxes in place that minimizes the loss of income to our children and grandchildren of our fiscal actions.

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[10] Edgar K. Browning and Jacquelene M. Browning, *Public Finance and the Price System*, Third Edition (New York: Macmillan, 1987), p. 354.

[11] See, for example, Eric Engen and Jonathan Skinner, "Fiscal Policy and Economic Growth," NBER Working Paper #4223, December 1992; Reinhard B. Koester and Roger C. Mormedi, "Taxation, Aggregate Activity and Economic Growth: Cross-Country Evidence on Some Supply-Side Hypotheses," *Economic Inquiry*, July 1989, and Paul Cashin, "Government Spending, Taxes, and Economic Growth," *International Monetary Fund Staff Papers*, June 1995.

Equity or Fairness

While virtually everyone agrees that a good tax should be fair, there is far less agreement on *what* is fair. A 20 percent flat rate tax appeals to some people as extremely fair, as everyone is treated equally (except possibly the poor who could be made exempt from taxation). Others believe that fairness means that those with a greater "ability to pay" should face a disproportionate tax burden. Aside from issues of vertical equity (people of differing incomes), there is an issue of horizontal equity – treating people of similar economic circumstance equally. Virtually everyone agrees, for example, that if two persons have roughly the same financial circumstances, but one pays far more tax than the other, than this is unfair.

Vertical equity is a subjective concept, yet there is some evidence supporting the position that many Americans, probably a significant majority, do not favor a tax system that has a "soak the rich" dimension to it. The proportion of Americans believing that government should "be involved in reducing income differences between the rich and the poor" has declined significantly since 1973, and now is less than 30 percent of the population.[12] Twice as large a proportion of Americans think the middle class is being "squeezed" more by the costs of welfare than tax breaks for the rich or business.[13] Polling done over the years indicate that state sales taxes are perceived as fairer – and are more far more popular – than the federal income tax. Moreover, the gap in popularity between sales and income taxes has grown over time.[14] Yet state sales taxes tend to be regressive (taking a large proportion of the pay of lower income groups) or roughly proportional, while the federal income tax is highly progressive - and perceived by many to be highly unfair. In general, the American public seems to support regressive taxes more than progressive ones. The recent heightened interest in a national sales tax or a flat rate federal income tax seems to suggest that no broad consensus exists supporting taxing the affluent proportionally dramatically more than the non-affluent.

As the income tax code becomes more complex, there is a greater probability of creating significant horizontal inequities. Tax credits and deductions lead to lower tax burdens for favored taxpayers than for others. Thus parents are favored over non-parents, although some non-married couples are favored over married ones because of the "marriage tax" implicit in the current tax system. People who buy homes pay lower taxes than those who rent. Other things held equal, the federal government taxes working people who spend considerable amounts on cigarettes or liquor

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[12] Everett Carll Ladd and Karlyn H. Bowman, *Attitudes Towards Economic Inequality* (Washington, D.C.: American Enterprise Institute, 1998), p. 111.

[13] *Ibid.*, p. 101.

[14] "Taking Our Temperature on Taxes," *The American Enterprise*, March/April 1995, p. 102. In 1972, in response to the question "Which do you think is the worst tax - that is, the least fair?," 19 percent said the federal income tax. By 1993, that proportion had risen to 36 percent.

much more than people who splurge on fancy restaurant meals or buy sexual services on the Internet. If you donate three dollars to funding presidential electoral campaigns, you get a tax break, but if you give the three dollars in cash to a homeless person on the street, you pay taxes on that money. You can get a tax break if you pay tuition to a college, but not if you buy an encyclopedia for your child to use. A child credit is available if your son or daughter is 16 years old, but not if he or she is 17. These tax provisions not only promote horizontal inequities, but they violate the principles of tax neutrality discussed above.

Transparency and Accountability

The essence of democracy is having major public policy decisions made after public debate by the people or their representatives. At the state and local level, many jurisdictions require explicit voter approval of any new taxes. "No taxation without representation" was the rallying cry for the American Revolution. State and local sales taxes are typically explicitly added onto prices, making us aware of the tax burden. Property taxes usually require a check to be written, so few are unaware of those costs. Similarly, despite withholding from paychecks, the annual ritual of paying federal and state income taxes makes us aware of those levies.

At the same time, however, the complexities of our federal income tax system have been used on occasion to reduce transparency, leading to policy changes without public discussion or even, in some cases, legislative action. For decades, inflation led to higher nominal incomes for taxpayers, pushing them into higher tax brackets without a congressional vote. Politicians were able to preside over higher tax burdens without explicitly approving the funds – a modern form of taxation without representation that was partly, but not completely, ended with tax indexation incorporated into the Reagan tax cut approved in 1981.

EVALUATING THE CURRENT FEDERAL TAX SYSTEM

How does the present U.S. federal tax system fare according to the criteria above? As Figure 1 shows, more than 92 percent of federal revenues come from either income taxes on individuals and corporations or from payroll taxes for Social Security/Medicare. The United States is unique among the world's industrialized nations in the extent to which it relies on income taxation, as opposed to taxes on consumption. Evaluating the federal tax system largely means assessing its system of income and payroll levies.

High Administrative Costs

By all criteria mentioned above, there are significant problems. Looking at tax administration, the current tax code is enormously complex, with the basic tax code now exceeding thousands of

pages, compared with 16 pages for the original income tax that took effect in 1913. *Money* magazine once asked 50 tax professionals to calculate the income tax liability for a hypothetical moderately prosperous family, and they came up with 50 different results![15] The high-end calculation of an $11,881 tax burden was about 65 percent higher than the low estimate of $7,202. Moreover, that hypothetical taxpayer would have had to pay anywhere from $201 to $2,000 for tax preparation. Not only does this demonstrate the complexity of the code, but it illustrates the substantial horizontal inequities that occur because alternative interpretations of tax law lead people of similar economic circumstance to pay widely differing amounts of tax.

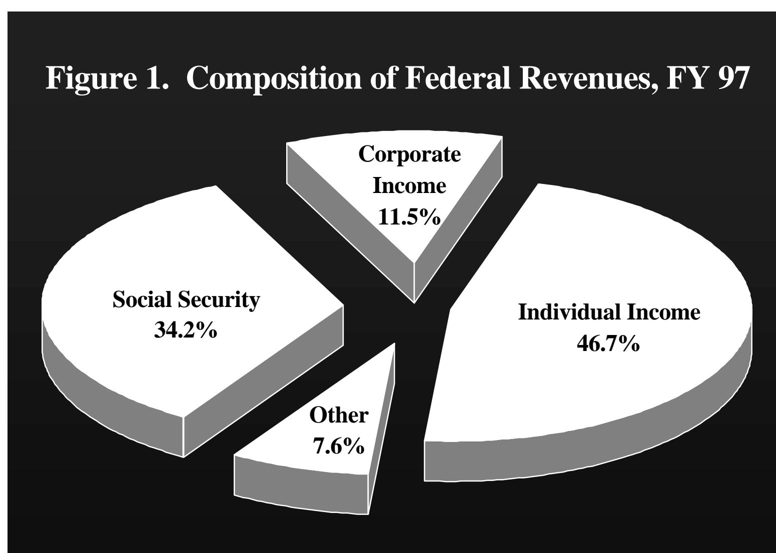

Figure 1. Composition of Federal Revenues, FY 97

One estimate is that three billion hours are spent by citizens and businesses on tax collection – the equivalent of 1,500,000 full time workers.[16] Representative Richard Gephardt estimates these labor costs are much higher.[17] Including the professionals working in tax preparation, tax law, tax administration, etc., the total "tax army" today is far larger than the U.S. Army that defends our nation. This tax army has approximately tripled in size between 1960 and 1995.[18] The Tax Foundation estimated in 1996 that the total costs of federal tax administration was $225 billion.[19] While other tax experts (e.g., Joel Slemrod of the University of Michigan) estimate the costs to be

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[15] "Even Seasoned Pros Are Confused This Year," *Money*, March 1988, pp. 134-43. Subsequent revisions in the tax law have not improved matters. See, for example, "Odds Are, Your Tax Preparer Doesn't Grasp the New Law," *Money,* March 1994, pp. 151-56.

[16] Arthur P. Hall, "Compliance Costs of Alternative Tax Systems II," Tax Foundation *Special Brief*, March 1996.

[17] See Representative Gephardt in "Let's Revamp the Tax Code - but How?," *Wall Street Journal*, April 15, 1998, p. A22.

[18] See Richard Vedder, *State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform*, Joint Economic Committee staff study, December 1995, p. 5.

[19] Arthur P. Hall, Senior Economist, made this estimate in testimony before the Ways and Means Committee of the U.S. House of Representatives on March 20, 1996. Representative Richard Gephardt puts the cost at $300 billion.

lower, by almost any accounting minimally tens of billions of dollars annually could be saved through substantial simplification of the tax code.[20]

In order to appear to maintain existing marginal tax rates, the Federal government in its 1990 and 1993 legislation used extremely complex means of eliminating deductions and exemptions for persons beyond certain income thresholds, effectively raising marginal tax rates. This enormously adds to tax complexity. Similarly, the 1997 move to progressivity in capital gains rates based on the length in which an asset is held has the doubly undesirable impact of reducing tax neutrality and increasing resources necessary to fill out tax forms, even though the overall lowering of capital gains marginal tax rates was highly desirable.

Distorted Resource Allocation and Reduced Economic Growth

America's perversely distorted tax system probably does far more damage to the economic welfare of its citizenry than any of its foreign enemies. The distortions in resources imposed by the tax system are immense, so large that it is impossible to do full justice to them in anything less than a book-length treatise. A few examples, however, will make the point.

While labor income is taxed at varying marginal tax rates up to, effectively, slightly over 40 percent, capital in general is taxed at higher rates. Consider the XYZ Corporation that has pre-tax profits of $300 million. If it is typical, it will pay U.S. federal corporate income taxes of about $100 million. Suppose the remaining $200 million is evenly divided between dividend payments to shareholders and retained earnings used to finance business expansion. The shareholders receiving the $100 million in dividend payments likely will have to pay $30 million or so in individual income taxes - double taxation on the corporate derived income. Ultimately these individuals will pay taxes on capital gains derived from the retained corporate earnings, and their families may have to pay estate taxes. Very likely the present value of these future tax liabilities is at least 30 percent of the $100 million in retained earnings (or $30 million). Thus, the total federal tax liability is $160 million ($100 million in corporate taxes, $30 million in ordinary individual income taxes, and $30 million in capital gains and estate taxes). The government will take 53 percent of the income earned - far higher than the taxes on labor income. Thus, the tax system favors labor resources relative to savings and investment resources, leading to savings and investment deficiencies that are tax induced.

Moreover, the above scenario probably understates the problem. Because of inflation, effective real marginal tax rates on capital gains income sometimes exceed 100 percent. Suppose someone bought XYZ Corp. stock in 1970 for $10,000, and sold that stock in 1997 for $40,000. Since prices

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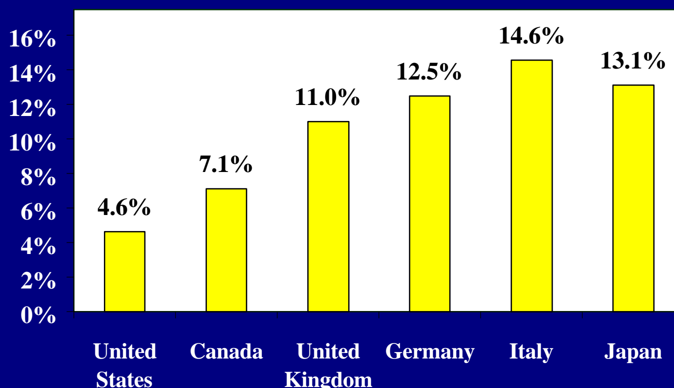
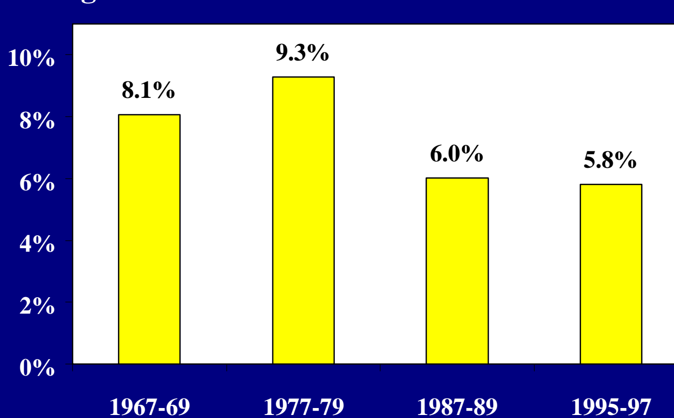
[20] In the early 1980s, Slemrod and Nikki Sorum estimated administrative costs of the income tax system at $35 billion annually, or 7 percent of revenues. That number would be much higher today. See Joel Slemrod and Nikki Sorum, "The Compliance Cost of the U.S. Individual Income Tax System," *National Tax Journal*, December 1984. See also Slemrod's "Optimal Taxation and Optimal Tax Systems," *Journal of Economic Perspectives*, Winter 1990, for a more extended technical discussion of both compliance and other issues in devising an "optimal" tax system.

more than quadrupled from 1970 to 1997, the $40,000 received upon the sale of the stock in 1997 is actually worth less than $10,000 of 1970 purchasing power. In reality, the individual received a small capital loss. Yet under current federal law, the individual would pay a tax of perhaps $5,400 on a totally fictitious capital gain. Thus the tax code is particularly discriminatory against long-term investments. The existence of state and local income taxes typically based on federal definitions of income adds to the problem.

Given the punitive rates of taxation on financial capital in the United States, the incentives to save out of disposable personal income are severely reduced. This is no doubt a key factor in explaining the low rates of personal savings in the United States relative to most other industrialized nations (see Figure 2). Similarly, net investment has declined sharply as a share of total output over time (see Figure 3).





We have a tax code riddled with many deductions and exemptions, requiring marginal tax rates on saving and investment sometimes effectively exceeding 40 percent. There are at least three alternative ways of addressing this problem by moving closer to a consumption-based tax. One alternative would be to expand existing incentives for IRAs and other forms of saving and investment. A second alternative would be to have fewer deductions and exemptions, a wider tax base, and much lower marginal tax rates, perhaps flattened rates as low as 20 percent. The third alternative would be not to tax income at all but have 15-20 percent sales tax rates imposed federally on most consumption expenditures. The adverse economic impact of excessive taxation of saving and investment would be greatly alleviated by each of these approaches.

Moreover, the distortions extend into the area of social values. Consider two 40-year-old couples with two children. In both cases, the couples earn $100,000 annually. In one case, the husband has two jobs so the wife can stay home with the kids. In the second case, the couple is unmarried, with each earning $50,000 a year teaching school. Suppose the married couple owns a modest $100,000 home, and that they have paid off their mortgage. The unmarried couple owns a $175,000 home with a $100,000 mortgage and a second vacation condo worth $100,000 with a $70,000 mortgage. While the two couples have equal earnings, are the same age, have the same number of children, etc., the unmarried big spending couple faces an annual federal income tax liability that is more than $6,000 less than the couple that married, lived conservatively, and got out of debt. The unmarried couple avoids any "marriage penalty," gets a child care tax credit for turning their children over to strangers instead of a family member, and gets huge mortgage tax deductions. The tax law often favors cohabitation to marriage, institutional to family child-care, and indebtedness to parsimony. Is this good social policy?

The plethora of distortions in the tax code suggests that sizable welfare gains can be obtained from tax revisions. In particular, the elimination of the over taxation of capital has had profound negative implications. Nobel Laureate Robert Lucas once estimated that replacing taxation on capital income with higher labor income taxes would lead to increases in consumption of about 1 percent a year, and Cooley and Hansen found even higher potential gains by moving to a pure consumption tax.[21] Numerous other studies show significant welfare gains from major tax reform.[22]

Equity and Fairness

To be sure, sometimes taxes that are economically neutral and have little distortive impact may also appear unfair. The economically most neutral of all taxes is a head tax, a levy of, say, $200 on every person. Increases in income lead to no increase in tax liability, and thus the tax does not distort or reduce productive economic behavior. Yet most persons would agree that it is unfair to charge a poor person the same tax as a rich one - the "ability to pay" is greater for the more affluent person, and the head tax is severely regressive, taking a larger share of the income of the poor than the rich.

Yet the equity issue is far more complicated than simply avoiding severe regressivity in tax burdens. While few would disagree with the proposition that it is appropriate to tax the affluent more

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[21] Robert E. Lucas, "Supply-Side Economics: An Analytical Review," *Oxford Economic Papers*, April 1990, 42, pp. 293-316, and Thomas F. Cooley and Gary D. Hansen, "Tax Distortions in a Neoclassical Monetary Economy," *Journal of Economic Theory*, December 1992, 58, pp. 290-316.

[22] See, for example, Robert G. King and Sergio T. Rebelo, "Public Policy and Economic Growth: Developing Neoclassical Implications," *Journal of Political Economy*, October 1990, Part 2, pp. S126-150; Jeremy Greenwood and Gregory W. Huffman, "Tax Analysis in a Real-Business Cycle Model," *Journal of Monetary Economics*, April 1991, 27, pp. 167-190; V.V. Chari, Lawrence J. Cristiano and Patrick J. Kehoe, "Optimal Fiscal Policy in a Business Cycle Model," *Journal of Political Economy,"* August 1994, pp. 617-652. Looking at the matter from an international (open- economy perspective), Mendoza and Tesar find sizable welfare effects from the taxation of foreign interest income. See Enrique G. Mendoza and Linda L. Tesar, "The International Ramifications of Tax Reforms: Supply-Side Economics in a Global Economy," *American Economic Review*, March 1998, 88, pp. 226-245.

dollars than the poor, it is not clear that they should be taxed a larger proportion of their income. To some people, it is "fair" to treat everyone the same - for example, everyone pays 20 percent of their income in taxes. Adam Smith held this view in his work that established economics as a modern discipline.[23] That principle, in effect, governs our Social Security payroll taxes within a fairly broad range of income.[24] A compromise between strict proportionally and having progressive marginal tax rates occurs when a certain subsistence level income is exempt from taxation, but income beyond that amount is taxed at a flat rate. Under such a scheme, the poor avoid taxation, and the tax as a proportion of income rises with greater affluence, yet the principle of treating all people the same in a marginal sense is maintained.[25]

Fairness is subjectively evaluated, and some people with a strong sense of envy believe it is appropriate to have highly progressive tax rates. Yet highly progressive marginal tax rates pose their own problems, some of them related to equity. High marginal rates retard economic activity and have negative growth effects. Beyond that, however, severe problems of horizontal equity arise with high marginal tax rates. Some persons use either legal tax "loopholes" or engage in illegal tax evasion, leading to widely varying tax liabilities for individuals of similar economic circumstance. Moreover, the American experience of the 1980s shows that sometimes flattening the rate structure actually leads to greater progressivity in tax *payments*.[26] The rich get out of tax shelters and start paying taxes, so the tax base expands rapidly at the upper ends of the income distribution, increasing the proportion of tax payments coming from the relatively affluent.

A strong case can be made that Americans today are primarily concerned about horizontal, not vertical equity. Sales taxation remains relatively popular at the state and local level. Sales taxes seem to treat people in similar economic circumstance roughly equally. Also they tax consumption, from which people derive material satisfaction, rather than income, which includes savings which do not provide material satisfaction in the current time period. The progressive federal income tax is perceived by the public as less fair than these relatively regressive sales taxes. Why? No doubt, because of severe problems of horizontal equity with the existing income tax - with all sorts of

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[23] Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, Book 5, chapter ii, Glasgow Edition (Oxford, Clarendon Press, 1976), p. 825.

[24] Actually, the Social Security payroll taxes are somewhat regressive, as they do not apply at all to income above some maximum amount.

[25] This seems to have been the view of John Stuart Mill, one of the first great economists; most true flat rate income tax proposals adopt this form. Under Mill's scheme, as that in most true modern flat rate income tax proposals, "each would ...pay a fixed proportion, not of his whole means, but of his superfluities." See Mill, *Principles of Political Economy* (New York: Augustus M. Kelley, 1965), p. 806.

[26] The share of total individual income taxes paid by the top 5 percent of income recipients went from 34.9 percent in 1981 (when the top marginal tax rate was 70 percent) to 45.5 percent in 1988 (when the top rate was 28 percent). See Lowell Gallaway and Richard Vedder, "The Distributional Impact of the Eighties: Myth vs. Reality," *Critical Review*, Winter 1993, 7, pp. 61-79. On a similar experience in the 1920s and 1960s, see Christopher Frenze, *The Mellon and Kennedy Tax Cuts: A Review and Analysis,* Joint Economic Committee staff study (Washington, D.C.: Government Printing Office, 1982).

deductions, exemptions and tax credits, persons of similar economic circumstance pay widely differing tax burdens. Indeed, a good case can be made for moving towards a flatter rate income tax with fewer deductions or to a national sales tax on equity grounds. The huge complexity of the tax system adds to the horizontal inequity via tax evasion, a problem that has an annual dimension that probably approximates $200 billion annually.[27]

Another equity issue arises with respect to financing Social Security. Individuals at or near retirement age have earned a reasonable or even very high rate of return on their compulsory tax payments into the Social Security system. Younger Americans, however, are likely to earn a dramatically lower return on their "investment," indeed a rate of return well below what they could earn if empowered to invest their own funds in some form of IRA-type account. One Social Security system estimate suggests the real internal rate of return on Social Security pensions varies from about 2 percent per year to over 30 percent, depending on the year of birth.[28] Perceptions of unfair-ness in the Social Security system already are high among recipients, particularly those in younger age brackets.[29] Intergenerational equity issues will no doubt be an important consideration in any revision of the Social Security system.

Transparency and Accountability

Hidden or stealth tax increases were severely curtailed with the Reagan tax cuts of the early 1980s, and by a reduction in rate progressivity in the 1986 tax reforms. The income tax rate increases of the 1990s, however, have increased the "bracket-creep" problem. While most deductions are indexed for inflation, rising incomes from economic growth automatically push persons into higher marginal tax brackets. Thus, tax rates rise without any explicit contemporaneous congressional and presidential action.

Similarly, the convoluted changes in tax laws in the Bush and early Clinton years in effect raise marginal tax rates on relatively affluent persons, but in a way that is extremely difficult to detect. Thus, the effective top marginal rate is sometimes far higher than what the tax rate tables suggest, as increases in incomes lead to reductions in deductions or exemptions. This type of tax change manages to violate *all* principles of good taxation. Administrative complexity is increased, inequities are created (some people have bigger dependency allowances, etc., than others), tax neutrality is reduced, and the measure violates elementary concepts of tax transparency.

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[27] Slemrod and Bakija estimate the costs at around $150 billion in 1995. See Joel Slemroad and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform* (Cambridge, MA: MIT Press, 1996), p. 148.

[28] See Dean Leimer, "Cohort-Specific Measures of Lifetime Net Social Security Transfers," Working Paper 59, Office of Research and Statistics, Social Security Administration, pp. 84-89.

[29] See Michael Tanner, "Public Opinion and Social Security Privatization," *Social Security Privatization*, August 6, 1996, p. 3.

Perhaps the ultimate transparency problem relates to FICA taxes. Great efforts are made to maintain the illusion that Social Security insurance payments are akin to insurance premiums or forced savings to fund pensions. The reality, of course, is much different, as the Social Security system is a modified pay-as-you-go system, not following the generally accepted actuarial principles of private pension schemes. Social Security payroll taxes are taxes, not premiums in the sense that they go into a specific account for the explicit benefit of the paying individual.[30]

CHANGING THE TAX SYSTEM

Given the problems outlined above, there are strong arguments for making major changes in the existing tax apparatus.[31] A new direction in tax policy would radically reduce the complexity of the existing system, lowering administrative costs and coincidentally reducing the problems of non-neutrality and horizontal inequity endemic with the federal income tax. The resulting new tax system should feature greater uniformity of treatment between different types of income, avoiding the multiple taxation of saving. Indeed, from the standpoint of both tax neutrality/economic growth and from a standpoint of fairness, the basis of taxation perhaps should be shifted from income to consumption. The social engineering encouraged by tax credits designed to promote activities favored by some policy-makers would be curtailed. With respect to social insurance and perhaps Medicare, greater transparency can be obtained by more closely tying payments to individual benefits, perhaps by establishing individual retirement accounts (and possibly medical savings accounts) which receive some or all of the Social Security and/or Medicare contributions of recipients.

A variety of existing or proposed legislative initiatives deal with varying degrees of effectiveness with the problems outlined above. There are sometimes tradeoffs between equity and growth considerations, or between simplicity and fairness. One thing is fairly certain, however. The existing tax code has grown incrementally over time, with little consideration in the aggregate as to how it comports with basic principles of administrative simplicity, economic neutrality, fairness, and transparency. These principles should guide future reform of the tax system.

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[30] However, looking at Social Security from the view of the individual's costs and benefits, the benefits must also be considered.

[31] Gary S. Becker and Casey B. Mulligan, drawing on earlier insights of James Buchanan, argue that an efficient tax system has one distinctly bad characteristic: It will lead to bigger government. As the pain from added taxation is reduced, spending increases. See their comments in "Let's Revamp the Tax Code - but How?," *Wall Street Journal*, April 15, 1998, p. A22.