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Murray L. Weidenbaum
Washington University in St Louis

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Weidenbaum Center on the Economy, Government, and Public Policy — Washington University in St. Louis
Campus Box 1027, St. Louis, MO 63130.

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Murrray Weidenbaum

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Contact:
Robert Batterson
Communications Director
(314) 935-5676

Washington University Campus Box 1208 One Brookings Drive St. Louis, Missouri 63130-4899

Tax Reform: Reconciling Economic Growth and Fairness

by Murray Weidenbaum

The emerging debate on fundamental tax reform in the United States is focused too narrowly. The key disagreement now is on promoting economic growth versus maintaining fairness via a progressive tax structure. Indeed, most of the reform proposals which have gained attention eliminate the progressivity which has been a long-term hallmark of the federal income tax system. As I will show in this paper, it is possible to achieve both objectives while making basic improvements in the federal revenue structure.

Shortcomings of Popular Proposals

The most radical reform proposal is to eliminate the federal income tax and replace it with a transactions-based consumption tax, notably a national retail sales tax or a value-added tax (VAT). Either of those two consumption taxes would lift the present heavy tax on saving and would create a powerful incentive to invest and thus spur economic growth. In the process, the burden of preparing the returns would be eliminated for most individual taxpayers (but not for business). However, the resultant tax structure would be regressive, with lower-income people paying to Uncle Sam a higher percentage of their incomes than higher-income taxpayers.

In contrast, the proposed flat tax would not be quite as extreme, as it would simplify rather than eliminate federal income taxes. It, too, would constitute a strong economic incentive by reducing the tax burden on the high-saving groups of our society. However, it

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Murray Weidenbaum is Mallinckrodt Distinguished University Professor and Chairman of the Center for the Study of American Business at Washington University in St. Louis. This paper was presented to the annual meeting of the American Economic Association in San Francisco, California on January 6, 1996.

also would move much closer to a proportional tax structure — where all taxpayers pay the same percentage of their income — than the United States has experienced in modern times.

When we examine each of these proposals in more detail, however, none of them is as simple as it looks. By eliminating withholding, the flat tax imposes a monthly return requirement on every taxpayer. The prospect of the Internal Revenue System having to process and audit tens of millions of monthly "postcard" returns — each with a check attached — is staggering. As for the postcard, the taxpayer will have to place it in an envelope in order to mail the check accompanying it — aside from any privacy considerations.

As for sales and value-added taxes, most of the proponents would soften their regressive nature by means which entail new complexity. Providing a refund, for example, means that many millions of low-income taxpayers would still have to file returns reporting their incomes and tax payments. The alternative of exempting food, medicine, etc., or levying lower rates on selected categories of purchases, is a very rough and not fully satisfactory method of maintaining progressivity in the revenue system.

A third approach is to provide an automatic refund of a fixed amount to each taxpayer. That, too, would require a bureau of the federal government to maintain an up-to-date roster of names and addresses and to mail out the refunds. In addition, a mechanism would still be required to collect the social security and medicare payroll taxes. In any event, the longevity of the Internal Revenue Service seems assured, whatever the title is given to that bureau.

A Fourth Alternative

There is a fourth alternative for comprehensive tax reform which would simultaneously provide a strong growth incentive, reduce the complexity of the Internal Revenue Code, and maintain fairness by keeping the progressive nature of the federal individual income tax. Like

the other three tax reform proposals, it would maintain "revenue neutrality" — generating the same flow of revenue to the Treasury that would be provided by the current federal income tax system.

How do we achieve all these good things? Not by tinkering with the details of the Internal Revenue Code. Instead, we must overhaul the present federal income tax so that it exempts savings, which is the seedcorn for economic expansion, but retains a progressive rate structure. Such a departure would not constitute a new tax, but it would be a sea change in the existing income tax structure insofar as the tax base would in effect shift from income to consumption. This fourth approach to fundamental tax reform has been introduced by Senators Sam Nunn and Pete Domenici as the USA Tax.

The Nunn-Domenici USA Tax Plan consists of two parts: a revised individual income tax and a new business tax. The latter replaces the existing corporate tax as well as the individual tax treatment of unincorporated businesses. The combined structure is designed to be "revenue neutral" in that it raises the same amount of revenue as the existing tax system. This is so, at least initially, in its static form. In a dynamic sense, the future revenue flow is likely to be higher than that generated by the current tax law because of the positive effects on the economy (the same is true for the other three reform proposals).

The Tax on Individuals and Families

The USA individual income tax is a progressive tax with an unlimited deduction for saving. The term USA refers to this latter feature as an "Unlimited Savings Allowance." Progressivity is achieved through a progressive rate table. Simplicity is attained by eliminating a great variety of special treatments of transactions and taxpayers.

In contrast to the current individual income tax, the USA version possesses the following characteristics:

- It permits a full and unlimited deferral on the portion of income that is saved, regardless of the form or amount of saving. The tax is paid only when the principal and earnings are withdrawn from savings and devoted to consumption.

- It treats all spent income equally for tax purposes. No distinction is drawn on the source of income.

- It allows wage earners a full credit for the entire payroll tax (the employee portion of the social security and medicare taxes).

- It exempts from taxation the consumption out of previously taxed savings because these funds have already been included in taxable income. Thus, a retiree who is drawing down savings accumulated prior to the USA Tax Plan can draw down and live on that savings tax free.

The Tax on Businesses

In the Nunn-Domenici USA Tax Plan, all businesses, whether incorporated or not, are taxed at the same flat rate of 11 percent on their annual gross profit. There is no tax advantage from shifting to or from the corporate form. Immediately expensing all investments in capital equipment is a tremendous simplification. It also encourages investment in durable business assets. Coupled with the new saving incentive contained in the individual income tax, the result is a substantial boost to the entire capital formation process.

Financial transactions are excluded from the calculation of gross profits. The business' tax return neither includes interest and dividends received nor deducts interest and dividends

paid. Furthermore, compensation of employees is not deductible from sales revenues. However, a credit is allowed for the employer FICA payroll tax on the wages paid to employees.

This new type of cash-flow tax is similar to a VAT because both use a tax base of sales minus purchases. However, the business cash-flow tax lacks the administrative complexities of a VAT, which requires firms to track on an invoice-to-invoice basis the amount of tax attributable to each transaction.

The Nunn-Domenici plan drastically simplifies current business tax procedures. Firms will devote fewer resources to complying with tax regulations (and to devising creative methods to minimize their tax burden), and more resources to productivity increasing investment.

Encouraging Saving and Investment

A major objective of the Nunn-Domenici USA Tax is to reduce the tax burden on saving and investment. The intent is to encourage a higher rate of capital formation and thus lead to a more rapidly growing economy. In addition, all consumption-based taxes have a different rationale than the status quo. They put the fiscal burden on what people take from society — the goods and services they consume — rather than on what they contribute by working and saving, as do income taxes. Over a period of time, society is likely to achieve higher levels of both saving and consumption because the added investment, by generating a faster growing economy, will lead to a bigger income "pie" to be divided among the various participants in economic activity.

This argument becomes more compelling when we examine the historical record. The data show that the United States consistently devotes a smaller fraction of its national output to saving and investment than do the other major industrial nations. In addition, the correlation

between the investment share of gross domestic product and the growth rate of national economies is striking and positive for the major industrialized economies over the last three decades.

A faster rate of economic growth also generates two favorable budgetary consequences. First, it enlarges the tax base without any change in the tax ground rules. This creates a faster flow of revenue into the Treasury, reducing the government's need to borrow. Likewise, a stronger economy means lower payments for unemployment benefits, welfare, and other transfer payments. This process is the most painless way of bringing down high budget deficits.

Promoting Simplification

We may never again achieve the level of simplicity offered by the original 1913 income tax. Its 1040 form was three pages long and accompanied by one page of instructions. It was filed by only 1 percent of the population. In this spirit, the Nunn-Domenici plan eliminates over 60 percent of the current income tax provisions in the Internal Revenue Code. The resultant simplification of the federal tax system would be evident in many ways. The several thousands of pages of the tax code would be reduced to approximately three hundred.

By making saving generally deductible from gross income, there is no need for the paperwork and other transaction costs now required to establish and maintain IRAs, Keoghs, and other "tax-favored" accounts. Nor need the taxpayer be concerned with staying within the arbitrary limits now required under these specialized savings incentives. Moreover, consumption-type taxes do not require complicated corrections for inflation because the tax base is inherently based on current cash flows.

Similarly, by expensing all real investment, the taxpayer no longer has to estimate the useful life of assets nor choose from an array of complicated depreciation systems. There is little incentive to fuss with the conversion of ordinary income into capital gains, because only the income actually consumed winds up in the tax base. Tax is deferred on capital gains, dividends, interest, and other forms of income as long as they remain in the pool of savings.

Because all businesses — whether incorporated or not — are subject to one and the same tax system, there is no longer any incentive to go through the expense and bother of repeatedly changing the legal form of the enterprise merely to take advantage of shifting differentials between individual and corporate income taxes.

Likewise, because interest and dividends are subject to the same tax treatment, there is no longer any tax incentive to leverage a company's financial structure or to convert dividend payments into interest payments. The result will not be an end to the current merger and acquisition boom. Rather, business decisionmakers will make such choices on the basis of underlying economic advantage rather than responding to tax considerations.

In one key aspect, the Nunn-Domenici Plan is deliberately more complicated than any of the alternatives: the designers of the plan have thought through and deal with the many painful transitional effects that arise as we move from an established revenue system to a new one. Thus, people who made financial commitments based on the old tax system will not find that a new set of ground rules is suddenly being applied to them.

Maintaining Fairness

The fairness of a tax system, like beauty, is mainly in the eye of the beholder. Economists view the subject in terms of horizontal equity and vertical equity. Horizontal

equity is our jargon for "equal treatment of equals." The idea is that taxpayers with similar incomes should generally pay the same tax.

The Nunn-Domenici USA Tax Plan moves to greater horizontal equity in many ways. For individual and family taxpayers, virtually all types of income are treated the same. Likewise, virtually all forms of saving face identical rules. This is even more apparent in the case of businesses, where all enterprises — corporations, partnerships, and individual proprietorships — become subject to a single tax system. Likewise, virtually all capital investment is treated equally, as is the return on financial investment (e.g., interest versus dividends).

As for vertical equity, a progressive rate structure is usually — but not universally — chosen as the appropriate way to achieve this aspect of fairness. Some esoteric assumptions underlie the proposition that it is fair for taxpayers with higher incomes to pay a higher *percentage* of their income than do those with lower incomes. A considerable literature is devoted to such questions as the diminishing marginal utility of income as the individual ascends the income scale and the difficulties in making interpersonal utility comparisons.

Quite a few public finance specialists, however, believe that the case for a progressive income tax structure is questionable or "uneasy." That line of reasoning supports a proportional tax system, whereby the government assesses all taxpayers the same percentage of their income. In contrast, there is no professional support for the adoption of a regressive tax structure — whereby the upper brackets pay a smaller percentage than the lower brackets. If the case for progressive taxation is "uneasy," surely the case against regressive taxation remains "easy."

As for the Nunn-Domenici proposals, the rate structure is clearly progressive. The USA Tax Plan contains three statutory rates — 19 percent, 27 percent, and 40 percent.

Because of the full credit given for the social security and medicare taxes, the net effective rates are really 11 percent, 19 percent, and 32 percent.

Conclusion

Among the different approaches to fundamental tax reform currently under consideration, the Nunn-Domenici USA Tax is the only one that provides a favorable combination of simplification, economic incentive, and fairness. The flat tax proposal introduced by Congressman Dick Armey provides a greater degree of simplification at the expense of some loss of fairness, as measured by progressivity.

In their fundamentals, the USA and flat taxes are closely related because both build on the traditional revenue system. Both soften the progressive nature of the federal income tax, promote capital formation and economic growth, and move toward simplification of the tax system. In contrast, value-added and sales taxes, by substituting a new tax, produce a new array of problems, ranging from generating new paperwork requirements to imposing a regressive tax structure.

In any event, none of the four reform alternatives is likely to be enacted, at least in the short run. It usually takes several years for a comprehensive tax-reform effort to go through the lengthy process of separate congressional hearings in the House of Representatives and the Senate, separate committee markups of the bill, reconciling the House and Senate versions, and surviving a possible presidential veto. During that extended period, the two tax writing committees typically make major modifications by adding numerous provisions reflecting their own experienced views of what is desirable tax legislation.

What is likely to emerge is a "Chinese menu" approach (some from Column A and some from Column B). A combination of key features of the flat tax and the USA tax might be

the most reasonable possibility for ultimate enactment. Such compromise legislation would have four major characteristics:

1. Encouragement to economic growth by exempting saving and expensing investment.

2. A flatter structure of tax rates, but one that is still progressive.

3. Retention of a few itemized deductions, such as charitable contributions and interest on home mortgages.

4. Several transition provisions to avoid large windfall losses, especially to avoid double taxation of income already taxed.

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