Ten Facts about Fundamental Tax Reform

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The older I get, the less time I seem to have to read, or to pay attention to anything at great length. I presume, or hope, that this is because I am busy, not on account of any biological decline. In any event, I have learned since my first days of talking about tax reform to try to keep things short and simple, especially in such a complex field.

Fundamental tax reform, the subject matter of these hearings, is a topic near and dear to my heart. What follows is my attempt to distil decades of critical reflection into ten easy to digest truths.

1. **Fundamental tax reform is needed.**

I hold this truth to be self-evident: The current tax system is a disgrace. It is too complicated, too inefficient, too unfair. Its unpopularity, itself a problem, is fully warranted. Among the many deficiencies of the status quo, its very complexity and the lack of transparency in its principles holds tax hostage to the whims of politicians and the fads of academics.

2. **Simplification can only occur with fundamental tax reform.**

I hold this truth too to be self-evident, or at least abundantly clear after too many decades of incrementalism. The current tax system is flawed at its root. Federal tax policy is an incoherent and inconsistent mixture of conflicting policy elements, effected through a confusing mixture of income, payroll, corporate income, and gift and estate taxes. It is hard to see any forest through the weeds and shrubs. If we are to obtain simplification—and any hope for political accountability and economic stability in tax can only come with simplification—we must revisit first principles, and create a consistently principled tax system.

3. **Fundamental tax reform is possible.**

It is easy to lose hope for a better future and thus to cling to a hopeless present. Many followers of tax policy draw a despairing lesson from the epochal Tax Reform Act of 1986. At the time, this Act, which broadened the income tax base and lowered its rates, seemed the last best hope for some semblance of sanity in tax on earth (Birnbaum and Murray 1987). Less than two decades later, the tax system is as complicated as ever. (McCaffery 1999). Perhaps fundamental tax reform, like federal budget surpluses, are doomed not to persist.

But this is the wrong lesson to be learned. The 1986 Act chose one of two routes for tax reform laid out in the classic Treasury study, *Blueprints for Tax Reform* (Bradford et. al., 1984)—namely that of "perfecting" the income tax by broadening its base and lowering its rate structure.

Sophisticated foresight would have shown then what hindsight has since proven: This was the wrong means to take, not a wrong end to pursue.

4. **Fundamental tax reform must center on the tax base.**

It is easy enough to get blinded by the rates when thinking about tax. But one way or another, total taxes in America are going to be fairly close to one-third of GDP, on average, because this is what government spending (at all levels) is. Truly fundamental tax reform—any tax reform that has any chance of effecting permanent gains in equity, simplicity, efficiency and accountability—must take on the question of the tax base, or the "what" of taxes. And here we must come to see that the current system is an incoherent mishmash of conflicting bases.

5. **The tax base is logically distinct from its rates.**

The simplest analytic truths can get lost in the fog of tax.

Reduced to its essence, any tax consists of the product of a base (what is being taxed) times a rate structure (how much it is being taxed). There ought to be, as I shall continue to argue below, broad and bipartisan consensus on the base question. Yet confusion over the analytics has impaired reasonable compromise.

Liberals miss the point that redistribution can be effected under any base by choosing an appropriate rate structure.

Conservatives for their part deserve their part of the blame for the intellectual stalemate, by continuing to link flat rates and a consumption base.

Finally, academics, by lumping all consumption taxes together, have not served the public discourse.

If we set aside disputes over the appropriate rate structure, and focus instead on the base question under at least moderately progressive rates, as we have had for nearly a century now, we can at last being to see fundamental tax reform in a new and better light.

6. **Fundamental tax reform must begin with the elimination of all direct taxes on capital, meaning a move to a consistent consumption base.**

Now we start getting to the heart of the matter.

An income tax, under the so-called Haig-Simons definition of income, is supposed to tax all consumption plus all savings, the two all-encompassing and mutually exclusives uses of "income" (McCaffery 2002). John Stuart Mill pointed out in the mid 19th Century that this leads an income tax to be a "double tax" on savings; Professor William Andrews of Harvard Law School observed in 1974 that the worst problems with the so-called income tax came in its commitment to taxing savings (Mill, 1848; Andrews, 1974).

Consider again the choices confronting policymakers at the time of the Tax Reform Act of 1986. The path chosen, as noted above, was that of "perfecting" the income tax. It failed, both because it did not really perfect the income tax (McCaffery 2003), and because no one really wanted it to do so, in any event.

The other path laid out in *Blueprints* was to abandon the attempt to have an income tax altogether and move instead to a consistent consumption tax. This is the right path to take. It means eliminating all attempts to tax savings directly under the income tax—having unlimited savings accounts, no capital gains taxes, no tax-law concept of "basis." It also means eliminating the adjutants or "backstops" to the income tax's porous and flawed commitment to taxing capital, namely the corporate income and gift and estate taxes (McCaffery, 2003). But it does *not* mean giving up the claims for fairness in tax, or the attempt to tax the yield to capital in the hands of the socially fortunate.

7. **All consumption taxes are not created equal.**

Now here is a point where the academy has led policy-makers astray.

There are two broad forms of consumption taxes.

In one model, the tax is imposed up-front, and never again: a wage tax, like social security, or so-called pre-paid or yield-exempt consumption tax. "Roth" IRA's work on this model (pay tax now, never again).

The second form of consumption tax imposes its single tax on the back-end: this is a sales tax, a postpaid, cash-flow or "qualified account model" consumption tax. Traditional IRAs work this way (no tax now, only later).

Now under flat or constant tax rates, the two principal forms of a consumption tax are equal. Both taxes are single taxes on individual flows of wealth.

But this equivalence does not hold under non-constant, or progressive rates.

8. **A consistent, progressive, postpaid consumption tax is a tax on the yield to capital, under just the circumstances in which it is fair and appropriate to tax such yield.**

The simple analytic truths lead to a different understanding of the traditional choices of tax policy, as I have been attempting to explain in my academic work (McCaffery, 2003). Better understanding points the way out of the current morass of tax policy politics, and towards a grand compromise.

Consider where the debate stands.

For some time now, conservatives have been clamoring for a flat consumption tax. Flat consumption taxes of all sorts are broadly equivalent—none effectively tax the yield to capital under any conditions. And so the choice among a Hall-Rabushka style flat wage tax, a national sales tax, or a value-added tax (VAT) is largely one of administrative convenience (Slemrod & Bakija, 2000).

Liberals for their part are opposed to any such tax, both because of its flat rate, and because of the thought that a consumption tax ignores the yield to capital altogether, and such yield is the domain of the socially fortunate. So liberals insist on maintaining, even strengthening, a progressive income tax, with its corollaries, the gift and estate and corporate income taxes.

But once we assume that we are going to have at least some progression in the rate structure, the traditional understanding of consumption taxes is no longer accurate. The two forms of consumption taxes, prepaid and postpaid, differ under progressive rates. Now there are three—not two—alternatives. The differences come in when the tax falls, and how this impacts choices of work, savings, education, and so on.

One, an income tax falls on all labor market earnings and savings, at the time they come into a household. Savers are hurt by the "double taxation" of savings, whatever the intended or actual use of the savings; and individuals, like the highly educated, who see their earnings come in relatively short concentrated bunches are hurt by the timing of the imposition of progressive rates.

Two, a prepaid consumption tax falls on labor market earnings alone, again at the time they come into a household. Once more, people whose earnings profiles are uneven throughout their lifetimes are hurt by the progressive rate structure. But those who live off the yield to capital are never taxed.

Three, a post-paid consumption tax does not come due at the time of initial inflows, but rather at the time of outflows, when money is spent in consumption. This means that a progressive postpaid consumption tax stands between an income tax, which double taxes all savings, and a prepaid consumption tax, which ignores all savings. A consistently progressive postpaid consumption tax treats savings differently depending on its use.

We can think of two broad uses of savings. One is to *smooth* out consumption profiles, within lifetimes or across individuals—to translate uneven labor market earnings into smooth consumption flows. We do this by borrowing in our youth, and saving for retirement in midlife. A second use of savings is to *shift* consumption profiles, up or down. This occurs when the fruits of our own or another's savings allow us to live a "better" lifestyle, or when beneficence of bad fortune means that we will live at a lower lifestyle than we otherwise could.

Once again, whereas an ideal income tax double taxes all savings, whatever their use, and a prepaid consumption tax ignores all savings, again whatever the use, a consistent progressive postpaid consumption tax splits the difference, but in a principled way, and by design. It allows taxpayers to lower their taxes by smoothing, but it does fall on the yield to capital when such yield is used to enhance lifestyles. This reflects simple, commonsensical attitudes about life, income, and savings. It can lead to a dramatically simpler tax system that is at the same time far fairer.

Consider for example the role of a separate freestanding gift and estate tax system within this construct. The current system aims to "backstop" the income tax, which is supposed to burden savings, by levying a hefty tax on those decedents who die with large estates.

This tax is obviously desired as a matter of fairness. But its very existence encourages the rich to consume more, and die broke, whether the spending is on themselves or their heirs. In contrast, a consistent progressive postpaid consumption tax never taxes savings directly. Saved assets have a zero basis. These can be passed on to heirs on life or at death, without the moment of transfer triggering tax. On the other hand, the *spending* by the heirs will generate tax, and under the progressive rate structure. A consistent progressive postpaid consumption tax does not need, in principle, a separate gift and estate tax, because the very design of the tax entails an accessions or inheritance tax.

A similar argument can be made against a separate corporate income tax. Such a tax either falls on workers and consumers, or on capital generally. But to the enxtent it falls on capital, it does not do so in any *individuated* way. Savers bear the burden of the corporate income tax whether they are rich or poor, saving for lifetime needs or emergencies or to support a high-end lifestyle.

9. **Actual tax policy is headed towards a flat prepaid consumption tax.**

In fact, however, when we observe the status quo, we see a slow but steady movement towards a flat or flattened *prepaid* consumption tax. Second taxes on capital have long been fairly easily avoided (McCaffery 2000). Recent legal changes, such as the lowering of the capital gains rate and the exclusion of corporate dividends from income, and proposals, such as those for unlimited Roth-style IRAs, continue and confirm the trend.

10. **Implementation of a consistent, progressive, postpaid consumption tax is practical, and the case for it is compelling.**

Academics tend to be idealists who get nothing done. These traits are reflected in the endless discussions over transitions from an ideal income to a consumption tax. But we do not have, and have never had, an ideal income tax. The current tax is so far on the path towards a consumption one that transition concerns should not deter the movement towards principled consistency.

There are two broad ways to implement a consistent, progressive, postpaid consumption tax.

One is to keep the basic income tax system in place, but repeal the limits on savings accounts: adopting unlimited IRA or savings account treatment, as in the Nunn-Domenici USA tax plan.

Two is to take advantage of the analytic equivalence of sales taxes and postpaid consumption ones, and replace the income tax with a three-part plan, consisting of :

- A national sales or value-added tax at a modest, sustainable rate, say 10 to 15 percent;

- A system of rebates to effect a "zero bracket" under the national sales tax, say $500 per person, which would offset $5,000 of taxable consumption (at the 10 percent rate);

- A supplemental "consumed income tax" for the wealthiest Americans, modeled along the lines of the existing income tax with unlimited deductions for savings. This tax could apply to households consuming say $80,000 a year or more, and would back out the national sales tax rate.

The net result of this three-step plan would be to have a zero bracket of $20,000 for a family of four; followed by a 10 or 15 percent bracket extending to $80,000; followed by 20 or 30 percent brackets, and so on, but effected by a consumed income tax with rates starting in again at 10 or 15 percent.

Now a simple fact of the matter is that the two broad choices lead to the same place: a consistent, progressive, postpaid consumption tax (McCaffery 2002).

Under either means for getting to a consistent postpaid consumption tax, and consistent with the principled basis of such a tax, we could and should repeal:

- All capital gains taxes under the income tax;
- All rules for "basis" of investment assets;

- All rules about maximum contributions to and minimum distributions from the savings accounts;
- The corporate income tax; and the
- Gift and estate tax.

Taxes would, at last, rest on a simple and consistent principle: tax people when they spend, not when they work or save. Simplicity, transparency, and efficiency would be enhanced; fairness would not be abandoned. Such a tax system would apply to the yield to capital, when but only when it is appropriate to do so. The rich would not be let off the social hook; their tax would come due when, as, and if they spent wealth on themselves. Progressivity could be maintained, even strengthened.

Here, at last, would be something fundamental, to get us off the treadmill of incrementally increasing complexity.

We should do it. It is high time to stop the insanity of tax today.

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