TESTIMONY OF

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BEFORE

THE COMMITTEE ON FINANCE
UNITED STATES SENATE

SEPTEMBER 28, 1982

Federal budget projections indicate that large deficits are in store for at least the next several years. To reduce these deficits, tax increases as well as spending cuts must be considered. Raising income or payroll tax rates would narrow the deficit, but at the same time would slow the economy and decrease economic incentives. What is needed, therefore, is a tax alternative that would encourage -- or at least not inhibit -- work, saving, and investment; that would increase capital formation, economic growth, and productivity; and that would reduce tax-induced misallocations of resources.

Two alternatives courses to explore are:

- o Broadening the base of the income tax to allow lower rates (or perhaps only a single low rate); and
- o Replacing the income tax with a broad-based expenditure tax.

A BROAD-BASED LOW-RATE INCOME TAX

The individual income tax is widely believed to be unfair, a drag on efficiency, and overly complex. Many Americans perceive that the wealthy have access to hidden and arcane legal provisions that permit them to pay little tax or none at all. Economists argue that this same tangle of legal provisions hinders economic efficiency by diverting resources from the activities with the greatest pre-tax yields into less profitable but tax-favored enterprises. And almost every taxpayer feels overwhelmed by the mass of forms and instructions he confronts every April.

Broadening the tax base is a widely discussed policy option because it would not only raise badly needed revenue, but also make the tax system simpler, fairer, and more efficient. Many of the preferential provisions in the tax law require more and longer tax forms, and add pages to the instructions that every taxpayer must wade through, whether he uses the preferences or not. Most taxpayers are left with a sense of favoritism and unfairness. And with so many preferences in the law, it is not surprising that some taxpayers use them, either individually or in combination, to reduce their tax liability. Repealing some or all of these preferences would cut back on this complexity and perceived unfairness.

Perhaps the greatest advantage of broadening the tax base, though, is that it would make it possible to raise additional tax revenue with less cost in inefficiently allocated resources. Many tax preferences in the law today induce taxpayers to invest differently from how they would in an entirely free market. For example, the tax system favors mineral extraction through depletion allowances, selective capital gains preferences, and expensing of intangible costs of even successful long-term development operations. It favors foreign operations and export activities through deferral of tax, and it exempts part of foreign salaries. It allows deductions to be accelerated and income to be postponed for certain projects. These examples are indicative of the efficiency price the economy pays for such tax subsidies, and the $273 billion total of tax expenditures in fiscal 1983 suggests that the influence of the tax system on resource allocation is by no means small.

Scaling back some tax expenditures, as this committee did in the Tax Equity and Fiscal Responsibility Act of 1982, pushes the tax system toward greater neutrality and a more market-responsive allocation of resources. Further base broadening could allow general tax rate reductions without loss of revenue. These general rate reductions can partly compensate those taxpayers whose preferences have been repealed, whereas a more limited base broadening would not provide the revenue for any compensating rate cuts. Further, lower tax rates yield their own efficiency benefits.

Lower tax rates increase the incentive to work, save, and invest, and they decrease the incentive to borrow. They therefore push in the right direction relative to the economy's need for greater productivity and capital formation, though the improvement that can be attained in these areas through the tax system alone should not be overestimated. At the same time, lower tax rates have numerous technical benefits. Distortions caused by the tax treatment of interest and debt during inflation, the double taxation of corporate-source income, the incentive to make use of tax shelter schemes, the marriage penalty, and the incentive to conceal income in the so-called "underground economy" would all be at least partly corrected if tax rates were lower and the rate schedule correspondingly flatter. The misallocation and waste of resources from attempts to profit from the tax code would likewise be cut back. Thus, the payoff from reduced tax rates can be far reaching.

How Much Broader Should the Tax Base Be? The theoretical efficiency benefits of having the broadest possible tax base must be weighed against some practical difficulties. First and foremost is that taxpayers have been making tax-preferred investments for years in anticipation of the continuation of those preferences. Millions of middle-income families have contractual mortgage obligations built into their household budgets; repeal of their mortgage interest and property tax deductions might squeeze many of those budgets to the breaking point. Homeowners' long-term contracts greatly reduce their flexibility to respond to a sudden and comprehensive broadening of the tax base. Further, repeal of the tax preferences might shrink the market values of homes so far as to eliminate the sales of homes as a potential solution to the family budget squeeze.

The charitable contributions deduction is another question to consider in the context of base broadening. Repeal of this deduction would eliminate the tax incentive for giving to finance many socially beneficial activities. Adjustment could be extremely difficult for the many educational, medical, artistic, and religious institutions now dependent on charitable giving.

Another potential limitation to base broadening is complication in the tax code. Though many tax preferences complicate the tax code, some types of income are excused from the tax because taxing them would be complicated. Non-wage employee benefits are an example. Costs of group life and health insurance coverage would have to be assigned to individual employees, which would be quite complex, particularly in instances when the employers self-insure. If pension contributions were also added to the tax base, even more difficult valuation problems would arise in the equal treatment of defined contribution and defined benefit plans. Many other base broadening steps would entail such difficulties.

How Flat Should the Tax Rates Be? Either lower graduated rates or a single flat rate could be used with a broader tax base. A flat rate tax would have some limited simplicity advantages over a tax with the same base and low graduated rates. The single rate would eliminate the incentive artificially to move taxable income from high-bracket to low-bracket taxpayers, or to postpone receipt of income to years when the taxpayer is in an unusually low tax bracket. Bracket creep could be eliminated (if any zero-rate bracket is indexed), and the marriage penalty could be reduced. Of course, simply lowering the graduated rates would at least reduce all of these problems.

But the most important effect of the flat rate tax would be a significant shift of the tax burden from upper- to middle-income taxpayers (and possibly even lower-income taxpayers, if larger personal exemptions and zero-bracket amounts were not provided). The attached table demonstrates this redistribution for four alternative flat rate tax systems. The largest group of losers would be the same middle-income families who might lose their homeowner deductions under a comprehensive broadening of the tax base.

To sum up, the broad-base, low-rate income tax has the potential to provide badly needed tax revenue with a minimum loss -- or perhaps even a gain -- of economic efficiency. It therefore clearly deserves a very serious examination. Equally clear is the fact that a blanket broadening of the tax base or a complete flattening of the tax rates would involve significant transition costs and a shift of the tax burden from upper- to middle-income taxpayers. Tax incentives such as the mortgage interest and charitable contributions deductions are widely used and deeply embedded in our economy, and they could be eliminated only at substantial costs in dislocation. Selectively maintaining all or some portion of such tax incentives could make the transition easier. Similarly, a flat tax rate would impose a larger tax burden on middle-income groups. Low but graduated tax rates could prevent such a redistribution.

Indexing the Tax Base. Some provisions now in the tax law, such as the exclusions of certain forms of retirement savings and part of long-term capital gains, are justified in part as compensation for inflation. If such provisions were repealed

TABLE 1. DISTRIBUTION OF TAX LIABILITIES UNDER ALTERNATIVE FLAT RATE TAX SYSTEMS COMPARED TO 1984 TAX LAW[a] AT 1981 INCOME LEVELS

			System 1 (11.8 percent tax on adjusted gross income with long-term capital gains included in full)			System 2 (19.5 percent tax on 1984 law taxable income less zero bracket amount)			System 3 (15.7 percent tax on 1984 law taxable income less zero bracket amount, with long-term capital gains included in full, and no itemized deductions)			System 4 (18.7 percent tax on taxable income as in System 3 with $1,500 personal exemption and $3,000 ($6,000) zero bracket amount for single (joint) returns)		
Expanded Income (thousands)	Number of Taxable Returns (thousands)	Tax Liability 1984 Law (millions)	Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)	Liability (millions)	Change (Percent)	Per Return)	Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)	Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)
< 5	6,482	403	5,479	1,259.5	783.07	1,574	290.7	180.71	2,232	453.7	282.10	1,996	395.2	245.71
5- 10	15,057	5,772	14,280	147.4	565.04	8,752	51.6	197.91	7,854	36.1	138.26	5,345	-7.4	-28.33
10- 15	13,092	12,526	19,700	57.3	547.99	17,610	40.6	388.31	15,720	25.5	243.97	12,698	1.4	13.11
15- 20	10,737	17,462	22,496	28.8	468.88	22,665	30.0	484.54	20,778	19.0	308.88	18,802	7.7	124.76
20- 30	16,800	44,080	49,701	12.8	334.58	52,871	19.9	523.28	49,978	13.4	351.06	48,170	9.3	243.45
30- 50	13,568	63,833	60,579	-5.1	-239.82	66,419	4.1	190.61	66,466	4.1	194.08	68,804	7.8	366.41
50-100	3,580	38,687	27,389	-29.2	-3,155.74	30,486	-21.2	-2,290.90	32,658	-15.6	-1,684.20	36,104	-6.7	-721.60
100-200	631	18,656	9,872	-47.1	-13,920.58	10,743	-42.4	-12,540.20	12,459	-33.2	-9,821.59	14,344	-23.1	-6,833.56
200 <	164	16,385	7,675	-53.2	-53,107.15	7,129	-56.5	-56,438.05	10,050	-38.7	-38,630.67	11,843	-27.7	-27,692.33
Total	80,110	217,803	217,172	-0.3	-7.87	218,249	0.2	5.57	218,194	0.2	4.88	218,106	0.1	3.78

SOURCE: Joint Committee on Taxation.

a. To facilitate comparison, 1984 law does not include the earned income credit, the two-earner couple deduction, or the IRA or Keogh provisions. The flat rate tax systems similarly do not include those provisions.

b. Outcomes under the flat-rate tax for tax returns of under $5,000 of income would be highly uncertain. Some taxpayers at that income level currently make use of tax preferences that would be terminated under the flat-rate tax, and those taxpayers would thus face substantial tax increases. A particular problem would arise under System 1, in which all income would be subject to tax without exemption or deduction; many households with very low incomes who are excused from filing tax returns under the 1984 law are therefore not represented in the table, but would have to file returns and pay taxes under System 1. The impact of this factor on the table would likely be small, though it would significantly change administrative burdens under the tax system.

as a part of broadening the tax base, greater interest in explicit inflation indexing might follow. An example of recent interest is the number of proposals for indexing capital gains to reflect the inflation that occurred since assets were purchased. But tax experts have long argued against indexing only part of the tax code. (Taxpayers could easily profit from a partly indexed tax code. For example, if interest income were indexed but interest receipts were not, a taxpayer who borrowed and lent identical amounts at the same interest rate would have his interest income reduced for tax purposes because of the inflation indexing, but could take his interest expense deduction in full.) Therefore, indexing would be necessary for all assets and debts. This would mean, for example, that the extra income debtors implicitly receive when inflation erodes the real value of their debt would be subject to tax.

Such indexing of the tax base would require some extraordinarily complex changes in the tax code and in taxpayer and business planning. (For example: What would be the correct inflation adjustment on the sale of a home that had been financed with a mortgage loan? Only the seller's equity in the home should be indexed, but that equity changed continuously as the mortgage loan was amortized.) Until the inflation statistics were compiled, taxpayers would be uncertain of the tax liabilities on the income from their investments. Debtors would have to pay tax on the depreciation of their liabilities without a corresponding cash receipt from which to pay the tax. Indexing the tax code might lead to further indexation of a broad range of financial transactions, causing a rapid transmission of inflationary shocks throughout the economy and making inflation even harder to stop than it already is. The government's finances would be less predictable, because they would be more dependent on inflation than they are now.

Indexing the tax base would greatly complicate the tax code, and it would mark a significant step away from the use of the dollar as our unit of account. It is thus not a step to be taken lightly.

The Corporate Income Tax. Just as broadening the individual income tax base would be an efficient way to raise needed revenue, so would broadening the corporate tax base. The efficiency and simplicity benefits would be analogous. For example, corporate tax preferences such as the Domestic International Sales Corporation (DISC) or subsidies for mineral exploration and development could be repealed or reduced, and the general corporate tax rates could be cut as partial compensation. The result would be a greater incentive to corporate enterprise generally in addition to a pickup of additional revenue.

One additional option is the elimination of the double taxation of corporate source income. Separate taxation of corporate enterprise places an extra burden on business activities that cannot be undertaken in non-corporate ways. (The existence of a corporate tax, however, discourages manipulation of the corporate form to avoid individual income taxes.) One approach to the elimination of double taxation is "integration," whereby all income of corporations would be attributed to shareholders, to be taxed only to them. The corporation would pay a withholding tax at the highest individual income tax rate; individual shareholders who pay less than the maximum tax rate would receive a refund of the excess corporate withholding.

While integration may be desirable to improve economic efficiency, it would hardly be a move toward simplification. The meshing of millions of corporate and individual tax returns on different tax years would be an enormous task, especially considering that corporate returns are typically not closed for years after the tax year ends. Shareholders would have to adjust the basis of their shares for retained corporate earnings, which would involve a great deal of paperwork. The handling of foreign taxes and the pass-through of foreign tax credits to individuals would be exceedingly complex. The treatment of shares held by tax-exempt organizations would be complex and could result in a large revenue drain. Finally, there would be a tremendous incentive just before the date of record for temporary trades of shares of corporations with tax losses from low- to high-bracket taxpayers.

In sum, the tax-writing committees would have their hands full with corporate tax integration if it were considered in isolation. Combining it with a comprehensive revision of the individual income tax might prove an impossible task.

AN EXPENDITURE TAX

A totally different approach would be an expenditure, or consumption, tax. Many recent income tax initiatives that have exempted various forms of saving from tax have moved in the direction of an expenditure tax; such piecemeal approaches, however, have left the tax code much more complicated and ripe for abuse than would a true expenditure tax.

An expenditure tax is essentially an income tax with a deduction for saving. Taxpayers would compute their liabilities by adding up all their income, and then deducting from that all saving. Exemptions would include purchases of stocks and bonds, deposits in bank accounts, business investments, and so on. Their tax would be computed on the income that they did not save, that is, their expenditure. (For corporations, the equivalent of the deduction of saving would be immediate expensing rather than depreciation of investment.)

The major argument for the expenditure tax is that it would increase the incentive to save through its deduction for saving. The deduction would also eliminate the income tax's "double tax" on saving--that is, taxing the money saved when it is earned, and then also taxing the interest that the savings earn. Economists differ on just how much additional saving would be forthcoming under an expenditure tax, but the amount is likely to be small. Also, the expenditure tax base would be smaller by the amount of saving than that of an equivalent income tax. That means that the expenditure tax would need higher tax rates than the income tax, and those higher tax rates would discourage work by a small amount.

An expenditure tax would in some respects be considerably simpler than an income tax. Because saving would be immediately tax deductible, there would be no need for depreciation accounting or tax base indexing. On the other hand, the expenditure tax would require a complicated transition to treat appropriately any previously accumulated wealth that may or may not have borne income tax (for example, money in savings accounts, as opposed to accrued but unrealized capital gains). Taxpayers would have to report their saving, as well as their income as they do now. Further, borrowed money, like income, would have to be taxed as consumption. Many problems of taxpayer compliance and administration could arise, but there is little experience to help solve them, inasmuch as the expenditure tax has been tried only very briefly in India and Sri Lanka, and is not now in use anywhere in the world.

An expenditure tax is sometimes envisioned as simpler than the income tax because it has no need for the many tax preferences now part of the U.S. income tax. But there is no guarantee that an expenditure tax would pass through the legislative process without alteration of the tax base. Many socially desirable forms of expenditure--housing, education, medical care, charitable giving, even domestically produced fuel-efficient automobiles--are likely candidates for preferential treatment under an expenditure tax. We could easily exchange a leaky and inefficiency-inducing income tax base for a leaky and inefficiency-inducing expenditure tax base.

People differ on the inevitably subjective value judgments regarding the fairness of the expenditure tax versus the income tax. While some argue that the expenditure tax would be fair because savings should not be taxed twice, others counter that the expenditure tax would be unfair because savings should not be exempt from tax when made. From this latter point of view, income is the appropriate tax base, because it measures the power to consume; people who already have considerable wealth have the greatest ability to save, and therefore can take the greatest advantage of the savings deduction. Finally, because the expenditure tax would allow saving without tax, some would argue for additional taxation of wealth to prevent almost unlimited tax-free accumulation, and might fear that such wealth taxation would not be forthcoming.

To sum up, the expenditure tax has a distinct advantage in its greater incentive to save, but the income tax provides a greater incentive to work. The expenditure tax is seen by some as more fair, because it taxes what people consume, while others call the income tax more fair because it taxes the power to consume. With no real practical experience in the administration of an expenditure tax anywhere in the world, and with the many imponderable factors regarding such a fundamental and complex transition, the expenditure tax is probably not a realistic option for dealing with our budgetary problems in the short term.

CONCLUSION

Unless major additional steps are taken to reduce spending and increase revenues, large budget deficits are likely to persist. In light of the importance of restoring economic growth, any sources for increased revenues must be carefully chosen to maximize incentives for work and capital formation.

Moving toward a broader based lower rate income tax appears to be a promising approach. Additional revenues could be gained by cutting back on individual and corporate tax preferences that distort the allocation of resources, while partly compensating general rate cuts would increase overall incentives for work, saving, and investment. Variations could be considered to minimize the impact on vulnerable sectors of the economy, such as homeowners and not-for-profit institutions, and to prevent any substantial redistribution of the tax burden to middle-income taxpayers.

Other revisions to the tax system, such as tax base indexing and corporate tax integration, offer some potential benefits but also considerable complexity. They would probably take some time to be developed fully. Similarly, an expenditure tax could replace the current income tax and increase the incentive for saving, though the debate on its fairness continues. Further, with no practical experience in its implementation and many complexities in store, it should probably be considered an option for the longer term.