CHAPTER III. EVALUATING TAXES AND SHORTCOMINGS OF THE CURRENT INCOME TAX SYSTEM

EVALUATING TAXES

Criteria. The income tax and proposals for change are evaluated in the following chapters according to three standard criteria: simplicity, efficiency, and equity.[1] The simplicity of a tax is gauged by how well taxpayers understand it and how easily they can comply with its provisions, as well as how easily the IRS can administer it. The efficiency of a tax is determined by the degree to which it distorts the allocation of resources and reduces national output in comparison to a lump-sum or head tax that all citizens must pay in a fixed amount and that cannot, therefore, influence behavior. Analysis of a tax on efficiency grounds centers around the tax's effects on work, saving, and the allocation of capital among investments. The equity of a tax is usually judged by two standards: whether the tax falls equally on taxpayers of like economic status (called horizontal equity) and whether the tax appropriately distinguishes between taxpayers of different economic status (called vertical equity).

The goals of simplicity, efficiency, and equity are often in conflict, and the current income tax reflects the tradeoffs that have been made among the three.[2]

Ideal Tax. The theoretically ideal income tax would tax individuals uniformly on all income, whatever the source, including wages and salaries, in-kind compensation, and the real increase in the net worth of all investments. The Internal Revenue Code generally follows this approach of measuring income according to its sources. (Economists usually take the alternative approach of defining income according to its uses, that is, as the increase in an individual's potential command over goods and services during the year. Income is therefore the sum of consumption and change in

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1 For good explanations of these criteria, see Statement of John Chapoton, Assistant Secretary of the Treasury for Tax Policy, before the Senate Finance Committee (September 28, 1982), pp. 6-10; and Joint Committee on Taxation, "Analysis of Proposals Related to Broadening the Base and Lowering the Rates of the Income Tax" (September 24, 1982), pp. 3-7.

2 See Joint Committee on Taxation, pp. 3-7.

net worth.)[3] Partly because of the difficult valuation and practical administrative problems of adhering to the ideal, the current income tax deviates from it in many respects. It also deviates from it in other ways because the tax is used to encourage certain activities, such as saving for retirement or conserving energy, and to aid taxpayers in certain circumstances.

The remainder of this chapter discusses some of the shortcomings of the current tax and important ways in which it deviates from a theoretically ideal income tax. Some of these imperfections in the current tax would be eliminated or alleviated if tax were imposed on consumption rather than income, if the income tax were indexed completely for inflation, or if the income tax base were broadened and rates reduced. When this is the case, it is noted in this chapter and discussed in more detail in the following chapters.

SHORTCOMINGS OF THE CURRENT TAX SYSTEM

Light Taxation of In-Kind Income

Much income is received in kind and must be assigned a monetary value in order to be taxed. This includes fringe benefits, nonmonetary transfer payments such as rent subsidies and subsidized medical care, income received through barter and from home production, and consumer durables. The difficulty of imputing the appropriate monetary values to this income has resulted in its being taxed less heavily than other income or not taxed at all. As a result, taxpayers strive to receive more of their income in kind than they would if taxed equally on all income, and horizontal equity is violated because families with equal incomes are taxed at different rates, depending on the mix of their monetary and in-kind income.

The free or reduced-rate standby flights that airlines offer their employees as a fringe benefit are a good example of in-kind income that is difficult to value.[4] Such a flight might be valued at the additional cost to

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3 For an elaboration of this Schanz-Haig-Simons definition of income, see Treasury Department, Blueprints for Basic Tax Reform (January 17, 1977), pp. 26-38; and Richard Goode, "The Economic Definition of Income," in Joseph Pechman, ed., Comprehensive Income Taxation (Washington, D.C.: The Brookings Institution, 1977), pp. 1-32.

4 This example is from Joint Committee on Taxation, "Analysis of Proposals," p. 23.

the airline of providing the seat, which is practically zero, or the cost of a full-fare ticket, or even the flight's subjective value to the employee. Another example of in-kind income is that received through barter. A carpenter who repairs a dentist's house in exchange for an hour of dental work in effect earns the money that it would cost to buy the dental work and should be taxed on that income.

Most proposals to broaden the income tax base would tax more in-kind income than currently is taxed, but full taxation is not practically feasible. It would be possible to come closer to full taxation of some in-kind income, for instance, by disallowing corporate tax deductions for fringe benefit expenditures. Similar valuation problems would arise under a consumption tax since some consumption is attained without the exchange of money.

Consumer Durables. Consumer durables, such as owner-occupied housing, automobiles, and appliances, receive preferential tax treatment because the income that they produce is received in kind and therefore is not taxed, although some of the associated expenses (property tax and mortgage and consumer interest) are deductible.[5]

Consumer durables are investments that yield returns over many years, just as stocks and bonds do, but in the case of consumer durables the returns are nonmonetary. The annual return to owner-occupied housing, for instance, is the amount of rent that the owners would have to pay to live in their houses if they did not own them.[6] In theory, the income

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5 The concepts discussed in this section are extremely complex. For a more complete explanation, see Congressional Budget Office, The Tax Treatment of Homeownership (September 1981), pp. 18-20. Opinion differs as to whether interest payments on consumer debt should be deductible, but most theorists agree that under an income tax all real interest payments should be deductible and that the imputed income from nonfinancial assets should be taxed. Certain assets, such as antiques and collectibles, are neither pure investments nor consumer durables. In theory, their income tax treatment should be the same as that of consumer durables.

6 To see why the rental value of consumer durables should be treated as income, consider two individuals who each have $50,000 to invest. The first purchases a $50,000 bond yielding $5,000 (10 percent) annually and rents a house for $5,000 per year. The second spends $50,000 to purchase rather than rent an identical house. Since the two are financially in the same position, each should be taxed on $5,000 annual income.

produced by consumer durables, net of the associated expenses of depreciation, property taxes, mortgage or consumer loan interest, insurance, and maintenance, should be taxed. In order for the income to be taxed, however, monetary returns must be imputed. Theoretically, for instance, the owner of a television set should be taxed annually on the rental value of the set, but allowed to deduct depreciation, maintenance expenses, and interest paid on borrowings used to purchase the set.

Net imputed income from consumer durables has never been taxed in the United States, partly because few noneconomists have accepted the idea that it constitutes income and partly because of the practical difficulty of imputing rental values each year in the absence of market transactions. The tax exemption of the imputed income of consumer durables has probably not been a serious problem except in the case of owner-occupied housing, whose tax advantage has diverted investment funds away from plant and equipment.[7]

Some proposals for broadening the income tax base attempt to correct partly for the tax exemption of income from consumer durables by repealing the deductions for property taxes and mortgage and consumer interest. Under a consumption tax, the ideal tax treatment of consumer durables can be approximated, as explained in Chapter VI.

Unrealized Income

Net worth increases whenever assets appreciate, whether or not they are sold, and these increases constitute income that should, in theory, be taxed to the owners. But it is extremely difficult to impose taxes on paper gains and claims to income that will be received in the future.

Capital gains are currently not taxed until realized upon sale. Similarly, even though a vested employee's net worth increases when his company's defined contribution pension fund appreciates (since the employ-

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7 See, for example, Frank deLeeuw and Larry Ozanne, "Housing," in Henry Aaron and Joseph Pechman, eds., How Taxes Affect Economic Behavior (The Brookings Institution, 1981), pp. 283-326. By liberalizing depreciation deductions for plant and equipment, the Economic Recovery Tax Act of 1981 might have given many investments the same tax exemption afforded owner-occupied housing. See, for example, Patric Hendershott and James Shilling, "The Impacts on Capital Allocation of Some Aspects of the Economic Recovery Tax Act of 1981," National Bureau of Economic Research (December 1981).

ee can then expect to receive a larger pension), pension income is not taxed until received in retirement. In both cases, the associated deferral of tax liability effectively reduces the tax due on the income, because taxpayers can earn interest on the tax between the time when the income is earned and the time when the tax is due.

As a practical matter, eliminating the tax advantage for unrealized income is complicated and costly under an income tax. In the case of capital gains, it would require annual valuation of all assets, some of which are not readily marketable.[8] In the case of pension income, it would require taxing income on the basis of an expectation of the amount that will be received in the future, when the actual amount received depends on the outcomes of many uncertain events, including how long the employee lives. Taxing on accrual could also pose liquidity problems, since it would require that tax be paid before income is in hand.

Since unrealized income does not constitute spent receipts, it would not be taxed under a consumption tax. Capital gains, pension income, and life insurance income would be taxed only when withdrawn for consumption and would, therefore, receive no advantage compared to realized capital gains under a consumption tax.

Effects of Inflation

Because capital income is often earned years after the associated costs of earning it are incurred, inflation tends to overstate capital income unless tax accounting converts income and expenses to dollars of the same purchasing power (called "indexing"). The current income tax does not require these conversions. As a result, the tax rate on real investment income varies with the inflation rate and with the type of investment--its capital intensity, type of financing, and whether assets are long- or short-lived. Horizontal equity is violated, because individuals with equal real incomes pay different amounts of tax, and economic efficiency is impaired, because the returns to different investments are taxed differently. Chapter V is devoted to the problems that inflation poses for an income tax and describes the tax-base indexing that would correct them.

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8 If an asset lost value during the year, its owner would be allowed a tax deduction for the loss. A stockholder might pay tax one year on a paper gain and then get a tax refund if his stock subsequently dropped in value before sale.

Under a consumption tax, tax is imposed only on investment proceeds withdrawn for spending. Since the withdrawal and spending occur in the same year, inflation poses no serious problems for a consumption tax.

Taxation of Married and Single People

Graduated-rate income or consumption taxes in which married couples are taxed as one unit cannot be marriage neutral.[9] In other words, upon marriage the tax liability of a couple would either increase or decrease. Marriage neutrality would be accomplished either by making the tax proportional rather than progressive or by taxing individuals rather than couples.[10] Generally, the less progressive the tax, the closer it comes to marriage neutrality. Most flat-rate income tax proposals come very close to marriage neutrality, and proposals for broadening the tax base and reducing tax rates can go far in that direction.

Taxing individuals rather than couples would add some complexity, since investment income and deductions would have to be allocated between spouses. Moreover, under a progressive tax imposed on individuals, different amounts of tax would be collected from married couples of equal incomes, depending on the way income was split between the spouses.

The two-earner deduction enacted in 1981 is a compromise. It reduced marriage penalties, but left some couples with sizable penalties, created or increased marriage bonuses for others, and added some complexity to the tax as well.

Lack of Integration of Corporate and Individual Income Taxes

Corporations are now taxed on their income under the corporate income tax. After-tax corporate income is either distributed as dividends and taxed to shareholders under the individual income tax (hence the "double taxation of dividends") or retained and reinvested. Retained earnings increase the value of stock and therefore generate capital gains on which shareholders pay income tax (at the lower capital gains rates) if

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[9] For a more complete discussion of this issue, see Joint Committee on Taxation, "The Income Tax Treatment of Married Couples and Single Persons" (April 2, 1980).

[10] Making individuals the unit of taxation does not ensure marriage neutrality if there are community property laws that assign each spouse's property jointly to husband and wife.

they sell their stock. By contrast, business income earned by partnerships and sole proprietorships is taxed only once, under the individual income tax as income to the owners.

The current tax treatment of business is often criticized because it taxes some corporate income very heavily (at rates up to 73 percent) and distorts business decisions.[11] Many economists argue that it discourages the corporate form of doing business, discourages corporations from distributing their earnings as dividends, and encourages firms to borrow rather than finance with equity. These problems could be solved by abolishing the coporate income tax and allocating corporate income directly to the shareholders, who are the true beneficiaries of the income. But this allocation process, called integration of the corporate and individual income taxes, is complicated to implement under a progressive income tax.[12] (The double taxation of dividends could be eliminated more easily, however, by allowing corporations to deduct dividends paid to shareholders or by giving shareholders a tax credit for the amount of pretax corporate income needed to pay their dividends.) A corporate income tax would be unnecessary under a consumption tax, as explained in Chapter VI, but some advocate retaining the corporate tax even then, just as others justify the corporate tax under the current tax system, as a tax on the privilege of doing business as a corporation with limited liability.

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11 Seventy-three percent is the combined corporate and individual tax rate paid on dividends distributed by corporations paying the top corporate tax rate of 46 percent to shareholders paying the top individual tax rate of 50 percent. Per dollar of corporate income, 46 cents is paid in corporate tax, and 50 percent of the 54 cents of dividends generated, 27 cents, is paid in individual income tax, for a total tax of 73 cents (46 + 27 = 73).

12 Integration would be easy to achieve if the corporate and individual taxes allowed no exemptions and shared the same single tax rate. Comprehensive reform of the corporate income tax would be just as controversial as a reform of the individual income tax. For an in-depth discussion of integration of the corporate and individual income taxes, see Alvin Warren, "The Relation and Integration of Individual and Corporate Income Taxes," Harvard Law Review (February 1981), pp. 719-800; and Charles McLure, Jr., Must Corporate Income Be Taxed Twice? (The Brookings Institution, 1979).

Uneven Taxation of Income from Capital

Although some capital income is taxed very heavily because it is not indexed for inflation and because it is taxed under both the corporate and individual income taxes, much capital income is effectively untaxed or lightly taxed, through noncompliance or tax expenditures for saving and investment.[13] The average tax rate on real capital income is low. In 1979, for example, only about 30 percent of net real capital income was reported on individual tax returns, and corporate and individual income taxes together totaled about 28 percent of the nation's net real capital income.[14]

The tax expenditures for capital income are listed in Table 5. They include the tax exemption of interest on municipal bonds and Individual Retirement Accounts, the exclusion of 60 percent of nominal capital gains, and the provisions allowing businesses to depreciate plant and equipment faster than they lose real value. These tax preferences exist for a variety of reasons, including to encourage saving and investment generally, to encourage investment in particular activities, to offset the effects of inflation, to make the tax simpler than the theoretically ideal tax, and to compensate for distortions caused by other tax provisions.

Other Problems

Some other fundamental structural issues are difficult to resolve, whether tax is imposed on income or consumption.[15] For the most part, these are not discussed in the following chapters, unless the option being

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13 Compliance is worse for capital income than for labor income, probably because of the fairly comprehensive withholding of tax required of labor income.

14 Eugene Steuerle, "Is Income from Capital Subject to Individual Income Taxation?" Public Finance Quarterly (July 1982), pp. 290, 292. Steuerle only approximates the effective tax rate on income earned in 1979, since he compares taxes paid in 1979 to income earned in 1979, although tax paid in 1979 was owed partly on income accrued earlier, and some tax will be collected in later years on income earned in 1979.

15 In addition to the questions listed below, questions arise as to the proper way to tax life insurance, trusts, alimony, child support, prizes, Social Security benefits, transfer payments, and educational expenses. Blueprints for Basic Tax Reform discusses most of these issues.

discussed would alleviate or worsen the problem. Some of these questions are:

- What critieria should be used to determine whether a person is a dependent, and to whom should the income or consumption of dependents be taxed?
- How should an income or consumption tax treat the income that foreigners earn in the United States and the income that Americans earn outside the United States?
- Regardless of whether the tax base is income or consumption, should deductions be allowed for mostly nondiscretionary expenditures, such as state and local taxes and medical expenses?
- Should gifts and inheritances be treated as income of the recipients and taxed under a standard consumption or income tax, or should they be taxed separately or not at all?
- Should charitable contributions and other gifts be tax deductible?

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TABLE 5. TAX EXPENDITURES FOR SAVING AND INVESTMENT BY INDIVIDUALS IN FISCAL YEAR 1983[a] (In millions of dollars)

Tax Expenditure	Estimated Revenue Loss for Fiscal Year 1983
Exclusion of Interest on State and Local Bonds	5,655
Exclusion of Capital Gains at Death	3,975
Capital Gains Exclusion and Tax-Free Rollover of Personal Residences	5,025
Exclusion of Capital Gains Other than Gains on Personal Residences	15,650
Deductibility of Nonmortgage Interest in Excess of Investment Income and Interest on Home Mortgages	32,800
Net Exclusion of Pension Contributions and Earnings	50,765
Exclusion of Interest on Life Insurance Savings	4,805
Exclusion of Other Employee Benefits: Premiums on Group Term Life Insurance	2,100
Individual Retirement Plans	2,695
Exclusion of Interest on Certain Savings Certificates	2,355
Dividend Exclusion	445
Deferral of Interest on United States Savings Bonds	50
Credit for Increasing Research Activities	30
Special Provisions for Accelerated Depreciation on Equipment, Rental Housing, and Buildings Other than Rental Housing	1,740
Investment Credit	3,390
Expensing of Capital Outlays: Agriculture, Research, Exploration, and Development of Fuels and Nonfuel Minerals	1,455
Excess of Percentage Over Cost Depletion of Fuels and Nonfuel Minerals	1,450
Tax Incentives for Preservation of Historic Structures	130
Five-Year Amortization for Housing Rehabilitation	30
Reinvestment of Dividends in Stock of Public Utilities	365
Amortization of Motor Carrier Operating Rights	5
Amortization of Business Start-Up Costs	105

SOURCE: Update of list appearing in Eugene Steuerle, "Is Income from Capital Subject to Individual Income Taxation?" Public Finance Quarterly (July 1982), p. 297. Updated tax expenditure amounts are from Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 1983-1988 (March 1983).

a. Excludes corporate tax expenditures.