CHAPTER VII. CONCLUSION

The preceding three chapters outlined in broad form the advantages and disadvantages of three possible major changes in the individual income tax system:

- o Broadening the income tax base and reducing marginal tax rates;
- o Indexing the income tax base for inflation; and
- o Taxing consumption instead of income.

The three approaches are summarized in Table 18. If the Congress decided that consumption was a better tax base than income, base indexing would be unnecessary, because all accounting would be done for current periods only. If the Congress wanted to tax income rather than consumption, it would need to decide whether to broaden the tax base and whether to index the base for inflation. Base broadening and indexing could be done separately, or both could be done together.

Retention of the current tax, which is neither a pure income nor a pure consumption tax, is also a possibility, of course, as are incremental changes in the direction of any of the major options. If comprehensive income tax base broadening was considered too radical a change, for instance, the base could be broadened incrementally by eliminating selective tax preferences. Similarly, steps could be taken to move the tax further toward a consumption tax, perhaps by excluding a specified percentage of interest income from taxation and allowing only the same percentage of interest paid to be deducted.[1] Under a pure indexed income tax, income from capital would be taxed at the same rate as wage and salary income, whereas most income from capital would not be taxed at all under a consumption tax. Indexing the income tax base while retaining tax preferences for capital income can be thought of as an intermediate step.

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1 Another proposal--to expand Individual Retirement Accounts by raising ceilings on annual contributions and relaxing or removing penalties for early withdrawal--cannot be implemented alone without creating oppportunities for tax arbitrage. In other words, taxpayers would be able to profit through the tax system without increasing their net savings simply by borrowing and taking a tax deduction for the interest payments and investing the borrowed proceeds in an IRA in which the earnings would be effectively tax free.

TABLE 18. HIGHLIGHTS OF THREE MAJOR APPROACHES TO CHANGING THE INCOME TAX SYSTEM

Option	Steps Needed to Implement Change	Effects of Change on Simplicity	Effects of Change on Efficiency
Broaden the Income Tax Base and Reduce Marginal Tax Rates	Reduce or eliminate special tax deductions, exclusions, exemptions and credits, and reduce marginal tax rates, possibly to one, flat rate.	Eliminating deductions makes tax simpler. Taxing income not now taxed could be complex in some cases, such as fringe benefits and imputed income on owner-occupied housing. Rate reduction would reduce incentive for tax avoidance.	Taxing all sources of income equally and reducing marginal tax rates improves allocation of resources among investments. Reducing marginal tax rates probably increases work and saving, although net effect on saving depends also on impact of loss of savings and investment tax incentives.
Index the Income Tax Base for Inflation	Adjust initial purchase prices of assets for inflation in calculating depreciation, capital gains, and cost of goods used from inventory. Tax only real interest income and allow only real interest expense to be deducted.	All changes would introduce new complexity, although this could be partly offset by simultaneous repeal of tax preferences.	Indexing, with repeal of savings and investment tax incentives, ensures that all capital income is taxed equally, so investment funds flow to highest before-tax returns.
Tax Consumption Instead of Income	Allow deductions for all net saving, including purchases of stocks, bonds, and other income-producing assets, deposits to savings accounts, and debt repayment. Tax new borrowing and full proceeds from sales of assets. Eliminate special tax deductions, exclusions, exemptions, and credits.	Eliminates need for depreciation and inventory accounting, tax base indexing, and defining, measuring, and taxing capital gains. Increases incentive to avoid tax due on sale of assets.	Easy integration with corporate tax. Eliminating tax preferences improves allocation of resources among investments. Eliminating tax on saving improves allocation of resources among time periods. Increase in marginal tax rate compared to equally comprehensive income tax lessens incentive to work in order to purchase current consumption goods.

(Continued)

TABLE 18. (Continued)

Option	Effects of Change on: Equity	Effects of Change on: Redistribution of Tax Burden	Major Problems That Would Remain
Broaden the Income Tax Base and Reduce Marginal Tax Rates	Generally improves equity since taxpayers with equal income pay equal tax, but can worsen equity if provisions relieving hardship are eliminated. Rate reduction could change the progressivity of the tax.	Taxes rise for those who now make heavy use of preferences or who are now eligible for special tax relief; taxes fall for those who do not use current provisions. Rate reduction could change progressivity of tax. Flat rate tax would probably reduce taxes for high-income and raise them for middle-income taxpayers.	Administratively infeasible to broaden tax base completely, so some income, such as fringe benefits and home production, remains lightly taxed. Real tax depends on inflation unless base is indexed. Complete integration with corporate tax difficult. Compliance still a problem. Difficult to disallow business deductions taken for personal expenses.
Index the Income Tax Base for Inflation	Improves equity since taxpayers with equal real incomes pay equal tax (assuming special tax provisions are also eliminated). Prevents tax rates on real income from exceeding 100%. Eliminates dependence of real tax rates on inflation. Unless accompanied by repeal of tax incentives for saving and investment, reduces taxes for wealthy and hence reduces progressivity.	Assuming no other change in tax law, taxes rise for current net borrowers, including many businesses and homeowners with mortgages. Taxes fall for those with capital gains and interest income on existing assets.	Unless indexing is comprehensive, equity and efficiency could be worsened rather than improved.

(Continued)

TABLE 18. (Continued)

Option	Effects of Change on: Equity	Effects of Change on: Redistribution of Tax Burden	Major Problems That Would Remain
Tax Consumption Instead of Income	Any degree of progressivity is possible through graduation of tax rates. Effect on equity depends on whether consumption or income is considered fairer tax base. Arguments in favor of consumption tax: annual consumption is a proxy for average lifetime income; consumption tax does not tax saving twice; income tax penalizes those who save early in life. Arguments in favor of income tax: potential command over goods and services best measures ability to pay tax and all income could potentially be spent; concentration of wealth could increase under consumption tax.	Within each income group, taxes fall for those who save early in life, taxes rise for those who always spend nearly all their income. Since most people borrow in youth, save in middle age, and draw down savings in retirement, their taxes would increase during youth and old age and fall in midlife.	Pressure might not abate for special tax provisions. Difficult to prohibit some personal consumption from being deducted as business investment. Compliance still a problem, and proper taxation of family vs. individual still difficult to decide.

CORPORATE TAX

Any of the three major changes discussed above would logically require corresponding changes in the corporate income tax. If the base of the individual income tax was broadened, it would make sense to broaden the base of the corporate tax to eliminate special business tax provisions. Otherwise, individuals would form personal corporations to take advantage of corporate tax preferences. As individual tax rates could be reduced substantially with base broadening, so corporate rates could also be reduced. Moreover, it might be appropriate to integrate partially the corporate and individual taxes to eliminate the double tax on corporate dividends.

If the base of the individual income tax is indexed comprehensively, the same changes should be made in the corporate tax. It would be logical to index interest, depreciation, and the cost of goods used from inventory for corporations if this was done for partnerships and the self-employed under the individual income tax. Otherwise, the tax system would be extremely complex and taxpayers would rearrange their affairs to have income taxed at the lowest rate possible.

The options for the corporate tax under a consumption tax were explored briefly in Chapter VI. Although a corporate income tax could be retained during a transition period, or permanently to tax foreigners on income earned in the United States, most consumption tax proposals call either for elimination of the corporate tax or conversion to a cash-flow corporate tax modeled on the individual consumption tax.

STATE GOVERNMENTS

States would, of course, benefit from any salutary economic effects produced by major changes in the income tax. By the same token, they would be hurt by any economy-wide dislocation caused by the transition to a new tax. Repeal of federal tax deductions for state taxes and the federal tax exemption of interest on state bonds would also hurt state governments, unless offset by increases in other federal assistance to the states.

Federal tax changes would affect those states that link their state income taxes to the federal tax.[2] Some states simply charge their residents a percentage of federal income tax liability. Those states would

2 As of October 1982, 34 states used federal taxable income as the base of the state income tax. (State Tax Handbook (Chicago: Commerce Clearing House, October 1982), p. 666.)

probably be unaffected by the change unless the total yield of the federal tax changed, and even then states could change their tax rates (as percentages of federal tax liability). Other states model their taxes on federal tax law but modify it somewhat by denying certain federal deductions or credits and allowing others not allowed on federal taxes. Those states would have to decide whether to change their taxes to mirror federal changes.

To the extent that states did not change their taxes to conform to the newly designed federal tax, some of the beneficial effects of the new federal tax would be lost. Retention of state tax preferences for certain kinds of investment, for instance, would offset the neutrality that could be achieved by redesign of the federal tax. Similarly, high or steeply graduated state tax rates would offset the beneficial effects of reduced federal rates.

MAJOR LEGISLATIVE PROPOSALS

Although indexing capital gains and depreciation has been considered by the Congress, no comprehensive base indexing legislation has been proposed. By contrast, legislation has been proposed recently to broaden the income tax base or to enact a flat-rate consumption tax. An example of each type of legislation is given below.

Bradley-Gephardt Bill (S. 1421 and H.R. 3271)

Of the many bills introduced in both houses to broaden the income tax base (some of which also call for enactment of one, flat tax rate), the one introduced by Senator Bradley and Representative Gephardt has received the most attention to date. Bradley and Gephardt would broaden the income tax base by eliminating many special tax provisions while retaining in limited form several of the largest, including the deductions for home mortgage interest, charitable contributions, large medical expenses, and state and local income and property taxes. In addition, they would retain the tax exemption of Social Security and veterans' benefits and interest on municipal bonds issued for public purposes. This bill would raise the personal exemption and zero bracket amounts and collapse the tax brackets into four brackets, with a maximum tax rate of 30 percent.

Because the proposal would retain many of the special provisions currently in the law, it would insulate beneficiaries of those provisions from much of the hardship they would experience in moving to a truly comprehensive income tax. Homeowners, charitable institutions, retirees, veterans, and state and local governments would be somewhat protected.

On the other hand, retention of special provisions would preclude maximum reduction of tax rates and continue some economic distortions such as that caused by tax preferences for investment in owner-occupied housing. At the lower tax rates in the proposal, however, these distortions would be lessened. Bradley and Gephardt would not integrate the corporate and individual taxes or index the income tax base for inflation.[3] Nominal capital gains would be taxed in full, but not at a rate above the top statutory rate of 30 percent. The retained deductions would be equivalent to tax credits of 14 percent for all taxpayers.[4]

Hall-Rabushka Proposal (S. 557)

Senator DeConcini has introduced a bill for a flat-rate tax formulated by economists Robert Hall and Alvin Rabushka.[5] Although not precisely a consumption tax, the Hall-Rabushka plan is more like a

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3 Bradley and Gephardt would tax all corporate income at the rate of 30 percent and repeal many business tax preferences.

4 A 14 percent tax would be applied to all net taxable income, with 12 and 16 percent surtaxes applied to total income (adjusted gross income) exceeding $25,000 for single taxpayers and $40,000 for married taxpayers. Taxpayers would first calculate adjusted gross income by totaling all income except that excluded from tax, such as Social Security and veterans' benefits and municipal bond interest. They would then subtract the retained deductions to calculate net taxable income. Tax would be due on 14 percent of taxable income. In addition, for those married taxpayers whose adjusted gross incomes exceeded $40,000 ($25,000 for single taxpayers), a surcharge would be applied to adjusted gross income. In essence, therefore, the deductions would be taken at a 14 percent rate for all taxpayers, since the deductions would enter into the calculation only of taxable income and not of adjusted gross income subject to the surcharge. Taxpayers having to pay the surcharge (roughly 20 percent of all taxpayers, according to Bradley and Gephardt) would no longer take deductions at the taxpayer's top marginal tax rate. Thus, taxpayers who now deduct mortgage interest and state and local taxes at rates up to 50 percent would pay a much greater percentage of those deductible expenses out of pocket, since they would be eligible for deduction at only the 14 percent rate. Since the retained deductions would apply at the rate of 14 percent to all taxpayers, they would be equivalent to 14 percent nonrefundable tax credits.

5 Robert Hall and Alvin Rabushka, Low Tax, Simple Tax, Flat Tax (New York: McGraw Hill Book Company, 1983). The book describes the

consumption than an income tax. Because of the flat tax rate, the proposal would very easily integrate the corporate and individual taxes. The plan calls for a single tax rate of 19 percent on both business and individual incomes.

Individuals would pay tax on all wages and salaries but not on interest, dividends or capital gains, and would be allowed no deductions or tax credits aside from a personal deduction. Excluding interest, dividends and capital gains from tax and disallowing interest deductions makes the tax a consumption tax in which all individuals are essentially required to use the prepayment method. According to Hall and Rabushka, the tax would be simple enough that most taxpayers' returns would be only a page long.

The new business tax would use the cash-flow approach, like the consumption tax, and would be imposed on all businesses, regardless of the form of ownership--corporate, partnership, or sole proprietorship. Businesses would be taxed on all sales but would deduct in full all purchases of plant, equipment, and goods in the year of purchase. They would also be able to deduct wages and salaries paid to employees, but not interest expense or fringe benefits provided to employees. The return to new business investment would essentially be tax-free, but tax would continue to be collected at the 19 percent rate on the return to business investments made prior to the effective date.

TRANSITIONAL CONSIDERATIONS[6]

Enacting any major change in the income tax would cause dislocation for many individuals, businesses, and institutions. Planning based on old

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Hall-Rabushka proposal, the motivation behind it, and the beneficial effects the authors expect would follow its enactment.

6 For more complete discussions, see Treasury Department, Blueprints for Basic Tax Reform (January 17, 1977), pp. 181-215; Joint Committee on Taxation, Analysis of Proposals Related to Broadening the Base and Lowering the Rates of the Income Tax (September 24, 1982), pp. 29-32; John Bossons, "Indexation After the Lortie Report" (Toronto: Institute for Policy Analysis, November 23, 1983); Michael Graetz, "Legal Transitions: The Case of Retroactivity in Income Tax Revision," University of Pennsylvania Law Review (1977), pp. 47-87; and "The 1982 Minimum Tax Amendments As a First Step in the Transition to a 'Flat-Rate' Tax," Southern California Law Review (January 1983), pp. 527-571.

tax law would be disrupted, asset values and incomes would rise or fall, depending on the change in their tax treatment, and the finances of currently tax-favored businesses, charities, and state and local governments could worsen.[7] The transition to a new tax, therefore, would probably be difficult.

It is debatable whether those who would suffer from a tax change should be compensated.[8] People know that tax law is often changed. In fact, yields of assets likely to lose preferential tax status rise to compensate owners for that possibility. Under these circumstances, direct government compensation, such as the extension of the old law tax treatment for owners of these assets on the enactment date, can amount, in essence, to overcompensation. Nevertheless, the Congress has in the past routinely enacted provisions to ease the transition to new tax law in an effort to relieve hardship for those who made decisions relying on a continuation of old law.

In addition to relieving hardship and allowing people time to plan for and adjust to a revision in tax law, transition rules can be used to prevent income from escaping taxation and to ensure that income is not taxed twice. For instance, transition rules can be used to tax on a one-time basis capital gains that had been earned but not taxed on the enactment date of the new law, or to ensure that, under a consumption tax, consumption financed from previously taxed income would not be taxed again. By their very nature, transition rules add complexity to tax law, but this complexity could be held to a minimum. Moreover, the rules should not create incen-

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7 Repeal of preferential tax treatment for an asset would reduce demand for it, immediately driving down its price. Over time, however, the supply of the asset would contract, raising the market price part way towards its initial level. For estimates of the redistribution of wealth that might result from enactment of a flat-rate tax, see Robert Tannewald, "Redistribution of Wealth in Conversion to a Flat Rate Tax," New England Economic Review (January/February 1983), pp. 5-17.

8 Graetz argues that it is no more appropriate to compensate investors for losses resulting from tax law changes than for losses resulting from market changes. In both cases, the losses reflect changes in society's tastes and preferences; in one case the vehicle for expression of the tastes is the marketplace, while in the other it is the political process. Similarly, few would consider compensating companies whose government contracts are not renewed. For an elaboration of these and other arguments against compensation, see Graetz, "Legal Transitions," pp. 64-66, 74-79.

tives for taxpayers to engage in unproductive behavior solely to reduce their taxes.[9]

There are several approaches to easing the transition: grandfathering, delaying the effective date of the new law, and phasing in the new provisions.

Grandfathering. Old law tax treatment could be permitted for transactions entered into before the new law's effective date. For instance, if the mortgage interest deduction was repealed, an exception could be granted for mortgages in place on the effective date. As is clear from this example, grandfathering could effectively prevent the new law from being completely enacted for many years (up to 30 years in the case of home mortgages). This would make the tax extremely complex and could cause a large revenue loss or prevent tax rates from being reduced as much as possible. Moreover, even this kind of grandfathering would not insulate taxpayers from losses stemming from the tax change. In this example, for instance, housing prices could drop generally if the mortgage interest deduction was not available on new purchases, so the value of a house could fall even though its present owners would still be able to deduct their mortgage interest.

Grandfathering would provide windfall gains to people holding tax-favored assets on the new law's enactment date. Since the stock of those assets would be fixed, scarcity would drive up their values. Moreover, if grandfathering applied only to owners on the effective date, owners would hold those assets longer than economics alone would dictate. Grandfathering only deductions for interest on mortgages held on the effective date, for instance, would discourage those homeowners from moving and would reduce the mobility of the labor force.

Delaying the Effective Date. The new tax law could be enacted with a delayed effective date so that its provisions would not go into effect until some future date. This would give taxpayers time to rearrange their financial affairs in anticipation of the change.[10] Again, however, asset prices would be expected to adjust immediately, because of the expectation of a changed tax treatment. Moreover, lengthy delays could introduce

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9 Joint Committee on Taxation, "Analysis of Proposals," pp. 30-31; and Treasury Department, Blueprints for Basic Tax Reform, pp. 186-187.

10 For instance, if fringe benefits were going to be taxed, employers might want time to restructure compensation packages to include more cash and fewer fringe benefits. (Joint Committee on Taxation, "Analysis of Proposals," p. 31.)

much uncertainty since taxpayers might expect the Congress to modify the new law before its enactment date.[11]

Phasing in New Provisions. The new provisions could be phased in gradually over a period of years.[12] In moving to a pure consumption tax, for instance, increasing percentages of interest income could be excluded from tax each year, while increasing percentages of interest expense were disallowed.

Probably some combination of the three transitional approaches would be used in any major change. Although they would ease the transition, they would all complicate the tax and delay any beneficial effects that would eventually result from the new law.

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11 Graetz made this point about enacting a broad-based income tax with a delayed effective date:

> Because of the necessary elimination of tax-favored treatment of a broad range of assets and the ability of currently benefited special interest groups to mobilize their arguments for continuation of favored treatment during the delay, the practical likelihood of moving to a broad-based income tax via a delayed effective date provision seems slight. (Graetz, "The 1982 Minimum Tax Amendments," p. 542.)

12 This approach to the transition to a broad-based income tax is explored in Graetz, "The 1982 Minimum Tax Amendments."

APPENDIX

APPENDIX. BENEFIT, SACRIFICE, AND ABILITY-TO-PAY THEORIES OF TAXATION

This appendix briefly summarizes the benefit, sacrifice, and ability-to-pay theories of taxation, which are commonly cited to support progressive income taxation.

BENEFIT THEORY

According to the benefit theory of taxation, each citizen's taxes should be proportional to the benefits received from government. Opinions vary as to whether government benefits increase more or less than proportionately with income, however, so this standard provides little practical guidance. It is particularly difficult to allocate the benefits of basic government services like police and fire protection. In addition, a significant share of government spending is for income maintenance and other programs for the poor, programs whose income redistribution rationale conflicts directly with the benefit theory.[1]

SACRIFICE THEORY

The proportionate sacrifice standard is the one that has received the most support during the past century as a justification for income tax progressivity. By this standard, the fairest tax is one that elicits proportionate sacrifice and, therefore, leaves all taxpayers equally worse off. Intuitively, it seems natural that only a progressive tax would impose proportionate sacrifice on all taxpayers, since a dollar taken in tax seems to inflict more hardship on a person of low income than on a person of high income. In fact, this is generally true if three premises hold: that well-being is a function of money, that each additional dollar of income provides less additional satisfaction than the last, and that the functional relationship between money and well-being is the same for all taxpayers. Blum and Kalven and others who reject the sacrifice theory do so because they feel uncomfortable making the bold interpersonal comparisons that these prem-

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1 Persuasive arguments can be made for charging user fees for many government services. That is a separate issue, however, from the more general one of the appropriate degree of progressivity in the entire income tax.

ises require.[2] Moreover, accepting the premises and the progressivity that follows is not sufficient to devise the best progressive rate structure. Only if the common mathematical relationship between well-being and money is known, can the optimal rate structure be devised. Of course, arguing that the correct degree of progressivity is indeterminate, or even that the correctness of progressivity is unverifiable, is not to conclude that a proportionate or flat-rate tax is the best choice.

ABILITY-TO-PAY THEORY

Progressive income taxes have also been justified on the theory that ability to pay tax increases more rapidly than income. Blum and Kalven argue that ability to pay can be nothing other than ability to bear a sacrifice and so reject ability to pay for the reasons just described.[3]

Nevertheless, ability to pay is often cited by legislators and the public in defense of a progressive income tax. Even though it cannot be proved unassailably that ability to pay tax increases faster than income, it can be adopted by an open democratic process as a workable proposition, if that view is held by a majority of the population.

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2 The sacrifice principle discussed in the text is that of "proportionate sacrifice," under which the ideal tax is one that reduces each taxpayer's well-being (utility) by the same percentage. Blum and Kalven favor the proportionate sacrifice principle over the principles of equal sacrifice and minimization of aggregate sacrifice. "Equal sacrifice" is attained when each taxpayer loses the same number of units of well-being. The conditions under which a progressive tax is needed to attain equal sacrifice are more restrictive than the three conditions spelled out in the text. In order to minimize the aggregate loss in satisfaction for all individuals, a tax would have to leave all taxpayers with equal income, assuming that the three premises put forth in the text hold true. (For elaboration of the three sacrifice principles, see Blum and Kalven, The Uneasy Case for Progressive Taxation (Chicago: University of Chicago Press, 1953), pp. 39-44, 49-55.)

3 Blum and Kalven, The Uneasy Case for Progressive Taxation, p. 64.