

Essentially this piece appeared as “Tax Reform: Waiting for a New Consensus of the Experts,” Tax Notes, May 18, 1998. It originated as notes for a panel presentation on Tax Reform at a conference sponsored by St. John’s Journal of Legal Commentary, held at St. John’s University School of Law, 8000 Utopia Parkway, Jamaica, NY, March 27, 1998.

Tax Reform: Waiting for a New Consensus of the Experts

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I have titled this little talk: “Tax Reform: Waiting for a New Consensus of the Experts.” By “experts,” I mean the people in this room. The title reflects my views that:

- There was an old consensus of the experts that contributed to a series of tax reforms (including the Tax Reform Act of 1986).
- The old consensus is gone.
- Not much coherent is going to happen until a new consensus emerges.
- A new consensus is visible on the horizon.

In my remarks I shall try to explain the content of that new consensus and what, modest, hopes it can fulfill.

The Old Consensus of the Experts

We are not, of course, governed by experts. Income tax policy must reflect basic political preferences of the electorate. But experts inevitably shape the crucial details of economic regulatory systems – the income tax is such a system – and thereby they make a lot of difference. An illustration: Most people – certainly most politicians – think that rebating tax on exports and charging tax on imports would be a big boost to the U.S. economy. Among the important factors that prevent this belief from being translated (more) into practice is the consensus among experts that the intuitively plausible view of politicians is, in fact, wrong.

For most of this century there was substantial agreement among experts about the general principles of an ideal income tax. Based on the concept called in our tax jargon Schanz Haig Simons income, that old consensus remains highly influential today. It remains the guiding tax policy principle of the U.S. Treasury.

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The competitor that has gradually been edging out Schanz Haig Simons income is consumption. The major component of Schanz Haig Simons income (the other is saving), consumption generates a similar distribution of tax burdens among people of various levels of “ability to pay” if subjected to appropriately calibrated rates.

From the point of view of tax design, it would be very convenient if all the experts were convinced that consumption were the preferred framework for the income tax. (Since I am arguing for a replacement of the old consensus income concept, maybe we should use a different term for the reformed system. I think if we adopt the scheme I have dubbed the X Tax, however, we could go on calling it an income tax. Only experts might object!)

The main advantage of taking the consumption approach is simplicity. To give an idea why this is so, I propose to describe the X Tax, which is a consumption-type tax, and explain some of the tough problems that it solves.

The X-Tax: A Consumption-Type Tax to Replace the Income Tax

The X Tax is a variant of the flat tax introduced by Robert Hall and Alvin Rabushka. It is a two-component system: a business tax (paid by all businesses, whether corporate, proprietorship or partnership) and a compensation tax (paid by all who receive compensation for services as employees or the equivalent). All businesses pay tax at, let us say, 30%, on a base consisting of the receipt from sales of all types (including sales out of inventory or sales of other existing assets) less the outlays for purchases from other businesses. Tax aficionados will recognize this as a subtraction type VAT, and thus a form of consumption tax.

In addition, businesses deduct payments to workers, whether for current, past, or future services. These are taxed at the recipient level under the compensation tax. All workers pay tax on the amount received from businesses (or payments of the same character from non-taxpaying entities such as governments). Payments from more than one employer are added together.

If the tax rate on compensation were the same as the business tax, we would still have the equivalent of a subtraction VAT. Instead, however, total compensation is taxed progressively, with an earned income credit at the low end, a zero bracket range, and successively higher graduated rates on higher levels of compensation. For example, the graduated rates might be 10 percent, 20 percent and 30 percent on successively higher levels of compensation above some exempt amount. An important design feature, the top rate of compensation tax would be the same as the single flat rate of business tax.

No other receipts (e.g., interest, dividends, etc.) are included in the compensation tax base. So, putting the pieces together, what we have is a consumption tax plus adjustments to workers’ burdens according to the level of their earnings.

Why Favor Such a Thing?

Why *should* the experts converge to a consensus on such a thing as a replacement for the individual and corporation income taxes?

First, it can satisfy the requirement of vertical equity, that is, it can match the present system's progressivity. This is presumably a requirement of reform, even if it is not really necessary that progressivity be provided by the thing we call a tax, instead of things we call transfers.

Second, beyond that required precondition, the X Tax makes possible a much simpler and more transparent system. (It would, for example, render moot essentially all of today's St. John's program. I hope that doesn't wipe out any incipient support for these ideas.) For today's purposes, I shall simply illustrate some of the advantages of such an approach.

Perhaps the most important problems solved by the X Tax have to do with what is typically labeled "capital income." Financial transactions are completely gone from the tax base of both individuals and companies. (Space prevents describing the – still simple – rules that would apply to financial institutions, consumer loans, etc.)

Financial Innovation

The past couple of decades have seen amazing innovation in finance. A good deal of the ingenuity of Wall Street's rocket scientists is directed toward obtaining the best tax results in connection with any particular economic activity (including making a profit at the expense of the U.S. and other governments). On the other hand, the tax rules often get in the way of accomplishing new financial arrangements. Both the wasted ingenuity and the obstacle to innovation would be gone in the X Tax.

Resolve the Interest Deduction Mess

The almost incomprehensible web of special rules relating to the treatment of interest payments and receipts that has grown up in the existing income tax would be gone.

Capital Gains

The fights over capital gains would be a thing of the past (business assets are accounted for on a cash flow basis; individually owned financial instruments do not enter the tax base).

Adjusting the Base for Inflation

Removal of financial transactions from the tax means that adjusting the base (as opposed to the brackets) for inflation would be feasible, relatively simple, and confined to the business level. (Actually, the adjustment would be completely automatic but for

transition considerations to which I allude briefly below.) Correctly regarded as important by tax experts, such indexing is generally considered impractical in the existing system.

A Level Playing Field for Investment, Including Owner-Occupied Housing

Uniform treatment of business investment would be automatic, regardless of legal entity and rate of inflation, for example, and requiring no judgments about the correct amount of depreciation. (As I shall point out, transition considerations may call for reintroducing some such judgments, but it should still be possible to do much better than under the current system.) Also automatic would be equivalent tax treatment of the yield from owner-occupied housing and business investments. I recognize that pushing this through might require big-time consensus among the experts. It is, however, a practical impossibility under the existing tax system, whatever the experts may think, which is that the implicit subsidy to owner-occupied housing investment is one of the system's most costly distorting shortcomings.

Cut the Complexity of Retirement Saving

The immensely complex rules relating to the qualification of retirement saving system for sheltered treatment would become entirely unnecessary. Essentially, all saving would receive the treatment now reserved for qualified retirement plans. So those rules designed to prevent tax abuse (as opposed to fiduciary matters), which are what make this area one of the most specialized in the world of tax practice, would be superfluous.

Integrate Corporation and Individual Taxation

Closely related is the automatic integration of corporation and individual tax accounts, long sought by income tax reformers. The complex rules regulating corporate restructuring and distributions, deriving basically from a need to distinguish corporate debt and equity, and rules distinguishing (Subchapter C) corporate from other legal forms of business enterprise would be gone.

Facilitate Individual Filing

A little-noted feature of the X Tax is that it would make it easy to use individual filing, thereby eliminating marriage taxes and subsidies. Whether this is desirable as a matter of policy is obviously debatable (I think probably so), but the division of property income that makes individual filing difficult under the present income tax is not a problem for the X Tax, since "property income" is taxed uniformly at the business level.

What's Wrong with the X-Tax?

Lose Cherished Deductions?

It is commonly thought that the X Tax would necessarily do away with cherished features of the existing income tax. Some of these, such as the mortgage interest deduction or the subsidy to state and local bond interest, would, it is true, be unnatural components of the X Tax. Others, such as the reciprocal deduction and inclusion of alimony, the deduction of charitable contributions and state and local taxes and the exclusion of employer-provided health care, would present the same policy issues as in the present income tax. (On traditional externality grounds, I would probably keep deductions for charity and state and local government taxes.) But most could be accommodated without losing the advantages I have cited.

Transition Impossible?

Some have stressed the difficulty of making a transition to the X Tax. I think it could be relatively easy. Because the X Tax is so simple, and uses mostly information already required for the income tax, institute it as a new schedule on the income tax. The first couple of years, pay 80% of the bottom line of the existing tax and 20% of the X Tax. Then make the proportions 60%-40%. After the required number of years, the existing tax system would be gone.

(Although it would take me beyond the scope of today's presentation to develop the point, I should note that transition considerations do, however, suggest we should consider substituting income style accounting for business investment, together with an interest allowance on undeducted basis, for the universal expensing regime I have described above. This is too bad, but does not, I think, extract a huge loss in the advantages I have described.)

The Big Enchilada, for Which the Backing of the Experts Is Essential

No, the big problem with the X Tax, at least for a slowly shrinking subset of the experts, is that it exempts capital income from tax! Surely, this is a terrible and regressive thing to do!

In my view these experts have been paying too much attention to words and not enough to substance. To illustrate my point, consider what it would take to convert the X Tax to an income, rather than a consumption base. All that would be required would be to substitute conventional income accounting for business capital expenses, substituting depreciation allowances, inventory accounting, etc., for the immediate write-off characteristic of the X Tax business component.

It seems evident to me, at least, that having to postpone my deduction for a capital outlay by some number of years is not the difference between rags and riches. The great fortunes are not made on early versus late deductions. They are made by inventing

Microsoft DOS or monopolizing the cigarette industry. These sources of great wealth are taxed alike under either the consumption-type or the income-type value-added tax.

What's In a Name?

The labels, “consumption,” “capital income” (the rest being, presumably, “labor income”), divert commentators from looking at what is actually going on. The valid point is that, in principle, the difference between income and consumption taxes is the treatment of the risk-free reward to waiting, certainly below 2% (real, inflation adjusted) per year. (I say “in principle” since, in practice, income taxes are such bad approximations to the Schanz Haig Simons ideal.) Whether or not one agrees with me that the timing of consumption should not affect a person’s discounted tax burden, it doesn’t amount to much, a point that is gradually being absorbed into the experts’ conventional wisdom.

Waiting for Consensus of the Experts

Eventually, the tide of expert opinion is going to shift decisively in favor of the consumption ideal and I hope we will postpone major reform until that happens. Such a new consensus will not bring on nirvana or the end of tax politics. It will, however, open up at least the possibility of a significantly simpler tax system, one that accomplishes its essential distributional and revenue-raising objectives more transparently and with far less waste.