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Policy Brief

Stanford Institute for Economic Policy Research

Perspectives on Tax Reform

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December 2005

Introduction

With the recent release of the report of the President's Advisory Panel on Federal Tax Reform, one might have expected a vigorous national debate on the level, structure and growth of taxes and their effect on our economy and society. Unfortunately, the meager post-report discussion thus far has focused on narrow issues of limiting this deduction or that credit. So much more than that is at stake. The evolution of taxes and spending will be a primary determinant of whether America remains a successful dynamic economy, providing rising standards of living, low unemployment and upward economic mobility or slides into complacent economic stagnation and socioeconomic ossification.

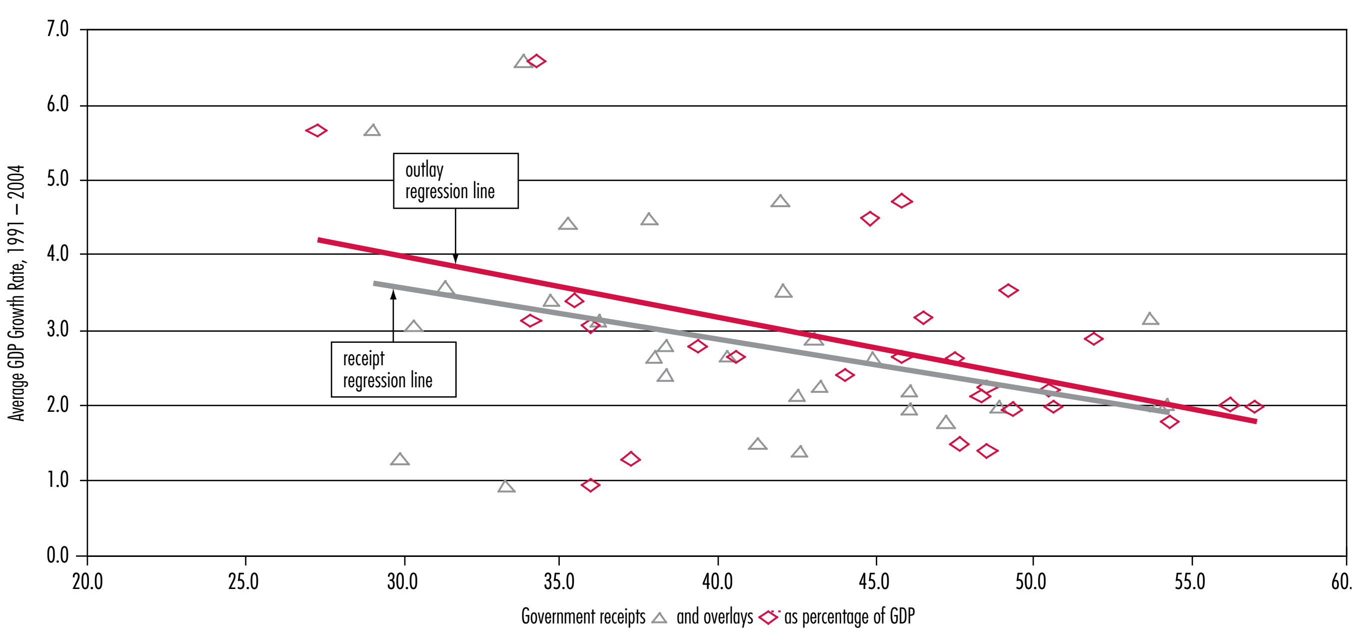
The current level of government in our economy appears to be consistent with solid economic growth and rising standards of living. A substantially higher tax and spending burden does not appear consistent with such performance. Consider Figure 1, which portrays the negative correlation between economic growth rates and government tax and spending burdens in the OECD countries. There are many other factors that influence growth rate and per capita income differentials, which is why all countries don't lie exactly on the line. But moving from U.S. tax levels – under one-third of GDP including state and local governments – to Western European levels – about one-half of GDP - might cut the growth rate by up to a full percentage point. Over a generation, that cumulates to huge differences in standards of living. It has resulted in a 30 percent lower living standard in France and Germany than in the United States.

Under current law, the federal government tax burden is projected to rise by more than one-third as a share of GDP in coming decades, because of the combined effects of the alternative minimum tax, real bracket creep, and other factors. Back in the Kennedy years, Democrats as well as Republicans used to worry about rising taxes causing "fiscal drag." Any sensible strategic management of our economic affairs starts with preventing that large step toward a European-style social welfare state. To do that, we will have to "cut" taxes and spending continuously relative to their projected growth.

While deductions and/or credits are theoretically desirable under some circumstances, a broad tax base and low rate or rates are highly desirable. The nine distinguished members of the Panel outline two such reform plans: The Simplified Income Tax Plan (SIT) and the Growth and Investment Tax Plan (GIT). The SIT would reduce the number of tax brackets from six to four (with a top rate of 33 percent); limit or eliminate popular deductions for mortgage interest, charitable contributions, employer-provided health care, and state and local income and property taxes; abolish both private and corporate alternative minimum tax (AMT); consolidate tax-deferred saving into three simple plans; exclude 75 percent of capital gains and 100 percent of dividends paid from domestic profits; simplify accelerated depreciation; limit the anti-competitive double taxation of foreign source income of American companies; and reduce the corporate rate to 31.5 percent. The SIT would also clean up definitions and numerous other provisions.

The more desirable GIT has much in common with the SIT, but moves the system closer to a progressive tax on consumed income, an ideal favored by economists for many decades. It would have three rates (with a top of 30 percent); tax dividends, capital gains, and interest at 15 percent; replace the corporate income tax with a 30 percent business cash flow tax; allow expensing of investment, but eliminate interest deductions. The plans include transition rules – for example, to grandfather existing mortgages – so the adjustment for the economy and individual taxpayers will be less wrenching.

Figure 1. **The Relationship Between Economic Growth and Size of Government (OECD Countries)**



In essence, the SIT and GIT swap capping or eliminating the popular deductions for abolition of the alternative minimum tax (which would eventually prevent a growing fraction of Americans from fully realizing the value of these deductions in any event). They also make the Bush tax rate cuts (plus a little more) permanent and thus stabilize federal taxes at the 18 percent of GDP historical average. *This is by far the most important aspect of the proposals* since the tax share of GDP is projected to rise to just under 20 percent, over $300 billion more per year, by the end of the 10-year budget window.

The Panel discusses, but does not recommend, replacing the corporate and personal income taxes with any of four more fundamental tax reforms: a progressive consumed income tax, a flat-rate (consumption) tax, a value-added tax, and a retail sales tax. The pure, some would say theoretical, versions of each would be more pro-growth than either the SIT or GIT. Hopefully, they will be given further consideration as tax reform unfolds.

Five Big-Picture Tests for Tax Reform

I use five big-picture tests to judge tax reform proposals.

1. *Will tax reform improve the performance of the economy?* By far the most important aspect of economic performance is the rate of economic growth, because that growth determines future living standards. The most important way the tax system affects living standards is through the rate of saving, investment, work effort, entrepreneurship, and human capital investment.

Immense harm is done by high marginal tax rates, especially on capital income. Consumption taxes are neutral with respect to consumption and saving (intertemporal neutrality) and also among types of investment (atemporal neutrality). A perfect income tax (which would require measuring true economic depreciation and inflation adjustment, among other difficulties) would only achieve atemporal neutrality, not the far more important intertemporal neutrality. As I first demonstrated 30 years ago, a progressive rate structure deters human capital investment. On these criteria, low flat rate consumption taxes work best, high-rate progressive income taxes worst.

An important dimension of economic performance is administrative and compliance costs, estimated by the Panel at over $140 billion per year. The flat tax, retail sales tax, and VAT do far better, and the SIT and GIT do somewhat better, but only if enacted as a replacement for current law.

Another dimension of economic performance is vertical equity. The current income tax system is very progressive (see Table 1: the top 1 percent pays 34 percent of the Federal income taxes, double its share of income; the top 5 percent pays 54 percent; the top 50 percent pays 97 percent); if every reform has to make the tax code even more progressive, we will wind up with an even smaller minority of voters paying all the income taxes, an unhealthy political dynamic in a democracy. What is important is that the rate(s) be as low as possible, especially the top rate on the most economically productive group in the population.

Table 1.
Federal Income Tax Shares, Selected Years

	Top 1%	Top 5%	Top 25%	Top 50%	Bottom 50%
1980	19%	37 %	73%	93%	7%
1988	28 %	46 %	78%	94%	6%
1996	32 %	51 %	81%	96%	4%
2003	34 %	54 %	84%	97%	3%

Source: IRS, Statistics of Income

Note: Data are rounded to nearest percent. Including the corporation income tax would make the distribution even more progressive on standard incidence assumptions; the net payroll tax financing of general government, less so. For 2003, the top 1% had 17% of income; the bottom 50% had 14%. The adjusted gross income cutoffs were $295K and $29K, respectively.

2. *Will tax reform affect the size of government?* It is important to control spending because of its effect on tax burdens and ultimately economic performance. The economic harm done by taxes distorting private decisions to save, invest, work, etc. goes up with the square of tax rates. Each dollar of additional revenues costs the economy about $1.40. Further, many programs are not designed or run efficiently, and some government spending crowds out private spending. Rigorous cost-benefit tests would thus reveal many spending programs badly in need of reform and retrenchment.

If everybody pays at a common rate, it will be harder to expand government and raise the rate, because a larger fraction of potential voters will have a stake in limiting the spending. The more progressive, thus more concentrated among the few, taxes become, the easier it is to expand government at the expense of a minority paying the bulk of costs. This was Milton Friedman's most important insight when he first proposed a flat tax in *Capitalism and Freedom*. This aspect of the case for a flat tax has unfortunately almost been lost in recent decades, as attention has focused on the important goal of simplicity, as in the postcard filing in the Hall-Rabushka flat tax.

Highly progressive rates also create an unhealthy dynamic in which revenues surge disproportionately in booms, the legislature spends it all (or more) and in the next downturn it is "impossible" to "cut" spending, leaving a growing fiscal gap and pressure to raise taxes to allow spending to ratchet up in the next boom. This is precisely what happened in California in 1999-2001 when revenues surged far more than rapidly rising income during the tech bubble, and state spending went up faster still. The inevitable correction led to a crisis with the state's credit rating below Puerto Rico's and the governor recalled.

Some proponents of the retail sales tax believe it would help control the growth of government spending by forcing an explicit transparent payment by consumers at the point of transaction, thereby greatly expanding the fraction of voters paying something to finance general government. Others believe a broad-based retail sales tax or VAT would collect so much revenue per percentage point that it would too easily finance government growth.

3. *Will a new tax structure affect federalism?* Some federal tax reforms risk crowding out state and local activity, e.g. a retail sales tax (or a VAT) might make it harder for them to raise revenue. Likewise, limiting or abolishing the deductibility of state and local income and property taxes, as in the SIT, GIT, and flat tax, will raise the net cost of raising revenue. While we should favor those tax systems that strengthen federalism and devolve authority and resources to the states and localities, the current system in effect subsidizes state and local spending relative to private or federal spending.

4. *Will a new tax structure likely endure?* We have had more than a dozen major tax law changes in the last quarter-century, about one every Congress. We should be concerned that we might move to a better tax system only to undo it shortly thereafter. In 1986, the trade-off was lower rates for a broader base. That was partially undone in 1990, and dramatically worsened in 1993, whereas in the past four years, rates have been reduced. A more stable tax system would both reduce uncertainty and be less complex, as taxpayers would not have to learn and adjust to new laws every year or two. Simplicity, transparency, and a common rate or rates are more promising than complexity and high rates.

5. *Over time, will tax reform contribute to a prosperous, stable democracy?* Are we likely to see a change in the ratio of taxpayers to people receiving income from government? We now have a much higher ratio of people who are net income recipients to people who are taxpayers than in any time in our recent history, reflecting not only

traditional transfers but the rapid growth of the EITC and other features of the income tax itself. Under the current income tax system almost half the population pays virtually no taxes (see Table 1). If the median voter has no "skin in the game," not even a tiny pro-rata share of the financing of general government, the constituency for limiting government spending will be weak, and the economy, which ultimately will have to finance the growing government spending by either current or future taxes, will eventually be severely damaged. In a few years, the demographics may drive an unstable political economy with an ever-larger fraction of voters demanding higher spending financed by higher taxes on a dwindling fraction of the population. Witness how difficult it is for the Europeans – with their larger ratios of benefit recipients to taxpayers – to make reforms which we would consider trivial, even from much higher levels of spending and taxes.

Conclusion

The five tests suggest we should be combining the best of recent tax and budget policies: the tax rate reductions and reforms of President Reagan and President George W. Bush with the spending controls of President George H.W. Bush, extended by the Congress and President Clinton, which worked quite well to control spending until the budget went into surplus in the late 1990s.

Our collective interest is in keeping the hand of government in the economy light. In keeping tax rates as low as possible. In preventing spending, tax and regulation decisions from gradually turning our society into the economic equivalent of a France or Germany, for that would surely portend economic and social disaster. Replacing the corporate and personal income taxes with the GIT, or something still closer to a pure flat rate consumption tax that prevented the projected increase in the tax share of GDP would be an important step in doing so.

About the Author

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are underwritten by a generous grant from the Taube Family Foundation.

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SIEPR **Policy Brief**

A publication of the
Stanford Institute for Economic Policy Research
Stanford University
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Stanford, CA 94305
MC 6015