



A Broader Perspective on the Tax Reform Debate

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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 mo-

bility or slides into complacent economic stagnation and socioeconomic ossification.

We don't need an academic treatise to demonstrate what is at stake (although see, for example, the 1996 National Tax Journal article by Eric Engen and Jonathan Skinner, 1996). History has performed that experiment. We daily witness economies such as the French or German staggering under bloated welfare spending and oppressive tax burdens, with standards of living 30 percent below American levels. The economies of Western Europe set their taxes and government spending at about half of GDP. In the United States, the figure is about one-third (including state and local government). While that is still too high, we have demonstrated we can make the current level of government in the economy consistent with solid economic growth and rising standards of

living. A substantially higher tax and spending burden does not appear consistent with such performance. To see why, 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, of course, all countries don't lie exactly on the line. But moving from U.S. tax levels to Western European levels might cut the growth rate by up to a full percentage point. Over a generation, that cumulates to huge differences in standards of living (as demonstrated by Edward Prescott in 2002).

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

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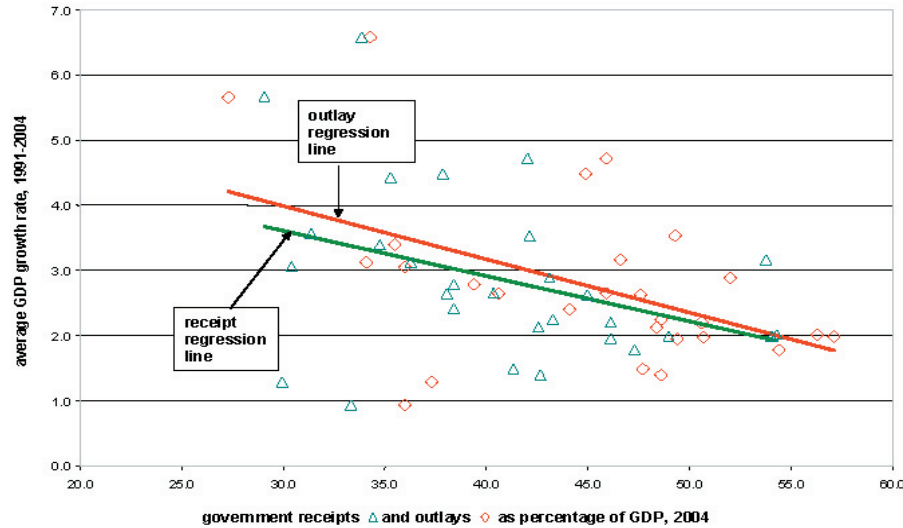
minimum tax, real bracket creep, and other factors. Back in the Kennedy years, Democrats as well as Republicans used to worry about such “fiscal drag.” Surely any sensible strategic management of our economic affairs starts with preventing that giant step toward a European-style social welfare state. 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 in an optimal tax system, as Joseph Stiglitz and I (1977) and Martin Feldstein (1980) have demonstrated, 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 the many tax-deferred saving vehicles 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. It 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.

Figure 1
Relation Between Economic Growth And Tax Burden
(OECD Countries)



The plans include transition rules, for example to grandfather existing mortgages, so the adjustment for the economy and individual taxpayers will be less wrenching.

The SIT and GIT, in essence, 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. Both plans stabilize federal taxes at the 18 percent of GDP historical average. *This is by far the most important aspect of the proposals.* 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 ten-year budget window. But, between the uproar from those who would lose popular deductions and the fact that most Americans are unaware of the AMT, even these incremental reform plans – which should be the starting, not end, point of reform — may be a very tough sell until many more voters are trapped by the AMT.

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. The Panel summarizes most of the pros and cons of these more fundamental reforms. For example, the VAT and retail sales taxes are viewed as risking becoming additional, rather than replacement, taxes, and potentially financing a big expansion of government (some Commission members opposed them on this ground, others thought they were a good way to finance growth in entitlement costs), and as becoming potential infringements on federalism. The flat tax and progressive consumed income tax were ruled out on (static) distributional grounds. Perhaps that is where Congress will eventually wind up, but wouldn't it be better to have a serious national debate on whether we are willing to trade potentially stronger growth and higher future living standards for relaxing narrow, and static at that, distributional constraints? Especially when the main driver of the large effects of the federal government on the distribution of economic well-being is in transfer payments, not the tax system?

FIVE BIG-PICTURE TESTS FOR TAX REFORM

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.

Modern academic public economics concludes that immense harm is done by high marginal tax rates, especially on capital income. This is a major reason virtually all prominent academic economists who have studied the issue recommend taxing consumption or that part of income which is consumed. Such a tax is neutral with respect to saving and investment, (intertemporal neutrality) and also among types of investment (atemporal neutrality). Think of intertemporal neutrality as a level playing field goalpost to goalpost and atemporal neutrality as level sideline to sideline. Even 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. A pure consumption tax, however levied, would guarantee both.

As I first demonstrated thirty years ago, it is the progressive rate structure that deters human capital investment. Most on-the-job training and much of higher education costs are financed by foregone earnings, which are not taxed. It is as if the foregone earnings were included in taxable income, but then immediately expensed. So a flat tax rate does not affect the net returns to such human investment decisions, but a progressive rate structure would reduce the returns and impede investment because the higher earnings generated by the investment would be taxed at a higher rate than that at which the investment was expensed.

On these criteria, low flat rate consumption taxes work best, high rate progressive income taxes worst. A growing body of research suggests that replacing the corporate and personal income taxes with a low rate pure consumption tax is the single most potent policy reform available

(articles by me in 1978, by Lawrence Summers in 1981, and by Robert Lucas in 1990 are important examples).

An important dimension of economic performance is administrative and compliance costs, estimated by the Panel at over \$140 billion per year. Here the flat tax, retail sales tax and VAT do far better, and the SIT and GIT somewhat better, than current law if enacted as a replacement. But if a sales tax or a VAT were added without removing the income taxes, large additional administrative and compliance costs would result. And any improvement in the federal income tax would only be an improvement in this dimension for taxpayers in the few states that do not have income taxes or explicitly piggyback on the federal tax base. For most taxpayers, they would only be an improvement when and if their states adopted tax bases (nearly) identical to the new federal law.

Another dimension of economic performance is vertical equity. Is the current distribution of the tax burden, shown in Table 1, about right? The current income tax system is very progressive (the top one percent pays 34 percent

of the Federal income taxes, double its share of income; the top five percent 54 percent; the top 50 percent, 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. This is especially true when combined with the aging of the population in which the fraction of the voters receiving government old age benefits will increase 50 percent in the next 20 years and double in the next 50. We can keep the tax distribution progressive with family exemptions and the EITC, even if we go to a single flat rate; and somewhat more progressive if there are two or three rates, as in the GIT. 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.

For 2003, the top 1% had 17% of income, the bottom 50%, 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 for its effect on tax burdens and economic performance. The economic harm done by taxes distorting

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 could 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%, 14%. The adjusted gross income cutoffs were \$295K and \$29K, respectively.

private decisions to save, invest, work, etc. goes up with the square of tax rates. Doubling tax rates quadruples the cost. The marginal cost is proportional to tax rates. Hence, each dollar of additional revenues costs the economy about \$1.40. When it is spent—as legislated by Congress, adjudicated in the courts, and administered by human beings—some of it is wasted, some not narrowly targeted on the intended purpose. Perhaps \$.80 or \$.90 contributes to the intended outcome in a well run program; only \$.30 or \$.40 in a poorly designed and administered program. Further, some of that government spending crowds

out private spending on the targeted activity. So the net government financed increase in spending on the activity is even less. Thus, rigorous cost-benefit tests would reveal many spending programs badly in need of reform and retrenchment.

Tax reforms that more closely tie the payment of taxes to expenditures will promote a more effective and efficient government. A new tax – a broad-based consumption tax, like a European VAT, for example—may just be piled on top of the existing taxes and used to raise revenue to grow government. This is what has happened

in many European countries and is now a major detriment to their economic performance.

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 the tax system becomes and the 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 (1983) 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 in support of spending on all 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 increase the net cost of revenue raised by state and local governments. While we should

favor those that strengthen federalism and devolve authority and resources to state and local governments, 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.

All tax systems are subject to intense economic and political pressure to change. The current system has many temporary features that need to be extended episodically; low rate(s) taxes on a broader base could raise much more revenue per percentage point increase. So which system is most likely to endure in some relatively pure form for a significant period? Here, simplicity,

transparency and common low-to-modest rates are more promising than complexity and high rates. Spending control is also vital, to minimize pressure for more revenue.

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. Do we really want to continue an income tax system in which 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.

As the baby boom generation approaches retirement, the fraction of the population in any given year who are receiving more than they are

paying will grow. We must deal with this both on the tax side (smaller underground economy, decreased proportion of population off the income tax rolls) and, especially, on the transfer payment side (slower benefit growth for the well off in entitlements programs) and do so soon, or we risk sliding into a spiral of higher benefits, higher tax rates, a weaker economy, and ever-greater political conflict between taxpayers and transfer recipients.

This suggests 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.

CONCLUSION

We have a rapidly closing window within which to have this great national strategic debate about the role of government in our economy, about the level and structure of spending and taxes. 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.

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 prevents the projected increase in the tax share of GDP would be an important step in doing so.

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