

Guidelines for Tax Reform

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I am grateful for the opportunity to present testimony on the next steps in tax reform. My expertise is in the operation of the U.S. economy and in tax policies to achieve higher growth. I serve as the McNeil Joint Senior Fellow of the Hoover Institution at Stanford and Professor in Stanford's economics department. I am co-author, with Alvin Rabushka, of *The Flat Tax*, which lays out the ultimate goal of tax reform as we see it. My testimony today deals with practical steps that could be taken in the direction of that ultimate goal. I will consider improvements that could be made in the personal and corporate income taxes. I will not comment here on the other major component of the federal revenue system, the payroll tax for Social Security.

A number of goals of tax reform command widespread support. First is *simplification*. The personal income tax today is ridiculously complicated. An improved tax would result in a one-page filing for every taxpayer.

The second goal is uniform, powerful *incentives for capital formation*. In today's tax system, entrepreneurial startups are heavily taxed while tax shelters are subsidized. Uniformity of powerful investment incentives is key to a pro-growth tax policy.

The third goal is *progressive distribution of the tax burden*. Today's tax system shields the poor from any income tax—a feature that should be retained—but its

distribution across middle- and upper-income taxpayers is cruelly uneven. We need an airtight progressive tax.

The fourth goal is *economic efficiency*. Once the other goals are achieved, efficiency calls for moderate top tax rates. Experience everywhere in the world at all times has taught that tax rates above about 30 percent generate inefficiencies that far outweigh the limited revenue that they collect.

The basic structure of a tax system that could achieve all of these goals is the *American value-added tax*. The VAT is the backbone of the revenue system of every country in Europe. It is the essence of simplicity. It provides exactly the right incentive for capital formation, because all investment is deducted from the tax base. The VAT is efficient because its rate is in the safe zone below 30 percent. The only defect of the standard European VAT—but a serious one—is its lack of progressivity. European countries complicate their VATs by applying higher rates to luxury goods, but they have not succeeded in achieving a fair distribution of the burden of the VAT. I will show how to make a simple VAT progressive without sacrificing any of its desirable features. The result is the American VAT.

Some proponents of tax reform are pushing a federal sales tax. In principle, a sales tax that exempts sales of investment goods has the same benefits as a VAT. But a VAT is much easier to administer than is a sales tax. In a VAT, *every* business pays the tax on all of its sales, whether to other businesses or to final customers. If the customer is a business, the customer deducts the purchase, so there is no double taxation. A seller does not need to keep track of whether its customers are businesses or final customers. Under a sales tax, the seller does need to make that distinction. Customers masquerade as reselling businesses when they are actually final customers. Sales taxes are notoriously leaky and cannot sustain tax rates much above 10 percent. The case against the sales tax is practical. In addition, a sales tax suffers from the same defect as a standard VAT—it is not progressive.

The following steps would take us to the progressive American VAT. The reformed tax system would meet all four of the key goals and would replace all of the current revenue of the personal and corporate income taxes:

1. Eliminate personal taxation of business income: interest, dividends, and capital gains
2. Bring all businesses under the corporate income tax, to be renamed the business tax
3. Remove the deduction for interest in the business tax and the personal deduction for mortgage interest
4. Extend depreciation of plant and equipment to first-year write-off

The result of all of these reforms would be a VAT, though its administration would be different from a standard European VAT. In Europe, the typical family does not have direct contact with the VAT. The tax is embedded in the prices the family pays, but the family does not fill out a form. That is why the VAT cannot be sensitive to the family's income level. Accordingly, the standard VAT cannot be progressive. In the American VAT, families would continue to fill out a personal tax form, but it would be simple enough to fit on a postcard. Only earnings are taxed on the form. The personal tax has a generous exemption and could have a couple of rates, say 15 and 25 percent.

In the business part of the American VAT, businesses report total revenue and deduct purchases of inputs, including the wages they pay. They also deduct purchases of plant and equipment. The business part of the American VAT is the same as the European VAT, except for the deduction of wages.

The business and personal parts of the American VAT mesh to form a standard VAT. Collecting the tax on earnings at the personal level is the secret of making the VAT fair and progressive. The American VAT is a big step forward over the European VAT because of its progressivity.

The American VAT meets all four of the key goals of tax reform. First, it is simple. Both the business and personal taxes fit on postcards. Second, it provides exactly the right incentives for capital formation, across the board, through first-year write-off. Third, it is progressive, because of the exemption and graduated rates in the personal part of the tax. Fourth, it is economically efficient because its top rate would be no more than 25 percent.

The American VAT would overcome grave inefficiencies in the current income taxes. The central problem is inconsistent incentives for capital formation that result in subsidies for some types of investment and high taxes on others. Incentives to capital formation come in two varieties. First is depreciation, including first-year write-off. Second is deduction of saving at the personal level. When both incentives are provided—as happens when a business finances investment by selling bonds to a pension fund and takes depreciation on the investment—the investment is inefficiently subsidized. This is the essence of a tax shelter. By far the best way to eliminate tax shelters is to move to a single coherent investment incentive.

Tax designers have developed a complete, coherent system based on personal deductions for saving. This is called the *cash-flow consumption tax*. Under such a system, businesses pay no taxes. Households file complex returns that account for all the inflows and outflows of cash—the base of the tax is the residual spent on consumption. The cash-flow tax is vastly more complicated and much harder to administer than any form of value-added tax.

The central issue in tax reform in the coming year will be the choice between evolving toward a VAT, on the one hand, or toward a cash-flow tax, on the other hand. Tax reform in recent years has taken steps in both directions, increasing the likelihood of conflicts that create tax shelters that exploit both investment and saving incentives and gain inefficient subsidies. We have been adding investment incentives and saving incentives and thus worsening opportunities for tax shelters without coordination.

In my view, we should move purposely toward the American VAT. The reductions in the dividend and capital gains taxes adopted last year were important steps in that

direction. We made the right choice by reducing the personal rates on these types of income rather than reducing the corporate rates.

The next step should be the elimination of all personal taxation of dividends and business capital gains. The public needs to be educated that these types of income have already been taxed at the business level. Removing personal taxation is not a giveaway to the rich, because the tax on these types of income has already been paid, at the top tax rate, at the business level. The corporate tax is a withholding tax.

Another important step is the rationalization of interest taxation. In some ways this step is easier, because the removal of interest deductions raises more revenue than is lost from removing taxation of interest at the personal level. The decrease in business interest deductions could be offset by an increase in depreciation, as I will discuss shortly. To avoid dislocations, certain transition rules would be needed. I will not try to spell these out here.

Of course, the big issue in interest taxation and deductions is home mortgage interest. Even an ivory-tower dweller like me knows that the mortgage deduction is sacrosanct. The deduction could be retained in the American VAT setting if there were a special corresponding tax on mortgage interest receipts that recaptured the tax lost from the deduction and maintained the VAT principle overall. Lenders would receive a small incentive to offer alternative mortgages at lower rates that lacked the privilege of interest deduction. The interest on these mortgages would not be taxed when received by the lender. Eventually, Americans would be weaned of deductible-interest mortgages.

At the same time that we are moving the taxation of all business income to the business and limiting personal taxation to earnings, we should phase in improvements in depreciation of plant and equipment. After a period of a decade or so, all plant and equipment should be written off for tax purposes in the year of purchase, in accord with the principle of the VAT. During the period of transition, depreciation and write-offs will be higher than normal, because we will be honoring past commitments to depreciation at the same time that new investment is written off immediately.

At the end of this process, we will have created the American VAT. The additional revenue from plugging existing loopholes will permit a top tax rate of about 25 percent for both the business and personal taxes. We will achieve the four key goals of simplification, uniform, powerful incentives for capital formation, progressive distribution of the tax burden, and economic efficiency.

Let me conclude with a few remarks about what we should *not* do. We should not consider a national sales tax—it is an administrative nightmare. We should not consider a European VAT—it is not progressive. We should not expand saving incentives at the personal level or make any other changes that anticipate moving to a cash-flow consumption tax—it too is an administrative nightmare. The progressive American VAT is the desirable goal of tax reform.