How Could We Improve the Federal Tax System?

What is a broad-based income tax?

Q. What is a broad-based income tax?

A. One that minimizes tax preferences with the goal of increasing revenue at a given rate of taxation.

BROADENING THE INCOME TAX BASE

Base broadening involves increasing the portion of income subject to taxation. It is often accompanied by proposals to decrease tax rates. The Bowles-Simpson plan, the Tax Reform Act of 2014, and a proposal from the Domenici-Rivlin Debt Reduction Task Force all fit this category.

In calculating tax liability, taxpayers have the right to exclude portions of their income through deductions, credits, exclusions, and the preferential treatment of income from certain sources. This, of course, lowers the revenues that could be collected if all income were taxed at the given rate. More than 150 such "expenditures" appear in the tax code; the 10 largest currently cost the government about $900 billion per year and account for approximately two-thirds of the budget impact.

SWITCHING TO A CONSUMPTION TAX

A consumption levy taxes the purchase of goods or services rather than income. A move to such a system was proposed by the 2005 President's Advisory Panel on Federal Tax Reform, forms the basis of Columbia Law School professor Michael Graetz's Competitive Tax Plan, and features in several other plans usually labeled as national retail sales taxes and flat taxes.

Retail Sales Tax

A national retail sales tax would levy a flat tax on all retail sales. In most proposals, the tax would have a broad base, exempting only expenditures for education, existing housing, purchases abroad by US residents, and food produced and consumed on farms. Proponents argue that the tax would be simpler to administer and create fewer economic distortions than the income tax. However, in most forms it would be regressive, disproportionately taxing low- and middle-income earners.

Value-Added Tax

Value-added taxes are collected from businesses at each stage of the production process. Under the "credit-invoice method," all sales by businesses are taxable, while firms claim credits for all taxes paid on purchases from other businesses. The result is that the tax base is equal to the full value of the final sale to the consumer. The United States is the only developed country that does not have a value-added tax, which tend to have lower administrative and compliance costs than income taxes.

Flat Tax

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A flat tax is really a value-added tax divided into two parts. It was first proposed in 1983 by economists Robert Hall and Alvin Rabushka of Stanford University's Hoover Institution. Their proposal called for a 19 percent tax at the business level on all value added other than wages. Households, for their part, would pay a 19 percent flat tax on all wages and pension benefits above a specified exemption level. The family exemption increases the progressivity of the tax. But the tax structure is regressive relative to the current system, as it lowers taxes for higher-income households.

X-Tax

The X-tax, proposed by the late David Bradford, is a variant of the flat tax. Businesses would still pay a single-rate value-added tax on all their nonwage value added. But unlike the flat tax, the wage tax would be set at progressive rates, beginning at zero and increasing until the business rate were reached. The plan would retain the earned income tax credit and the deduction for charitable contributions and would provide a credit for payroll taxes paid. A modified version of the X-tax was proposed in the 2005 reports of the President's Advisory Panel on Federal Tax Reform, in which the income tax would be replaced with a 30 percent tax on firms and top wage earners. (The panel would have supplemented the X-tax with a 15 percent tax on capital income earned by individuals.)

Consumed Income Tax

In general, all income can either be spent immediately or saved to be spent later. A consumed income tax would tax only current consumption, exempting all savings until it is spent. Proponents argue that the exemption of savings would encourage investment, which would increase economic growth.

A variation of the consumed income tax, the Unlimited Savings Allowance Tax, was offered by Senators Sam Nunn and Pete Domenici in 1995 as a replacement for the income tax. Under their plan, households would pay a progressive consumed income tax with deductions for some education costs, mortgage interest, and charitable contributions. Businesses, for their part, would be taxed with a subtraction-method value-added tax with a flat rate of approximately 11 percent. Both households and businesses would be able to claim a payroll tax credit.

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What would and would not be taxed under a broad-based income tax?

Q. What would and would not be taxed under a broad-based income tax?

A. Generally, all forms of income, but there are as many options as there are proposals.

Base broadening could include all forms of income, such as wages and "anything that allows you to spend more, either now or in the future" (President's Advisory Panel 2005, 20). These sources include retirement account income, capital gains, dividends, rental income, employer-provided health insurance, unrealized increases in the value of real estate, and securities.

The President's Advisory Panel looked closely at a somewhat less comprehensive broad-based income tax that would eliminate credits, "above the line" deductions, and itemized deductions. The individual alternative minimum tax would go; tax filers would get to keep the standard deduction and personal exemptions.

The Bowles-Simpson Commission's "zero-base budgeting" plan would modify the income tax to lower rates and deficits by cutting tax expenditures. This tax would eliminate all tax expenditures (an estimated $1.1 trillion per year) but would not modify the payroll tax base.

The Domenici-Rivlin plan, for its part, eliminates the standard deduction and personal exemption, taxes capital gains and dividends as ordinary income, simplifies the earned income tax credit, shortens the list of itemized deductions, and caps deductions for medical expenses.

The 2017 Tax Cuts and Jobs Act was decidedly not a base-broadening tax reform. Among other changes, it eliminated personal exemptions but replaced them with them much larger standard deductions and child tax credits. It also eliminated some smaller itemized deductions, including those for unreimbursed employee expenses tax preparation fees, and most casualty losses, but added a significant new deduction for pass-through business income.

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What would the tax rate be under a broad-based income tax?

Q. What would the tax rate be under a broad-based income tax?

A. That depends on what exclusions, credits, and deductions are left in and whether revenue neutrality is a must.

The President's Advisory Panel on Federal Tax Reform estimated how much marginal tax rates could be reduced under a broad-based income tax that generated the same revenue as the current system. As table 1 shows, the switch would permit across-the-board cuts of about one-third. This sort of reform would not be an easy political pill to swallow, however. The panel's version, for example, would preserve only the standard deduction and personal exemptions, and would eliminate credits, "above-the-line" deductions, and itemized deductions. On the plus side, a broad-based tax would eliminate the much-despised individual alternative minimum tax.

TABLE 1

Marginal Tax Rates for Married, Filing Jointly Households

Under current law and a broad-based system, 2006

Tax bracket	Current law system	Broad-based system
$15,050 and under	10.0%	6.6%
$15,051 – $61,100	15.0%	9.9%
$61,101 – $123,250	25.0%	16.4%
$123,251 – $187,800	28.0%	18.4%
$187,801 – $335,400	33.0%	21.7%
$335,401 and over	35.0%	23.0%

Source: President's Advisory Panel (2005).

The Bowles-Simpson alternative provides similar estimates but argues that its zero-base budgeting methodology would allow the system to reduce rates and the deficit simultaneously (table 2).

Note, however, that after the 2017 Tax Cuts and Jobs Act, these estimates are dated and both the projected revenues and tax base have changed.

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TABLE 2

Marginal Tax Rates in 2011 under Current Law and Broad-based Systems

Bowles-Simpson plan

	Current law system	Broad-based system	Illustrative plan[a]
Bottom rate	15.0%	8.0%	12.0%
Middle rate	28.0 – 31.0%	14.0%	22.0%
Top rate	36.0 – 39.6%	23.0%	28.0%

Source: National Commission (2010).
(a) The illustrative plan eliminates all tax expenditures except for the Child Tax Credit and Earned Income Tax Credit. It also taxes capital gains and dividends as ordinary income.

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