

How Could We Improve the Federal Tax System?

COMPREHENSIVE TAX REFORM

What is comprehensive tax reform?

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A. The term refers to broad, sweeping changes to the tax system. What qualifies as “comprehensive” is a judgment call.

Rather than taking a piecemeal approach, making small changes to provisions of the tax code, comprehensive reform would address the inequities, complexities, and inefficiencies of the entire tax system. The last comprehensive reform to the US tax system took place in 1986, when the Tax Reform Act lowered income tax rates and broadened the tax base.

Some more recent proposals are more of the same, broadening the tax base to lower tax rates without lowering revenue. Other proposals would scrap the current system entirely, replacing the income tax with a consumption-based tax system. But the broad goals of greater fairness, efficiency, and simplicity remain the same.

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What are the major options for comprehensive tax reform?

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A. In a nutshell, broaden the income base while lowering tax rates, tax consumption instead of income, or do a bit of both.

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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