How Could We Improve the Federal Tax System?

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A. The answer depends more on politics than on economics.

Any fundamental tax reform that seeks to collect the same amount of revenue in a new way is almost certain to redistribute tax burdens, affect asset values, and change price levels. Those who stand to lose would try to prevent the reform or secure "transition relief" that delays or blunts the impact.

The national retail sales tax proposal illustrates these issues starkly. Could the proposal withstand the inevitable political pressures to provide some with preferential treatment or to introduce transition relief? The issue is pivotal because backsliding would undermine the logic of pressing the reform in the first place.

The transition to a national sales tax would open a can of worms. At one extreme, the sales tax could include no adjustments. At the other, policymakers could grant extensive relief by adjusting Social Security benefits to reflect higher retail prices, allowing consumption to be tax free if financed by existing wealth, and so forth. In practice, the transition relief accompanying much smaller tax reforms has tended to balloon.

The economic case for transition relief depends on how it affects the simplicity, efficiency, and equity of the new tax system. Providing no relief would be simpler, transition rules could prove complex, and the transition period could stretch out for years. However, there are wheels within wheels here. Not providing relief would also be problematic because it would create strong incentives for individuals to adjust their behavior before the tax takes effect.

Not providing transition relief would certainly be more efficient. A consumption tax that exempts old assets is just a tax on future wages. While a pure consumption tax (one that taxes all old capital) is usually found to be more efficient than a pure income tax, a wage tax (which exempts all old capital) is usually found to be less efficient than a pure income tax. Not taxing existing assets requires higher tax rates on the rest of the tax base to raise the same revenue, increasing the disincentives to work that plague any tax on wages.

Surely the strongest argument for transition relief is fairness. The assets that people own today were priced, purchased, and used under the current tax system. Is it fair to their owners to change the rules midstream?

The answer may not be as obvious as it seems. First, a one-time implicit tax on existing capital would be very progressive. The distribution of such capital is more skewed toward wealthy households than the overall distribution of wealth. And the overall distribution of wealth is, in turn, more skewed toward the wealthy than the distribution of income. Second, since wealthy households would benefit most from the switch to a consumption-based tax, it seems reasonable to ask them to pay some of the costs.

Third, older households tend to have more assets than younger ones, so taxing existing capital places heavier burdens on older generations. But there's rough justice here: those older households, on average, have received transfers through Social Security and Medicare that far exceed what they have put in. And the vast majority of most elderly households' income and wealth is in earnings (which have not yet been taxed), housing (which receives extraordinarily preferential treatment under the current tax system), pension income (which already receives consumption-tax treatment), Social Security benefits (which everyone agrees would be indexed for inflation with tax reform), and Medicare benefits (which are not taxed). Few elderly households finance much of their living expenses from other assets, and those that do tend to be well off.

Ultimately, the political case for transition relief would determine whether it was part of the package. And history strongly suggests that it would be. Even in much smaller tax reforms, the losers—households and businesses made worse off by the reform—have been compensated. A big question, then, is whether imposing what might be called "sales tax lite" would be worth the economic dislocation.

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Further Reading

Esenwein, Gregg A., and Jane G. Gravelle. 2004. *The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues*. Washington, DC: Congressional Research Service Report for Congress.

Gale, William G. 2005. "The National Retail Sales Tax: What Would the Rate Have to Be?" *Tax Notes*, May 16.

President's Advisory Council on Federal Tax Reform. 2005. *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System.* Washington, DC: President's Advisory Council on Federal Tax Reform.