

## **My Beautiful Tax Reform**

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Although he was most certainly not speaking of tax policy, Ralph Waldo Emerson might just as well have been when he wrote, in *The Conduct of Life*: “We ascribe beauty to that which is simple; which has no superfluous parts; which exactly answers its end” (Emerson 1860). The idea that simplicity is beautiful has often been embraced by artists and writers. Many scientists have argued that simplicity leads us to *truth*. Indeed, the Nobel laureate physicist Richard Feynman (1965) said one “can recognize truth by its beauty and simplicity.” The Nobel physics prize winner four years after Feynman, Murray Gell-Mann (1964), said that in physics, “A chief criterion for the selection of a correct hypothesis . . . seems to be the criterion of beauty, simplicity, or elegance.” Social scientists and certainly economists generally admire, and aspire to, the rigor of natural science. In tax policy, many experts equate the best tax system with the simplest, and the best tax reform with the one that most simplifies the system. But for many reasons, in economic and tax policy the simplest, most elegant policy need not be the best.

One reason is that tax policy involves a tradeoff among objectives, including equity and efficiency objectives, and often, achieving equity and efficiency requires some complexity. For example, at first blush the simplest tax system is what economists call a lump-sum tax, where the tax liability (not the tax rate) is the same for everyone, but not linking a family’s tax liability to its level of well-being will certainly violate most people’s, if not everyone’s, concept of what is fair. This illustrates that determining the best tax policy depends not only on an understanding of economics, but also on values.

Because my favored tax system depends both on my economic assumptions and on my value judgments, which not everyone shares, saying exactly what tax reform I favor without laying out what leads me to this choice would not contribute much to the public policy debate. Thus, in what follows I will try to lay out explicitly what has led me to my viewpoint, so the reader can get a sense of how his own economics or values would lead to a different policy prescription.<sup>1</sup>

First, I believe we should seek the best (to be defined more carefully as I go along) tax system, not the worst. This may sound obvious, but it is not. Some people who believe that the government wastes most of the money it raises have argued that the tax system should purposely be made inefficient in order to limit how much tax revenue can be collected (Becker and Mulligan 2003). I disagree strongly with this point of view. If spending restraint is the objective, there are less costly ways to achieve it than by purposely running an inefficient tax system.

There are also serious practical obstacles to achieving an ideal system. Among other things, a tax system is a vast bureaucracy of collection and enforcement. This is important because no government can simply announce a tax system, sit back, and wait for the money to roll in. At first, most tax obligations would be remitted by citizens who are dutiful or not convinced that the IRS has really been dismantled. But after a while, the dutiful citizens would begin to feel like suckers, and the wary citizens would accept that there were no consequences from flouting the law. Revenue would dry up. Even a half-hearted attempt to enforce the tax system favors the amoral and aggressive.

Practical considerations are critical in assessing a tax reform that some argue is beautiful in its simplicity—replacing the federal income tax with a national retail sales

tax (RST). This is, to be sure, a radical reform and also, at least at first glance, a radical simplification, in part because no individuals would have to file tax returns. Some supporters of the RST argue that adopting it would allow us to abolish the IRS.

If simple is beautiful, from afar the RST looks beautiful, indeed. But this is deceiving. First, keep in mind that the tax rate needed to replace federal income tax collections fully would be jaw-dropping, but not in a good way—about 27 percent if the federal sales tax base were the same as that of the average state, and considerably higher if the base did not include purchases of business inputs, as it should not. Add to that current state and local sales tax rates, maybe doubled to account for the fact that few states will maintain their income tax if the feds have abandoned theirs, and the rate would be well over 30 percent. Under a 30 percent-plus RST, the enforcement problems would be different than now, to be sure, but not smaller. All of the collection onus falls on one business sector for which the other side of the taxed transactions—consumers—has no incentive to help enforce the tax. Indeed, I believe it would be impossible to levy such a tax at the standards of equity and intrusiveness to which we are accustomed. Undoubtedly for these reasons, only six countries have operated an RST at a rate over 10 percent, and all but one has since abandoned it. I am a risk-averse person and would not bet the fiscal integrity of the United States on an untested—or more precisely, a tested-but-found-to-be-wanting—system of collecting revenue.

Unless, of course, I *wanted* to blow a (bigger) hole in the budget. But I do not. The tactic of “starving the beast” that is the federal government with big tax cuts has so far proven to be a failure. The resulting deficits lower national saving at a time when the country should be saving more to prepare for the retirement of the baby boom generation.

This is an issue of intergenerational fairness, because it puts off assigning the tax burden to the future. We current taxpayers could soften the tax blow on our children by saving more and passing more along to them, but the evidence suggests that few people think this way (and many are too constrained to act even if they did think this way), and so by spending more than it takes in, the government is encouraging a spending spree at the expense of future generations. Tax reform should not be an occasion to worsen this problem.

Although a national retail sales tax looks beautiful only from afar, it has a more attractive sister called the value added tax (VAT), which is now operated by more than one hundred countries. The VAT has a key administrative advantage over the RST in that it is collected from not only retail businesses, but all businesses, and can have a clever self-enforcing feature that improves compliance. Some countries that levy a VAT raise nearly as much money, as a percentage of GDP, from it as the United States now raises from its income tax. It is not without its problems and complexities; the cost of compliance is not trivial, but is still probably half or less of that of our income tax.

In spite of the fact that a VAT promises considerable simplification over the current system, the VAT should not be a substitute for the income tax. I believe the government has an obligation to consider how its policies affect not only the dollar sum of GDP, but also whether the total is equitably shared. There is no value-neutral or self-evidently beautiful way to assign tax burdens. I favor a distribution of tax burdens in which the tax burden, as a proportion of income, should rise as income rises—what economists call *progressivity* of the tax burden. Not only should Bill Gates have a higher tax burden than a single mother earning \$10,000 a year, but his tax burden as a fraction of

his income should be higher (much higher, in my opinion). This conclusion reflects both my values and my economics. Where my values come from is not relevant, nor could I convince anyone to embrace my values. As for my economics, I recognize that a progressive tax distribution requires higher marginal tax rates, which dampen the incentive to work and do anything else that engenders financial success, and encourage privately rewarding but socially inefficient activities that reduce taxable income. But my reading of the empirical evidence has convinced me that the efficiency cost of progressivity is not so large (a professional judgment) that it overwhelms the benefits of a more equal distribution of well-being that tax progressivity provides (a value judgment).

Business-based tax systems such as the RST and the VAT cannot, on their own, deliver enough progressivity for me. Yes, both systems can exempt commodities, such as food, that comprise a higher percentage of the consumption basket of low-income families. But this is a very inefficient way to deliver progressivity, for the simple reason that not only low-income families buy food, and one that is incapable of delivering a program such as the earned income credit. One could couple an RST or a VAT with universal payments to families, but that would require an even higher rate of tax as well as a vast transfer-paying bureaucracy.

Enter the flat tax. By flat tax I do not mean any tax system that features one and only one tax rate. (If this were true, then both an RST and a VAT would qualify.) I mean *the* flat tax first proposed by Robert Hall and Alvin Rabushka (1983) in the early 1980s. This flat tax is really a VAT, with two related modifications. First, unlike a VAT, under the flat tax, businesses can deduct from the tax base payments to employees; second, employees are subject to tax on their labor income at the same rate of tax faced by

businesses. These alterations do not imply much change at all in who remits tax to the government, because businesses could continue to withhold and remit the employees' tax liability. They do, though, require 100 million or so employees to file tax returns when they otherwise would not, which, to put it mildly, seems like an unnecessary administrative expense.

Why do it, then? Introducing the notion of individual tax liability facilitates introducing progressivity into the assignment of the tax burden. The Hall-Rabushka flat tax proposal takes advantage of this opportunity in one way only—it allows a standard deduction and personal exemptions, so there is an exempt level of labor income, which varies by family size. It then applies a single rate to all *labor* income above this level. In principle, though, there is no reason that a graduated tax rate schedule cannot be applied to the flat tax personal base. David Bradford has proposed exactly that, in what he calls the X-tax, a name which has an air of mystery about it, to be sure, but arguably is less prone to confusion than calling it a “graduated flat tax” (Bradford 1996).

Having a separate personal tax allows something other than progressivity—the personalization of the tax burden. But having created the possibility, the creators of the flat tax do not partake. They allow no deductions, other than the standard deduction and personal exemptions—none. No deduction for mortgage interest, no deduction for charitable contributions, no child care credits, no tuition credits, and so on. But personalizing the tax system facilitates its use as a vehicle for an unlimited number of social and economic policies, incentives to particular behaviors, and rewards to particular constituencies. The prospect of eliminating *all* of these incentives and rewards is exhilarating to someone who seeks simplicity and beauty in a tax system, but is

Pollyannaish to those who understand the American political system and the rewards showered on those politicians who control the dispensation of these goodies.

This is the issue that separates the tax-reform men from the tax-reform boys concerning the most fundamental of all questions—the extent of government involvement in the economy. Many conservatives who pay lip service to limited government get cold feet when it comes to sweeping away the interventions that occur via the tax system. I believe that, besides ensuring progressivity, the government’s role in the economy should be limited. Not doing this inflicts costs in equity, efficiency, and complexity. Moreover, even in a time when more and more people use, or hire accountants who use, tax-preparation software, a complex tax system erodes the transparency of the fiscal relationship between government and citizens, at a cost to an informed participatory democracy.

Putting aside whether extensive government intervention is a good idea in principle, whether one should favor in practice cleaning up the current U.S. personal income tax base certainly depends on whether on balance one approves of the particular web of incentives and rewards that now exists. I am inclined to sweep the system pretty thoroughly, getting rid of many of the big items and most of the little items. In this chapter, I have the space to address only a few examples. Consider the itemized deduction for state and local income and property taxes, extended in the 2004 tax bill to state income or sales tax for the tax years 2004 and 2005. It is a subsidy for subfederal government expenditures at a rate that increases with the affluence of the jurisdictions’ residents, because more affluent taxpayers are both more likely to itemize their deductions in the first place and, if they do, are likely to be subject to higher marginal tax

rates, which is the effective rate of subsidy. It would never (and should not) be approved by Congress as a stand-alone subsidy program.

The same problem applies to the current preferential tax treatment of employer-provided health insurance, under which, unlike for cash compensation, health insurance expenditures are deductible to employers but not taxable to employees. This makes providing compensation in the form of health insurance significantly more attractive than it otherwise would be, and especially so for high-income taxpayers, and creates strong incentives for employers to offer more generous health benefits than otherwise. I favor capping or eliminating this tax preference, although this action should be taken only as part of a larger health-care reform effort that does not weaken the incentive for employers to provide group insurance plans without providing a viable health insurance alternative.

I favor abandoning the huge subsidy to owner-occupied housing implicit in the income tax but do not have an easy way to accomplish this (just eliminating the mortgage interest deduction will not do the trick because the return to the housing asset remains untaxed and self-financed owners are treated better than those who must take out a mortgage). Credit programs for education should be consolidated and simplified. The same goes for credits aimed at low-income families, which probably should be converted into a “standard credit” along the lines of the standard deduction, which eliminates the need for most families to itemize and document their eligibility for a host of programs with similar objectives. Those itemized deductions that remain should be turned into a credit at the first, basic income tax rate of about 15 percent.

If the tax base could be significantly cleaned up, it could achieve one of the key selling points of an RST—(most) individuals would not have to file tax returns. The



British and Japanese income tax systems work this way now, and the U.S. Treasury Department has said it could work in the United States, too. It requires that the tax system be simplified enough that employer withholding can be exact for most taxpayers, meaning that little or no reconciliation by the individual is required. A no-individual-return, business-based system can be both progressive and personalized to the extent that employees (or third parties) provide employers with the information needed to calculate correctly how much tax to remit to the IRS on behalf of the employee. But ultimately, it must be the employee's responsibility to verify the accuracy of the information used to calculate tax liability, so that even though individuals might not file returns, they will in some way have to be involved in the tax collection system. A highly personalized no-individual-return system requires that individuals provide their employers with information that currently goes to the government, which changes the locus but not the extent of intrusiveness.

Because of the withholding taxes that they remit on behalf of their employees, businesses are central to the process of taxing labor income. But, not surprisingly, businesses are also central to the taxation of business income, and they could be central to how we tax the income received by those who supply capital to businesses. How this works in the current system is a mess.

To see why, first consider how a progressive, comprehensive (i.e., all sources of income are subject to tax) income tax system should work. Business income would be attributed to the owners of the business and taxed at whatever rate is appropriate, given the total income of the owner. If nonowners have supplied capital to the business, the cost

of obtaining the capital should be deducted from business income, and the income paid should be subject to tax at the appropriate tax rate of the supplier of the capital.

This is how it works now for all but the biggest public corporations. Any business with one hundred or fewer owners, which accounts for the vast majority of businesses, can retain the legal advantages of incorporation—principally limited liability and perpetual ownership—while paying no corporation income tax. The company's income is allocated to the owners and added to their individual taxable income. However, an incorporated business or, since 1997, even an unincorporated business can elect to be subject to the corporation income tax and its graduated rate structure, which subjects annual taxable income up to \$75,000 to first a 15 percent and then a 25 percent rate.

Although the graduated rate structure of the corporation income tax mimics the graduation of the personal tax, it cannot be justified on progressivity grounds because the total income of the owner of the business may put him well into the top (currently 35 percent) individual bracket, so that the tax relief afforded by the lower corporate rates is unjustified. Thus, for the vast majority of businesses, the corporation tax is by no means a burdensome double tax; rather, it is an option for tax reduction. One of two changes should be made to this system: Restrict the ability of companies to be subject to the corporation rate structure, or eliminate the low rates of tax on the first \$75,000 of income.

An entirely different system applies to the big, publicly owned companies that comprise only a few thousand of the several million businesses in the country but account for a large fraction of business activity. Publicly owned corporations cannot elect out of the corporation income tax. This produces an odd system in many ways. First, it subjects the corporation's income to what is effectively a flat rate of 35 percent (the tax benefits of

the lower rates in the bottom brackets are trivial compared to the vast income of public corporations), regardless of what tax bracket the owners of the corporation are in, and regardless even of whether the shareholders are tax-exempt entities. Taxing big corporations by attributing business income directly to the shareholders would in principle solve these problems, but it raises formidable and probably insurmountable practical problems. Many other countries allow shareholders a partial credit for the taxes that corporations have already paid, approximating the way that employers withhold personal income tax for their employees, but with no attempt to adjust the amount of tax withheld and remitted by the business to the personal tax circumstances of the shareholders.

A second issue is that although the tax treatment of business borrowing is consistent with the ideal—interest payments are deductible as a business expense but taxable to the lender—the taxation of equity finance does not follow this pattern. The corporation is not allowed to deduct anything in recognition of the cost of attracting the financing, but the equity providers (i.e., the shareholders) are taxed to some degree on the income they receive. This system causes inefficient incentives for corporations to raise capital by borrowing and to manage payments from the corporation to the shareholders in tax-efficient, but otherwise inefficient, ways. Finally, the two levels of tax, corporate and individual, could cause the tax rate on business income to be higher than it is on other income and the cost of capital for corporate businesses to be higher than it is for other businesses, neither of which is justifiable.

The most sensible approach to these problems is to allow a personal tax credit to shareholders for some or all of corporation taxes paid. In 2003, the United States adopted

a different approach when the personal tax rate on dividends and capital gains was capped at 15 percent, compared to a maximum 35 percent rate on other income. There are two problems with this approach. First, it moves the system toward one where the rate of tax on corporate income is 35 percent regardless of the tax situation of the owner, which is inconsistent with progressivity and certainly inconsistent with the oft-heralded idea of making stock ownership attractive to lower-income people. Second, it cuts the personal tax on corporate-source income while doing nothing to ensure that the corporate-level tax was in fact paid. Notably, the original Bush administration proposal in the 2003 legislation linked the two levels of tax by making dividends tax-free (and not just capped at 15 percent) only to the extent that the dividend-paying corporation had actually paid corporation tax. Linking the two taxes ensures that, in the quest for attaining a single level of tax on corporate income, we do not end up collecting no tax at all; this is an important policy issue in light of the apparent but difficult-to-document increase in abusive corporate tax shelter schemes that have drained corporation tax collections. This link, abandoned in the legislation that was eventually passed, should be revived by allowing a credit only for corporation taxes actually paid.

Apparently many public corporations opposed the link in the original 2003 proposal because it would reveal publicly that they paid little or no corporation income taxes. One might think that their financial statements would reveal this fact, but they do nothing of the kind, due to the myriad differences between accounting for book income and taxable income. To promote transparency of public policy, I believe public corporations should have to reveal how much tax they pay—not all the details of their tax return, which might reveal information helpful to competitors and reduce the

informativeness of the tax return, but just the bottom line. In addition, the IRS should be allocated the resources it needs to investigate, and the courts should crack down on, abusive corporate tax shelters and avoidance schemes.

Finally, just as the personal tax base should be cleaned, so should the tax base be cleaned of tax loopholes carved out solely for specific companies or industries. These provisions generally have no principled economic justification—rather the beneficiaries are often the most politically connected—and therefore cause resources to flow to less efficient uses. A principled commitment to a less activist government requires leveling the playing field among businesses and, with only limited exceptions, letting private entrepreneurs and capital owners determine how the economy's resources are directed.

In sum, with my beautiful tax reform, business and capital income would be more systematically subject to progressive taxation, by eliminating the benefit of graduated corporation income tax rates, offering a credit for corporation taxes paid by tax-paying public corporations, and cleaning the corporate tax base. There are, to be sure, other intriguing proposals for rationalizing the taxation of business and capital income. For example, under the comprehensive business income tax (CBIT), both corporate dividends and interest payments are tax-free at the individual level but, in parallel, corporate interest payments are no longer a deductible business expense, putting them on a level playing field with dividends and eliminating the distortions to financial behavior the tax system now produces. Under the CBIT, all business income is taxed at 35 percent, as opposed to the current system, under which, for the vast majority of businesses, the income is taxed at the appropriate tax rate of the owner. As with the RST, the VAT, and

the Hall-Rabushka flat tax, under a CBIT there is no distinction between corporations and other businesses.

The CBIT eliminates the tax consequences of payments of dividends and interest (to the payer and the recipient) made by businesses, but leaves them in place for other transactions, including mortgage interest payments. One could go farther and eliminate the tax consequences of all financial flows, as occurs under an RST, a VAT, or a Hall-Rabushka flat tax. This would not cost as much revenue as one might first guess because it would not only be exempt from tax receipts of interest, but it would also disallow interest deductions. Because the latter on net are taken by taxpayers in higher tax brackets than those who receive interest payments, attempting to collect revenue on financial flows raises little or no revenue in aggregate. Eliminating the tax consequences would eliminate a highly complex area of the tax law that tries to measure the taxable flow of a vast array of complicated financial instruments, such as zero-coupon bonds and swaps. Although I admit to being intrigued by this type of proposal, I do not support this type of reform because it raises serious unresolved issues regarding the transition from the current system and how well it would integrate with the tax systems of the rest of the world.

Note that I have now come full circle in my discussion of tax reform options. Requiring all businesses to pay tax at a single rate on a base with no deductions for interest payments and taking dividend and interest receipts out of a completely cleaned-up personal tax base is, with one important exception, exactly the Hall-Rabushka flat tax (or, with a graduated personal tax structure, the X-tax). The one exception is that under an income tax or a CBIT, businesses must depreciate the purchase of capital goods, while

under the flat tax they can immediately write off expenses. In this way, income of all types can be taxed at the business source of income. As noted, taxing (only) at the business source affords considerable simplicity but does not easily accommodate a progressive distribution of the tax burden.

### **Conclusion**

Under my beautiful tax reform, most Americans would not have to file tax returns. The tax system would no longer be the primary source of goodies passed out by the government and a major determinant of how resources are allocated—what goodies and subsidies that remain would be consolidated. Progressivity would be retained with a system under which most, but not all, American taxpayers would be subject to a low, basic rate, the same rate at which all tax credits can be redeemed. Taxation of business income would be rationalized with the objective of taxing all business income at the appropriate tax rate of the income earner, sharply reducing tax sheltering, and making corporation tax payments more transparent.

I recognize that this system is not as beautiful as others that have been proposed, and that therefore the title of my chapter involves some irony. My tax reform is not more beautiful because beauty as simplicity is not the only criterion for choosing a tax system, and, alas, there are tradeoffs among the characteristics that matter to me. My desire for progressivity rules out entirely business-based systems. My desire to avoid serious unintended consequences means that tax systems that eliminate the tax consequences of

financial flows will have to wait until the transitional and international implications are more fully worked out. By the standards of the scientist and philosopher Buckminster Fuller, who said that “when I have finished [working on a problem], if the solution is not beautiful, I know it is wrong,” I have probably failed. But I take comfort in the words of perhaps the greatest of all scientists, Albert Einstein (1977), who once cautioned that “everything should be made as simple as possible, but not simpler.”



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<sup>1</sup> My views on tax policy are laid out in much more detail in Joel Slemrod and Jon Bakija (2004).