



Toward an Optimal Tax System, Part 2: What Might Full-Blown Tax Reform Look Like, and What Can We Hope to Accomplish by Improving the Tax System? June 29

What benefits might we expect from a complete tax overhaul? The Tax Cuts and Jobs Act amended the income tax, but was not a full-blown reform of the tax system. Several features of the new tax system (as with the old system) remain less than optimal. There is a tax base that is still overly complex and inconsistent with basic tax principles for efficiency and growth. Several alternative tax regimes will be presented, including a rationalized income tax and systems based on consumed-income or cash flow.

1. How does our current tax system compare to a “pure” income- or consumption-based tax?
2. Corporate and noncorporate business income are taxed differently; one approach to this difference is integrating the tax system. Because of the tax treatment of interest, businesses can also be taxed differently depending on whether they utilize debt or equity financing.
3. Neutral or consumption-based taxes would treat all savings like an Individual Retirement Account or pension, either by deferring taxes or exempting returns. Examples of this include the cash-flow tax, a national sales tax, a value-added tax, and the Flat Tax.
4. Expensing of investment should include equipment and structures.
5. Most tax systems borrow from different approaches to tax foreign profits. Ideally, in some consistent manner, the tax system should stop at the border.
6. The federal income tax code still contains more than 100 “tax expenditures,” provisions that offer preferential tax treatment to specific economic activities or groups of taxpayers, leading to reduced federal revenue. Which tax expenditures are appropriate depends on which type of tax you view as “normal.”

Further Reading:

“Expensing: The Right Tax Treatment for All Investment Regardless of Financing Arrangements” – Stephen J. Entin, <https://taxfoundation.org/expensing-right-tax-treatment-all-investment-regardless-financing-arrangements/>

“The Neutral Cost Recovery System: A Pro-Growth Solution for Capital Cost Recovery” – Stephen J. Entin, <https://taxfoundation.org/neutral-cost-recovery-system-pro-growth-solution-capital-cost-recovery/>

“Tax Reform Bill Will Increase the Trade Deficit. Good or Bad?” – Stephen Entin, <https://taxfoundation.org/tax-reform-bill-will-increase-trade-deficit-good-bad/>

“The Inflow Outflow Tax—A Saving-Deferred Neutral Tax System” – Institute for Research on the Economics of Taxation, http://iret.org/pub/inflow_outflow.pdf

Robert E. Hall and Alvin Rabushka, *The Flat Tax*, second edition, Hoover Institution Press, Stanford, CA, 1995.

David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, second edition, revised, Tax Analysts, Arlington, VA, 1984; also available in an earlier form on the Treasury Department web site.



Moving Toward Fundamental Tax Reform

Tax Foundation University 2018, Part 5

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Key Points

- Two competing ideas about what to tax are “income” and “consumption,” but definitions matter.
- How to treat cost recovery (depreciation) and interest are important decisions in creating one or the other type of tax.
- An income tax falls harder on saving/investment than on consumption. Many types of tax systems are more neutral in treating saving/investment versus consumption, and they support a higher level of capital formation and wages.

Equalizing Treatment of Saving and Consumption

- **Expense investment** (immediate write-off of plant, equipment, and structures, or present value equivalent).
- **Make saving either tax-deferred or returns-exempt** (as with regular or Roth-style IRAs, but for all saving, with no limitations on amounts or timing).
- **Integrate corporate tax with owners' tax** (tax at business or ownership level, not both).
- **End estate and gift tax.**

Income Concepts

Change in the Ability to Consume: Includes current labor income, earnings on savings and investment, capital gains as accrued, and assumes economic depreciation. No adjustment for time value of money. Proposed by Haig and Simons to further redistribution. Leads to **income tax**.*

Revenue Less Cost of Earning Revenue: Labor income, earnings on savings and investment after full, immediate expensing of all costs (saving; purchases of machines, buildings, materials; cost of tuition, training). Reflects time value of money. Proposed by Fisher to maximize output/income. Leads to **consumed income** or **saving/consumption neutral tax**.*

*See Appendix

Income and Consumption Elements in U.S. Tax System

Income Elements

- Ordinary taxation of saving: taxing both the amounts saved and returns on saving
- Depreciation and amortization in accordance with “economic depreciation”

Consumption Elements

- Tax-deferred or Roth-style pensions and retirement plans
- Tax-exempt bonds
- Treatment of owner-occupied housing
- Accelerated depreciation or expensing provisions

DEPRECIATION CONCEPTS

Economic Depreciation: Loss of value year-to-year as asset wears out or obsolesces. No adjustment for time value of money.

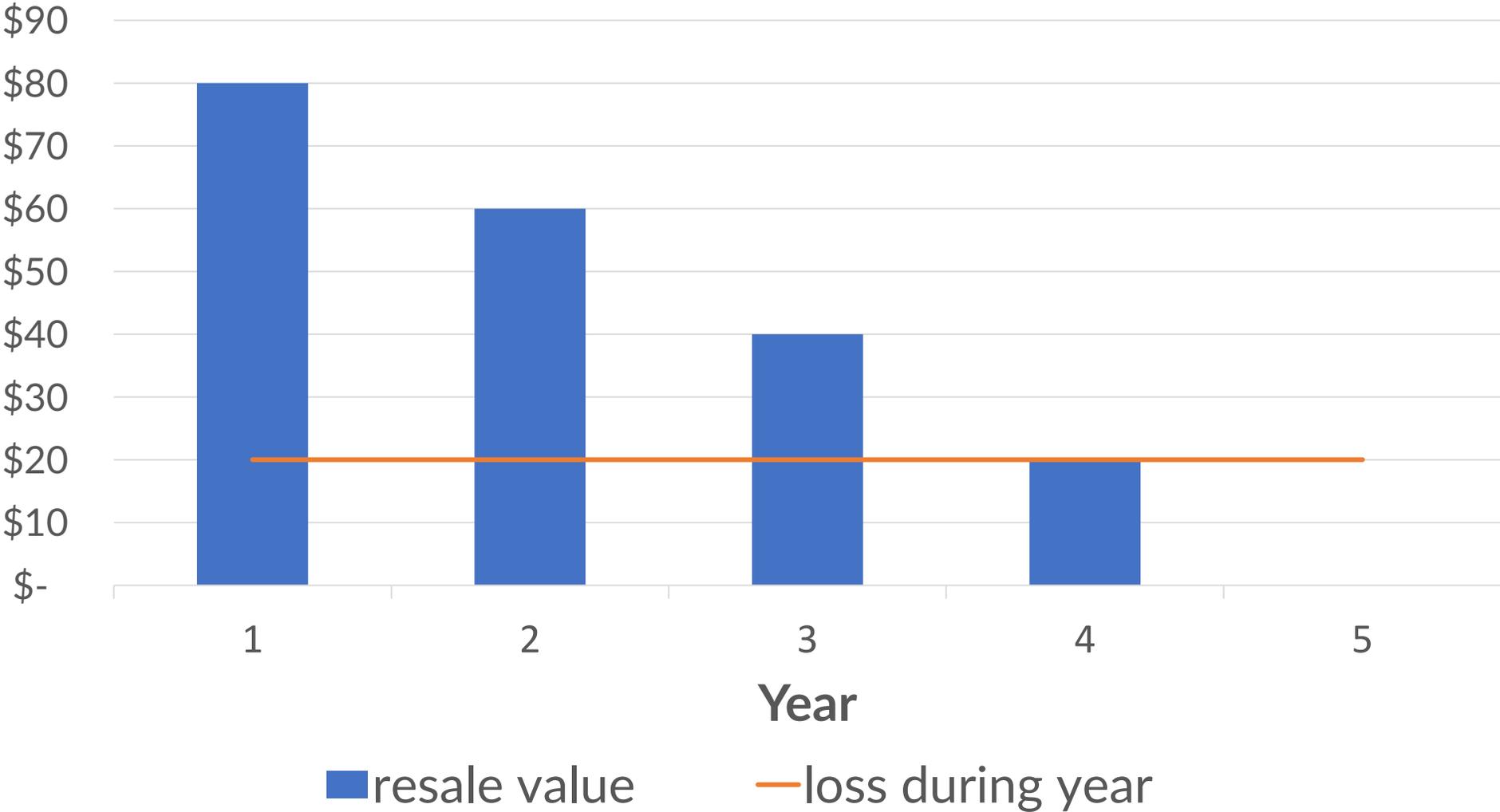
Straight Line Depreciation: Equal annual write-down over presumed asset life with no adjustment for time value of money.

Accelerated Depreciation: Greater write-down in early years, less later.*

Expensing: Immediate write-off. Reflects time value of money as cost.*

*GAAP assumes economic depreciation. With acceleration or expensing, GAAP rules report a dollar-for-dollar offsetting “deferred tax liability” to reflect higher taxes due later, but do not discount the future taxes to reflect the time value saved by deferring them. Because of this arbitrary convention, acceleration does not affect the “bottom line” in financial statements. The rule is misleading, because faster write-offs raise the value of the earnings. GAAP rules show the full benefit of a rate cut, but hide some of the benefit of expensing.

Rationale for Straight Line Depreciation: Assume EOY Resale Value of \$100 5-year Machine Drops \$20/Year



Depreciation vs. Expensing

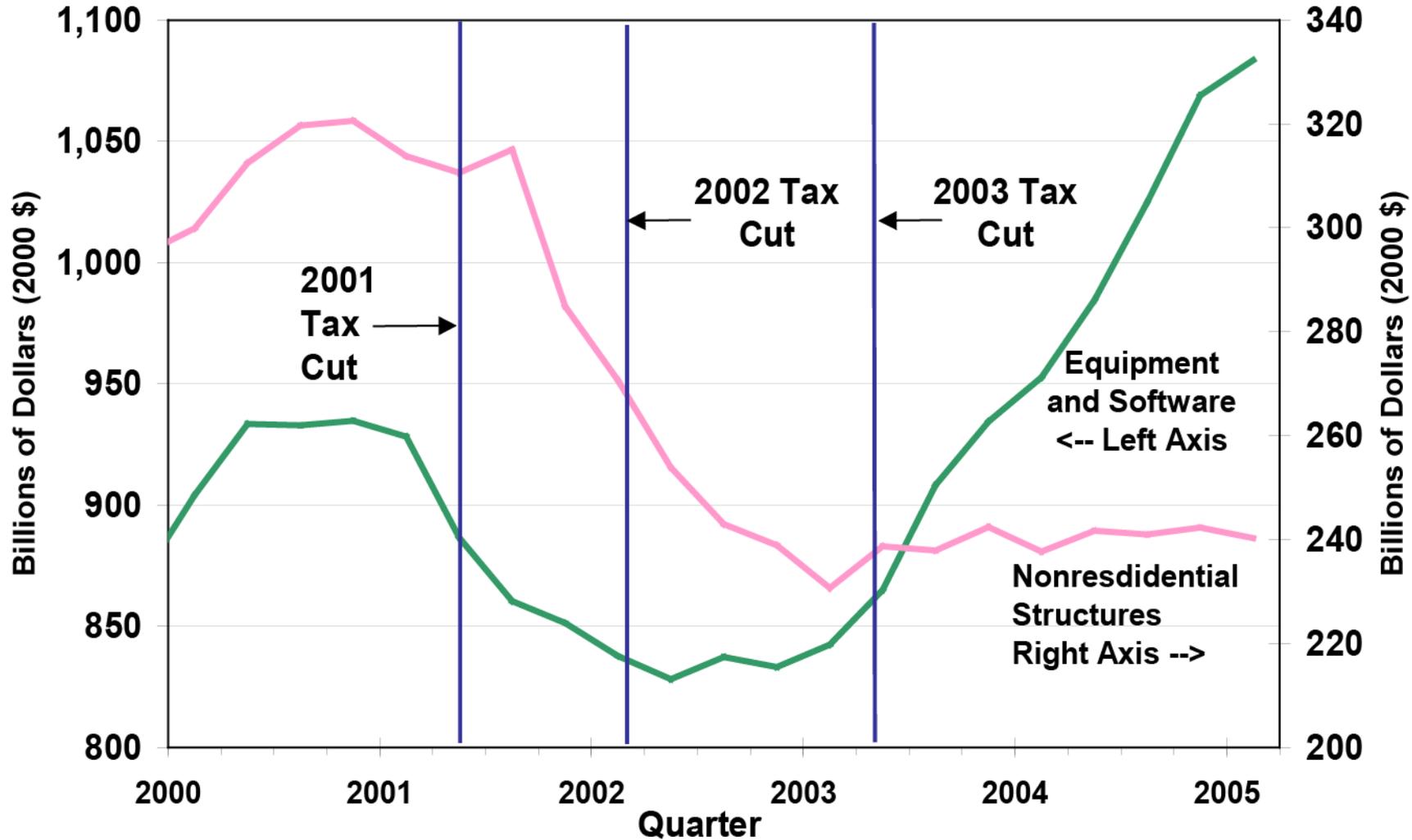
The time value of money and inflation reduce the value of depreciation allowances below the full cost of the asset.

Present Value of Cost Allowance per Dollar of Investment

	3-year asset	7-year asset	39-year asset
Expensing	\$1.00	\$1.00	\$1.00
MACRS at 0% inflation	\$0.96	\$0.91	\$0.55
MACRS at 5% inflation	\$0.92	\$0.81	\$0.30

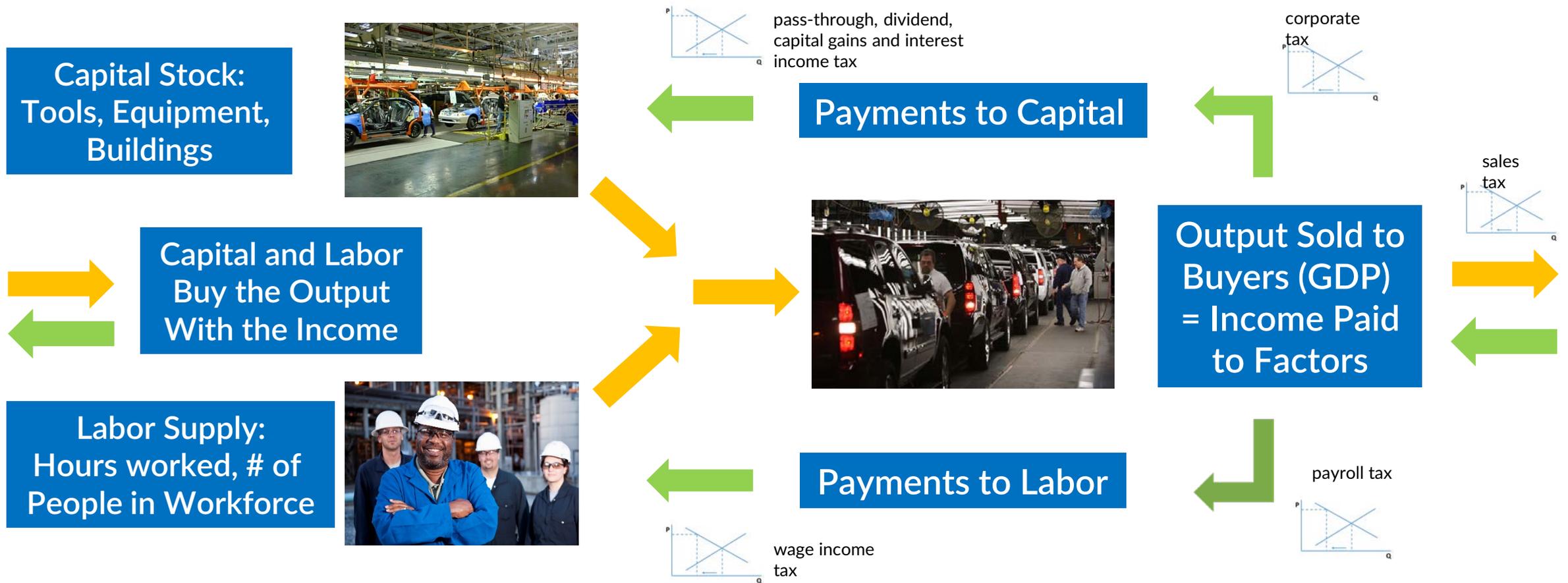
Assumes 3.5% real discount rate, plus inflation.

Real Private Investment And 2001, 2002, and 2003 Tax Cuts



Data Source: BEA, National Income and Product Accounts, Table 5.3.6, accessed via www.bea.gov.

Output Equals Income: Labor and Capital Produce Output → ← Sales Proceeds Pay Labor and Capital



Tax Treatment of Interest: Is It In or Out of the Tax Base?

In: Taxable interest where marginal tax rates are 33.33%

Pretax 6% → Post-tax 4%

Pre-tax interest rate of 6% is 4% after-tax to the borrower after deducting interest paid, and 4% after-tax to a taxable lender who must pay tax on interest received. (Tax-exempt lenders keep the full 6%.)

Out: Interest is not deductible and not taxable:

Pretax 4% → Post-tax 4%

Pre- and post-tax interest rates are 4% for everyone.

Half in/half out: Capping deduction → double taxation

Pretax 6% → Post-tax 6% to borrower → Post-tax 4% to lender

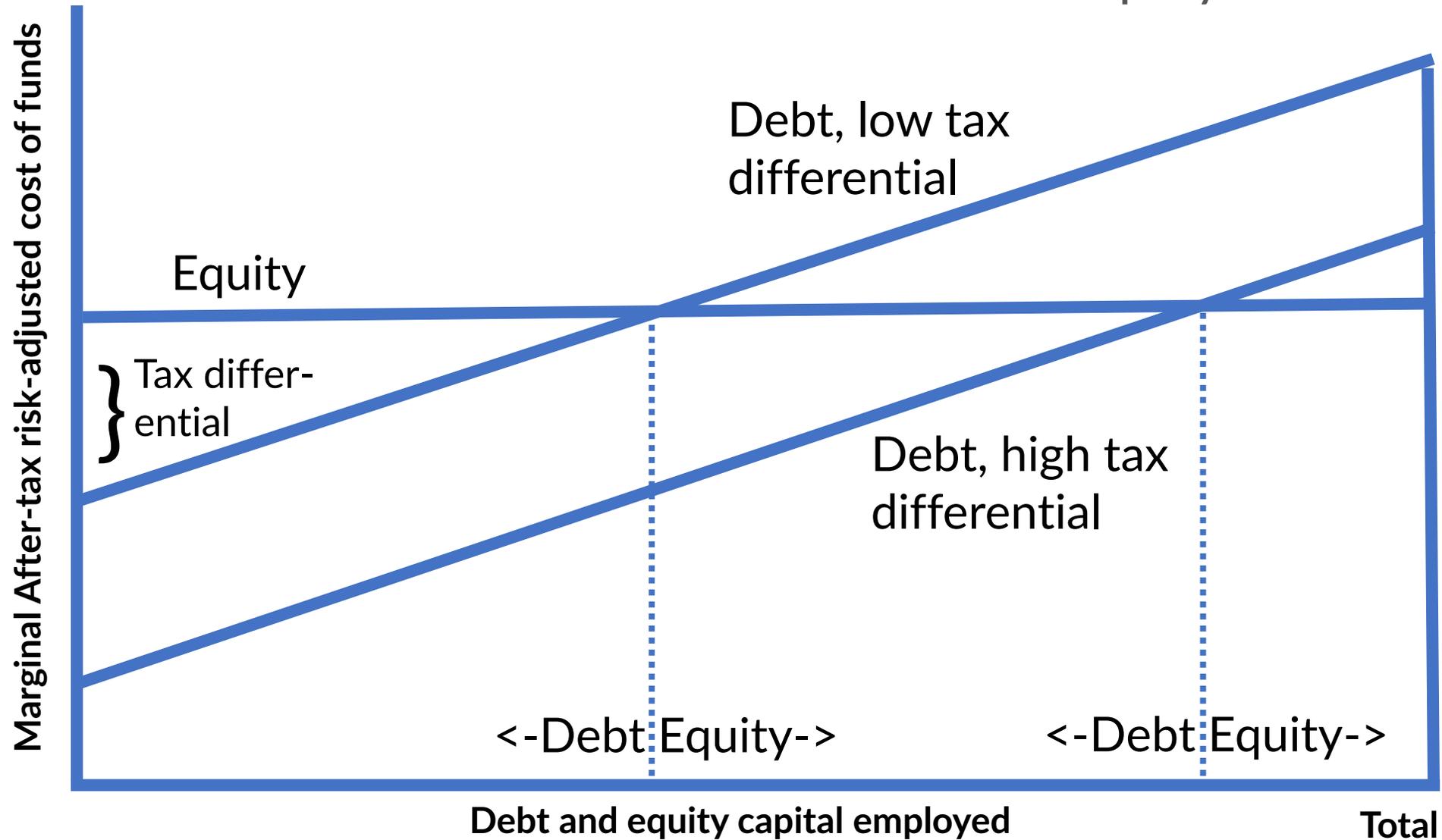
Tax Treatment of Interest with Expensing

Capital returns are shared by borrower & lender, but owners of assets get the cost recovery.

Some claim that deducting the cost and deducting interest is a double deduction that results in negative taxes to the business.

This claim is false. It forgets the tax on the lender. (Marginal lenders are taxable.)

Debt and Equity Cost the Same at the Margin After Risk Adjustment; Tax Differential Affects Ratio Employed



Four Neutral Tax Types

National Retail Sales Tax

Value Added Tax

Flat Tax

(Hall-Rabushka or Armey)

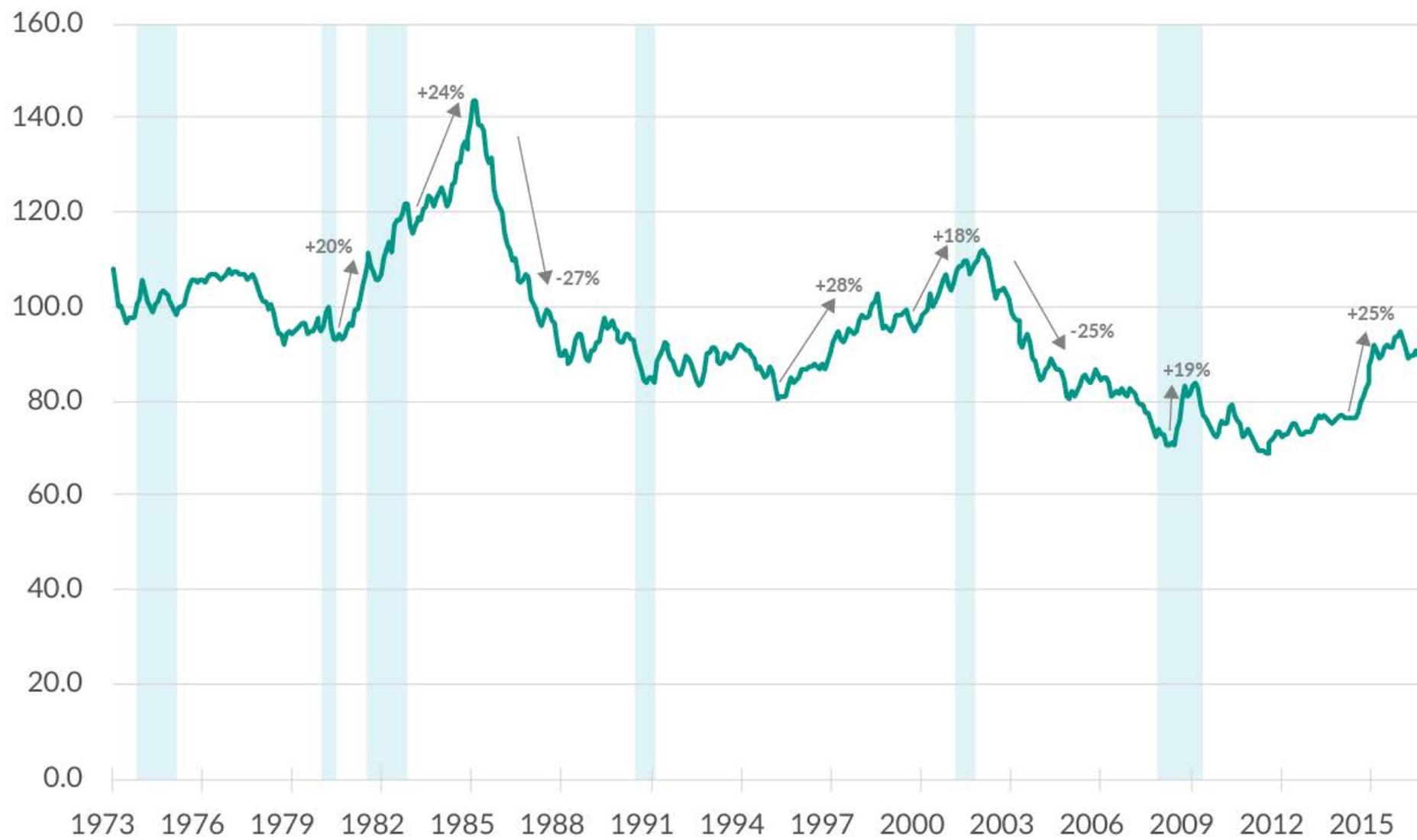
Personal Expenditure Tax

(cash flow tax, consumed-income tax, Bradford X-tax, Inflow-Outflow tax)

Comparison of Sales Tax and Value Added Tax

	Sales price	Sales tax 10%	Value added	Value Added Tax 10%
Iron and coal	\$6,000	None	\$6,000	\$600
Steel and parts	\$18,000	None	\$12,000 (= \$18,000 - \$6,000)	\$1,200 (= \$1,800 - \$600 rebate)
Automobile	\$27,000	\$2,700	\$9,000 (= \$27,000 - \$18,000)	\$900 (= \$2,700 - \$1,800 rebate)
Final sale, total value added and total tax	\$27,000	\$2,700	\$27,000	\$2,700

Nominal Trade Weighted U.S. Dollar Index: Major Currencies



Source: Federal Reserve Bank of St. Louis, <http://bit.ly/2IMloMr>

Flat Tax

Business tax (all businesses, any size)		Personal tax	
Value added (sales less purchases from other businesses)	\$300,000	Labor income of worker and any deferred pension	\$50,000
Less cash paid to labor (wages and salaries but not fringe benefits)	-\$200,000	Less large family allowance (no other deductions)	-\$30,000
= Taxable business income (business value added + fringes)	\$100,000	= Taxable income (worker's share of value added)	\$20,000
Tax at 20%	\$20,000	Tax at 20%	\$4,000

Inflow Outflow Tax, Form 1040: Individual Tax Form

1. Sum of: Labor compensation, Pension receipts, Taxable Social security, transfer payments (from W-2 forms) and business income (Schedule C).	\$33,000
2. Net saving (+) or net withdrawals (-) (from Schedule B)	\$ 3,000
3. If line 2 is net saving (+), subtract dollar amount from line 1; if net withdrawal (-), add the dollar amount to line 1.	\$30,000
4. Other itemized deductions from Schedule A	\$10,000
5. Personal allowances (taxpayers and dependents): $\underline{\$5,000} \times \underline{2} =$	\$10,000
6. Subtract sum of lines 4 and 5 from line 3. This is your taxable income.	\$10,000
7. Tax from table (or, line 6 times 20%).	\$ 2,000
8. Withholding, from W-2, plus estimated tax payments.	\$ 2,100
9. Amount due (+) or amount of refund (-) (line 8 less line 9).	-\$100

Inflow Outflow Tax: Schedule A, Itemized Deductions

1. Sum of individual payroll tax (from W-2), state and local tax withheld (from W-2), estimated state and local tax less refunds from previous year, local property taxes.	\$ 5,000
2. Gifts, contributions.	\$ 1,000
3. Qualified tuition, training expenses.	\$ 4,000
4. Total. Enter on Form 1040, line 4.	\$10,000

Inflow Outflow Tax: Schedule B, Saving

List net saving (+) or withdrawals (-) from financial institutions reported on 1099 forms:

First National Bank	-\$1,000
Merrill Paine Schwab	+\$4,000
Total (if greater than zero, net saving; if less than zero, net withdrawal). Enter on Form 1040, line 2.	\$3,000

Inflow Outflow Tax: Schedule C, Business Income

Business sales or other revenue:	\$100,000
Purchases from other businesses	\$50,000
Labor compensation, and other taxes paid	\$30,000
Net business income (line 1 less sum of lines 2 and 3). Enter on Form 1040, line 1.	\$20,000

President's Advisory Panel on Tax Reform, 2005

Simple, Fair, and Pro-Growth: *Proposals to Fix America's Tax System*

The Simplified Income Tax Plan with simplified accelerated depreciation and Roth-type saving incentives, graduated tax rates and most deductions replaced by credits

The Growth and Investment Tax Plan, similar but with expensing, and with interest removed from the tax system

Also discussed: a full-blown cash flow tax, VAT, and NRST

Is It Normal or a Tax Expenditure? Depends on What is Considered “Normal”. Deviation May Be Positive or Negative

Item	Income Tax	Consumption base
Expensing	tax expenditure	normal
Accelerated depreciation	tax expenditure	negative t.e. if less than expensing
Saving plans and pensions	tax expenditure	normal, negative t.e. if there are limits
Reduced rates on capital gains, dividends	tax expenditure	normal, if the saving was not tax-deferred
Deferral of tax on capital gains	tax expenditure	normal
Not taxing imputed rent	tax expenditure	normal, unless depreciation were allowed
Exclusion of health insurance premiums	tax expenditure	tax expenditure
Child credits and EITC	tax expenditure	tax expenditure
Corporate tax	normal in the "usual" income tax	negative t. e. if shareholders are also taxed
Standard deduction, personal exemption	normal in the "usual" income tax	tax expenditure in a pure consumption tax, probably "normal" in a progressive one
Graduated tax rates	amount below highest rate a t.e.?	amount above lowest rate a negative t.e.?
Deduction of interest paid	normal when interest is in income	normal when interest is in income
Credits: environmental, housing, etc.	tax expenditure	tax expenditure, even if less than expensing, as not all investments qualify
And hundreds more.....		

Appendix: Henry Simons, Personal Income Taxation, pages 18-20:

- The case for drastic progression in taxation must be rested on the case against inequality -- on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely...
- The degree of progression in a tax system may also affect production and the size of the national income available for distribution. In fact, it is reasonable to expect that every gain, through taxation, in better distribution will be accompanied by some loss in production...
- [I]f reduction in the degree of inequality is a good, then the optimum degree of progression must involve a distinctly adverse effect upon the size of the national income...
- With respect to capital accumulation... the consequences are certain to be significantly adverse... [I]t is hardly questionable that increasing progression is inimical to saving and accumulation... That the net effect will be increased consumption... hardly admits of doubt.
- The contention here is not that there should be correction of the effects of extreme progression upon saving but that government saving, rather than modification of the progression, is the appropriate method for effecting that correction, if such correction is to be made.

Appendix: Two problems with Simons's analysis:

- The government almost never runs surpluses.
- Surpluses would not correct the disincentives to invest inherent in the high tax rates (the wedges). Private saving would shrink to match the tax-generated surplus.

Alfred Marshall had a better idea: a neutral tax base with graduated rates, i.e., a progressive consumption tax:

Alfred Marshall, Principles of Economics, 8th edition, 1920, p.661:

- [T]here is a general agreement that a system of taxation should be adjusted, in more or less steep graduation, to people's incomes; or better still to their expenditures. For that part of a man's income, which he saves, contributes again to the Exchequer until it is consumed by expenditure.