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Taxing More, Taking Less: How Broadening the Federal Tax Base Can Reduce Income Tax Rates

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Introduction

The composition of the tax base—or what gets taxed—will be one of the major issues that the President's Advisory Panel on Federal Tax Reform will have to grapple with in its report due to be released in late 2005.

In recent years there has been growing interest in abandoning the system of taxing income altogether and replacing it with a system that taxes consumption. In other words, the panel might propose a tax system that would tax *actual consumption* rather than changes in the *ability to consume*, which is what occurs under an income tax.

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There is much merit in such a proposal. However, as long as the nation keeps its conventional income tax, it could levy the tax in a much more comprehensive manner.

How Much of Our Income Do We Tax?

The current federal individual income tax system taxes less than half of the income that potentially could be taxed. This results in tax rates that are more than twice as high as they could be. Moreover, when we tax some income heavily and some not at all, taxpayers naturally change their financial activities. Often these changes are economically nonsensical, but they make tax sense. The combination of high tax rates and tax-induced economic distortions harms the nation's economic performance and lowers the U.S. standard of living.

Defining Income

At the U.S. Department of Commerce, the Bureau of Economic Analysis is the official estimator of how much the nation earns. In 2005 individual Americans are expected to accrue $10.2 trillion from all sources. This is called "personal income." If that measure were used as the tax base of the federal individual income tax system this year, the $912 billion that the current system is expected to collect could be raised with a flat rate of just 9 percent. If today's six income tax rates were applied to all personal income, they would range from 4 percent to 17 percent instead of starting at 10 percent and going all the way to 35 percent. The reasons for this discrepancy are illustrated in Figure 1.

Before an income tax can be levied, the government must decide what constitutes income. Economists have traditionally defined income broadly as the money value of the change in an individual's power to consume during a given period.[1] In other words, a person's annual income is equal to his consumption during a year plus or minus any change in his savings.

This economic definition of income encompasses everything generally thought of as income, such as wages, salaries and investment income, because each of these obviously increases an individual's ability to consume goods and services. It also includes items sometimes not thought of as income, such as medical insurance coverage that individuals receive as a fringe benefit of employment and employer contributions to retirement plans, because these also increase individuals' power to consume, either now or in the future.

Also included in the economic definition is income that people receive from capital assets such as shares of stocks. Such income can be of two varieties. One is obvious: annual cash payments such as interest or dividend income. The other is more obscure: the non-cash value that assets provide to their owners. Owner-occupied homes, for example, provide their occupants with valuable housing services each year. Similarly, durable goods provide their owners valuable services over their lifetimes.

Not only do stocks and capital assets send a stream of measurable benefits to their owners, but they rise and fall in resale value on a daily basis. Ideally these changes, known as capital gains and losses, would be also be considered when calculating an individual's annual income.

Why Define Income Broadly?

There is a general consensus among economists that competitive markets are the best guide for people's financial decisions because they maximize social welfare. Economists equally agree on the inadvisability of allowing peculiarities in the tax code to guide, or misguide, our economic decisions.

If our laws dictate that some types of income be taxed and others not, or if some types of income are taxed at different rates than other types, the competitive market is distorted and the nation's economic performance diminished.

Economists are attracted to the notion of broadly taxing income because it would help to ensure that an income tax system is *economically neutral*—meaning that it would not alter

The Appeal of Consumption Taxes

Interest has grown in the idea of abandoning the federal individual income tax system altogether and replacing it with a consumption-based system. Individuals would be taxed on the total value of goods and services they consume, rather than on the income they earn (which is equal to their consumption plus net changes in their savings). In other words, we would tax money spent instead of income earned.

A number of consumption-based tax plans have been proposed. Probably the best known is the so-called flat tax proposed by economists Robert E. Hall and Alvin Rabushka. Presidential candidate Steve Forbes made a version of it the centerpiece of his 1996 campaign, and former House Majority Leader Dick Armey endorsed a version of this tax. Other well known consumption tax plans include the national retail sales tax, the value added tax, and the cash flow tax. While these tax systems may appear markedly different from one another, they are actually quite similar because they all aim to tax what individuals consume.

One of the major impetuses behind this movement is the belief that the existing system dampens economic growth by taxing the proceeds of saving, impeding investment in productive plant and equipment. Since consumption taxes leave savings untaxed, they offer the promise of a better economy overall. A well designed consumption tax system would also encourage workforce participation and simplify the tax code, especially by eliminating the inter-temporal accounting problems that plague income tax systems (see text box on page 4).

At first glance, replacing the federal individual income tax system with a consumption-based system may appear radical. However, the existing system is far from a pure income tax. Under current law many types of savings are exempted from taxation, as they would be under a consumption tax. Consequently, the transition from our hybrid income-consumption tax to a pure consumption tax is certainly not impossible and probably would not even be terribly disruptive.

[1] What is termed the economic definition of income in this paper is also frequently referred to as the Haig-Simons definition. Economists Robert M. Haig and Henry Simons helped to develop this definition in the first half of the last century.

individuals' choices away from those that they would make in the absence of the tax—with respect to earning different types of income over time.

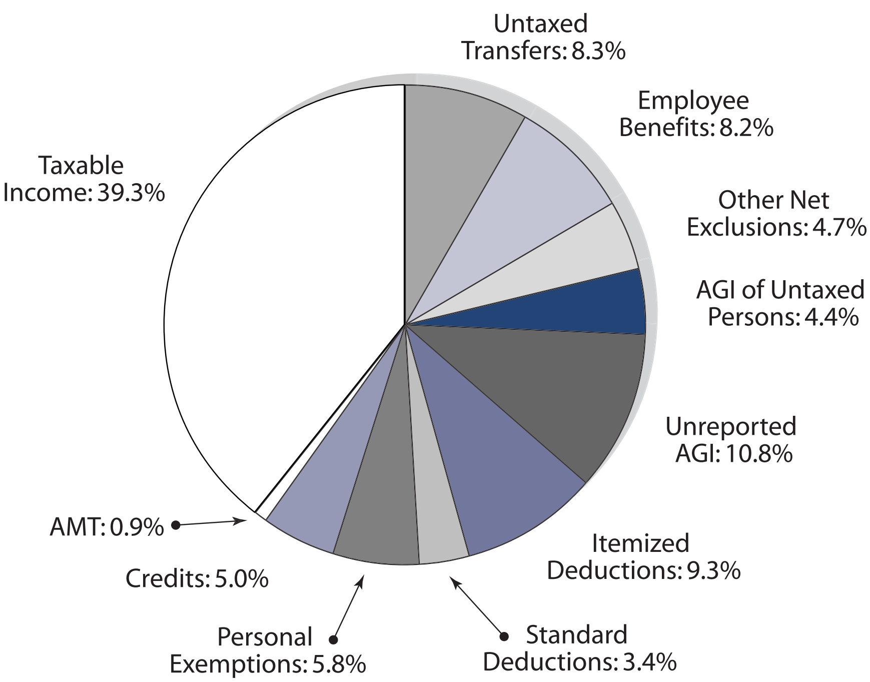
Another virtue of broadly taxing income is that it would help make an income tax system *horizontally equitable,* meaning that everyone with the same income would bear the same tax burden regardless of the sources of their income.

Practical Problems

As attractive as an income tax system based on the traditional economic definition of income is, any attempt to implement a system strictly based on this definition would run into a number of obstacles.

For starters, it would be difficult for any government to tax some of the items that this definition includes as income. For example, government would be required to tax the value of goods and services produced in the home, such as meal preparation and child care.

Figure 1
Taxed and Untaxed Categories of Personal Income in the United States
Fiscal Year 2005



Sources: Bureau of Economic Analysis, Department of Commerce; and Tax Foundation calculations.

Obviously, as a practical matter, it would be very difficult to tax such things.

Other problems crop up when we are dealing with capital assets. These problems take two forms. First, as discussed above, many capital assets produce income streams lasting years for their owners. Since it is often difficult to accurately attribute the revenue and expenses associated with these streams to the appropriate period, it is almost inevitable that an income tax system will tax capital assets at different effective rates (see sidebar on page 2). All else being equal, lower effective tax rates on some types of capital assets will encourage investors to invest in tax-preferred assets rather than those which are the most economically productive. This, in turn, will lead to an inefficient use of capital assets in the economy and diminished social welfare.

The other problem concerns the timing of capital gains. Ideally, under the economic definition of income, we would want to measure how a valuable asset's price changed from the beginning to the end of the year and adjust the individual's income by adding or subtracting this amount. For goods that are actively traded in markets, such as stocks, that calculation could potentially be done. For goods that are not actively traded in markets, however, it would be an administrative nightmare.

For a number of reasons then, implementing an income tax based on a strict interpretation of the economic definition of income is not practical. Nevertheless, if lawmakers plan to raise revenue using an income tax, it is important that they not be too cavalier about dismissing the basic tenets of the economic definition. After all, every deviation from it makes the economy less efficient and lowers social welfare.

The Federal Individual Income Tax System

As noted above, what is considered income by the federal individual income tax code amounts to only a fraction of the income accruing to individuals. This shrunken tax base necessitates higher rates. The following tour of the IRS 1040 form shows how various exclusions, preferences and other factors have eroded the potential individual income tax base.

Calculating AGI

As anyone who has ever filled out a federal tax return knows, calculating income tax liability is a long, arduous task. The process begins when the taxpayer calculates his adjusted gross income (AGI). He sums up some of the income he has received during the year from various sources and makes several adjustments to it, for such things as alimony paid and IRA contributions made. While many of the items that the economic definition defines as income are included in AGI, there are some significant omissions. These can be sorted into three broad categories (see Figure 1).

The first category, untaxed transfers, includes cash and in-kind benefits received by beneficiaries of government programs. Such transfers clearly increase recipients' ability to consume and should, according to the economic definition of income, be considered income. But they are not. As illustrated in Figure 1, exclusion of untaxed transfers reduces the individual income tax base by 8.3 percent.

The second category constitutes 8.2 percent of personal income and escapes income taxation because it is paid in the form of employee benefits rather than as wages and salaries. Such benefits include employer-provided health insurance, employer contributions to pensions and other retirement plans, as well as a host of other fringe benefits. Since these benefits increase employees' ability to consume, they should be counted as income according to the economic definition. But they are not.

The third category of excluded income in Figure 1 is "other net exclusions." This is a hodgepodge of cash and in-kind income, such as interest from tax-exempt bonds as well as income earned from some other types of capital assets, which individuals can earn without taxation. As with untaxed transfers and employee benefits, such income increases the recipients' ability to consume and should count as taxable income. But it does not. This exclusion removes an amount equal to 4.7 percent of personal income from federal individual income taxation.

Deductions and Exemptions

Even after the government passes over these three large slices of the economic pie, it doesn't stop there. The federal tax system does not simply levy a tax on AGI. Instead, filers are able to exclude a portion of their AGI from taxation through the use of deductions and exemptions.

There are two types of deductions. Standard deductions allow filers to exclude a predetermined portion of their AGI from taxation. This amount varies by filing status. For 2005 single filers will be able to claim a standard deduction of $4,950 while joint filers will be able to claim $9,900. Additional amounts are available to the elderly and blind.

The economic definition of income provides no justification for granting standard deductions. Anything that increases individuals' power to consume, as the AGI excluded by the standard deduction clearly does, should be considered income. The granting of the standard deduction is typically justified on charitable grounds to forgive taxation on a subsistence level of income. As illustrated in

Matching of Revenues and Expenses under an Income Tax: A Fatal Flaw?

A fundamental problem with taxing income instead of consumption is that measuring income from investments is often close to impossible.

To see why, recall that income from investments is found by subtracting expenses from revenue generated. That means that in each year, revenue must be matched accurately with expenses. If not, the tax system will systematically distort returns to investments, potentially leading to large economic losses.

Why do income taxes fail to match revenue and expenses? Because while revenue is easy to measure, expenses—which include the economic depreciation of assets—are not. As one leading author writes, "We know very little about actual depreciation patterns."[1] Since we can not observe actual depreciation, the IRS's depreciation schedules are largely arbitrary. As a result they fail to correctly tax income from investments, under-taxing some and over-taxing others.

This quirk of income taxation is so pervasive that some experts have dubbed it the "fatal flaw" of taxing income, and have advocated a switch to consumption taxation as the only long-term solution to the problem.[2]

1 Harvey S. Rosen, Public Finance, McGraw-Hill Irwin 2002, p. 455.

2 William D. Andrews, "The Achilles' Heel of the Comprehensive Income Tax." in New Directions in Federal Tax Policy for the 1980s, Ballinger, 1983, pp. 278-84.

Figure 1, the standard deduction reduces the income tax base by 3.4 percent.

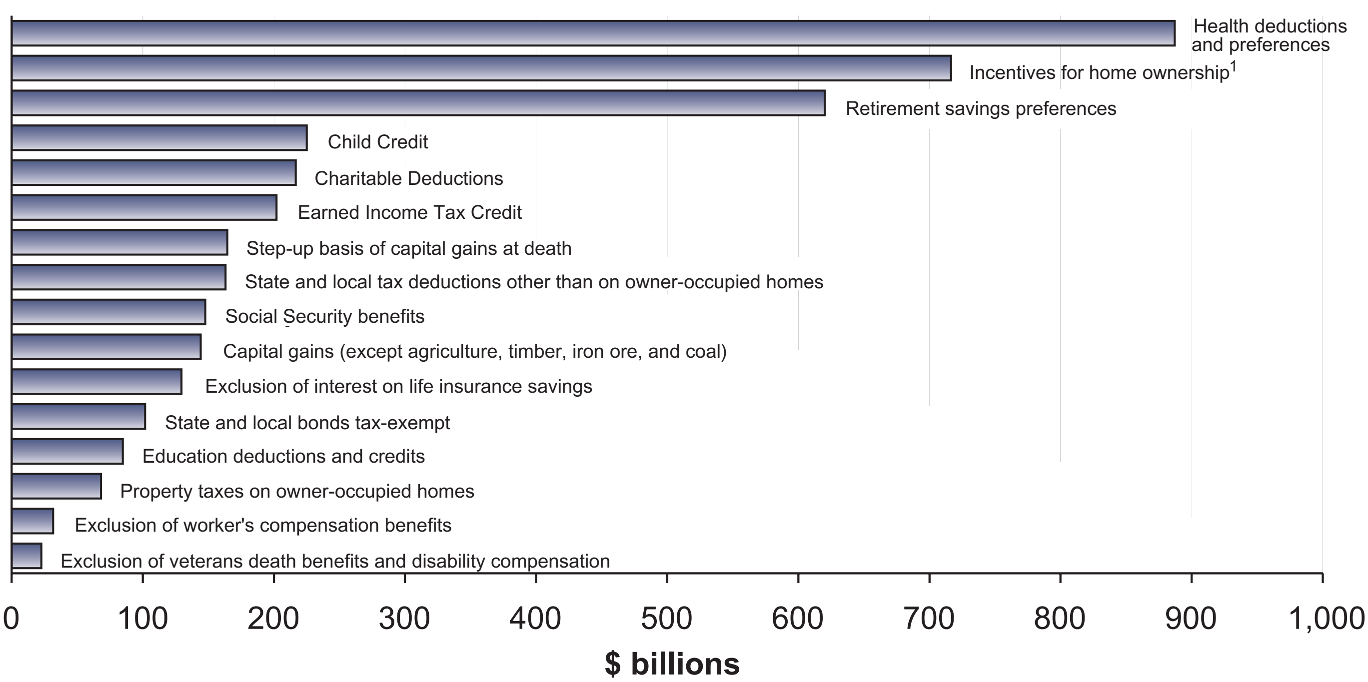
In lieu of taking the standard deduction, taxpayers may itemize their deductions. The federal individual income tax code allows deductions for a wide variety of expenditures. Under the economic definition of income, deductions would be justified only if they were actual expenses associated with earning taxed income. But this is largely not the case. Today the value of itemized deductions claimed in just three categories makes up more than 85 percent of the amount claimed. Those categories are taxes paid, interest paid and money given to charity. Figure 1 shows that the taking of itemized deductions reduces the income tax base by 9.3 percent.

Exemptions are similar to standard deductions in that they allow taxpayers to exclude a portion of their AGI from taxation. Unlike standard deductions, however, exemptions provide additional lump sum exclusions for *each* eligible taxpayer or dependent listed on a tax return. For tax year 2005 the exemption amount will equal to $3,150. A married couple with two children is therefore generally able to reduce the family's taxable income by $12,600.

As with standard deductions, the economic definition of income provides no justification for the granting of personal exemptions. Traditionally they have been defended as another way of exempting a subsistence level of income from federal individual income taxation. Figure 1 shows that the use of personal exemptions reduces the income tax base by some 5.8 percent.

After subtracting deductions and exemptions from AGI, taxpayers arrive at "taxable income." The federal tax system applies successively higher marginal tax rates as a filer's taxable income moves through a series of tax brackets. For tax year 2005 there are six marginal tax brackets for each of the four filing statuses.

Figure 2
Largest Individual Tax Expenditures
Fiscal Year 2006–2010



[1] Does not include exclusion of net imputed rental income on owner-occupied homes, $185.2 billion.
Source: Office of Tax Analysis, U.S. Department of the Treasury

Tax Credits

While the calculation of taxable income, multiplied by the tax rates, would seem to mark the end of the income tax road, this is not the case. The federal tax code offers numerous tax credits that taxpayers subtract from what they owe. As with deductions, tax credits run the gamut from the well known (the child tax credit) to the obscure (the federal tax credit for first-time homebuyers in Washington, D.C.).

Certain tax credits, such as the earned income credit, are refundable. That means if the

The Tax Reform Act of 1986 famously lowered income tax rates by broadening the tax base, and the system continued to raise the same amount of tax revenue. This base broadening was accomplished by eliminating or reducing many deductions and exemptions, several of which were popular and thought to be "untouchable." Tax reformers are hoping the nation can muster the political will to enact similar reforms now.

Table 1
Selected Individual Income Tax Base Changes in the Tax Reform Act of 1986

Base-Broadening Provisions	**Before 1986**	**After 1986**
Net Capital Gain Deduction	Deduction for 60 percent of net capital gains	Repealed
Two-Earner Deduction	$3,000 (max)	Repealed
State and Local Sales Tax Deduction	All retail sales taxes fully deductible	Repealed [1]
Investment Interest Deduction	Deductible with limitations	Deductibility much more limited.
Personal Interest Deduction	Generally deductible	Only mortgage interest on principal residence deductible
Miscellaneous Deductions for Business Expenses	No floor on miscellaneous itemized business deductions	2% floor on miscellaneous itemized business deductions
Tax Shelters	No limitation on using deductions and credits from passive losses and activities to offset other income	Deductions and credits from passive losses generally cannot offset other income
Investment Tax Credit	10% credit allowed for certain ACRS property	Repealed
Deductions for Meals, Travel and Entertainment	Expenses generally deductible	Deduction reduced by 20 percent; and travel deductions severely limited
Individual Retirement Accounts (IRAs)	Contributions deductible even if taxpayer is enrolled in employer-sponsored retirement plan	Deduction limited if taxpayer is enrolled in employer-sponsored retirement plan
3-Year Basis Recovery Rule for Contributory Plans	Special 3-year recovery rule for annuity payments from qualified plans	Repealed
Base-Narrowing Provisions	**Before 1986**	**After 1986**
Earned Income Tax Credit	Equal to 11 percent of first $5,000 of income (maximum of $550)	Equal to 14 percent of first $5,714 of income (maximum of $800)
Standard Deduction	$3,670 [2]	$5,000 [3]
Personal Exemption	$1,080	$1,900 in 1987; $1,950 in 1988; $2,000 in 1989 and thereafter

1. The state and local sales tax deduction was partially reinstated as part of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004).

2. This was the zero bracket amount (ZBA) before the 1986 tax reform for married couples filing jointly. For singles and head of household, the ZBA was $2,480.

3. This was the standard deduction for a married couple filing jointly. For head of household, the new standard deduction was $4,400 and for singles the new standard deduction was $3,000.

Sources: Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87); Tax Foundation, *Facts and Figures on Government Finance* (38th Edition).

Tax-Exempt State and Local Bonds: A $20 Billion Waste

One way individuals can earn income free of federal tax is to buy tax-exempt bonds issued by state and local governments. Even though the interest that investors earn on these bonds clearly increases their ability to consume in the same way that taxable income does, Uncle Sam doesn't touch it at tax time.

The tax deduction for interest on government bonds distorts economic choices and leads to greater "horizontal inequity." That is, people with identical income shoulder different tax burdens. To make matters worse, the deduction is an inefficient way to accomplish its stated purpose – to help state and local governments.

To see why, let's look at who buys government bonds now, and how those investors might change if the deduction were repealed. Let's assume that with no special tax incentive, a $1,000 state or local government bond would have to pay a 10 percent return annually, or $100, to attract enough bond buyers. Any investor looking for a relatively safe investment that paid 10 percent would buy it, and investors at all income levels would benefit equally from purchasing it.

However, with the deduction, investors do not all earn the same. Individuals in the highest tax bracket (35 percent) would be willing to lend state or local governments funds for as little as 6.5 percent since the $35 in tax savings they receive from owning the bond brings their annual earnings from the bond to the desired 10 percent. In such a case, the $35 gain to state and local governments would equal the $35 in lost federal tax revenue.

However, state and local governments need to attract other investors who don't have enough taxable income to reach the 35 percent bracket. To do this, state and local governments must raise the interest rate they pay to everybody. For example, to attract investors whose annual taxable income puts them in the 25 percent bracket, tax-exempt bonds would have to have a minimum interest rate of 7.5 percent, the point where the amount they save in taxes, $25 (25 percent of $100), brings their annual earnings from the bond up to the desired level of 10 percent.

Because there is no practical way of selectively selling bonds with different interest rates to investors in different tax brackets, the highest rate necessary to clear the market for these bonds must be given to all bond holders. Returning to the example above, investors in the highest tax bracket, 35 percent, get a better deal on the bond, earning $110 annually instead of the $100 earned by people in the 25 percent bracket.

In fiscal year 2005 the U.S. Treasury estimates that the lopsided nature of this provision will cost the federal government more than $20 billion. This loss could easily have been avoided by directly transferring funds from the federal government to state and local governments, rather than transferring it indirectly through the tax system.

sum of a taxpayer's refundable credits exceeds tax liability, the federal government will write them a check for the difference. As with itemized deductions, few tax credits are justified under the economic definition of income. This year, the Internal Revenue Service will pay out nearly $48 billion in refundable tax credits alone. Figure 1 shows that the use of tax credits reduces the income tax base by 5 percent.

Tax Foundation economists estimate that nearly 43 million tax returns, returns that represent 122 million people, were filed in 2004 by people who owed nothing in taxes. That is, they got back every dollar that had been withheld from them during the year, and often more.

Other Exempted Income

The federal tax system exempts individuals who earn below a certain amount from having to file an income tax return. The levels of these thresholds vary by filing status and age. In 2005, for example, single filers under age 65 will not be required to file a form 1040 if they earn less than $8,100. For joint filers who are under 65 this threshold will climb to $16,200. Tax Foundation economists estimate that 15 million Americans earned some income in 2004, but not enough to meet filing requirements.

The economic definition of income provides no justification for excluding the AGI of filers below certain levels from the tax base. As with standard deductions and personal exemptions, the treatment of such income has traditionally been justified on the grounds of exempting a subsistence level of income from taxation. Figure 1 shows that excluding such income reduces the income tax base by 4.4 percent.

Finally, a fairly large amount of personal income escapes income taxation as a result of criminal evasion. In 2005 underreporting of income coupled with overstatement of adjustments, deductions and exemptions reduced the federal individual income tax base by an estimated $392.5 billion, or about 11 percent of personal income. Ironically, a major factor encouraging tax evasion is the relatively high marginal tax rates needed to raise hundreds of billions of dollars in federal individual income tax revenue from a heavily eroded tax base.

Experience has shown that lower tax rates encourage greater compliance with the tax system.

High effective tax rates coupled with tax-induced economic distortions harm the nation's economic performance and lower the standard of living of all Americans.

The AMT

As the above discussion makes clear, the fact that nearly one-fifth of personal income escapes income taxation entirely—coupled with the current myriad of deductions, exemptions and credits—creates a situation where some savvy taxpayers can avoid paying federal individual income taxes altogether.

To prevent this, Congress enacted the alternative minimum tax in 1969. The AMT is essentially a parallel tax system that attempts to ensure that individuals cannot take "too much" advantage of preferences in the tax code. It does this by requiring that taxpayers meeting certain criteria calculate their income tax liability under both the ordinary individual income tax system and the AMT, which has a somewhat broader definition of income and fewer preference items. Taxpayers are then required to pay the larger of the two amounts.

While the AMT has helped to prevent some tax avoidance, to date its impact has been modest. As illustrated in Figure 1, in 2005 the AMT is expected to bring an amount equal to 0.9 percent of personal income back into the federal individual income tax base.

Conclusion

One of the major issues that the President's Advisory Panel on Federal Tax Reform will have to confront in its report is the composition of the tax base.

Under current law, a myriad of exclusions, preferences and other provisions exempt more than half of all personal income from income taxation. This results in effective tax rates more than twice as high as they could be if a more expansive tax base were used.

Moreover, the disparate treatment of different types of income causes individuals to engage in activities for tax reasons rather than because they make economic sense. High effective tax rates coupled with such tax-induced distortions harm the nation's economic performance and lower the standard of living of all Americans.

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