FORUM

Efficient Taxation of Income

Properly done, tax reform can make our society significantly better off. Herewith, a modest proposal.

by DALE W. JORGENSON

In June 2001, President George W. Bush signed the Economic Growth and Tax Relief and Reconciliation Act into law, initiating a 10-year program of tax reductions. This January, the president proposed a second round of tax cuts that will be debated by the new Congress. This leaves open the possibility, suggested by former Secretary of the Treasury Paul O'Neill, that the Bush administration would propose a thoroughgoing reform of our tax system. That possibility is worth pursuing, because intelligent tax reform holds forth the promise of enormous economic gains for our society—potentially dwarfing any payoff from lowering tax rates.

Tax *reforms* must be carefully distinguished from tax *reductions*. Former Secretary O'Neill emphasized that any Bush administration proposals for tax reform would be revenue neutral, so that the federal deficit would be unaffected. Pamela Olson, Treasury's top tax official, reiterated this goal in a *Washington Post* interview

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in October. Revenue neutrality was an important objective of the last major tax reform in 1986 and insulated the two-year debate over reform from the contentious issue of the federal deficit.

Taxing Consumption

OLSON HAS DIVIDED the Treasury's tax-reform programs between short-run measures to simplify the tax code and long-run proposals to reform the tax system itself. It is important to emphasize that there is no conflict between these goals. Indeed, somewhat paradoxically, tax simplification is necessarily complex, since it would eliminate many, but not all, of the myriad special provisions of tax law now affecting particular transactions. By contrast, tax reform is relatively straightforward.

A major objective of tax reform is to remove barriers to efficient allocation of capital that arise from disparities in the tax treatment of different forms of income. The centerpiece of the Bush administration's new round of tax cuts is the elimination of taxes on dividend income at the individual level. Taken alone, this step would not be revenue neutral, but it is a tax-cutting measure closely allied with a goal of tax reform. Making dividends tax-free to recipients would help to remedy one of the most glaring deficiencies in the existing U.S. tax system, namely, discriminatory taxation of corporate income.

In the United States, as in most other countries, corporate income is now taxed twice: first, through the corporate income tax, and second, through taxes paid by individuals on corporate dividends. Noncorporate income is taxed only at the individual level. Eliminating individual taxes on dividends would help to achieve parity between corporate and noncorporate income.

To achieve revenue neutrality (something the president did not propose), the dividend tax would have to be replaced by another source of revenue. One possibility would be to introduce a value-added tax levied on business revenues less expenses. Purchases by individuals and governments are all that constitute that revenue, so that substitution of a value-added tax for the tax on dividends would have the effect of shifting the tax burden from corporate income to consumption.

With Australia's adoption of a value-added tax in 1999, the United States is the only industrialized country without such a levy. During the 1990s the Committee on Ways and Means of the U.S. House of Representatives held extensive hearings on consumption-tax proposals, including the value-added tax, the Hall-Rabushka Flat Tax, and a national retail-sales tax. All these proposals tax consumption in different ways—they vary primarily in methods for collection.

The U.S. corporate income-tax rate is currently 40 percent, combining federal, state, and local taxes. (This does *not* include the taxes levied on corporate dividends and interest through the individual income tax.) One popular proposal for replacing the existing income-tax system by a consumption tax, the Hall-Rabushka Flat Tax, would reduce the marginal tax rate to 19 percent. However, a revenue-neutral flat tax that includes state and local as well as federal taxes would require a rate of 29 percent.

Substitution of a value-added tax for the tax on dividends would help to eliminate one of the two main barriers to efficient capital allocation in our existing system. The exclusion of owner-occupied housing from the tax base is the second—and more substantial—disparity.

Society's benefits from investment in housing or any other asset are best measured by what individuals are willing to pay to use the asset. The rentals paid to corporate owners of housing must bear two taxes, the corporate income tax on the rental income and individual taxes on dividends paid out by the enterprise. Owner-occupied housing is not subject to either of these taxes. Any proposal that leaves this disparity unaffected would sacrifice most of the gains from tax reform—whereas shifting a dollar of investment from owner-occupied housing to rental housing in the corporate sector, once the disparity has been removed, would double the rate of return to society, as measured by the return before taxes.

Taxing Income More Efficiently

THE ACHILLES HEEL of proposals to shift the tax base from income to consumption, at least so far, is the redistribution of tax burdens. Recipients of income from property, including corporate shares, are generally much more affluent than recipients of income from work. Excluding property-type income from the tax base would shift the burden of taxation from the rich to the poor. Attempts to make a consumption tax progressive would drastically raise the marginal rate.

Due to the redistribution of tax burdens under a consumption tax, the tax-reform debate is therefore likely to focus on improvement of our existing income-tax system. The objectives would remain the same—namely, treat income sources symmetrically, reduce marginal rates, and retain progressivity. While this may sound suspiciously like trisecting an angle, these three objectives can be accomplished simultaneously by a proposal I call Efficient Taxation of Income.

The new approach would remedy the glaring deficiencies corporate income and exclusion of housing

Efficient Taxation of Income is a new approach to tax reform based on taxation of *income* rather than *consumption*. This would avoid a drastic shift in tax burdens by introducing different tax rates for property-type income and earned income from work. Earned income would be taxed at a flat rate of 10 percent, while property-type income would be taxed at 30 percent. Precisely the same distinction between earned and property-type income existed in the U.S. tax code between 1969 and 1982, so that no new tax loopholes would be created.

The taxation of all earned income at a flat rate of 10 percent would be greatly welcomed by wage earners and would provide powerful new incentives for participating in the labor force. Enhanced participation would strengthen upward mobility by en-

abling workers to receive greater rewards for investments in their own formal education and training. New incentives for these investments would be provided at every wage level.

The key to Efficient Taxation of Income is a system of investment tax credits for business income. Each dollar of new investment would generate a credit against business income taxes. The rates for these credits would equalize tax burdens. The average tax credits for corporations would be 4 percent on equipment and 19 percent on structures. (Noncorporate businesses, not subject to the corporate income tax, would receive smaller credits of 0.5 percent on equipment and 8 percent on structures.)

The tax credits for new investments in structures by corporations and noncorporate businesses would apply to new rental housing. These credits would provide incentives for real-estate developers to expand the construction of rental housing. The added supply of housing would provide existing renters with more attractive and affordable options. It would also substantially reduce housing costs for newly formed households.

In order to equalize tax burdens on business and household assets, including owner-occupied housing and consumers' durables like automobiles, taxes on new investments by households would be collected by car dealers and real-estate developers. The rates would be 7 percent on new durables and 32 percent on new housing. This new source of revenue would precisely offset the new tax credits for business investment, preserving revenue neutrality.

Homeowners would be deemed to have prepaid all taxes at the time of their original purchase, so that no taxes would be imposed on existing housing. This is essential for enactment, since 68 percent of households own their homes and homeowners are voters who can express concerns about property values at the ballot box. The new taxes and credits would apply only to new investments and would protect property values after tax reform is enacted.

An important advantage of Efficient Taxation of Income is that individuals would continue to file the familiar Form 1040, while corporations would file corporate income-tax returns. Since the definitions of individual and corporate income would be unchanged, no cumbersome transition rules would be required. Efficient Taxation of Income could be enacted today and implemented tomorrow.

Deductions from taxable income, as well as tax credits and exemptions, would be unaffected by Efficient Taxation of Income. Businesses would continue to claim depreciation on past investments, as well as tax deductions for interest paid on debt. Mortgage interest and property taxes would be deductible from individual income for tax purposes. The tax treatment of Social Security and Medicare, as well as private pension funds, would be unchanged. The pension-fund industry would not be eviscerated and pension plans would be unaffected.

Another major concern is the impact of Efficient Taxation of Income on states and localities. Most states use the same tax bases as the federal corporate and individual taxes. Since these tax bases would not change, state and local income taxes would be unaffected and would continue to generate the tax revenues that support schools, roads, law enforcement, and other services provided by state and local governments.

In short, Efficient Taxation of Income would preserve all the features of the existing tax code that have been carefully crafted by generations of lawmakers since adoption of the federal income tax in 1913. At the same time, this new approach to tax reform would remedy the glaring deficiencies in our tax system that arise from differential taxation of corporate income and exclusion of owner-occupied housing and consumers' durables from the income-tax base.

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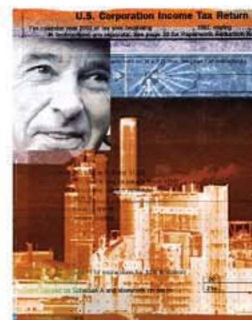
The Payoff

What are the gains from tax reform? This turns on the answer to the question, How much additional wealth would be required to purchase the additions to consumption of goods and services, as well as leisure, made possible by the reform? Since *consumption*, not *investment*, is the goal of economic activity, this is the most appropriate yardstick for comparing alternative tax-reform proposals.

I estimate that gains from Efficient Taxation of Income would be equivalent to 19 cents for every dollar of U.S. national wealth. The total gains would be a whopping $4.9 trillion! By comparison, the nation's gross domestic product was $8.1 trillion and national wealth was $25.4 trillion in 1997, the base year for this comparison. These gains encapsulate the benefits of shifting investment to higher-yielding assets. They also reflect greater investment and faster economic growth.

Instituting the new investment tax credits would stimulate investment, especially in the corporate sector. The revival of economic activity would raise earned income from work and property-type income and would stimulate consumption. And Efficient Taxation of Income would have a much greater impact than a revenue-neutral version of the flat tax. I estimate that the flat tax would yield $2.1 trillion in new national wealth—only about 40 percent of the gains attainable from Efficient Taxation of Income.



Tax-reform proposals, like cherry blossoms, are hardy perennials of the Washington scene. Occasionally, a new approach to tax reform appears and changes the course of the debate. President Ronald Reagan's proposal of May 1985, leading to the Tax Reform Act of 1986, is the most recent example of a new approach to tax reform. Like Efficient Taxation of Income, it retained the income tax rather than shifting to a consumption tax. This is still the most fruitful direction for reform.

Economist Dale W. Jorgenson, Ph.D. '59, is Morris University Professor. A book-length version of his proposal is presented in Lifting the Burden: Tax Reform, the Cost of Capital, and U.S. Economic Growth *(MIT Press, 2001), written with Kun-Young Yun, Ph.D. '84.*