STATEMENT OF

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Mr. Chairman, thank you for inviting me to speak today about the importance of tax reform.

PROBLEMS WITH THE CURRENT SYSTEM

The federal income tax, which accounts for almost half (48 percent in 1983) of the federal government's annual revenues, has come under sharp criticism. Public opinion surveys reveal that the personal income tax has now surpassed the homeowners' property tax as the levy taxpayers regard as most unfair. Conspicuous flaws in the system--noted both by taxpayers in general and by policymakers in particular--include:

- The narrowness of the income tax base,
- The high marginal tax rates most taxpayers face,
- The complexity of the income tax code and its obscurity for most filers,
- Inequities that cause taxpayers in similar economic circumstances to face different tax burdens, and
- The income tax's bias against saving.

PROPOSED REFORMS

Such criticisms have led to reviews of current policy and proposals for reform in both the Congress and the Administration. Several Members of Congress

have introduced schemes, though these vary widely from plan to plan. Some would continue a trend that emerged in 1982, when the Congress passed the Tax Equity and Fiscal Responsibility Act (TEFRA). That law broadened the existing income tax base by restricting certain deductions and exclusions then in the tax code. The tax bill just passed by the 98th Congress--the Tax Reform Act of 1984--continues this strategy.

Other, more sweeping plans combine base broadening with reductions in tax rates. While some plans would retain a structure of graduated tax rates, others would have only one uniform, or "flat," tax rate. Even more radical approaches would shift the burden of tax from income to consumption. For example, they would exempt all forms of saving from tax, or eliminate the corporate income tax and replace it and the individual income tax with some form of national sales tax. The theory behind all such proposals is that the current tax system penalizes savers and investors, and because savings are essential to the nation's economic growth, the system must be changed.

Together, the array of reform measures now under review responds to many of the income tax's perceived shortcomings. In my remaining time, I would like to examine the sources of these perceptions and discuss possible remedies for these problems, in light of the tax code as it now stands and what is known about economic behavior.

The Scope of the Income Tax Base

"Economic income" as used in the discussion of tax issues has been defined either as the sum of income from various sources--wages and salaries, capital gains, interest on savings, rents, dividends--or alternatively, as a household's consumption plus the change in its net worth. This definition is somewhat different from the way incomes are reported to the Internal Revenue Service (IRS) and tracked by the Department of Commerce. Although the gross national product (GNP--that is, the total value of U.S. goods and services produced) differs somewhat from the concept of economic income--notably in its exclusion of capital gains and its inclusion of depreciation--this measure can be used as a convenient starting point to illustrate the erosion of the tax base.

The Congressional Budget Office's forecast of the nation's GNP for 1984 is nearly $3.7 trillion. Of this total, roughly 45 percent is not subject to tax. Much of this amount is untaxed because it represents costs of doing business or is never received by individuals, for example, depreciation and employer's social insurance contributions. However, among the kinds of income that escape taxation are fringe benefits (such as health insurance) that firms provide to their employees and unreported income. These two categories account for roughly one-quarter of the untaxed total.

The 55 percent of GNP remaining after these exclusions and some adjustments--for example, to include capital gains--is referred to as "adjusted gross

income" (AGI). AGI, in turn, is subject to further exclusions, deductions, and exemptions that erode the tax base by another 10 percent to 15 percent. In sum, the taxable base is about 45 percent of GNP, and after taking account of the standard deduction and personal exemptions available to all taxpayers, this figure drops below 40 percent.

If one were to compute total income taxes as a share of AGI from the data most recently published, this figure, which represents the average tax rate on AGI, would be 15 percent for 1982. A similar measure based on GNP would be 9 percent. These figures compare with 19 percent, the actual average tax rate on taxable income in 1982. The difference between either of the first two rates and the actual average rate suggests the extent to which, in theory, tax rates could be cut if the tax base were further expanded.

Inclusion of additional income items in the tax base, as proposed under several tax reform proposals, would reduce the disparities in the tax treatment of taxpayers with similar economic incomes. Fringe benefits, for example, being tax free, permit workers who receive a larger portion of their compensation in this form to pay taxes at lower rates than do other employees. This provision also encourages workers to request compensation in this untaxed form, regardless of whether they would prefer such non-monetary benefits to cash payments, were there not tax considerations.

As evidenced by recent data on 1981 tax returns, current tax provisions result in a wide disparity of tax rates for individuals with similar incomes, without regard to the level of their incomes. For example, taxpayers with 1981 AGIs between $4,000 and $6,000 faced tax rates on their last dollar of income earned between zero and 19 percent; those with incomes between $200,000 and $500,000 faced rates between 24 percent and 70 percent.

Even with changes that brought about further base broadening, certain deductions and exclusions in the present tax code--such as personal exemptions or deductions for charitable contributions--would still be regarded as appropriate and would probably not be eliminated. If one preserved these and similar provisions, but included all other non-taxed forms of income, the tax base could potentially be increased by 50 percent.

High Marginal Tax Rates

Because so much income is currently excluded from the tax base, very high rates must be applied to what remains in order to produce the revenues needed to finance federal activities. A result is undue influence on economic activity, with some individuals and firms pushed out of ordinary economic activities and toward those favored by the tax law. Indeed, most special tax provisions explicitly aim to encourage specific activities. But many of those provisions were designed in the distant past, and whether they still serve their original social or economic purposes is now unclear. Moreover, special provisions often interact in ways that induce

unintended results. Some of the more exotic tax shelters are clear examples of this phenomenon.

More generally, the high tax rates on ordinary activities very probably discourage work effort and saving compared to what would occur in a more broad-based system that raised similar amounts of federal revenue. Though the magnitude of such effects is much disputed, it is generally agreed that the greatest work disincentives affect a family's so-called "secondary workers"--primarily, employed wives and teenagers.

Perhaps the greatest inefficiencies our tax system produces result from aberrations in the taxation of capital income. Though these distortions apply mainly to corporate activities, they lead to often-compounding distortions of the personal income tax. The effective tax rate on the return to a particular investment can vary greatly, depending on whether the investment is:

- Corporate or noncorporate,
- Financed by debt or equity,
- In inventory, equipment, structures, or research and development,
- Domestic or foreign, or
- Motivated by special tax inducements.

Further problems arise from the effects of inflation on the measurement of the return on capital. Inflation erodes the real value of the depreciation

deductions allowed by the tax law. It creates illusory--but taxable--capital gains on inventory and other investments, and it erodes the real value of the debts owed by firms and individuals. It can therefore significantly raise or lower a firm's effective tax rate on the real return to capital, depending on the characteristics of the firm's balance sheet. In theory, this problem can be solved by indexing the tax base, but this would be so extraordinarily complex as to be impractical. (Note that the problem of indexing the tax base is very different from indexing the tax rate structure to prevent "bracket creep." The latter is relatively simple and is to be done for the individual income tax starting in 1985.)

As a result of the many anomalies in the tax law, effective tax rates on particular investments can vary from strongly positive to strongly negative. Consequently, the allocation of the nation's scarce capital resources among various economic activities may be determined more by the incidental effects of tax law than by judgments about where investment can be most productive for the nation as a whole.

In fact, the foregoing discussion only scratches the surface. The law has become so complex that most large firms have at least one IRS agent assigned to them full time, and the tax consequences of many transactions have to be negotiated in advance. Indeed, if historical trends continue, there is a danger that the corporate tax in particular could evolve into the worst possible tax--one that greatly distorts investment choices while raising precious little revenue.

Income-Based Versus Consumption-Based Taxes

Our society seems always to have been a bit ambivalent about whether income or consumption should be the basis for the tax system. No absolute answers are available to guide policymakers about which constitutes the most appropriate tax base. The present code contains tax-base features designed to accommodate both schools of thought. Thus, most sources of income are taxed, but many special provisions favor saving and investment.

For several decades, the appropriate basis for taxation has been a subject of fundamental dispute. Most other nations' tax systems have incorporated into their tax structures the notion that tax burdens should in some way be based on a household's yearly ability to pay. For this reason, taxes are paid on a wide range of incomes, and tax structures are generally progressive--that is, the more income a taxpayer has, the greater a portion of it he or she pays in tax.

An alternative view of the income tax is that it should be directed less toward the amount of income or output an individual generates and more toward the amount he or she consumes or takes away from the economy. According to this view, savers should be rewarded by being permitted to exempt from taxation however much income they save. To put it another way, taxpayers' consumption can be taken as their own assessment of their ability to pay. Consumption depends on considerably more than one year's income; income earned in prior years--a

critical determinant of taxpayers' overall wealth--is also important to one's ability to pay taxes.

In recognition of this view, some proposals would institute progressive "expenditure" taxation and eliminate the corporate income tax altogether. Expenditure taxation could take several forms: a national sales tax, a value-added tax, or a progressive expenditure tax.

Under all such plans, income saved would be tax-exempt. Some observers worry that this approach could result in concentrated accumulations of wealth, and it has been suggested that consumption taxes be complemented by taxes on gifts and bequests. This could, however, somewhat discourage saving, though probably less than the current income tax does.

In addition, an expenditure tax approach has some appeal because of its simplicity. It would do away with the complications created by the corporate tax, and more generally, would do away with the many layers of the tax code devoted to defining capital income. For example, concern about the effects of inflation on the tax base would vanish, as would the need to determine depreciation, and the need to differentiate capital gains from regular income.

I do not mean to imply that an expenditure tax would be simple. No tax ever is. Because consumers' expenditures for durable goods can be lumpy--for example, house or car purchases can occur at odd or long intervals--averaging

would become more important. Particularly difficult problems would attend the transition to an expenditure tax. It would probably be deemed unfair to tax consumption financed with savings accumulated from after-tax income during the superseded income tax regime. Dealing with this problem can quickly become extremely complicated.

The Tax Code's Complexity

Simplification is perhaps the most misrepresented issue in the debate about tax reform. Surveys have indicated that taxpayers would support the elimination of all tax breaks; at the same time, however, polls also show that people would object to the withdrawal of the homeowners' mortgage-interest deduction or to loss of the charitable deduction.

Taxpayers' complaints about the complexity of the current income tax may derive less from their own experiences than from impressions about their neighbors' use of the tax code. Roughly two-thirds of all tax filers did not claim itemized deductions in 1982, and almost 40 percent used a short form. At the same time, the number of taxpayers who turned to professional tax preparers increased to 40 percent.

Taxpayers' concerns about complexity may be motivated by the wish to discover what loopholes might have been overlooked. This concern is reinforced by the numerous special-purpose provisions in the tax code for which most tax filers

are ineligible. But even with the IRS's ingenuity in designing relatively simple tax forms, the complexity of tax law makes it almost impossible for filers to divine from the forms what the underlying law really is. For example, filers using tax tables to determine their liabilities cannot easily tell what tax rate brackets they are in. Not knowing why one has a certain tax liability has to be frustrating.

Diminished tax evasion is another argument made for simplification. The multitude of tax preferences available today may encourage ineligible persons to seek tax avoidance in other ways. Elimination of special provisions might give the impression of a more equitable system, making lower tax rates possible and compliance more attractive. The result could draw income from the "underground economy" into the taxed mainstream. But because so little is known about the underground economy--precisely because it is underground--how much income that now goes unreported (aside from income at or below the zero-bracket amount) would be claimed is unclear. For policymakers to rely on this phenomenon as a major source of additional federal tax revenue would seem imprudent, however.

Fairness

An often discussed but fairly elusive aspect of tax proposals is their "fairness." (I should point out that at least two of the better-known tax-reform plans include the word "fair" as part of their titles.) Equity is very subjective, however. What may appear to be an equitable arrangement to one taxpayer may seem wholly unjust to another.

The everchanging notion of how progressive the current tax code should be is evidence enough of this fact. Studies of the income tax code have shown that its distributional effects have fluctuated. Over the years, the combination of legislative changes and inflation-induced bracket creep have made the tax system more progressive during some periods and have moved it in the opposite direction during others.

Motivated by efforts to accommodate concerns about distributional effects, many of the tax-reform plans circulating through the Congress highlight the fact that their effects on the distribution of tax burdens by major income groups change only slightly from current law. Any significant reform, however, will radically influence the distribution of tax burdens among income groups. Reform could also result in capital losses on assets losing special tax privileges and attendant gains for other capital assets. The prospect of such adjustment problems has been a major factor impeding reform in the past. But I should note that, if we can enact a tax system that is truly efficient, a net gain in the value of all assets that grows over time should follow.

CONCLUSION

As the income tax laws grow more complex, the case for tax reform gains strength. That the current level of federal revenues could be achieved with greater efficiency, simplicity, and fairness seems clear.

But reform in itself can cause problems, with some big winners and big losers both from changes in the taxation of income flows and from the capital gains and losses that those changes induce. The current system is so complex that predictions of who those winners and losers stand to be in the short and long run is impossible. But to the extent that a more efficient and equitable system can be designed, the pains of the transition period can be eased by the fact that society as a whole will be a net winner.