

A conversation with Bill Gale on March 28, 2014

Participants

- Bill Gale — Senior Fellow, Economic Studies Program, Brookings Institution; Co-Director, Urban-Brookings Tax Policy Center
- Alexander Berger — Senior Research Analyst, GiveWell

Note: These notes were compiled by GiveWell and give an overview of the major points made by Dr. Gale.

Summary

GiveWell spoke to Dr. Gale to learn more about opportunities for philanthropy around fundamental tax reform. Conversation topics included the basic components of reform, political barriers to reform, value-added taxes, progressive consumption taxes, and state and local taxes.

Fundamental tax reform

Tax policy is important because the way taxes are structured has major implications for the economy, social policy, family formation, and distributional justice. Tax policy is particularly important in the U.S. because we have implemented many aspects of our social policy through the tax system.

Generally speaking, fundamental tax reform would involve addressing three aspects the U.S. tax structure:

1. **Base.** The base is what the system is trying to tax, typically consumption or income. The U.S. nominally has an income tax, though we are pretty far away from taxing a true measure of income.
2. **Deviations.** The U.S. income tax currently includes many deductions, exemptions, and exclusions, as do most income taxes globally. Although these features can make tax codes more complicated, combining social programs with the income tax can help cut down on paperwork. There have been proposals to merge, for example, the Free Application for Federal Student Aid (FAFSA) with the income tax. Many new value-added taxes (which are a kind of consumption tax) have few deviations, though the older generation of value-added taxes often had much bigger holes in them.
3. **Rate structure.** The rate structure determines how progressive or regressive a tax system is. The U.S. income tax system is progressive, which means that marginal tax rates rise with income. Value-added taxes typically have a flat rate, and there have been proposals for other flat rate national taxes.

When people talk about "fundamental" tax reform, they are typically talking about a

combination of shifting from income to consumption taxation, eliminating many deviations, and flattening the rate structure.

Fundamental tax reform is politically difficult, even though most policymakers are critical of the current system and there is broad support among experts for a larger base and lower rates overall, which is the structure advocated by the Bowles-Simpson plan, the Domenici-Rivlin plan, and the 2005 report of the President's Advisory Panel on Federal Tax Reform, among others. There is no natural political constituency for fundamental tax reform, though, because the potential benefits are widely distributed, while the potential costs are concentrated (on groups who would lose some form of favored tax status). This dynamic makes it risky for policymakers to support broad-based reforms. Though many people talk about it, there is no major constituency really pushing hard for fundamental tax reform.

Economists are mostly focused on ways to restructure the tax code, keeping the current revenue level and progressivity constant. While purely structural debates are important, Dr. Gale thinks that economists can and should be debating about appropriate revenue and progressivity levels as well.

Foundations do not provide much funding for work on fundamental tax reform per se. They tend to support efforts related to taxes that are relevant to social policy, such as health care, education, and family structure.

Comparing pure income and pure consumption taxes

While some economists argue that a pure consumption tax would be much better than the existing U.S. income tax, Dr. Gale believes that most of the benefits of such a tax come from the shift from the existing income tax to a pure income tax (that taxed all income at the same rate with no exclusions or deductions), rather than the further shift from a pure income tax to a pure consumption tax. Shifting from a pure income tax to a pure consumption tax would likely have a relatively small impact on saving and investing (and therefore growth), because a pure consumption tax eventually taxes most of the returns to saving and investing, namely, the compensation for bearing risk and idiosyncratic returns. Although a pure consumption tax does not tax the return to delaying consumption, this return tends to be quite low and represents a small share of the overall return to saving and investing.

A pure consumption tax could potentially allow for a single flat tax rate in the mid or low teens, but that would involve raising taxes on low-income families by a lot. Broadening the base and lowering rates could generate more economic growth, but there is controversy about how large those effects are.

For instance, after World War II, the U.S. federal government significantly increased taxes and spending. In most simulation models, this would be expected to cause enormous economic harm, but what actually occurred was adjustment to the new levels of taxation and spending, followed by 25 years of strong growth, presumably not because of higher taxes and spending but in spite of such changes.

Value-added tax (VAT)

Dr. Gale believes that the addition of a federal value-added tax (VAT) to the existing tax system is likely to be inevitable, because existing revenue sources are unlikely to cover the rising costs of Social Security, Medicare, and other popular social programs. Because it is regressive, a federal VAT would probably lead to other changes in the tax system, such as hollowing out the income tax for low- and middle-income households. A VAT could be earmarked to federal health spending, which could help make the public more amenable to the tax, shield the deficit from healthcare spending uncertainty, and put pressure on the healthcare system to decrease spending. State sales taxes, many of which are poorly designed, could benefit from the administrative machinery of a federal VAT, just as state income taxes have with the federal income tax.

Progressive consumption taxes

The X tax, a form of progressive consumption tax, is often proposed as a substitute for the current tax system, but Dr. Gale thinks that an X tax would be hard-pressed to raise enough revenue and would be inconsistent with existing tax treaties. Dr. Gale does not consider other forms of progressive consumption tax—such as the USA tax, which taxes income but exempts unlimited savings—to be practicable options either, primarily because of transition issues and tax sheltering.

State and local taxes

State income taxes are less progressive than the federal income tax. It is harder to tax progressively at the state level than the federal level, because people, firms, and goods are more mobile at the state level. A revenue-sharing program in which taxes are collected at the federal level and distributed to states could help finance states more progressively.

Most state and local sales tax systems are regressive and poorly designed. Most State retail sales taxes don't tax services, so they miss an enormous share of consumption, and many of them exempt particular products, further cutting into the base. State sales taxes are also not good at distinguishing business and consumer purchases, which leads them to tax business inputs when they often should not do so.

Other people to talk to

- Leonard Burman, Director of the Tax Policy Center
- Alan Viard, Resident Scholar at the American Enterprise Institute
- Joel Slemrod, Professor of Economics at the University of Michigan
- Alan Auerbach, Professor of Economics and Law at University of California, Berkeley
- Michael Graetz, Professor at Columbia Law School
- Daniel Shaviro, Professor at New York University School of Law

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