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Should We Eliminate Taxation of Capital Income?

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The Urban Institute

Prepared for Conference on Taxation of Capital Income
Cosponsored by the Tax Policy Center, the American Tax Policy Institute, and Tax
Analysts
September 23, 2005

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INTRODUCTION

Current law taxes capital income only partially and taxes it unevenly across economic sectors and groups of taxpayers. (Slemrod, this volume) Competing models of fundamental tax reform have sought either to broaden the tax base and make capital income taxation more comprehensive, or to eliminate all taxes on income from capital by replacing an income tax with a consumption tax that exempts income from capital. The Tax Reform Act of 1986 broadened the base of capital income taxation, while lowering tax rates, but fell far short of a fully comprehensive income tax. Major sections of the original U.S. Treasury Department proposal (1984) that would have moved towards a system that taxed all capital income once were discarded or modified before final enactment, while other provisions designed to curtail tax sheltering were added.¹

In recent years, tax reform models that would replace the income tax with a consumption-based tax that exempts income from capital, such as the Hall-Rabushka flat tax (Hall and Rabushka 1995, hereafter HR tax) or the X-tax (Bradford 1986) have gained increased popularity both among academic tax experts and policy-makers. The President's Tax Reform Commission is considering alternatives for reducing or

¹Provisions in Treasury I that were dropped included indexing of the basis for capital gains and depreciation, a partial exclusion of interest income and deductions (as an ad hoc indexing measure), reduction of the double taxation of corporate dividends, elimination of accelerated depreciation (relative to economic depreciation) on machinery and equipment investments, and capitalization of intangible drilling and development costs for oil and gas and mining properties. Congress also retained an alternative minimum tax and enacted limitations on deductions of passive losses to curb tax shelters; both of these provisions were not in the original Treasury proposals on the grounds that they were not needed under a comprehensive income base.

eliminating taxation of income from capital, either within the current income tax structure, or by replacing the current income tax with some form of consumption tax.

With few exceptions, most tax experts believe that a truly comprehensive income tax on all accrued capital income is either impractical or politically unacceptable. A full comprehensive income tax would require assessing tax annually on changes in the value of all assets, with an adjustment for inflation, including changes in the values of shares in non-traded companies and in the value of outstanding debt.² This paper will assume that a full comprehensive income tax is not a realistic option (although some base-broadening may be desirable) and will consider instead whether eliminating all taxes on capital income should be a goal of tax reform. We believe it could be equally unlikely to convert the tax system to a comprehensive consumption tax that is easy to comply with and administer and not subject to manipulation, while roughly maintaining the current distribution of the tax burden. We are especially concerned that partial steps towards a consumption base through expanding or adding new preferences for capital income taxation could significantly erode the tax base, while failing to accomplish any of the goals that a comprehensive consumption base could achieve.

The discussion of tax policy generally, and capital income taxation in particular, abounds in semantic confusion. As we discuss below, if one defines capital income in the strict economic sense as the reward for postponed consumption, then the base of an income tax that excludes capital income is economically equivalent to the base of a consumption tax.³ But what we actually classify on tax returns as returns to capital – interest, dividends, and profits of corporations and unincorporated businesses – includes much more than this reward for waiting. Eliminating taxation on these returns will not necessarily lead us to a consumption tax. Moreover, developing a comprehensive consumption tax that exempts only this “normal” return to capital income may turn out to

² Shakow (1986) describes how such a tax might work. Alternatively, one might tax the normal return to capital, as in the Dutch imputation scheme. (Cnossen and Bovenberg 2002) Under certain circumstances, this is economically equivalent to a tax on accruals and possibly more practical. It does raise enormous political challenges, however. (Burman and White, 2003)

³ With graduated tax rates, a consumption tax could impose a positive tax rate on income from capital if the return to saving raises an individual’s tax base enough in the future to make her marginal tax rate on future consumption higher than the marginal tax rate at which she deducts current saving.

be as difficult as it has been to develop a comprehensive income tax. For the remainder of this paper, we will use the term “normal returns” to represent income from capital in its classical sense as representing the reward for deferring consumption.

While other papers at this conference will discuss in more detail the question of how much we do or can tax capital income, it is important to highlight the fundamental differences in how the current U.S. income tax treats low-, middle-, and high-income taxpayers. Low-income taxpayers, especially those with children, are for the most part exempt from income taxation and many receive income tax rebates from the Treasury. A married couple with two children under the age of 17 and all of its income from earnings does not owe income tax until its earnings exceed \$37,000 per year. In 2005, low-income families will receive \$47.3 billion per year in earned income and child tax credits in excess of income taxes they pay (Office of Management and Budget 2005). Moreover, although taxpayers must have earned income to receive these refundable tax credits, eligibility for the credits phases out based on a measure that includes income from capital. Eligibility criteria for assistance under many spending programs also are based either on a measure that includes capital income or on a separate measure of assets. (Steuerle 2005)

For the most part middle-income families pay *negative* taxes on capital income because most of their savings are in the form of qualified retirement accounts, other tax-deferred accounts and homes, but they can deduct interest on home mortgages. To the extent they pay any capital income tax, it is largely due to the impact of the corporate income tax on their returns from saving in tax-deferred accounts. The very highest income families, in contrast, will receive most taxable capital income and pay the bulk of capital income taxes. In 2005, taxpayers with income over \$200,000 (3.2 percent of all tax units) will receive about 25 percent of all income, but will receive 68 percent of income from capital gains, dividends, and interest and 71 percent of business income (Table 1). Taxpayers with income over \$1 million will receive almost half (45 percent) of all dividends, interest and capital gains. This means that the debate about eliminating capital income taxation is largely a debate about whether capital income taxes should be

eliminated for the highest-income families and, to a lesser extent, for corporations. The effect of the latter depends, of course, on the incidence of the corporate income tax – an issue on which the economics profession still lacks consensus.

The remainder of this paper explores issues that must be addressed in considering whether to eliminate the remaining taxes on income from capital. We first explore the relationship between a consumption tax and an income tax that exempts capital income from the tax base. We illustrate how a proto-typical entrepreneur would be taxed under a consumption tax, an ideal income tax, the current income tax, a consumption tax, and the current income tax with an exemption for all interest, dividends, capital gains, and business profits. We then review evidence on the composition of current capital income – examining different types of returns that are currently called returns to investment and the extent to which these returns represent the reward for deferring consumption and so would be exempt under a consumption tax. In the following section, we assess arguments for preferring an ideal consumption tax to an ideal income tax on groups of fairness and efficiency, assuming that such ideal taxes could be implemented.

We then turn our attention to possible options in implementing a progressive consumption tax, examining existing proposals and presenting empirical evidence on the distributional effects of enacting a structure similar to the flat tax or X tax by eliminating taxation of capital gains, interest, and dividends in the individual income tax, replacing depreciation of capital investments and capitalization of inventories with expensing, and eliminating all interest deductions. We estimate the proportional rate increases needed to generate the same revenue as under current law and simulate an alternative rate structure that roughly replicates the current distribution of the tax burden among income groups, except for the very highest income taxpayers.

We then consider the effects of eliminating taxes on income from capital on private saving, total output, and economic efficiency in the context of incentives to save within the income tax. The final section concludes and briefly discusses alternative approaches to tax reform.

CONSUMPTION TAXES AND YIELD-EXEMPT INCOME TAXES

In economic terms, capital income is the return to postponing consumption. By deferring consumption today and instead investing in productive assets, society can increase output and potential consumption tomorrow. Investment need not just take the form of purchases of physical assets, such as machines or buildings. An individual who defers consuming the wine bottle in his cellar for 5 years instead of consuming it today in anticipation that the wine's quality will improve is investing in capital just as much as the producer who buys better casks to hold the wine before bottling. The key to whether an item of expenditure represents current consumption or investment is in the *timing* of the benefits from the outlay; if the benefits are immediate, the outlay is consumption; if the benefits are received over time, the outlay is investment.

Example of Equivalence Between a Consumption Tax and a Yield-Exempt Income Tax

A consumption tax is simply an income tax that exempts net saving from the tax base. This follows from the fact that all accruals of income must be either spent or saved. If a person receives \$200,000 in wages, interest, dividends, capital gains, and business profits (net of costs), then the entire \$200,000 would be included in a comprehensive income base. If the same person saved \$40,000 of that income, either through bank deposits, purchases of financial assets, or investment in a business, then her consumption tax base would be \$160,000. If, instead of saving, the person withdrew \$40,000 of assets for consumption (for example, by selling shares or withdrawing money from a bank account), she would pay tax on \$240,000 of consumption.

Income ultimately is the source of all consumption. The key difference between the two tax bases is that under an income base all income is taxed in the year it accrues, while under a consumption base, tax is deferred until the income is consumed. In practice, this means that under an income tax the \$40,000 that is saved is not deducted because it is treated as simply a transfer of wealth from one form (cash) to another (a

financial or real asset). Future returns from the wealth are taxed also, but withdrawals of the (previously taxed) principal are tax-free. Under a consumption tax, the entire asset purchase is deductible, but future net withdrawals from both income on the asset and returns of principal are subject to tax, the latter because the principal had not been taxed previously.

All consumption taxes embody the feature that asset purchases or saving is immediately deductible. Consumption taxes, however, can be implemented in a variety of ways. (See Box 1).

Box 1 – Ways of Implementing a Consumption Tax

All consumption taxes exempt net saving, but consumption taxes can be collected in different ways. A retail sales tax is imposed on sales of goods and services by businesses to final consumers. Sales of capital goods to business are not included in the retail sales tax base. A subtraction-method value-added tax (VAT) is imposed on gross receipts of all businesses, less deductions for the cost of purchases of intermediate goods, including capital assets, from other businesses. Thus, a VAT is simply a retail sales tax collected at each stage of production instead of solely on final sales to consumers. An alternative form of VAT, widely used in Europe and elsewhere, is a credit-invoice VAT. Under a credit-invoice VAT, business pay tax on their gross sales, but claim a credit for taxes paid by businesses that sell goods and services (including capital goods) to them. The retail sales tax and the VAT share the property that all tax liability is imposed on businesses (although for this purpose self-employed individuals can be treated as a business)

The HR tax is a special form of subtraction method value-added tax that allows businesses to deduct both wages and intermediate purchases (again including capital goods) in computing taxable net receipts. The tax on the portion of value-added that represents labor services is collected from individual wage earners instead of from businesses. Imposing a portion of the tax on wage earners makes it possible to make the tax system progressive either by exempting a portion of wages (as in the H-R flat tax proposal) or taxing wages on a graduated rate schedule (as in the X-tax).

Finally, it is possible to collect a consumption tax wholly from individuals by modifying the current income tax to allow an unlimited deduction for all saving and to tax all net borrowing, net asset sales and net withdrawals from savings accounts. The Unlimited Savings Account (USA) tax plan introduced by Senators Nunn and Domenici in 1995 was a tax of this form.

The choice of how to collect a consumption tax has huge implications for costs of administration and compliance, evasion possibilities, and the ability to implement a progressive tax. Two points are worth noting. First, making a consumption tax progressive and enabling it to take account of family circumstances requires imposing some or all of the tax on individuals, as in the HR tax or the USA tax. Second, consumption taxes can either include or exclude purely financial transactions. A tax base that excludes “financial transactions”, such as a VAT or HR tax is referred to as an R-base; “real returns” to businesses are in the base and taxed at the enterprise level, but financial returns resulting from businesses activities, including interest received and paid, dividends, and capital gains from sales of financial assets, are outside the tax base. In contrast, an individual-based consumption tax such as the USA tax is referred to as an R + F base because it includes all asset transactions, whether from real or financial assets. The exclusion of financial transactions under an R-base tax can create anomalies and opportunities for evasion because the distinction between real and financial transactions is often murky (Weisbach 2000; Kleinbard, this volume).

If income from capital is *by definition* the reward for postponed consumption, a flat rate tax on consumption (income less net saving) can be shown to be equivalent to a flat rate tax on income from wages that excludes capital income. Suppose an individual earns \$100 of wages in a year, which she uses to purchase a bond with an annual interest rate of 10 percent. After a year, the amount in the account is \$110. If she withdraws the amount for consumption in the second year and the tax rate is 20 percent, she will be left with after tax consumption of \$88 (80% of \$110). Under a wage tax with the same rate, she will pay tax in the year the wages are earned and have only \$80 dollars to invest. With no tax on interest income, the amount available for consumption after one year is \$88 – exactly the same as under the consumption tax. In contrast, if income from capital is also subject to a 20 percent tax rate, the after-tax interest rate is reduced to 8 percent and the amount available for consumption in the second year is only \$86.40 (the original \$80 invested plus \$6.40 in after-tax interest).

Consumption Taxes and Above-Normal Returns

In this simple example, with capital income representing the reward for deferring consumption, a consumption tax is exactly the same as an income tax that exempts the return to saving. But individuals who invest in productive assets or financial claims to assets receive more than just the time value of money as a return. Observed returns to capital, in the form of business profits, or dividends and capital gains received by individuals include rewards for risk-bearing and entrepreneurial efforts. They also include economic rents and returns from inherited wealth. The treatment of entrepreneurial income is especially relevant. The classic example is someone whose skill, enterprise, or brilliant new idea gives birth to a highly profitable enterprise. The successful entrepreneur creates wealth valued at many multiples of his or her financial investment. His or her increase in wealth is really in large part income from labor services, but because it is capitalized into the value of the firm, it is not taxable under current law unless the shares are sold during the owner's lifetime and, even if tax on the gain is ultimately paid, the tax is deferred and assessed at preferential capital gain rates.

The entrepreneur's annual profit from the business represents in large part a deferred recognition of income from labor services that previously went untaxed.⁴

The question of how a consumption tax treats entrepreneurial returns and other super-normal returns can be analyzed in different ways (Toder 1997). Under a flat rate consumption tax implemented as a wage tax, the pre-tax return to investment is the same as the after-tax return. So if an investor gets a 25 percent rate of return pre-tax on her saving, she will also get 25 percent under a consumption tax.⁵ But her present value of tax payments, discounted at a risk-free rate, will be positive whenever the discount rate is lower than the return on the investment.

The key point is that, under a consumption tax, the government becomes a partner in the investment. It puts up a share of the capital, but captures a share of the returns. (Under an income tax, in contrast, the government captures a share of the returns, net of depreciation, but does not contribute to the investment.)⁶ If higher than normal returns are associated with scarce investment opportunities, monopoly rents or a good idea that cannot be replicated, then government under a consumption tax can be an *unwanted* partner in the business. For every dollar of equity the investor wants to put in the high return activity, she can only invest $(1-t)$ dollars and must settle for normal returns on the other t dollars she is willing to save.⁷ To the extent that observed investment returns represent economic rents or returns to entrepreneurial activities (see Box 2), a consumption tax differs substantially from a yield-exempt income tax.

⁴ Note this is only a problem for a wage tax, as under a system that taxed consumption directly the entrepreneur would pay taxes when he or she consumes out of accrued income from any source.

⁵ In a situation where there is not a flat rate tax the rate of return will stay the same as long as the person doesn't change tax brackets.

⁶ Similarly, Weisbach (2000) notes that the fundamental difference between a consumption and income tax is in the treatment of capital outlays; if capital outlays are deductible under a consumption tax, returns should be taxed the same as under an income tax.

⁷ In cases where there are no limits on the scale of the profitable investment, government participation limits the return but also bears part of the risk. Alternatively, the investor can restore his return in the "no-tax" world simply by increasing the scale of the investment. In what we view as a more typical case of super-normal returns, the entrepreneur or investor is subject to diminishing returns on his investment with increases in scale and does not want to share his extra-normal profit with the government.

Box 2. Example: Taxing Entrepreneurial Income

An entrepreneur (E) gets an idea how to market a product of a large manufacturer to previously untapped groups. He starts a company to do this and approaches the product's manufacturer with an offer -- guarantee me exclusive marketing rights to these new market segments and give me a fixed percentage of all sales if I can develop the markets. The manufacturer agrees because there is no risk to him and he knows he can make a net profit paying the fee that E charges if the new markets materialize.

E's marketing idea proves wildly successful. The fee gives his company a large, guaranteed source of annual revenue, far in excess of his marketing costs. E spends \$1 million in upfront costs, including foregone earnings, payments to his employees, and investment in office equipment, developing the new markets. As CEO, E pays himself a salary, but the remainder of the revenue, net of labor and other operating costs, gives his company a steady profit of \$50 million per year, which he spends on lavish homes, expensive cars and boats, and foreign travel. At a 5% discount rate, this stream of profits is worth \$1 billion. At the end of 20 years, E decides to retire and sells the business for \$1 billion.

Under a pure accrual income tax, E would pay tax on \$999 million of accrued capital gain in the year his business starts generating revenue and establish a basis of \$1 billion (\$999 million of gain plus \$1 million of capitalized outlays) for his share of the business. He would then pay tax annually on the \$50 million of net profit and would pay no tax on the final sale, which would yield a profit of zero. Under a pure consumption tax, he would deduct the \$1 million upfront costs and would pay tax on whatever portion of his annual salary, the \$50 million of annual profits and the \$1 billion sales proceeds at the end that he spends instead of reinvesting. The difference between the income and consumption tax models is in the timing of the tax on the \$999 million net gain from setting up the business. An income tax would include in the base \$999 million of net gain in the first year, while a consumption tax would allow a deduction of \$1 million of costs in the first year and then assess tax on the \$1 billion of sales proceeds 20 years later, providing those proceeds are not re-invested.

Under the current income tax, E would be able to deduct the portion of the \$1 million start-up costs that represents payments to employees, but would have to capitalize the portion that represents buildings and equipment and recover those costs over time through depreciation. The \$999 million of accrued capital gains would initially be exempt and the \$50 million of annual profits would be taxable, just as under the consumption tax. (The profits would generate two levels of tax if the business was organized as a C-corporation and E paid himself dividends, but would only be taxed once if organized as an LLC, a partnership, a sole proprietorship, or an S-corporation.) The \$999 million of capital gain might be taxed at a reduced rate when E leaves the business, unless E could figure out a way to defer a taxable realization event until death, at which point his heirs would inherit a basis of \$1 billion in the business and no tax would be paid ever on the initial capital gain. In contrast, under a tax on wages that exempts the return from his investment, E would pay tax only on the salary he declares from the business. The \$999 million of gain would escape tax entirely, as would the \$50 million of profit. In this example, current law taxation of entrepreneurial income is much closer to a consumption tax base than to a comprehensive income tax because of the deferral of tax on the initial gain and may be more favorable than a consumption base if the entrepreneur can escape tax on the gain because of the step-up in basis at death. A yield-exempt income tax, in contrast, would impose much less tax on E than either a consumption tax or the current income tax. (Note that in this example, we are omitting discussion of estate and gift taxes because an estate tax could supplement either an income tax or a consumption tax.)

What Does Reported Capital Income Represent?

Income tax returns do not reveal what share of reported capital income represents normal returns to capital and we have to rely on bits and pieces of evidence from other sources. Hubbard and Gentry (2000) find that “entrepreneurial households” own a substantial share of household wealth and income, especially among those with high wealth. They define an entrepreneur as a household who owns one or more active businesses with a total market value of at least \$5,000. They also find that entrepreneurial households hold highly undiversified portfolios. (That is, they are heavily invested in their own enterprise.) While this cross-section evidence does not address directly how the wealth was acquired (someone who saved to accumulate wealth or inherited money may have started a business later in life), it does suggest that a significant share of wealth may reflect past entrepreneurial profits rather than normal returns to saving.

Combining successive years of the Federal Reserve Board’s Survey of Consumer Finances (SCF) with estimates of savings rate by age from the Consumer Expenditure Survey, Wolff (1999) calculates that capital gains account for 75 percent of the growth in wealth for cohorts in both the 1962 and 1983 SCF surveys and 76 percent for cohorts in both the 1983 and 1992 surveys. While normal returns could come in the form of capital gains (to the extent they reflect retained corporate profits), this also suggests a potentially large role for unusually successful investments in generating the current wealth distribution.⁸

As an alternative way of addressing this question, we slightly modify calculations by Gordon *et. al* (2004b) on the effects of switching from current law taxation of corporate income to taxation of corporate income under an R-base⁹ The Gordon *et. al*

⁸ These data are consistent with personal observations that people who become very rich are those who succeeded in a start-up business, not those who invested an unusually large percentage of their earnings in a diversified portfolio.

⁹ An R-base tax system is one in which corporate real assets are taxed while financial assets are not. For more discussion of R-based tax systems see Gordon *et. al*. We add back net interest payments and subtract net capital gains and dividends received from their measure of the size of the 2004 corporate tax base to

calculation (see Slemrod, this volume) eliminated all net financial income (interest and dividends received and paid) from the business tax base and replaced rules for depreciation and capitalization of inventories with current expensing. We use their data to calculate the percentage reduction in the tax base from the switch from depreciation and inventory capitalization to expensing by itself and interpret the change in capital recovery rules as eliminating tax on the share of all business returns (from both debt and equity) attributable to normal returns to capital. For the corporate sector, we find with this modified calculation that the new tax base is equal to 68 percent of current taxable income (including interest received by lenders to the corporate sector) arising in the corporate sector. Thus, if moving to expensing can be interpreted as eliminating the tax on normal returns to capital, this implies that normal returns are roughly 32 percent of all corporate returns.

These data are suggestive of the sources of income that generate wealth, but not the shares of wealth that people accumulate on their own instead of receiving as inheritances or gifts. A number of studies have estimated the share of wealth attributable to inheritances or gifts (Modigliani 1988, Kotlikoff 1988) with widely divergent results, but some recent studies estimate significant shares of wealth from these sources. For example, Gale and Scholz (1994) estimate that over half of wealth comes from gifts and bequests. Wolff (1999) estimates that about two-thirds of the lifetime accumulation of wealth of individuals comes from gifts and bequests.

All this research suggests that normal returns to saving may account for a relatively small fraction of what we measure as capital income. What comes out as measured capital income includes both a deferred recognition of disguised labor compensation plus some combination of rewards to risky investments and returns to inheritance. A pure wage tax, arrived at by exempting individual capital income under the current income tax and allowing the corporate tax base to erode would miss these returns permanently.

derive a rough estimate of taxable profits from both equity-financed and debt-financed real assets in the corporate sector.

ISSUES IN COMPARING IDEAL INCOME AND CONSUMPTION TAXES

The previous section has reviewed the differences between an income tax, a consumption tax, and a wage tax, noting that observed taxes on returns to assets in our system represent a combination of taxes on normal returns to saving, taxes on returns to inherited wealth, and taxes on returns to economic rents and previously untaxed entrepreneurial income. Eliminating existing taxes on returns to assets would not necessarily lead us to a consumption tax. But if we could implement either an ideal income or an ideal consumption tax, which would we prefer? In other words, do we want to exempt normal returns to saving from the tax base?

The issue of whether consumption or income is a more appropriate tax base is one of the oldest questions in public finance. In this section, we briefly review the rationale for preferring consumption to income as the tax base, assuming that we could implement an ideal base, on grounds of fairness and economic efficiency.

Equal Treatments of Equals

One threshold question of fairness is whether the tax law treats people in the same circumstances equally. The answer of whether we should tax both capital income and wages may seem obvious to people who believe that the tax system should treat people in equal circumstances in an even-handed way. Unfortunately, the answer that seems obvious to some is not the same as the answer that seems obvious to others.

One obvious answer is that we *should* tax income from capital because otherwise the tax system would otherwise discriminate in favor of wealth holders and against wage earners. Consider two taxpayers, K and L. K owns \$1 million of U.S. government bonds, which he inherited from his grandfather. The bonds pay interest of \$50,000. L is a schoolteacher and earns \$50,000 per year. It would appear inappropriate that K should

pay less income tax than L because K gets income from government bond interest, while L gets income from wages.

A different obvious answer is that we *should not* tax capital income because it penalizes people who save. Suppose now that K and L are both schoolteachers who have both earned \$50,000 per year for 10 years and paid a 20 percent tax on their earnings, leaving them with \$40,000 after tax. L spent \$40,000 each year on consumption, while K lived on just \$30,000 and saved the remainder in U.S. government bonds at a 5 percent interest rate. Without any tax, K could have accumulated savings of \$125,779 after 10 years. But taxing the interest on his bonds at 20 percent per year would reduce his wealth to \$120,061.

This year L will pay \$10,000 of tax on her salary. But K will pay \$10,000 of tax on his salary plus another \$1,200 of tax on about \$6,000 of interest income. Moreover, his interest income would have been \$286 higher if he had not paid tax on interest in earlier years. So K's total tax burden is really \$11,486. Why should K pay more tax than L, when both had the same opportunities, but K was frugal and choose so save so he could enjoy an expensive vacation after 10 years, live better in retirement, or maybe even leave some money to his kids?

These examples suggest two differences in perspective about the fairness of taxing capital income. The first is a question of whether the wealth was accrued out of previously taxed or untaxed income. This is primarily a question of whether a consumption tax is implemented by taxing current consumption or by taxing wages, while exempting returns to capital; if the latter, as discussed in the previous section, it might exempt returns from assets acquired with income that was never taxed. If the tax were imposed annually on current consumption, both K's interest and L's wages would be taxable, but only to the extent they were spent.

The second difference in perspective relates to determining the appropriate time frame to use in measuring ability to pay tax. If annual accruals are the right measure of

ability to pay, capital income should be in the base. But, using a longer time perspective, the second example shows how a tax on capital income can discriminate against the person who chooses to save in order to consume later in life. More generally, if a person leaves no bequests, then the value of her lifetime resources (including inheritances, windfalls, and the present value of labor earnings) must equal the present value of her consumption over a lifetime (U.S. Department of the Treasury, 1977; Bradford and U.S. Treasury Tax Policy Staff, 1984). A flat rate consumption tax would impose the same tax on everyone with the same lifetime endowment, without regard to the timing of consumption or labor earnings. In contrast, for two people with the same endowment, an income tax that includes normal returns to capital in the base would impose a higher tax on the person who consumes later in life (saves more) and on the person whose earnings come earlier in life (and who therefore must save more than someone with a more back-loaded pattern of earnings to finance the consumption).

The lifetime equity argument provides powerful reasons for supporting consumption taxes, but also has its limitations. In the absence of perfect capital markets, people cannot always borrow and lend money at a risk-free rate so that current income as well as the present value of lifetime earnings can affect ability to pay. Congress cannot commit future Congresses to a stable tax policy. In cases where taxes need to be raised temporarily (as in World War II), people may believe that current income recipients (who may spend either today or in the future) should bear the burden instead of current spenders only (Graetz 1997). A model of horizontal equity based on a stable tax policy and the assumption that tax units are stable over a lifetime may not translate well to a world in which tax policies are constantly shifting and the composition of individual tax units changes as individuals marry, divorce, and die.

As a practical matter most people may not share the lifetime perspective of economists and as a result the fairness of a tax system that exempts capital income may not be apparent to them. It would be hard to justify, for example, imposing high tax rates as a share of income on young people who are borrowing to make ends meet simply because they can expect to earn higher income in the future. It also may be difficult to

rationalize high tax rates on the income of those with temporarily low incomes (due to unemployment or business reverses) who are trying to maintain living standards in the short run.

Progressivity

A corollary to the principle that people with equal ability should pay the same tax is that people who have more ability to pay by whatever measure we use should pay more tax. General tax principles do not provide specific guidance as to *how much* additional tax should be imposed on people with more ability to pay. We share, however, the widespread but by no means universally shared belief that people with more ability to pay should pay higher tax rates; that is, the tax system should be progressive. We further assert that, in the current environment of increasing income inequality (Levy and Murname, 1992; Piketty and Saez 2003), tax reforms should not make the system markedly less progressive. This is of course a value judgment that not all people will share.

With the same rate structure, an income tax is more progressive than a consumption tax because the ratio of consumption to income declines with income. In principle, a consumption tax could be made as progressive as an income tax by changing the rate structure, but maintaining the current distributional burden would require much higher marginal rates at the top consumption levels than the top marginal rates now applied to income. Further, implementing a progressive consumption tax would require collecting at least part of the tax from individuals. We discuss in a separate section the feasibility of implementing a progressive consumption tax and the type of rate structure such a tax might require.

Consumption Taxes, Income Taxes and Economic Efficiency

Taxes in general reduce economic efficiency when they cause people to alter their economic behavior to reduce their tax liability. They do this by imposing a wedge

between the price that buyers pay for goods and services (including services of labor and capital in production) and that price that sellers receive, thereby preventing some transactions that would have been mutually advantageous to buyers and sellers in the absence of tax. Assuming that people act rationally in their best interests and that prices of goods sold in the marketplace reflect their additional value to society, taxes that distort economic choices either lower output or cause an inefficient set of outputs to be produced, in the sense that output is different than what people would choose in the absence of tax distortions.

Imposing an equal tax on everyone (a head tax) is non-distorting because tax liability is not affected by economic behavior, but imposes a high burden on those with little ability to pay. Taxing all economic activities at the same rate would also be non-distorting, but it is only feasible to tax observed market transactions. This means in practice that the value of time spent in leisure and home production cannot be taxed.

A wage or consumption tax is equivalent to a uniform tax on all goods purchased in the marketplace, with non-market activities (leisure and home production) not subject to tax. **(See Box 3)**. Atkinson and Stiglitz (1976) developed a seminal model of commodity taxation that has been used to compare consumption across time periods. Under certain assumptions, they find that tax rates on all goods should be equal to minimize distortions. In their model, future consumption is one good; consumers purchase this good by foregoing consumption today. Thus uniform commodity taxation requires taxing consumption today at the same rate as consumption in future periods or, equivalently, not taxing capital income. Assuming there is no initial endowment of wealth (no bequests), there are perfect capital markets and all income from capital represents the return from deferring consumption, the decision of what goods to purchase is separate from the decision of how much to work, and all individuals have identical preferences, a consumption or wage tax will unambiguously improve efficiency relative to an income tax or, in other words, the optimal tax rate on capital income is zero.

Box 3. Distortions From Income and Consumption Taxes

Assume people choose among three activities – current consumption, future consumption, and current leisure. They need to work (sacrifice leisure) to earn the income to purchase current and future consumption goods and, in addition, must spend less than their income from working in order to purchase future consumption goods.

A consumption tax is neutral between current and future consumption because both goods are taxed at the same rate. But a consumption tax distorts the choices between leisure and current consumption and between leisure and future consumption because leisure is untaxed. An income tax distorts the choice between leisure and current and future consumption and also distorts the choice between current and future consumption by reducing the rate of return to saving. For example, suppose a person saves \$100 this year and the pre-tax interest rate is 10 percent. By sacrificing \$100 of consumption today, she can buy \$110 worth of consumption goods next year. But if a tax at 25 percent rate is imposed on capital income, her rate of return is reduced to 7.5 percent and the same amount of saving only buys \$107.50 worth of future consumption goods. An income tax makes future consumption relatively more expensive in terms of current consumption and thereby distorts the incentive to save.

An income tax can raise the same revenue at a lower rate than a consumption tax because the base of the tax is broader. Thus, an income tax imposes a smaller distortion between leisure and current consumption. But it imposes a larger distortion between leisure and future consumption because of the inclusion of capital income in the tax base. In general, therefore, it cannot be said that an income tax distorts the incentives to work (sacrifice leisure) by less than a consumption tax.

If one assumes that people's decision on how much to work is independent of their decision of how much of their income to save for future consumption (technically, the utility function is separable in leisure and consumption), then it can be shown that a consumption tax is unambiguously less distorting than an income tax. But an income tax might be less distorting than a consumption tax if leisure and future consumption are complements (working less raises the value of an additional dollar of future consumption), so that taxing future consumption is an indirect way of taxing the untaxed activity, leisure. Alternatively, if leisure and current consumption are complements, the optimal tax rate on capital income could be negative. Thus, we cannot assert with certainty that a consumption tax is less distorting than an income tax, but in the absence of clear evidence on how capital income taxes might affect the labor leisure choice, many economists would take as a starting point that the tax rate on normal returns to capital should be zero.

If we drop the assumption that choices about how much to work and not work (consuming leisure or participating in non-market productivity – say taking care of one's children) and what goods to consume are not made separately, we can no longer unambiguously assert that a consumption tax always causes less efficiency loss than an income tax. In general, the distortion against non-market production in the tax system can be reduced by taxing at higher rates goods that are complements¹⁰ to the untaxed

¹⁰ Goods are often categorized as complements or substitutes. Complements are goods that are more often consumed together, or if one good is consumed more the other is likely to increase as well –for example, hamburgers and French fries. In contrast, substitutes are goods that are more often consumed instead of each other – hamburgers or hot dogs.

good (non-market production). This means that an income tax could be more efficient than a consumption tax if non-market goods and future consumption are complements; that is, if spending less time working raises the relative marginal value of future consumption. If the reverse is true, however, or other circumstances apply, the optimal tax rate on capital income could be negative.¹¹

Other authors, however, have advanced arguments about why a tax on capital income can be positive in an optimal tax framework that includes a desire for redistribution. Cremer et.al. (2001) find that if individuals differ in their initial wealth, and there is interest in reducing income inequality, then social welfare can be improved by adopting a positive tax on capital income. Saez (2002) generalizes the Atkinson–Stiglitz model allowing for non-identical tastes and a non-linear income tax and finds a role for a small tax on savings in addition to a wage tax if high income earners have a higher taste for savings. That is, again overall welfare can be improved, if redistribution is a goal of the system, by adding an additional tax on savings.

Is there reason to believe that high-income or high-ability individuals have higher tastes for savings? In addition how valid are models that assume the benefits from wealth are simply the future consumption that can be bought with savings? Carroll (2000) examines the savings behavior of the very wealthy and finds that their saving behavior is not explained well by standard economic models that assume that people save in their high-earning years in order to consume in retirement or leave a bequest. For the very wealthy, consumption does not increase enough in later periods to decrease wealth stocks and the spending and saving patterns of these individuals also is not consistent with other motivations for saving (such as maintaining precautionary balances or leaving a bequest). He posits that for the very wealthy, there is some benefit or utility from the accumulation of assets beyond the consumption stream purchased by these goods. Thus there is utility from the accumulation of wealth in itself. If this hypothesis is true, then a tax on either wealth or capital income of high-income people can be a relatively efficient way to redistribute resources.

¹¹ Judd (1985) finds that the optimal tax rate on savings is zero and in follow-on work (1997) that relaxes the assumption of perfect competition finds that the optimal tax rate is negative because higher saving will lift earnings of non-savers.

We conclude this brief survey by noting that there is a general presumption that capital income should not be taxed if we assume all capital income comes from deferred consumption, wealth in itself provides no utility apart from financing future consumption and there is either no inherited wealth or infinite-horizon consumers. However, these conditions do not hold in the real world, so the efficiency argument for not taxing capital income is not necessarily decisive and we need to look more closely at how a tax system that exempts all income from capital would be implemented and how it would affect saving when compared with our current tax system, which is also not a pure income tax.

IMPLEMENTING A PROGRESSIVE CONSUMPTION TAX

Alternative Models of Progressive Consumption Taxes

Two prototypes of progressive consumption taxes have been proposed; a cash flow consumption tax collected only from individuals and the X-tax, which is collected from individuals on wages and from businesses on gross receipts less wages and purchases from other firms.

Cash-Flow Individual Consumption Taxes. One approach for developing a progressive consumption tax is to transform the current income tax system into a “cash-flow” tax on consumption of individuals by allowing an unlimited deduction for all net deposits to qualified savings accounts and requiring all loan proceeds to be included in the tax base. Graduated rates could be applied to “cash-flow” consumption of individuals. Corporate profits could be taxed either under an R-base system, a cash flow R plus F base (with expensing), or not at all.¹² No country has a tax system of this type. The U.S. Treasury proposed a graduated expenditure tax in 1942 as a war finance measure, but Congress rejected it summarily. (Graetz 1997)

More recently, there have been two models advanced of a cash-flow consumption tax. The Treasury Department in the report Blueprints for Basic Tax Reform released at

¹² Discussion of these types of systems and the differences between an R-base and an R plus F base system are discussed in Box 1.

the end of the Ford Administration (U.S. Treasury Department, 1977; Bradford and U.S. Tax Policy staff, 1984) described a model cash-flow consumption tax for individuals, combined with elimination of the corporate income tax. Senators Sam Nunn and Pete Domenici proposed the USA (for Unlimited Savings Account) tax in 1994. No Administration ever advanced the Blueprints model as a legislative proposal and the Nunn-Domenici proposal attracted little support in Congress.

A cash flow tax would most closely approximate a tax on annual consumption, but would add complexity by requiring taxpayers to keep track of all net saving and dis-saving.¹³ In particular, measuring whether deposits to savings accounts represented net saving or a transfer of old wealth would require a comprehensive wealth accounting when the system is introduced. In addition, compromises made necessary for political realities (such as maintaining preferences for mortgage interest and municipal securities) and provisions to relieve individuals on double taxation on consumption from previously taxed wealth could open the system to significant tax avoidance.¹⁴

The Flat Tax or X-Tax. An alternative to the cash-flow tax is an R-base business tax with wages taxed at the individual level, modeled on the Hall-Rabushka (1995) flat tax proposal (HR tax). This is essentially a subtraction-method value added tax with a deduction for wages, combined with a personal tax on wages. Capital is expensed at the business level, so the tax base is consumption, not income. Interest expenses are not deductible to businesses and interest, dividends, and capital gains are not taxable to individuals. The flat tax applies a single rate to the business and individual tax bases, but allows generous taxpayer and dependent exemptions to introduce a degree of progression in the wage tax on individuals.¹⁵

¹³ The *Blueprints* proposal attempted to avoid this complexity by allowing taxpayers to “pre-pay” tax on saving and exempt returns on assets held outside of qualified accounts, but as discussed above exemption of returns is equivalent to consumption tax treatment only under certain restrictive assumptions. In addition, allowing alternative treatment of assets could give rise to substantial tax avoidance opportunities by enabling individual to exploit the difference in timing rules between the two treatments of saving. For a discussion of implementation issues in a *Blueprints* type consumption tax, see Graetz (1979).

¹⁴ Ginsburg (1995) discusses how transition rules and preferences for mortgage interest and municipal bonds in the USA tax could have led to tax avoidance and reduced saving, contrary to the intention of its sponsors.

¹⁵ The HR framework of combining an R-base tax at the business level with a wage tax at the individual level could also be the basis for an alternative way of implementing an income tax, if business investments

The X-tax (Bradford, 1986) is a variant of the HR tax with graduated rates for individuals. While HR proposes a broad tax base by disallowing individual deductions (including deductions for mortgage interest, charitable deductions, and state and local income taxes) and taxing employer provided health insurance and other fringe benefits (by denying deductibility for fringe benefits from the business tax), most of these preferences could be retained within the HR framework. (Retaining the mortgage interest deduction is possible, but problematical because it allows individuals to engage in pure arbitrage by deducting interest on loans used to purchase tax-free interest-bearing assets.) An earned-income tax credit and other credits, either refundable or not, could also be retained within the HR framework.

The HR tax is much less complex than a personal cash-flow consumption tax and also simpler than the current income tax. But part of this simplicity comes from the elimination of tax preferences that are unrelated to the switch from income to consumption taxation and that Congress may wish to retain. Weisbach (2000) identifies administrative problems in the income tax (related to recognition rules and measurement of changes in net worth) that the HR plan would eliminate, but also describes significant administrative issues not present in the current tax that an HR type tax would need to resolve. Among the serious problems are those that arise from inconsistencies between the treatment of real and financial transactions, ability to manipulate results through arrangements with taxpayers outside the system, and inconsistencies the new business tax would introduce between the U.S. and other countries' corporate tax rules. (See also Bankman and Schler, this volume.)

An interesting question is whether the HR tax is a yield-exempt tax base or a consumption tax that includes above-normal returns in the base. On the surface, the individual tax base appears as a yield-exempt system because it does not tax capital

are capitalized instead of being expensed. Such an approach was suggested in the Comprehensive Business Income Tax (CBIT) plan for integrating the corporate and personal income taxes. (United States Treasury Department, 1992)

gains, dividends, or interest income, while allowing no deductions for asset purchases. In a closed economy (with no international capital flows), however, the effect of expensing and full inclusion of business income would be to reduce the purchase price of business assets to households, including the price of corporate shares, and to reduce after-tax income of households from business profits. The net effect would in theory be the same as for a cash flow consumption tax that allowed deductibility of saving and taxed all returns from real and financial assets. The exception is for debt, which would be taxed in effect by a yield exempt method. Because the tax rate on capital income is zero, interest rates and bond prices would be unaffected by the tax, relative to a no-tax world, so that interest would be taxed on a yield-exempt basis.

But a closer look suggests that an HR tax may in fact also operate to some degree as a yield-exempt tax for some equity investments. First, returns from foreign assets held directly by U.S. individuals would be wholly exempt from any U.S. tax under the HR plan. Second, because the HR business level tax, unlike European value added taxes, is an origin-based tax with no tax on foreign source income, there would be substantial incentives to avoid tax by manipulating transfer prices (Weisbach 2000, Bradford 2005). Corporations for example, would have an incentive to shift income to overseas subsidiaries by understating the sales prices of intangible assets to them. The yield-exemption method of individual taxation places a substantial burden on enforcement of a business-level tax base that is subject to many opportunities for manipulation if there is to be any taxation of investment returns at all because there is no tax on distributions or capital gains from asset sales.

This discussion also assumes no transition rules, meaning that existing business assets would have a tax basis of zero and no further depreciation would be allowed. If basis and capital recovery could be retained for old assets, this would make an HR base a yield-exempt tax for owners of claims to income from those assets. Moreover, even without transition rules, an origin-based tax of the HR variety exempts old wealth held by U.S. resident in the form of foreign assets. (See Grubert and Newlon, 1995)

If the U.S. were to implement a progressive tax on a base that excludes capital income, we believe the most likely method would be a variant of the HR approach. The mechanics of how such a tax base would work, especially with regard to transition rules and with how changes in the corporate tax would be coordinated with other countries' tax rules, needs much further development. Below, however, we present some illustrative simulations of the distributional effects of moving to an HR base for capital income both with and without changes in the rate structure that would be needed to maintain revenue neutrality and then consider rates that would be necessary to maintain approximately the same current distribution of the tax burden as under current law.

Distributional Effects of Adopting an HR Tax Base

We simulate the effects of eliminating capital income by replacing the current individual and corporate income taxes with an HR base tax, while maintaining all preferences in current law other than interest deductions. The simulations assume that there is no transition relief under the business tax, the tax can be perfectly enforced, and that individuals cannot escape capital income taxation by shifting funds overseas. The simulations also assume that the burdens of both the current and revised corporate income tax are borne by all recipients of income from capital (including recipients of income from tax-free retirement saving plans). We note that we are not simulating the HR tax proposal itself, merely the change from our existing tax base to a system that eliminates individual taxation of capital income by exempting taxes on interest, dividends, and capital gains and eliminating individual interest deductions and that eliminates capital income taxation at the business level by allowing expensing of capital and inventories and eliminating business interest deductions. We maintain the current tax bracket structure and all tax preferences not related to capital income taxation (such as deductibility of state and local taxes and charitable contributions) in the simulations. The purpose is to illustrate the effects of changing the tax base from the current tax base to one that exempts income from capital.

We simulated the distributional effects of eliminating taxation of capital income using the Urban-Brookings Tax Policy Center (TPC) micro-simulation model of the federal individual tax system. To implement this, for individuals, we simulated elimination of all taxes on interest, dividend, and capital gains income and elimination of deductions for mortgage interest, investment interest, and student loan interest. We kept current provisions for contributions to tax-deferred savings accounts intact, on the grounds that deductible IRA provisions provide the same present value of tax benefits as eliminating taxation of capital gains, interest and dividends from IRA investments, assuming the individual remains in the same tax bracket. We also examined models where the mortgage interest deduction is retained. For corporations, we assumed that the corporate tax base would be replaced with an “R-base” with no transition rules for old assets, using a methodology similar to that used in Gordon *et. al* (2004a). Note that the distributions presented are from a static model and assume no behavioral response. That is, individuals are not assumed to change their investment and savings decisions once these returns are no longer taxed.

The benefits of eliminating taxation of capital income accrue overwhelmingly to the highest income taxpayers. Taxpayers with income over \$1,000,000 receive 82.5 percent of the benefits and see their average federal tax burden drop by 20 percent. (Table 2). Taxes would increase for taxpayers with income between \$75,000 and \$200,000, largely because the loss of the mortgage interest deduction would outweigh benefits to them from lower taxes on interest, dividends, and capital gains and the reduced burden of the corporate-level tax. Ranking taxpayers by income percentile reveals that taxpayers in the top 1 percent of the distribution receive over 100 percent of the tax cut (Table 3). The changes in tax burden are very small in the bottom four quintiles; slightly negative in the bottom three and slightly positive in the fourth quintile. The highest income taxpayers receive the largest increase in after-tax income; for taxpayers in the top 0.1 percent of the distribution, after-tax income goes up by 11 percent.

Implementing these changes would reduce annual revenue by about \$75 billion per year at 2005 levels. The cost of exempting capital income from taxation is partly offset by the elimination of the mortgage interest deduction. If the mortgage interest deduction were retained (and there was no change in household behavior) the overall cost of the change would nearly double to \$145 billion.¹⁶ (Table 4, top panel) With the mortgage interest deduction retained, taxes now decline on average for households with incomes between \$75,000 and \$200,000. The share of benefits going to taxpayers at the very top of the income distribution declines, but the top one percent of households still receives over half of the tax cut. (Table 4, bottom panel) The majority of tax units in the bottom three quintiles experience no change in their taxes.

If mortgage interest deductions were retained and savings and investment income were not taxed, individuals could reduce their tax liability without any change in saving or housing consumption by increasing their housing-backed debt and investing the additional funds in tax-exempt securities. To estimate the revenue loss from this arbitrage opportunity, we assume individuals raise their housing debt to 80 percent of housing value (up to a maximum of \$1 million) and calculate the resulting increase in mortgage interest deductions assuming an interest rate of 5%.¹⁷ Under these assumptions, the cost of exempting capital income and retaining the mortgage interest deduction increases by \$30 billion annually to \$176 billion (Table 5). This assumption of arbitrage reduces the share of benefits received by the very highest income taxpayers, in part because the \$1 million limit in current law in the amount of mortgage debt on which interest is deductible limits their additional borrowing.

¹⁶ Even if the mortgage interest deduction is retained about 9 percent of tax-units still receive tax increases. This is due to the elimination of the deduction for student loan interest (this largely affects those earning less than \$100,000), disallowing schedule D losses and investment interest, and taxing some business income at higher effective rates. The R-tax broadens the base through adjustments to Schedule C,E and F income or loss amounts similar to those done in Gordon, Kalamokidis and Slemrod (2004); the main reason the tax base increases for some types of business income is that the elimination of interest deductions outweighs any reduction in the tax base through changes in capital recovery and inventory rules.

¹⁷ This is a preliminary estimate assuming that house values for itemizers are 100 times the value of itemized deductions for real-estate taxes. We derived this assumption from data on the ratio of property taxes to housing value of owner-occupied housing calculated from the 2000 Census. We plan to expand the model to incorporate more detailed imputations of housing values, which will also allow us to estimate additional borrowing for taxpayers who are currently not itemizing, but may find it profitable to do.

If these changes are paid for in a more revenue neutral way with individual and corporate tax rates being increased proportionately (to a top marginal rate of 37.4 percent on individuals and corporations and a top individual AMT rate of 29.9 percent)¹⁸, taxes would decline for the very highest income taxpayers, decline slightly for the very lowest income taxpayers¹⁹, and increase for all groups in between. Average federal tax burdens would drop by 15 percent for taxpayers with income over \$1,000,000 and by 3.6 percent for taxpayers with income between \$500,000 and \$1,000,000, but would increase on average for all groups of taxpayers with income between \$20,000 and \$500,000 (Table 6, top panel). For these groups, the increase in tax rates and the loss of the mortgage interest deduction would outweigh any benefits from lower taxes on interest, dividends, and capital gains. Ranking taxpayers by income percentile (Table 6, bottom panel) shows similar results.

To simulate a consumption tax base that roughly maintains the current distribution of tax burdens, we increase individual and corporate rates (but not AMT rates) to keep taxes (including the estimated corporate tax burden) approximately constant in each tax bracket. This requires large increases in the top two marginal rates; the top rate and the corporate rate rise from 35 to 44 percent.²⁰ At this corporate rate (assuming no behavior), corporate revenue is about 95 percent of revenue under current law.

This rate structure roughly maintains the current distribution of the tax burden in the bottom four quintiles of the income distribution, but there continue to be some big changes within the top quintile. Taxpayers with income over \$1 million receive an

¹⁸ Proportionate increases would lead to the individual income tax rates, the alternative minimum tax rates and the corporate income rate being increased by 6.8 percent. Increasing the corporate tax rate from 35 to 37.4 percent results in corporate tax revenue that is 81 percent of its current-law value. This is assuming that the mortgage interest deduction is repealed, if it were retained tax rates would need to increase by 14-18 percent (depending on if there was a change in the amount of mortgage interest deductions taken). Simulations assuming the mortgage interest deduction is retained are available from the authors.

¹⁹ The lowest income groups include some taxpayers with substantial amounts of interest, dividends, and capital gains, offset by business losses that reduce their net income.

²⁰ The entire set of individual income tax rates would change from 10,15,25,28,33 and 35 percent to 9.5, 14.2, 23.5, 32.3, 37.4 and 43.9 percent. The corporate rate would equal the top individual rate of 44 percent resulting in corporate revenue that is 95.3 percent of current law revenue.

average tax cut of almost \$25,000, or slightly over 1 percent of income, but taxpayers in income groups between \$100,000 and \$1,000,000 on average all pay higher taxes. (Table 7, top panel.) Even within the very top income group, most individuals would pay higher taxes. Only the very small minority of taxpayers with a very large share of their income coming from capital would benefit from the change. For all income classes and for all quintiles of the income distribution, the number of individuals facing tax increases is higher than those receiving tax cuts. For example, of those with cash income over one million dollars, 63.5 percent of individuals would be subject to a tax increase, while only 36.5 percent would receive a tax cut.

Thus moving to a system that exempts savings from taxation decreases the progressivity of the income tax system and would increase the size of the expected budget deficit unless offset by tax rate increases or reduction in other, non-capital income related preferences. Roughly maintaining the progressivity of the tax system would require much higher top marginal tax rates. Maintaining the same tax burden at the very top of the income distribution would require adding another, even higher, tax bracket.

Departures from a Consumption Base

In the simulations above, we assumed a comprehensive consumption tax base could be implemented. But, as Bankman and Schler (this volume) and others have shown, there could be substantial departures from the flat tax base and as we discussed above, even with perfect enforcement it would not tax all consumption arising from business profits. Two other sources of departure from a consumption tax that would erode the tax base for high-income people would be transition rules and omissions of those provisions necessary to implement a consumption base that would *increase* instead of reducing tax liabilities for some individuals and companies.

Transition Rules and Taxation of Returns to Old Capital

A consumption base would exempt the normal returns to new savings, but there would still be the issue of how to tax old capital; that is capital that was accumulated out

of after-tax income under the current income tax. We follow others in referring to this as the *transition* problem. In the long run, all normal returns to capital will be exempt from tax. In the short run, however, a fairly large percentage of wealth could be subject to double-taxation when the tax law changes. (Double taxation would occur when wealth that was accumulated with after tax dollars is taxed again when the funds are used for consumption.)

The return to new saving and investment would be exempt under a consumption tax, but without an explicit exemption for old wealth, both the return to old assets and withdrawals from the stock of existing assets that are not reinvested will be taxed. Imposing a Federal value-added tax (VAT) would automatically tax all withdrawals from existing savings that are used for consumption – even if those savings were accumulated out of after-tax income. The total wealth of U.S. households is estimated at about \$45 trillion. Much of this wealth is in the form of assets such as pensions and unrealized capital gains, which have not yet been taxed. Excluding housing, we estimate that the basis of private assets in the United States could be as much as \$15 trillion.²¹ Transition rules governing the treatment of consumption financed by existing wealth will determine to what extent this significant amount of previously taxed savings is subject to the consumption tax.

Transition rules would be required to relieve the tax burden on savers who have accrued savings from after-tax income and would be taxed again when those savings were spent under a consumed income tax. Transition rules could be developed to reduce the burden on individual savers if the tax on returns to wealth is assessed to individual taxpayers.

For example, without a transition rule for past savings, a retiree who accumulated \$100,000 in a savings account out of after-tax income before the imposition of a

²¹ Information on the stock of household wealth comes from the Federal Reserve Flow of Fund Accounts. We estimated the basis of private assets by excluding housing assets, pension funds and the net value of life insurance and assuming the value of unrealized capital gains in publicly-traded stock and mutual funds is 26.8 percent of asset value, based on Poterba and Weisbenner (2001).

consumption tax would be taxed on withdrawals from that account that are for consumption expenditures. A transition rule could allow savings that were accumulated under the income tax to be separated from “new” savings and deducted from income. Such a rule could treat the \$100,000 as tax-paid savings and would enable the retiree to make tax-free withdrawals from the savings account. It is difficult, however to design a system that would differentiate between individuals who reduce their accumulated savings in order to consume, and individuals who only rearrange assets among accounts. Allowing tax-free withdrawals from past savings, for example, would enable any individual with accumulated wealth to gain a tax deduction simply by transferring old assets into “new” savings accounts. It would enable a millionaire living off the interest on her accumulated assets, for example to receive the equivalent of tax-free interest income – a substantial benefit compared to current law.

If the consumption tax were in the form of a standard VAT or flat tax that collected taxes on consumption from old wealth from businesses, then transition rules could not distinguish among individuals, based on whether they were saving or consuming out of old wealth. Individuals would bear the transition burden either through higher prices or through lower asset values of their equity shares in business. Transition relief would be focused on businesses that had purchased assets that they were required to capitalize under the prior income tax. They would see the basis of those assets reduced to zero in the absence of transition relief. Relief could take the form of allowing businesses to retain basis or some fraction of basis in old assets and allowing them to continue to recover basis in old assets through depreciation or could allow for the immediate expensing of the remaining basis.

It is hard to imagine that an HR consumption tax could be enacted without some form of relief for businesses that had purchased assets before enactment of the tax. But such relief would be costly and would effectively move the system in the direction of a tax on wages instead of consumption by effectively exempting income from old capital from tax. It would also provide windfall gains to owners of existing assets who are

planning to maintain their capital instead of spending it down. (See Box 4 – Winners and Losers from Transition to a Consumption Tax)

Box 4 – Winners and Losers From Transition to a Consumption Tax

Suppose an individual had accumulated \$100,000 of wealth under the current income tax from earnings and interest from taxable bonds. Suppose also that the marginal tax rate the individual faces is 28 percent and that on January 1, 2006 the income tax is repealed and a 28 percent consumption tax is imposed.

Under the current income tax, the person could spend \$100,000 from his wealth without paying any additional tax, but would pay a tax on any interest income on the wealth. If the interest rate is 10 percent, he could earn a before-tax return of \$10,000 per year and after tax return of \$7,200 per year. Under a consumption tax without transition rules, he would pay a 28 percent tax on spending from the wealth, leaving him with only \$72,000 of potential consumption. But if he chose to live off the interest from the wealth, he could finance the same \$7,200 of annual consumption that he could under the income tax because his return on saving would be the full 10 percent. And if he chose to save part of his capital income, he could accumulate more wealth faster under the consumption tax than under the income tax. Thus, without transition rules, replacing the income tax with a consumption tax would hurt the person who is dis-saving, help the saver, and leave the person consuming all his capital income, but none of his principal, in the same position. People consuming their principal are likely to be older people who have saved for retirement in their working years. People who have saved in traditional tax-favored retirement accounts, however, would pay tax on their return of investment under both the current income tax and the proposed new consumption tax.

If transition rules allowed people to retain basis on their old assets, the person spending from old wealth will be held harmless by the transition. But all other wealth holders will benefit; they will avoid the one time “lump sum” transition tax on their wealth, while receiving a higher rate of return. In that sense, transition rules would confer a windfall gain on all wealth holders who are planning either to preserve or further enhance their capital.

Dessert Without the Broccoli. Moving from current law to a consumption-base treatment of savings reduces the tax base to some degree and benefits many wealth holders. It also will raise taxes, however, on some individuals and businesses. As noted above, eliminating deductibility of interest will raise taxes on many middle and upper-middle income individuals with large home mortgages and very little taxable capital income. Eliminating interest deductibility will also raise taxes on highly-leveraged businesses, especially those currently holding tax-favored assets or engaging in tax sheltering transactions that lower taxes on their profits. Incremental movement toward eliminating taxes on capital income without taking the complementary steps of limiting

interest deductions create opportunities for taxpayers to reduce their tax liability without undertaking any additional saving. Instead they could engage in tax arbitrage, offsetting deductible interest payments against tax-free interest receipts.

The five easy pieces proposal (see Box 5) is one example of an incremental approach to eliminating taxation of capital income that would substantially erode the tax base, while maintaining current-law incentives to borrow money by keeping interest deductibility. Major portions of the five easy pieces proposal have already been enacted. Further advancing this agenda would not be a move towards consumption taxation or economic neutrality, but instead a move to erode the tax base by enabling investors to engage in tax arbitrage transactions to reduce their tax liability. This proposal illustrates the dangers of incremental moves toward a consumption tax that start with the “easy” part, while ignoring the heavy lifting.

Box 5. Five Easy Pieces

The “five easy pieces” proposal (Christian and Robbins, 2002) would:

- Reduce marginal tax rates.
- Eliminate taxes on capital gains and dividends.
- Move towards expensing of business investments.
- Eliminate the estate tax.
- Allow individuals to establish tax-free personal savings accounts, on top of retirement savings incentives already in the tax law.

The proposal represents a “stealth” approach to replacing the income tax with a consumption tax through incremental changes in the current system. The current Administration and Congress have already enacted or partially enacted several of these items, including lower marginal tax rates, a temporary 15 percent rate on capital gains and dividends, partial expensing of business investments (now expired), and elimination of the estate tax for one year in 2010. The Administration has proposed large tax-free personal savings accounts in previous budgets, but Congress has not enacted these proposals. Elimination of individual taxes on capital gains and dividends and expensing of business investments would also be part of the HR-type consumption tax option that we simulate in this section.

But these proposals do not represent a move towards a consumption tax because they retain deductibility of mortgage interest and interest deductions by corporate and non-corporate businesses. They effectively would allow a substantial erosion of the tax base by high-income taxpayers and businesses who could offset tax-free or tax-favored income from investments with fully deductible borrowing. In addition, there are no provisions to offset revenue losses; although the proposal would reduce the tax base, it would also reduce rates instead of raising rates or closing other tax preferences to finance the proposed tax cuts.

SAVING, GROWTH, AND ECONOMIC EFFICIENCY

Elimination of capital income taxation could increase economic growth and efficiency by increasing private saving and/or by improving the efficiency of capital use.

Capital Income Taxes and Private Saving

Elimination of taxation of capital income raises the after-tax return from new saving. The increase in the amount of future consumption available from sacrificing a dollar of current consumption gives people an incentive to save more (the *substitution effect*). But with a higher rate of return, people do not need to save as much to achieve a given target level of future consumption and so may choose to save less (the *income effect*).

The magnitude and sign of the income effect varies across individuals and is highly sensitive to how the capital income tax cut is financed. If the tax change is revenue neutral (by, for example, raising taxes on labor income), there is no income effect in aggregate, but changes in the distribution of income could still affect total private saving depending on whether taxes are reduced for people with low or high propensities to save.

If elimination of capital income taxes is implemented as part of a reform that substitutes a consumption tax for the current hybrid income tax system, with no transition relief for consumption from old wealth, then the income effect could reinforce the substitution effect and also promote increased saving. It would do this by redistributing tax burdens from those with high saving propensities to those with low saving propensities. In particular, part of the burden of the tax change would fall on retirees, who are financing their consumption in part out of the proceeds of previously accrued

wealth, while young people who are saving to finance their future retirement could see their taxes fall.²²

If, instead, capital income taxes are reduced within the income tax system, while consumption from the proceeds of old wealth remains tax-free, existing wealth holders will receive a net tax cut and be able to consume more today, while maintaining planned future consumption. Under this scenario, taxes would be reduced for retirees and for those with large fortunes who are maintaining their wealth across generations and would be increased for younger people with income mostly from wages.

Empirical research on the relationship between private saving and the after-tax rate of return gives mixed results. An early and often cited study by Boskin (1978) estimated that a 10 percent rise in the real after-tax rate of return would increase saving by 4 percent, but subsequent studies found that Boskin's results were not robust to changes in specification (Howrey and Hymans 1980, Bosworth 1984). Other studies have found insignificant or mixed effects of interest rates on saving (Carlino 1982; Friend and Hasbruck 1983; Blinder and Deaton 1985, Skinner and Feenberg 1991; for reviews of these studies, see Gravelle 1994 and Congressional Budget Office 1997).

Simulation models that estimate the effects of tax reform must make some assumption about the degree to which households substitute present for future consumption in response to a change in the after-tax return on saving. The assumed responsiveness of the timing of consumption to changes in the relative prices of current and future consumption can have a large effect on the simulated benefits of tax reform. For example, a widely cited study of the economic effects of tax reform by Altig *et. al* (2001) assumes a "modest" substitution elasticity of 0.25 between present and future

²² Compared with current law, their taxes would fall only to the extent that they are saving more than the amounts they are currently allowed to deposit in IRAs, 401k plans, and other tax-deferred saving plans. Most people, however, currently deposit less than the allowable limits, so they would not benefit from consumption tax treatment of all their saving.

consumption, suggesting a mainstream view that saving behavior is somewhat but not very responsive to rates of return.²³

If the choice between current and future consumption is assumed to be responsive to the rate of return, simulation models by economists show that replacing the current income tax with a consumption-based tax will raise economic efficiency and output in the long run, although in most mainstream models the gains are modest. In these models, much of the efficiency gain from introducing a consumption tax comes from the implicit lump-sum tax on existing capital (Box 4). These gains are reduced if transition rules are incorporated in the models. For example, the study by Altig *et al* (2001) cited above estimates that replacing the current tax system with a proportional consumption tax would lead to a 9 percent increase in output with no transition rules. However, this increase will hurt older transitional generations because of the implicit levy on their existing capital and the transition rules combined with the flat rate structure will leave lower income households worse off. In simulations that temper the distributional effects across income classes by retaining graduated rates and that allow for transition relief by maintaining present depreciation allowances for existing capital, Altig *et al.* find that long-run annual output gains are reduced to just under two percent.

Savings Incentives Under the Income Tax

Since the late 1970s, tax policy has sought to encourage private saving by broadening opportunities for workers to save a portion of their wages in IRAs, 401k plans, and other qualified accounts. These accounts receive consumption tax treatment; the contribution is deductible, capital income from the assets is tax-free, and the proceeds of withdrawals are included in income. An alternative form of IRA – the Roth IRA – provides yield-exempt treatment of saving in IRA accounts (the contribution is not deductible, but capital income and withdrawals are tax-free).

²³ The relationship between the assumed elasticity of substitution between present and future consumption and the interest-elasticity of savings depends on other parameters of the model.

If the economic theory underlying optimizing models of saving behavior is correct, these accounts should not increase saving for many people because the amounts they can contribute are limited. This means that, for those who would otherwise save more or have other assets, the accounts do not increase the rate of return to an additional dollar of net saving, but instead just increase the returns to infra-marginal saving that would have occurred without the tax preference. People who could finance contributions by increasing the size of their tax-deductible mortgage or taking out a home equity loan also face the after-tax return on a dollar of additional net saving. The tax benefits also increase the after-tax income of contributors, which allows them to consume more today without sacrificing future consumption.

The accounts could increase net saving, however, for people who would not otherwise be saving that much and cannot finance their contributions with tax-deductible borrowing at a rate close to the return they would be earning in the account. In addition, because IRAs and 401k plans are less liquid than other savings accounts (because of penalties for early withdrawals), households may consider them as less than perfect substitutes for other saving and may choose to finance a portion of their deposits by reducing current consumption.

Research results are ambiguous as to whether or not IRAs and 401k plans increase net saving, although there is stronger evidence that they increase saving among low and middle-income taxpayers than among others. The results are ambiguous because the data researchers use on contributions to retirement plans and total saving by households cannot determine what households would have saved absent the incentives without further assumptions. Because households do not have identical preferences for saving, one cannot simply assume that a positive correlation between contributions to tax-preferred accounts and total saving means that the accounts boosted saving.

Based on somewhat different identifying strategies, Poterba, Venti and Wise (1996) estimate that 401(k) contributions increase net saving, while Engen, Gale and Scholz (1996) find that most contributions reduce other saving. In subsequent research,

Engen and Gale (2000) find that savings plans have raised wealth for relatively low-income households, but not for relatively high-income households. Engen, Gale, and Uccello (1999), Gale, Iwry and Orszag (2005), and Neuberger, Greenstein and Sweeney (2005) argue that increasing participation among low and middle-income households is more likely to represent new savings instead of asset shifting than additional contributions by high-income households.

More recent research by economists in the “behavioral economics” school suggests that increased saving depends at least as much on the form in which incentives are conveyed as on the actual financial benefit from the incentive. For example, there is evidence that the take-up rate on 401k plans is much higher when employers automatically deposit money in the plan, with an option for an employee to opt out, than when the employee is simply offered an opportunity to contribute (Choi *et. al* 2004). These studies suggest that targeted savings plans designed to encourage broader participation could be much more effective in stimulating saving than increases in after-tax returns by themselves.

Because of anti-discrimination rules that require broad participation for qualification of 401(k) plans, many employers need to offer generous incentives for low-income employees to participate so that the plans will be available for the high-income savers who benefit the most. Over 80 percent of 401k plans include an employer match. (U.S. Census, Survey of Income and Program Participation 1996) Removing taxes on income from capital would remove the incentive for employers to provide 401k plans for their workers. Paradoxically, the effect could be to reduce saving by employees who would no longer be receiving the matched contributions that characterize many 401k plans.

In conclusion, while in theory private saving should be higher under a comprehensive consumption tax than under an equal revenue comprehensive income tax, eliminating capital income taxation could either increase or decrease private saving, *compared with current law* if the responsiveness of saving to after-tax returns is low and

if a consumption tax causes employers to stop subsidizing employee contributions to retirement saving plans. Absent more compelling evidence that eliminating capital income taxation in our current system would raise saving, we do not find the arguments that cutting capital income taxes would increase saving, and thereby raise economic growth, to be persuasive.

Would Eliminating Capital Income Taxation Reduce Differentials in Tax Rates Across Economic Sectors?

Even if aggregate saving does not increase, eliminating capital income taxation could raise output permanently if it encourages investors to deploy the existing amount of capital more efficiently. In general, profit-seeking investors will try to select investments that yield the highest after-tax returns. If all tax policy is *neutral* among investments by taxing all returns to capital at the same rate, then investments with the highest after-tax returns will also have the highest pre-tax returns and will have the highest economic productivity, absent external effects.

Both a comprehensive income tax and zero taxes on capital income would achieve tax *neutrality* among investments, but the current income tax does not do so. In part, it is impossible to achieve perfect neutrality under an income tax because we cannot measure all changes in net worth. In contrast, eliminating tax on capital income at least in theory accomplishes this goal by making all effective tax rates on capital income equal at a rate of zero. Economic models that assess the economic efficiency effects of tax reform find that equalizing tax rates across capital assets increases efficiency, especially by reducing the differentials between Federal tax treatment of business capital and untaxed owner-occupied housing and between corporate and non-corporate capital.

In practice, differences in effective tax rates across activities will not disappear under any consumption tax likely to be enacted. Differential taxation may be retained for forms of non-capital income that are tax-preferred under current law, such as employer contributions for health insurance and other fringe benefits, and for certain deductible consumption items. On the capital income side, for political reasons, Congress may

choose to retain a mortgage interest deduction or enact an alternative preference for owner-occupied housing. (The President's instructions to the Tax Reform Commission include retaining incentives for home-ownership and charitable contributions.)

While a consumption tax eliminates the problem of measuring changes in net worth for business assets, it creates new issues for measuring the tax base for investments in household capital and human capital – two very large sources of capital investment in the economy. To be consistent with the treatment of business assets, a consumption tax would have to allow a deduction for the purchase of household assets and then impose a tax on their imputed rental value. More likely, if they are taxed at all, household assets would be taxed under the pre-payment method with the initial purchase taxed and returns exempt. The use of the pre-payment method is equivalent in present value to consumption taxation for assets with normal returns, but would exempt large and unanticipated gains on housing. In principle, investments in human capital should be deductible under a consumption tax, but rules would be needed to determine what portion of educational and training outlays is investment (producing future taxable income) and what portion is consumption (producing current consumption value or future untaxed benefits). Without any deduction for investments in human capital, a consumption tax would introduce a bias in favor of physical assets and against human capital. (The current income tax system allows partial expensing of human capital. The portion of costs that reflect foregone earnings are effectively deductible and a portion of outlays for tuition for post-secondary education benefit from either deductions or credits, but some of the expenses cannot be recovered either through expensing or deductions over time.)²⁴

CONCLUSIONS

Unlike most other OECD countries that have both income and consumption taxes, the United States does not impose a broad-based consumption tax at the Federal

²⁴ For college and graduate students, the portion of education expenses that are deductible as foregone earnings are also likely to be subject to a positive effective tax rate on the capital income they produce because the marginal tax rate on the foregone earnings will usually be much lower than the marginal tax rate on the earnings that their education produces.

level. The current federal income tax, however, is in reality a hybrid between consumption and income taxation. With Federal tax reform again on the national agenda, a number of proposals are on the table that would eliminate the Federal income tax entirely and replace it with a consumption-based tax or, alternatively, convert the Federal income tax into one that exempts most or all returns from saving.

The debate as to whether consumption or income is the appropriate base for taxation has been ongoing for generations. Under certain assumptions, it can be shown that consumption taxes produce less distortions of economic decision-making than income taxes because they are neutral in the choice between present and future consumption, and provide more even-handed treatment than does an income tax of individuals with an equal ability to pay tax over their lifetime. If capital income is defined as the reward for waiting, then a consumption base tax can be shown to be equivalent to a tax base that exempts capital income. These two propositions form the core of the case to eliminate taxation of capital income. Some proponents of eliminating capital income taxation also assert that a tax base that excludes the return to saving would increase private saving and economic growth.

In this paper, we have reviewed these arguments, noting the conditions under which they would hold true and qualifications. We conclude that the neutrality arguments probably favor consumption taxes in the abstract, given economists' standard framework, but that the conclusions could be different if ability and future consumption are complements. There is also a role for income taxation if, unlike in the standard analytical framework, people seek wealth for reasons in addition to the present value of future consumption benefits that it produces. The case that consumption taxes are fairer than income taxes in a lifetime context is also less compelling when tax policies and the composition of tax units are changing over time than in the stable policy and demographic framework that some people assume.

The assumed equivalence between consumption taxes and income taxes that exempt the return to saving is especially problematic. Income that appears as returns to

capital includes much more than compensation for sacrificing current consumption; it also includes economic rent, entrepreneurial profits, and returns from inheritances. A tax on annual consumption would capture these returns, but a yield-exempt tax would not. Evidence on the sources of capital income is fragmentary, but points to a conclusion that normal returns account for a minority of individual wealth accumulation and corporate profits. A tax that excluded super-normal returns and returns from old wealth would be equivalent to a tax on wages alone. It would not have the efficiency properties of a consumption tax and would not be equitable in the sense of imposing the same burden on all people with equal lifetime ability to pay.

Maintaining a progressive tax system requires imposing liability on individual taxpayers based on some measure of their well-being. A comprehensive consumption tax that included all income receipts in the tax base, but allowed people and business to deduct all saving, while taxing all borrowing and all withdrawals from saving, could achieve that objective and arguably might be superior to an income tax. But no such tax is being seriously proposed, in part because imposing a comprehensive consumption tax on individual taxpayers is seen to be unacceptably complex. Instead, consumption tax advocates are promoting modified versions of the Hall-Rabushka tax plan. These plans would impose a graduated wage tax at the individual level, while moving the business tax base towards a consumption base by allowing expensing of new investments. In theory, this could result in a consumption base if in addition to expensing and exemption of capital income, interest deductions are also eliminated, as HR provides. But we have argued that in practice the result may be closer to a yield-exempt tax (with super-normal returns exempt) on wages alone.

Even if a consumption base could be implemented with an HR-type tax, the top tax rates would have to be raised substantially to maintain the current distribution of the tax burden. This finding follows from the fact that taxable capital income is very highly concentrated among very high-income taxpayers within the highest income quintile. Maximum tax rates of 44 percent on individual and corporate income would roughly maintain the current tax burden throughout most of the distribution, but still result in

sizeable tax cuts at the very top. Thus, exempting taxes on capital income would lead to more distortions in behavior due to much higher marginal tax rates.

Eliminating taxation of capital income could increase private saving and economic growth by raising after-tax returns and could raise the productivity of the capital stock by eliminating tax differentials across assets, especially the favorable treatment of owner-occupied housing compared with business assets. But evidence of the responsiveness of saving to after-tax returns is weak and there could be an offsetting drop in saving if eliminating capital income taxation causes employers to drop retirement plans. Efficiency of capital allocation would probably improve if capital income taxes were eliminated, but this requires that preferential treatment of housing be eliminated and may require special rules to address human capital investments.

An alternative to eliminating capital income taxes is to rationalize the current tax treatment of returns to saving. Under current law, most capital income of middle-income taxpayers is already exempt from tax. One approach to reform would simplify the current complex set of retirement and other saving incentives and introduce new provisions to limit the ability to offset tax-free returns with interest deductions. This would move the system closer to one that exempts capital income for most taxpayers, while maintaining a residual capital income tax on high-income individuals and corporations. Alternatively, Graetz (1997) has proposed introducing a value-added tax and using the revenue to remove most people from the individual income tax, while maintaining an income tax, at lower rates, on high-income individuals and corporations.

In conclusion, we contend that the case for eliminating all taxes on capital income of high-income people is problematical. Without substantially higher marginal tax rates, it would make the tax system less progressive, without any clear indication that it would raise saving, improve economic performance, result in a simpler tax system and on balance reduce opportunities for tax sheltering behavior. While an ideal consumption tax is potentially attractive, departures from the ideal, particularly through retention of interest deductions and transition rules that enable people to receive tax-free returns from

old capital, could more than offset any potential economic benefits and allow many high-income people to avoid tax on large parts of their income that do not represent a return to new saving. We hope that instead more attention is focused on alternatives to improve and simplify our current system.

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**Table 1: Distribution of Capital Income
by Cash Income Class, 2005¹**

Cash Income Class (thousands of 2005 dollars) ²	Tax Units		AGI		Interest Income, Capital Gains and Dividends		Business Income	
	Number (thousands)	Percent of Total	Amount (millions of \$)	Percent of Total	Amount (millions of \$)	Percent of Total	Amount (millions of \$)	Percent of Total
Less than 10	19,560	13.5	55,716	0.9	3,887	0.6	5,266	0.8
10-20	25,611	17.7	228,534	3.5	12,495	1.8	16,587	2.5
20-30	19,953	13.8	351,595	5.5	13,871	2.0	14,878	2.3
30-40	15,289	10.6	403,764	6.3	12,575	1.8	12,239	1.9
40-50	11,738	8.1	413,926	6.4	15,646	2.2	13,106	2.0
50-75	20,700	14.3	1,033,153	16.0	40,575	5.8	32,950	5.0
75-100	11,936	8.3	853,738	13.3	32,702	4.7	36,799	5.6
100-200	14,432	10.0	1,555,116	24.1	86,310	12.4	102,216	15.6
200-500	3,797	2.6	793,922	12.3	100,424	14.4	151,428	23.1
500-1,000	642	0.4	284,304	4.4	59,456	8.5	94,025	14.4
More than 1,000	335	0.2	522,227	8.1	314,282	45.0	220,378	33.7
All	144,573	100.0	6,441,556	100.0	698,847	100.0	654,415	100.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3a).

(1) Calendar Year.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

**Table 2. Exempt Capital Income From Taxation
With Adjustment to Corporate Tax Revenue
Distribution of Federal Tax Change by Cash Income Class, 2005 ¹**

Cash Income Class (thousands of 2005 dollars) ²	Percent of Tax Units ³		Percent Change in After-Tax Income ⁴	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate ⁵	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (% Points)	Under the Proposal	Change (% Points)	Under the Proposal
Less than 10	17.2	0.5	0.3	0.4	-15	-7.3	0.0	0.2	-0.3	3.3
10-20	27.8	3.1	0.3	1.3	-38	-5.4	0.0	1.0	-0.3	4.5
20-30	35.3	8.9	0.2	1.3	-47	-1.9	0.1	2.8	-0.2	9.9
30-40	38.1	18.3	0.1	0.4	-20	-0.4	0.2	4.4	-0.1	14.4
40-50	40.9	28.9	0.1	0.3	-19	-0.3	0.2	5.1	0.0	16.7
50-75	42.9	39.9	0.0	0.4	-13	-0.1	0.5	13.5	0.0	18.4
75-100	36.3	56.7	-0.3	-3.6	226	1.3	0.7	12.0	0.3	20.3
100-200	32.3	65.4	-0.5	-10.2	529	1.8	1.5	25.1	0.4	22.7
200-500	41.6	57.9	1.2	12.6	-2,501	-3.4	0.1	15.4	-0.9	24.5
500-1,000	52.7	47.2	3.3	14.1	-16,490	-8.9	-0.3	6.2	-2.4	24.8
More than 1,000	66.0	33.9	9.1	82.5	-184,815	-20.1	-2.8	14.2	-6.3	25.0
All	33.5	24.8	1.1	100.0	-520	-4.1	0.0	100.0	-0.9	19.9

Change in Federal Revenue (\$billions)

-\$75.18

**Baseline Distribution of Income and Federal Taxes
by Cash Income Class, 2005 ¹**

Cash Income Class (thousands of 2005 dollars) ²	Tax Units ³		Average Income (Dollars)	Average Federal Tax Burden (Dollars)	Average After-Tax Income ⁴ (Dollars)	Average Federal Tax Rate ⁵	Share of Pre-	Share of Post-	Share of	
	Number (thousands)	Percent of Total					Tax Income Percent of Total	Tax Income Percent of Total	Federal Taxes Percent of Total	
Less than 10	19,560	13.5	5,618	200	5,418	3.6	1.3	1.5	0.2	-0.2934
10-20	25,611	17.7	14,885	706	14,178	4.8	4.4	5.2	1.0	-0.97322
20-30	19,953	13.8	24,715	2,488	22,227	10.1	5.6	6.4	2.7	-0.93779
30-40	15,289	10.6	34,863	5,023	29,840	14.4	6.1	6.6	4.2	-0.30578
40-50	11,738	8.1	44,824	7,501	37,323	16.7	6.0	6.3	4.9	-0.22302
50-75	20,700	14.3	61,482	11,337	50,145	18.4	14.5	15.0	12.9	-0.2691
75-100	11,936	8.3	86,246	17,261	68,985	20.0	11.8	11.9	11.4	2.69754
100-200	14,432	10.0	133,489	29,744	103,744	22.3	22.0	21.6	23.7	7.63453
200-500	3,797	2.6	287,471	72,859	214,612	25.3	12.5	11.7	15.3	-9.4963
500-1,000	642	0.4	678,426	184,509	493,916	27.2	5.0	4.6	6.5	-10.5866
More than 1,000	335	0.2	2,943,745	919,538	#####	31.2	11.3	9.8	17.0	-61.913
All	144,573	100.0	60,566	12,544	48,022	20.7	100.0	100.0	100.0	

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).

(1) Calendar year. Baseline is current law. Under the proposal, corporate tax revenue is assumed to be 76 percent of its current-law value.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

**Table 3. Exempt Capital Income From Taxation
With Adjustment to Corporate Tax Revenue
Distribution of Federal Tax Change by Cash Income Percentile, 2005 ¹**

Cash Income Percentile ²	Percent of Tax Units ³		Percent Change in After-Tax Income ⁴	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate ⁵	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (% Points)	Under the Proposal	Change (% Points)	Under the Proposal
Lowest Quintile	19.6	0.9	0.3	0.7	-19	-7.9	0.0	0.4	-0.3	3.0
Second Quintile	32.1	5.2	0.3	1.9	-49	-3.6	0.0	2.2	-0.3	6.9
Middle Quintile	37.8	18.0	0.1	1.1	-28	-0.6	0.3	8.1	-0.1	14.1
Fourth Quintile	42.1	38.8	0.0	-0.2	4	0.0	0.8	18.2	0.0	18.4
Top Quintile	35.4	61.3	1.8	95.9	-2,493	-5.5	-1.0	70.9	-1.4	23.3
All	33.5	24.8	1.1	100.0	-520	-4.1	0.0	100.0	-0.9	19.9
Addendum										
Top 10 Percent	36.2	62.5	2.7	102.5	-5,327	-7.5	-2.0	54.5	-2.0	24.1
Top 5 Percent	41.2	58.3	3.8	108.5	-11,282	-10.1	-2.8	41.7	-2.8	24.5
Top 1 Percent	54.8	45.1	6.7	101.7	-52,884	-15.9	-3.3	23.3	-4.7	24.9
Top 0.5 Percent	60.2	39.8	7.8	92.9	-96,550	-17.9	-3.1	18.4	-5.4	25.0
Top 0.1 Percent	72.0	28.0	10.6	71.4	-370,923	-22.7	-2.5	10.5	-7.2	24.6

**Baseline Distribution of Income and Federal Taxes
by Cash Income Percentile, 2005 ¹**

Cash Income Percentile ²	Tax Units ³		Average Income (Dollars)	Average Federal Tax Burden (Dollars)	Average After-Tax Income ⁴ (Dollars)	Average Federal Tax Rate ⁵	Share of Pre-Tax Income	Share of Post-Tax Income	Share of Federal Taxes
	Number (thousands)	Percent of Total					Percent of Total	Percent of Total	Percent of Total
Lowest Quintile	28,340	19.6	7,487	242	7,245	3.2	2.4	3.0	0.4
Second Quintile	28,910	20.0	19,134	1,377	17,757	7.2	6.3	7.4	2.2
Middle Quintile	28,916	20.0	34,409	4,880	29,528	14.2	11.4	12.3	7.8
Fourth Quintile	28,916	20.0	59,726	10,965	48,761	18.4	19.7	20.3	17.5
Top Quintile	28,914	20.0	183,278	45,140	138,138	24.6	60.5	57.5	72.0
All	144,573	100.0	60,566	12,544	48,022	20.7	100.0	100.0	100.0
Addendum									
Top 10 Percent	14,457	10.0	271,934	70,892	201,042	26.1	44.9	41.9	56.5
Top 5 Percent	7,228	5.0	408,681	111,532	297,149	27.3	33.7	30.9	44.5
Top 1 Percent	1,446	1.0	1,126,790	333,361	793,429	29.6	18.6	16.5	26.6
Top 0.5 Percent	723	0.5	1,774,411	539,278	1,235,133	30.4	14.7	12.9	21.5
Top 0.1 Percent	145	0.1	5,136,564	1,636,532	3,500,032	31.9	8.5	7.3	13.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).

(1) Calendar year. Baseline is current law. Under the proposal, corporate tax revenue is assumed to be 76 percent of its current-law value.

(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

**Table 4. Exempt Capital Income From Taxation, Retain Home Mortgage Interest Deduction
With Adjustment to Corporate Tax Revenue**

Distribution of Federal Tax Change by Cash Income Class, 2005 ¹

Cash Income Class (thousands of 2005 dollars) ²	Percent of Tax Units ³		Percent Change in After-Tax Income ⁴	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate ⁵	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (%) Points)	Under the Proposal	Change (%) Points)	Under the Proposal
Less than 10	17.3	0.3	0.3	0.2	-15	-7.4	0.0	0.2	-0.3	3.3
10-20	28.5	1.9	0.3	0.8	-42	-6.0	0.0	1.0	-0.3	4.5
20-30	37.9	4.4	0.3	1.0	-74	-3.0	0.2	2.9	-0.3	9.8
30-40	44.1	8.0	0.3	1.0	-96	-1.9	0.3	4.5	-0.3	14.1
40-50	52.7	11.0	0.5	1.6	-200	-2.7	0.3	5.1	-0.5	16.3
50-75	63.3	12.7	0.8	5.7	-395	-3.5	0.6	13.6	-0.6	17.8
75-100	69.9	16.5	0.8	4.7	-567	-3.3	0.6	11.9	-0.7	19.4
100-200	74.7	20.2	1.3	13.4	-1,341	-4.5	0.9	24.6	-1.0	21.3
200-500	76.7	22.4	3.1	17.3	-6,595	-9.0	-0.2	15.1	-2.3	23.1
500-1,000	75.2	24.6	4.4	9.7	-21,893	-11.9	-0.3	6.3	-3.2	24.0
More than 1,000	77.4	22.5	9.5	44.4	-191,505	-20.8	-2.4	14.6	-6.5	24.7
All	46.6	8.7	2.1	100.0	-1,001	-8.0	0.0	100.0	-1.7	19.1
Change in Federal Revenue (\$billions)					-144.718					

Distribution of Federal Tax Change by Cash Income Percentile, 2005 ¹

Cash Income Percentile ²	Percent of Tax Units ³		Percent Change in After-Tax Income ⁴	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate ⁵	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (%) Points)	Under the Proposal	Change (%) Points)	Under the Proposal
Lowest Quintile	19.7	0.6	0.3	0.4	-20	-8.2	0.0	0.4	-0.3	3.0
Second Quintile	33.4	3.0	0.3	1.2	-60	-4.3	0.1	2.3	-0.3	6.9
Middle Quintile	44.0	7.7	0.4	2.2	-107	-2.2	0.5	8.3	-0.3	13.9
Fourth Quintile	61.8	12.5	0.7	7.2	-362	-3.3	0.9	18.4	-0.6	17.8
Top Quintile	73.4	19.6	3.2	88.8	-4,441	-9.8	-1.5	70.5	-2.4	22.2
All	46.6	8.7	2.1	100.0	-1,001	-8.0	0.0	100.0	-1.7	19.1
Addendum										
Top 10 Percent	76.5	20.7	4.1	82.2	-8,226	-11.6	-2.2	54.3	-3.0	23.1
Top 5 Percent	77.4	21.6	5.1	75.6	-15,132	-13.6	-2.7	41.8	-3.7	23.6
Top 1 Percent	76.1	23.8	7.4	58.4	-58,436	-17.5	-2.8	23.8	-5.2	24.4
Top 0.5 Percent	76.3	23.6	8.3	51.3	-102,627	-19.0	-2.6	18.9	-5.8	24.6
Top 0.1 Percent	79.9	20.1	10.8	37.8	-378,114	-23.1	-2.1	10.9	-7.4	24.5

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).

(1) Calendar year. Baseline is current law. Under the proposal, corporate tax revenue is assumed to be 76 percent of its current-law value.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Baseline distribution tables are given as the bottom panels of Tables 1 and 2.

**Table 5. Exempt Capital Income From Taxation But Retain Home Mortgage Interest Deduction
With Adjustment to Corporate Tax Revenue and Allowing Increase in Mortgage Interest Deduction**

Distribution of Federal Tax Change by Cash Income Class, 2005 ¹

Cash Income Class (thousands of 2005 dollars) ²	Percent of Tax Units ³		Percent Change in After-Tax Income ⁴	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate ⁵	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (%) Points)	Under the Proposal	Change (%) Points)	Under the Proposal
Less than 10	17.3	0.3	0.3	0.2	-15	-7.4	0.0	0.2	-0.3	3.3
10-20	28.6	1.9	0.3	0.6	-44	-6.2	0.0	1.0	-0.3	4.5
20-30	38.5	4.2	0.4	0.9	-82	-3.3	0.2	2.9	-0.3	9.7
30-40	45.6	7.5	0.4	1.0	-117	-2.3	0.4	4.6	-0.3	14.1
40-50	55.2	10.1	0.7	1.7	-260	-3.5	0.3	5.2	-0.6	16.2
50-75	67.3	10.7	1.1	6.5	-552	-4.9	0.7	13.6	-0.9	17.5
75-100	75.9	12.6	1.3	6.2	-912	-5.3	0.6	11.9	-1.1	19.0
100-200	82.3	13.7	2.1	17.9	-2,188	-7.4	0.6	24.3	-1.6	20.6
200-500	84.7	14.6	4.0	18.4	-8,552	-11.7	-0.3	14.9	-3.0	22.4
500-1,000	81.1	18.7	5.0	9.1	-24,827	-13.5	-0.3	6.3	-3.7	23.5
More than 1,000	80.2	19.7	9.7	37.2	-195,306	-21.2	-2.2	14.8	-6.6	24.6
All	49.1	7.0	2.5	100.0	-1,218	-9.7	0.0	100.0	-2.0	18.7
Change in Federal Revenue (\$billions)					-176.09					

Distribution of Federal Tax Change by Cash Income Percentile, 2005 ¹

Cash Income Percentile ²	Percent of Tax Units ³		Percent Change in After-Tax Income ⁴	Share of Total Federal Tax Change	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate ⁵	
	With Tax Cut	With Tax Increase			Dollars	Percent	Change (%) Points)	Under the Proposal	Change (%) Points)	Under the Proposal
Lowest Quintile	19.7	0.6	0.3	0.3	-20	-8.3	0.0	0.4	-0.3	3.0
Second Quintile	33.7	2.9	0.4	1.0	-63	-4.6	0.1	2.3	-0.3	6.9
Middle Quintile	45.4	7.2	0.4	2.1	-130	-2.7	0.6	8.4	-0.4	13.8
Fourth Quintile	65.7	10.6	1.1	8.4	-514	-4.7	1.0	18.5	-0.9	17.5
Top Quintile	80.5	13.8	3.9	87.9	-5,350	-11.9	-1.7	70.3	-2.9	21.7
All	49.1	7.0	2.5	100.0	-1,218	-9.7	0.0	100.0	-2.0	18.7
Addendum										
Top 10 Percent	84.0	13.9	4.8	78.9	-9,609	-13.6	-2.4	54.1	-3.5	22.5
Top 5 Percent	84.7	14.5	5.7	69.9	-17,034	-15.3	-2.7	41.7	-4.2	23.1
Top 1 Percent	81.6	18.2	7.8	50.5	-61,454	-18.4	-2.6	24.0	-5.5	24.1
Top 0.5 Percent	80.3	19.6	8.6	43.5	-105,988	-19.7	-2.4	19.1	-6.0	24.4
Top 0.1 Percent	81.6	18.4	10.9	31.4	-382,235	-23.4	-2.0	11.1	-7.4	24.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).

(1) Calendar year. Baseline is current law. Mortgage interest deduction is allowed to increase, reflecting individuals refinancing their houses, up to 80% of house value or having value up to a million dollars. House value is assumed to equal 100 times real estate taxes and payments are limited to reflect real estate values of one-million dollars

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income. Baseline distribution tables are given as the bottom panels of Tables 1 and 2.

**Table 6. Exempt Capital Income From Taxation
With Adjustment to Corporate Tax Revenue
Revenue-Neutral, Proportional Changes to Individual and Corporate Tax Rates to Offset Individual and Corporate Income Tax Change**

Distribution of Federal Tax Change by Cash Income Class, 2005 ¹

Cash Income Class (thousands of 2005 dollars) ²	Percent of Tax Units ³		Percent Change in After-Tax Income ⁴	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate ⁵	
	With Tax Cut	With Tax Increase		Dollars	Percent	Change (% Points)	Under the Proposal	Change (% Points)	Under the Proposal
Less than 10	16.4	2.9	0.2	-11	-5.4	0.0	0.2	-0.2	3.4
10-20	23.1	26.9	0.1	-18	-2.6	0.0	1.0	-0.1	4.6
20-30	24.3	54.8	-0.1	19	0.8	0.0	2.8	0.1	10.2
30-40	20.3	72.2	-0.4	115	2.3	0.1	4.3	0.3	14.8
40-50	19.5	78.2	-0.5	201	2.7	0.1	5.0	0.5	17.2
50-75	18.8	80.5	-0.7	357	3.2	0.4	13.3	0.6	19.0
75-100	16.5	83.3	-1.2	830	4.8	0.5	11.9	1.0	21.0
100-200	18.2	81.8	-1.7	1,755	5.9	1.4	25.1	1.3	23.6
200-500	28.8	71.1	-0.6	1,187	1.6	0.3	15.5	0.4	25.8
500-1,000	35.2	64.8	1.3	-6,568	-3.6	-0.2	6.3	-1.0	26.3
More than 1,000	46.3	53.7	6.8	-138,099	-15.0	-2.6	14.4	-4.7	26.6
All	20.4	55.6	0.0	1	0.0	0.0	100.0	0.0	20.7

Distribution of Federal Tax Change by Cash Income Percentile, 2005 ¹

Cash Income Percentile ²	Percent of Tax Units ³		Percent Change in After-Tax Income ⁴	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate ⁵	
	With Tax Cut	With Tax Increase		Dollars	Percent	Change (% Points)	Under the Proposal	Change (% Points)	Under the Proposal
Lowest Quintile	18.0	7.8	0.2	-13	-5.5	0.0	0.4	-0.2	3.1
Second Quintile	24.6	38.9	0.1	-12	-0.9	0.0	2.2	-0.1	7.1
Middle Quintile	20.9	70.5	-0.4	105	2.2	0.2	8.0	0.3	14.5
Fourth Quintile	18.5	80.6	-0.7	359	3.3	0.6	18.1	0.6	19.0
Top Quintile	19.7	80.2	0.3	-425	-0.9	-0.7	71.3	-0.2	24.4
All	20.4	55.6	0.0	1	0.0	0.0	100.0	0.0	20.7
Addendum									
Top 10 Percent	22.9	77.0	0.9	-1,893	-2.7	-1.5	55.0	-0.7	25.4
Top 5 Percent	27.9	72.1	1.9	-5,656	-5.1	-2.3	42.2	-1.4	25.9
Top 1 Percent	37.5	62.5	4.5	-35,629	-10.7	-2.8	23.7	-3.2	26.4
Top 0.5 Percent	41.4	58.6	5.6	-68,811	-12.8	-2.7	18.7	-3.9	26.5
Top 0.1 Percent	51.8	48.2	8.3	-289,779	-17.7	-2.3	10.7	-5.6	26.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).

(1) Calendar year. Baseline is current law. Under the proposal, the corporate tax rate is increased by 6.8 percent, from 35 to 37.4 percent resulting in corporate tax revenue that is 81 percent of its current-law value. Individual income tax rates would also rise by 6.8 percent, from 10, 15, 25, 28, 33, and 35 percent to 10.7, 16.0, 26.7, 29.9, 35.2, and 37.4 percent; the individual alternative minimum tax rates would rise from 26 and 28 percent to 27.8 and 29.9.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

Baseline distribution tables are given as the bottom panels of Tables 1 and 2.

**Table 7. Exempt Capital Income From Taxation
With Adjustment to Corporate Tax Revenue
Distributionally-Neutral Changes to Individual and Corporate Tax Rates to Offset Individual and Corporate Income Tax Change**

Distribution of Federal Tax Change by Cash Income Class, 2005 ¹

Cash Income Class (thousands of 2005 dollars) ²	Percent of Tax Units ³		Percent Change in After-Tax Income ⁴	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate ⁵	
	With Tax Cut	With Tax Increase		Dollars	Percent	Change (% Points)	Under the Proposal	Change (% Points)	Under the Proposal
Less than 10	15.7	0.5	0.0	-2	-0.9	0.0	0.2	0.0	3.5
10-20	44.1	3.0	0.1	-15	-2.1	0.0	1.0	-0.1	4.7
20-30	69.5	7.9	0.2	-42	-1.7	-0.1	2.7	-0.2	9.9
30-40	76.2	15.0	0.2	-56	-1.1	-0.1	4.2	-0.2	14.3
40-50	73.6	23.7	0.2	-83	-1.1	-0.1	4.8	-0.2	16.6
50-75	67.7	31.4	0.3	-141	-1.2	-0.2	12.8	-0.2	18.2
75-100	53.4	46.2	0.0	1	0.0	0.0	11.4	0.0	20.1
100-200	39.9	59.8	-0.4	407	1.4	0.3	24.0	0.3	22.6
200-500	32.8	67.1	-0.7	1,397	1.9	0.3	15.6	0.5	25.9
500-1,000	32.1	67.8	-1.7	8,475	4.6	0.3	6.8	1.3	28.5
More than 1,000	36.5	63.5	1.2	-24,506	-2.7	-0.5	16.5	-0.8	30.4
All	52.9	21.7	0.0	17	0.1	0.0	100.0	0.0	20.8

Distribution of Federal Tax Change by Cash Income Percentile, 2005 ¹

Cash Income Percentile ²	Percent of Tax Units ³		Percent Change in After-Tax Income ⁴	Average Federal Tax Change		Share of Federal Taxes		Average Federal Tax Rate ⁵	
	With Tax Cut	With Tax Increase		Dollars	Percent	Change (% Points)	Under the Proposal	Change (% Points)	Under the Proposal
Lowest Quintile	21.8	1.0	0.0	-3	-1.3	0.0	0.4	0.0	3.2
Second Quintile	56.2	4.7	0.2	-29	-2.1	-0.1	2.2	-0.2	7.1
Middle Quintile	75.3	14.9	0.2	-59	-1.2	-0.1	7.7	-0.2	14.0
Fourth Quintile	68.1	30.8	0.3	-121	-1.1	-0.2	17.3	-0.2	18.2
Top Quintile	42.7	57.0	-0.2	295	0.7	0.4	72.4	0.2	24.8
All	52.9	21.7	0.0	17	0.1	0.0	100.0	0.0	20.8
Addendum									
Top 10 Percent	36.4	63.4	-0.2	490	0.7	0.3	56.8	0.2	26.3
Top 5 Percent	33.5	66.3	-0.2	579	0.5	0.2	44.6	0.1	27.5
Top 1 Percent	34.0	65.9	0.2	-1,336	-0.4	-0.1	26.4	-0.1	29.5
Top 0.5 Percent	34.1	65.9	0.5	-5,951	-1.1	-0.3	21.2	-0.3	30.1
Top 0.1 Percent	40.1	59.9	2.4	-83,340	-5.1	-0.7	12.4	-1.6	30.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0305-3A).

(1) Calendar year. Baseline is current law. Individual income tax rates would change from 10, 15, 25, 28, 33, and 35 percent to 9.5, 14.2, 23.5, 32.3, 37.4, and 43.9 percent (alternative minimum tax rates are unchanged from current law). The corporate rate would be equal to the top individual income tax rate of 43.9 percent resulting in corporate revenue that is 95.3 percent of its value under current law. Under the proposal, the aggregate sum of the individual and corporate tax burden remains approximately the same as under current law for individuals in each statutory individual income tax bracket.

(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

(5) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash

Baseline distribution tables are given as the bottom panels of Tables 1 and 2.