Taxation-Fundamental
Tax Reform
(Chapter 25)
Taxation-Fundamental Tax Reform

• Why?
  – Three fundamental objectives
    • Increase tax compliance
    • Make tax code simpler
    • Improve tax efficiency
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• Increase Tax Compliance
  – **Tax compliance:** the willingness of individuals or corporations to obey the tax laws.
  – **Tax evasion:** illegal nonpayment of taxes
    • Tax avoidance: changing behavior to avoid taxation
    • Tax evasion: Not paying the taxes owed
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• Increase Tax Compliance
  – Theory of tax evasion

• **Benefits:** amount of taxes avoided
• **Costs:** risk of getting caught and the penalty to be paid if caught.
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• Increase Tax Compliance
  – Theory of tax evasion
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• Increase Tax Compliance
  – **Evidence of tax evasion**
    • In the U.S.: the ‘tax gap’ between taxed owed and taxes paid is $280 billion, 16.3% of the taxes paid.
    • Developing nations: the Philippines loses 73% of its individual income tax revenue.
    • Clotfelter (1983): noncompliance is correlated with the marginal tax rate, with an elasticity between 0.5 and 3.
    • Slemrod et. al. (2001):
      – Conducted an experiment in which they randomly sent letters to Minnesotans before tax returns were due, some threatening an audit, others appealing to people’s consciences to be honest on returns
      – The appeals have no effect, while the audit threat increased reported income for lower and middle-class families
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• Increase Tax Compliance
  – Why should we care?
    • Why care about tax evasion when we can still raise the same tax revenue increasing tax rates?
      – Efficiency: raising a given tax revenue with a lower tax rate is more efficient.
      – Vertical equity: cheating as a share of income is higher among the wealth compared to the poor. A system with less cheating will hence be more equitable.
      – Horizontal equity
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• Making the tax code simpler
  – At the end of 2003:
    • 131-page instructions to fill out the form 1040
    • IRS estimated that it would take between 13 and 14 hours to complete the tax forms
    • Guyton et. al. (2003) estimated that in 2000, taxpayers spent 3.2 billion hours and $18.8 billion filling out tax forms, an average of 25.5 hours and $149 per filer.
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• Improving tax efficiency
  – **How does changing tax rate change revenues?**
    • **Direct effect:** A higher tax rate increases revenues given a certain level of tax base
    • **Indirect effects:**
      – **Gross income effect:** A higher tax might reduce the tax revenues by lowering the amount of labor supplied, the savings undertaking or risk-taking.
      – **Reporting effect:** A higher tax rate will cause individuals to reclassify income in ways that are not subject to a tax.
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• Improving tax efficiency
  – **How does changing tax rate change revenues?**

• Indirect effects:
  – **Income exclusion effect:** A higher tax rate will induce individuals to take more advantage of the deductions and exemptions.
  – **Compliance effect:** A higher tax rate will cause higher tax evasion.
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• Improving tax efficiency
  – How does changing tax rate change revenues?

Before tax increase, taxable income = $50,000
  (tax rate = 10% flat rate)

Wage income ($45,000)

Lawn mowing ($5,000)

Revenue = 10%($50,000) = $5,000

After tax increase, taxable income = $35,000
  (tax rate = 20% flat rate)

Wage income ($40,000)

Health benefits ($2,500)

Charity ($2,500)

Lawn mowing ($5,000)

Revenue = 20%($35,000) = $7,000

- Income included in tax base
- Income not included in tax base
- Tax revenue
- Decrease in wage earnings
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• Improving tax efficiency
  – Evidence of revenue consequences of higher tax rates
    • The indirect effects do offset the direct effect of raising tax rates to a significant degree: roughly a 4% decline in the base of taxable income for each 10% rise in tax rates.
    • Most of this response comes from the indirect effects of reporting, income exclusion and compliance, not from the indirect effect of gross income earning.
    • Most if not all of this response comes from the rich.
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• Two Radical Reforms
  – Consumption Taxation

  Thomas Hobbes:
  “It is fairer to tax people on what they extract from the economy, as roughly measured by their consumption, than to tax them on what they produce for the economy, as roughly measured by their income.”
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• Two Radical Reforms
  – Consumption Taxation
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• Two Radical Reforms
  – Consumption Taxation – Why?
    • Improved Efficiency
      – Limits the means of tax evasion
      – A particular source of inefficiency in our current tax system is the lack of a “level playing field” across investment choices.
Taxation-Fundamental Tax Reform

• Two Radical Reforms
  – Consumption Taxation – Why?
  • Less Distortion to Savings Decisions

<table>
<thead>
<tr>
<th>TABLE 25-3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income Versus Consumption Taxation and the Treatment of Savers</strong></td>
</tr>
<tr>
<td></td>
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<tr>
<td><strong>Income tax</strong></td>
</tr>
<tr>
<td>Income in period 1</td>
</tr>
<tr>
<td>Taxes in period 1</td>
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<tr>
<td>Consumption in period 1</td>
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<tr>
<td>Savings in period 1</td>
</tr>
<tr>
<td>Interest earnings in period 2</td>
</tr>
<tr>
<td>Taxes in period 2</td>
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<tr>
<td>Consumption in period 2</td>
</tr>
<tr>
<td>PDV of taxes</td>
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<tr>
<td><strong>Consumption tax</strong></td>
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<td>Income in period 1</td>
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<td>Interest earnings in period 2</td>
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<tr>
<td>Taxes in period 2</td>
</tr>
<tr>
<td>Consumption in period 2</td>
</tr>
<tr>
<td>PDV of taxes</td>
</tr>
</tbody>
</table>
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• Two Radical Reforms
  – Consumption Taxation – Why not?
    • Vertical Equity
      – Same marginal tax rate for all individuals regardless of their wealth level.
      – More progressive expenditure tax: tax goods that can be considered ‘luxury’ more harshly compared to those that can be considered as ‘necessities’.
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• Two Radical Reforms
  – Consumption Taxation – Why not?
    • Asymmetric Information
      – Government wishes to redistribute from the most-able to the least-able.
      – Issue: difficult to identify due to moral hazard.
      – Saez (2002) shows that the most-able are also the ones who save the most, hence it might make sense to use capital income as a targeting device for redistribution.
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• Two Radical Reforms
  – Consumption Taxation – Why not?
  • Transition Issues
    – Middle-aged and old citizens who paid taxes on their incomes for all of their lives will be taxed twice, since with the transition, they will be taxed on their consumption when they retire.
    – They will definitely oppose such a transition.
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• Two Radical Reforms
  – Consumption Taxation – Why not?
    • Compliance
      – Hard to prevent the buyers to negotiate with the sellers to avoid the consumption tax.
      – Pay the retailer some amount less than the consumption tax not to ring up the sale for tax purposes.
      – Use the ‘black market’.
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- Two Radical Reforms
  - Consumption Taxation – Different Types

  - **Value added tax (VAT):** A consumption tax levied on each stage of a good’s production on the increase in value of the good at that stage of production.
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• Two Radical Reforms
  – Consumption Taxation – Different Types
    • Value added tax (VAT) – Self policing

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**TABLE 25-4**

<table>
<thead>
<tr>
<th>Agent</th>
<th>Purchase Price</th>
<th>Sale Price</th>
<th>Value Added</th>
<th>Tax Paid (VAT = 20%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Logger</td>
<td>$0</td>
<td>$25</td>
<td>$25</td>
<td>$5</td>
</tr>
<tr>
<td>Manufacturer</td>
<td>25</td>
<td>75</td>
<td>50</td>
<td>10</td>
</tr>
<tr>
<td>Retailer</td>
<td>75</td>
<td>100</td>
<td>25</td>
<td>5</td>
</tr>
</tbody>
</table>

Total tax paid: $20
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• Two Radical Reforms
  – Consumption Taxation – Different Types
    • Value added tax (VAT)
      – **Upside:** self-policing and less tax evasion
      – **Downside:** can become very complicated.
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• Two Radical Reforms
  – Consumption Taxation – Different Types
    • Expenditure tax: a consumption tax levied on yearly consumption rather than on specific sales.
      – **Upside:** can be designed as progressive as the current income tax system while having the benefits of using consumption as a tax base.
      – **Downside:** compliance problems and complex information requirements.
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• Two Radical Reforms
  – Flat Tax Rate
    • Advantages:
      – The most important are the efficiency gains from having one flat rate on a broad income definition.
      – The flat tax would have enormous benefits in terms of simplicity.
      – Compliance would also likely improve because the simpler tax system would make it harder to find ways to evade taxes; for almost all taxpayers, their entire tax bill could be collected through withholding from earnings.
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• Two Radical Reforms
  – Flat Tax Rate
    • Disadvantages:
      – The problems with the flat tax are similar to those raised with consumption taxation.
      – First, while a flat tax can be made fairly progressive for low- and middle-income earners, it will be much less progressive for high-income earners than our current system.
      – Second, there are difficult transition issues raised by the flat tax.