

How to Fix Our Dysfunctional Tax Code

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Give an economist a clean slate, unencumbered by political ideology or allegiance, and charge him or her with designing an ideal tax system. What emerges will look nothing like the dysfunctional personal and corporate tax codes now administered by the IRS. Instead, it could resemble Larry Kotlikoff's "purple tax plan," an economic reform [plan](#) he designed to appeal to both Democrats and Republicans alike.

Tax code reform has grabbed voters' interest in the upcoming election. Herman Cain's surge in the polls among Republican candidates owes in part to his "9-9-9" plan, which would impose 9% taxes on personal income and corporate profits, along with a 9% sales tax.

Kotlikoff, a Boston University professor of economics and a columnist for Bloomberg, described his purple tax plan to me during a breakfast meeting last week. Cain's plan is interesting and merits careful study, according to Kotlikoff, who has his own political ambitions. "I believe my purple tax plan is more progressive, will generate more revenue, is generationally more equitable, and has better work incentives," he said. "But I have to do my homework on this."

The three elements of Kotlikoff's purple tax plan

The ideal tax code would eliminate the regressive provisions in the current tax code, such as the payroll tax, which poses the greatest burden to poor people. Kotlikoff wants it to be simple, too, and so he advocates eliminating the federal personal income tax, corporate income tax and the estate tax.

He would keep a 15% payroll tax, but he would make it progressive by eliminating the ceiling (which is currently \$106,800) and exempting the first \$40,000 in the employee portion of the tax.

Kotlikoff also wants to tax consumption, indeed every dollar of consumption as defined by our national income accountants. He'd do so by implementing a 17.5% retail sales tax on all goods and services and tax the consumption services (what economists call "imputed rent") we derive from the use of our home, car, plane or boat. Essentially, this tax would be based on what it would cost someone to use ("rent") those assets and would be collected just like a local annual property or excise tax.

Kotlikoff said 17.5% is the nominal rate, but the effective rate is 15%. For every dollar someone spends at the store, they will pay 15 cents in taxes and will receive 85 cents in



consumption goods and services. If you divide 15 cents by 85 cents you get back to the nominal 17.5 percent rate. But the bottom line is that out of each dollar you have to spend, whether it's a dollar of wages or wealth, you're effectively surrendering 15 cents.

Kotlikoff points out that taxing consumption, per se, is neither regressive nor progressive. It's proportional. Economists measure progressivity by asking whether people with more spending power – more wages and wealth – get to consume a smaller share of these resources than people with less spending power. Simply taxing all consuming at a 15 percent rate is, thus proportional, since those with more spending power and those with less spending power all end up getting to consume 15 percent less of that spending power (their wages and wealth).

Kotlikoff says that the popular view that taxing consumption, whether via a retail sales tax or a value added tax or a flat tax, is regressive is simply wrong. "No decent public finance economist would subscribe to that proposition."

But Kotlikoff wants to make his consumption tax progressive. So he'd have the issue payments to every family based on its size, with larger families receiving greater payments. For the wealthy, this payment or "demogrant" (a term coined by George McGovern) would be trivial, but for the poor it would be large enough to cover all their sales tax payments.

"The poor are completely exempted from my proposed sales tax," he said, "so that makes it highly progressive."

Kotlikoff's sales tax is very similar to the value-added taxes that are common across Europe, except that it is collected somewhat differently. He said his version of the tax would be easier to enforce, because it has fewer taxpaying entities, many of which would be very large retailers, like Wal-Mart. And taxing imputed rent produces a much broader tax base and, thus, permits a much lower tax rate.

Kotlikoff said the current system, with very high marginal tax rates, has "big disincentives" to work and save. More problematic, though, is the complexity of the tax code. Kotlikoff knows this because he and one of his graduate students spent a year designing and building a computer program to model every tax and benefit policy as part of his effort to develop Economic Security Planner, a financial planning application (which I'll write about in a future article).

The third element in Kotlikoff's plan is a 15% inheritance tax that goes into effect on cumulative inheritances and gifts received once they exceed \$1 million. Kotlikoff says that if we care about inequality, we should tax not what rich people leave but rather the degree to which they leave it in very few hands. If they share their wealth very broadly, it's much different than if they leave it all to one person.



April 15th is just another day

One of the attractive things about Kotlikoff's plan is that households don't need to file annual tax returns. Recall, he's abolishing the personal income tax. Retailers would simply collect the federal sales tax and transmit these taxes to Uncle Sam and employers would continue to transmit FICA taxes (modified as described above).

"Tax accountants and lawyers would have nothing to do," Kotlikoff said.

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His purple plan is far simpler than the current tax code. Indeed, it's completely transparent. Anyone could determine how much tax someone else would be paying. It would also be transparent, in the sense that each rate is 15%, and if federal revenues were insufficient to cover expenses, the rates would need to rise in tandem.

"We will have a connection between the fiscal side and our taxes," he said. "That will make the political economy much easier and clearer."

The political reality

Kotlikoff is trying to speak to each side in its own language, which is where the purple (a mixture of red and blue) part comes into play. He wants conservatives and liberals alike to understand that tax code reform is something they both might want, "because they are talking past each other," he said. "There is actually something the economics can contribute here which is clarity."

Our fiscal institutions were designed by the members of Congress, but he said virtually none of them have the requisite training in public finance. "Having 535 members of Congress design our tax system is not a lot different from asking 535 members of Congress to design a building. In each case, you'll end up with a disaster."

As for Herman Cain's 9-9-9 tax plan – the most outside-the-box tax reform proposal getting any play in the political marketplace at the moment – Kotlikoff said it has some similarities to his own and he's studying it. He believes it's less progressive than what he proposes and will generate more revenue, but he doesn't want to speculate.

Kotlikoff's tax plan is one of five such purple plans he has proposed; others include ways to address issues such as energy, health care and social security.

Kotlikoff is thinking about running for president as a third-party candidate through [Americans Elect](#). "We need to focus on policies, not people," he said. "Electing the president can no longer be a beauty contest or a debating contest. Our problems are simply too big to keep making these mistakes. We need a leader who has bold, simple,



and clear plans that will turn the country around. We also need someone who can talk to both sides of the political divide and, frankly, is not a politician.”

“President Obama is, in my view, the best president we’ve had in decades. But his policies fall very far short of what’s needed. He’s also far too beholden to one side of the political spectrum.”

Kotlikoff said Obama has been handcuffed by having to work with only those options that are politically acceptable, both to his party and to Americans as a whole. “That is a great tragedy because he needs to abandon both parties and say, ‘I’m actually here to fix things. I’m not here to get reelected.’”

He cited Paul Ryan’s proposed healthcare plan as a failure of Obama’s leadership. “The president was extremely critical, but if you look at Ryancare closely, it’s almost identical to Obamacare except for labels and cosmetics. The president could have used this moment to join forces with Ryan to, in effect, provide Obamacare for the entire country. But he went the other way. He used this as an opportunity to go after someone he saw as a political rival. What he did disserved himself as well as Ryan.”

“Yes, Ryan’s plan had a big problem – namely allocating too little money for the elderly’s healthcare through time. But that would have changed in the negotiations. The key point is he was moving Medicare away from its fee-for-service structure, which is extremely expensive and, in fact, driving our country broke. “

The same could be said of politicians and policymakers now grappling with the current tax code. And Kotlikoff is hoping that he, or others like him, can be among those who help show the way forward.

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