In June 2001, President George W. Bush signed the Economic Growth and Tax Relief and Reconciliation Act into law, initiating a 10-year program of tax reductions. This January, the president proposed a second round of tax cuts that will be debated by the new Congress. This leaves open the possibility, suggested by former Secretary of the Treasury Paul O'Neill, that the Bush administration would propose a thoroughgoing reform of our tax system. That possibility is worth pursuing, because intelligent tax reform holds forth the promise of enormous economic gains for our society—potentially dwarfing any payoff from lowering tax rates.

Tax reforms must be carefully distinguished from tax reductions. Former Secretary O'Neill emphasized that any Bush administration proposals for tax reform would be revenue neutral, so that the federal deficit would be unaffected. Pamela Olson, Treasury's top tax official, reiterated this goal in a Washington Post interview.

Properly done, tax reform can make our society significantly better off. Herewith, a modest proposal.

by DALE W. JORGENSON

Efficient Taxation of Income
in October. Revenue neutrality was an important objective of the last major tax reform in 1986 and insulated the two-year debate over reform from the contentious issue of the federal deficit.

**Taxing Consumption**

Olson has divided the Treasury’s tax reform programs between short-run measures to simplify the tax code and long-run proposals to reform the tax system itself. It is important to emphasize that there is no conflict between these goals. Indeed, somewhat paradoxically, tax simplification is necessarily complex, since it would eliminate many, but not all, of the myriad special provisions of tax law now affecting particular transactions. By contrast, tax reform is relatively straightforward.

A major objective of tax reform is to remove barriers to efficient allocation of capital that arise from disparities in the tax treatment of different forms of income. The centerpiece of the Bush administration’s new round of tax cuts is the elimination of taxes on dividend income at the individual level. Taken alone, this step would not be revenue neutral, but it is a tax-cutting measure closely allied with a goal of tax reform. Making dividends tax-free to recipients would help to remedy one of the most glaring deficiencies in the existing U.S. tax system, namely, discriminatory taxation of corporate income.

In the United States, as in most other countries, corporate income is now taxed twice: first, through the corporate income tax, and second, through taxes paid by individuals on corporate dividends. Noncorporate income is taxed only at the individual level. Eliminating individual taxes on dividends would help to achieve parity between corporate and noncorporate income.

To achieve revenue neutrality (something the president did not propose), the dividend tax would have to be replaced by another source of revenue. One possibility would be to introduce a value-added tax levied on business revenues less expenses. Purchases by individuals and governments are all that constitute that revenue, so that substitution of a value-added tax for the tax on dividends would have the effect of shifting the tax burden from corporate income to consumption.

With Australia’s adoption of a value-added tax in 1999, the United States is the only industrialized country without such a levy. During the 1990s the Committee on Ways and Means of the U.S. House of Representatives held extensive hearings on consumption-tax proposals, including the value-added tax, the Hall-Rabushka Flat Tax, and a national retail-sales tax. All these proposals tax consumption in different ways—they vary primarily in methods for collection.

The U.S. corporate income-tax rate is currently 40 percent, combining federal, state, and local taxes. (This does not include the taxes levied on corporate dividends and interest through the individual income tax.) One popular proposal for replacing the existing income-tax system by a consumption tax, the Hall-Rabushka Flat Tax, would reduce the marginal tax rate to 19 percent. However, a revenue-neutral flat tax that includes state and local as well as federal taxes would require a rate of 29 percent.

Substitution of a value-added tax for the tax on dividends would help to eliminate one of the two main barriers to efficient capital allocation in our existing system. The exclusion of owner-occupied housing from the tax base is the second—and more substantial—disparity.

Society’s benefits from investment in housing or any other asset are best measured by what individuals are willing to pay to use the asset. The rentals paid to corporate owners of housing must bear two taxes, the corporate income tax on the rental income and individual taxes on dividends paid out by the enterprise. Owner-occupied housing is not subject to either of these taxes. Any proposal that leaves this disparity unaffected would sacrifice most of the gains from tax reform—whereas shifting a dollar of investment from owner-occupied housing to rental housing in the corporate sector, once the disparity has been removed, would double the rate of return to society, as measured by the return before taxes.

**Taxing Income More Efficiently**

The Achilles heel of proposals to shift the tax base from income to consumption, at least so far, is the redistribution of tax burdens. Recipients of income from property, including corporate shares, are generally much more affluent than recipients of income from work. Excluding property-type income from the tax base would shift the burden of taxation from the rich to the poor. Attempts to make a consumption tax progressive would drastically raise the marginal rate.

Due to the redistribution of tax burdens under a consumption tax, the tax-reform debate is therefore likely to focus on improvement of our existing income-tax system. The objectives would remain the same—namely, treat income sources symmetrically, reduce marginal rates, and retain progressivity. While this may sound suspiciously like trisecting an angle, these three objectives can be accomplished simultaneously by a proposal I call Efficient Taxation of Income.

Efficient Taxation of Income is a new approach to tax reform based on taxation of income rather than consumption. This would avoid a drastic shift in tax burdens by introducing different tax rates for property-type income and earned income from work. Earned income would be taxed at a flat rate of 10 percent, while property-type income would be taxed at 30 percent. Precisely the same distinction between earned and property-type income existed in the U.S. tax code between 1969 and 1982, so that no new loopholes would be created.

The taxation of all earned income at a flat rate of 10 percent would be greatly welcomed by wage earners and would provide powerful new incentives for participating in the labor force. Enhanced participation would strengthen upward mobility by en-
that arise from differential taxation of
and consumers’ durables from the income-tax base.

Economist Dale W. Jorgenson, Ph.D. ’59, is Morris University Professor. A book-length version of his proposal is presented in Lifting the Burden: Tax Reform, the Cost of Capital, and U.S. Economic Growth (MIT Press, 2003), written with Kun-Young Yun, Ph.D. ’84.