Tax Reform

MILTON FRIEDMAN

Two principles are basic to every discussion of tax reform.

First, tax reform consists of more than changes in those items that are called taxes. The real cost of government—the total tax burden—equals what government spends plus the cost to the public of complying with government mandates and regulations and of calculating, paying, and taking measures to avoid taxes. Currently, this burden, at federal, state, and local levels combined, exceeds half of national income: 40 percent in direct spending and more than 10 percent in indirect costs. Anything that reduces that real cost—lower government spending, elimination of costly regulations on individuals or businesses, simplification of explicit taxes—is a tax reform.

Second, essentially every tax affects incentives by altering the rate of exchange between various activities—between work in the market and at home (e.g., painting your house yourself or hiring a painter), between work and leisure, between one vocation and another, between buying a product or service from one seller or another, and so on in infinite variety. In short, there is no such thing as a neutral tax. But the lower the tax rate, the broader the base, and the more equal the tax rates, the less distortion it introduces. On these grounds, our present corporate and individual income taxes must surely rate as among the most misshapen monstrosities that ingenious tax-gathers have ever created.

Discussion of fundamental tax reform has recently centered on two proposals: House Majority Leader Dick Armey's flat-rate income tax and House Ways and Means Chairman Bill Archer's flat-rate retail sales tax. Both would greatly simplify the tax system and reduce the cost of tax compliance to taxpayers and of tax collection to the government. Both would eliminate double taxation from the corporate tax and the individual tax, reduce the bias against saving, eliminate the marriage tax, level the playing field for income from diverse sources, and reduce the disincentive of high marginal rates to innovation and enterprise.

Though each has advantages and disadvantages, the differences between the two are trivial compared with the superiority of either to our present system. Unfortunately, neither has a chance of being enacted by Congress, because their greatest economic merit is a political demerit. Neither performs one major function of the present tax system: enabling legislators (and presidents) to raise campaign funds by inserting or removing loopholes in our present obscenely complicated code.

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Accordingly, it is worth considering less radical, more incremental reforms. Of the many such, two seem to me to deserve special attention.

• *End real bracket creep.* "Bracket creep" became a household term in the 1970s, when galloping inflation was pushing people into higher income-tax brackets. Such inflation-induced bracket creep was eliminated in 1981, when income-tax brackets were indexed for inflation. However, bracket creep remains in a different form as a result of rising real income. Since President Clinton moved into the White House, federal tax receipts have risen by 42 percent, though national income has risen by only 30 percent, thanks partly to the Clinton tax increase in 1993 but mostly to real bracket creep.

A solution: Index tax brackets to the rise in per capita nominal (i.e., dollar) income, and not merely to the rise in prices. One further step would complete the 1981 reform: Index for inflation (a) the base for capital gains and (b) interest payments and receipts.

• *Privatize Social Security.* The payroll tax is arguably the worst of our bad taxes. It should be eliminated as part of the privatization of Social Security. Contrary to much talk, there is no rational obstacle to immediate and complete privatization of Social Security. The impression to the contrary arises from the need to convert what is now an unfunded liability into a funded liability. But that accounting change does not alter the real government debt, which is a multiple of the figures conventionally cited.

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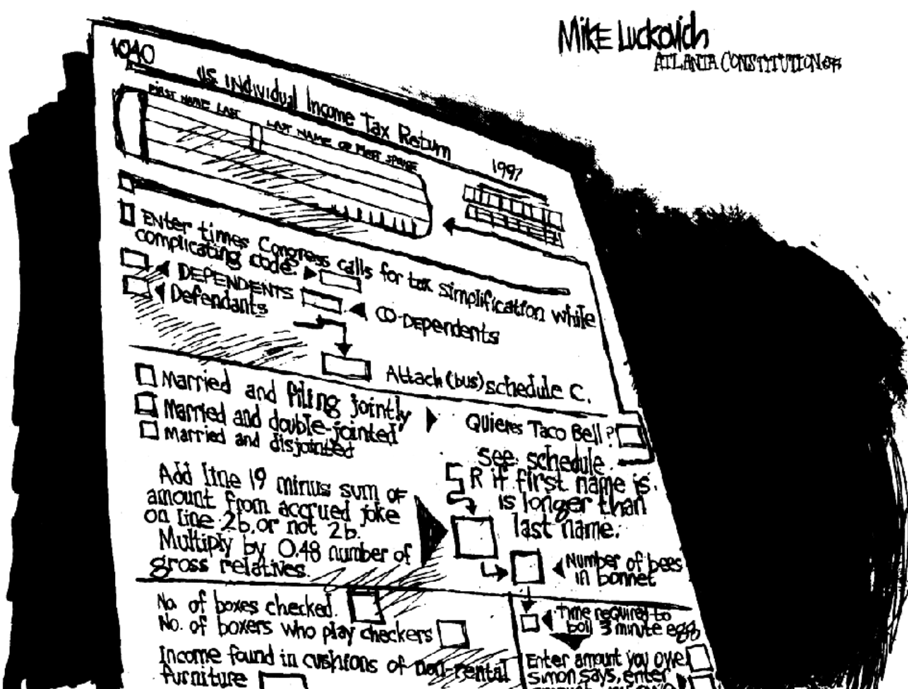

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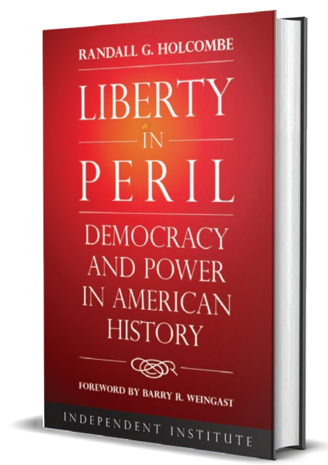

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