

CHAPTER 25: Fundamental Tax Reform and Consumption Taxation

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April 12, 2026

Fundamental Tax Reform and Consumption Tax

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Why Fundamental Tax Reform?

1. Improve tax compliance.
 - **Tax compliance:** Efforts to reduce the evasion of taxes.
 - **Tax evasion:** Illegal nonpayment of taxation.
 - **Tax avoidance:** Legal action to reduce tax burden.
2. Make the tax code simpler.
3. Improve tax efficiency.

APPLICATION: Tax Evasion

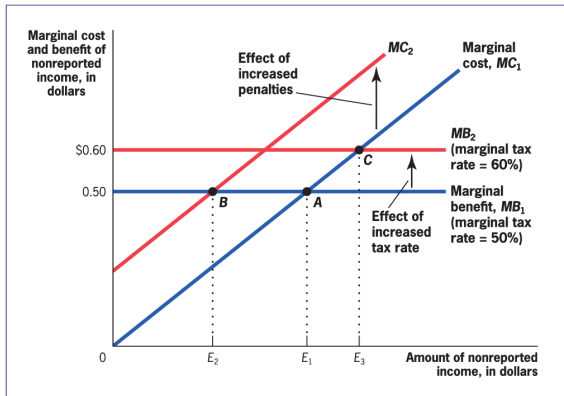
The distinction between tax *avoidance* and tax *evasion* is often a fine one but not always.

- Stanley S. Tollman hid \$100 million in profits from the IRS but eventually paid \$105 million in taxes, interest, fraud, and lawsuits.
- Once filers had to list Social Security numbers as well as names to claim exemptions for dependents, 6 million dependents disappeared from the tax rolls.
- Greek property taxes are assessed on self-reported value, so in one town only 300 residents report having a pool, while about 20,000 actually have one.

Theory of Tax Evasion 1/2

- The theory of tax evasion emphasizes the trade-offs involved:
 - Save money on unpaid taxes if not caught.
 - Penalties or jail if caught.
 - Higher taxes increase the benefit of avoidance without increasing the cost, increasing evasion.
 - Increased penalties decrease the cost of evasion and therefore reduce it.

Theory of Tax Evasion 2/2



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Evidence on Tax Evasion

- Tax evasion is pervasive in the United States and around the world.
 - U.S. “tax gap” between taxes owed and taxes paid was \$450 billion, 10.5% of tax revenue in 2014.
 - Similar to Sweden's 10% in 2008.
 - Worse in developing countries: 69% tax gap in Pakistan.
- Evidence that evasion increases with tax rates and decreases with threats of audits.

EMPIRICAL EVIDENCE: What Determines Tax Compliance?

- Kleven et al. (2011) ran a massive experiment using 40,000 taxpayers in Denmark, half of whom were randomly selected to be audited while the remainder were not. The next year, a new randomization was done, with half receiving letters threatening an audit while the remainder were not.
- Several conclusions:
 - Evasion of income reported by third-party sources was quite low.
 - Evasion of self-reported income was substantial and responded strongly to being audited or threatened with an audit.
 - Higher tax rates led to more evasion but primarily led to other effects, such as legal tax avoidance.

EMPIRICAL EVIDENCE: What Determines Tax Compliance?

- A study by Slemrod et al. (2001) showed that threatening an audit led to increased reported income for lower- and middle-class families but *lower* reported income for upper-class families.
 - Appeals to people's consciences had no effect.
- Boning et al. (2018) found that auditing firms caused them to report more income, but it also caused firms that were served by the same tax preparer to report higher incomes, suggesting network effects of government enforcement.
- Cullen, Turner, and Washington (2018) found that when a county's population is no longer in alignment with the party of the president (because of an election), that county's tax compliance fell.

APPLICATION: The 1997 IRS Hearings and Their Fallout for Tax Collection

- 1997 Senate hearings detailed abuses of taxpayers by the IRS, creating strong pressure for IRS reform.
- In 1998, the Taxpayer Bill of Rights passed.
- But the hearings painted a skewed, possibly deliberately misleading picture of the IRS.
- The IRS's enforcement capacities have been severely impaired by the Bill of Rights, so audits have fallen.
 - The IRS has identified \$30 billion in unpaid taxes but cannot afford the \$2 billion up-front price to collect it.

Why Should We Care About Tax Evasion?

1. Efficiency

- Tax evasion narrows the base, reducing efficiency.

2. Vertical equity

- The wealthy can evade more easily, reducing their tax burden at the expense of poorer Americans.

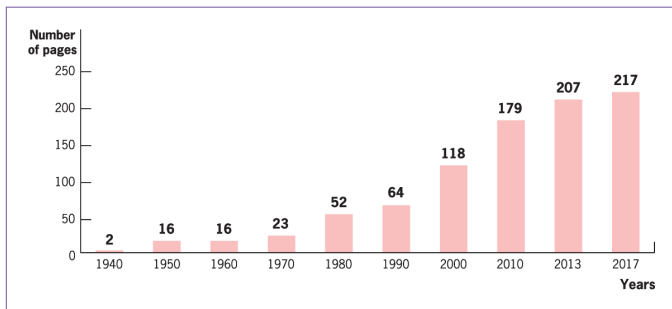
3. Especially: horizontal equity

- A tax evader with the same income as a non-evader clearly has a lower tax burden.

Making the Tax Code Simpler 1/2

- At the end of 2014, the IRS sent taxpaying individuals a packet with instructions for completing their Form 1040. The IRS estimated that it would take about 16 hours to complete the tax forms.
- In 2000, taxpayers spent 3.2 billion hours and \$18.8 billion filling out tax forms, an average of 26.4 hours and \$209 per filer.
- Reducing exemptions or deductions would simplify the tax code.
 - But this may increase reporting requirements, with an unclear total impact on simplicity.

Making the Tax Code Simpler 2/2



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Improving Tax Efficiency

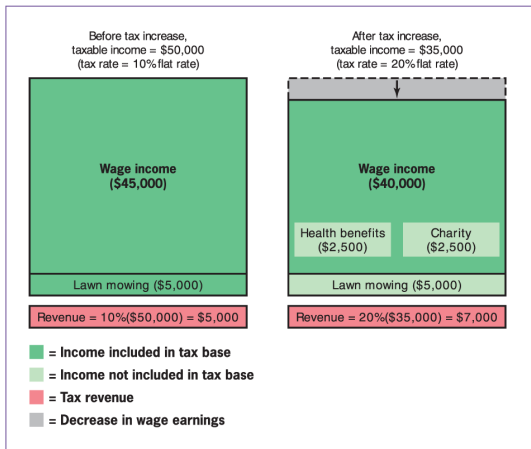
- Efficiency of the tax code depends on elasticity of revenues with respect to the tax rate.
- Tax code changes have two effects on revenue:
 - **Direct effect of tax changes:** A higher tax rate that raises revenues on a fixed base of taxation.
 - **Indirect effects of tax changes:** A higher tax rate that lowers the size of the revenue base on which taxes are levied.

Indirect Effects of Tax Changes on Efficiency

Tax changes can have four indirect effects:

- *Gross income effect*: A higher tax rate reduces gross income by lowering labor supply, savings, or risk taking.
- *Reporting effect*: For a given level of gross income, a higher tax rate causes people to report less income to avoid additional taxes.
- *Income exclusion effect*: For a given reported income, a higher tax rate causes people to take more deductions and exclusions.
- *Compliance effect*: Finally, higher tax rates may reduce revenues through increased tax evasion.

Changes in the Tax Base as Tax Rates Rise



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Evidence on the Revenue Consequences of Higher Tax Rates

- A large, growing literature explores how taxable income responds to tax rates.
- Central estimate: 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 and not from the indirect effect of gross income earning.
- Most, if not all, of this response comes from the rich.

Summary: The Benefits of Fundamental Tax Reform

Fundamental tax reform helps address all three of the tax reform goals:

- Improves tax compliance and tax efficiency by expanding the tax base and lowering tax rates.
- Simplifies tax filing by ending many detailed exemptions and deductions and taxing different forms of income at the same rate.

The Politics and Economics of Tax Reform

- TRA 86 broadened the base and reduced rates, representing a “victory” for tax reform.
- But this victory was short lived.
 - In 1993, top tax rates rose.
 - The 1997 Taxpayer Relief Act gave many new credits.
 - Tax reforms in 2001 and 2003 continued to complicate the tax code.
- Why is it so hard to maintain a simple, broad-based tax code?

Political Pressures for a Complicated Tax Code

- Political pressures are strongest when the winners are concentrated and have much to gain and the losers are diffuse and don't lose much per person.
 - Continuation of Bush tax cuts would save 3% of Americans \$810 billion.
- Naive voters may oppose explicit government spending but support tax expenditures.
 - Clinton's educational tax credits.

Economic Pressures Against Broadening the Tax Base 1/2

- Any attempt to broaden the base may simply encourage additional tax shelters, undoing the base increase.
- **Tax shelters:** Activities whose sole reason for existence is tax minimization.
- Tax shelters have real economic costs but save the shelters' creator money by reducing the tax burden.

Economic Pressures Against Broadening the Tax Base 2/2

Action	Result
Invest \$100,000 in oil venture	
Sell oil venture for \$90,000	Lose \$10,000 in value
Deduct \$60,000 from this year's income	Save \$30,000 on taxes
Deduct \$10,000 loss from next year's income	Save \$5,000 on taxes
Net effect	Make \$25,000

Transitional Inequities

Because of tax capitalization, eliminating tax shelters can create large transitional inequities.

- **Tax capitalization:** The change in asset prices that occurs due to a change in the tax levied on the stream of returns from that asset.
- **Transitional inequities from tax reform:** Changes in the treatment of similar individuals who have made different decisions in the past and are therefore differentially treated by tax reform.

APPLICATION: Grandfathering in Virginia

- In 2003, Virginia began to transform its tax system.
- The reform eliminated the \$12,000 annual deduction that Virginians age 65 or older received on their state income taxes.
- To make the law politically palatable, it included a true grandfather (and grandmother) clause that exempted current seniors.

The Conundrum

- Political and economic pressures are significant barriers to moving to a broad-based system.
- Political forces are constantly pushing for the use of the tax code to deliver benefits to particular groups at the cost of potentially inefficient and inequitable holes in the tax base.
- After these tax breaks are in place, it is very hard to remove them because doing so would create horizontal inequities for those who made decisions based on the existence of these tax breaks.

APPLICATION: TRA 86 and Tax Shelters

TRA 86 closed many tax shelters.

- It is politically infeasible to just close the shelters, though it would have increased equity, efficiency, and simplicity.
- Instead, it distinguished between ordinary income, investment income, and *passive income*, including tax shelters or real estate income.
- Losses from one type cannot offset losses from others.
- These changes ended the worst use of tax shelters, but they made the tax code much more complicated.

Learn by Doing: Practice Question 1

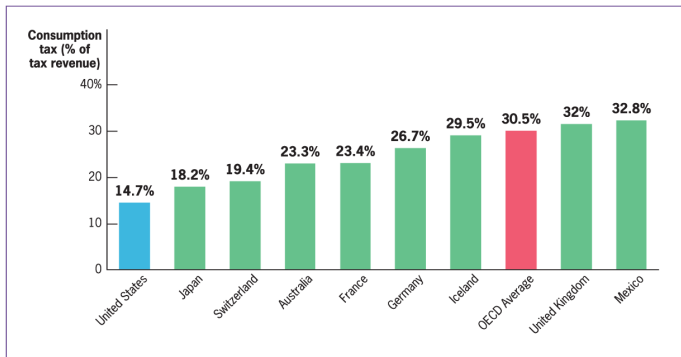
Which of these is NOT a goal of fundamental tax reform?

- a. Increasing efficiency
- b. Increasing vertical equity
- c. Making the tax code simpler
- d. Removing transitional inequities

Consumption Taxation

- Consumption taxation is a radical reform preferred by many economists.
- **Taxing consumption:** Taxing individuals based not on what they earn but on what they consume (such as through a sales tax).
- Used by state and local governments and many governments around the world.

Consumption Taxation in OECD Nations



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Improved Capital Allocation

- The current tax system encourages some kinds of investment over others.
 - Real estate favored through tax-exempt status.
- A particular source of inefficiency in our current tax system is the lack of a “level playing field” across investment choices.
- Better allocation improves economic efficiency.

Fairer Treatment of Savers and Less Distortion to Savings Decisions

	Homer	Marge
Income Tax		
Income in period 1	\$100	\$100
Taxes in period 1	50	50
Consumption in period 1	50	25.61
Savings in period 1	0	24.39
Interest earnings in period 2	0	2.44
Taxes in period 2	0	1.22
Consumption in period 2	0	25.61
PDV of taxes	50	51.11
Consumption Tax		
Income in period 1	\$100	\$100
Consumption in period 1	50	26.19
Taxes in period 1	50	26.19
Savings in period 1	0	47.62
Interest earnings in period 2	0	4.76
Consumption in period 2	0	26.19
Taxes in period 2	0	26.19
PDV of taxes	50	50

Simplicity

- Another advantage of the consumption tax is simplicity.
- In principle, it is much more straightforward to simply tax individuals on their purchases than on a complicated definition of income.

Why Might Consumption Be a Worse Tax Base?

Consumption taxes reduce **vertical equity**.

- Rich people save more, so consumption taxes are regressive.
- Net lifetime savings are bequests, so an estate tax might help, but estate taxes are very unpopular.
- A progressive expenditure tax could correct this but would introduce other complications.

Why Might Consumption Be a Worse Tax Base?

- **Differences Between Savers and Non-Savers**
 - Taxing savings might help tax high-ability people.
- **Transition Issues**
 - Seniors could be devastated by the transition.
- **Compliance**
 - It is harder to measure consumption than income.
- **Cascading**
 - One business's output is another's input, making it difficult to avoid double taxation.

Designing a Consumption Tax: Value-Added Tax

- A value-added tax addresses cascading and compliance.
 - **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.
- VATs are widely used around the world.
- Firms have an incentive to make sure that the firms they are buying from and selling to are honest, as dishonesty to reduce one firm's taxes would increase the other firms' taxes.

Value-Added Tax in Practice

Agent	Purchase Price	Sale Price	Value Added	Tax Paid (VAT = 20%)
Logger	\$0	\$25	\$25	\$5
Manufacturer	25	75	50	10
Retailer	75	100	25	5
			Total tax paid:	\$20

Design a Consumption Tax: Expenditure Tax

- An alternative to a VAT is an expenditure tax.
- **Expenditure tax:** A consumption tax levied on yearly consumption rather than on specific sales.
- It is straightforward to make an expenditure tax progressive, making the consumption tax system more vertically equitable.
- However, it is difficult to track expenditures throughout the year.

Backing into Consumption Taxation: Cash-Flow Taxation

- Cash-flow taxation is a third alternative.
- **Cash-flow tax:** A tax on the difference between cash income and savings.
- Effectively taxes consumption and can be based on year-end total consumption.
- The United States has features of this system through tax-deferred savings accounts, 401(k)s, and IRAs.

The Flat Tax

- Hall and Rabushka proposed the Flat Tax in 1981:
 1. Corporations pay a flat-rate VAT on their sales but deduct wages. No corporate income tax.
 2. Individuals pay a tax on labor income only, not capital income, at that same flat rate.
 3. All tax expenditures would be eliminated and replaced by a single family-level exemption.
- VAT-like system, but income tax + exemption makes it progressive.

Advantages of a Flat Tax

- Efficiency gains from having one flat rate on a broad income definition.
- Enormous benefits in terms of simplicity.
- Compliance improvements:
 - 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.

Problems with the Flat Tax

The problems with the flat tax are similar to those raised with consumption taxation:

- 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.
- There are difficult transition issues raised by the flat tax.

Distributional Implications of the Flat Tax

	Household Income (Married Couple with Two Children)	Household Income (Married Couple with Two Children)	Household Income (Married Couple with Two Children)	Household Income (Married Couple with Two Children)	Household Income (Married Couple with Two Children)
	\$25,000	\$50,000	\$100,000	\$300,000	\$1,000,000
Current tax code	0.4%	5.5%	8.7%	18.3%	30.1%
Hall- Rabushka flat tax	0%	9.5%	14.3%	17.4%	18.5%

Learn by Doing: Practice Question 2

Which of these are TRUE concerning alternatives to the income tax?

- I. Consumption taxation tends to favor the rich and can be hard to enforce.
 - II. A cash-flow tax is actually another form of income tax.
 - III. A flat tax is likely to be less progressive than the current tax system.
- a) I and II only
 - b) I and III only
 - c) II and III only
 - d) I, II, and III

Conclusion

- The complications, economic distortions, and redistribution inherent in the U.S. system of income taxation leave many unhappy with the income tax as the nation's primary source of revenue raising.
- Fundamental reform of the income tax is not easy.
- Moving to fundamental reform, such as replacing income taxation with consumption taxation or a flat tax, raises difficult issues about the appropriate trade-off between efficiency and equity in our tax code.