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# Tax Reform: Current Problems, Possible Solutions, and Unresolved Questions

*James Poterba and Michael J. Graetz*  
*Introduction by John S. Reed*

This presentation was given at the 1898th Stated Meeting, held at the House of the Academy on February 9, 2006.

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## John S. Reed

In a couple of months – sixty-five days from today to be precise – most of us will file federal income tax returns, or at least ask for extensions. Beyond the effect that taxes have on each of us personally, the structure of the country’s tax policy has a direct impact on the national economy and on the government’s actions and programs. Title 26 of the U.S. tax code, the Federal Internal Revenue Code, contains more than 3.4 million words,

which amounts to about 7,500 pages or 24 megabytes.

Whether debating macroeconomic theory, predictions about the future performance of markets, or any other subject, economists are well known for having different points of view. Yet virtually all of them agree that our nation’s system of taxation could be made both simpler and fairer. We are fortunate to have two speakers this evening who are authorities on U.S. tax policy. James Poterba and Michael Graetz are eminently qualified to examine the challenges and choices facing policymakers in Washington. Michael will introduce Jim and then offer his own views on tax reform.

Michael Graetz is the Justus S. Hotchkiss Professor of Law at Yale University. An expert on taxation and tax policy, he has authored or edited six books and many articles on the topic. In addition to a distinguished career in academia, he has served as Deputy Assistant Secretary for Tax Policy in the U.S. Treasury.

## Michael J. Graetz

This is the first time I’ve ever been asked to introduce a speaker, tell you how wonderful he is, and then tell you why he’s wrong. But that seems to be my mission tonight.

Jim Poterba has taught at MIT since 1982. He is the Mitsui Professor of Economics and Head of the MIT Economics Department. He has authored or edited numerous books on how taxation affects the economic decisions of households and firms.

Jim’s presentation is based on his recent work as a member of the President’s Advisory Panel on Tax Reform – a group of nine people who spent much of 2005 reviewing the tax code and developing ways to improve it. Since Jim was the only member of the panel who did not use a paid tax-return preparer, he has an intimacy with the tax law that was missing elsewhere in the panel.

A graduate of Harvard College, Jim received his Doctor of Philosophy degree as a Marshall Scholar at Oxford. He is among the most decent, thoughtful, generous, serious, and engaging people I’ve ever met. He will ultimately help put the lie to the widespread notion that economics is the dismal science.

## James Poterba

The Academy's archivist reports that tax policy has never before been discussed at a Stated Meeting of the Academy. Let me therefore begin with some historical background. Colbert, the finance minister to Louis XIV, defined the art of taxation as "the plucking of the goose, so as to obtain the largest amount of feathers with the smallest amount of hissing." Last year, I was part of a tax-reform panel that studied how to collect feathers without hissing and suggested several options for tax-reform. This evening, I will discuss three broad issues in tax policy and tax reform. First, I will consider some of the difficulties in the current tax code. These are elements that are cited as major problems and that motivate the quest for alternatives to the system we now have in place. Second, I will outline several potential directions for tax reform, including both options suggested by the President's Tax Panel and other alternatives that were not suggested. Finally, I will address some of the practical difficulties of reform that plague both current and future attempts to change the tax code.

### *The tax code is complicated, and it has become more complicated over time.*

Let me start by saying just a word about the tax panel that was appointed in January 2005. The group consisted of two former Senators and a Congressman, three academics, and three others with various perspectives, including a former head of the Internal Revenue Service. We were charged with proposing revenue-neutral ways to make individual and corporate income taxes simpler, fairer, and more pro-growth. The revenue-neutral element of our charge must be underscored, because true reform of the tax system doesn't mean tax cuts. It means changing the structure to try to find a better way to raise revenue. Tax reform can be combined with raising or lowering the level of taxation.

Most of the tax panel's work consisted of holding hearings and working with Treasury staff as well as with our own staff to develop reform options. The work usually involved

sober analysis of tax policy and tax law. There were occasional moments of levity, however. Our chair was the former Senator Connie Mack of Florida. His namesake is his grandfather, the Baseball Hall of Famer and legendary manager of the Philadelphia Athletics. At one point, a witness was testifying about a reform proposal that would change how we tax capital gains, so that small capital gains would be untaxed and very large capital gains would be taxed very heavily. The witness labeled this plan the "home run tax." Senator Mack stopped him in mid-sentence and said, "With my heritage, I am deeply opposed to any plan for taxing home runs."

As we studied the current tax code, our panel was able to identify three key problems: the increasing complexity of the income tax; the expanding reach of the alternative minimum tax; and tax-induced distortions in economic activity, which might involve labor supply, saving, or financial choices.

The first issue that motivates many tax-reform discussions is the complexity of the current system. This is the easiest problem to describe, but it is probably the least important of the three justifications for reform. Today, more than 60 percent of taxpayers, finding the tax code just too difficult to grapple with on their own, use a paid preparer to help ensure the accuracy of their tax returns. Estimates suggest that, as a nation, we spend about \$140 billion collecting taxes and complying with the income tax code. We raise about a trillion dollars from the income tax, so we're spending about 15 percent of the revenue yield on compliance. This figure includes not just the checks people write to tax preparers but also the time spent collecting records, preparing returns, and getting financial affairs in order.

The tax code is complicated, and it has become more complicated over time. We have done more and more social engineering through the tax system, for example, by trying to encourage conservation by providing special incentives such as education savings accounts, by using health savings accounts to encourage particular types of insurance purchases, and by providing incentives for various kinds of business investments. Each provision of this type moves us away from a simple system toward one that is more cumbersome to comply with and to understand.

### *Beyond the broad concern that the current tax system discourages labor supply and investment more than some alternative systems might, there are specific concerns with distortions and efficiency costs created by the tax code.*

In 1986, the watershed tax-reform year of the postwar period, the federal income tax was dramatically simplified and reformed. Since then there have been more than fifteen thousand changes to the tax code. Many have added complexity. Until recently, for example, there were five different definitions of "child" in the tax code. There were different definitions for when a child was a dependent, when she could be used to qualify her household for the Earned Income Tax Credit (EITC), and when she could receive a childcare dependency credit. The current tax code also includes more than a dozen different ways to save, in a tax-preferred way, for retirement, education, and health-care needs.

Some of the tax changes since 1986 have involved "rifle shot" provisions: specialized rules that are trying to provide tax relief or a tax incentive, often for just a small part of the economy. Other provisions offer favorable tax treatment to substantial sectors of the economy. A witness who testified before the tax panel illustrated one such provision, the current tax provision for a lower corporate tax rate on firms in manufacturing than in other industries. The witness delivered a box of donuts to the chairman of the tax panel, explaining that the donuts had been purchased at a bakery, where they had been baked on the premises. Because of this, the bakery did not qualify as a manufacturing establishment. However, a mass producer of donuts, which baked its donuts at a common site and delivered them to grocery stores, would qualify for a lower tax rate under the special manufacturing tax credit enacted in 2003. Thus the playing field was not level across donut providers. Provisions

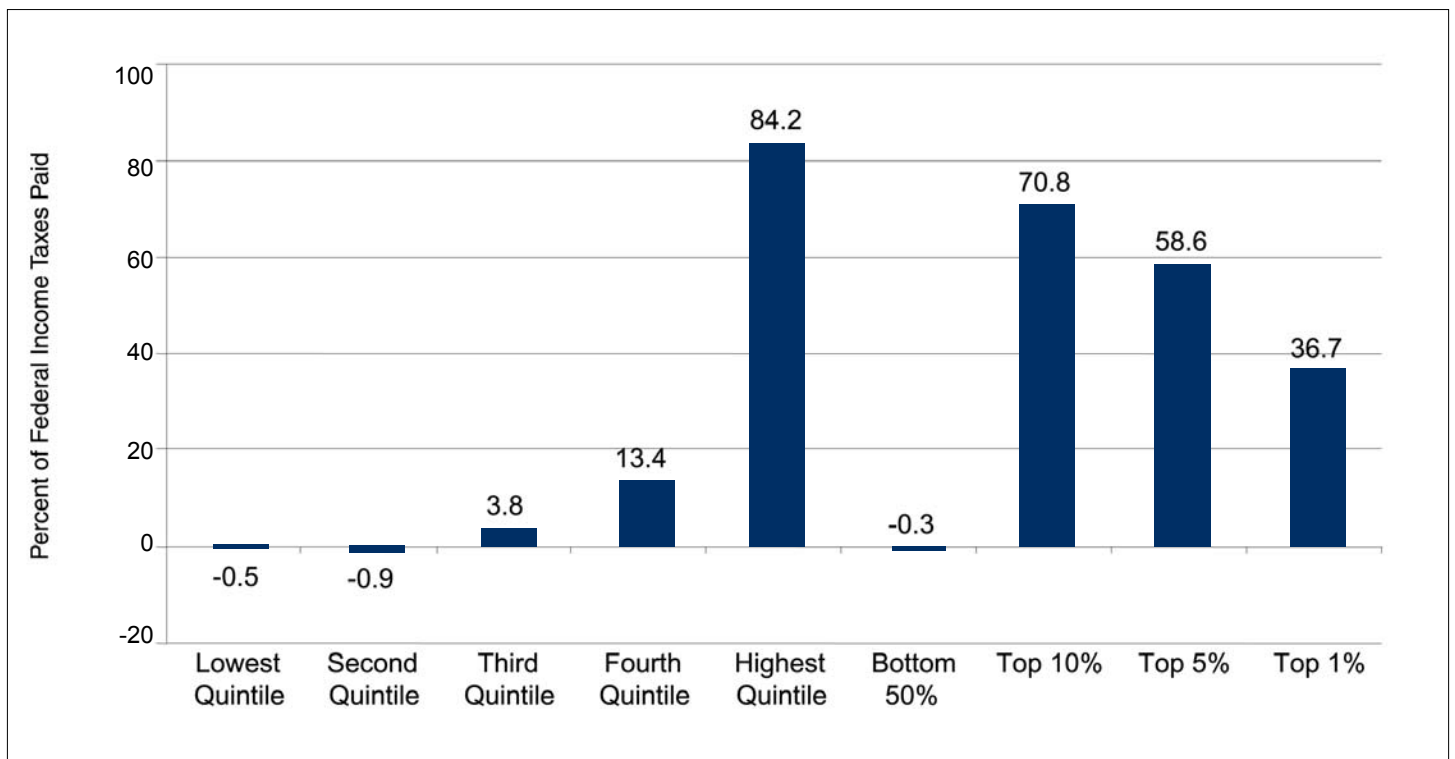


Figure 1: Distribution of Federal Income Tax Payments by Household Income Categories, 2006.  
Source: President's Advisory Panel on Federal Tax Reform

like this have complicated the tax code while distorting the economic behavior of households and firms.

In part because of new tax provisions that reduce the tax liability of low-income wage earners with children, a large fraction of households pays no, or very little, income tax, while a small fraction pays the lion's share. Figure 1 demonstrates this.

The first five bars in the figure represent the quintiles of income distribution. The top 20 percent of taxpayers, ranked by income, currently accounts for about 85 percent of the taxes paid under the income tax. The four bars on the right side of Figure 1 provide more detail on the tax payments by those at the top of the income distribution. The top 1 percent pays about 37 percent of the taxes, while in aggregate tax filers in the bottom half of the income distribution receive a refund because of the EITC and the exemptions that absolve households with low incomes from income tax liability. The payroll tax, which finances Medicare and Social Security, begins to raise revenue from households at a much lower income level than the income tax. Even combining the payroll and income taxes, however, taxpayers in the top quintile of the income distribution account for a very large fraction of total taxes paid.

The second issue that motivates many current discussions of tax reform is the recent expansion of the Alternative Minimum Tax, the AMT. The United States today has two parallel tax systems operating in tandem: the regular income tax, which specifies tax

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liability as a function of income and taxpayer characteristics, and the AMT, which calculates tax liability in a different way. After doing both calculations, the taxpayer is asked to figure out which is greater, and then to pay that amount. One of the reasons the AMT is so unpopular is simply because the last step in the calculation involves paying the maximum, not the minimum, tax liability.

The AMT was designed to apply to a broader income base than the regular income tax, and thereby to levy tax on some taxpayers with high gross income but large deductions who face very low regular income tax liabilities. The AMT base includes some things that are traditionally excluded from the income tax base, such as state and local tax deductions. Business and some medical expenses are also added back to taxable income in computing the AMT base. After excluding a threshold amount of AMT taxable income, a taxpayer applies the AMT rates, usually 26 or 28 percent, to Alternative Minimum Taxable income. Because of its high level of state and local taxes, Massachusetts has one of the highest fractions of resident taxpayers facing the AMT.

Of the 130 million households that filed income tax returns in 2005, about 4.5 million paid the AMT. If Congress does not act soon to increase the AMT threshold, then more than 20 million taxpayers will pay the AMT in 2006. Going forward, the growth of the AMT is even more striking. By 2015, 50 million taxpayers, or nearly one in three, will pay the AMT, and about two-thirds of taxpayers with incomes between \$50,000 and \$100,000 will pay the AMT. Virtually everyone with incomes between about \$100,000 and about \$400,000 will be taxed

under the AMT rather than the regular income tax. The cost of repealing the AMT will exceed the cost of repealing the regular income tax.

## *The second involves reducing the revenue yield from the income tax, and making up the lost revenue with an alternative tax source.*

The growing role of the AMT motivates discussions of tax reform for two reasons. First, the AMT creates extra complexity. Some protest that the AMT requires taxpayers to do their taxes twice. For many taxpayers, this may overstate the burden. I use a computer program to prepare my taxes, and once I have typed in all of my data, it's really only one more step to get the program to calculate my AMT liability as well as my regular income tax liability. For some taxpayers, however, the burden is much greater, because the AMT may require recordkeeping or information reporting that is not required under the regular income tax. The second, and larger, issue is that the AMT complicates tax planning. A taxpayer's marginal rate differs under the regular income tax and the AMT. The top AMT rates are lower than the top rates under the regular income tax. Uncertainty about which tax system a taxpayer will face complicates many decisions, such as charitable gift planning. Both of these considerations have placed the AMT at the top of the Treasury Department Taxpayer Advocate's list of the most important problems in the income tax code.

The problems created by the growth of the AMT could be addressed either by repealing the AMT, or by modifying it so that it once again applies only to the very top of the income distribution. The tax panel recommended repealing the AMT – a very expensive action that set the stage for most of our other recommendations. Under the assumption that the 2001 and 2003 tax cuts are permanent, which is built into the administration's baseline budget, repeal of the AMT would cost \$1.2 trillion over the next ten years. Most of the cost falls in the years between 2012 and 2016, when the AMT accounts for a significant share of total revenue. Even if we assume the 2001 and 2003 tax cuts expire in 2010, as they are currently

scheduled to do, repealing the AMT would still cost about \$700 billion over ten years.

By recommending AMT repeal, the tax panel created a large revenue gap that needed to be filled. That is why the panel recommended many base-broadening reforms of the current tax code, such as tightening the limits on mortgage-interest deductions and taxing a fraction of employer-provided health insurance. Each of those reforms could help finance AMT repeal.

The third justification for tax reform focuses on the incentive effects of the income tax system, and the efficiency costs associated with the current structure. The tax system influences behavior of both households and firms. It affects a wide range of decisions, including how much to work, how much to save, and for firms, how much to invest. A central proposition in tax economics is that lower marginal tax rates go along with lower distortions. Raising revenue with a broad tax base and low rates is not nearly as distortionary as raising the same revenue with a smaller tax base and higher rates.

The impact of tax rules on some household and firm decisions is difficult to determine solely on the basis of economic theory, so empirical evidence plays a central role. Consider, for example, the effect of taxes on labor supply. In theory, there are two effects of taxing earnings. An income effect makes the taxpayer poorer and encourages additional work, while a substitution effect recognizes the lower after-tax wage rate and the associated reduction in work incentives. Empirical evidence, based on studies of the 1986 tax reform in the United States and of the 1990 tax reform in Sweden, suggests that when there are sharp reductions in marginal tax rates on earnings, labor supply increases. This suggests that the substitution effect dominates the income effect with regard to labor-supply behavior.

Tax policy can also distort savings and investment. Theoretical studies that compare different tax structures suggest that economic growth would rise if the tax burden on capital was reduced. Yet these efficiency gains may come at a cost in the distribution of tax burdens. Because the ownership of capital is concentrated among a small share of taxpayers, lowering capital tax burdens may make it difficult to achieve what some would view as a fair distribution of tax liability.

Beyond the broad concern that the current tax system discourages labor supply and investment more than some alternative systems might, there are specific concerns with distortions and efficiency costs created by the tax code. The current system treats different types of corporate entities, such as S and C corporations, differently, and thereby provides incentives to structure business activity in one way versus another. Debt and equity, capital gains and dividends, partnerships and corporations are treated differently. Housing is treated differently from other investment assets. All of these distortions create incentives for taxpayers to change their behavior to reduce their tax liability.

Having outlined three concerns with the current tax system, namely its complexity, the role of the AMT, and its effect on efficiency and growth, the next question is what do we do? What are the possible solutions? There are three broad types of reform. The first involves reforming the income tax by lowering rates, broadening the base, and removing as many of the distortions as possible while preserving some sense of fairness. That's one of the options the tax panel proposed. The second involves reducing the revenue yield from the income tax and making up the lost revenue with an alternative tax source. The value-added tax (VAT) is often considered for such a role. A VAT is a type of sales tax: it collects revenue by taxing consumption. If we supplemented the

## *The third possibility is to go further and literally replace the income tax with a consumption tax.*

current system with a VAT, we would be able to reduce income tax rates while still collecting the current level of revenue. The United States is the only major industrial country that does not rely to a significant extent on a VAT structure at the federal level.

The third possibility is to go further and literally to replace the income tax with a consumption tax. This could be done in a variety of ways; the VAT is one of them. Another approach that is receiving a fair amount of popular attention at the moment is the National Retail Sales Tax. Such a tax could replace either the income tax or the

combination of the income tax and the payroll tax. The retail sales tax is sometimes promoted in the United States as an example of an “American” tax because the United States uses the retail sales tax at the state

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level. The VAT, on the other hand, is sometimes portrayed as a European tax because France was the first country to adopt it. If one reads the history more carefully, though, it turns out that something very similar to the VAT was proposed by a Yale economics professor in 1921, in a paper published in the *Quarterly Journal of Economics*, which is edited at Harvard. We cannot credit the Europeans for getting there first!

Another approach to consumption taxation would involve a progressive consumption tax, a tax with a long history. This requires tracking consumption at the household level, so that the tax burden can be levied at different fractions of consumption depending on total household spending. In the United States, a detailed plan for implementation was developed by David Bradford and the U.S. Treasury staff in their 1977 report *Blueprints for Basic Tax Reform*. David, as many of you know, died tragically last spring in a fire. There were many times during the work of the President’s Tax Panel when we kept wishing that we could call David and ask how best to handle a particularly difficult problem of expenditure tax design.

Our limited time this evening does not permit me to describe the detailed provisions of any of the specific proposals that were developed by the tax-reform panel. However, I can offer a rough sense of the panel’s two reform proposals. The first called for simplifying the income tax by broadening the base and lowering rates. The second called for moving toward a consumption-oriented tax

system, by adopting a hybrid structure that combined a consumption tax with a flat rate tax on household capital income.

The challenge in the first approach is that to lower rates, one must broaden the base to raise enough revenue to offset the lost revenue that rate-reduction implies. That means attacking some of the expensive and popular deductions that are currently in the tax code. Take the favorable treatment of owner-occupied housing, for example. Today, the failure to tax the imputed rent of owner-occupied housing, while still permitting deductions for mortgage-interest payments and property-tax payments, accounts for about \$142 billion of lost revenue. To place this in perspective, we collect about a trillion dollars each year from the corporate and individual income tax. Employer-provided health insurance accounts for another revenue hit of \$126 billion. Pensions, IRAs, and 401(k) contributions are another \$118 billion; state and local taxes, another \$56 billion. “Base broadening” is a popular concept, but when the specifics of lost deductions become apparent, the political economy of achieving it is very difficult because of the need to limit some of these very popular deductions.

The second approach recommended by the tax panel, which combines a consumption tax structure with a vestigial income tax, is more complicated to explain than the first recommendation. It involves a cash-flow tax, a tax that is similar to a VAT but allows for a deduction for wage payments at the business level. At the household level, this proposal combines a progressive tax on wage income with a flat-rate tax on capital income. Thus the proposal involves elements of both consumption and income taxation.

One of the traditional challenges in designing a consumption-based tax-reform proposal has been achieving distribution goals. Consumption taxes tend to fall more heavily on those who consume a lot relative to their income, typically those near the bottom of the income distribution, than on those with lower consumption-to-income ratios. One way to address this problem is to give each household a rebate from the government to cover tax payments on a bundle of necessities. But options like that complicate the tax structure, require much more recordkeeping at the household level and on the part of the tax administrator, and may create opportunities for evasion. One of the discoveries of the tax panel’s research was that a hybrid

structure of consumption and income taxes could come close to replicating the current distribution of tax burdens throughout most of the income distribution.

Many have heard the description of the various tax-reform alternatives and have asked what gains would justify such reforms. Estimates by leading tax economists, including Larry Kotlikoff of Boston University who is here this evening, suggest that aggregate economic output could rise by as much as 5 percent, after twenty years, if we moved to a consumption tax rather than the current income tax system. That gain dwarfs the differential costs of complying with different tax systems. Ultimately, the tax panel realized that growth was the key issue to consider in tax reform, subject to the constraints of preserving a fair distribution of burdens.

One of the difficult realities of tax reform is that it is hard to get from where we are to some of the more attractive alternatives. First, it is very hard to explain to the public how to think about these different tax systems and their effects. There is broad confusion about a central point in tax economics, namely that taxes collected from firms ultimately are paid by individuals, either in their role as investors or as workers. This creates a political bias toward collecting taxes from firms rather than individuals. In a similar vein, there appears to be some confusion about the differences between various types of consumption tax reforms. The VAT, which is collected in steps throughout

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the production and marketing process, is ultimately very similar to a retail sales tax that is collected only at the point of purchase. Yet many who oppose one of these taxes favor the other, which raises an educational challenge for economists and tax-policy practitioners of all kinds.

A simple example can illustrate the difference between a retail sales tax and a VAT. If

a wheat farmer sells \$100 worth of wheat to a baker, and the baker sells \$200 worth of bread to a consumer, a retail sales tax at 10 percent would collect \$20 from the consumer at the point of purchase. The VAT is essentially a retail sales tax that is collected in stages. It would collect \$10 from the baker and \$10 from the farmer because each of them added \$100 to the total value. Thus the VAT and the retail sales tax have similar economic effects.

An even larger problem, however, is the need to consider transition relief in tax reform. It's very likely that if we put a bipartisan group of nine economists and tax lawyers in a room and said, "Design a tax system," they would come up with a system that differs from the one we currently have in place. Whether it would look exactly like the proposals of the tax panel, I'm not sure. But it would not look like what we have today. However, the challenge is to get from where we are to any of these reform options. The key problem is the entrenched interests that have taken action based on the current tax system and would lose under some of the alternatives.

A standard canon of tax economics holds that taxes on things that cannot be changed are very efficient taxes. Imagine, for example, that you've just built a new rental apartment building. You've got a long stream of tax-depreciation claims that you're hoping to get under the current system. Now say we eliminated those and said, "Tomorrow we're going to adopt a new tax rule. You can't take those claims anymore. But, because we don't have those deductions, we'll tax your income at a lower rate." To an economist, this plan seems like a way of collecting revenue without any distortion because the building will not change – it is the result of past investment. To most other participants in the economic system, however, including all the business people on the tax panel, this example seems like a route to bankruptcies, disruption, and all kinds of other problems. These are important and valid concerns, and they raise the challenge of determining how to change the tax system without creating a great many distortions. If we provide generous relief to those who lose tax benefits that they had previously counted on, then it is more difficult to reduce tax rates in the reform environment. This means the efficiency gains are smaller than they might be if transition relief was more limited.

In considering tax reform, it is essential to recognize that the three objectives that our tax panel was charged to achieve – to simplify, to be fair, and to improve economic growth – are often in conflict. There are trade-offs among these goals, and it is difficult to find reforms that achieve all three. If we want to have a system that is fair, we may need to complicate the structure a bit. If we want to promote growth, it may mean moving toward taxing capital income less, which could have distributional consequences that some might brand as unfair.

Colbert knew that designing a tax system was hard. Louis XIV didn't have much success with the systems that he tried. The United States has had a relatively stable tax system, and one that by and large has worked well. Yet there is a never-ending chorus of calls for reform, but little action. Bill Archer, the former Chairman of the Ways and Means Committee, said, "There's a tremendous appetite for tax reform in Washington until people find out what it really is." Perhaps that explains this paradox!

## Michael J. Graetz

Jim and I agree entirely on what's wrong with the existing system. My list is pretty much the same as his, beginning with complexity. I would also add the fact that neither the public nor the overwhelmed IRS can comply with the existing system. I also agree with his points on the AMT.

I do want to add what I call the problem of chicken soup. It refers to the fact that the Congress and presidents of the United States now use the tax code the way my mother used chicken soup, as a remedy for whatever ails society. For example, whenever we have a crisis in health insurance, the President in his State of the Union address will propose a new tax incentive – this time for health-savings accounts. Everyone has a different idea about how to go about solving these social and economic problems, complicating matters further.

Jim mentioned the five definitions of a child in the tax code. There are also thirteen different provisions that provide incentives for higher education, including two tax credits for higher education: one is available if you were convicted of a felony drug crime; the other one is not.

To describe the income tax today, I want to refer back to Jim's figure about the distribution of the income tax burden. The income tax has changed. Prior to World War II, it affected only a very thin slice of high-income earners. In order to finance World War II, however, the income tax was extended to the masses. As recently as the 1986 reform, it was still a mass tax. But in the past two decades, largely through the expansion of the Earned Income Tax Credit (EITC) and child tax credits, more and more people have come off the income tax rolls.

Of the 130 million returns filed each year, nearly a quarter are not taxable. Most of them collect money from the government. Thus, the IRS is not only a tax-collection agency; it is our principal check-writing agency. The amount of refunds paid out for

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the EITC now exceeds, by a factor of two, the amounts that are paid for welfare, the so-called TANF provisions. There are more refunds now in earned income tax credits than in Supplemental Security Income (SSI), which provides income for low-income people. So the EITC has become our largest social-welfare program, and it is in the tax code. And it is enormously complicated, not only for reasons that Jim has suggested, but also because it creates huge marriage penalties for people at the bottom.

For the middle-income group, tax credits also add complexity. Do I take this education credit? If I draw money out of my education IRA, I lose my credits. Who can figure this out? Maybe TurboTax or a tax preparer can, but this complexity alienates the public from the government when they file their tax returns. Paying taxes is no longer an act of patriotic pleasure. It's not a patriotic act of figuring out your share of funding civilization, except for the few econo-

mists who do their own returns. Most people don't look forward to April 15 – and not because they owe money. Many are receiving refunds.

At the same time, the bottom-half of the population is not paying income taxes but is receiving checks. And two-thirds of the income tax revenue is coming from the top 10

*We need a tax system that could actually produce some more revenue, if we need more in the future.*

percent. In terms of collecting money, we're now back to a situation where most of the money is coming from a thin slice of upper-income Americans, not from the masses who used to pay it.

The panel has come up with two tax-reform proposals. The first is a really thoughtful reform of the income tax; I compliment them on it. But it is not surprising to me that no politician in America, including the president who commissioned them to undertake this assignment, has picked up on this plan and said, "Let's have it." The reason: the slaughtering of sacred cows. People focus on the loss of deductions – home-mortgage deductions, particularly, but also charitable deductions. People would also lose their state- and local-tax deductions, which makes a difference in what are called the blue states, most of which, including this one, have Republican governors. So, when you start repealing state and local taxes, it's a bipartisan problem.

What would people get out of this reform? One benefit is the repeal of the AMT. However, only four million people are paying it right now, with only the threat that everybody will have to pay it down the road. The typical political response is to "wait and see." The other benefit is that the panel would lower the tax rate from 35 percent to 33 percent. Ronald Reagan lowered the top tax rate from 70 percent to 28 percent; when you make that kind of reduction, you can slaughter a few cows along the way and simplify the law. But when you're lowering the top rate from 35 percent to 33 percent, please leave my cows in the yard. The income tax proposal, while worthwhile, is not one that I

would put a lot of money on crossing the finish line.

The other proposal is the so-called growth-and-investment tax. I love the label. The income tax, as we know, is a tax on income, but the growth-and-investment tax is not a tax on growth and investment. We don't know what kind of tax it is: it's a mystery tax. David Bradford used to call it the X tax, which also had a little mystery about it.

The growth-and-investment tax is a hybrid between an income tax and a consumption tax. What's most interesting to me about this consumption-tax exercise is the emphasis on American exceptionalism. Bob Hall and Alvin Rabushka had to invent the so-called flat tax. David invented the X tax. The panel invented the growth-and-investment tax. The fair-tax people proposed a sales tax at rates much higher than those used anywhere in the world. But, lo and behold, there is actually a very well-functioning consumption tax used not just in Europe but in 150 countries throughout the world: the value-added tax, which collects the money that it's supposed to collect at very low compliance costs compared to ours. Nobody wants to talk about the VAT because it's the "French tax," or the "European tax," or something else. But it has the advantage of working well. I testified before the President's panel, suggesting that what we needed was a third plan that involves a VAT.

Let me say something about the VAT. I do not believe that we can have a revenue-neutral tax system for very long. Jim emphasized that we cannot have any more tax cuts, because the panel assumed all of the President's tax cuts are permanent. In January 2001, Alan Greenspan famously testified to the Budget Committee of the U.S. Senate that the surpluses, which were then estimated to be \$5 trillion over the coming decade, were so large that we would pay off all the nation's debt and have so much money left over that we would have to invest public dollars in private assets, including corporate stock. And he – and I agree with him – said: "The government shouldn't buy corporate stock; it shouldn't be in that business." So, he added, we need a tax cut. Well, the good news is now that Alan Greenspan has left the government, that problem has been solved.

The bad news is that we have more than \$8 trillion of debt. The Secretary of the Treasury is back before Congress, asking to raise

the debt ceiling of the United States to \$9 trillion. We have hundreds of billions of dollars in annual deficits as far as the eye can see, and we have a tax system that is not well designed to raise money going forward. Further, we have a demographic problem: the population is aging. The Social Security problem, where George W. Bush spent his political capital, is a very small problem compared to the Medicare and Medicaid problems. Estimates predict that about 27 percent of our nation's GDP will be spent on the benefits we currently receive from those programs. Historically, we've spent 20 percent of GDP on all federal spending. Perhaps we can keep it at 20 percent or 21 percent by restructuring spending programs. However, our current tax system is raising only 17.5 percent of GDP. The tax panel has come up with a revenue proposal that's revenue-neutral: it gets rates down by 2 percentage points, but it doesn't raise any more revenue for us. So, we have a gap between 17.5 percent here and 20 or 21 percent there. It doesn't add up.

We need a tax system that could actually produce some more revenue, if we need more in the future. People fear a VAT because it just might work. If we need revenue, we could get it. I've come up with a four-step plan that says, "Let's use the VAT," because I'm in the same camp that says, "We ought to be taxing consumption a little more than we do now, and income a little less."

First, instead of repealing the AMT, I would repeal the regular tax. Why? Because the AMT's rates are lower and its base is broader, two objectives that the panel is struggling

*We ought to be taxing consumption a little more than we do now, and income a little less.*

to achieve with its tax-reform proposal, which only gets the income tax rate down to 33 percent. I would get it down to 28 percent by repealing the regular tax. Also, in 2015, with all the people paying the AMT, it's cheaper to repeal the regular tax than it is to repeal the AMT. So I would repeal the regular tax, keep the AMT, and then raise the exemption to \$100,000 for a married couple (indexed for inflation). Thus, no married

couple with a combined income of less than \$100,000 would pay the tax. I would then lower the rate further to 25 percent, maybe less.

I would also apply similar measures to the corporate tax. In the last two decades, this nation has gone from having the lowest corporate-tax rate in the OECD to having one of the highest. Corporate-tax rates have been coming down around the world because people can move money around and the international income tax system is so archaic that it cannot, now, effectively collect high corporate taxes. One way to decrease the incentives for corporations to move money to countries with lower tax rates is to become one of those countries. So, countries throughout the OECD have lowered their tax rates. I would lower the corporate-tax rate also to 25 percent, or lower.

When we lower the individual and corporate income tax rates, these taxes in the United States as a percentage of GDP would comprise about 4 percent, compared to their current 10 or 11.8 percent, of GDP. These two measures would make these income taxes as a percentage of GDP lower in the United States than in any of the OECD countries.

Then I would enact a VAT. As a percentage of GDP, the United States relies much less heavily on consumption taxes than any of the other countries in the world with whom we compete. The VAT would replace the revenue lost by taking all of these people out of the income tax structure, raising the tax-free level to \$100,000, and lowering the rate to 25 percent. We would need somewhere between a 10 and 14 percent VAT to do that, depending on our value-added tax and income tax bases. That 14 percent tax would put us at about the same level as consumption taxes in the OECD and Europe.

I also would suggest a substitute for the EITC: refund some payroll taxes and do not require people to file tax returns in order to get their refunds. Here's the payoff: of the 130 million tax returns now being filed, 100 million disappear, leaving roughly 30 million returns and making April 15 just another day for about 150 million people.

I wouldn't get rid of the income tax completely, as many people want to do. I keep it to avoid the shift in the distribution of income that would result if we didn't tax some of the income at the top. Jim talked about

the need to tax capital for the same reasons. I would also tax capital, but at low rates.

One final point: I do not think that the growth-and-investment tax can work. Two types of individuals missing from the panel were a practicing tax lawyer and a tax accountant. As a result, the panel lacked certain practical experience. The responsibility for this shortcoming belongs to Alberto Gonzales. He told tax lawyers and tax accountants that if they served on this panel, they could have no dealings with the IRS during the panel's life because of the appearance of impropriety. That mandate pretty well ruled them out.

*In order to move forward politically, we're going to have to think about alternatives beyond those in the panel's report. . . . Tax reform will involve many hard choices.*

The growth-and-investment tax – and the panel recognizes this – has two major problems. First, it doesn't work for financial institutions because of a number of technical issues. The bigger problem is that the tax doesn't work internationally. The growth-and-investment tax would require us to renegotiate all 86 of our bilateral income tax treaties throughout the world because this tax prohibits a deduction for interest at the corporate level. Our treaties provide that, in order to have an income tax, a country has to have a deduction for interest. The tax would also be border adjustable (meaning it assesses imports and exempts exports), but we can't legally put that into effect under the General Agreement on Trade and Tariffs (GATT). So, we would have to convince Congress as well as all other countries to renegotiate the GATT – a transition problem that is very different from the usual transition problems in tax reform.

In order to move forward politically, we're going to have to think about alternatives beyond those in the panel's report. I proposed the changes I have just discussed to the panel, and it did not unanimously accept

them. Enacting a VAT is not easy, politically. Tax reform will involve many hard choices.

## James Poterba

Michael has done an outstanding job of outlining some of the open issues and shortcomings of the proposals offered by the tax-reform panel, and of explaining his own alternative reform proposal. His plan involves a VAT, and I should comment briefly on that element. The tax-reform panel spent a good deal of time thinking about the VAT and learning about how it would work. I think there was broad agreement that it, in fact, is a very efficient way of raising revenue. Michael accurately portrayed the concerns that worked against recommending this tax: some panel members were extremely worried that this would be such an effective revenue-raising device that it would lead to growth in the size of government. As one of the jokes about the VAT goes, "the reason we don't have one is because the Republicans think it's a money machine and the Democrats think it's regressive, and as soon as they switch sides, we'll enact one immediately."

## Questions and Answers

**Question:** Judging by the reaction to your thoughtful report, there seems to be a difference between what may be economically sensible and what may be politically possible. One of the concerns about a consumption or value-added tax must be the 76 million baby boomers, who have made a lot of income that's been taxed and who are now entering their retirement years. They're going to spend that income, and it's going to be taxed again as they consume. Moreover, these are the politically active people who vote. Could you talk about the political realities and what might be possible, especially as you transition from an income- to a consumption-based tax?

**Poterba:** Let me start by explaining the basis for this question, just to make sure everyone understands the problem it alludes to. Envision a situation in which you earned income last year and paid the 35 percent income tax on it. You've got \$10,000 saved outside an IRA to help fund your retirement spending.

*Taxing old saving again has some appeal from the standpoint of economic efficiency, but it may be viewed as unfair and it does raise the problem that taxpayers may fear future double taxes.*

And now Congress announces that it is going to eliminate the income tax and replace it with a national sales tax at a rate of 30 percent. In some sense, your \$10,000 in the bank has just been reduced in value, because now you're going to have to pay the sales tax at 30 percent, whereas you used to think of the sales tax as a nominal state-level tax. Those who have accumulated assets under the old rules are hit by the consumption tax going forward. Notice, by the way, that if you had put the money into an IRA or a 401(k) where it wasn't taxed the first time out, then you're all right, because instead of paying the income tax when you make a withdrawal from one of these accounts, you now pay the consumption tax instead. But for those with retirement saving or other wealth in taxable accounts, there would be a double tax.

Taxing old saving again has some appeal from the standpoint of economic efficiency, but it may be viewed as unfair and it does raise the problem that taxpayers may fear future double taxes. Taxing past saving makes it possible to lower all marginal rates going forward because it yields revenue that would otherwise have been collected from taxes on wages or future capital income. Unfortunately, such a tax would also lower the standard of living of the people who saved before. Now, there are some who will argue that that has some appeal because the baby boomers are the ones who, as Michael's comments suggested, are going to put tremendous fiscal strains on our system when they receive Social Security and Medicare and Medicaid. To finance some of that with a consumption tax as they draw down their assets may be a way of getting them to pay for that on a pay-as-you-go basis. But the AARP has figured this out, and they are actively explaining to the elderly and not-so-

elderly that they will be double-taxed under these systems. Thus, politically, it may be very difficult to tax the existing assets.

**Graetz:** I just want to emphasize one thing that Jim said. It's only a double-tax for the income that's already been taxed and not for income that's going to be taxed. If you have investment income, it would be taxed under the income tax. If you have pension income, it would be taxed under the income tax. If you have Social Security income, and you've got more than \$25,000 of income, it would be taxed under the income tax. Consequently these people are going to pay a lot of income taxes. At least under my plan, the taxes balance out because if they pay lower income taxes, they pay higher consumption taxes. The people at the very top-end are paying more than they would because it's basically a 39 percent total rate, rather than a 35 percent total rate, if they consume everything. But somebody's got to pay for government.

**Question:** My question goes to the longer history of taxes and growth since World War II and the observation that some have made that during the first thirty years after World War II, when tax rates were substantially higher at the margins, we had much better growth than we've had in the last thirty years, when tax rates have been lower. So, is the appropriate growth-and-investment tax one with higher marginal rates?

**Poterba:** Economists love to point out the difficulties of drawing strong inferences from what are called time-series correlations. Yours is an example of how it's hard to control for all the other factors that were contributing to growth: the stock of knowledge accumulated in World War II, the baby boomers entering into a highly productive period, the growth in the U.S. educational system.

Economists draw information by looking at more narrowly focused experiments. For example, when we enact bonus depreciation for a couple of years, do we see more plant and equipment investment? When we compare countries with higher versus lower tax burdens on capital income, do we see somewhat higher investment rates in places where the tax burdens are somewhat lower? When we find rare experiments that are generated by either tax reform or by circumstances that individuals face, do we see them basically saving a bit more when the tax burdens are lower than when these burdens

are higher? In most of those cases, there's a body of evidence that is not absolutely convincing, but that suggests that if we had lower tax burdens, we would see more saving and investment, which would lead to more growth.

One of the important challenges to recognize is that in an increasingly global economy, encouraging saving and encouraging investing are different things. In a closed economic system such as a single isolated country, when individuals save, the resources get invested in the economy. This leads to a larger productive capital stock and higher productivity. In an open economy, however, when policy encourages individuals to save – in the United States, for example, by building bigger 401(k)s and bigger IRAs – the most productive place to invest those new resources may be in another nation. In this setting the saving country does not get a larger capital stock. Instead, its residents receive the return, later on, on their capital investment abroad. In the U.S. case, these insights suggest that we could encourage investing without encouraging saving by making it more attractive for foreign corporations to invest here. The open global capital market can make it difficult to interpret statistics like the ones that your question mentioned.

*One of the important challenges to recognize is that in an increasingly global economy, encouraging saving and encouraging investing are different things.*

**Question:** The VAT does influence trade, thus affecting the trade deficit, per se. One of the primary reasons the Europeans decided to push more on the VAT is because it helps their trade. When I talk to people in other countries, including in the United Kingdom and France, they're very much aware that the VAT gives them a big advantage in world trade. Right now, the United States has a huge trade problem. Would you speak to the one point you didn't discuss – the trade deficit.

**Graetz:** Just so everybody understands, a value-added tax gives you a trade advantage compared to a corporate income tax because you're taxing imports and exempting exports. So you've increased the price of imports relative to exports. Today, we're importing so much more than we're exporting

*...a value-added tax gives you a trade advantage because you're taxing imports and exempting exports.*

that changing that price looks like something you might do. I've had these debates with economists endlessly, and the economists will tell you that it doesn't matter because exchange rates will shift and wash out the difference completely. But this assumes that exchange rates move freely, and at least some of our big trading partners – China comes to mind – don't seem too willing to let their exchange rates move quite so freely.

Although it didn't count the revenue from the tax on imports that it would get, the panel decided to make this growth-and-investment-tax proposal border-adjustable in the same way that the VAT is. The problem, which they acknowledge, is that border adjusting is illegal under the GATT, because there is a deduction for wages. Here is another argument for going to the standard VAT.

**Poterba:** Let me begin by clarifying the standard economic analysis of border adjustments. Think about the current world of an income tax, and the decision of whether to buy a doll produced in China versus a doll produced in Arkansas – there's a level playing field there. Now move to a world where we have a sales tax. The sales tax, presumably, gives you the same level playing field – everything's getting taxed, so there's no greater incentive to buy something produced in one place versus another. Even when goods come into the country from China, provided they are charged the sales-tax rate, the neutrality proposition remains true. Note that the tax is collected on goods coming into the country, but not on goods that are shipped abroad. This observation implies that the retail tax would be collected on goods coming into the country, but not on domestically produced goods that are

being shipped abroad. That's the standard argument made for a sales tax or a VAT: we collect the tax on the imported goods and do not collect the tax on the exports; therefore, the tax promotes exports.

The economists in the audience can see that with flexible exchange rates, the exchange rate can undo the effect of taxing the goods coming into the country and not taxing the goods going out. Michael's comment about what happens when the exchange rate is not free is the first important argument.

There's a second one, though. Consider a world with no taxes, and then ask if putting in place a VAT or a sales tax would help your trade balance. Many economists would say, "The answer to that question is no," and expect rather to see changes in the exchange rate. But ask, "What if I replace the corporate income tax or the individual income tax with the sales tax, and I reduce the tax burdens currently levied on capital income in the United States, putting a tax on consumption instead?" Then – and this is the part that doesn't get emphasized enough – the economists will line up with the business people and say, "Yes, in fact, this is a system that is going to promote capital investment and exports because it's lowering our cost of doing business." So you're right: there would be some pro-export effect of moving to these kinds of systems, but it is not because we do not tax the exports. It is because we replace other taxes that burden exports with the sales-tax structure.

**Question:** The difference between the European systems and the American one is that the chicken-soup effect is far smaller there. You don't use the tax system to solve various social ills. I think this is probably more important than the VAT. What do you think about that?

**Graetz:** I have two things to say about it. First, the reason the United States uses the tax system in instances where the rest of the world uses other forms of social insurance is a political and historical story, not an analytical one. I think it's very important to eliminate the filing of tax returns by a very large swath of Americans in part because most of these very costly provisions – sacred cows, including education expenses, the health accounts, and so forth – are not special-interest provisions; they're general-interest provisions. They're enacted to help the broad taxpaying public. If we removed

people making incomes below \$100,000 from the tax system, though, politicians would lose the benefit of saying, "Well, we're going to give you a tax break for this."

In completing a book on social insurance, I discovered that doing social insurance through the tax system doesn't work. You end up rewarding the top-half of the income scale and creating all sorts of strange incentives. The health-insurance system is a perfect example. We have this tax-preferred way of doing health insurance – what are the results? We've got the highest health costs in the world, more uninsured people than elsewhere, and no better health outcomes. Health insurance is the Titanic of domestic policy. It doesn't work.

We have to change the political incentives. In order to do so, we have to get masses of people out of the income tax because that's where all of this politicking has been taking place. If we had a pure income tax, or a growth-and-investment tax, or even the flat tax of Hall and Robushka – where people would supposedly file postcard returns because we would tax only wages for individuals – it wouldn't be a postcard for very long. Because if all of those people are paying taxes and filing returns, the incentives for U.S. politicians are just too great to reward them with a tax break for this or that. And politics will continue, and reform will unravel, just as the 1986 Act has unraveled in the last two decades.

I don't think there's a solution short of really narrowing the scope of the income tax so that it really does become a special-interest issue and not one for the broad public. ■

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