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Tax Advise for the Second Obama Administration

by

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You have asked all of the participants here for their ''tax advice for a second Obama Administration'' — and I will surely get to that. But I want to begin by noting that this year we are celebrating — if that is the right word — the 100th anniversary of the modern U.S. income tax.

Then, as now, economists played a key role in shaping this nation's understanding and furthering the enactment of the income tax. Lawyers, less so. Let me mention two: both founders and early presidents of the American Economics Association. The first was Richard T. Ely, who in an 1888 book described the income tax as ''the fairest tax ever devised.'' The second was Columbia's Edwin Seligman, who argued that the income tax was essential to ''round out the existing tax system in the direction of greater justice.'' Elliot Brownlee, the most important tax historian for this time, describes the crucial role of economists as helping to ''shift the discourse over taxation . . . to an emphasis on a moderate redistribution of the tax burden.''

To many economists today — but not all — their predecessors' focus on a fair distribution of the tax burden may seem quaint and archaic, perhaps even inapt for their profession. But make no mistake: achieving greater tax justice is what the 1913 adoption of the income tax was all about — the culmination of a two-decade, broad-based, popular effort to achieve greater fairness in our nation's tax system, one that required the extraordinary support of the American people necessary to amend our Constitution.

Enactment of the Sixteenth Amendment, of course, did not end the debate. From the White House, the former Princeton political scientist Woodrow Wilson presciently observed in September of 1913: ''Individual judgments will differ with regard to the burden it is fair to lay upon incomes which run above the usual levels.'' As we have witnessed just last December in the ''fiscal cliff'' debate, a century later, differences in such judgments remain at the center of U.S. political battles.

If we were to ask our students, ''Why does the U.S. have an income tax?'' they would no doubt respond, ''because we need the money.'' And that indeed explains the origins of this nation's first income tax, the one enacted 150 years ago in 1863, after Treasury Secretary Salman P. Chase told President Lincoln that the Union government couldn't borrow enough money to finance its war needs — a doleful truth that eluded the Confederacy until it was too late.

But by 1893, revenue needs no longer accurately capture our nation's movement to tax income. In fact, as Elliot Brownlee recounts, ''Virtually none of the income tax proponents within the government believed that the income tax would become a major, let alone the dominant permanent source of revenue, within the *consumption-based* federal tax system.'' He insists: ''Support for a 'progressive income tax' had far more to do with the search for social justice in an industrializing nation than the quest for an elastic source of revenue,'' concluding that: ''the revenue goals of the tax were far less important than the desire to use the tax to advance economic justice.''

The income tax enacted in 1913 was both less progressive and less ambitious in its revenue goals than the previous Civil War income tax or the 1894 income tax, which had been struck down by a conservative Supreme Court in the *Pollock* case.

In his excellent book, *The Great Tax Wars*, detailing the 50-year struggle over income taxation that culminated in 1913, the journalist Steven Weisman describes the political battle as one between ''justice'' and ''virtue,'' with proponents of the former insisting ''that it was fair for society to tax income at graduated rates according to ability to pay, because of a need to establish some level of social equity and to curb the power of great wealth over government.'' And those on the other side countering that allowing citizens to keep the wealth they earned was vital to the spirit of free enterprise. The claim of income tax opponents then was that taxing wealth ''wrecks the incentives that have fueled the engine of American prosperity.'' Sound familiar?

A century has passed, but the debate is essentially unchanged. Importantly, notwithstanding the ups and downs of marginal income tax rates, a progressive rate tax on income has been a key element of American taxation for a hundred years. Advocates for ''virtue'' — those most concerned about incentives — peaked more than eight decades ago, in 1932, when Andrew Mellon succeeded in reducing the top marginal income tax rate from its World War I high of 77 percent to 24 percent. Half a century later, Ronald Reagan nearly managed to duplicate that feat, moving from a 70 percent top income tax rate when he first took office in 1981 to a 28 percent top rate when he left eight years later. Now the top rate is back up to 40 percent.

The income tax was transformed when our nation faced massive revenue needs to finance World War II. Then — for the first time — our nation became one full of income taxpayers. According to Brownlee, in 1939 less than four million Americans paid income tax, but by 1945 that number had increased tenfold to more than 40 million people. Income tax revenues rose during the same period from $2.2 billion to $31.1 billion. By the time World War II came to an end, individual income taxes accounted for 40 percent of federal revenues, and corporate income taxes contributed another third. For the seven decades since, the income tax has remained the centerpiece of the United States tax system.

Now everyone agrees that our current system is broken — that it is overly complex, that it causes too many unwise distortions in people's decisions, and that it could be made far more conducive to economic growth. Two years ago, many tax publications, including *Tax Notes*, celebrated the 25th anniversary of the Tax Reform Act of 1986, the last major U.S. tax reform — legislation that many, including the Bowles-Simpson fiscal commission, have urged that we use as a template for tax reform now. Surely the crowning domestic achievement of Reagan's presidency, that legislation was widely heralded as the most important tax legislation since the income tax was converted into a tax on the masses during World War II. Since pundits and politicians from across the political spectrum are now calling for a replay, it is worth taking a moment to review what happened then.

The 1986 reform increased the permissible amount of tax-free income; lowered and flattened income tax rates; shut down mass-marketed tax shelters for high-income individuals; curtailed the ability to shift income to lower-income, lower-rate family members; and taxed capital gains at the same rate as ordinary income. By shutting down tax shelters for individuals and repealing tax benefits for equipment and real estate, Congress not only financed a reduction in the corporate tax rate (from 46 to 34 percent) but also paid for some of the individual rate reductions. The corporate changes also made the income tax considerably more neutral across industries. Soon thereafter, the law's rate-reducing and base-broadening reforms were mimicked throughout the OECD.

But the changes wrought by the 1986 Act proved neither revolutionary nor stable. The 1986 tax law resulted from an uneasy, temporary marriage between the forces of ''justice'' and ''virtue.'' The conventional tax reformers, who were principally interested in improving tax equity by broadening the income tax base so that income would be taxed similarly regardless of its source, joined together with supply-siders and deregulators, who were most concerned about incentives and wanted to enact lower tax rates ''to get government off the backs'' of the American public and American businesses. The ink was hardly dry on the 1986 Act before the divorce proceedings started. Thousands of pages of legislation in the years since 1986 have narrowed the income tax base, while the top tax rate crept upward.

Even though deficits were becoming a great concern by the mid-1980s, the linchpin of the 1986 Act was revenue neutrality. By insisting on revenue neutrality, the Reagan administration and the Congressional leadership were able to demand that amendments to the tax bill could be offered only if any revenue losses were offset by revenue gains. Legislators behaved better when to pay Peter they had to be explicit about how they intended to rob Paul.

Tax reform was not only revenue neutral, but also roughly distributionally neutral: So the 1986 law was not an occasion for significantly shifting the distribution of income tax burdens among income classes. Distributional neutrality, along with revenue neutrality, became guiding principles for this legislation.

Most importantly, Reagan rejected almost unanimous calls from economists and some law professors to move away from income taxation to taxing consumption.

But today conditions are very different. First, revenue neutrality and distributional neutrality will not likely suffice for long. Given the size of the national debt and projected increases in that debt for the near and long-term future, it now seems essential for tax reform to put our nation in a better position to raise additional revenues. But, since California adopted Proposition 13, 35 years ago, antipathy to taxes has served as the glue that has held the Republican coalition together. So, revenue-increasing tax reform will be extremely difficult — if not impossible — politically.

Second, given the rise in inequality — especially the increase in the share of income and wealth concentrated at the very top — some of our political leaders will not be willing to settle for a distributionally neutral tax reform. Even after the fiscal cliff settlement, they may urge that tax reform should make the federal tax system more progressive.

Third — and very importantly — there is no pot of gold from which to finance tax reform. In 1986, as I have said, repeal of tax benefits for investment in plant and equipment and limitations on individual tax shelters, along with the elimination of lower rates for capital gains, financed much of the rate reductions for individuals.

Now, however, given the internationalization of economic activity and increased competition from abroad, repeating the 1986 Act's reliance on increased taxation of corporate income is not possible. Corporations and others holding large amounts of capital move money quickly and easily around the world, making it much more difficult for any nation — including the United States — to tax their income. And because of access to large pools of private capital, including private equity and sovereign wealth, large partnerships are accounting for an unusually large share of business income. This further complicates the quest for business tax reform.

Technological advances also allow the ownership of valuable intellectual property to be moved around the world with the click of a mouse, and financial innovations, along with differences in tax rules among nations, facilitate tax planning opportunities. The interdependence of the world economy makes trying to impose high income tax rates on multinational corporations and business partnerships counterproductive. Deductions flock to high-tax-rate countries, and income flocks to those with low rates. There is only so much the United States can do unilaterally to address this problem.

In order to attract capital to create better conditions for American workers and businesses, the United States must be an attractive place for both foreign and domestic investors. And American companies need to be positioned to take full advantage of the global market for goods and services, labor, and capital.

I have come to believe that, absent broad international agreement and cooperation foregoing tax competition — a transformation that is certainly not on the horizon — a low statutory corporate tax rate is essential. This year we have the highest statutory corporate tax rate in the developed world.

The substantive difficulties of designing sound corporate income tax policies for today's global economy are hard enough, but taking political considerations into account makes the task positively Herculean. Corporate income taxes are popular with the public, despite the virtually unanimous view among tax policy analysts that the corporate tax is a bad tax economically. It is child's play to characterize large corporations, especially large multinational corporations, as villains. This is probably why the public seems to like a tax that economists hate. But high tax rates on corporate income in today's global economy are a bad way either to achieve economic growth or to obtain and maintain progressivity in the distribution of the tax burden.

So, the corporate tax now should not, and as a practical matter will not, be able to be used to finance tax cuts for individuals. At most, reforming corporate income taxation will itself be revenue neutral.

Nor can tax reform be financed by more borrowing. That was George W. Bush's trick in 2001 and it has been used up. That year, Alan Greenspan famously told Congress that projected federal budget surpluses were so large that the government would soon pay off the national debt and have to begin investing in corporate stocks — a prospect he abhorred. The good news is that this problem has been solved. Our national debt is now larger as a share of our economy than at any time since World War II. And then 95 percent of the debt was owed to Americans.

This time there is no pot of gold to finance tax reform — unless it is hiding somewhere under a rainbow. People talk about broadening the tax base and lowering tax rates. But here is the ugly truth.

The 1986 legislation did not induce Congress to forsake the income tax as a blunt instrument to serve non-revenue-raising public policies. Presidents and members of Congress from both political parties continue to act as if an income tax credit or deduction is the best prescription for virtually every economic and social problem our nation faces. In the process, the Internal Revenue Service has become the administrator of many of the nation's most important spending programs.

To keep track of all the tax benefits, the federal budget each year contains a list of so-called "tax expenditures." The number of these tax expenditures has grown substantially since 1986, from 128 to more than 200. And, once enacted, no matter how ineffective or distortive, tax expenditures "tend to stay in place.'' Their total cost in lost revenues is estimated to exceed $1 trillion a year.

But here is the rub. These are not just narrow special-interest tax loopholes. The biggest items are tax breaks widely available to broad segments of the general public. The largest tax expenditures are very popular: tax advantages for employees' payments for health insurance and retirement savings, deductions for home mortgage interest, state and local taxes, charitable contributions, and low or zero rates on capital gains.

No politician likes to admit it, but if tax reform is to be financed by broadening the income tax base, these are the tax breaks that will have to be eliminated or at least sharply curtailed. Martin Sullivan in *Tax Notes* showed that what he described as an ''aggressive tax reform'' would only finance a 10 percent cut in tax rates — from a top rate of 40 percent to 36 percent and a low rate of 10 percent to 9 percent. Hardly the kind of rate reduction for a member of Congress to wager a political career on.

Sadly, I have come to regard the 1986 Act as a promise failed. I do not believe that the best path for tax reform is simply to improve the income tax. Changes in the past 25 years make this a dead end.

As we now know, it does not take very long after a good cleansing of the income tax for the law to get very dirty again. Many of the 1986 Act's reforms have been reversed: its broad base and low rates have been transformed into a narrower base with higher rates. How can anyone remain optimistic about fixing the income tax without radical surgery? Joel Slemrod has observed that when people are young, we really enjoy celebrating their birthdays, but when they head toward 100, they have almost certainly become decrepit. That is the state of today's income tax.

Although few noticed it, the most recent big push for tax reform occurred just eight years ago in 2005. Two weeks before his second inauguration in January 2005, Bush established a nine-person Tax Reform Panel headed by former Senators John Breaux and Connie Mack to fulfill Bush's campaign promise to ''lead a bi-partisan effort to reform and simplify'' the nation's tax law. The panel's 272-page report, issued in November 2005, endorsed a 1986-type income tax reform or, alternatively, a consumption tax modeled on David Bradford's X-tax, which it called a ''Growth and Investment Tax,'' coupled with a separate schedular tax on income from capital. In 2006, a few months after the president had thanked the panel and bid it goodbye, Breaux was in the Oval Office and started peering into cupboards and corners. When the President asked, ''What are you looking for, John?'' Breaux answered, ''My panel's report, Mr. President.'' This thoughtful report had disappeared into oblivion.

But, in fact, the panel's report injected some sorely needed political and practical reality into our tax reform conversation. I want to mention just two of its most important conclusions here. First, after careful consideration, this quite conservative panel rejected both the Flat Tax and a National Sales Tax, the two most popular ideas with House Republicans. In doing so, the panel concluded that continuing to tax capital income was essential for the American people to regard any tax reform as fair.

Second, and equally important, the panel concluded that any consumption tax must be border adjusted to function properly — that, regardless of the economics, border adjustments were essential to tax compliance — a conclusion I agree with, by the way. Then, surprisingly, the panel endorsed a unique form of consumption tax — a variation of Bradford's X-tax — that not only would have to be enacted by Congress, but also would require renegotiation of all of our bilateral income tax treaties and our multilateral trade treaties as well. This, I think, was a colossal mistake that inevitably consigned this panel's recommendations to history's dustbin.

Today's tax reform challenge is daunting: to reduce deficits and debt in the long-run, and simultaneously to achieve a fair distribution of the tax burden and promote our nation's economic growth. The fundamental problem is that in today's international economy the United States can no longer afford to rely so heavily on income taxation to finance federal expenditures.

What our nation needs is a new and better tax system, one that is far simpler, fair, and more conducive to economic growth. No one who has read my work will be surprised at my tax advice for the second Obama administration. Ironically, it is our nation's tax system in 1913 that points the way. The United States is a low-tax country, but we are not a low-income-tax country. Our income tax takes a share of our economic output similar to other nations. The big difference is that we are the only OECD country without a national level tax on sales of goods and services. Reforming the income tax will do nothing to change this fundamental economic disadvantage. After the Second World War, when the United States had virtually all the money there was, with Europe and Japan in shambles and China beginning to enter a dark communist period, even a horrible tax system — with income tax rates up to 91 percent — could not impede our success in the world economy. This century we can no longer afford to so hobble ourselves.

We need to restructure our nation's tax system if we want to succeed in today's global economy. I have shown that it is quite practical to combine a tax on sales of goods and services with an income tax on higher-income people that is at least as progressive as current law and also raises at least as much revenue. We need to reunite ''virtue'' and ''justice'' by moving back toward the mix of consumption and income taxes adopted in 1913. I have demonstrated how this can be done in my book, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States*. With a grant from the Pew Charitable Trusts, the non-partisan Tax Policy Center has estimated my plan. Here is what they concluded: Enacting a 12.3 percent tax on sales of goods and services could fund a $100,000 exemption from the income tax, removing more than 150 million Americans from the income tax rolls. Making this system revenue neutral, with a distribution of the tax burden similar to that of current law, could be accomplished with an income tax rate of 16 percent on income between $100,000 and $200,000 and 25.5 percent on incomes above $200,000, a 15 percent corporate tax rate, along with a debit card that exempts from the consumption tax a substantial amount of purchases and significant payroll tax offsets that together will protect low and moderate income families from a tax increase. After the fiscal cliff legislation, a third income tax rate of 30 percent or so for incomes above $350,000 or $400,000 may be necessary to maintain distributional neutrality. Small businesses with up to $500,000 or even $1 million or less of sales could be exempted from having to collect the consumption tax. Needless to say, I was relieved when the Tax Policy Center found that this plan would eliminate 111 million tax returns, freeing nearly 175 million Americans from ever having to deal with the IRS.

Gearing up to implement such a consumption tax might take businesses and the IRS up to two years after Congress enacts the law. Experience elsewhere shows that during this interval Americans would accelerate their purchases of large ticket items, such as cars, and large appliances, providing a short-term boost to our economy.

Over the longer term, such a tax reform would make the United States a much more favorable place for savings, investment, and economic growth. Most Americans would owe no tax at all on their savings, and everyone would face lower tax rates on savings and investments. The vast majority of Americans would never again have to deal with the IRS. This tax reform also would make the U.S. a much more attractive place for corporate and other investments. Importantly — unlike the other unique consumption taxes that have captured so many economists' fancy — my plan fits well with international tax and trade agreements. This system would solve the problems caused by international tax planning by multinational corporations, and, consistent with our obligations under trade treaties, it would tax imports and exempt exports, yielding hundreds of billions of dollars for the U.S. Treasury in the years ahead from sales of products made abroad.

By returning the income tax to its pre-World War II role as a relatively small tax on a thin slice of high-income Americans, there would be no temptation for Congress to use tax breaks as if they are solutions to America's social and economic problems. We have tried that, and it doesn't work.

The 1986 Tax Reform Act gave our income tax a good cleansing, but its ink had hardly dried before Congress started adding new tax breaks and raising rates. A replay is simply inadequate now to address our current economic and fiscal challenges. A dramatic reform that uses a goods and services tax to reduce our nation's reliance on income taxation is the only path forward that will, once again, embrace both virtue and justice and enhance economic growth without abandoning tax equity. We now need a major overhaul of our nation's tax system, not just another oil change and lubrication.