

**Statement of Michael J. Graetz, Professor of Law, Yale Law School**  
**At a Hearing of the Senate Finance Committee**  
**on Fundamental Tax Reform**  
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Mr. Chairman and Members of the Committee---

Thank you for inviting me to testify here today on this important and difficult subject.\*

**The Need for Fundamental Reform**

Our nation's tax system is badly broken. No one quarrels with that.

First, our nation's basic tax structure came into place in the World War II era, when the United States essentially had all the money there was. Even a horrid tax system – with income tax rates up to 91% – could not then stall our economic progress. From 1946 through 1973, when OPEC quadrupled the price of oil, the economy grew by an average of 3.8% a year and unemployment averaged 4.5 percent. Since 1973, our economy has grown more slowly and so have the wages of middle income Americans. Today, the United States' economy must compete for the investment capital essential for economic growth – capital necessary to produce a rising standard of living for the American people – with many countries throughout the world, including not only places like Europe and Japan, but also Brazil, Russia, China, and India. Our tax system should advance the competitiveness of American workers and businesses not stifle it.

Second, our tax revenues are not quite adequate to pay for our current spending, and, much more importantly, will fall short of producing the revenues necessary to fund our government after the baby boom generation retires and is collecting the benefits of Medicare and Social Security. Everyone agrees that, absent dramatic changes in our spending or tax policies, a large long-term gap between spending and revenues will emerge. An aging population and rising health care costs will make our current tax policy unsustainable. Social Security, Medicare and Medicaid benefits will likely have to be reduced somewhat, and those programs may even be dramatically restructured, but it is foolhardy to assume that taxes will not also have to be raised. While in the short-term, we need not increase taxes, down the road--even assuming that Congress reduces the costs of the Medicare, Medicaid and Social Security programs--only by

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\* This testimony is largely adapted from my recently published book: *100 Million Unnecessary Returns—A Simple, Fair, and Competitive Tax Plan for the United States* (Yale University Press 2008). References have been omitted.

restructuring our nation's tax system can we effectively finance our government. Although not all tax reformers agree on how to proceed with fundamental reform, there is now broad agreement that our situation is sufficiently grave that we must act.

Third, the scheduled expiration in 2010 of large tax cuts enacted in 2001 and 2003 builds a large tax increase into the current tax law. If Congress fails to act, income tax rates will rise, as will tax rates on capital gains and dividends, and people will lose many other current benefits, including credits for children and relief from marriage penalties. Under current law, the estate tax exemption rises to \$3.5 million next year with a 45% top rate, the tax is repealed in 2010, and in 2011 the tax comes back with a \$1 million exemption and a 55% top rate. This cannot actually occur. And, as this committee knows well, the Alternative Minimum Tax (AMT) is currently structured in a way to catch millions more Americans and must be fixed or repealed.

If the tax cuts are allowed to expire in 2011 as scheduled, the Congressional Budget Office (CBO) estimates that federal revenues will exceed 20 percent of GDP, a level reached only once since World War II. In contrast, if the tax cuts are extended and the exemption from the AMT is indexed for inflation, tax revenues will be about 18 percent of GDP. This is a large difference in revenues amounting to hundreds of billions of dollars each year. Congress therefore needs to reexamine our nation's tax laws by 2010.

If we don't solve the problem of a grossly inefficient system of raising revenues, all the other challenges our government faces will eventually be overwhelmed by one over-arching reality: we will have too little money and will lack the means to raise it without damaging our economy. Doing nothing is not an option.

Fourth, our current income tax is a mess because presidents and the Congress ask it to do too much. The result is a level of complexity that baffles experts, let alone ordinary Americans at tax time. Presidents and members of Congress from both political parties seem to believe that an income tax credit or deduction is the best prescription for every economic and social problem our nation faces. In the process, we have turned the Internal Revenue Service from a tax collector into the administrator of many of the nation's most important spending programs. To keep track of all this, the federal budget each year is required to contain a list of "tax expenditures," defined as all tax credits, deductions or exclusions that deviate from a "normal" income tax. The number of these tax expenditures has grown enormously in recent years. Forty-five percent—66 of 146—listed in the 2006 budget have been added since 1986. Their total cost in lost revenues is estimated at about \$700 billion a year.

I am not talking here about narrow special interest tax loopholes to benefit this company or that. Mostly, these are tax breaks widely available to broad

segments of the general public—tax cuts for the large middle-class. The largest of these are very popular: tax advantages for employees' payments for health insurance and retirement savings, deductions for home mortgage interest, state and local taxes, and charitable deductions.

And yet we know that trying to solve the nation's problems through "targeted tax breaks" does not work. Take health insurance, for example. Our nation, contrary to others throughout the world, has long relied on a tax benefit for employers and employees as its main mechanism for covering Americans who are neither poor nor aged. What has been the result? Our health-care costs are the highest in the world and more than 45 million Americans remain uninsured. Moreover, these costs are making American businesses and products less competitive in the world economy and are gobbling up wage increases of American workers. Nor has our tax-based energy policy produced better results. Nor do tax credits for working parents produce affordable childcare. I could go on and on.

Historically when competing policy ideas aimed at a common goal emerged in Congress, the leaders of the tax writing committees would fashion a compromise provision. Now, Congress often compromises by enacting *all* of the ideas, leaving unsophisticated taxpayers bewildered about how to cope. For a vivid illustration, consider the income tax incentives for paying for higher education. There are eight tax breaks for current year education expenses: two tax credits, three deductions and three exclusions from income. Five other provisions promote savings for college expenses. In 1987, there were only three provisions encouraging college expenditures or savings. The 1997 Act alone added five provisions that were estimated to cost \$41 billion over five years; together they represented the largest increase in federal funding for higher education since the GI Bill.

Comprehending the tax savings provided by these provisions, their various eligibility requirements, how they interact, and their recordkeeping and reporting requirements is mind-boggling. Each of the provisions has its own eligibility criteria and definition of qualified expenses. For example, they do not provide consistent treatment of room and board, books, supplies and equipment, sports expenses, nonacademic fees, or the class of relatives whose expenses may be taken into account. A student convicted of a felony for possession or distribution of a controlled substance is not eligible for one of the education credits, but such a conviction is no bar to another one. And this is just the tip of the iceberg.

Relying, as we do, on income tax deductions and credits is about as successful a solution to our national needs as handing out more gunpowder at the Alamo. We must be weaned away from using tax deductions or credits as a cure-all for our nation's ills. I believe that the only path to success is to remove most Americans from the income tax altogether.

Our income tax is a mess. Today, no matter what their income, Americans confront extraordinary complexity in filing their taxes. Today the instruction booklet spans more than 100 pages and the form itself has more than 10 schedules and 20 worksheets. No wonder more than 60 percent of income tax filers hire tax preparers (and many of the rest rely on computer programs) to tell them what to do. And tax return preparers have become notorious for peddling other products of dubious value to their customers, most notoriously so-called “refund anticipation loans,” which often advance tax refunds by a few days at an exorbitant interest cost.

The income tax has become so complex and riddled with perverse incentives that Americans spend an estimated 3.5 billion hours each year preparing and filing their taxes. Families, businesses, and the federal government now spend a staggering \$150 billion each year just to calculate and administer the system. It is \$150 billion of wasted money.

In fact, the income tax so confuses ordinary Americans that 2 million people paid more than \$1 billion extra because they made the wrong choice about whether to itemize or take the standard deduction. And while these people overpaid because of the complexity, far more pay too little –many deliberately. The IRS estimates that taxes are underpaid by about \$300 billion every year, which requires honest taxpayers to pay more than \$2,000 each to make up the loss.

In addition to these losses, the incentives in today’s tax law for unproductive expenditures, coupled with the efforts of individuals and businesses to structure their affairs in a tax-favorable fashion, are estimated to cost our economy a further \$1 trillion dollars a year. For a long time after the Second World War, we could endure such waste and hardly notice. But today, when American businesses and workers are engaged in a highly competitive global economic environment, these are costs that we can no longer afford.

## **Tax Reform Principles**

Except in extraordinary circumstances, the minimal requirement for a tax system should be that it raises sufficient revenue to pay for government expenditures. A good tax system ought to do so fairly, keeping its costs of compliance and administration as low as feasible. It ought to be conducive to economic growth. Finally, it ought to promote freedom by interfering minimally with private decision-making. Our nation’s tax system fails on every count.

It should be a simple truth that tax revenues ought to be adequate to finance the government’s spending. Economic conditions, to be sure, may

occasionally call for deficits to provide a short-term economic stimulus. And unforeseen circumstances—a terrorist attack or a devastating hurricane, to name two—may create a temporary shortfall in government collections that will take time to correct. But routinely financing government with borrowing simply shifts the taxes to our children and grandchildren, and running up interest on the federal debt will inevitably require higher taxes from someone down the road. But because “someone down the road” does not yet vote, deficit finance is catnip to many politicians. As Herbert Hoover put it, “Blessed are the young for they shall inherit the national debt.”

Deficit finance increases our economic vulnerability when it is coupled with a substantial imbalance in trade. Because we import far more than we export, other nations accumulate dollars, which they use to purchase U.S. assets, including government debt. And they are accumulating many more dollars everyday. If they were to dump those bonds or dollars on the market, it would cause a precipitous decline in the value of the dollar and might destabilize our economy. Allowing foreign governments such control over our economic well-being may ultimately prove harmful not only to our economic health but also our national interest and security. As Harvard economist Benjamin Friedman puts it: “Government deficits sustained year after year even when the economy is operating at full employment, reduce net capital formation and induce foreign borrowing. Both effects accumulate over time. Both are harmful.”

We have been unwilling either to pay for the government we have or to have a substantially smaller government. The time has come to put our fiscal house in order. We must stop pretending that we can continue to live with a tax system inadequate to finance what we are spending. Controlling that spending—and cutting it down whenever we can—should be a priority. But our federal government cannot continue to spend 20 or 21 percent of GDP while raising only 16 to 18 percent in taxes.

Although the income tax now affects nearly everyone, that hasn’t always been so. It wasn’t until World War II that the federal government expanded the income tax beyond wealthy individuals to tax nearly all middle and moderate income Americans. Sixty years later, this system is badly broken and unable to produce adequate revenues for the future without threatening economic growth. Relying as heavily as we do on income tax revenues to fund our government has become a liability in the current competitive international marketplace. In a world immeasurably more interdependent than the world of the mid-twentieth century, when our current system of taxation took shape, a vital question for any reform proposal is: Will it make American workers and businesses more competitive in the global economy, while maintaining the progressive structure that fits with our nation’s historical insistence on fairness?

We need a tax system that will encourage investment in the United States to create good jobs and will help make the goods and services our businesses and workers produce more affordable to consumers around the world.

Let me conclude this brief discussion of principles with a few words about the fair distribution of taxation's burdens.

In our country today, the gap between the wealthy and the poor is wider than it has been in a long time. One has to go back to the 1920s to find a chasm so big between the ultra-wealthy and the least well off in our society. Some insist that to even notice this fact, much less do something about it, amounts to an endorsement of some utterly leveling socialism or even communism. This is nonsense. And dangerous nonsense at that. As Andrew Jackson and Teddy Roosevelt, to name just two, understood, the establishment of a permanent economic aristocracy is inimical to the American ideal of fairness for all its citizens. George W. Bush in February 2007 recognized the issue: "The fact is that income inequality is real; it's been rising for more than 25 years." And Henry Paulson, in his first speech as Bush's Treasury Secretary identified "wage growth and income distribution" as one of the major economic challenges facing our nation. Any serious reform of our tax system must retain as one of its first principles the progressive structure we have used for nearly a century.

As James Q. Riordan, a staffer for the conservative Tax Foundation said, "the need for a progressive tax system is imprinted on the American DNA." This sentiment has been echoed by the liberal congressman Richard Neal (D. Ma.) who said "From the Boston Tea Party to now, tax fairness is firmly parked in the American psyche." The need for a progressive tax system is not a partisan issue.

Today's tax reform debate has re-opened the contest between what Stephen Weisman in his book *The Great Tax Wars*, labeled "virtue", on the one hand, which views "wealth as a product of hard work, thrift, ingenuity and risk taking"--something the state should encourage and protect--and "justice", on the other, which, according to Weisman, is taxation based on ability to pay with progressive taxes on income or wealth. Weisman, like most Americans, views progressive taxation as necessary to "soften the edges of the distribution of wealth in the interest of justice and fairness".

Drawing appropriate lines in the battle between virtue and justice has always haunted tax lawmaking. Today's tax reform debate raises fundamental questions that many thought were settled by the enactment of the income tax nearly a century ago--- questions that have not been at issue since the income tax was extended to the masses to finance World War II. Advocates for replacing the income tax with a "flat tax" or a national sales tax are quite willing to sacrifice tax justice to promote economic virtue and reward success. One need

not view the current tax distribution as ideal to know that tax reform should not be used to shift the tax burden away from those at the top down the income scale.

In addition to producing a simple tax system that will raise adequate revenue without inhibiting economic growth, the critical challenge for tax reformers today is to fashion a tax reform that will better reward virtue and promote economic growth *without* sacrificing tax justice, *without* shifting the tax burden downward. Last century's solution--the progressive rate income tax--has fallen into disrepair and disrepute. Relying--as we now do and have since World War II-- exclusively on the income tax as the solution to this dilemma no longer seems wise.

The current income tax is a horrible mess. But it is quite progressive today. More than two-thirds of the total income tax is paid by the highest 10% of earners, more than one-third by the top 1 percent. It is impossible to duplicate this distribution by substituting a flat rate tax on consumption for the income tax. In restructuring our tax system, we need not, and should not, enact a massive tax reduction for the country's wealthiest people--those who least need such relief--while increasing taxes for those with less income or wealth.

In 1986, Congress was able to achieve a bipartisan tax reform only by agreeing to leave the distribution of the tax burden as it was. Maintaining the existing distribution of the tax burden may somewhat complicate the task of tax reform and limit the options available, but, at a minimum, it is essential if reform is to be fair. Despite several tax reform plans currently before Congress that throw into question the century-old American principle that taxes should be distributed in accordance with people's ability to pay, replacing much of our income tax with a tax on goods and services need not strip away the progressivity we have in our system. As the Competitive Tax Plan, described in my recent book, demonstrates, this distribution can be maintained with a new mix of taxes in a far simpler system that can produce adequate revenue as our population ages--and in a manner much more conducive to economic growth.

## **Tax Reform Alternatives**

Tax reform will not be an easy task. When this committee and the Congress tackle tax reform, you will not have the luxury of federal budget surpluses that might be tapped to finance an-overall tax cut to sweeten the bitterness from the inevitable reduction and elimination of many tax breaks. This option was available in 2001, but the president and Congress took a different path.

### *Income Tax Reform*

Although an income tax was used to help finance the Civil War, it did not become a permanent part of our nation's financial picture until World War I. The

corporate income tax dates from 1909, but it was not until after the 16<sup>th</sup> Amendment was ratified in 1913 that a tax on individual incomes was enacted. From the end of the Civil War until 1913, the federal government raised its revenue almost exclusively from tariffs on imported goods and excise taxes on this or that. By the beginning of the 20<sup>th</sup> Century, however, there was great dissatisfaction with this system. Tariffs and excise taxes raised the costs of goods for everyone, while large fortunes accumulating in real estate, corporate stock and other investments were left untaxed. In 1893, for example, an Atlanta newspaper complained that “most of our tariff taxes...fall heavier on the poor.” The income tax was adopted—with the extraordinary public support necessary to amend our constitution—to fund a reduction in tariffs and to counterbalance the effect of taxes on consumption with a tax more closely linked to people’s ability to pay. When first enacted, the income tax was expected to contribute only a small portion of ordinary government revenues and to supplement other revenue sources in times of emergency.

So the income tax was not originally supposed to play the central role in financing the federal government that it now does. Until World War II our income tax had exemptions that shielded most Americans from having to pay it. During World War I, these exemptions were lowered and rates increased so that the income tax played a crucial role in financing the war, but after that war ended, the tax was rolled back to its original limited scope. From 1918 to 1932 only 5.6 percent of the population filed taxable income tax returns, and from 1933 to 1939 that number dropped so that on average only 3.7 percent of the total population filed taxable returns. Public opinion polls in 1938 and 1939 showed large majorities of Americans favored an exemption level that would exclude at least 75% of the population from income taxes. Thus, through the economic shocks of the Great Depression and the creation and expansion of the New Deal, the reach of the income tax remained quite limited: true to its original conception, it was a low-rate tax on a relatively small group of higher-income Americans. But World War II changed everything.

Legislation in 1940 and 1941 increased the number of Americans subject to the income tax by 400 percent, from 7.4 million to 27.6 million. After the U.S. entered the war, the number of income tax payers expanded dramatically. By 1943, taking into account both the regular income tax and a so-called “Victory Tax” (a 5 percent tax on incomes over \$624) 50 million Americans—nearly 70 percent of the population—were required to file income tax returns.

As we now know, the imposition of the income tax on nearly the entire population has led to perverse results in terms of complexity and congressional policy making. And as our history shows us, it needn’t be so. What we should do now is return the income tax to its original, manageable purpose. That is the collection of a simpler tax on high-income earners who tend to have multiple income sources.



The Tax Reform Act of 1986 was widely heralded as the most significant change in our nation's tax law since the income tax was extended to the masses during World War II. It was the crowning domestic policy achievement of President Ronald Reagan, who proclaimed it "the best anti-poverty measure, the best pro-family measure and the best job-creation measure ever to come out of the Congress of the United States." The law's rate reductions and reforms were mimicked throughout the OECD. Even at the time, however, reading the paeans to this legislation was like watching a Tennessee Williams play: something was terribly wrong, but nobody was talking about it.

Two decades later, the changes wrought by the 1986 act have proven neither revolutionary nor stable. The legislation was a rearrangement of the income tax law in which marginal tax rates were reduced and the tax base was broadened by limiting or eliminating various loopholes, deductions, and exemptions. The act did enhance both the equity and efficiency of the income tax, but it was far from the purist cleansing of the tax code that some of its more ardent admirers implied.

The 1986 act substantially increased the permissible amount of tax-free income, removing about six million low-income people from the income tax rolls; 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 family members subject to lower tax rates; and taxed capital gains at the same rates as ordinary income. An increase in corporate tax revenues was used to finance an overall reduction in individual income taxes, although, by cutting back on deductions for plant and equipment, Congress found the money to reduce the corporate tax rate (from 46 to 34 percent).

The Tax Reform Act neither spurred American productivity, as some of its admirers hoped, nor destroyed it, as many of its detractors had warned. University of Michigan economist Joel Slemrod estimated that the 1986 Act may have spurred as much as a 1 percent increase in hours worked -- a genuine benefit, but hardly a new American revolution. In addition, the act ultimately fell short of creating a substantially fairer income tax because it left in place many avenues for tax-favored treatment. Complex new rules limited personal interest deductions to homeowners, disadvantaging renters who lost their ability to deduct interest on their credit cards. Many provisions offering incentives for specific investments were continued, and new ones were added. Hundreds of scatter-shot "transition" rules were enacted to give special tax breaks to particular companies or individuals.

Compromise is often the handmaiden of tax complexity, and the 1986 legislation was forged out of hundreds of political compromises. Rather than eliminating provisions of dubious merit, Congress settled for reducing their benefits or restricting their use. Examples abound: the tax law now contains rules distinguishing at least 17 different categories of interest expenses; the 1986 rules

for international investments were stupefying in their complexity; and the alternative minimum tax (AMT) provisions require two different ways of calculating income, each with its own rate schedule.

In the two decades since 1986, Congress has amended the code annually, adding thousands of pages of new legislation. In retrospect, the inherent weaknesses of the 1986 Tax Reform Act have become easy to identify. First, as I have said, the fragile political coalition that enacted the law left in place a variety of ongoing complexities, inequities and inefficiencies. Second, the 1986 Act had little public support even when it was passed. Third, and most importantly, the 1986 tax act was based on retaining and strengthening the income tax itself, rather than heeding the calls of many economists and politicians to replace all or part of it with some form of tax on purchases of goods and services.

Given the internationalization of economic activity during the past two decades, the 1986 Act's reliance on increased taxation of income from capital and corporate income has made the United States economy less competitive with other national economies that tax corporate income at a relatively lower rate. For all these reasons, tax experts now regard the 1986 Act as a promise failed. There are, however, many people who continue to think that the best path for tax reform is to reprise the 1986 Act and simply improve the income tax.

### *Income Tax Reform Proposals*

There are two recent prominent proposals for income tax reform, echoing the 1986 reform, that I shall discuss here. The first is the "simplified income tax" (SIT) proposal offered by President Bush's tax reform panel; the second is the "Fair Flat" tax proposal introduced in Congress in 2005 by Senator Ron Wyden (D. Ore.) and Congressman Rahm Emmanuel (D. Ill.). Both would eliminate the AMT and cut down on deductions and other tax breaks to pay for it.

Two weeks before George Bush's second inaugural, on January 7, 2005, he issued an executive order establishing the "President's Advisory Panel on Federal Tax Reform." He charged it to submit to the Treasury Secretary "revenue neutral options for reforming the Federal Internal Revenue Code." Bush picked two former senators to head this group: Connie Mack (R. Fla) and John Breaux (D. La).

Bush's nine-person panel traveled the country, holding twelve public meetings in five states and in Washington D.C. It took testimony from experts of all political persuasions, who offered devastating criticisms of the current income tax and many suggestions for how to fix or replace it. In November 2005, four months later than originally anticipated, the panel issued a 272 page report detailing two proposals that it supported unanimously and a third option, closely related to the plan I recommend in my recent book, which it described as "worthy

of further discussion.” The panel also explained in detail why it had rejected complete replacement of the federal income tax with a “flat tax” or a national sales tax.

With its extensive study and thoughtful report, the president’s hand-picked panel injected an unwelcome dose of reality into the tax reform debate. The panel’s report carefully considered the two ideas that have garnered the most political support among congressional Republicans--a “flat tax” and a national sales tax--and rejected them both. Instead, the panel proposed two alternatives: an income tax restructuring along the lines of the 1986 tax reform and the combination of a new consumption tax with a tax on some income from capital. Both of the panel’s two recommended plans would (1) reduce the top marginal tax rate—to 33 and 30 percent respectively; (2) eliminate the alternative minimum tax (AMT), which now requires people to calculate income tax two different ways and pay the higher amount; (3) replace the earned income tax credit and refundable child credits with a refundable “work credit”; (4) replace personal exemptions, the standard deduction, and child tax credits with a “family credit”; (5) eliminate all deductions for state and local taxes; (6) extend tax breaks for interest on home mortgages and charities to non-itemizers, but reduce the amounts that can lower tax; (7) cap the fringe benefit for employer-provided health insurance; and (8) expand and simplify tax-favored savings opportunities. President Bush’s panel also would maintain, but revise, the tax benefits for dividends and capital gains. Both plans also would eliminate many other income tax deductions and credits.

Once the Panel decided to eliminate the AMT, which would cost more than \$1 trillion during the next 10 years, it was not able to reduce tax rates much and it had to struggle to find offsetting revenues. This required attacking political sacred cows, such as the mortgage interest deduction, the charitable deduction and the deduction for state and local taxes.

The Wyden/Emmanuel proposal has much in common with the panel’s plan, but there are some important differences. It has three tax rates—15, 25 and 35 percent. It would also eliminate many deductions, exclusions and credits and promises a shorter tax form. Senator Wyden and Congressman Emmanuel would retain many of the most popular provisions, including deductions for home mortgage interest and charitable gifts, the EITC and child credits, savings incentives for healthcare, retirement and education, and various benefits for the elderly, disabled, soldiers and veterans. They also would add a new refundable credit for 10% of state and local taxes. And they would tax dividends and capital gains at the regular tax rates.

For those interested in more detail, the table at the end of this testimony contains a side-by-side comparison of the main features of the two plans. As Senator Wyden has said, both would give the tax code “a good cleansing.” He adds that this is what the “tax code desperately needs.”

While either of these proposals would certainly improve current law, they do not, in my view, go far enough. As we now know, it doesn't take very long after a "good cleansing" for things to get very dirty again. Even those who applauded the 1986 Act as a wildly successful tax reform must concede now that this legislation was not a stable solution. Over time, many of its 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? What the nation needs is a new and better tax system, one that is far simpler, fair, and more conducive to economic growth.

It is the central contention of my book, and the centerpiece of my proposal, that the fundamental reform required to create an internationally competitive, administratively efficient, and viable long term solution to our funding requirements is to make a different choice. We should eliminate the income tax for the overwhelming majority of Americans and replace it with a broad-based tax on sales of goods and services. While I am by no means the first to propose the adoption of a consumption tax, my plan, unlike some national sales tax proposals such as the "FairTax" currently making the rounds in our capital, offers a non-ideological, reasoned, fiscally sound, and feasible way to modernize our tax system.

### *A Role for Consumption Taxes*

When it comes to meeting its funding requirements, a government has four basic choices as to what it can tax: income, wages, consumption or wealth. From these four basic categories of revenue, we in the United States have since World War II chosen two—income and wages—as our primary forms of government funding. While it is true that our Federal government has at one time or another imposed more than fifty kinds of taxes on everything from filled cheese to cotton futures, from telegraph messages to the manufacture of tires, none of these revenue streams could ever suffice today to fund today's government budget. Put together, our individual and corporate income taxes along with our payroll tax on wages account for about 92% of federal revenues annually. State and local governments rely on their own versions of these taxes in addition to taxes on sales and property. And while the federal government imposes a handful of excise taxes—on alcohol, tobacco and gasoline, for example—unlike the rest of the world, we do not have a national tax on the third category, consumption. That is a tax on people's purchases of goods and services.

Overall, the U.S. is a relatively low tax country. But we are not a low income tax country. Looking at total taxes including federal, state and local taxes, as a percentage of total economic output (GDP) the U.S. at about 25 percent (including state taxes) has considerably lower taxes than the EU, which averaged about 40 percent before the recent addition of 10 new lower-tax

members, mostly from eastern Europe. Our taxes are also lower than the approximately 36 percent of GDP average of the thirty countries of the Organization for Economic Cooperation and Development (OECD). Our income tax level is comparable, however. We collect about 12 percent of our GDP in corporate and individual income taxes, while the OECD nations average about 13 percent and Europe around 14 percent. The biggest difference in our tax structure is that most other nations rely much more heavily on consumption taxes than we do. Indeed, we are the only OECD nation that does not impose a national-level tax on sales of goods and services.

The most common types of modern consumption taxes are retail sales taxes and value-added taxes (VATs). As you know, retail sales taxes in the United States are commonly imposed by state and local governments. States vary in their sales tax coverage and exemptions, and many local governments also impose sales taxes. In 2006 there were 7,588 separate retail sales tax jurisdictions in the United States. Large multi-state corporations commonly file more than 200 different state and local sales tax forms monthly.

Elsewhere in the world, the most common form of consumption tax is the VAT, a tax on value-added. The difference between the value of a business's purchases and its sales is the value it has added to its products or services, and it is this increase in value that is taxed. A VAT is much like a retail sales tax, except in a value-added tax system it is not only retailers who collect the tax and pass it on to the government. Wholesalers and manufacturers also withhold tax as a product moves through the chain of production, distribution, and sale. In other words, a retail sales tax only taxes sales to directly to consumers, while a VAT collects a portion of the tax at each level of production. The cumulative value added at all stages of production and distribution of a good or service necessarily equals the total value of the retail sale, with the result that a retail sales tax and a VAT of the same rate are economically equivalent.

After reading the previous paragraph it might sound as if the real difference between a retail sales tax and a VAT is that the VAT simply taxes more levels of production. Indeed, many people who oppose such taxes characterize them as if they actually taxed the same retail sale many times. This, however, is simply incorrect. In a value-added tax, businesses receive a tax-credit for the amount of VAT they have paid on their own purchases of goods and services from other businesses.

Value-added taxes are now imposed by all of the other OECD countries and by nearly 150 countries worldwide. In the OECD, the VAT rates range from a low of 5 percent in Japan to a high of 25 percent in Sweden, Hungary, Norway, and Denmark. In Ireland—which has been called by the *Wall Street Journal* the “Hong Kong of the west with the fastest pace of economic growth and jobs in the Eurozone” for its low 12.5% corporate tax rate—and other low income tax

countries, VATs generate significant revenues that make low income rates possible. Ireland, for example, imposes a VAT at a 21% rate.

Another key feature common to consumption taxes, regardless of how they are structured, is that the total tax base is generally sales, and thus the tax does not impose any burden on savings or investments. If a person spends less than her current income, the difference—her savings—is exempt from taxation. If a person spends more than her current income by either drawing down prior savings or borrowing to finance the spending, a consumption tax should be imposed on such spending.

Our federal government has frequently considered imposing a national consumption tax. For example, in 1921, when the income tax was only eight years old and a fraction of its current size, Ogden Mills, then a Congressman from New York, who later served as Herbert Hoover's Secretary of the Treasury, argued that Congress should substitute a tax on "spendings" for the income tax. Mills' proposal for taxing consumption rather than income was not a new idea, even in the 1920s. John Stuart Mill had been a fan of taxing consumption, and Alexander Hamilton had only praise for consumption taxes.

In 1942 Franklin Roosevelt's Treasury Secretary Henry Morgenthau advanced a progressive, graduated rate tax on spendings to finance the Second World War, but Congress again rejected it. Instead, the Revenue Act of 1942 began the conversion of the income tax, which had applied only to high income people, into a tax on the masses. Had this episode turned out differently, the income tax might have remained narrowly targeted to high income people, and a consumption tax, rather than the income tax, might have become the federal government's mainstay revenue raiser.

After that, from time to time, presidents and members of Congress have considered taxing consumption rather than income, but when Ronald Reagan and the Congress retained and strengthened the income tax in 1986, rather than replacing it with a consumption tax, many observers thought that signaled the demise of the political movement to replace all or part the income tax with a consumption tax.

After the Republicans' sweep of the Congressional elections of 1994, however, proposals for substituting a consumption tax for the income tax vaulted back into the forefront of the nation's political dialogue. Republican Senate Budget Committee Chairman Pete Domenici of New Mexico and Democratic Senator Sam Nunn of Georgia in 1995 introduced legislation to replace the individual income tax and a portion of the social security payroll tax with a progressive rate tax on consumption and to substitute a valued-added tax for the corporate income tax. Ways and Means Committee Chairman Bill Archer of Texas and 1996 Republican Presidential candidate Senator Richard Lugar of Indiana said that they too wanted to replace the income tax with a consumption

tax. Chairman Archer never said what kind of consumption tax he favored. Senator Lugar proposed a retail sales tax to be collected by the states, which he claimed would put the IRS out of business. This torch is now being carried by Congressman John Linder and the “FairTax” movement. In 1995 Dick Arme of Texas, the new Republican majority leader, and Republican Presidential candidate Steve Forbes urged replacing the corporate and individual income taxes and the federal estate tax with a flat-rate tax on consumption –a variation of a subtraction-method value added tax-- which they call a “flat tax”. The Princeton economist David Bradford added a second rate to the flat tax to make it more progressive and named this the X-tax. In 2005 President Bush’s tax reform panel added a third rate and a supplemental income tax on dividends, interest and capital gains, turning it into a hybrid of an income and consumption tax, and called it the “Growth and Investment Tax Plan.” All the rejiggering and relabeling makes it impossible for the public to know exactly what kind of tax system is being proposed.

The recent ascendancy of consumption tax proposals raise three fundamental questions. First, should the United States adopt a national tax on sales of goods and services? Second, if so, in what form? How should such a tax be structured? And, third, what should the revenues from such a tax be used for? In particular, what other tax reforms should accompany introduction of a national consumption tax? The answers to these questions will determine whether and how much tax reform will improve the simplicity, fairness and economic wisdom of our tax system.

The simplification advantages of a consumption tax depend on how it is implemented. Retail sales taxes and VATs are collected from businesses rather than families, greatly easing the compliance burdens of households and freeing them from having to deal with the tax collector. Other forms of consumption taxes such as the “flat tax” (which is a consumption tax although the public may believe it to be an income tax) tax the wage element of value added to individuals and thus require households to file tax returns. Since under the “flat tax” only wages would be taxed to individuals, and all deductions, exclusions and credits would be eliminated, its proponents claim that the annual return will shrink to a postcard that everyone would be able to fill in quickly and easily. Adding more than one tax rate as, for example, the president’s panel recommended, does not substantially complicate matters.

The fact is, both the flat tax and the GIT are variations on a form of value-added tax that in fact resembles an income tax. They are what is called “subtraction-method value-added taxes.” This kind of VAT taxes the difference between the total receipts from a business’s sales of goods or services and the total amount of the business’s purchases of goods or services from other businesses. The difference between sales and purchases is the business’s value added and the tax rate is applied to that amount. This subtraction-method VAT seems to be enjoying great favor among some consumption tax advocates.

At the same tax rate, a retail sales tax, a subtraction-method VAT and the much more common credit-method VAT should produce similar results. The flat tax and the panel's GIT proposals essentially split the collection of a single rate subtraction-method value-added tax between businesses and individuals. Rather than denying businesses any deduction for wages, as is usual under a value-added tax, the flat-tax allows businesses to deduct wages in addition to purchases from other businesses. This type of consumption tax is collected at each stage of production, as under a typical value-added tax, except that the tax on wages is directly remitted by individual wage-earners. In combination, the total of the business and individual tax bases should equal total sales, putting aside any exemptions.

The principal advantage of dividing a value-added tax between businesses and individuals is that it enables the exemption of a certain amount of wages from tax and may thereby eliminate, for wage earners, the regressivity of a standard flat-rate tax on consumption. The amount of the exemption or standard deduction will, of course, vary depending on the flat tax rate and the other exclusions, deductions or tax credits allowed. (As my recent book details, there are other methods of addressing this issue under a VAT or retail sales tax.) This division of the consumption tax base tax also allows the imposition of progressive rates on wages, as the panel's GIT demonstrates, though it is a bit mysterious why only wages and not investment income should be subjected to progressive tax rates.

Two problems remain, however. First, the flat tax (and its variations) are consumption taxes invented by academics, which are untried and untested anywhere in the world. All experience warns us that even if such a tax could be enacted in its pure form with all deductions, exclusions and credits eliminated—a real long shot—the tax would stay neither pure nor flat for very long. Tax breaks for homeownership, charitable gifts and education expenses, to name only a few, would soon make their way back into the tax code. Second, as the president's panel discovered, taxing only individuals' wages and not their income from investments offends our notions of tax justice. This is why the panel—hardly a bunch of liberals and none of whom, as John Breau has reminded us, is standing for re-election—coupled their consumption tax proposal with a tax on interest, dividends and capital gains, albeit at a lower 15% rate. The panel concluded -- correctly in my view -- that the American public will not accept taxing families only on their wages and not on the income they receive from their investments or savings.

In the 1990s Senators Sam Nunn and Pete Dominici proposed coupling a VAT with a progressive rate tax on consumption—a so-called expenditure tax. The Senators called their tax a "Uniform Savings Allowance," or "USA" tax. The senators designed their proposal this way to avoid the substantial tax cut for high-income families which would occur under flat-rate consumption taxes that



entirely replace the income tax. Again, unlike the VAT or retail sales tax, a progressive consumption tax is essentially untested, although it has long been discussed and often applauded in academic circles. Only India and Sri Lanka have ever enacted an expenditure tax, and both repealed the tax shortly after it was enacted.

Senators Nunn and Domenici modified the standard form of expenditure tax in an effort to make their proposal more appealing politically. Their proposals would exempt, for example, much consumption financed out of sales of people's existing assets and would defer the tax on consumption from borrowed funds. These modifications required complex rules to track both borrowing-financed consumption and consumption from dispositions of pre-enactment assets. Indeed, the Nunn-Domenici plan floundered because of its inability to solve problems of transition from an income tax to this type of consumption tax and its failure to tax consumption financed with borrowing. In combination, these two problems allowed people with assets or the ability to borrow to avoid the tax. The personal tax was essentially a tax on wages, but by borrowing for consumption and reinvesting the proceeds of asset sales, people could have avoided even the wage tax. Senators Nunn and Domenici also concluded that it was necessary politically to retain a number of existing income tax preferences, including, for example, not taxing interest on state and local bonds. This created other opportunities to consume tax free.

The Nunn-Domenici experiment suggests that enacting a coherent progressive tax on consumption is probably not politically viable. This is hardly surprising since no other nation relies on such a tax.

What all this history of attempts to enact a consumption tax teaches us is that in order for such a tax to become a politically viable alternative to our current income tax system it will have to produce an outcome that is better for businesses, better for savings and investment, feasible, and fair to moderate-income Americans. I believe that my proposal, which is described briefly below, meets these criteria. Unfortunately, other plans currently popular in Washington don't.

For example, both the "flat tax" and "FairTax" proposals would reduce taxes on those at the top and make up the lost taxes from people with less income or wealth. This seems particularly inappropriate when between 1979 and 2006 the income of the richest one percent of Americans nearly doubled, while the income of middle-class Americans increased by only about 11½ percent, according to the most reliable numbers. Over the same period, the wage at the 10<sup>th</sup> percentile, near the bottom of the wage distribution, rose just 4 percent, while the wage at the 90<sup>th</sup> percentile, near the top of the distribution, rose 34 percent. The share of after-tax income garnered by the top 1% of households increased from 8 percent in 1979 to 14 percent in 2004. Even within the top 1 percent the distribution of income has recently widened. And although the

nation's economy grew by 11.7% in the period 2001-2005, the income of the median household fell by 0.5% in that period.

Wealth is even more unevenly distributed than income, with the wealthiest one percent owning about one-third of all wealth in the United States. The bottom 50 percent hold just 2¼ percent of all wealth. As University of Chicago economist Austan Goolsbee has pointed out, "The average net worth of the top 10 percent of American families is almost 30 times greater than the average net worth of families in the middle 50 percent of the spectrum -- and these disparities in net worth have been growing even faster than the disparities in income."

To be sure, people move in and out of these wealth and income classes; some of the rich lose money and some poor people become rich over time. But, while Americans can debate forever what constitutes a fair distribution of taxes, surely it is not appropriate to shift the tax burden downwards now when those at the very top are doing so very much better than everyone else. This, however, is exactly what proposals like the "flat tax" and the FairTax would do.

Those who advocate such a shift claim it to be essential for economic growth, but they offer little credible evidence for that proposition. They also cite polls showing that many people regard a single tax rate as "fair." Their opponents shout: "Tax cuts for the rich, tax cuts for the rich." And they reply, "class warfare, class warfare." This shouting match is a prescription for stalemate—or, if something is enacted, for future instability and uncertainty.

#### *A Major Problem with Many Consumption Tax Alternatives: They Do Not Work Well Internationally*

Every schoolchild knows that we live in a more globally competitive economic environment than we did in the years of the post-war economic boom. American businesses and workers are now competing with a vastly increased array of foreign companies and economies. In the 1960s the total value of all our imports made up just 3.2% of our GDP. By 2005, that number had risen to 13.6%. Amidst all the talk of how to make our economy more competitive, one issue that is rarely brought to the public's attention is the idea that our tax system might itself be a drag on our economic efficiency in the realm of international trade and investment.

While my proposal would harmonize our tax system with international standards and thus open up the possibility of real cost-savings for companies doing business in more than one nation, the unusual nature of the methods used to collect the flat tax and GIT create large difficulties under our international tax and trade treaties. The value-added taxes of the standard credit-invoice sort that I am proposing fit well with these agreements. They can be—and usually are—imposed only by the country where the consumption takes place. They therefore tax imports and exempt exports, so that the location where a good is produced is

irrelevant. In contrast, income taxes are typically imposed on all domestic production and the tax on production abroad is generally ceded to the country where the production occurs.

Mostly for compliance reasons, the president's panel decided—rightly in my view—that any U.S. consumption tax should be border adjusted and imposed in the standard manner: on a destination basis. Otherwise, imports would not be taxed but exports would. The latter kind of tax is said to be imposed on an “origin” basis. This occurs under the flat tax. Thus, for example, if Ford sells cars manufactured in the United States to be used in the United States, their full retail sales value would be included in the flat tax base. Likewise, if Ford or any other U.S. automobile manufacturer sells automobiles in the U.S. to a foreign dealer for use abroad, the manufacturer's sales price would be subject to the U.S. flat tax. But a U.S. dealer of cars made in Japan, Germany or another foreign country would be taxed only on the excess of the dealer's total receipts from its sales over the costs of the cars from the foreign manufacturer. As a result, the costs of manufacturing cars abroad would not be included in the U.S. consumption tax base; only the foreign car dealer's markup would be subject to U.S. taxation.

Economists, including the inventors of the flat tax, claim that we should be indifferent to this distinction because currency exchange rates — the value of the dollar relative to other currencies — will adjust to compensate for these tax differences. But U.S. automobile manufacturers and other U.S. companies that compete with products from abroad will not readily accept the economists' assurances that exchange rates will adjust so perfectly. Especially when the country with whom we have the largest trade deficit, China, has yet to allow its currency to float freely against the dollar. Domestic businesses undoubtedly will resist rules that impose a U.S. tax on the full retail price of products manufactured in the United States, but tax only the dealer markup of products manufactured abroad. They will view such a tax as fundamentally unfair to American businesses and perhaps as seriously disadvantaging U.S. manufacturers competitively. Moreover, the president's panel determined that imposing a consumption tax on an origin basis would raise major enforcement difficulties. In my view, border adjustments of a consumption tax will be an important -- perhaps even decisive -- issue.

The president's panel acknowledged that its recommended consumption tax, the GIT, along with other consumption taxes such as the flat tax, which allow businesses to deduct wages and tax the wages to individuals, cannot be imposed on a destination basis without violating our major trade treaty (the GATT) and all 86 of our existing bilateral income tax treaties. Tax reform proposals so out of sync with international trade and tax arrangements to require renegotiation of all our trade and tax treaties are essentially unrealistic.

It is puzzling to me that U.S. economists and policy-makers have struggled to fashion novel consumption tax alternatives, like the flat tax or the Growth and Investment Tax, when there is a well-functioning consumption tax—the value-added tax—being used throughout the OECD and in nearly 150 countries worldwide. Given the interconnectedness of the world economy, this does not seem the right place to insist on American exceptionalism.

While, as we have seen, there are a variety of methods for imposing and collecting a consumption tax, the best alternative is the credit-invoice method of the sort used throughout the world. Experience demonstrates that such a tax works well. Since sellers of goods and services collect taxes and receive credits for VATs paid on their purchases, tax revenues are collected regularly throughout the year from companies at all levels of production, rather than just from retailers, thereby easing enforcement. A credit-method VAT also facilitates exemptions for small businesses (and for specific goods or services if such exemptions become necessary politically). The key point is this: the consumption tax should be collected only from businesses, and the tax should be imposed on a broad enough base to raise sufficient revenues to free the vast majority of Americans from any income tax liability and any requirement to file tax returns.

Consumption taxes are used in the states and throughout the industrial world as a part of tax systems that typically also contain progressive income taxes. Clearly consumption taxes have a role to play as a part of a modern tax system. Enacting a VAT—a national sales tax with withholding by businesses other than retailers—would permit a major restructuring of our tax system into one that is vastly simpler and far more conducive to savings, investment and economic growth. And this can be accomplished in a way that is fair, a way that neither increases the tax burden of low and moderate-income taxpayers nor shifts taxes away from those at the top of the income scale. There is a limit, however, to how much we can rely on consumption taxes to finance our government. Today, we rely too little on such taxes, but those who would rely solely on such taxes to finance the federal government are playing Pollyanna. A national sales tax at a rate of 30% or higher, as the FairTax plan requires, for example, is much higher than elsewhere and is simply not a practical alternative.

### *Corporate Income Taxes*

An important goal of tax reform should be to create better conditions for American workers and businesses, domestically and internationally. America needs to be an attractive place for both domestic and foreign investments, and American companies need to be positioned to take full advantage of the new global marketplace.

In order for this to happen, as part of the overall reform of our tax system, we should lower corporate tax rates considerably. My proposal calls for reducing the corporate income tax rate to 15% to 20%. This would improve the competitive

position of the American economy, reduce tax-sheltering behavior, and if done right, need not worsen our fiscal position.

The corporate income tax is an odd phenomenon, even by the mysterious lights of the tax law. Corporate taxes are quite popular with the public. People think the taxes remitted by corporations, especially large multinational companies, are paid by someone other than themselves. But as Paul H. O'Neill, George W. Bush's first Treasury Secretary, observed, "corporations don't pay taxes, they collect them."

The question: who actually bears the economic burden of corporate income taxes—who ultimately pays them—has tormented public finance economists since the tax first came into existence. Three candidates come instantly to the fore: people who own the companies, people who work for the companies, or people who buy the companies' products. Since the tax may affect wages, prices, and/or returns to capital, economists believe that workers, consumers, or owners of capital generally may bear the economic costs of the tax. For many years, the conventional wisdom among economists was that the tax principally reduced returns to capital, at least in the short run, and thus the tax was considered to be quite progressive, even if economically distortive. Ultimately, however, the reduced capital due to the tax might result in lower wages, so in the long run, workers may pay. As the economy has become more open internationally, recent economic studies have concluded that the tax is less likely borne by capital generally, but rather by consumers or workers. A number of recent studies claim that more than half the burden, maybe three-fourths, burdens workers. The uncertainty in the economics profession contributes to the public view that the tax is probably paid by someone else.

Economists are unanimous, however, that the corporate income tax is a bad one. It creates incentives for investing in noncorporate businesses and housing instead of corporations, and it induces many distortions in corporate finance. For example, since interest but not dividends are deductible and thereby not subject to the corporate tax, the tax creates a bias in favor of debt over equity finance. The combination of individual and corporate income taxes also has created an advantage for corporations to repurchase shares rather than paying dividends. The invention and deployment of innovative financial products has added new distortions as companies structure their financial transactions to achieve income tax advantages. And the internationalization of businesses, along with the greater mobility of capital, has made collecting corporate income taxes much more difficult. Companies, for example, now routinely manipulate their corporate structures, finances and inter-company prices to take advantage of lower corporate tax rates in other countries. These are just some of the reasons that economists hate a tax the public seems to love.

## A Tax Reform Plan

Mr. Chairman, I know that the purpose of this hearing is to examine broad issues of tax reform and that it is premature for you to seriously consider reform alternatives. I cannot, however, resist this opportunity to describe briefly here the proposal that I have detailed in my recent book. This plan would allow our government to raise the necessary revenues without limiting our nation's economic potential. It would substitute a tax on goods and services for much of the income tax, thus freeing the vast majority of Americans from having to deal with the IRS at all. Unlike many other tax reform plans that have been advanced, it would not shift the tax burden away from our wealthiest citizens to people with less income. It would be far simpler and less costly for the American people to comply with. It would be more favorable to savings, investment and economic growth than our current tax system. And it would fit well with international arrangements and improve the competitiveness of American businesses and workers. Finally, it would stop the madness of relying on tax breaks as the solution to the nation's social and economic problems.

Unlike some other ideas that have become prominent in our political debate, this plan does not undermine our nation's longstanding and fundamental commitment to justice--to using progressive taxes as a fair way to alleviate our great inequalities of income and wealth. Nor does it, on the other hand, simply tinker once again within the interstices of our broken income tax as a way of responding to wasteful complexities and economic shortcomings.

The plan centers on eliminating the income tax for nearly all Americans. In doing so, we would return the income tax to its pre-World War II status—a low-rate tax on a relatively thin slice of higher-income Americans. A value-added tax imposed at a 10% to 14% rate could finance a \$100,000 family exemption from income tax, eliminating 150 million Americans from the income tax rolls and allowing a simpler income tax at a 20 to 25% rate to be applied to incomes over \$100,000 and a low 15 to 20% tax rate on corporate income. In combination, these two taxes would produce revenues roughly equivalent to the current income tax. This proposal, unlike the “flat tax,” the FairTax, and other such proposals, would not dramatically shift the tax burden away from high-income families to middle-and lower-income families. Also, rather than relying on tax structures like the “flat tax” and progressive consumption taxes, which were invented in ivory towers and are untested in today's economy, this plan combines two of the world's most common tax mechanisms, while exploiting our nation's substantial advantages as a low-tax country.

Here, in brief, then, is what I propose:

(1) Enact a value added tax:

The VAT would work like a national sales tax, but instead of depending only on retailers to collect the tax, a VAT is collected piecemeal at all stages of production, so it is much more difficult to evade. This is a common tax used by nearly 150 countries on 6 continents. Its rate would be 10% to 14%.

Many countries that have enacted value-added taxes do not require retailers to state separately the amount of tax imposed on the goods they sell; the tax is buried in the price of products. But this weakness is easily cured if Congress simply requires that the total amount of tax be separately stated whenever goods or services are sold. That way people will know how much tax they are paying.

The key point is this: the consumption tax would be collected only from businesses, and the tax would be imposed on a broad base of goods and services at a level sufficient to free the vast majority of Americans both from any income tax liability and from any requirement to file tax returns. It would tax imports and exempt exports.

(2) Eliminate the Income Tax for most Americans:

All income under \$100,000 (for married couples, \$50,000 for singles) would be exempt from the income tax, and this cut-off would be indexed for inflation. This would eliminate more than 100 million tax returns and free more than 150 million Americans from having to file them. A lower rate of tax, say, 20 to 25%, would be imposed on the taxable income of high-income individuals. The income tax that would remain for high-income taxpayers could be simplified substantially. The marriage penalties of the existing income tax should be eliminated. Most of the special income tax credits and allowances that now crowd the tax code and complicate tax forms should be repealed. But the deductions for charitable contributions and large medical expenses would be retained. The deductions for home mortgage interest could either be retained in their current form or modified. Congress would have to decide whether to keep, eliminate, or cut back on deductions for state and local taxes. Until better alternative policies are forged, employers would continue to have payroll and income tax incentives to provide their employees retirement savings plans and health insurance. Congress could tax capital gains at the standard rate of 20 to 25% or maintain a lower rate, such as the current 15%. Likewise, Congress could retain the current 15% rate on dividends, tax dividends at the regular rate, or eliminate dividend taxes completely on income where corporate taxes have been paid. There would be only one income tax calculation rather than the two that the AMT of current law requires.

(3) Lower the Corporate Income Tax Rate:

The corporate income tax rate would be lowered to 15 or 20%, making the United States a far more attractive country in which to do business and making our economy more globally competitive. In addition, the new law should require that book and tax accounting be more closely aligned to solve, at last, the tax

shelter problem that has plagued the corporate income tax for years. If Congress wants to maintain certain book-tax differences, such as for depreciation, research and development expenses, and foreign taxes, for example, these differences should be made explicit. The corporate alternative minimum tax should be repealed. The taxation of small-businesses should be greatly simplified.

(4) Introduce a Payroll Adjustment or “ Smart Cards” to Protect Low and Moderate Income Workers:

To avoid what would otherwise be the regressive impact of imposing a broad-based consumption tax, this plan would replace the EITC and refundable child credits with a payroll adjustment or a “ smart card” (like a bank debit card). Providing low-and middle-income workers benefits this way would allow tax returns to be eliminated for these workers without generally increasing their taxes or eliminating the EITC wage subsidy.<sup>†</sup> Moreover, payroll adjustments or smart cards would put money in low-income workers’ pockets when their paychecks are earned rather than through a lump-sum tax refund after year-end, as the EITC now does.

*The Key Advantages of this plan*

The plan I have offered is fair. It is simple for the average American to understand and comply with. It is fiscally sound. It is designed to replicate existing federal government revenues in the short-term and to put in place a tax system flexible enough to permit future tax increases without crippling the economy, should we need more resources down the road.

The plan takes advantage of our status as a low-tax country, something our current income tax fails to do. It would make the United States very similar to the average of OECD countries in taxing consumption relative to GDP and in terms of tax rates on consumption. Our income tax, however, would be very much smaller—and could be very much simpler—than what people generally face abroad.

This new tax system would have a number of important advantages:

- It would be far more favorable for savings and economic growth. Most Americans would owe no tax on their savings, and taxes on savings and investment would be lower for everyone. We would also maintain incentives for employers to provide both health insurance and retirement savings plans for their employees until we can agree on a better system. The United States would be an extremely attractive place for business investments by both U.S. citizens and foreigners. This plan would stimulate economic growth and create additional jobs for American workers, producing substantial long-term benefits for the American economy.

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<sup>†</sup> Details may be found in chapter 10 of my book.



- Unlike the current income tax, the plan would eliminate all marriage penalties, something that Congress has so far been unable to do under the current income tax.
- The U.S. would enjoy a substantial economic leg up in the world economy, while using a combination of taxes common throughout the world. Thus, this system facilitates international coordination and fits well within existing international tax and trade agreements.
- Because it retains the corporate income tax (at a much lower rate) and a dramatically shrunken individual income tax, the plan avoids the difficult issues of transition (involving the treatment of unrecovered tax basis) to an entirely new system that have haunted other proposals to move away from reliance on the income tax.
- By eliminating 100 million tax returns a year, the plan would drastically reduce compliance costs and headaches for the American people. It would also ease the IRS workload and thus allow it to perform its job far better. No politician would ever urge bringing all these people back into the income tax, absent some genuine catastrophe. After all, it took World War II to persuade Congress originally to extend the income tax to the masses.
- By diminishing dramatically the political advantages of income tax incentives, the plan would challenge our political leaders to produce policies that work and provide increased stability over the long haul, creating more predictability for both individuals and businesses.

Here is what *Forbes Global* has said about my plan: “If enacted, Graetz’s proposals would make the U.S. one of the most competitive countries in the world for human capital, investment and foreign direct investment. . . .The overall tax burden of the U.S. would not change, staying, as it is this year, the third lowest in the OECD.”

Our nation can no longer afford our broken tax system. It hampers our economy; it is uncompetitive; it distracts us from forging genuine solutions to our nation’s most pressing problems; and it wastes enormous resources due to its overwhelming complexity. Three decades ago, when he was running for President, Jimmy Carter described our nation’s tax system as a “disgrace to the human race.” And it still is.

To achieve fundamental reform we must recognize that the income tax, centerpiece of our overall tax system, has grown too complex and has proven a failure as a mechanism for solving our nation’s economic and social difficulties.

The health of our nation's economy, the cohesion of our society, the future of our nation's children all demand major changes. This will not be an easy task.

**Table**  
**A Side-by-Side Comparison of the Main Features**  
**of the Two Income Tax Reform Plans**

Provisions	Tax Reform Panel Income Tax	Wyden-Emanuel Fair “Flat Tax”
<b>Households and Families</b>		
Tax rates	Four brackets: 15%, 25%, 30%, 33%	Three brackets: 15%, 25%, 35%
AMT	Repealed	Repealed
Personal exemption	Replaced with family credit available to all taxpayers: \$3,300 for married couple, \$2,800 for unmarried with child, \$1,650 for singles, \$1,150 for dependent taxpayer; additional \$1,500 credit for each child and \$500 for each other dependent	Unchanged
Standard deduction	See Personal exemption	\$30,000 for joint filers, \$15,000 for singles, \$26,500 for head of household
Child tax credit	See Personal exemption	Unchanged
Marriage penalty	Reduced. All tax brackets, family credits, and taxation of Social Security for couples are double those of individuals	Persists
<b>Other Major Credits and Deductions</b>		
Home mortgage interest	15% home credit, limited to average regional price of housing	Unchanged, except that interest paid on second home not deductible
Charitable giving	Deduction available to all taxpayers	Unchanged
Health insurance	Taxpayers may purchase health insurance with pretax dollars, up to the amount of average premium	Unchanged; requests report from Treasury on how to eliminate \$10 billion in tax subsidies that create inefficiency in health insurance markets

Provisions	Tax Reform Panel Income Tax	Wyden-Emanuel Fair “Flat Tax”
<i>Other Major Credits and Deductions—Continued</i>		
Education	Taxpayers can claim family credit for some full-time students	Unchanged
State and local taxes	Not deductible	New, refundable credit for 10% of state and local taxes available to all taxpayers
Itemized deductions	None	Eliminates deductions for wagering losses, elementary teachers’ expenses, and moving expense. 2%-of-AGI floor eliminated
Exclusions from income	Eliminates exclusions for employer-provided group-term life insurance and most fringe benefits except meals furnished for the convenience of the employer	Eliminates exclusions for employer-provided group-term life insurance, worker’s compensation, rental value of personage, income earned abroad, most fringe benefits, and meals furnished for the convenience of the employer
<i>Individual Savings and Retirement</i>		
Defined contribution plans	Consolidated into save-at-work plans that have simple rules	Unchanged
Defined benefit plans	Unchanged	Unchanged
Retirement savings plans	Replaced with save-for-retirement accounts (\$10,000 annual limit)	Unchanged
Education savings plans	Replaced with save-for-family accounts (\$10,000 annual limit) covering education, medical, new home costs, and retirement saving needs	Unchanged

*(Continued)*

**Table —Continued**

Provisions	Tax Reform Panel Income Tax	Wyden-Emanuel Fair “Flat Tax”
Individual Savings and Retirement— <i>Continued</i>		
Health savings plans	See Education savings plan	Cafeteria plans and FSAs eliminated
Dividends received	Exclude 100% of dividends of U.S. companies paid out of domestic earnings	Taxed at regular income tax rates
Capital gains received	Exclude 75% of corporate capital gains from U.S. companies	Taxed at regular income tax rates
Interest received	Taxed at regular income tax rates	Taxed at regular income tax rates
Social Security benefits	Married taxpayers with less than \$44,000 in income pay no tax on Social Security benefits	Unchanged
Small Business		
Rates	Taxed at individual rates	Taxed at individual rates
Record-keeping	Simplified cash-basis accounting	Unchanged
Investment	Immediate expensing (except for land and buildings)	Straight-line depreciation over longer periods
Large Business		
Rates	31.50%	35% (on all corporate income)
Investment	Simplified accelerated depreciation	Straight-line depreciation over longer periods
International tax system	Territorial tax system	Deferral eliminated