

A Fair and Balanced Tax System for the 21st Century

American Enterprise Institute

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FAILINGS OF THE INCOME TAX

Complexity

The Code contains more than 700 provisions affecting individuals and more than 1500 provisions affecting businesses. The Code and regulations total more than 9.4 million words.

Administration

The IRS, tasked with administering many programs, has difficulty keeping up. It has diverted resources away from corporate and high-income individual returns.

AMT Growth

If left unchanged, the Alternative Minimum Tax will soon be imposed on 30 million Americans, who will have to calculate their taxes twice.

Chicken Soup

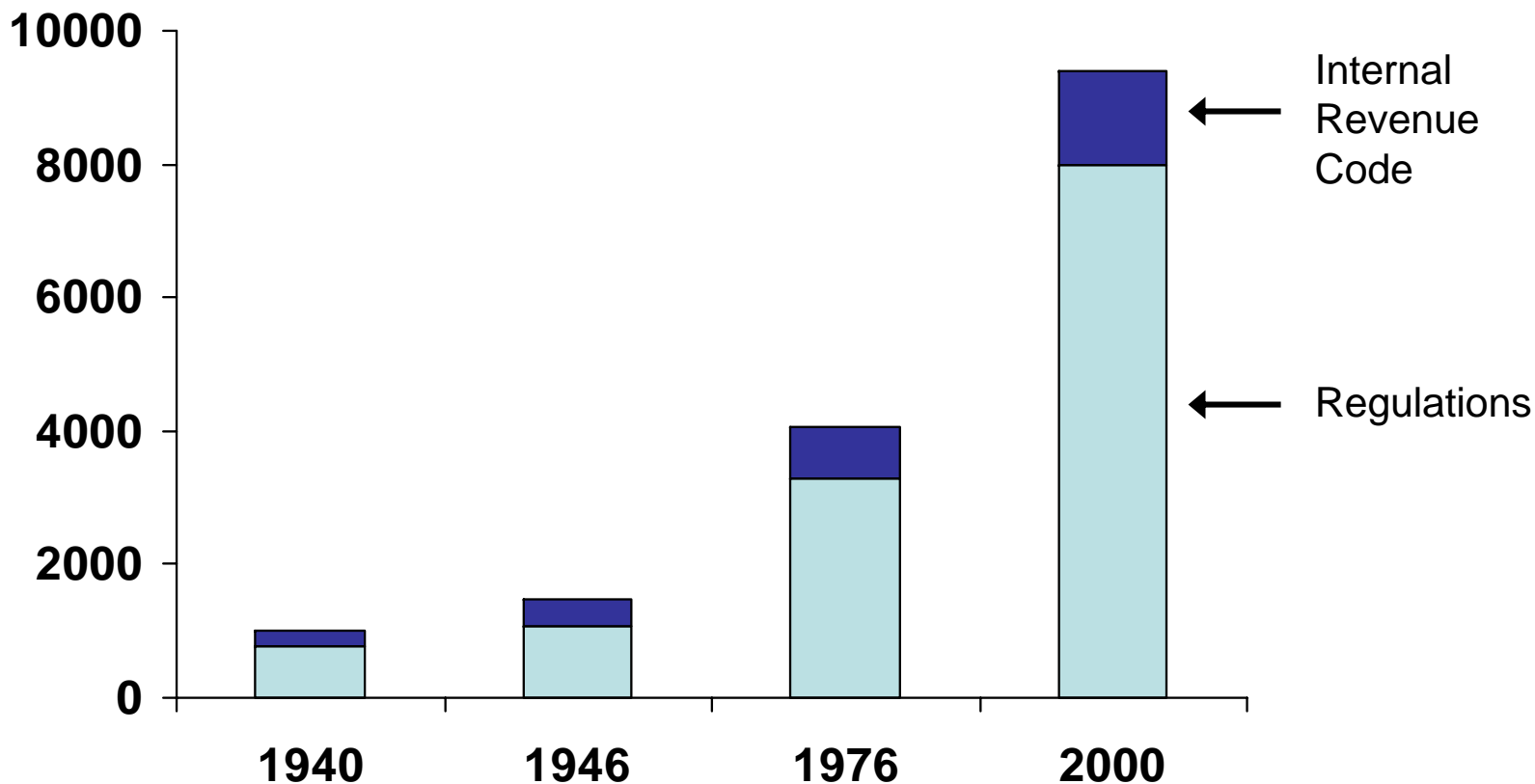
For any social problem – including education, child care affordability, health insurance coverage, retirement security, or the financing of long-term care – an income tax deduction or credit is advanced as the answer.

Cynicism

The income tax's failings discourage individuals from paying taxes they legally owe. Young people, especially, admit feeling little compunction about dishonestly completing tax forms.

TAX CODE COMPLEXITY:

THOUSAND OF WORDS IN IRC AND REGULATIONS



Source: Calculations based on U.S.C. (1940, CCH 1952) and C.F.R. (1940, 1949) and Tax Foundation calculations, based on West's Internal Revenue Code and Federal Tax Regulations (1975), Study of the Overall State of the Federal Tax System... 4 (2001).

A FOUR-PIECE FAIR AND BALANCED PROPOSAL

PIECE 1: PARING BACK THE INCOME TAX

Repeal the
Income Tax

Instead of heeding the frequent call to repeal the AMT, repeal the regular income tax instead and modify the AMT.

Raise AMT
Exemption

Increase the AMT exemption for married couples to \$100,000 (\$50,000 for singles) and index the exemption to inflation to keep the income tax in check.

Lower AMT
Rates

Lower the AMT rate to a flat 25% and permit appropriate deductions for income-producing activities.

Payoff

About 150 million people will file no tax returns. The marriage penalty will be eliminated, but deductions for home mortgage interest and charitable contributions and incentives for retirement savings plans and health insurance would be preserved.

A FOUR-PIECE FAIR AND BALANCED PROPOSAL

PIECE 2: CLEANING UP THE CORPORATE INCOME TAX

Lower the
Tax Rate

Lower the corporate income tax rate from 35% to 25%, the rate which will apply to individuals and flow-through entities.

Align Book &
Tax Acct'ng

More closely align book and tax accounting while allowing Congress to make explicit any book-tax differences, such as for depreciation, R&D expenses, and foreign taxes.

Institute
Territorial
Tax System

Consider relaxing the foreign tax credit with an exemption for dividends paid from foreign subsidiaries to eliminate barriers to repatriation of foreign earnings.

Simplify
Small Business
Taxation

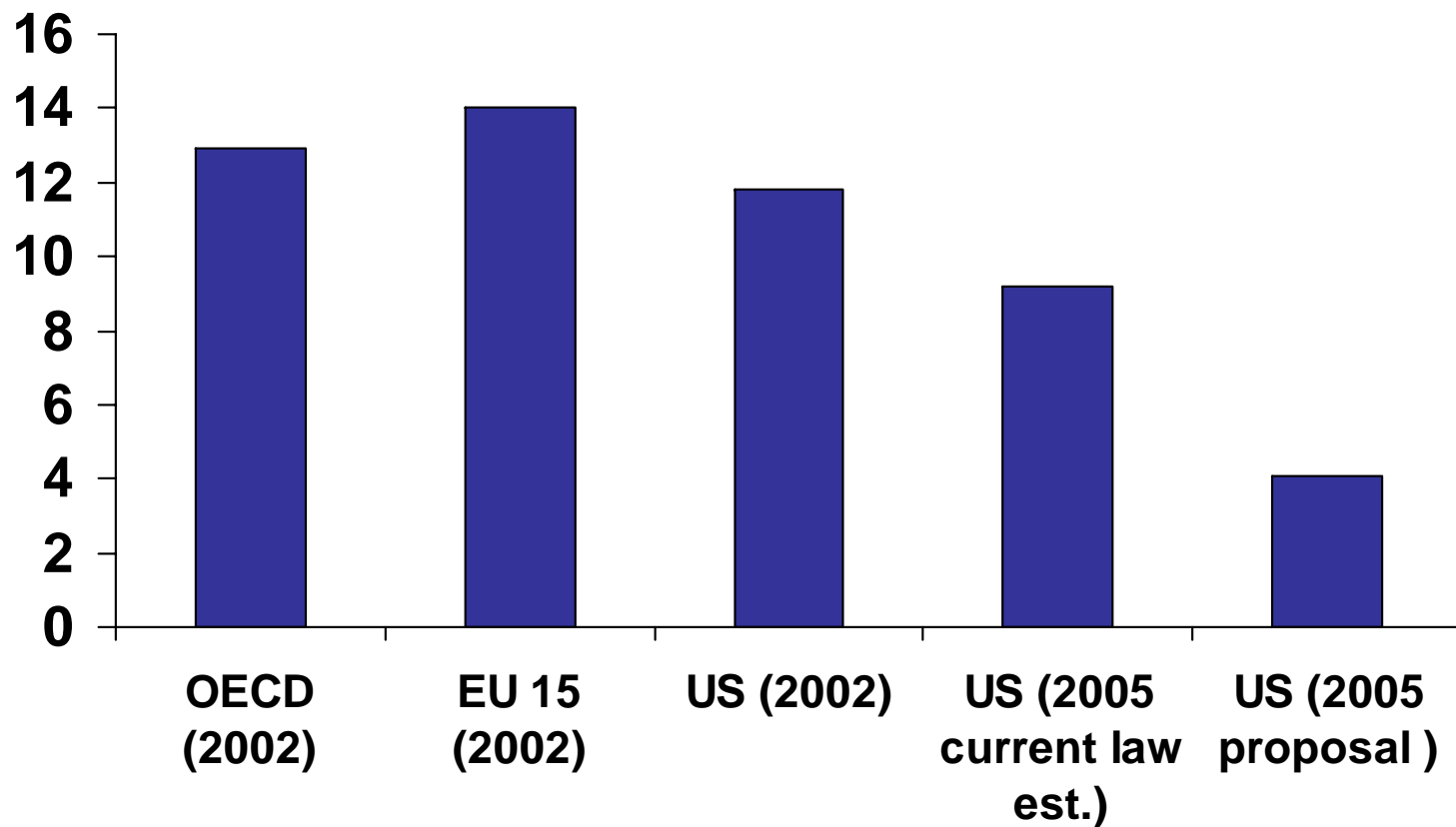
The taxation of small businesses should be greatly simplified. Consider a single flow-through regime for all small businesses and a greater use of cash accounting.

Payoff

Small corporations could be taxed on a flow-through basis, simplifying taxation for many small businesses. Greater book-tax conformity will assist in the battle against tax shelters.

INCOME TAXES AROUND THE WORLD

INCOME TAX REVENUE AS A PERCENT OF GDP



Source: OECD Revenue Statistics (2004, release 1); U.S. figures for 2005 are author's estimates.
Note: OECD reports U.S. revenue for 2003 as 10.9% of GDP.

A FOUR-PIECE FAIR AND BALANCED PROPOSAL

PIECE 3: ENACT A VALUE ADDED TAX

Enact a VAT

To replace revenues lost by eliminating income tax for most taxpayers, enact a broad-based 10% to 14% credit-method VAT such as that used throughout the world.

Make the VAT Visible

Require the total amount of VAT to be separately stated wherever goods and services are sold so that consumers are aware of the price of government.

Exempt Small Businesses

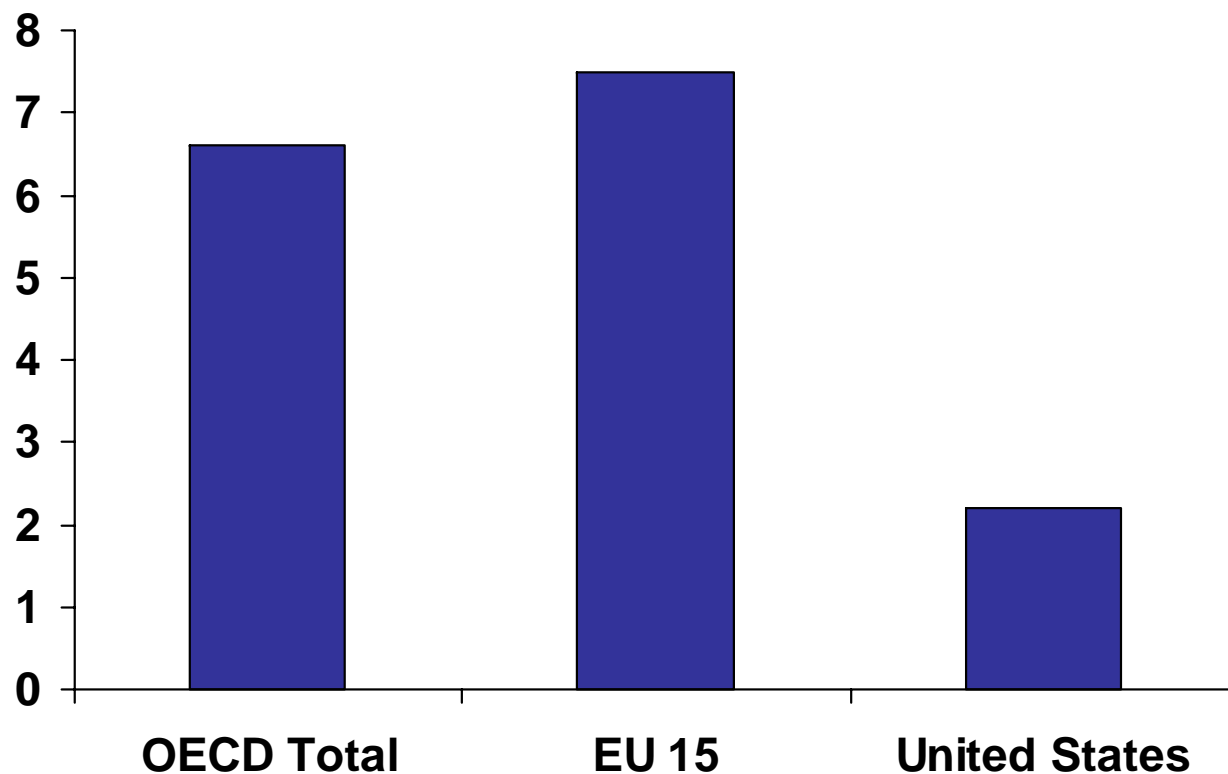
Businesses with gross receipts of less than \$100,000 annually (nearly 80% of 25 million U.S. small businesses) should be exempt from collecting VAT or filing returns.

Payoff

A VAT imposes compliance costs 1/3 to 1/4 as large as our income tax,* is easily enforceable based on international experience, and minimizes economic distortions.

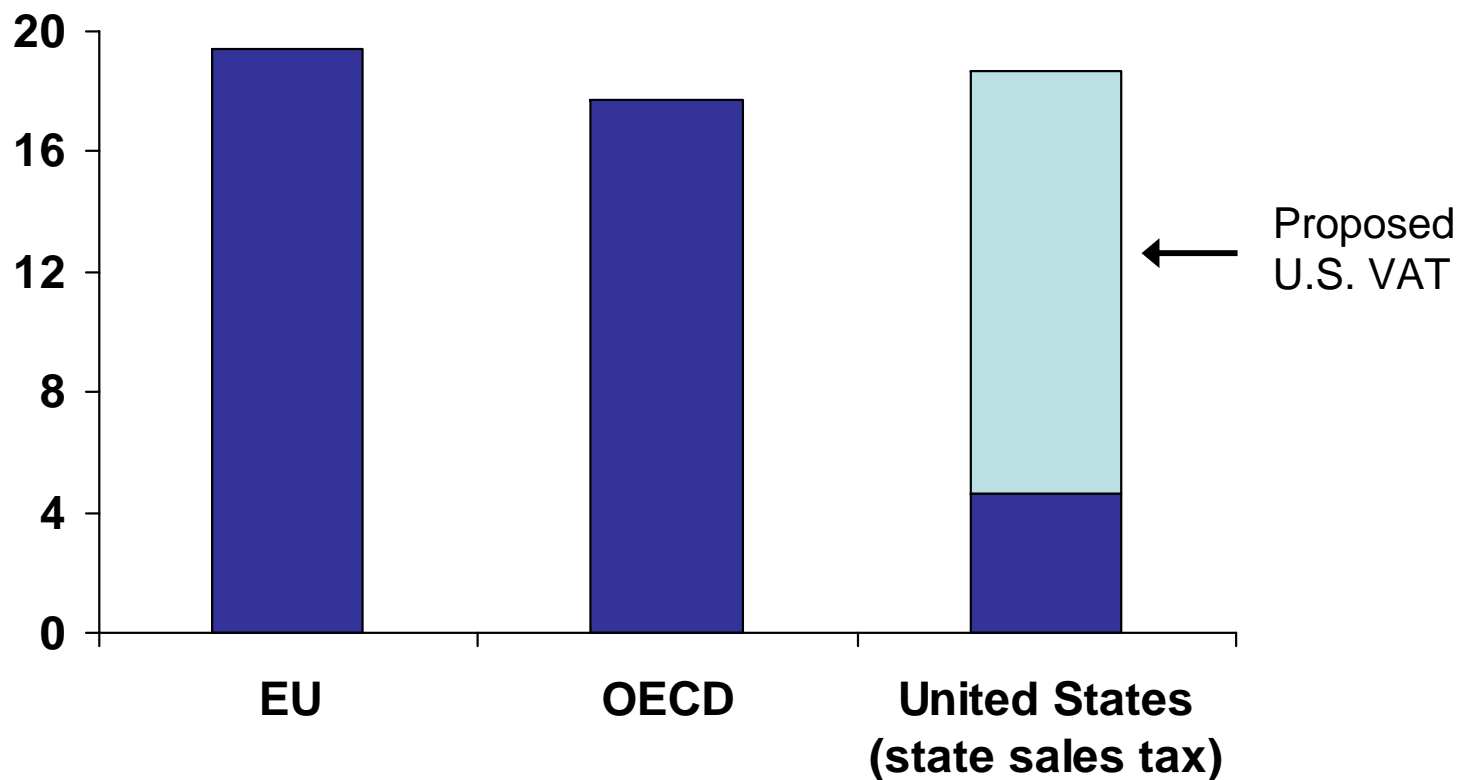
CONSUMPTION TAXES AROUND THE WORLD

VAT AND SALES TAX REVENUE AS PERCENT OF GDP - 2002



CONSUMPTION TAXES AROUND THE WORLD:

VAT AND SALES TAX RATES – 2000 (UNWEIGHTED AVERAGES)



A FOUR-PIECE FAIR AND BALANCED PROPOSAL

PIECE 4: PROVIDE A REFUNDABLE PAYROLL TAX OFFSET

Replace the EITC

Replace the earned income tax credit with a payroll tax offset both to replace the EITC and protect low- and moderate-income families from increased tax burdens.

Guard Against Regressivity

Any movement away from the income tax to a consumption tax collected by businesses will require some adjustment of this sort to protect against regressivity.

Improve Incentives

Eliminate the EITC's serious marriage penalties and recognize financial obligations of non-custodial parents to their children while preserving EITC's work incentives.

Assist Employers

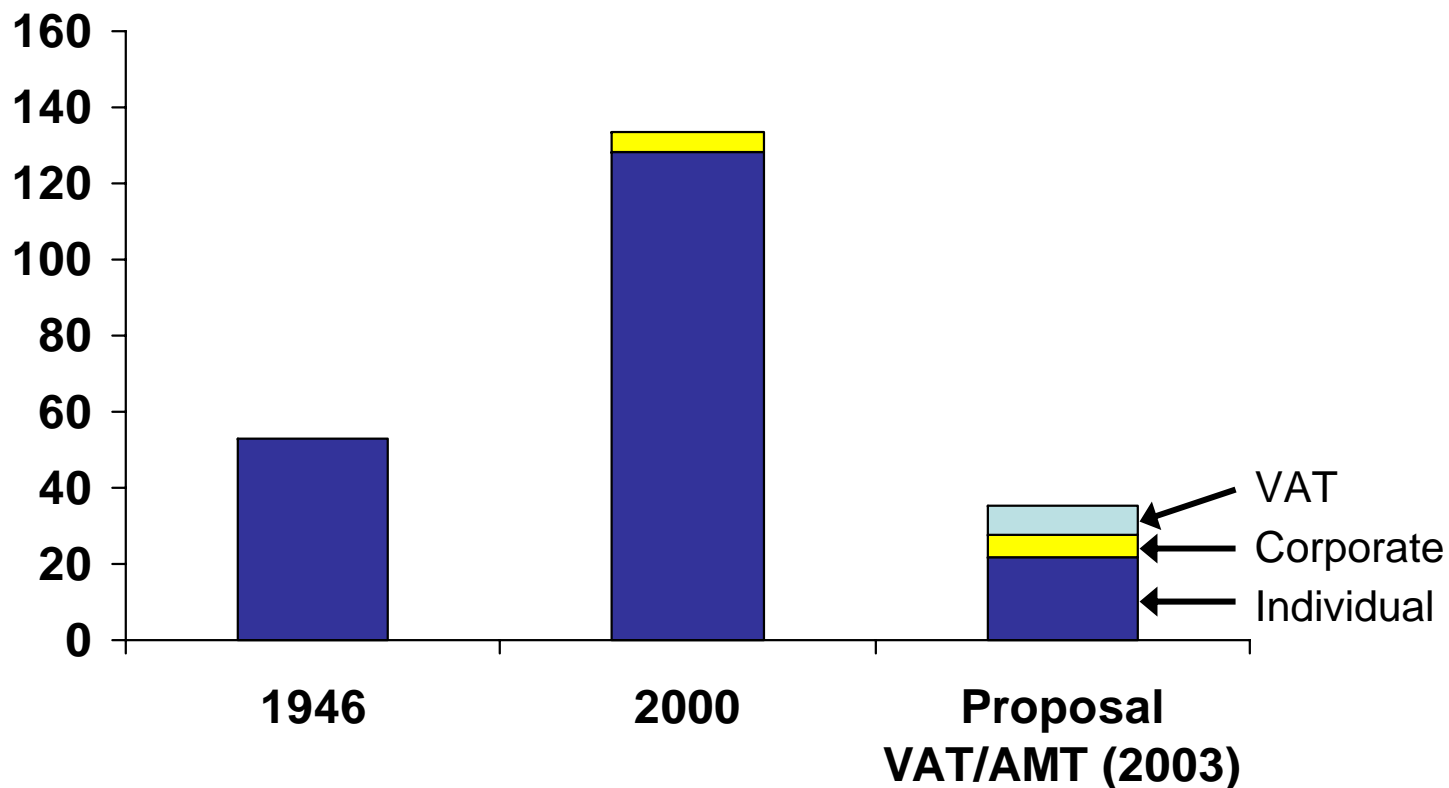
The IRS would assist employers in calculating payroll tax withholding by providing tables showing payroll tax offsets at different wage levels and family sizes.

Payoff

A payroll tax offset would maintain EITC's work incentives and leave Social Security benefits unaffected while eliminating marriage penalties, increasing take-home pay, and ensuring distributional neutrality. With VAT exemptions for certain necessities such as some food and clothing, the payroll tax offset could be smaller.

SIMPLIFYING TAX COMPLIANCE

MILLIONS OF TAX RETURNS UNDER CURRENT LAW AND PROPOSAL



GAO has estimated that an exemption for small businesses with gross receipts of \$100,000 or less would reduce the required number of VAT returns from 24 million to 5.4 million. We assume here that such a small business exemption would be included in a VAT and show 8 million VAT returns filed, since some small businesses will opt into the VAT to obtain refunds and to account for growth since the GAO report was published. VAT Administrative Costs, GAO/GGD-93-78 (1993) at 62. Sources: 1946: Statistical Abstract of the United States (1956); 2000: Internal Revenue Service Databook (2000); Proposal 2003: Treasury estimates (individual), author estimate (corporate), GAO estimate (VAT).

A FOUR-PIECE FAIR AND BALANCED PROPOSAL

KEY ADVANTAGES

Fewer Filers

Elimination of 100 million of 135 million income tax returns reduces compliance and administrative costs and counteracts cynicism generated by income tax complexity.

Economic Growth

The new tax system would encourage saving and investment in the United States, stimulating economic growth and creating additional jobs for American workers.

No Marriage Penalties

Unlike the current tax, this system eliminates all marriage penalties, something Congress has been unable to do under the current income tax.

International Coordination

By combining taxes commonly used throughout the world, this system facilitates international coordination and fits well within existing international tax and trade agreements.

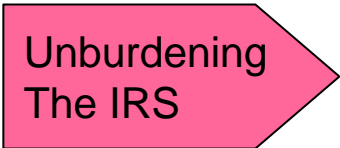
A FOUR-PIECE FAIR AND BALANCED PROPOSAL:

KEY ADVANTAGES



Easy Transition

This plan avoids the difficult issues of transition to an entirely new system that have haunted other proposals to move completely away from the income tax.



Unburdening The IRS

With far fewer income tax filers and an easily administrable VAT, this system would reduce the IRS workload so that it can do its job.



Stability

With few Americans filing tax returns, there will be less temptation for political tinkering with the tax system. International capital mobility, the initial level of the VAT rate, and a supermajority voting requirement would limit rate increases.

Table 1: Illustrative Summary of Revenues
 Graetz Proposal to Revise Individual Income Tax and AMT:
 Summary of Rates and Balances at 13% VAT (billions of dollars)

| | Calendar year | | | | | | | | | | |
|---|---------------|------|------|------|------|------|------|------|------|------|-----------|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2003-2012 |
| 1 10% VAT | 565 | 596 | 628 | 661 | 696 | 731 | 768 | 807 | 848 | 891 | 7191 |
| \$100,000 individual income tax exemption/AMT base/25% rate 1/ | -577 | -601 | -640 | -655 | -694 | -732 | -779 | -826 | -878 | -938 | -7320 |
| 2 2% VAT | 113 | 119 | 126 | 132 | 139 | 146 | 154 | 161 | 170 | 178 | 1438 |
| Replace EITC | -36 | -36 | -37 | -38 | -39 | -41 | -42 | -44 | -44 | -44 | -401 |
| Additional funds for tax relief for low- and moderate- income families 2/ | -77 | -83 | -89 | -94 | -100 | -105 | -112 | -117 | -126 | -134 | -1037 |
| 3 1% VAT | 57 | 60 | 63 | 66 | 70 | 73 | 77 | 81 | 85 | 89 | 721 |
| Base broadening 3/ | 58 | 58 | 83 | 81 | 75 | 79 | 78 | 75 | 74 | 77 | 738 |
| Corporate rate reduction to 25% | -88 | -89 | -117 | -117 | -113 | -117 | -118 | -117 | -117 | -121 | -1114 |
| 4 13% VAT total rate net | 15 | 24 | 17 | 36 | 34 | 34 | 26 | 20 | 12 | -2 | 216 |

1/ The proposal would (1) repeal the regular individual income tax, (2) increase the AMT exemption to \$50,000 (singles) and \$100,000 (joint returns), (3) index the AMT exemption, (4) lower the AMT rate to a flat 25%, and (5) phase out the AMT exemption at \$20 for every \$100 in excess of \$100,000 (singles) and \$200,000 (joint returns). (The current AMT phase-out is \$25 for every \$100 over \$112,000 (singles) and \$150,000 (joint returns).) Further broadening the AMT base could reduce the revenue cost of this change. 2/ Assumes 2 percentage points of VAT devoted to relief for low- and moderate-income families. 3/ A substantial portion of this cost might be funded by broadening the base of the corporate tax.

NOTE: These estimates were prepared for a seminar delivered to the U.S. Treasury Office of Tax Policy in August 2002. The Treasury's Office of Tax Analysis assisted in the development of these estimates in connection with that seminar. The proposals are assumed to be effective January 1, 2003. The sunset of the 2001 Act, scheduled for 2011, is assumed to be repealed. These estimates do not include any potential interactions among proposals. They have not been updated to reflect economic or policy changes since 2002 and are therefore made available here for illustrative purposes only.

CONCLUSION

BACK TO THE FUTURE

Flexibility

One alternative requested by the President is reform of the existing income tax. The structural reform suggested here can be combined with any reform of the current income tax.

A Role for the VAT

After reforming the current income tax, adding a 10-14% VAT, along the lines here, would allow Congress to:

- eliminate at least 150 million people from the income tax rolls through an exemption of at least \$100,000, and
- reduce income tax rates by about 10 percentage points.

Back to the Future

A low-rate income tax on a small slice of high-income Americans combined with consumption taxes on everyone describes the U.S. tax regime before World War II. Then, the consumption tax in the form of tariffs was economically inefficient. The modern VAT is a far more equitable and efficient tax.

Appendix

DIFFICULTIES OF OTHER PROPOSALS

THE “FLAT TAX”



Instability

Given Congress' propensity to enact targeted tax breaks, a flat tax – which would require all wage earners to file tax returns – would not remain flat or simple for very long.



Export Taxation

American businesses will not stand for taxing exports while exempting imports, as is required by our trade agreements under a flat tax.



Pensions and Health Ins.

The flat tax would eliminate employers' incentives to provide employer-based health insurance and pensions, threatening employers' provision of both.



Progressivity

Americans are uncomfortable with taxing income from wages but not from wealth. Moreover, the flat tax would increase the tax burden on the middle class.

DIFFICULTIES OF OTHER PROPOSALS

NATIONAL RETAIL SALES TAX

Insufficient Revenue

Compliance difficulties prevent sales tax rates sufficiently high to replace the income tax. Only six countries have adopted such taxes at a rate above 10%, and none currently exist.*

Pension and Health Ins.

Like the flat tax, the retail sales tax would eliminate employers' incentives to provide employer-based health insurance and pensions, threatening employers' provision of both.

Progressivity

A retail sales tax would reduce progressivity by increasing the tax rate on low-income individuals, who consume most of their income, and lowering the rate for higher-income individuals, who consume relatively less.

DIFFICULTIES OF OTHER PROPOSALS

A PROGRESSIVE PERSONAL CONSUMPTION TAX (E.G. NUNN-DOMENICI)

Transition Problems

The transition provisions of the Nunn-Domenici plan created incentives for dissaving and for wasteful tax avoidance activities.

Sheltering Opportunities

Failure to tax consumption financed with borrowing under the Nunn-Domenici plan would allow people with assets or the ability to borrow to avoid the tax.

Preferences Maintained

Other preferences will likely be retained, offering additional opportunities to consume tax-free.

Novelty

Since no other nation relies on such a tax, more unforeseen difficulties are likely to arise upon implementation. Only India and Sri Lanka ever tried such a tax and both abandoned it.

DIFFICULTIES OF OTHER PROPOSALS

TAX REFORM IN “FIVE EASY PIECES”

Insufficient Revenue

This plan proposes to lower capital gains rates, allow 100% expensing, expand Roth-type saving opportunities, eliminate the double-tax on corporate earnings, and implement territorial taxation. The first four items are major revenue losers.

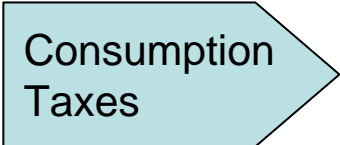
Tax-free Consumption

Like the Nunn-Domenici progressive consumption tax, this plan would create opportunities for tax shelters and to consume entirely tax-free by borrowing. This problem is exacerbated by the piecemeal approach.

Continuing Complexity

Because of its incremental nature, this plan to convert the income tax into a consumption tax a step at a time could actually increase complexity of the tax system.

PROVIDING RELIEF FOR MIDDLE-INCOME TAXPAYERS



Consumption Taxes

Consumption taxes such as credit- and subtraction-method VATs, the flat tax, and the retail sales tax have roughly equivalent tax bases and are less progressive than income taxes of the same rate since lower-income individuals consume a larger fraction of their income than higher-income individuals.



Flat Rates

Flat-rate tax systems such as the flat tax and the retail sales tax are less progressive than revenue-equivalent graduated taxes since lower-income individuals must pay the same tax rate as higher-income individuals.

PROVIDING RELIEF FOR MIDDLE-INCOME TAXPAYERS

Four-piece Proposal

The plan described in these slides addresses the loss in progressivity from flat rates and the introduction of a VAT by a payroll tax offset and retention of income taxation for high-income taxpayers.

Other plans

Other consumption-based tax reform plans must introduce provisions like a payroll tax offset or more steeply graduated rates in order to avoid imposing a greater tax burden on lower- and middle-income taxpayers. Some consumption tax plans offer neither.

Bottom Line

Any move toward consumption taxation requires careful attention to distributional concerns. Without careful design, a shift to a consumption tax may entail tax cuts for the wealthy and tax increases for low- and moderate-income people.