

COMMENT ON LEONARD E. BURMAN,  
“A BLUEPRINT FOR TAX REFORM AND HEALTH REFORM”

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Leonard E. Burman’s tax and health care reform proposal<sup>1</sup> would be a considerable improvement over the policies that are likely to prevail in the absence of reform. Unlike many proposals put forward by candidates and others, Burman’s proposal is largely responsive to the long-term fiscal realities confronting the United States and respects budget constraints. Notably, he suggests an efficient revenue source to replace part of the inefficient income tax. His proposal has some limitations, however, and pays insufficient attention to the need to restrain entitlement spending growth.

I. THE NEED FOR REFORM

I agree with Burman’s assessment of the need for reform. I discuss this topic briefly to emphasize the factors that I view as important.

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<sup>1</sup> Leonard E. Burman, *A Blueprint for Tax Reform and Health Reform*, 28 VA. TAX REV. 287 (2008).

### A. *The No-Reform Path: Deficits and Higher Marginal Tax Rates*

If “reform” means “to put or change [something] into an improved form or condition,”<sup>2</sup> then it may seem that reform is always desirable. Who could be against improvement? Because the enactment of sweeping reforms is costly, however, such changes are unlikely to be adopted unless the perceived gains from reform are relatively high. In short, there must be a need, not merely a desire, for reform. An assessment of the need for reform requires a prediction about what will happen in the absence of reform.

As a first cut, one might view the Congressional Budget Office’s (CBO) current-law baseline as a description of the no-reform path. It does not provide an inspiring picture of the future. The baseline envisions the expiration of the Bush tax cuts at the end of 2010, which causes a significant increase in marginal income tax rates, including the tax burden on saving. In particular, the top two statutory marginal rates rise from 33% and 35% to 36% and 39.6%, respectively, with the top tax rate on dividends jumping from 15% to 39.6%.<sup>3</sup> The baseline also envisions the migration of tens of millions of ordinary taxpayers from the regular income tax to the alternative minimum tax (AMT), implying a substantial increase in complexity.<sup>4</sup>

Nevertheless, one feature of the CBO baseline strikes a more positive note. Under the September 2008 version of the baseline, the federal budget deficit falls sharply from \$325 billion in fiscal year 2011 to \$126 billion in fiscal year 2012 and remains at or below 1% of GDP through fiscal year 2018.<sup>5</sup> The lower deficits halt the growth of federal indebtedness as a share of GDP; debt held by the public falls slightly from 36.9% of annual GDP at the end of fiscal 2007 to 35.5% of annual GDP at the end of fiscal 2018.<sup>6</sup> This deficit reduction would provide a boost to national saving.

Burman correctly notes, however, that the CBO baseline does not offer a realistic description of what will happen in the absence of reform. In accordance with statutory mandate, CBO generally assumes that current tax legislation will not be modified by future congressional action. Under the CBO baseline, therefore, the bulk of the Bush tax cuts expire at the end of 2010 and legislative relief from the spread of the AMT expired at the end of 2007.<sup>7</sup> The September 2008 baseline also does not reflect the enactment of the Emergency Economic Stabilization Act on October 3, 2008.<sup>8</sup> These features of the baseline must be modified to obtain a more realistic picture of what will happen in the absence of reform.

Unfortunately, the realistic no-reform path is, on the whole, even more unfavorable than the CBO baseline. To be sure, the movement of tens of millions of taxpayers to the AMT will be averted. But, the marginal rate increases for high-income taxpayers will largely occur, as

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<sup>2</sup> MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY 1046 (11th ed. 2003).

<sup>3</sup> CONG. BUDGET OFFICE, EFFECTIVE FEDERAL TAX RATES UNDER CURRENT LAW, 2001 TO 2014, at 8–9 tbl.1 (2004), available at <http://www.cbo.gov/ftpdocs/57xx/doc5746/08-13-EffectiveFedTaxRates.pdf>.

<sup>4</sup> CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2008 TO 2018, at 88 (2008), available at [http://www.cbo.gov/ftpdocs/89xx/doc8917/01-23-2008\\_BudgetOutlook.pdf](http://www.cbo.gov/ftpdocs/89xx/doc8917/01-23-2008_BudgetOutlook.pdf).

<sup>5</sup> CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE, at 2 tbl.1-1 (2008), available at <http://www.cbo.gov/ftpdocs/97xx/doc9706/09-08-Update.pdf>.

<sup>6</sup> *Id.*

<sup>7</sup> CONG. BUDGET OFFICE, *supra* note 4, at 99.

<sup>8</sup> Emergency Economic Stabilization Act of 2008. Pub. L. No. 110-343, 122 Stat. 3765.

President-elect Obama generally opposes the extension of those parts of the Bush tax cuts.<sup>9</sup> Moreover, the reduction of the federal budget deficit will not occur, due to revenue losses from several probable legislative actions.

First, significant parts of the Bush tax cuts will almost certainly be maintained indefinitely, whether through a single permanent extension or through an unending series of short-term extensions. Democratic President-elect, Senator Barack Obama (D-Illinois), proposes permanent extension of the Bush tax cuts for virtually all households with incomes below \$200,000 (\$250,000 for couples).<sup>10</sup> Such a partial extension will incur roughly half of the total revenue loss that would arise from extending all of the Bush tax cuts.<sup>11</sup> Senator Obama has also proposed additional middle-class tax cuts,<sup>12</sup> which will cause a further ten-year revenue loss larger than that from the partial extension of the Bush tax cuts.<sup>13</sup> Such tax cuts, which are primarily intended to serve distributional rather than efficiency goals, will generate large revenue losses while doing little or nothing to reduce marginal tax rates. Preventing the spread of the AMT will trigger large additional revenue losses.<sup>14</sup> It is also possible that Congress will adopt another stimulus package to address the weakness in the economy.

In the absence of reform, therefore, the near-term outlook is likely to feature both large budget deficits and increases in marginal tax rates.

### *B. Long-Term Fiscal Realities*

The problem with the no-reform path is that it does not properly prepare the United States for the long-term fiscal challenge that it faces. In the extended-baseline scenario of its most recent long-term budget projection, CBO projects that the three largest federal entitlement programs (Social Security, Medicare, and Medicaid) will grow from 8.4% of GDP in 2007 to 18.1% of GDP in 2050 while federal revenue will rise only from 18.8% of GDP to 23.5% of GDP.<sup>15</sup> This imbalance will cause an explosive growth of federal debt.

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<sup>9</sup> Obama has proposed, however, that the dividend tax rate rise to only 20%, not the 39.6% envisioned in the baseline. See LEN BURMAN ET AL., TAX POLICY CTR., AN UPDATED ANALYSIS OF THE 2008 PRESIDENTIAL CANDIDATES' TAX PLANS: REVISED AUGUST 15, 2008, at 13 (2008), [http://www.taxpolicycenter.org/UploadedPDF/411749\\_updated\\_candidates.pdf](http://www.taxpolicycenter.org/UploadedPDF/411749_updated_candidates.pdf) (describing Obama's dividend-tax proposal).

<sup>10</sup> See *id.* (describing Obama's proposal to generally extend those cuts for households with adjusted gross incomes below the thresholds stated in the text). A few households with adjusted gross incomes slightly below the stated thresholds have taxable incomes above the levels at which the top two brackets apply (\$171,550 for single taxpayers, \$190,200 for heads of household, and \$208,850 for married couples in 2009). Because Obama would not extend the rate reductions for those brackets, those households would not receive a full extension of the Bush tax cuts.

<sup>11</sup> Compare *id.* at 22 tbl.R2 (listing 2009–2018 revenue loss of \$853.5 billion for Obama's proposal to extend these portions of the Bush tax cuts), with *id.* at 18 tbl.R1 (listing 2009–2018 revenue loss of \$1729.8 billion for McCain proposal to extend Bush tax cuts other than estate-tax repeal).

<sup>12</sup> *Id.* at 13–16 (describing Obama's proposals).

<sup>13</sup> *Id.* at 22 tbl.R2 (listing combined 2009–2018 revenue loss of \$1316.8 billion for the following Obama proposals: "Making Work Pay Credit", "Universal Mortgage Credit", savings incentives, "American Opportunity Tax Credit", expansions of earned income tax credit and child and dependent care tax credit, and income tax exemption for senior citizens).

<sup>14</sup> *Id.* at 22 tbl.R2 (listing 2009–2018 revenue loss of \$1167.1 billion for Obama AMT relief proposal).

<sup>15</sup> CONG. BUDGET OFFICE, THE LONG-TERM BUDGET OUTLOOK, at 5 tbl.1-2 (2007), available at <http://www.cbo.gov/ftpdocs/88xx/doc8877/12-13-LTBO.pdf>.

This fiscal gap gives rise to four long-term realities that any reform plan must face.<sup>16</sup> First, it is politically necessary that federal revenue increase as a share of GDP. Second, the growth of entitlement spending must be slowed, relative to the trajectory scheduled under current law. Third, as revenue increases, some type of consumption taxation must play a larger role in the federal tax system. Fourth, the middle class must bear much of the burden of closing the gap.

The first reality is the political imperative that federal revenue, as a share of GDP, rise above today's level. To be sure, federal revenue could remain at its current share of GDP if the major federal entitlement programs were held at, or close to, their current share of GDP. But, that degree of spending restraint is not politically feasible. As noted above, Social Security, Medicare, and Medicaid are projected to more than double as a share of GDP by 2050 under current law. Stabilizing them as a share of GDP would therefore require cutting them by more than half from their current-law trajectories. While such a policy would probably be good for long-run GDP growth, it would not command support from the American people. In a recent survey on how to correct the long-run Social Security deficit, Alan S. Blinder and Alan B. Krueger found that a mere 5% of the public favored relying mainly on benefit cuts, 30% favored relying mainly on payroll tax increases, and 34% favored a mix of payroll tax increases and benefit cuts.<sup>17</sup> There would surely be even less support for benefit cuts as the main response to the much larger Medicare-Medicaid imbalance. Given the public disinterest in dramatic entitlement reductions, it will be politically impossible to avoid revenue increases.

Second, despite the foregoing, entitlement spending must be restrained to some extent, relative to its current-law path. While entitlement spending cannot be held at its current share of GDP, it also cannot be allowed to more than double by 2050, as the current-law baseline implies. That pace of entitlement spending growth would force revenue to rise to a staggeringly high share of GDP, with dire implications for economic growth.

Third, as federal revenue becomes a larger share of GDP, consumption-tax elements must play a larger role in the tax system. The distinctive shortcoming of the income tax is that, unlike wage and consumption taxes, it penalizes saving, which magnifies the harm to long-run economic growth.<sup>18</sup> Since the economic costs of income taxation rise as greater use is made of it, its relative importance must be scaled back as total revenues rise.

Fourth, the middle class must bear much of the burden of closing the fiscal gap, whether the gap is closed through entitlement cuts, tax increases, or (as the preceding analysis suggests) both. An entitlement-reduction strategy must necessarily focus on the middle class; the middle class receives a significant share of entitlement spending, with much of the remainder going not to high-income groups, but to low-income groups who will and should be shielded from deep cuts.<sup>19</sup>

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<sup>16</sup> Part of this analysis is drawn from the author's February 20, 2008 remarks to the Tax Council Policy Institute. For an edited transcript of those remarks, see Symposium, *Session 1: The Fiscal Picture, Today and Beyond — Implications for Tax Reform*, 86 TAXES 41, 44–46 (2008).

<sup>17</sup> Alan S. Blinder & Alan B. Krueger, *What Does the Public Know About Economic Policy, and How Does It Know It?*, BROOKINGS PAPERS ON ECON. ACTIVITY 327, 375–81 (2004).

<sup>18</sup> A voluminous literature compares income and consumption taxation. For excellent expositions of the case for consumption taxation, see DAVID F. BRADFORD, *TAXATION, WEALTH, AND SAVING* 1–31 (2000), and Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006).

<sup>19</sup> In 2005, \$224 billion of government cash transfers went to households in the bottom quintile of the income distribution, with \$134 billion going to the second quintile, \$85 billion going to the middle quintile, \$62 billion going to the fourth quintile, and \$57 billion going to the top quintile. See U.S. BUREAU OF LABOR STATISTICS & U.S. CENSUS

Under a tax-increase strategy, some of the burden can be placed on upper-income households, but less than might be thought. Although such households earn a significant share of national income, only a limited amount of revenue can be raised from them without levying prohibitively steep marginal tax rates that would impair economic incentives.<sup>20</sup> Moreover, to the extent that higher income tax rates on the wealthy would retard saving and investment, middle-class workers would bear an indirect burden through lower wages.

### *C. Burman's Proposal*

The no-reform path does not adequately respond to these long-term realities. Federal revenue rises very little as a share of GDP, entitlement spending grows unchecked, the federal tax system continues to rely upon income taxation, and no sacrifices are imposed on the middle class (who are actually promised additional tax cuts). Burman's proposal offers a welcome contrast because it better responds to these long-term realities.

Understandably, Burman does not spell out all details of his proposal. My analysis primarily relates to the following major provisions:

First, a health voucher replaces current federal medical programs, the current state share of Medicaid, and the tax exclusion for employer-provided health insurance.

Second, a value added tax (VAT), with a rate likely to exceed 20%, is instituted to finance the voucher.

Third, the income tax is scaled back in size. It is also restructured through rate reduction and base broadening, including repeal of the exclusion for employer-provided health insurance and the deduction for state and local taxes. The AMT is repealed.

Fourth, other federal taxes are reduced or repealed. The corporate income tax is scaled back, but not integrated with the individual income tax. The Medicare component of the payroll/self-employment tax, which is a 2.9% tax on wages and self-employment earnings, is repealed. The estate and gift taxes are reduced, particularly for smaller estates.

Burman's proposal responds clearly and forcefully to three of the four long-term realities. His proposed VAT raises additional revenue, is a consumption tax, and taxes the middle class. His proposal falls short, however, with respect to the restraint of entitlement spending growth.

I now undertake a more complete evaluation of the proposal. I discuss Burman's choice of the VAT as a consumption tax in Part II, before turning to other issues in Part III.

## II. CHOICE OF CONSUMPTION TAX

### *A. The VAT*

In economic terms, the VAT is a relatively efficient revenue source. As a consumption tax, it

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BUREAU, CPS ANNUAL DEMOGRAPHIC SURVEY, MARCH SUPPLEMENT (2007), available at [http://pubdb3.census.gov/macro/032006/altinc/newinc01\\_001.htm](http://pubdb3.census.gov/macro/032006/altinc/newinc01_001.htm).

<sup>20</sup> For further discussion of this point, see Alan D. Viard, *The Trouble with Taxing Those at the Top*, AM. ENTER. INST. TAX POL'Y OUTLOOK, June 2007, at 1, 3, [http://www.aei.org/docLib/20070614\\_TPO02\\_g.pdf](http://www.aei.org/docLib/20070614_TPO02_g.pdf) (extrapolating from CONG. BUDGET OFFICE, BUDGET OPTIONS 255 (2007), available at <http://www.cbo.gov/ftpdocs/78xx/doc7821/02-23-BudgetOptions.pdf>, that the same modest amount of revenue that could be raised from an across-the-board 2.2% rate increase would require a 10% increase if the rate increase was confined to the top two brackets or a 13% increase if the increase was confined to only the top bracket).

does not tax the return to saving. Burman uses the VAT to replace part of the existing income tax system and, perhaps more importantly, to forestall some of the future income tax increases that would otherwise occur in response to rising health care costs.

Because the proposal employs the VAT as only a partial replacement for the income tax, it retains inefficient taxes on saving, albeit at a lower rate than current law. The individual and corporate income taxes and the estate and gift taxes remain in place, although each of them is scaled back, and the individual and corporate income taxes are not integrated. As I discuss in Part II.B, it would be possible and desirable to replace the entire income and transfer tax system with a consumption tax, although such a replacement could not be done through a VAT.

Despite the appeal of a more sweeping change, the partial replacement of the income tax by a VAT is probably the most likely route to an increased emphasis on consumption taxation in the federal tax system. Burman is not alone in advocating such a replacement; as he notes, William G. Gale and Michael J. Graetz have also called for the VAT to play such a role.<sup>21</sup>

The VAT has some advantages.<sup>22</sup> It has been successfully implemented by nearly 150 nations and international trade rules allow VAT to be imposed on imports and rebated on exports.<sup>23</sup> Although this “border adjustment” does not confer the competitiveness advantage that some claim for it, it probably makes the tax easier to administer and certainly adds to its political appeal.<sup>24</sup>

One serious problem, to which Burman alludes only briefly, deserves more attention. The introduction of a VAT poses a transitional monetary-policy dilemma because it reduces the market-clearing level of the real wage. To see this, consider a worker whose marginal product is ten apples. In a no-tax world, the worker would be paid a wage equal to the consumer price of ten apples; if apples sold for \$1 each, the worker would be paid a wage of \$10. The worker continues to receive the same \$10 wage in a world with a 20% individual income tax, although the worker pays \$2 of the \$10 as income tax, retaining only \$8 (enough to buy eight apples) in disposable income.

Now, suppose that the 20% income tax is replaced by a 20% VAT. If the Federal Reserve’s monetary policy keeps the *tax-inclusive consumer* price of apples unchanged at \$1, the firm clears only eighty cents for each apple sold, with the other twenty cents paid in VAT. Because the ten apples produced by the worker are now worth only \$8 to the firm, the market-clearing wage falls to \$8. Of course, with the income tax removed, the worker keeps the entire \$8 wage, which gives the worker the same real disposable income as under the income tax. (The worker can still buy eight apples because his or her disposable income is unchanged at \$8 and the price of apples, including tax, is unchanged at \$1.) The only difference between the two taxes is that the VAT is taken out of the wage before the worker receives it while the income tax was paid from the wage after the worker received it. In a frictionless textbook economy, that is no difference at all.

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<sup>21</sup> See MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 83 (2008); William G. Gale, *Fixing the Tax System: Support Fairer, Simpler, and More Adequate Taxation*, BROOKINGS INST., Jan. 17, 2008, at 11, [http://www.taxpolicycenter.org/UploadedPDF/1001128\\_fixing\\_tax\\_system.pdf](http://www.taxpolicycenter.org/UploadedPDF/1001128_fixing_tax_system.pdf).

<sup>22</sup> See, e.g., GRAETZ, *supra* note 21, at 82–83, 188–89 (listing some advantages of the VAT).

<sup>23</sup> See *id.* at 64–66, 80–82.

<sup>24</sup> See DAVID F. BRADFORD, THE X TAX IN THE WORLD ECONOMY: GOING GLOBAL WITH A SIMPLE, PROGRESSIVE TAX 5–10 (2004) (arguing that imposing VAT tax on imports but not exports does not increase anyone’s competitive advantage, although it does make the tax more administrable).

Yet, that difference might be significant in the real world, in which it may be difficult for firms to reduce nominal wages. Suppose that the worker's nominal wage remained rigid at \$10 rather than falling to the new market-clearing level of \$8. Significant unemployment would then result as firms paid VAT on top of an unchanged real wage. If nominal wages stubbornly refused to fall, market clearing could be restored only if the Federal Reserve altered monetary policy to allow the tax-inclusive consumer price of apples to rise to \$1.25. (Each apple would then be worth \$1 to the firm, net of VAT, and \$10 would be the market-clearing wage.) This monetary accommodation would allow real wages to fall without reducing nominal wages. Such accommodation seems likely; regardless of whether nominal wages would actually be rigid, the Federal Reserve would probably be reluctant to take any chances. Unfortunately, the substantial one-time increase in the price level would be disruptive for financial contracts written in nominal terms.

Burman recognizes that the VAT is likely to be accommodated by the Federal Reserve. He sensibly proposes to ameliorate the resulting disruption by phasing in the VAT over time. The gradual phase-in has the drawback, however, that it provides an incentive to accelerate consumption and reduce saving; the neutrality of the VAT or any other consumption tax with respect to saving depends on the tax rate being constant over time.

On the whole, the VAT is a reasonable choice for an add-on consumption tax, although its introduction will pose transitional problems.

### *B. The Path Not Taken: The Bradford X Tax*

The introduction of a VAT as a partial component of the federal tax system is one way to reduce the taxation of saving. Another more sweeping approach would replace the entire individual and corporate income taxes (and the estate and gift taxes) with a consumption tax, thereby completely eliminating the federal taxation of saving. To be sure, it would not be feasible to replace the income tax system with a VAT or retail sales tax, due to the reduction in progressivity. The transitional monetary-policy dilemma would be an additional obstacle, as a full replacement of the income tax would require an even higher VAT rate and an even larger increase in the consumer price level.

The best approach for a complete income-tax replacement is likely to be the Bradford X tax.<sup>25</sup> The X tax has the same basic design as the "flat tax" proposed by Robert E. Hall and Alvin Rabushka.<sup>26</sup> It is a two-level VAT, in which part of the VAT is collected from firms and part is collected from households. Under a flat tax or X tax, firms pay tax on their VAT tax base less their wage payments, while households pay tax on their wages. Because the flat tax and X tax simply rearrange the components of the VAT, which is a consumption tax, the flat tax and X tax are also consumption taxes. As an alternative way to see the point, the flat tax and X tax are consumption taxes because they differ in two key respects from today's income tax system. First, the household tax applies only to wages, with no tax on any component of capital income. Second, the business-firm tax applies to business cash flow, with capital expenditures expensed rather than depreciated over time. As a result, the business-firm tax imposes no tax burden on the normal returns to investments made after the reform is introduced, although it taxes above-normal investment returns and the cash flow from the capital held on the implementation date.

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<sup>25</sup> For a full description of the X tax, see BRADFORD, *supra* note 18, at 67–73.

<sup>26</sup> See ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995).

The X tax differs from the flat tax in one important respect — its rate structure. The flat tax imposes a single tax rate on business cash flow and taxes households at that same rate on wages above an exemption amount. The exemption for households makes the flat tax somewhat more progressive than a conventional VAT; the tax applies to all consumption financed from above-normal investment returns and initial wealth, but only to some consumption financed from workers' wages. The X tax expands this element of progressivity by taxing business cash flow at a single tax rate and wages at graduated rates.<sup>27</sup> Wages below an exemption amount are taxed at zero, the highest wages are taxed at the same rate as business cash flow, and intermediate wages are taxed at intermediate rates. With this set-up, any degree of progressivity can be achieved; the President's Advisory Panel on Federal Tax Reform developed, though it did not definitively recommend, a replacement X tax with a top rate of 35% that largely replicated the progressivity of the current income tax system.<sup>28</sup>

Unlike a VAT or retail sales tax, the X tax can be a replacement for, rather than an addition to, the income tax system because it can be as progressive as desired. Also, the transitional monetary-policy dilemma disappears because the tax on wages continues to be collected at the household level.

To be sure, the taxation of wages at the household, rather than the firm, level causes the X tax to face three problems that the VAT does not face. First, because wages and business cash flow are taxed differently, it is necessary to distinguish them, which is difficult for sole proprietorships and other closely held firms in which the same individuals supply both labor and capital to the business. Second, due to economically irrational distinctions drawn by international trade rules, the movement of the wage tax to the household level may make it impermissible to impose the X tax on imports and to rebate it on exports.<sup>29</sup> Although the inability to border-adjust the X tax in this manner would not harm the competitiveness of American firms, it would make the tax politically less attractive and might raise administrative difficulties. Third, the fact that business firms deduct wages in computing their X tax base means that many firms will have negative tax liabilities in any given year. If Congress does not allow full refundability of the negative liabilities, the efficiency properties of the tax will be diluted. These challenges must be addressed to make the X tax a politically viable reform option.

For those of us who wish to eradicate the taxation of saving, the X tax path seems attractive. Burman's proposal takes a more modest approach by making only a partial switch from income to consumption taxation, but still achieves a large portion of the gains from a complete switch.

### III. OTHER FEATURES OF PROPOSAL

#### A. Repealing the Medicare Tax

The replacement of the 2.9% Medicare component of the payroll/self-employment tax by the VAT is a desirable provision. While there is some disagreement about the relative merits of consumption and income taxes, it is relatively clear that a consumption tax is better than a *wage*

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<sup>27</sup> See BRADFORD, *supra* note 18, at 67–68.

<sup>28</sup> See PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 182–90 (2005), [http://www.taxreformpanel.gov/final-report/TaxReform\\_Ch7.pdf](http://www.taxreformpanel.gov/final-report/TaxReform_Ch7.pdf).

<sup>29</sup> See generally Jane L. Seigendall, Comment, *A Framework on Consumption Taxes and Their Impact on International Trade*, 18 DICK. J. INT'L L. 575, 598 (2000) (providing a discussion on international trade rules as they pertain to consumption taxes).

tax (a roughly accurate description of the payroll/self-employment tax). A consumption tax is equivalent to a wage tax plus a tax on above-normal investment returns and a one-time tax on the initial wealth held when the tax is introduced. Although there are some subtle issues concerning how initial wealth should be treated, the addition of taxes on the above-normal returns and initial wealth generally makes a consumption tax both more efficient and more equitable than a wage tax.<sup>30</sup>

The equity and efficiency gains would be even larger if the 12.4% Social Security component of the payroll/self-employment tax were also replaced by the VAT. Unfortunately, replacement of the Social Security component would raise difficult issues about the design of that program. Under current law, Social Security benefits rise, though less than proportionately, with lifetime earnings that have been subjected to Social Security tax. That design is intended to provide a contributory rationale for Social Security by linking benefits received from the program to taxes paid into the program. If Social Security were instead financed by a VAT, it would no longer be possible to compute individuals' benefits in a manner directly linked to individuals' tax payments into the program, forcing an abandonment of the contributory rationale.<sup>31</sup>

Burman sidesteps those difficulties by maintaining the Social Security portion of the payroll and self-employment taxes and replacing only the Medicare component. The replacement of the Medicare component does not raise the same issues. Since Medicare Part A benefits already have little relationship to taxes paid into the program, there is little or no contributory rationale to maintain. Accordingly, Burman's proposal reaps some of the equity and efficiency gains of moving from a wage tax to a consumption tax without encountering the thorny problems of Social Security design.

### *B. Broadening the Income Tax Base*

Besides scaling back the income tax, Burman's proposal broadens the income tax base in order to finance further reductions in statutory tax rates. While such base broadening is generally a good idea, the gains it produces are often misunderstood.

In general, a revenue-neutral base broadening reform of an income tax does *not* lower disincentives to work and save.<sup>32</sup> Consider an economy in which workers devote half of their purchases to apples and half to oranges. A revenue-neutral move from a 50% tax that exempts oranges to a 25% uniform tax does not change work disincentives. The first tax has the same 25% effective tax rate on work as the second tax because its 50% statutory tax rate applies to only half of the marginal dollar earned. Nevertheless, such base broadening can be quite beneficial. Although moving from a 50% tax on apples to a 25% uniform tax does not reduce work

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<sup>30</sup> For early discussions of the relationship between consumption and wage taxes, see Lawrence H. Summers, *Capital Taxation and Accumulation in a Life Cycle Growth Model*, 71 AM. ECON. REV. 533 (1981) and ALAN J. AUERBACH & LAURENCE J. KOTLIKOFF, DYNAMIC FISCAL POLICY 57–82 (1987). For a more recent discussion, see Bradford, *supra* note 18, at 71–72, 93–94, 99–100.

<sup>31</sup> The only way to maintain a visible contributory rationale would be to link each individual's Social Security benefits with his or her lifetime consumer spending, but a VAT is collected from firms and does not provide information on individuals' consumption spending. Benefits could still be linked to lifetime earnings, but that would not provide a readily understood contributory rationale. (The FairTax plan, which would replace the payroll tax with a retail sales tax, links benefits to lifetime earnings. H.R. 25 110th Cong. § 903 (2007).)

<sup>32</sup> For an application of this principle to the Tax Reform Act of 1986, see Alan J. Auerbach & Joel Slemrod, *The Economic Effects of the Tax Reform Act of 1986*, 35 J. OF ECON. LITERATURE 589, 600–03 (1997).

disincentives, it eliminates the distortionary incentive to consume oranges rather than apples.

Holding fixed the amount of revenue to be raised from the income tax, therefore, Burman's repeal of the state and local tax deduction and of the exclusion for employer-provided health insurance and accompanying reductions in statutory tax rates are roughly a wash in terms of work and saving incentives. His proposal is beneficial, however, because it removes distortions that encourage the growth of state and local government and first-dollar employer-provided health insurance.

AMT repeal is another desirable feature of the proposal. Burman also outlines a variety of other changes, such as revamping credits for work and children, replacing deductions with credits, and making a partial move to a return-free system. Without going into details, these provisions are generally desirable and promise to yield a simpler and more rational income tax system.

### *C. Revamping Federal Health Programs*

Burman's replacement of a mix of health programs with a uniform voucher is a desirable step toward equity and simplicity. The politics are likely to be difficult, though, as such a sweeping change will create losers as well as winners. Others with more expertise on health care should address these provisions of the proposal.

Although the movement of Medicaid to the federal level is a step that state governments should welcome, historical experience suggests some caution about how this step will be received. In 1982, President Reagan's New Federalism proposal would have moved Medicaid to the federal level and would have reduced or abolished federal taxes on oil production, gasoline, alcohol, and tobacco, in exchange for states assuming responsibility for food stamps, Aid to Families with Dependent Children, and dozens of discretionary spending programs. While states would have been happy to shed responsibility for Medicaid, they were wary of assuming responsibility for the other programs and the proposal did not become law.<sup>33</sup> As with the New Federalism proposal, states may be wary of other aspects of Burman's proposal, such as the repeal of the state and local tax deduction.

One concern that prevented New Federalism from being adopted was the geographical disparity in Medicaid benefits across states.<sup>34</sup> It would have been quite expensive for the federal government to replicate the most generous state's benefits nationwide, yet any other policy would result in some recipients experiencing a loss of benefits. The same issue will arise under Burman's proposal because the voucher will not and should not replicate the most generous states' Medicaid benefits.

### *D. Restraining Government Spending*

Burman's proposal is less satisfactory in responding to the need to restrain the growth of entitlement spending than it is in responding to the other long-term realities. The proposal does not include any legislated reductions in entitlement spending growth. Burman includes and discusses some changes to budget processes and institutions that may produce some spending

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<sup>33</sup> For a discussion of the proposal and its failure to become law, see *Congress Cool to Reagan's 'New Federalism'*, 38 CONG. Q. ALMANAC 536 (1982).

<sup>34</sup> *Id.* at 537.

restraint, but the effects of these changes are likely to be modest.

Burman stresses the visibility of the VAT rate as a restraint on health spending. The tight linkage between health spending and a tax rate faced by everyone in the country should produce some political pressure to restrain health spending. Burman notes that the VAT payment could be listed separately on customer receipts; that practice (followed in Canada, but not in most European nations) should be adopted to make the tax more visible. Even so, the federal government will have two major tax sources rather than one — a combination that could well be a spur to spending. Even if the VAT is restrained, there may be pressure to raise the income tax back to its original levels.

Burman also suggests consideration of caps and triggers on entitlement spending, but does not definitively endorse any changes of that kind. It is hard to know how effective any such procedures might be; changes in budget processes can be an aid to, but not a substitute for, the political will to restrain spending.

The proposal could be improved by including legislated reductions in entitlement spending. Burman notes that the health-care voucher could be limited to the provision of a high-deductible health insurance plan; that approach would be more successful than trying to cover most of national health spending. It would also be desirable to include changes to the growth of Social Security benefits — perhaps by incorporating a longevity adjustment or indexing each cohort's starting benefits to prices rather than wages.

#### IV. CONCLUSION

As Burman recognizes, any sweeping reform plan faces an uphill challenge. He holds out some hope by noting the Tax Reform Act of 1986, which overcame long odds against its adoption. Burman's proposal is, of course, considerably more ambitious than the 1986 Act, which casts doubt on its near-term prospects.

At some point, though, our nation will have to confront the fiscal challenges that it faces. When it does, policymakers will want to have proposals like Burman's at their fingertips.