Tax Policy at the Beginning of the Clinton Administration

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Ten years ago, in 1983, the Yale Journal on Regulation was started by students at the Yale Law School to foster scholarship and debate on issues of regulatory policy. Today the Journal staff consists of students from Yale University graduate and professional programs in law, management, forestry, and public health. One of the Journal's primary missions was to track the regulatory/deregulatory developments under the Reagan Administration and later the Bush Administration. Since our tenth anniversary coincided with the installment of a Democratic Administration under President Clinton, we have asked two professors at the Yale Law School to submit an essay discussing a policy issue in their respective field of expertise and any predictions and recommendations they have as a result of the new administration and change of party leadership.

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Michael J. Graetz†

When this Journal asked me to write a short essay on tax policy at the beginning of the Clinton Administration, I thought it odd; however, now that this Administration's first set of tax proposals has been unveiled, a journal on regulation seems the perfect place for a few observations. Before commenting on where tax policy seems to be heading, I shall try briefly to describe where we are—with a backwards glance at how we got here.¹

The Deficit

The key political and economic fact motivating the first tax proposals of the Clinton Administration is the size of existing and projected deficits. The Administration concluded that a major effort at deficit reduction is essential to the health of the American economy.

In fiscal year 1992 that ended last September 30, the federal government had a deficit of about $290 billion, or nearly 5% of gross domestic product (GDP)—a very high figure but still below the record 6.3% reached in fiscal

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1. For a somewhat similar exercise, see Alvin C. Warren, The American Tax Agenda in the 1990's, lecture to the faculty of Law, Bar Ilan University (Dec. 1992).
year 1983. In fiscal year 1980, before Ronald Reagan took office, the deficit was $74 billion, about 3.7% of GDP—a comparable number today would be about $180 billion. The last Budget released by the Bush Administration in January 1993 estimated a deficit for fiscal year 1993 of more than $325 billion, over 5% of GDP, which is then expected to decline before rising again in 1998 to $320 billion, or nearly 4% of GDP.

While we have all learned to take such projections of future deficits with a bit of salt, they do suggest that the deficit is not simply going to behave like Alice’s cheshire cat and disappear. Even with economic growth substantially higher than the economic forecasts of most economists for 1993, the deficit is estimated to be nearly $200 billion in fiscal year 1998 if federal tax and spending policies are not changed.

The cumulative federal debt held by the public, including foreigners, is now about $3 trillion and is estimated to rise to nearly $5 trillion over the next five years, in the absence of a major reduction in projected deficits. Interest on the federal debt paid to the public in fiscal year 1992 was about $290 billion, more than 20% of total federal outlays and about 5% of GDP. The share of federal spending to pay interest on the federal debt is at an all-time high, either as a percentage of total federal outlays or of GDP.

Federal deficits, however, are not a recent phenomenon. Fiscal year 1969—24 fiscal years ago—was the last year that we had a balanced federal budget.

Contrary to popular notions, tax reductions in the past decade do not explain the nation’s current deficit condition. Taxes in fiscal year 1992 were $1.1 trillion, or 18½% of GDP. Outlays were $1.4 trillion, about 23¾% of GDP. Federal taxes historically have taken a relatively constant share of GDP: 17.7% in 1950-55; 18.2% in 1960-65; 18.4% in 1970-75; 19.7% in 1980-85; and 18.5% today. The current and projected deficits exist principally because, while the level of taxes has remained relatively constant, federal spending has increased as a share of GDP over time—beginning in the late 1970s from about 20% to 23-24% of GDP today. Major increases in spending have included: defense, income security, health care, and interest on the federal debt.

When one adds state and local taxes to the federal take, total U.S. taxes are about 30% of GDP. This is low by international standards—the average for OECD countries is about 38%, with a range from 29-56%. But those countries’ spending patterns are also different, especially with regard to health and education where the government’s share of spending is much higher than in the U.S.

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2. I am dealing here only with debt owed to the public and not debt owed within the government, such as the social security trust funds.
Total federal revenues have increased in both real and nominal terms because GDP has grown consistently over a long period of time. The important point here is that economic growth—not changes in the kinds or rates of tax, nor a dramatically more burdensome federal tax structure—has long been the engine of federal revenues. Obviously, to reduce or eliminate the deficit, either federal spending will have to be reduced significantly, or taxes must be increased, or both. The economic proposals of the Clinton Administration reflect this transparent reality. Before discussing these proposals, however, I shall describe briefly five important tax policy events of the past decade.

**Five Key Tax Policy Events**

The key political tax event of the last decade or so was the tax limitation movement, starting with Proposition 13 in California, followed shortly by Proposition 2 in Massachusetts, and culminating in 1988 with George Bush's notorious "No new taxes" pledge. The tax limitation movement has generated two important current developments: First, it is unmistakable that the conservative promise of the tax minimization movement has been shattered at the federal level. Contrary to conservative dogma, tax reductions do not necessarily mean spending reductions or a reduction of government size—at least in the absence of a balanced budget requirement. Second, the American populace has learned to resist additional taxes. Despite the new public interest in deficit reduction and the general popularity of "soaking the rich," an overall increase in tax burdens can still be very costly to politicians. Together, these two facts make deficit reduction an extremely difficult task.

In addition to state constitutional amendments and legislation that limit taxation, four particularly important federal tax enactments warrant special mention.

First, although the Economic Recovery and Tax Act of 1981 is best known for its overall rate reductions and business and real estate tax incentives, its most significant enduring feature was the elimination of rate bracket creep through inflation adjustments. These inflation adjustments eliminated the sizeable automatic income tax increases that had been produced even at relatively low levels of inflation. The lasting revenue impact of this change is dramatic—far greater than is generally known. If inflation adjustments had not been enacted, we simply would not be facing the deficit problem that is now of such economic and political concern.

As a political matter, inflation adjustments to the personal exemption, standard deduction, and rate brackets eliminated the escalation of revenues that previously had enabled Congress routinely to provide tax cuts; instead they created a plateau, requiring Congress to enact explicit tax increases to boost revenues. This produced a now familiar case of legislative paralysis.
Second, the 1983 Social Security Amendments moved Social Security from a pay-as-you-go system to a system based on an "actuarially sound financing" of the retirement benefits of the baby boom generation. The employment tax was increased substantially in an effort to fund future benefits, and, as a result, the Social Security Trust fund is now experiencing annual surpluses of about $300 billion. Indeed, even though the overall federal tax level has remained relatively constant over a long period of time, the share of employment taxes to finance Social Security has increased dramatically relative to GDP, changing substantially the composition of U.S. taxes. The sole cause of the increased tax burden on middle-income taxpayers is not income tax increases but rather the payroll tax increases to finance Social Security. But the promise of future benefits has not served to offset the popular perception that the wages of the middle class are being overtaxed. Moreover, this change may be having an adverse effect on the nation's level of private savings, although whether or not this is actually occurring is quite controversial.

Third, the far-reaching 1986 Tax Reform Act was the result of an uneasy political marriage between the conservatives' desire for low tax rates and the liberals' desire for a broad tax base. Both sides of this compromise are now under attack and seem to be in considerable jeopardy from the Clinton Administration's tax proposals. Additionally, the most important aspect of the 1986 Act—the decision to strengthen the income tax rather than to replace it with a consumption tax—is now being challenged. However, President Clinton's emphasis on increasing income taxes of higher income individuals suggests that complete substitution of consumption taxes for the income tax resides in some distant future.

Finally, the 1990 Budget Enforcement Act provided a blueprint for the Clinton Administration's tax and spending proposals and established new budget enforcement and process provisions. It abandoned the Gramm-Rudman-Hollings sequester mechanisms—automatic spending cut mechanisms—in favor of two devices: (1) specific spending caps for defense and for domestic and international discretionary spending, and (2) a pay-as-you-go system for revenues and entitlement spending, which required new tax cuts or entitlement spending increases to be offset by either tax increases or entitlement spending cuts. Despite the Clinton's Administration's call for retention of much of this structure, this budget enforcement process clearly is not stable. The financing of domestic spending is to be contingent upon defense spending cuts, and the failure of the 1990 Act to control spending on entitlements—particularly for Medicare and Medicaid—must be remedied in the forthcoming health care

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reforms. The 1990 Act also foreshadowed the political tax debate of the 1992 election: during enactment of the 1990 Act, economic growth and tax fairness were treated as mortal enemies.

As one congressional staffer has observed, in 1991 and 1992, the 1990 Budget provisions survived a war, drought, floods, fire, recession, the collapse of communism and, against all odds, a Presidential election year. It remains to be seen whether they will survive Democratic leadership at both ends of Pennsylvania Avenue. In early 1993, President Clinton has already declared an "emergency" under the 1990 Act in the hopes of enacting a short-term fiscal stimulus package without spending or revenue offsets. Only a Republican filibuster in the Senate thwarted this effort.

Ironically, the much maligned political deadlock, along with the pay-as-you-go provisions of the 1990 Act, had a very beneficial effect on the tax system. After enactment of nine major tax bills containing more than 8,000 pages of statutory changes during the period 1981 to 1990, there was no significant tax legislation in either 1991 or 1992. Although the unending threats of forthcoming legislation added risk to investment decisions during that period, at least neither the IRS nor taxpayers and their advisers had to struggle with new legislation or new tax forms. Unfortunately, this brief stability of the tax system is destined to end in 1993.

Let me turn now to the Clinton proposals for tax changes.

The Short-Term Stimulus

The President's short-term tax and spending proposals are far more important politically than economically. President Clinton simply could not afford to be a mere bystander to the economic recovery that seemed apparent in the fourth quarter of 1992. But his $30 billion of proposed fiscal stimulus would have little short-term economic impact, and it makes little or no economic difference whether his proposed new spending or temporary investment tax credit proposals are enacted.

In fiscal year 1992, the deficit was $110 billion lower than the Bush Administration had estimated in January, principally due to postponed savings and loan expenditures, but with more than $30 billion of the reduction resulting from increased revenues and reduced outlays. There is simply no evidence that this fiscal change made any difference to the nation's economic performance. Thirty billion dollars is not a large amount in a $6 trillion economy. The nation's short-term economic health remains primarily in the hands of the Federal Reserve. Even with low interest rates, the growth in the monetary

supply has been consistently below the Federal Reserve Board's targets and the President knows well that real help from the Fed is essential to economic recovery. It was no accident that Federal Reserve Chairman Alan Greenspan occupied the seat of honor next to Hillary Rodham Clinton at the President's State of the Union address.

The condition of financial institutions is also important to the nation's short- and long-term economic health. Financial institutions have—for many reasons—become much more cautious in their lending policies; they have been holding record levels of Treasury debt, and their lending to businesses has been weak. President Clinton has promised to address this situation, and we await the details.

Long-Term Deficit Reduction

The heart of the President's economic plan, of course, is his program for long-term deficit reduction. Here I will discuss only the tax aspects of his proposals, putting aside both his proposed reductions in defense spending and shifts in domestic spending priorities.

Years ago, Senator Russell Long announced the Politicians' Tax Policy Credo:

Don't tax you.
Don't tax me.
Tax the fellow behind the tree.

During the campaign President Clinton's fellows behind the tree were "the rich" and his proposals fulfill his campaign promise of higher tax rates on upper-income individuals. The Democrats have clearly now become committed to the belief that an increase in top marginal income tax rates will not inhibit economic growth. The top federal rate under the Clinton proposals will exceed 40%—an increase of about 10 percentage points. The individual minimum tax will also increase, and the proposals contain a significant expansion of earned income tax credits for the working poor.

President Clinton's proposals contain but a faint echo of a long history of redistributional tax politics in the United States—begining with Wilson, continuing with Roosevelt, and up to the present—which has been marked by increases in taxes on corporations. Clinton seeks to increase the corporate tax rate from 34 to 36% and to offset any economic risks from such a change by introducing an investment tax credit for certain small businesses and an incremental investment tax credit for other businesses. The Clinton Administration defends this reversal of the 1986 tax reform by citing certain
economists' arguments that equipment purchases play a special role in stimulating economic growth. Space does not permit an in-depth evaluation of the President's investment credit proposals here, but skepticism about the economic effectiveness of this trade-off—as well as about the practical viability of an incremental investment tax credit—is surely warranted.

During the 1992 campaign, President Clinton also promised to raise $45 billion of revenue from foreign-owned corporations, adding a second stanza (coined by Dan Rostenkowski) to Russell Long's ditty:

Don't tax you.
Don't tax me.
Tax the firms across the sea.

In his proposals, however, the promised $45 billion of additional revenue from foreign-owned corporations has dwindled to less than $4 billion, and the President's international tax proposals instead increase taxes on U.S.-owned multinationals by about three times that amount. Ironically, the most controversial of these proposals, which would revise the treatment of foreign source royalties of U.S. multinationals, seems to undercut Clinton's oft-repeated desire to encourage multinational companies to conduct research and development of new technologies and products in the United States. This essay is being written prior to any congressional action on the specifics of the President's proposals, but it would not be surprising if the incremental investment tax credit were to disappear and the corporate tax increase scaled back as the tax legislation progresses through Congress.

The President also proposed a targeted capital gains tax cut, particularly valuable to owners of certain small and medium sized businesses. Indeed—although small business would be defined three different ways in qualifying for lower corporate tax rates, investment tax credits, and capital gains relief—for many proprietorships, Subchapter S corporations and partnerships, these tax reductions would be countered by increased individual-level tax rates.

Tax relief for middle-income taxpayers, promised in the campaign, was not recommended; instead the President proposes income tax increases for Social Security recipients with more than $32,000 of income ($25,000 single) and a broad-based energy tax on heat (BTU) content, not only to further deficit reduction but also out of concern for the environment and for reducing our dependence on foreign sources of oil.

The most difficult practical economic, and perhaps political, obstacle to implementing the energy tax is its failure to make border adjustments that would exempt exports and tax imports of products where energy is a substantial component of price. This induces manufacturers and farmers to complain that the tax unfairly burdens domestic production of such products and hurts their competitive position in both domestic and international markets. Before a broad-based energy tax can be enacted, an exemption for manufacturing and agriculture may prove politically necessary, but that would require a rate increase on other energy uses to meet the President’s revenue targets and would at least somewhat blow the “ecocover” of the tax. When the legislative dust settles, Congress may settle for a simple increase in the gasoline tax. If so, the likelihood of a value added tax increases in the not so distant future.

The energy tax is but one instance where the Clinton Administration proposes to use the tax system to direct investment or consumption or even as a substitute for regulation. Other examples include denial of income tax deductions for lobbying or for executive compensation in excess of $1 million not appropriately or sufficiently linked to the company’s performance. Incidentally, the latter proposal, which would turn tax consequences on shareholder approval of executive pay, conflicts with the SEC approach to the executive pay issue, which heretofore has relied on disclosure rules and nonbinding shareholder resolutions.

Using the tax system to further specific industrial policies seems to be a direction the Clinton Administration plans to continue. For example, two months after the State of the Union Address, newspaper reports indicated that the Administration was considering using the tax system to benefit the airline industry. Likewise, selected excise taxes on tobacco and perhaps on alcohol and firearms have been mentioned by Administration officials as potential financing sources for health reform, although one should never underestimate the political resistance of Joe SixPack. At the Andrews Budget Summit in 1990, the late Silvio Conte proposed taxes on junk food and soda pop, which California has since adopted, thereby proving Will Rogers’ old adage that when a legislature makes a joke, it’s a law.

Unlike direct regulation, using the tax system to deter energy or tobacco consumption creates special problems for an administration that has made tax fairness its rallying cry. These taxes would fall more heavily on lower- and middle-income taxpayers than on persons with higher incomes. Similar distributional consequences occur with regulations that tend to increase prices without corresponding remittances to the government, but their regressive efforts have been more easily ignored in the political process.

The current context, however, in which taxes are being increased on specific items of consumption that the nation wants to reduce for health, conservation, or environmental reasons, may create an opportunity for Congress to begin
looking at tax distributional issues in a new light. In contrast to a broad-based consumption tax, in this case people could substantially reduce their tax burdens by shifting to less harmful consumption patterns. When Congress has regulated, rather than taxed, items to reduce consumption, it has demonstrated little concern for distributional burdens. This, for example, has distinguished proposals for a tax on sulfur or nitrogen emissions from the regulation and emissions trading mechanisms of the Clean Air Act of 1990.

At a minimum, Congress should view the distributional burden of such selected excise taxes over a longer time horizon rather than solely by short-term references to annual income. Tobacco taxes have been found to be proportional to lifetime income, and alcohol taxes slightly progressive. Some low-income offset, however, is clearly required to ease the burden of a significant broad-based energy tax on low-income taxpayers and this is one reason the Administration proposed increases in the earned income tax credit.

Using tax increases for both regulatory and revenue purposes does create a special problem for achieving success on both fronts. To the extent that the regulatory goal is successful and consumption of the heavily taxed goods decreases, the amount of revenues produced from the tax will also decline. This suggests that the level of the tax must be well calibrated to produce the desired compromise between the regulatory and revenue goals—an exercise which does not inspire great confidence. It seems far more likely that either the anticipated revenues will prove elusive or that the regulatory (environmental, health, etc.) benefits will be overstated—or, more likely, both.

As occurs with many regulations, targeted tax increases often have unintended effects. The most obvious unintended consequence of the Clinton proposals is the increase in the marriage penalties for both high- and low-income families. Even though so-called “family values” was a rallying cry of the other party, surely these effects are accidental. The additional tax burden for low-income people with children who marry could rise to more than $4,000 a year under the Clinton proposals. Likewise, for high-income two-earner married couples, the best tax planning strategy may be divorce. Two single people can earn $230,000 before the Clinton tax rate would increase from 31 to 36 percent, but only $140,000 if they marry—a tax difference of $4,500 a year, and the additional 10 percent surcharge kicks in for a married couple at $250,000 of income, but an unmarried pair can earn $500,000, for a potential tax savings of more than $13,000. In the late 1960s, Congress created a marriage tax penalty that gave young people a reason for living together


without marrying that their parents could understand. In the 1990s, President Clinton may be giving some of these same people a reason for divorcing that their children can comprehend.

It is no accident that I have not mentioned tax simplification—the process of lessening the burdens and costs of complying with the tax laws by making them simpler to comprehend and deal with. If the President's tax proposals are to be taken as a guide, the Administration seems not to be taking seriously the economic burden of tax compliance. Tax simplification is no priority. In the Clinton proposals, simplification is the dog that did not bark.

The Big Wild Card

As President Clinton well knows, reform of the nation's health care system poses the greatest threat to both the fiscal responsibility and the political credibility of his administration. If means to flatten the rate of growth of this nation's medical costs are not found quickly, achieving a sound economic and fiscal position for the country may be little more than a pipe dream.

President Clinton's budget proposals contain more than $60 billion in proposed Medicare and Medicaid savings during the period 1994-1998—$17 billion in 1997 alone. He also proposes eliminating the ceiling for high-income people on the payroll tax that funds Medicare's part A hospital insurance to produce an additional $25 billion in revenue during 1994-1998. These savings are critical to achieve the deficit reductions the President has promised. But, at an average cost of $2000 a person, extending health insurance to the 37 million people currently uninsured is a $75 billion a year problem (ignoring the $10-15 billion of savings that hospitals may realize from no longer having to provide emergency room or other care to the uninsured). This suggests that substantial amounts of mandated premiums or a payroll tax or some other broadly applicable tax is likely to be necessary to avoid huge deficit increases from the Clinton Administration's forthcoming health reform proposals. Ultimately, President Clinton may have to duplicate Franklin Roosevelt's Social Security feat and convince the American people that a payroll tax is an insurance premium—a maneuver that should prove far more difficult in light of people's experience with Social Security. If a second round of tax increases to finance these proposals is to be kept to a minimum, it may be necessary to divert any Medicare and Medicaid savings to financing the expansion of health care access. Health reform is the lingering other shoe of President Clinton's deficit reduction endeavor. To see where it falls, we will have to await Act II.

On both the tax and health issues, one should be alert to scorekeeping games. Dick Darman, George Bush's Director of the Office of Management and Budget, for example, would simply count the tax increases and spending reductions twice. But in this Administration of change, that will not be possible.
Nevertheless, there will be great pressures on the Friends of Bill to overestimate revenue gains and cost savings and to underestimate tax reductions and spending increases. This scenario is an old story. Congress, for example, ignores revenue losses that occur subsequent to the five-year budget window and routinely counts and spends revenue increases from extending expiring provisions—such as estimated tax changes—while ignoring the revenue decrease from the expiration. The Clinton proposals follow these longstanding traditions. But if the citizenry is genuinely serious in its demands for deficit reduction, increased attention to such accounting maneuvers will be required.

The Longer Term

After Congress works its will on the Clinton economic and health care proposals, at least six major tax policy issues will remain on the longer term agenda.

The first is the future role of consumption taxation at the federal level. This nation’s low reliance on consumption taxation is currently the largest difference between the U.S. and the tax systems of our trading partners. Consumption taxes account for an average of 30% of revenue in other OECD countries versus 17% here. The apparent desire to increase revenues, coupled with a desire to stimulate increased private savings, are powerful arguments for consumption tax advocates and have produced widespread agreement among economists that additional revenues should come from taxing consumption. The Clinton Administration has seemed to settle on an energy tax, coupled with specific excise taxes on such things as tobacco and alcohol, in lieu of a broad based consumption tax, such as a business transfer tax (BTT) or a value added tax (VAT).

The Clinton proposals for increasing top income tax rates make clear that a broad based consumption tax remains very unlikely to replace income taxes, at least for high income individuals. The more interesting question is whether a BTT or VAT could be enacted to replace both the proposals for selected excise taxes and a substantial portion of income or payroll taxes for middle-income taxpayers. Such an outcome seems far more realistic in the near-term if President Clinton’s proposal for an energy tax is defeated or is made so complex through exemptions and special rates that it proves not to be viable.

Second is the issue of the future of payroll taxes. The growth of the payroll tax to finance Social Security and Medicare hospital insurance is surely the most important development in the federal tax structure over the past four decades. These taxes have risen from less than 10 percent of total budget receipts in 1952 to nearly 40 percent in 1992. As I suggested earlier, the impact of this increase has been especially dramatic for low and moderate income
earners. The growth in the wage-based payroll tax has been defended on the
ground that wage-based taxes are appropriate to finance wage-replacement
social insurance for unemployment, retirement, or disability. The Clinton
Administration is also considering a payroll tax as a principal source of finance
for its health insurance proposals.

The payroll tax is now well entrenched as an important source of federal
revenues, but its structure is haphazard and, on the whole, regressive.8 Even
at its current level, there are important concerns about compliance, particularly
in the classification of workers as employees or independent contractors and
a substantial increase in payroll taxes will raise concerns about their effect on
both employment and middle-class tax burdens. As the population of the U.S.
ages in the years ahead, with fewer workers supporting more retirees, the ability
to rely on payroll taxes to fund social insurance will decrease. At a minimum,
restructuring and better coordination of payroll taxes seems likely in the years
ahead, and substitution of consumption taxes for all or part of the payroll tax
will also likely reach the political agenda.

The third long-term issue is corporate tax integration. Over the long-term
the present corporate tax system seems very unstable, particularly in its
preference for debt over equity and in favoring noncorporate over corporate
investment.9 The current income tax preference for housing investment relative
to corporate investments is striking, as are the consequences.10 Virtually all
of our trading partners have at least partially integrated their corporate and
individual income taxes, and at some future time we also seem likely to move
in this direction.

Fourth is the subject of taxation of international income. This may be the
most difficult long-term issue. The growth and speed of international capital
markets threaten the nation’s ability to fashion its own tax system. Our
normative underpinnings for taxing international income either conflict with one
another or are unattainable in practice, or both. Efforts to strengthen one’s own
national position are threatened by beggar-thy-neighbor reactions by one’s
trading partners. Economic knowledge concerning the effects on our domestic
economy of international tax options is very much in its infancy. The current
division of business income among source and residence countries is archaic,
but difficult to change.

President Clinton by now knows that his campaign rhetoric—looking to
foreign corporations for large amounts of revenues—offers no solution, even

8. See generally, Michael J. Graetz, The Troubled Marriage of Retirement Security and Tax
INDIVIDUAL INCOME TAXES; TAXING BUSINESS INCOME ONCE (Jan. 1992) and AMERICAN LAW
10. See U.S. TREASURY DEPARTMENT, supra note 9, at 5.
in the short-term. His international tax recommendations to date reveal protection of the United States tax base as his short-term goal, and there seems to be some desire in the Administration to use the tax system for protectionist goals. In the short-term, this nation's international tax law seems likely to continue the instability begun in the 1986 legislation, while both analysts and policy makers search for a coherent multilateral policy. In the meanwhile, continuation of the international trend towards lower withholding taxes especially on intercorporate dividends seems likely. Ultimately I believe that in order to maintain incomes taxes on production within the U.S. economy we will move in the direction of source-based taxation of business income, perhaps along the lines of Treasury's January 1992 Comprehensive Business Income Tax Proposal.11

Fifth, the tax system needs a more coherent response to the continuing and rapid development of a variety of financial instruments. The market for over-the-counter financial derivatives, such as interest-rate swaps, currency swaps, and related financial instruments has grown from about $3 billion a decade ago to more than $3 trillion today. The current income tax is ill-equipped to deal with the complexity of these instruments, their ability to take new forms, and their rapid growth. To date, the income tax system has been responding on an ad hoc basis, sometimes dividing a new financial instrument into its component parts in an effort to reveal assets familiar to the tax system, sometimes combining two or more financial transactions to produce something recognizable to the income tax. The internationalization of financial markets makes this problem one of staggering complexity. The Treasury response to date tells taxpayers: "Don't go too far; Don't be too abusive to the income tax." These new financial instruments and their internationalization may pose the greatest threat to the nation's ability to tax capital income, and may ultimately prove to be the Achilles heel of the income tax.

Finally, we must rethink our federalist system of taxation. The multistate taxation of corporate income is showing increasing strains as state tax rates have increased—strains that are related to the taxation of international income of these same entities. Wasteful costs of compliance with multiple tax systems have escalated for individuals and businesses alike. For example, large multistate retailers may be required to file more than 100 state and local sales tax forms each month. States, of course, must be free to set tax rates to meet their fiscal requirements, but we must think seriously about moving to greater uniformity in state tax bases and greater coordination among federal and state tax laws and enforcement. As experience with attempting to encourage state

11. See id. at chapter 5.
piggybacking on the federal income tax base demonstrates, this will be a daunting political challenge.

Conclusion

For both the long- and short-term, the goals of the nation’s tax and fiscal policies will be what they always have been: to facilitate growth of the nation’s economy and to do justice in the distribution of the burdens and benefits of government. During the recent years of divided government, the political parties have treated economic growth and fairness as if they were enemies. Bill Clinton has now promised a reconciliation—a fairer tax system that encourages savings and investment and nurtures economic growth. However, his detailed tax proposals do not engender confidence that these goals, which we all share, will be realized.

President Clinton’s State of the Union address to Congress marked the end—at least for now—of divided government in the United States. The Democrats’ outpouring of applause on that occasion demonstrated their enthusiasm for controlling both ends of Pennsylvania Avenue. An era of bipartisan conflict and compromise over matters of tax and budget policy has ended. Liberated from any responsibility for governing, Congressional Republicans are now free to behave purely as the opposition, a role some will find quite congenial. Democrats believe they must compromise only with themselves. They can claim credit for success and must bear responsibility for failure.

In Great Britain, 1992 also marked the end of a tax policy era. For the first time since Edward’s abdication of the throne in 1936, the monarch has agreed to pay taxes. On this side of the Atlantic, the pain of increased taxes shall be spread more broadly.