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Book Review

Tax Reform in the Real World


William G. Gale†

Introduction

Although tax policy debates are a never-ending source of amusement and frustration, recent years have witnessed a shift in the tenor of such discussions. In particular, serious consideration is now given to proposals that would not just modify the existing tax system, but rather completely replace major components of the federal tax system with new consumption-based taxes.1 Most such proposals would eliminate federal individual and corporate income taxes and the federal estate tax and establish in their place a new national retail sales tax,2 also called value-added tax (VAT),3 "flat tax,"4 or "USA" tax.5

Clearly, the income tax as we know it suffers from significant problems. Broadly speaking, the extant system is thought to be overly complex, unfair, and not conducive to good economic performance.6 These concerns have existed for a long time, however, and have plausibly declined in import over the last two decades.7 Thus, while these concerns are very real, the recent political fervor over fundamental reform may be attributed, at least in part, to factors other than problems with the income tax. It is possible, of course, that such critiques are motivated by an effort to shrink government by attacking its revenue source, though the effort to reduce government by shifting to simpler, more efficient tax systems could actually backfire.8 At least some of the focus

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2. See, e.g., MICHAEL J. GRAETZ, *THE DECLINE (AND FALL?) OF THE INCOME TAX* 212 (1997) (chapter on "The Flat Tax, the 'USA' Tax, and Other Uncommon Consumption Taxes").

3. See, e.g., id.

4. See, e.g., id.

5. See, e.g., id. at 214.


7. See infra notes 97-110 and accompanying text.

8. Theoretical arguments and empirical estimates establish the possibility that a well-functioning tax system makes it politically easier to expand the size of government. Becker and Mulligan, for
is purely political; bashing the tax system (and the IRS) is often good politics regardless of the actual merit of the proposed reforms.\footnote{9}

As a result, no current (or even recent) policy debate contains rhetoric that is so overblown and so weakly related to reality as that of tax reform. Tax reform proponents often tell us that a new tax system would be incredibly simple,\footnote{10} would eliminate lobbyists and tax politics,\footnote{11} would be fair,\footnote{12} and would generate massive economic growth.\footnote{13} Despite these gross oversimplifications by advocates, comprehensive tax reform is a complex and subtle subject.

The purpose of Michael Graetz’s book, *The Decline (and Fall?) of the Income Tax*,\footnote{14} is to tackle this subject head on. The majority of Graetz’s book is a careful and nuanced diagnosis of the problem. Graetz examines the strengths and weaknesses of the existing tax system, linking them to the history and politics of tax policy. This is no small or unimportant task: Understanding the claims and mistakes of the past as well as the political constraints placed on tax policy is a requisite prelude to intelligent tax reform.

Graetz also suggests his own reform. Specifically, he proposes to implement a national, broad-based VAT similar to European VAT taxes. Individual income tax would be substantially revised to completely exempt low- and middle-income households and to tax high-income households at a relatively low, flat rate. The corporate tax rate would be cut in half.

It would be a mistake, however, to consider Graetz’s book simply as a platform for advocating this proposal. The proposal is made almost sheepishly; in fact, it is first mentioned on page 262 and only four or five pages are devoted to supporting explanations and details. Thus, while the example, provide an intriguing analysis of this idea. See Gary S. Becker & Casey B. Mulligan, *The Endogenous Determination of Time Preference*, 112 Q.J. ECON. 729-58 (1997). Even the creators of the so-called flat tax, Hall and Rabushka, note that such tax “could make it easier to expand government.” ROBERT HALL & ALVIN RABUSHKA, THE FLAT TAX 48 (2d ed. 1995). This is the type of thinking that is rumored to have led Milton Friedman to conclude that the only good tax is a bad tax. See also Per Krusell et al., *Are Consumption Taxes Really Better Than Income Taxes?*, 37 J. MONETARY ECON. 475 (1996) (using political models to predict that income taxes will tend to be lower, and therefore that median voters will not benefit from consumption taxes).


14. GRAETZ, supra note 2.
proposal itself deserves serious consideration, one should not judge The Decline solely on whether one agrees with the ultimate tax proposal. Graetz’s diagnosis of the income tax, his analysis of the history and politics of taxation, and his humorous (and insightful) anecdotes are well worth the price of admission.

The structure of the book is straightforward. The introductory chapter lays out the problem succinctly: Twenty-five years ago, the income tax was considered the most fair federal tax, but by the end of the 1970s, it was considered the least fair and has remained relatively unpopular. Graetz asks: What happened to cause this dramatic shift? Why? What, if anything, should be done in response?

The following five chapters—or “The Decline”—attempt to address the causes of the shift. Specifically, Graetz argues that, aside from a general fall from grace of public institutions, public support for the income tax declined due to five factors: the tax penalty for marriage, tax shelters, inflationary problems, unnecessary complexities of the income tax, and increased evasion.

The next six chapters—aptly entitled “The Sausage Factory”—speak to the history and politics of tax policy, and hence address why, according to Graetz, the income tax shifted as it did. This part of the book especially is a wide-ranging and lively discussion that covers everything from the Reagan administration’s Rosie Scenarios to the politics of energy taxes, from the role of tax experts to the never-ending debate over capital gains taxes (the last cogently summarized as “The Madness of Two Georges”). The main message “illustrates the trap of confusing sensible tax policy proposals with legislation that can actually be enacted.” In sum, the second section of the book adds useful political, historical, and institutional detail to the economic analysis of the first section, reminding the reader that taxation is often constrained by politics.

The final four chapters—“The Fall?”—address policy options. In this section, Graetz critiques the strengths and weaknesses of consumption taxes,

15. See id. at 3-4. Note that Graetz’s conclusion about the income tax’s decline in popularity may rest upon weak empirical data. He appears to rest his finding upon surveys utilizing a common question asked over a long period of time, but in general survey results on tax policy are easily manipulated and are of dubious value. For example, a question asking whether the respondent favors a tax system where everyone is treated alike would likely get strong support, whereas a question asking if the respondent thinks that tax rates should be raised substantially for working poor households and dramatically cut for millionaires would likely receive a negative response. Yet both questions could be construed as describing or representing the flat tax.
16. See id. at 29-107.
17. See id. at 111-92.
18. Id. at 158.
19. See id. at 195-292.
makes proposals for modifying the income tax, and describes his comprehensive reform. Graetz goes beyond simple tax reform, however; he closes with an intriguing discussion of the importance of amending the political process itself, at least with regard to tax policy. The book closes with a telling story about holiday hams provided to politicians by funeral homes, ending with the modest and certain-to-be-well-received suggestion that, if members of Congress cannot fix the political problems that lead to distorted tax and other policies, they should resign! Although the final chapters—on the political process—provide no ready answers, Graetz deftly brings the reader back to the political environment that informs tax reform.

The book is not simply a “pocket guide” that provides the minimum necessary information for one confidently to formulate opinions about tax policy. It is, rather, a rich trove of stories and history woven around serious, but non-technical, analysis of taxation. As such, it makes for entertaining, informative, and engaging reading for lay persons, who will find, by the book’s end, that they have learned some economics and a little law. Tax professionals, on the other hand, will learn new case studies in tax foolishness and may also benefit from the book’s comprehensive application of tax principles that takes the real world seriously. Graetz’s anecdotes and stories are not simply entertaining; they help put a human face on otherwise abstract tax concepts. Academically debating the virtues or drawbacks of tax shelters in principle is fine, but it lacks the clarity and potency of being reminded how some shelters actually worked. It is hard to defend, for example, the so-called rent-a-navy episodes of the early 1980s as good tax policy where, for tax reasons, the Department of Defense sold its ships to private companies and leased them back for national use.

Overall, The Decline is largely successful in its discussions of the underlying difficulties with income tax, of the role of tax politics, and of problems with the comprehensive tax reform proposals. The analysis, it seems to me, is level-headed, insightful, and makes many fundamental points that are (or ought to be) central to the current tax reform debate. Along the way, Graetz makes numerous proposals for modifying the income tax, most of which are sensible as well. The proposal for comprehensive tax reform—that is, the VAT coupled with a high-end, flat income tax and halved corporate taxes—deserves a hard, long look. However, as discussed below, it may well crash on the very reefs that have claimed other such proposals.

This Review will largely parallel the organization of Graetz’s book. In Section I, “The Decline,” I describe and critique Graetz’s reasoning for the decline of the income tax and the motivations for tax reform in general. Section II, “The Sausage Factory,” examines the part of Graetz’s book by the same name that analyzes recent fiscal and political history. In Section III,
"The Fall?", I discuss Graetz’s analysis of income tax modifications, wholesale replacement of the current system with a consumption tax, and his own proposal for reform.

I. The Decline

There is broad agreement, in principle at least, on the characteristics of a good tax: It should raise sufficient revenue to finance government and it should be simple, fair, and economically efficient. In practice, there is probably less agreement on what some of these principles mean; fairness, for example, is generally in the “eyes of the beholder.” In addition, extreme disagreement exists about the relative value of each of these characteristics and about how they should be traded off against one another.\(^2\)

Graetz argues that the dominant criterion of a good tax is fairness (that is, that the tax reflects one’s ability to pay),\(^2\) and that the income tax was first implemented earlier this century precisely to create a fairer tax system.\(^2\) While the income tax has been subjected to continuing debate on how high rates should be and on what type of deductions should be allowed, a progressive income tax has long been the centerpiece of the federal tax system on both redistributive and revenue grounds.\(^2\)

A. Graetz’s Reasons for the Decline of the Income Tax

Graetz attributes the decline of the income tax to five factors and further calls for fundamental tax reform in these areas.

1. The Marriage Tax

Graetz’s first culprit is the tax penalty on marriage, whereby a married couple pays more in taxes than they would have paid had they remained single. The basic problem is that if the tax system applies rising marginal tax rates to income and imposes the requirement that families with equal income pay equal taxes, the system cannot avoid imposing marriage penalties or marriage subsidies (or both). With the exception of revenue costs, a marriage subsidy does not sound like a bad idea until one realizes that such a subsidy translates into a tax penalty for those who are single.

In his book, Graetz traces the history of taxation on married and single persons in the United States.\(^2\) He cites one recent study that estimates two-

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20. See id. at 10-13.
21. See id. at 11.
22. See id. at 15-16.
23. See id. at 20-21.
24. See, e.g., id. at 29-40.
thirds of all married couples pay a marriage penalty. A more recent study, published after Graetz's book, indicates that 42% of married households pay penalties while 51% receive bonuses. Annual marriage penalties total about $29 billion while marriage bonuses total about $33 billion.

Graetz concludes that "when a tax system departs dramatically from the fundamental values of the people it taxes, it cannot sustain public support." Graetz further argues that "if Congress refuses to embrace other remedies to eliminate it [the marriage penalty], perhaps the marriage penalty alone justifies a flat-rate, or at least flatter-rate, income tax."

This last statement of Graetz's is too strong for three reasons. First, Graetz presents no other remedies. A recent proposal would allow married couples to choose whether to file singly or jointly. This option would eliminate marriage penalties, but would cost $29 billion per year. An alternative would require all people to file as individuals. To a first approximation, everyone filing as individuals would eliminate both marriage penalties and bonuses, and would generate revenue of $4 billion.

Second, although Graetz's attention to the marriage penalty has proven prescient, in that the penalty has received substantial attention since the fall of 1997, it is worth noting that the marriage tax had not been a major issue in recent tax debates prior to 1997. For example, the marriage tax is not listed in the index of Hall and Rabushka's book on the flat tax, which spares little effort in disparaging the income tax.

Third, to eliminate the marriage penalty Graetz proposes to flatten rates, which could significantly affect the distribution of tax burdens across income classes. If fairness is the dominant criterion of a good tax, the relative tax burdens on the very wealthy and the very poor may be at least as important as a marriage penalty. It may make more sense then to abandon the notion that families with equal incomes should pay equal taxes. That notion is already damaged almost beyond recognition in the existing code, where tax payments

25. See id. at 29.
27. See id. at xiv.
29. Id. at 40.
30. See United States Congressional Budget Office, supra note 26, at xiv.
31. See id.
32. See id. There could still be marriage bonuses because couples might have discretion over how they allocated their capital income.
33. See David E. Rosenbaum, Marriage-Tax Amendment Moves Anti-Smoking Bill Along in Senate, N.Y. Times, June 11, 1998, at A1 (Republican party leaders in Congress "have made elimination of the marriage penalty their No. 1 tax priority this year").
34. See Hall & Rabushka, supra note 8.
depend not just on the level of income but also on the sources and uses of income.

2. **Tax Shelters**

The second problem with the income tax are tax shelters. Graetz’s chapter on tax shelters is one of the most entertaining in the book as he highlights the zeal with which tax shelters have been pursued and the lengths to which some people will go to find and exploit shelters.\(^{35}\) Tax shelters involve using certain features of the tax system to generate paper losses, offsetting other income, and thus reducing the household’s or firm’s overall tax level. In other words, tax shelters create income that is taxed at negative rates. To operate a successful shelter requires only a few basic principles: taxes on income should be deferred as long as possible, the rates should be as low as possible when taxes are due, investment should be financed with debt—the interest payments of which are tax deductible—and the debt should be deducted as soon as possible and at as high a rate as possible.

The shelter craze of the 1970s was fueled by both inflation and the overall level of tax rates.\(^{36}\) High inflation raises both the interest rate on debt payments and the nominal return on investment. However, since all interest payments are tax-deductible while only part of the nominal return is taxed, higher inflation results in a net gain for most tax sheltering schemes. High overall tax rates increase the value of deferring taxes and the value of being taxed at a preferred rate.

The Economic Recovery Tax Act of 1981\(^{37}\) further fueled shelters by providing generous cuts in capital income tax and write-offs for particular types of investments.\(^{38}\) The Tax Reform Act of 1986 (TRA 86),\(^{39}\) on the other hand, put an end to many shelters by directly prohibiting some practices and by allowing certain types of losses to be taken only against certain income.\(^{40}\) In addition, TRA 86 capped the overall level of sheltering activity that could occur by strengthening the alternative minimum tax (AMT).

\(^{35}\) See GRAETZ, supra note 2, at 41-51.

\(^{36}\) See id. at 54.


Shelters cause numerous economic and political problems. Graetz nicely summarizes the resulting misallocation of capital, noting that “[c]apital was running around the country like the Keystone Kops, looking for the most tax-favored investments”\footnote{GRAETZ, supra note 2, at 42.} and concluding that “[i]t doesn’t take a rocket scientist to know that a country that has designed and maintained a tax system that has inspired its nation’s savings to chase after chinchilla coats, bad movies, rosebushes, and overvalued Bibles is seriously handicapping itself . . . .”\footnote{Id. at 49.}

Graetz points to two additional effects of the sheltering phenomenon that are less often discussed than others, but perhaps of equal importance. First, fraud accompanied many of the sheltering schemes. In principle, sheltering is distinct from fraud, but it may also be the case that sheltering encourages fraudulent behavior. Graetz provides several examples—that ostensibly show the follies of shelters—where the problem was not the presence of a shelter but rather that the shelter was fraudulent.\footnote{See, e.g., GRAETZ, supra note 2, at 45-46 (describing potentially fraudulent chinchilla farms and other schemes).} Second, Graetz argues that the sheltering boom caused a subtle but major shift in the philosophy of tax advisers—attorneys and accountants—from the view that a tax return should be the taxpayer’s best determination of the actual tax due, to the view that every issue should be resolved in favor of paying fewer taxes, on the assumption that the taxpayer will most likely not be audited or, if audited, the IRS agent will either overlook or compromise on the issue.\footnote{See GRAETZ, supra note 2, at 51.} I am not in a position to judge Graetz’s claim, as I am not an attorney or accountant, and did not have any taxable income prior to 1986. But, if Graetz is right, the tax-shelter boom that was curtailed in 1986 may have had an important, lasting consequence on the government’s ability to raise revenues and tax capital income.

Graetz did not, however, give sufficient emphasis to some issues raised by shelters. Besides being unfair—why should investments in rosebushes, for example, receive subsidies when other investments do not?—shelters reduce revenue, which in turn necessitates higher tax rates to keep overall revenues constant. This result, of course, breeds demands for additional loopholes since escape from high tax rates is a cause of shelters in the first place. In addition, the presence of shelters and the attendant higher tax rates on the unsheltered income might make it more difficult for Congress to resist providing additional shelters. Additionally, the sheer administrative costs of shelters are a further deadweight loss. Sheltering schemes were (and are) often quite complex, even if they arise from the few basic principles outlined above.\footnote{See, e.g., id. at 46-48.}
example, Graetz's description of the rent-a-navy episodes conjures up an image of armies of attorneys at work for months.

In addition, the chapter fails to focus to any great extent on the elaborate "financial engineering" schemes that have developed in recent years along with their developments in financial markets.46

Finally, Graetz does not emphasize enough that some of our most cherished tax regimes—the mortgage interest deduction, 401(k) plans, IRAs, etc.—are essentially tax shelters, or at least can easily be converted into tax shelters. For example, while arguments can be made in favor of interest deductions and 401(k)s separately, it is hard to think of arguing for allowing people to finance their 401(k) contributions with increased mortgage debt or home equity loans. There is, however, some evidence that 401(k) contributions have been financed largely, if perhaps unintentionally, by increases in mortgage debt.47 The problem for tax policy is that trying to prohibit such a practice without prohibiting either the interest deduction or the 401(k) is futile. This problem indicates the difficulty of distinguishing between "shelters" and "incentives," and suggests that tax shelters will always exist in an income tax.

3. Inflationary Problems

The third problem addressed in The Decline is the interaction between income tax and inflation. Inflation creates several problems in the income tax and exacerbates others. Increases in prices tend to raise people's nominal income, but not their real income. Before the 1980s, higher nominal income would raise one's inflation-adjusted (real) tax payments, both by raising the level of taxable income and sometimes by increasing the marginal rate of taxation—the latter known as "bracket creep."48 The lack of indexing was thus a tremendous money machine for the government. For example, between 1965 and 1980, the price level rose by 162%.49 This generated automatic increases


47. See, e.g., Eric M. Engen & William G. Gale, Death, Taxes, and the Effects of 401(k)s on Household Wealth Accumulation (1997) (unpublished mimeograph, on file with the Brookings Institution). There is similar but weaker evidence that a similar phenomenon financed a significant portion of IRA contributions as well. See id. However, one would naturally expect that debt-financing is relatively more attractive for 401(k)s than for IRAs, since the former often contain an employer matching contribution.

48. GRAETZ, supra note 2, at 53-54.

in revenues that could be used to "cut" taxes or to finance additional shelters. Thus, in addition to raising the demand for tax shelters as described above, the interaction between inflation and the income tax created the mechanism by which shelters could be financed.50

The 1981 Tax Act (effective in 1985) indexed personal and dependent exemptions, standard deductions, and tax brackets for inflation.51 The importance of this change is much under-appreciated. Even the moderate annual inflation rates that occurred between 1985 and 1996 had the cumulative effect of raising the price level by about 45%.52 In the absence of indexing, this would have led to automatic substantial revenue increases. In the presence of indexing, however, income tax revenues were relatively flat as a proportion of gross domestic product (GDP).53

Despite these changes, the income tax is not fully indexed for inflation and much work would be required to make the income tax inflation-proof.54 The treatment of assets and debt pose particular problems. As is now well-known, capital gains are taxed on a nominal basis.55 This means that sales of assets that represent nominal gains but real losses still face a positive tax burden. Note that taxing capital gains at a preferred rate, as in the current income tax, does nothing to solve this problem. An oft-repeated proposal of indexing capital gains for inflation would solve this problem.56 This change may, however, prove complicated, as Graetz argues.57 Moreover, it would exacerbate other problems in the taxation of asset income. Capital gains are already taxed at lower effective rates than other assets because of the preferred tax rate, the ability to defer gains taxes by not selling the asset, and the ability to avoid all capital gains taxes if the asset is held until death. Indexing capital gains would thus increase the disparity between the taxation of capital gains and other forms of asset income. It would also create problems with debt financing. Since all interest payments are deductible, indexing only the capital gains would increase the ability to shelter income with debt-financed purchases of assets that generate capital gains.

A complete solution would index all forms of capital income and interest payments for inflation. This implies, however, that all interest deductions under the current income tax would be reduced, and as Graetz notes, "[n]o politician has any will to advance indexing for debt . . ."58 In any case, the

50. See GRAETZ, supra note 2, at 55.
51. See id. at 56.
52. See COUNCIL OF ECONOMIC ADVISORS, supra note 49, at 349 tbl.B-60.
53. See id.
54. See GRAETZ, supra note 2, at 59.
55. See, e.g., id.
56. See, e.g., id.
57. See id.
58. Id. at 64.
indexing of all capital gains is probably too complicated to be enacted, especially if one of the goals of tax reform is to reduce complexity.

In short, none of the three solutions—not indexing asset income or payments, indexing only capital gains, nor indexing all asset income and payments—is fully satisfactory. Thus, inflation will always cause problems under an income tax. One of the advantages of well-designed consumption taxes is that they are inflation proof.59

Graetz does not highlight the AMT as a source of inflationary problems, but it may soon become one. The AMT is a notoriously complex tax that applies to anyone who generates what the law considers to be “too many” deductions relative to their level of income.60 In the AMT, income is taxed on a relatively broader base and relatively flatter rate than under the conventional income tax. The inflation problem is that the personal exemption under the AMT is not indexed for inflation. For this and other reasons, recent estimates suggest that in 2007, 9 million households will face the AMT, compared to only about 700,000 in 1997.61 Fixing this problem, at the very least by indexing the exemption level for inflation, would cost a substantial amount of revenue.62

4. Unnecessary Complexities

The fourth problem is the complexity of the income tax. Graetz describes a so-called typical family, headed by Joe and Jane Six-Pack, who start out sounding like Ward and June Cleaver but end up stuck in a tax version of Friday the 13th, part 1040. Jane is a self-employed physical therapist, while Joe drives a company-provided truck. They live with their children, one of their mothers, and a local college student who pays reduced rent in exchange for provision of household services. As a seemingly unimportant foreshadowing detail, they also have a maid!

Like a good director, Graetz slowly takes his reader through the tax horrors facing this innocent family: miscellaneous itemized deductions, the child care credit, deductions for work clothing and the home office, deductions for work travel (for Jane) and the company truck (for Joe), the appropriate imputation of rental income, payroll taxes for the maid, and how the presence of renters affects the mortgage interest deduction.63 The most

59. An example of a poorly designed consumption tax would be the flat tax with a mortgage interest deduction. Under that system, interest income is not taxed, but interest payments would be deductible, creating large opportunities to game the system.
61. See, e.g., id. at 453, 463-71.
62. See id. at 471.
63. See GRAETZ, supra note 2, at 68-80.
incredible morasses involve the dependency requirements (how to determine whether the mother is a dependent),\textsuperscript{64} the child care credit (the taxpayer must ensure that the child care provider is in compliance with "all applicable federal rules"),\textsuperscript{65} interest deductions\textsuperscript{66} (Graetz claims the law currently distinguishes seventeen types of interest payments for tax purposes\textsuperscript{67}), and whether the Six-Packs need to make payroll tax payments for their maid\textsuperscript{68} (you don't want to know). On top of all that, the Six-Packs may also face important differences between federal and state/local taxes.\textsuperscript{69} But, the reader learns that the couple should be grateful, as they have no complicated capital income transactions, do not face the AMT, nor are eligible for the Earned Income Tax Credit (EITC).

It would be interesting to know whether the Six-Packs favored the 1997 Tax Act. If they did, they deserve the added nightmares they now face: up to fifteen different tax rates on capital gains,\textsuperscript{70} child credits,\textsuperscript{71} education credits,\textsuperscript{72} and a bewildering maze of tax-favored savings accounts.\textsuperscript{73} Although sequels are usually not very good, an update of the Six-Packs to include the Taxpayer Relief Act of 1997 (TRA 97) would be a horror film worth watching.

The tax system is undoubtedly an outrageous nightmare of complexity for the Six-Packs. Graetz is convincing that even ordinary tax circumstances can quickly turn ugly and complicated. He goes further, however, and argues that extraordinary complexity is a hallmark of the income tax. This is partially due to compromise in legislation among the various principles or goals of tax policy, and partially to the fact that taxation of business or capital income is inherently difficult. His solution is for Congress to be more arbitrary—that is, to make fewer fine distinctions of tax law and settle for rough justice in trying to measure income.\textsuperscript{74}

Graetz is clearly onto something here, as complexity is no doubt a sore point with taxpayers. He appears, however, to overstate his case in three ways. First, while many people \textit{could} end up like the Six-Packs, it is not clear how many actually do. About forty-four million tax filers submit a simplified

\textsuperscript{64} See id. at 77.
\textsuperscript{65} See id. at 70-71.
\textsuperscript{66} See id. at 75-77.
\textsuperscript{67} See id. at 76.
\textsuperscript{68} See id. at 78-80.
\textsuperscript{69} See id. at 261-62.
\textsuperscript{70} See, e.g., Leonard E. Burman, \textit{Big, Big Postcard}, TAX NOTES 111-12 (1997).
\textsuperscript{72} See, e.g., id.
\textsuperscript{73} See, e.g., id.
\textsuperscript{74} See GRAETZ, supra note 2, at 85.
1040A or 1040EZ form. Blumenthal and Slemrod present evidence from a survey of taxpayers that suggests that 30% of households spent between zero and five hours preparing their tax return and keeping records for tax purposes, and an additional 15% spent less than ten hours. Almost half made no financial expenditure on tax preparation, and an additional 17% paid less than $50.

Second, as Graetz notes later in The Decline, many of these complexities have less to do with the income tax relative to, say, the flat tax, than with permitting deductions for given activities. For example, the child care credit could just as easily be enacted in a flat tax. The flat tax achieves simplicity with regard to the child care credit simply by eliminating it. This could occur under the income tax too. If a credit is allowed under either tax, however, a variety of decisions regarding what is and is not included have to be made.

Third, Graetz notes that it cost Mobil $10 million in 1993 to prepare its tax return, which comprised a year’s work for fifty-seven people. What is one to make of this figure? For one thing, Mobil itself provided the figure. For another, in 1993, Mobil operated in more than 100 countries and had world wide revenue of $65 billion. Mobil’s revenues exceeded the GDP of 137 countries and twenty-two of the states in the United States, and Mobil paid U.S. income taxes of $19 million. Thus, Mobil’s total U.S. income tax burden, including compliance costs, was $29 million (if one believes the $10 million figure), or roughly 0.04% of worldwide revenues. Its total worldwide tax burden was $1,931 billion, so only 1% of its tax payments were due to the federal income tax.

In contrast to Mobil, a recent study of the Hewlett-Packard corporation concluded that "[a] large U.S. multinational company can complete an accurate corporate tax return with the functional equivalent of three full-time tax professionals." It would be interesting to know why Mobil’s return was so much more costly than HP’s. To the extent that the problem lies in the tax system, it would be useful to know which features caused the problems.

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77. See id. at 189-200
78. See GRAETZ, supra note 2, at 85.
79. See id.
82. See MOBIL CORP., supra note 80, at 40.
83. See id.
5. *Evasion*

The fifth income tax problem that Graetz identifies is evasion. Well over $100 billion per year in tax payments on legitimate income is owed but not paid to the IRS.85 The underground economy probably accounts for a significant additional amount.86

Graetz makes several important points in this chapter. First, the current system has essentially two different enforcement tiers. For households that receive all of their income from wages, the IRS is able to match virtually all returns to wages reported by the employer.87 Thus, effectively, all of these households are audited. Not surprisingly, the estimated evasion rate for these forms of income is quite low.88 In contrast, households with a significant portion of their income from capital gains or from sole proprietorships or farms face much greater opportunities to evade taxes; not surprisingly, the estimated evasion rate for these forms of income is quite high.89

Second, over the past two decades, the IRS has essentially conducted an experiment in trying to raise compliance. The experiment consists of three parts: reduced audits (6% of returns were audited in 1965, compared to only 2½% in 1976, and less than 1% in the early 1990s), more third-party reporting of information, and larger penalties for those who are caught cheating.90 Graetz applauds the increase in information reporting but argues that reducing the audit rate was a major mistake "from which the IRS probably will never recover."91

Economic theory indicates that lower tax rates raise compliance by reducing the incentive to evade taxes. Graetz notes, however, that the reduction in capital gains tax rates in the mid-1980s resulted in lower, not higher, compliance rates on income from capital gains.92 He concludes that "[t]he Pollyannaish notion that compliance problems will disappear if we lower tax rates or shift from an income to a consumption tax does not withstand even cursory analysis."93

Although this chapter by Graetz is generally quite good, it nonetheless contains some red herrings, or at least some unfair criticisms, of the income tax. For example, the chapter highlights a waitress confessing that she under-

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85. See Graetz, supra note 2, at 105.
86. See id. at 105.
87. See id. at 93.
88. See id. at 93.
89. See id. at 94-95.
90. See, e.g., id. at 96-98.
91. Id. at 93.
92. See id. at 94.
93. Id. at 105.
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reports her tip income. Does anyone believe that would change under a flat tax?

In addition, Graetz repeats a common mistake in the analysis of consumption taxes and tax evasion. He argues that an advantage of a consumption tax is a reduction in evasion: "A drug dealer who [currently] evades income taxes will pay sales taxes when he spends his illegal earnings." While it is true that the dealer would pay taxes under a sales tax, it is also true that he would not end up worse off than under the income tax. Under the income tax, his income is not taxed but the income of people who buy drugs is taxed. Under the sales tax, the dealer’s consumption is taxed, but the drug consumption of people who buy drugs is not taxed. Either way, one party to the transaction becomes free of the tax.

In summary, The Decline succeeds in identifying five significant problems. It would, of course, be desirable to fix or reduce the problems arising from marriage penalties, inflation, shelters, complexity, and non-compliance. However, doing so is neither simple nor easy, as solving any one of these problems often worsens the others.

B. What's Really Driving Tax Reform?

A basic problem with Graetz’s analysis is that he overstates the degree to which the problems he identifies in The Decline have driven recent proposals for fundamental tax reform. For example, he notes that “[t]oday’s proposals for radical change in the income tax—such as the flat tax, which, as I shall subsequently demonstrate, have serious problems of their own—are in large part a response to the public’s well-founded dissatisfaction with the current income tax.”

Before explaining why I disagree with this interpretation of today’s fundamental tax reform movement, let me first note that I would be delighted

94. Id.
95. An example can show why. Suppose that, currently, the dealer sells $100 worth of drugs (assume for simplicity that there is zero cost of producing the drug). The dealer should pay $20, say, in income taxes but does not, so he is able to consume $100 worth of goods, rather than $80. Now suppose we remove the 20% income tax and replace it with a sales tax of 25% and assume for simplicity that it shows up as an increase in the price of goods. (Because sales taxes are measured on a base that excludes the tax, while income taxes are measured on a base that includes the tax, a 20% income tax is equivalent to a 25% sales tax in an economy where consumption equals income (i.e., there is no saving). In the current example, 25% of $80 (the consumption tax base) is equal to 20% of $100 (the income tax base).) The key point is that now the dealer can sell the same quantity of drugs for $125 rather than $100, since all prices have increased by 25%. If he then spends the proceeds on consumption, and pays the sales tax, he can still consume $100 worth of goods after-tax under the sales tax. Thus, he is no worse off under the sales tax than under the income tax. The sales tax raised his tax payment on consumption, but it raised his income by the same amount.
96. GRAETZ, supra note 2, at 8.
to believe that Graetz’s interpretation of these trends is correct—that rational and thoughtful analysis of several problems has led households to rethink their support for the income tax. The infusion of so much economics and logic into the information set and apparent preference determination of the typical American household would be a dream come true for economists and policy wonks. And there are sound economic reasons why disciplined, conceptually consistent tax reform could improve overall economic performance and reduce tax complexity. Nevertheless, for several reasons, I doubt that Graetz’s interpretation is correct.

First, the issues he raises are problems of long standing; it is unclear why they should have come to a head in the mid-1990s. Perhaps the problems have accumulated critical mass over time, but the income tax has plausibly improved since the late 1970s. At that time, the highest rates were 70%,97 annual inflation was around 10%,98 taxes were not indexed for inflation,99 and shelters were booming.100 Since then, the highest tax rate has dropped to 39.6%,101 inflation has slowed to 3% or less,102 tax brackets,103 standard deductions,104 and personal exemptions105 have been indexed for inflation; and a significant portion of tax shelters have been eliminated.106 The effects of the marriage tax have been mixed: More families face the marriage tax today than in the 1970s, largely because of changes in family structure, but the average penalty among those households has fallen by about a third from its peak in the late 1970s.107 In any case, as noted above, the marriage tax attracted so little attention before 1997 that the tax act that year actually exacerbated the penalty in some cases (e.g., with the child credit).108 Nor, as far as I can tell, is the income tax accused of strangling the economy so often these days as the economy moves through its seventh year of expansion and has suffered only one relatively mild recession in the last fifteen years,109 while the stock market has increased manyfold.110 As Graetz notes repeatedly, even advocates of

99. See GRAETZ, supra note 2, at 52-54.
100. See id. at 41-51.
101. See Aaron & Gale, supra note 1, at 246.
103. See GRAETZ, supra note 2, at 56-57.
104. See id.
105. See id.
106. See id. at 48.
110. See id. at 390 tbl.B-95 (common stock prices and yields).
fundamental reform try to call their reforms some type of "income tax" rather than a "consumption tax." He argues that this results from lingering public beliefs that income taxes in principle are fair. In short, the problems Graetz identifies are long-standing, and it is not clear why those problems should make people want to abandon income taxation rather than modify it.

My second concern with Graetz's interpretation is that current reform proposals do not solve some of the five problems he lists, and more importantly would have their largest effects on aspects of taxation that Graetz does not discuss as problems. For example, Representative Richard Armey's flat tax proposal contains an annual marriage penalty of $3,300 times the tax rate for every couple with children where the husband and wife each earn at least $14,000 annually. Similarly, the national retail sales tax contains substantial marriage penalties. Moreover, it is difficult to see how the sales tax would engender higher compliance than the income tax does since such plans would reduce income reporting and withholding, with some variants of the proposal envisioning the abolition of the IRS.

In addition, fundamental tax reform—or at least the sales tax and the flat tax—seems to address three issues other than the problems Graetz emphasizes in *The Decline*. First, the reform proposals would provide large tax cuts for the wealthiest households. Gale, Houser, and Scholz estimate that families in the top 1% of income distribution would see their total (i.e., federal and state) tax liabilities fall by about $38,000 if the flat tax replaced the individual and corporate income tax. Gentry and Hubbard estimate that households in the top 1% would see tax payments 24% lower under a broad-based consumption tax than under the current income tax. Feenberg, Mitrusi, and Poterba estimate that replacing the individual income tax, corporate income tax, and

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111. See, e.g., GRAETZ, supra note 2, at 216.
112. See The Freedom and Fairness Restoration Act of 1997, H.R. 1040, 105th Cong. (introduced by Representative Richard Armey); see also The Freedom and Fairness Restoration Act of 1997, S. 1040, 105th Cong. (introduced by Senator Richard Shelby). The exemption levels in the Armey/Shelby flat tax are $14,000 for a single head of household, $10,700 for singles, and $21,400 for married couples. Therefore, two people with children could obtain $24,700 if they are not married, but only $21,400 if they are married. Thus, if both earn in excess of $14,000, their combined tax base will be $3,300 larger if they remain married. At a tax rate of 20%, their annual tax burden would be $660 higher as a married couple than if they were single.
estate tax with a national retail sales tax would reduce the tax burden on households in the top 1% of income distribution by over $65,000 annually.116

Second, the reforms are likely to involve an overall tax cut. Any large-scale tax restructuring that is revenue-neutral will inevitably result in a large number of winners and losers. Simultaneous tax cuts would reduce the number of losers and raise the number of winners, and thereby help grease the political wheels of tax reform.117

Third, most fundamental tax reforms would reduce or eliminate the government's ability to administer social policy through the tax code. Currently, the income tax contains subsidies for homeownership, charitable giving, health insurance, low-income workers, pensions, state and local government programs, and other sectors and activities.118 Fundamental tax reform would hinder use of the tax code to achieve these policy objectives.119

Graetz, however, does not identify any of these factors as problems with the income tax. There does not appear to be simmering resentment among the populace, for example, over excessive taxes that they foisted onto the wealthy. Nor do complaints about the overall level of taxes have much basis; the overall ratio of federal taxes as a proportion of GDP has remained fairly constant over the last thirty years.120 To the extent that it has risen, the increase is due to specific actions financing social security and Medicare and balancing the budget.121 Nor does Graetz claim that there is strong public support for abolishing social policies toward housing, health, charity, retirement provision, or other goals. Support for these subsidies appears firmly entrenched; they provide major benefits for targeted sectors, acting as replacements for government spending programs. In one sense, these subsidies are like the tax shelters of the 1970s and 1980s—they provide incentives to redirect households' and businesses' activities. Yet in another sense they are quite different; while the public may not support subsidies for chinchilla coats, support for housing, health care, charity, and retirement subsidies is probably much stronger.

116. See Daniel R. Feenberg et al., Distributional Effects of Adopting a National Retail Sales Tax, 11 TAX POL’Y & ECON. 75-82 (1997). This allows demogrants, which would provide payments of the poverty line times the tax rate to each family. If demogrants were eliminated, the annual reduction in taxes for the top income group would be about $100,000. See id.

117. Representative Armey is in fact very candid about this aspect of tax reform. See Armey, supra note 10.

118. See OFFICE OF MGMT. AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1999.

119. The pro-simplicity, pro-growth purposes of fundamental reform would be frustrated by the introduction of complicating social purposes. See infra notes 181-185 and accompanying text.

120. See COUNCIL OF ECON. ADVISORS, supra note 49, at 374 tbl.B-79 (government revenues); id. at 375 tbl.B-80 (outlays by function).

121. See id. at 374 tbl.B-79; id. at 375 tbl.B-80.
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Thus, Graetz is correct not to identify the level of taxation of the wealthy, the overall level of taxation, and the use of social policies in the tax code as major sources of public complaint about the income tax. Yet these are three of the largest changes in taxation that the sales or flat tax would bring about. Thus, the tax reform movement appears to be addressing different issues than the legitimate problems that Graetz points out, and perhaps even different issues than the public cares about.

Tax activities in 1997 are the third reason to doubt that Graetz’s five concerns are driving current movements in tax policy. TRA 97 introduced child and education credits; increased the tax preference for capital gains; created new saving incentives for retirement, education, and other purposes; provided estate tax relief for farmers, small businesses and others; and enacted many other changes. The fall of 1997 witnessed hearings on IRS abuses and saw proposals that might reduce the agency’s enforcement and audit powers.

What sort of preferences led to these policies? Certainly not a desire to reduce complexity: TRA 97 makes the code more complicated in numerous ways, including the treatment of capital gains, rules regarding education and saving accounts, and child credits. While Congress may truly oppose tax complexity, that opposition appears to be conditional: Complexity that reduces taxes is tolerated much more than complexity that raises taxes. Nor did there appear to be a congressional desire to raise compliance. Reducing the authority and ability of the IRS to gather information will likely reduce voluntary compliance by giving taxpayers more courage to abuse or, at least, favorably interpret the rules. Nor was there concern about the marriage penalty, which I do not recall having even entered the public discussion. In fact, some of the credits in TRA 97 actually increase the marriage tax because they are phased out as income rises. Furthermore, concern over tax shelters would not have led to a cut in the rates on capital gains. Low capital gains rates actually encourage the shelter industry, in that deferring income and

122. Some would argue that the major change is the switch from an income to a consumption tax. See, e.g., Barbara H. Fried, Fairness and the Consumption Tax, 44 STAN. L. REV. 961 (1992); Alvin Warren, Would a Consumption Tax Be Fairer Than an Income Tax?, 89 YALE L.J. 1081 (1980). As I argue below, however, the distinction between a pure income tax and a pure consumption tax is quite minimal—and focuses on whether business' capital purchases are all deducted in the year of purchase or must be depreciated over their useful lives. See, e.g., Bradford, supra note 1, at 126-38. See generally Gentry & Hubbard, supra note 115.
123. See, e.g., Reischauer, supra note 71, at 162.
125. See, e.g., Reischauer, supra note 71, at 162.
126. See, e.g., id.
127. See, e.g., id.
taxing it at preferential rates, along with tax-deductible debt finance, are the cornerstones of the tax shelter industry.\textsuperscript{129} The interaction between inflation and income taxes probably had some influence on the debate, as efforts to index capital gains gained steam but ultimately failed.\textsuperscript{130} Thus, whatever preferences actually drove tax policy in 1997, they appear to have been largely orthogonal to Graetz’s concerns. In Graetz’s defense, TRA 97 occurred after his book was written. Nevertheless, TRA 97 can be used as an out-of-sample test that fails to support the view that the five factors identified in \textit{The Decline} motivated the interest in tax reform.

The fourth piece of evidence against Graetz’s view is simply that TRA 97 was almost the exact opposite of fundamental tax reform in most respects. It made the tax code more complicated, introduced more tax distinctions based on how money was earned or spent, created new shelters, and raised effective tax rates.\textsuperscript{131} Yet many of the same people who advocated fundamental tax reform in 1996 (and are currently pushing for further reform) were the architects of TRA 97.\textsuperscript{132} Although all of Graetz’s five criticisms are valid, they cannot explain the impulses for fundamental tax reform in 1996 and 1998—or support for the Taxpayer Relief Act of 1997. Graetz’s own rejection of the flat tax, sales tax, and USA tax as alternatives to the current system suggests that Graetz implicitly agrees that the five problems he lays out are not the primary sources of those reform proposals.

To reiterate, my major critique of \textit{The Decline} is that the five legitimate and important concerns raised by Graetz do not appear to be actually driving the fervor for fundamental tax reform. This critique leads to two important questions: First, what is driving the fervor, and second, why does it matter? One explanation consistent with the issues raised above is a public or congressional desire to reduce the overall level of taxation, and with it the power, size, and scope of government. Why attack taxes to cut the size of government? Because taxes are the least popular aspect of government. That is, although the level of government spending and the structure of the tax systems are separate issues, advocates of smaller government may be using hostility to taxes as a cover for shrinking government.

The motivation for tax reform matters because the implementation of fundamental tax reform would require dealing with a host of issues whose resolution would impact the structure of the plan. If the goal of tax reform is to obtain a more disciplined, consistent, and simple tax system, one hopes that the details would be carried out systematically and coherently. However, if the

\textsuperscript{129} See supra notes 36, 47, 50 and accompanying text.

\textsuperscript{130} See generally Reischauer, supra note 71.

\textsuperscript{131} See, e.g., Reischauer, supra note 71, at 162.

goal of reformers is to cut the size of the government, then implementation could raise as many inconsistencies, shelters, and complexities as it resolves. Graetz himself emphasizes throughout his book that political motivations have always had a major hand in shaping tax policy.

For example, Representative Armey proposes a flat tax rate of 17% with an exemption level of $31,400 for a family of four.133 Under 1996 law, that would reduce tax revenues by $138 billion.134 However, if transition relief were provided—as it would likely have to be—taking the minimal form of allowing firms to grandfather depreciation deductions on previous investments, an additional annual revenue loss of approximately $50-100 billion would result.135 If deductions for taxes paid, mortgage interest, charity, etc. were allowed, the deficit would increase by an additional $100 billion or more.136 This is obviously not a sustainable outcome—either taxes would have to be raised or spending reduced. But if the goal of policy makers is to cut the current size of government, a flat tax coupled with a tax cut would force the issue and shift the terms of the debate.

II. The Sausage Factory

The next six chapters of Graetz’s book provide perspectives on tax policy over the last thirty years. The main purpose of this section is to illustrate that taxation is politically constrained. Chapter Seven discusses the gradual diffusion of power in tax policy over the last three decades. Whereas the Ways and Means committee chairman (Wilbur Mills) once appeared to be the second-most-powerful man in the country, that power has since diffused in several directions. Other congressional committees, additional congressional staff, an increased role for lobbyists, and other factors have led to a complex morass, with numerous interested parties having access to the decision-making process.137 Graetz’s main point here is that this diffusion can stifle the tax policy process. While his conclusion seems correct, it is also interesting to note that the last twenty years have been a very busy period for tax reform,138

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135. See id. at 722-23. Transition relief would plausibly also include grandfathering of interest deductions on existing loans and net loss carryforwards. As Graetz notes in chapter 8, one must also consider the likelihood of one-time, back-door transition relief snuck into the code in order to generate political support for favored groups and individuals.
136. See Gale, supra note 134, at 722-23.
137. See, e.g., GRAETZ, supra note 2, at 116-20.

Chapter 8 discusses tax policy in the 1980s. I do not find the views expressed here very controversial. Graetz argues that the 1981 tax cut was a Christmas tree of overly generous subsidies to capital. He also argues that TRA 86, while an improvement over the existing system, did not approach a full solution. In particular, despite substantial closing of tax shelters and reductions in tax rates, the Act failed to simplify vast portions of the code and left numerous deductions and exclusions intact. 147 Graetz also highlights some of the more dubious “transition rules” that accompanied the Act. 148 These drained about $10-15 billion in revenue, and were widely regarded as payoffs to favored constituencies (or individuals) to clear the way for political support for TRA 86. 149 In light of the potentially profound changes invoked by fundamental tax reform, the prospect of such deals should be taken seriously.

Chapter 9 provides an interesting perspective on the raging capital gains debate of recent years. Graetz argues that the fiercest advocates on both sides

147. See GRAETZ, supra note 2, at 134.
148. See id. at 137-39.
149. See, e.g., id. at 138-39.
of the debate are misguided. Opponents of capital gains cuts overstate the virtues of taxing capital gains at the full income tax rate because they ignore the fact that people have discretion over when to realize capital gains. Thus, taxing the gains at high rates does not mean that substantial revenue would accrue. Proponents of capital gains tax cuts overstate the virtues of reducing the rate because there is at best weak evidence that investment or entrepreneurship would rise in response to the tax cut. Graetz’s solution is to set the capital gains tax rate at the rate that maximizes revenue, as any other rate would require that revenue be made up somewhere else. He seems to imply that the revenue-maximizing rate is between 19% and 28%.

This “solution,” however, is troubling in a number of respects. First, Graetz violates it himself later in the book when he proposes that capital gains be taxed at the same rate as other income (in my view a more desirable outcome than the one he initially proposes). Second, tax literature offers a host of alternative criteria, none of which involve setting the marginal revenue collected equal to zero. Third, much of the debate on capital gains occurs precisely because of disagreement about what the revenue-maximizing rate is. One issue in this debate is the appropriate time horizon to employ. The revenue-maximizing rate over a short time horizon is typically lower than over a longer horizon because a tax cut now will induce people to cash in some of the capital gains they would have cashed in the future. Both time series and cross-sectional analyses also face difficult problems. Many of these can be resolved by examining panel data that spans various tax reforms. Burman and Randolph use panel data, finding that the short-term elasticity is an order of magnitude higher than the long-term elasticity. Calculations based on these results imply that the revenue maximizing long-run rate is actually well above 28%.

Chapter 10 discusses both the advantages of increased taxes on alcohol, tobacco, energy use, and pollution and the political difficulties of passing such taxes. So-called “sin taxes” have the advantage of providing incentives to
reduce the extent of activities widely believed to have negative social consequences. One can, of course, go too far—it is possible to have tax rates on these items that are excessive relative to the damage they cause. Graetz argues, however, that we are not currently in danger of reaching those excessive taxation levels.

Chapter 11 covers the 1990 and 1993 tax acts with few surprises. It turns out that the tax changes involved in the acts were really boring. Chapter 12, however, had me worried. The chapter discusses how economists fail to truly agree on anything, and thus appears to suggest that one should take all expert opinion, presumably with the book’s author excepted, with a grain of salt. This is a tenuous conclusion. On the one hand, Graetz is certainly correct that major issues in determining the sensitivity of economic behavior to economic incentives have not been resolved by professionals. These disagreements range from the effects of various government programs and taxes on saving and labor supply, to the burden of corporate taxes, to the effects of the overall level of taxes on economic growth. On the other hand, there is much that economists do agree on, and the type of discussion found in this chapter is often prelude to an author making a proposal that lacks any economic sense. Fortunately, Graetz does not fall prey to that trap, but it takes the rest of the book to be sure!

Chapter 12 also discusses the problems created by what Graetz calls “paint-by-numbers” lawmaking. In a nutshell, the claim is that, by focusing on short-run (five-year) budgetary consequences, Congress ignores more noble, disciplined, cost-benefit approaches to policy making. This criticism is certainly valid, but it is hard to know what policy arrangement would work to make Congress better focused. At the very least, a five-year budget window is more effective than a single-year constraint, although a longer window could be even more useful. But it does seem clear that the budget rules have been effective at least in restraining Congress to some degree.

In summary, the second section of the book adds useful political, historical, and institutional detail to the economic analysis of the first section. My criticisms of Graetz’s proposals regarding the capital gains tax and the budget rules notwithstanding, this section of the book provides a strong basis for considering tax reform solutions subject to political and other constraints imposed by the real world.

III. The Fall?

The final section of the book examines solutions to the tax system’s woes.

157. See GRAETZ, supra note 2, at 177-82.
A. Four Proposals for Fundamental Reform

One approach to tax reform is to throw out the existing system and replace it with a new one. There are four main proposals for such fundamental reform. The national retail sales tax taxes all sales between businesses and households. The VAT requires each business—corporate as well as non-corporate—to pay taxes on the difference between gross revenue from sales and the costs of materials, services, and capital goods. This difference—wages, interest, and profits—represents the value added by the firm. Because the final retail sales price of a good is simply the sum of the value added to that good by each firm at each stage of production, the VAT covers the same net tax base as a retail sales tax. The flat tax operates in the same way as the VAT, except that wages are subtracted from the business-level tax base, and wages are taxed at the individual level with personal exemptions provided. Without the personal exemptions, the flat tax has the same base as the VAT or the retail sales tax. The “USA” tax is modeled more closely on the income tax. Under this system, households determine their tax liability by calculating their income and then subtracting their net saving. The difference is consumption, and is taxed at graduated rates. The USA tax retains a number of current deductions and credits, and includes a business-level VAT. Both the individual- and business-level USA tax allow refundable credits for payroll taxes paid.

B. Analysis of the Proposals

All four plans represent taxes on consumption, even if they appear to tax something else entirely. Thus, the main differences between the plans involve (a large number of) administrative issues, the presence of exemptions, deductions and credits, and the rate structure. In short, evaluating such taxes is a daunting task. Graetz breaks the task down into several smaller chunks.

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158. See id. at 99.
159. See id. The VAT described here is a subtraction-method VAT. An alternative type of VAT, using the credit-method, places a tax on gross sales of the firm, but allows a credit for the VATs paid by the firm in purchasing material goods, services and capital goods. If all goods are taxed at the same rate, the subtraction- and credit-method approaches yield identical results. However, when tax rates vary across goods or producers, only the credit-method approach can determine tax liabilities appropriately. See, e.g., id. at 199-200.
160. See, e.g., id. at 217-19.
161. For further descriptions, see Henry J. Aaron & William G. Gale, ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 1, 4, 8-13 (Henry J. Aaron & William G. Gale eds., 1996).
1. Fairness

The first question Graetz addresses is whether consumption taxes are fair. A common fairness argument for consumption taxes is that while income taxes tax people on what they add to society, consumption taxes tax people on what they consume, and therefore what they take away from society. Graetz argues that this reasoning contains a fundamental flaw in that it assumes a common pool of resources from which members of society make their consumption choices. In fact, he argues, the institution of private property implies that my consumption of my resources does not reduce your consumption of your resources.

A second measure of fairness is the ability to pay taxes. This measurement is complicated: There are questions about both what should be taken into account in measuring ability to pay and the appropriate time horizon. Consumption tax advocates note that, under certain theories of economic behavior, consumption is proportional to lifetime income. More generally, over the course of one's life, consumption should roughly equal lifetime income. Thus, they argue, consumption is a good measure of ability to pay. Opponents note, however, that the presence of borrowing constraints implies that current income may be a more appropriate measure of ability to pay for some households than lifetime income. This is an especially important problem when the half-life of tax policy can be brutally short. Another rarely-discussed problem is that not all “consumption” necessarily represents ability to pay; a cancer patient going through a divorce has very high consumption expenditures, but may not be in a good position to bear a heavy tax burden in the same year.

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162. See GRAETZ, supra note 2, at 202.
163. See id. at 222. An interesting implication of this argument is that it makes more sense to tax consumption in situations where resources are pooled, say in a kibbutz, than in an atomized, private economy.
An additional argument against consumption taxes relates to their potential for regressive impact. Because household saving rates tend to rise with income, households with low income tend to consume a higher portion of their income than do households in higher income brackets. Thus, consumption taxes will look more regressive when examined from the perspective of a household’s annual income than from the perspective of a household’s lifetime income.

Other countries have dealt with these consumption tax problems by exempting food, clothing, housing, or other necessities from the tax base. This turns out, however, to be quite inefficient because high-income households tend to consume more of each of these goods (although with a smaller proportion of their income) than do poor households. A more direct way to introduce progressivity is to provide an exemption, as in the flat tax. This limits the size of the effective exemption that high-income households can obtain and does not distort household choices about the consumption of various goods.

Ultimately, Graetz does not clearly determine which tax is fairer. He retreats to the assertion that taxing only consumption strikes him as unfair. While it might, indeed, be unfair, one would hope for a stronger case here. On firmer ground, Graetz notes that it is hard to obtain significant progressivity at the top end without a tax on income or wealth, and that achieving fairness was the main reason to tax income and tax it at progressive rates in the first place.

It is important to note that the debate about whether income or consumption provides a fairer tax base is completely independent of whether taxes should be proportional or progressive. Graetz makes a strong case for progressive taxation, based largely on arguments put forth in his 1983 article on the estate tax. He argues that market returns do not necessarily represent fair outcomes because incomes derive from, among other things, fluctuations in consumer tastes, joint use of products, the functioning of government institutions, luck, and inheritances (the latter broadly defined to include

166. See, e.g., PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, ECONOMICS 422-23 (15th ed. 1995) (explaining how consumption patterns vary across income levels); Fred S. McChesney, Problems in Calculating and Awarding Compensatory Damages for Wrongful Death Under the Federal Tort Claims Act, 36 EMORY L.J. 149, 171 (1987) (using tabular data to argue that savings rates vary systematically with income, that savings rates are negative at lower levels of income, and that savings begin to accumulate only as incomes exceed $20,000).


168. See, e.g., David F. Bradford, What Are Consumption Taxes and Who Pays Them?, 39 TAX NOTES 383, 389-90 (1988) (noting that exempting items such as clothing may actually make consumption taxes more regressive).

transfers of cash, education, and personality). Thus, even if the market
functions perfectly, Graetz argues, "the ethical justification for its
distributions of income and wealth would be dubious." Moreover, he
argues, markets often do not operate perfectly—legal barriers to entry,
political influence, lack of equal opportunity, and other impediments may
occur.

It is worth noting that even the "flat" tax is progressive. Because of the
exemption, average tax rates rise with income (above the exemption level)
even though marginal tax rates do not. Thus, while Graetz's arguments for
progressivity are convincing, they do not dictate the optimal degree of
progressivity.

On the other hand, there is no particular reason to have only one positive
tax rate. Some flat tax proponents have argued that it is immoral to have more
than one rate, but this argument is quite strange. After all, given the
existence of an exemption, the flat tax itself has two rates—zero for income
below the exemption level, and the flat tax rate for income above the
exemption level. Suppose a flat tax with an exemption level of $30,000 is
implemented, with a tax rate of 20% on all wages above that amount. It is
hard to see anything immoral about starting from that system and then
changing it so that, for example, the first $20,000 of taxable wages are taxed
at 10% while wages above that amount remain taxed at 20%.

The fairness of particular consumption taxes depends not only on
theoretical considerations but on the actual distributional impacts. Both the
flat tax and the retail sales tax (with or without exemptions for a base amount
of consumption) would generate large tax cuts for the wealthiest families. The
USA tax, on the other hand, would be very close to being distributionally
neutral across income classes.

2. Complexity

After considering the fairness of consumption taxes, Graetz turns to the
issue of their simplicity. Consumption taxes could, in principle, be simpler
than the existing income tax. On the other hand, the income tax could itself
exist in a much simpler form than it currently does.

170. GRAETZ, supra note 2, at 224.
171. See Alice Gresham Bullock, Taxes, Social Policy, and Philanthropy: The Untapped
(noting that John Stuart Mill found progressive income taxation to be "graduated robbery"). See
(1968).
172. See GRAETZ supra note 2, at 262.
173. See, e.g., Gale et al., supra note 161, at 281, 318.
Complexity in the existing system arises from several sources. For example, the taxation of business income, broadly defined to include the self-employed, raises several issues. In particular, debate is invoked by the treatment of inventories and depreciation, the AMT, distinguishing capital from current expenses, distinguishing business from personal expenses, and limits on tax arbitrage. Some of these complexities could be eliminated by moving to a flat tax. A major source of simplification in the income tax or the consumption tax would be to tax all capital income at the business level.

The enactment of social policy through the tax code is another source of complexity. This is achieved through such items as the dependency exemptions; child-care credits; the EITC; and deductions for mortgage interest, charitable contributions, pension contributions, health care, fringe benefits, etc.

Returning to Joe and Jane Six-Pack, Graetz notes that they would suffer many of the same problems under the flat tax that they do now. Along these lines, Alan Feld illustrates that the flat tax will either generate complicated business transactions to skirt the rules or complicated tax laws to reduce the gaming possibilities. Graetz notes that the nonconformity between state and federal taxes might remain a source of complexity even after fundamental tax reform.

Graetz also notes that some analysts believe the USA tax is virtually unworkable due to implementation complexities and tax-planning opportunities. The retail sales tax also poses substantial administrative barriers. As Graetz notes, the combined federal-state sales tax rate would likely be in excess of 30%. At that rate, experience suggests that enforcement becomes quite difficult. Joel Slemrod surveys the evidence on these issues and pronounces both plans nonadministrable at accepted standards of equity and intrusiveness.

3. Savings and Economic Growth

The third issue addressed in this section of the book is the extent to which consumption tax plans would affect saving and economic growth. Here, Graetz notes a wide variety of estimates among professional economists, but gives no sense of why these estimates vary.

174. See GRAETZ, supra note 2, at 230-32.
175. See id. at 226-32.
177. See GRAETZ, supra note 2, at 261-62.
178. See id. at 227.
179. See id. at 205-06.
Much more can be said about the effects of tax reform on economic growth if one is willing to look more closely at empirical evidence. For example, David Altig and his colleagues run simulations of numerous models of tax reform. They show first that a flat consumption tax with no personal exemptions, no transition relief, and no product exemptions could raise the size of the economy by 9% after ten years (and 11% in the long run). The required tax rate would be just under 15% to start with and eventually fall to about 12.5%. These growth effects are huge, relative to the likely impact of other policies, but the policy is not likely to be enacted—even advocates of reform acknowledge the need for personal exemptions. The flat tax allows for these exemptions, but that raises the required tax rate. Altig and his colleagues estimate that the flat tax with exemptions would raise national income by 4% after ten years (and 6% in the long run), with tax rates starting at 21-22% and falling eventually to 19.4%. Thus, allowing for the personal exemption cuts their estimated growth effect in half. However, 4% is still sizable growth over ten years.

The pure flat tax is not politically realistic either. Almost everyone—including the Kemp Commission—acknowledges the need for transition relief for business. One component of transition relief would allow firms to continue taking depreciation deductions on investments that were made before tax reform. Altig and his colleagues estimate that allowing for this type of relief reduces the long-run growth effect to 1.8% after 10 years, and 3.5% in the long run.

These estimates indicate that a huge source of variation in growth effect estimates is the realism of the reform under consideration. Simply allowing for personal exemptions and transition relief reduces the ten-year impact of tax reform on economic growth by 80%, from a 9% increase to a 1.8% increase. Even the 1.8% rate, however, may be larger than would be generated by current political proposals. Altig's estimates use smaller personal exemption levels than Armey's flat tax proposal; they do not include Armey's child exemptions; and their assumed transition relief does not include any

181. See ALTIG ET AL., supra note 146.
182. See id. at 4, 20-21.
183. See id. at 20-21.
184. See, e.g., NATIONAL COMM’N ON ECON. GROWTH AND TAX REFORM, supra note 13, at 21.
185. See ALTIG ET AL., supra note 146, at 4, 22-23.
186. See, e.g., NATIONAL COMM’N ON ECON. GROWTH AND TAX REFORM, supra note 13, at 98-102.
187. See, e.g., Aaron & Gale, supra note 1, at 249-50.
188. See ALTIG ET AL., supra note 146, at 23-24 (noting long-run effects of transition relief). Compare id. at 44 tbl.5 (under a pure consumption tax, output in the year 2005 is 1.09 times what it otherwise would have been), with id. at 48 tbl.7 (under a flat tax with transition relief, output in the year 2005 is only 1.018 times what it otherwise would have been).
189. See Aaron & Gale, supra note 1, at 258-59.
grandfathering of existing interest deductions on loans taken out by businesses and net loss carryforwards.\textsuperscript{190} If adjustments are made for either higher personal exemptions or more generous transition relief or both, the implied growth effect would be even less than 1.8\% over 10 years, and could plausibly be negative.

That is not, however, the end of the story. For similar reasons, the mortgage interest deduction might be grandfathered (or actually retained) in a flat tax. After all, the political argument would go, if major corporations are able to deduct interest payments on their old debt, why shouldn’t homeowners? As another example, eliminating the deductibility of health insurance payments would cause an estimated 6-14 million person increase in the number of uninsured households and a 21\% increase in the price of health insurance.\textsuperscript{191} Politicians and voters may well support retention of the health insurance deductions rather than face these sacrifices. Similar stories might be told about other important tax expenditures, such as the charitable contributions deductions, the EITC, the deductibility of state and local income and property taxes for households, and the deductibility of state and local taxes and payroll taxes for businesses. If all of these deductions are allowed, the flat tax rate would have to rise to about 31\% to replace current income and corporate tax revenues.\textsuperscript{192}

No formal estimates predict the growth effects of these changes. However, if raising the consumption tax from 14\% to 24\% causes the 10-year growth effect to fall from 9\% to 1.8\%, it seems reasonable to presume that raising it another seven percentage points could wipe out all of the remaining 1.8\% growth effect. Thus, economists can plausibly say both that a pure consumption tax reform would raise the size of the economy by 9\% over 10 years, and that a consumption tax reform that allows for personal exemptions, transition relief, and retention of a few popular deductions would have virtually zero effect on growth.

4. **Political Dimensions**

Finally, Graetz deals nicely with a variety of more outlandish claims put forth by advocates of tax reform. As he writes, the claim that tax reform would eliminate the role of tax lobbyists is “palpable nonsense.”\textsuperscript{193} Tax reform would simply start the lobbying game over again from a different starting point. Advocates also claim that having a single tax rate, as in the flat tax, would help government stay small, because to raise one person’s rate

\begin{itemize}
\item \textsuperscript{190} See Altig \textit{et al.}, supra note 146, at 5-18.
\item \textsuperscript{191} See Aaron \& Gale, supra note 1, at 235, 252-53.
\item \textsuperscript{192} See id. at 250. This rate does not allow for transition relief for interest payments.
\item \textsuperscript{193} See Graetz, supra note 2, at 278.
\end{itemize}
would mean raising everyone's rate. This assertion embodies a view of politics that the rich and poor must band together to stop the power of government. A more likely scenario, to my mind, is that rich, poor, and other taxpayers battle each other to extract resources from government. If so, the flat tax provides no guarantee against bigger government or more taxes in the future. It would therefore be straightforward to add a second, third, or more rates onto the base employed by the flat tax. Adding graduated tax rates to the flat tax is precisely what is offered in Bradford's X-tax.194 Moreover, the VAT in Europe and the social security tax in the United States are both flat rate taxes that have increased dramatically over the past several decades.195 Thus, although the goal of tax reformers may be to reduce the size of government, as discussed above, this goal may backfire.

5. What's Missing?

I would add a few additional substantive points to Graetz's analysis of consumption taxes. First, Graetz notes that flat tax advocates do not want to call their tax a consumption tax. This stems partly from simple confusion—many flat tax advocates truly seem not to understand that their tax is a consumption tax. But advocates may also feel that taxing income still resonates well with the public. The cloaking of consumption taxes in income tax garb, however, is odd because the difference between a pure consumption tax and pure income tax is actually surprisingly small. For example, the flat tax allows firms to expense all current investment. If the flat tax instead only allowed firms to deduct their investment expenditures over time in accordance with economic depreciation, the flat tax would be an income tax. That is, the difference between a consumption and an income tax boils down to the tax treatment of depreciation. Yet, I would venture that anyone who favors the flat-tax-with-expensing over the current system would also favor the flat-tax-with-economic-depreciation over the current system, and that anyone who favors the current system over the flat consumption tax would also favor the current system over the flat income tax. If so, the debate is not really about income versus consumption taxes—that is, it is not about the tax base, but rather about other features of tax reform.

What, then, are those other features that galvanize both support and opposition to the flat tax? In my view, they are: flat rates (that is, a large reduction in the taxes paid by the top income classes), the elimination of

194. See Bradford, supra note 168, at 384-87.
social policy through the tax code, the integration of corporate and personal
taxes, and differences in the point of collection of the tax.

Another useful addition to Graetz's analysis of consumption taxes would
have been to illustrate how the various plans do or do not resolve the five
major problems in the income tax that Graetz identified earlier in the book. As
an example, I focus here on the flat tax, as that seems to me to be the most
plausible alternative.

First, as noted above, the marriage tax would continue to exist under the
flat tax. Moreover, the flat tax would effectively renegotiate most divorce
agreements in the country. Currently, alimony is deductible for the payer and
taxable to the recipient. The flat tax would reverse the situation so that
alimony would be neither deductible for the payer nor taxable to the
recipient.

Tax sheltering would also continue under the flat tax, but could take a
very different form. Potential opportunities for sheltering abound, but one
stands out. Under the flat tax, interest income is not taxed and interest
payments are not deductible, but receipts from sales are taxed and purchases
of goods are deductible. This situation implies that any firm with funds
coming in will try to label those funds as "interest" and any firm with funds
going out will try to label those funds as "purchases." These incentives will
have no effect on domestic inter-business transactions, as long as both firms
face the same rates and base. However, in interactions between domestic
businesses and individuals, government, non-profits, and especially foreign
businesses or individuals, there will be substantial opportunities for tax
avoidance.

Compliance could improve somewhat due to the structure of the flat tax,
both because a higher proportion of the tax is collected at the business level
and because rates are lower. However, Graetz presents a strong argument that
increased auditing and enforcement would help compliance even more, with
or without the flat tax. Inflation would in general no longer be an issue.
Whether the flat tax would end up simple or not is discussed above.

196. See, e.g., William G. Gale et al., Voices, in THE FLAT TAX PRIMER 127, 129-30 (Douglas
Sease & Tom Herman eds., 1996).
197. See, e.g., id.
199. See id. at 603-04.
200. See supra note 2, at 98-107.
201. See supra subsection III.B.2.
C. Graetz’s Proposals

In the last two chapters, Graetz proposes his own solutions. His first batch of solutions would modify the existing tax structure and proceeds as follows.

1. Specific Modifications

Graetz’s specific recommendations focus on increasing savings rates and simplifying the tax code. Saving could be influenced by restraining interest deductions, focusing particularly on altering the treatment of home equity loans, enhancing pension coverage, creating IRAs that allow deductions for amounts of saving in excess of stated floors, and integrating corporate and personal taxes. Simplification could be achieved by both increasing the standard deduction and accepting “rough justice” in various settings, such as the treatment of interest income and expense; the definition of a dependent; and deductions for work expenses; commuting; and child care. The treatment of inventory, pensions, and rules for small businesses could also be simplified dramatically. State and local taxes could be induced to conform with federal taxes, perhaps by allowing deductions only for states who key off of the federal form. Congress could further simplify by limiting filing requirements for many households to spare them “the costs and agony of filing tax returns,” and by converting the EITC to a social security tax credit. Oh, and by the way, social security should be partially privatized and the estate tax should be either converted to an inheritance tax or “retained and improved” in some unstated way.

These tax proposals are mainly sensible; none are novel. It would be nice to stimulate saving through the income tax. My sense, however, is that doing so has proven quite difficult, and some of the options presented—for example, IRAs that subsidize saving above one threshold and below another—are complicated. Enhancing pension coverage is a terrific idea, and if we knew how, we could do it. It would also be nice to simplify the tax code. Many of the simplifications proposed involve trade-offs, however, and the effort to provide rough justice will not sit well with those whose taxes go up as a result. For example, “simplifying” the EITC by converting it into a payroll tax credit would cost recipients a large chunk of the benefits currently

202. See, e.g., GRAETZ, supra note 2, at 245-49, 258-61.
203. See id. at 258-61.
204. Id. at 259-60.
205. See id. at 249-58.
206. Id. at 267-68.
207. I will avoid discussion of social security.
provided.\textsuperscript{208} This is not to say we should not try, but rather that my sense of the previous attempts is that we have had little success in the past.

2. \textit{Comprehensive Reforms}

Graetz's second set of proposals is for more comprehensive tax reform.\textsuperscript{209} Graetz proposes to implement a national VAT that would raise half as much revenue as the current corporate and individual income tax.\textsuperscript{210} The funds would be used to cut the corporate tax rate in half, and to convert the income tax into an instrument that only taxes the high end of the income distribution and does so at a flat rate. The proposal is worth taking seriously, and at a general level, several points can be made.

My interpretation of this proposal is that Graetz does not want to get rid of the income tax entirely because of fairness considerations, but does not feel that the problems with the income tax can be solved in any clean way. Thus, the solution is to keep the income tax but limit its applicability to only the highest income groups. Lowering and flattening the income tax rate would reduce some current sources of complexity and eliminate others.

The plan offers many advantages. It would eliminate the income tax for over 90\% of current filers.\textsuperscript{211} It would impose a broad-based consumption tax that could be implemented at the revenue levels needed.\textsuperscript{212} It would retain both progressivity and the appearance of progressivity.\textsuperscript{213} It would eliminate the marriage tax, if the exemptions for single people in the marriage tax were set at half the exemptions for married couples.\textsuperscript{214} Capital gains would be taxed at the same rate as other income\textsuperscript{215} (violating Graetz's earlier suggestion that they be taxed at the revenue-maximizing rates). The proposal is also consistent with international aspects of taxation: The ability to impose steep capital income taxes is limited by globalization of world capital markets.\textsuperscript{216}

\begin{itemize}
\item\textsuperscript{208} See, e.g., Nancy J. Altman, \textit{The Reconciliation of Retirement Security and Tax Policies: A Response to Professor Graetz}, 136 U. Pa. L. Rev. 1419, 1435-37 (1988) (arguing that the EITC can offset more taxes facing the poor than a payroll tax credit can, and that it better targets poor individuals); see also George K. Yin, \textit{Accommodating the “Low-Income” in a Cash-Flow or Consumed Income Tax World}, 2 Fla. Tax Rev. 445, 479 (1995) (noting that a payroll tax credit withheld throughout the year might be less useful for beneficiaries than the EITC, which delivers advance payments).
\item\textsuperscript{209} See GRAETZ, supra note 2, at 262-66.
\item\textsuperscript{210} See id. at 264-66.
\item\textsuperscript{211} See id. at 264-65.
\item\textsuperscript{212} See id. at 264-66.
\item\textsuperscript{213} See id. at 266.
\item\textsuperscript{214} See id.
\item\textsuperscript{215} See id.
\item\textsuperscript{216} See id. at 271.
\end{itemize}
States face some of the same problems and have relied more on consumption taxes, as have European countries.\textsuperscript{217}

The plan also has negative aspects. It could be claimed that the proposal combines the worst aspects of both systems—the regressivity and potential complexity of the VAT and the complexity of the income tax. The proposal still needs to address low-income working households that currently receive the EITC. Providing a rebate of payroll taxes as a substitute for the EITC would significantly reduce the incentive to work that the EITC currently provides.\textsuperscript{218} A better way may be to provide household-level demogrants, a point to which I return below. The complexity of the income tax is worst at the high end, the protestations of the Six-Packs notwithstanding, and would remain. But it might be possible to simplify the income tax considerably if it only applied to a small minority of households. And if rates were lower than they currently are, it may be even easier to simplify. The proposal would not stimulate much saving or investment, but note from the discussion above that plausible versions of the flat tax are unlikely to do so either.\textsuperscript{219} There likely would be reductions in pension coverage and health insurance coverage, both because corporations would face sharply lower rates and because most households would no longer face income tax incentives to participate in such programs. These reductions would likely be smaller than the ones occurring under the flat tax.

By stipulating that more than 90% of current filers would no longer pay income tax, the proposal thus eliminates many items that are currently considered “problems” of the income tax. But many of these—for example, subsidies for housing, charity, and child care—appear likely to show up again as either spending, tax, or regulatory programs.\textsuperscript{220}

Graetz proposes a tax on adjusted gross income, but my guess is that deductions for mortgage interest, charity, and state and local taxes would remain. The first and third were in the original income tax of 1913, and the second was established shortly thereafter.\textsuperscript{221} All three were established when the income tax applied to only a tiny fraction of the population. Including these items might be required to help defuse political opposition.

A VAT on the order of 15-20%, which I view as a more likely outcome than 10% for reasons discussed below, would impart a significant effect on the price level. Increases in VATs, whether of a stand alone nature or as a

\begin{footnotesize}
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\textsuperscript{217.} See, e.g., id. at 199.
\textsuperscript{218.} See, e.g., Stacey Dickert et al., Taxes and the Poor: A Microsimulation Study of Implicit and Explicit Taxes, 47 NAT'L TAX J. 621, 636 (1994).
\textsuperscript{219.} See supra subsection III.B.3.
\textsuperscript{220.} See generally UNITED STATES GEN. ACCOUNTING OFFICE, TAX EXPENDITURES DESERVE MORE SCRUTINY (1994).
\textsuperscript{221.} See id.
\end{footnotesize}
replacement for existing income taxes, have tended to raise the price level in Britain and other European countries.²²²

It should be emphasized that the proposal is only briefly sketched out. It is more of an idea than a fleshed-out proposal. This was apparently a deliberate strategy by the author, aimed at getting people interested in the idea of a VAT-plus-income tax, without burdening them with complicating and deadening details.

On the other hand, the vagueness of the proposal will tend to make the proposal look good relative to realistic, detailed alternatives. All tax policies look “cleaner” and simpler when discussed in the abstract. In tax policy, the author would agree, the devil is in the details. It will therefore be hard for readers to evaluate the proposal when the book only spends four pages laying it out.

The vagueness also leaves important questions unanswered. Which goods or services would be exempt from the VAT? Would there be family-level demogrants? Which deductions would remain in the income tax? Ultimately, it is not at all clear what is actually being proposed.

3. Obstacles to Graetz’s Comprehensive Reform

There is a silver lining, however. If the author does not fill in the details, he leaves room for others to do so. So here is one effort to fill in the details and to do so in a way that takes seriously the political constraints that Graetz emphasizes throughout his book.

Graetz’s proposal is for a 10% VAT that would replace half of all revenues from personal income taxes.²²³ An additional 2% VAT would allow the corporate tax rate to be cut in half.²²⁴ The personal income tax would be modified to allow “exemption of all tax returns below $75,000 of adjusted gross income combined with a flat-rate 21% tax on the total adjusted gross income of returns above $75,000.”²²⁵

There are two major problems with this specification. First, the proposal would tax the total adjusted gross income (AGI) of returns above $75,000.²²⁶ This would not happen. One cannot exempt households with income below $75,000 and then tax all of the AGI of households above $75,000. Doing so would mean that a household with income of $74,999 would pay no income tax, while a household with income of one dollar more would pay $15,750.

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²²³ See GRAETZ, supra note 2, at 264-65.
²²⁴ See id. at 264, 266.
²²⁵ Id. at 265.
²²⁶ Id.
The only practical way to tax only those households with income above $75,000 is to grant a $75,000 exemption (or deduction) and only tax the AGI in excess of $75,000, rather than total AGI. Unfortunately, that reduces the tax base significantly and hence raises the required tax rate.

Second, the tax rates quoted by Graetz are unlikely to raise sufficient revenue. For example, to raise half of 1993 income tax revenues with a tax on all AGI above $75,000 would have required a tax rate of 37%.\textsuperscript{227} If itemized deductions for mortgage interest, charitable deductions, and state and local taxes were retained for high-income groups, the required rate would have risen to about 50%. If “only” a $50,000 exemption were provided, the revenues could have been made up with a 25% flat tax on all AGI above $50,000. If itemized deductions were retained for the high-income groups, a tax rate of about 32% would have been required.\textsuperscript{228} With a $50,000 exemption, 20% of current filers would have been required to file returns.\textsuperscript{229}

To replace half of the revenues from personal and corporate income taxes, a VAT would have to raise 5.1% of GDP in revenues, based on the average of U.S. data from 1990 to 1997.\textsuperscript{230} What VAT rate would be required to replace half of these revenues? According to Vito Tanzi, European countries raise 7.17% of GDP in broad-based VATs with an average rate of 17.2%.\textsuperscript{231} This implies that raising 5.1% of GDP would require a rate of 12%, if the VAT were structured like European VATs. A second way to estimate the VAT rate is to note that Feenberg and his colleagues show that replacing the personal, corporate, and estate tax with a retail sales tax that taxed all plausibly taxable private consumption would require a tax rate of 17% for a pure retail sales tax and 29% if demogrants equal to the poverty line were provided for each household.\textsuperscript{232} Since retail sales taxes and VATs tax the same net tax base, the VAT rate would be 8.5% without demogrants or 14.5% with demogrants if the VAT taxed all items.\textsuperscript{233}

\textsuperscript{227} This figure, and the others in this paragraph, are based upon the author’s calculations using data from Tax Statistics (visited June 5, 1998) <http://www.irs.ustreas.gov/prod/tax_stats> (calculations on file with the author).

\textsuperscript{228} The required rates with itemized deductions depend on the $75,000 allowance being an exemption. If it is instead structured as a standard deduction, the required rate would probably be much closer to the required rate with no deductions.

\textsuperscript{229} This figure is based upon the author’s calculations using data from Tax Statistics, supra note 227 (calculations on file with the author).

\textsuperscript{230} This figure is based upon the author’s calculations using data from Tax Statistics, supra note 227 (calculations on file with the author).

\textsuperscript{231} See VITO TANZI, TAXATION IN AN INTEGRATING WORLD 50 (1995).

\textsuperscript{232} See Feenberg et al., supra note 116, at 52-57.

\textsuperscript{233} These claims, and those in the next paragraph, are based upon the author’s calculations using data from Tax Statistics, supra note 227, and from Feenberg et al., supra note 116, at 52-65, 70-74, 78-81 (calculations on file with the author).
Tax Reform in the Real World

Putting these figures together illustrates some of the trade-offs involved. Suppose the income tax placed a 21% tax on AGI in excess of $75,000 and allowed itemized deductions for mortgage, charity, and state and local taxes. This would only raise about 21% of existing income tax revenues, though, and would require a VAT rate of about 21% if there were a demogrant and all consumption were in the tax base. The VAT rate would rise to about 26% if an additional 20% of consumption were exempted for social policy, tax administration, fairness, or other reasons.

These figures may fundamentally alter the character of Graetz's proposal. Or they may not. It is hard to know in the absence of more details. To be sure, these recalculations are not a reason to jettison the proposal; however, it is important to have a sense of how the numbers work out rather than just the idea behind the proposal, even where the idea is a solid one.

4. Political Reform

Graetz does not stop at tax reform. In the last chapter, he argues cogently that the political process itself needs reform if we are to create sensible and durable policies in taxation and other areas. He notes four ways to inhibit congressional misbehavior. He argues that the first way, enacting constitutional amendments, is difficult and should not be undertaken lightly. The second way would be for the judicial branch to strike down legislation as unconstitutional. Graetz seems to want the judicial branch to attack tax policy in this way, but acknowledges that it is not likely to happen soon. Third, Congress could constrain actions of future congresses via rules, for example, that regulate budget outcomes, or that require a 60% majority to raise taxes. The problem here is that Congress can and has voted to override such rules at various times. Finally, Congress could revise campaign finance rules. Graetz and many other knowledgeable observers argue that the pressure of financing expensive campaigns has polluted the political process. In that regard, Graetz notes that lower tax rates reduce the

234. See GRAETZ, supra note 2, at 279, 281.
235. See id. at 279.
236. See id. at 285-86.
237. See id. at 279-80.
238. See id. at 286.
239. See id. at 288-92.
incentive to lobby for tax breaks, but of course benefits to favored constituencies can be passed along in many ways.\textsuperscript{241}

Although the chapter provides no ready answers, it provides a useful purpose and concluding point: It brings the reader back to the political environment in which tax reform ultimately will be considered. While it is important to consider the theoretical basis of tax reform, it is impossible to make adequate judgments about such policies without focusing on how the reforms would actually work after they have been exposed to Congress, an army of lobbyists, the tax shelter industry, and the American public. Unlike many advocates of comprehensive reform, Graetz should be congratulated for taking both the principles and the practice of tax policy seriously.

\textsuperscript{241} See GRAETZ, supra note 2, at 277-98.