

ESSAY

TAXES THAT WORK: A SIMPLE AMERICAN PLAN*

*Michael J. Graetz***

WHO WILL STEP UP?¹

In November 2005, the President's Advisory Panel on Tax Reform, appointed by President Bush to suggest options for reforming and simplifying the federal tax code, unanimously recommended two alternative plans: a "simplified income tax" (SIT) and a "growth and investment tax" (GIT). The two plans shared much in common. For example, both would: (1) Reduce the top marginal tax rate—to 33% under the SIT plan and 30% under GIT plan; (2) eliminate the alternative minimum tax (AMT); (3) replace the earned income tax credit (EITC) and refundable child credits with a "work credit"; (4) replace personal exemptions, the standard deduction, and child tax credits with a "family credit"; (5) eliminate all deductions for state and local taxes; (6) extend deductions for interest on home mortgages and charities to non-itemizers, but reduce deductible amounts; (7) cap the exclusion for employer-provided health insurance; and (8) expand and simplify tax-favored savings opportunities. In addition, the proposed SIT would eliminate tax on dividends distributed by U.S. corporations from U.S. earnings and would exempt 75% of capital gains on the sale of corporate stock; other dividends and capital gains would be taxed at standard rates.

The two plans also suffered from a common problem. Once the panel decided to eliminate the AMT (a loss of more than \$1 trillion in revenue over the ten-year budget period), it struggled to find offsetting revenues to achieve revenue neutrality. This required attacking political sacred cows, such as the mortgage interest deduction. As a result, neither of the Panel's plans has been endorsed by congressional Republicans or Democrats. And toeing their party lines, Republicans complain that the Panel did not

* © 2005 by Michael J. Graetz. A version of this Essay was previously published in *TOWARD FUNDAMENTAL TAX REFORM* 48-69 (Alan J. Auerbach & Kevin A. Hassett eds., 2005). Republished with permission by the American Enterprise Institute for Public Policy Research.

** Justus S. Hotchkiss Professor of Law, Yale Law School.

1. This section includes material previously published in Michael J. Graetz, *Tax Reform: Time For a Plan C?*, *ECONOMISTS' VOICE*, December 2005, <http://www.bepress.com/cgi/viewcontent.cgi?article=1138&context=ev>. Republished with permission by The Berkeley Electronic Press.

recommend a greater reduction in tax rates, while Democrats criticize the Panel for favoring capital over labor income.

The Panel also considered—indeed, found worthwhile, but did not unanimously recommend—“Plan C”: a partial replacement of individual and corporate income taxes with a value-added tax (VAT). This approach holds the most promise of any tax reform proposal. In fact, the VAT has been successful throughout the world, often operating alongside an income tax. I have long favored limiting the income tax to income over \$100,000 and making up the revenue lost with a VAT. This would eliminate the need for about 100 million tax returns each year, producing real simplification. And yet, despite the obvious advantages of Plan C, the question is: Does a VAT stand a chance of becoming law?

As always, the smart money is against tax reform. In 1986, the smart money bet against tax reform until the night before the new law was enacted. So the smart money doesn't always win. Beating it, however, demands extraordinary leadership from both the White House and Capitol Hill. In 1986, in addition to President Reagan's personal efforts, crucial leaders emerged in Congress from both sides of the aisle. The legislative proposals of Democrats Bill Bradley and Dick Gephardt and of Republicans Jack Kemp and William Roth, while different, pointed the way to the income tax reform that actually happened. And Republican Senate Finance Committee Chairman Bob Packwood and Democratic Ways and Means Committee Chairman Dan Rostenkowski supplied essential leadership in passing the legislation. The key question is whether members of Congress will step up this time.

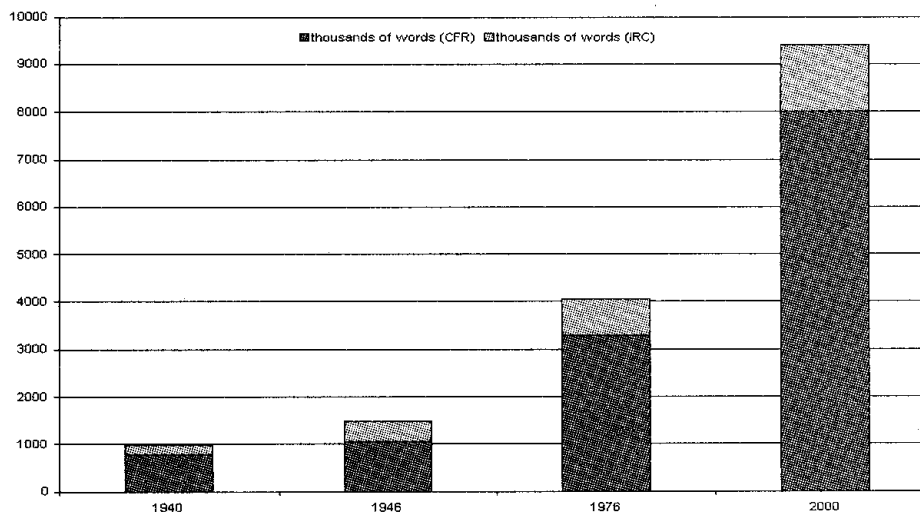
The tax policy debate between Democrats and Republicans so far offers reasons for pessimism. Democrats seem to be looking to cut taxes of the poor, to provide tax breaks to the middle class for this or that expenditure, and to raise taxes for high-income people. Many Republicans seem to be looking mostly to provide more tax cuts for savers and investors, who tend to be those with higher incomes. The 1986 tax-reform coalition of supply-side Republicans and tax-reforming Democrats, which produced the revenue-neutral, distributionally-neutral, rate-lowering, base-broadening, tax-reform legislation signed by Ronald Reagan, has come completely unglued. Tax legislation during the 1990s completed the unraveling of the 1986 Tax Reform Act, which had promised, but failed to deliver, a better and simpler income tax. Republicans seem to favor a narrower tax base with low rates, Democrats a different but also narrower tax base with higher rates. Attempting to overhaul the income tax, as in 1986, does not seem a promising path.

THE INCOME TAX IS BADLY BROKEN

I remember decades ago my father taking over our dining room table, sitting there filling out his tax return off and on from about mid-February until April 15 every year. This infuriated my mother for obvious reasons. My father struggled on, viewing his duty to determine how much tax he owed the way Justice Holmes did: as the price we pay for a civilized society.

What has happened since? Substantively, the income tax is a mess. Taxpayers at every income level confront extraordinary complexity. In 1940, the instructions to the Form 1040 were about four pages long. Today the instruction booklet spans more than a hundred pages, and the form itself has more than ten schedules and twenty worksheets. The Internal Revenue Code contains more than 700 provisions affecting individuals and more than 1,500 provisions affecting businesses—a total of more than 1.4 million words—making the tax law four times larger than *War and Peace* and considerably harder to parse. The regulations contain another 8 million words, filling almost 20,000 pages. And both the Code and regulations grow fatter every year (see Figure 1).

Figure 1: Tax Code Complexity²



2. Calculations for this figure are based on previous versions of the Internal Revenue Code and Treasury Regulations, as published in the United States Code and Code of Federal Regulations. See also STAFF OF J. COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION (Comm. Print 2001),

In America today, very few people share my Dad's attitude toward taxes. Many feel like "chumps" if they pay the taxes they legally owe. Young people, especially, admit that they feel no compunction about filling out their tax forms dishonestly. And the Internet has facilitated growth of the "tax deniers" movement—people who spread their rejection of the legitimacy of any income tax requirements, including the requirement for employers to withhold taxes on their employees' wages. When the IRS shuts down one Internet site, more replace it.

We are moving inexorably toward a crisis of compliance with our income tax. Filing a tax return no longer links the American people to their government. Instead, it is just one more commercial operation. H&R Block, Jackson-Hewitt, TurboTax, and a legion of accountants sit between Americans and their government.

Congressional Republicans and Democrats, along with every president, now use income tax incentives the way my mother employed chicken soup, as a magic elixir for every economic or social ill. If the nation has a problem in access to education, child-care affordability, health insurance coverage, retirement security, or the financing of long-term care, to name just a few, an income tax deduction or credit is supposedly the answer.

The competition to give tax breaks for this or that expenditure has badly broken the income tax. It is way too complicated; estimates suggest ordinary citizens and businesses waste about \$125 billion every year—thirteen cents for every dollar collected—trying to comply with it, or to avoid it.³

At the same time, the IRS is now incapable of administering and enforcing the income tax law. The fundamental problem is that it is being asked to do too much. Having to administer the EITC—the nation's wage subsidy for low-income workers—has diverted IRS audit resources away from corporate and high-income individual returns, leading to headlines that the agency is targeting the poor for audits. The IRS routinely processes more than 130 million individual and corporate income tax returns and nearly 1.5 billion information documents each year. It is also supposed to issue regulations promptly implementing frequent and massive legislative changes, to ferret out and deter income-tax protestors and corporate tax shelters, to halt tax evasion, and to bring the underground economy to the surface. The IRS cannot do all of these things well. Many it cannot do at all.

Then, there is the train wreck coming down the tracks. The AMT, if left unchanged, will soon be imposed on more than 30 million Americans.

available at <http://www.house.gov/jct/5-3-01vol2.pdf>.

3. Joel Slemrod, Presentation to the President's Advisory Panel on Federal Tax Reform: The Costs of Tax Complexity (Mar. 3, 2005), available at http://www.taxreformpanel.gov/meetings/docs/slemrod_03032005.ppt.

Tens of millions of people will have to struggle to calculate twice—with different rates and different bases—what income tax they owe. The cost of fixing this problem—perhaps \$1 trillion over ten years—is why Congress, since 2001, has simply postponed it. The pony in this manure is that the coming AMT disaster offers politicians a terrific opportunity to make some major improvements in our nation's tax system.

It's not surprising that the American people now say the income tax is the worst tax in the U.S. system. For a long time—until 1978—the income tax was regarded by the American people as the nation's best tax.⁴

How can anyone remain optimistic about fixing the income tax without radical surgery? Even those who applauded the 1986 Act as a wildly successful tax reform must concede now that this legislation was not a stable solution. Over time, its broad base and low rates have been transformed into a narrower base with higher rates. What the nation needs is a new and better tax system, one that is far simpler, fairer, and more conducive to economic growth.

If tax reformers are truly serious about getting the IRS out of the lives of the American people, they must place tax simplification at the top of the agenda. But in Congress, simplification is not a priority. Democrats are primarily concerned with maintaining a progressive tax system, while many Republican tax-cutters want to eliminate all taxes on wealth and capital income—they say to spur economic growth.

President Bush has said that any tax reform must be revenue-neutral, maintain a progressive tax system, and promote economic growth. He has emphasized that “simplification would be the goal” of any changes to the tax code.⁵ But the specifics of his plan are unknown. Will he propose tinkering with the income tax? Or will he go for a flat-rate tax on what people consume or on wages only, exempting all savings or investment income? Or will Bush propose the favorite plan of some congressional Republicans—complete replacement of the income tax with a national sales tax?

Unfortunately, despite their cleverness, the proposals for broad change that have recently been circulating in the Congress—ideas like the “flat” tax and a national sales tax (which its proponents have somehow labeled the “fair tax”)—are essentially unrealistic. They supply nice vehicles for railing against the current system and for making political points, but they fail to offer genuine alternatives. This is no time to play Pollyanna.

4. MICHAEL J. GRAETZ, *THE DECLINE (AND FALL?) OF THE INCOME TAX* 3-4 (1997).

5. President George W. Bush, Press Conference (Nov. 4, 2004) (transcript available at <http://www.whitehouse.gov/news/releases/2004/11/20041104-5.html>).

THE "FLAT TAX," A NATIONAL SALES TAX, AND A PROGRESSIVE
CONSUMPTION TAX ARE NOT REALISTIC ALTERNATIVES

Flat-tax advocates trumpet their claim that they would shrink the individual tax return to fit on a postcard. But given Congress's propensity for enacting tax breaks to encourage particular expenditures or activities, it is foolish to believe that a flat tax—which would require all wage earners to file tax returns—would stay flat or simple for very long. The political allure of giving Americans tax breaks for specific expenditures or investments is catnip to both Congress and the White House. The Form 1040 itself could once have fit on a postcard.

Nor does the idea of taxing only people's wages seem likely to sit well with the American public over time. The belief that it is unfair to tax only wages, and not income from wealth, is what led this country to add the Sixteenth Amendment to our Constitution.

Politically, the flat tax's greatest weakness is its treatment of exports and imports—taxing exports, while exempting imports—which makes it anathema to American businesses.⁶ Notwithstanding economists' widespread agreement that exchange-rate adjustments will offset this disadvantage, American producers will not stand for a consumption-based tax reform that taxes U.S. production, no matter where the goods are consumed, but fails to tax foreign production of goods consumed in the United States. Its treatment of international commerce—which is required under the General Agreement on Trade and Tariffs (GATT)—is alone enough to doom the flat tax politically.

Proponents of replacing the income tax with a national sales tax have labeled their proposal the "fair tax" and are spending millions of dollars to build grass-roots support. And quite a few congressional Republicans have cosponsored legislation endorsing this idea. But there is no reason to believe that any government can collect a retail sales tax at the high rates necessary to replace the income tax completely. Only six countries have ever adopted retail sales taxes at rates of 10% or more; none currently exists.⁷ The temptations for retailers to pocket the money are just too great. This is why more than a hundred nations have instead adopted value-added

6. Most sales or value-added taxes are levied only on consumption that takes place within the country. Exported goods are exempt from the tax. These exemptions are not available under a flat tax, which would tax the entire value of goods manufactured in the United States whether sold here or abroad, but would tax only the U.S. markup of imported goods manufactured abroad. Economists do not regard this as significant because they expect exchange rates to adjust to compensate for this difference. Business owners, on the other hand, perceive a major competitive advantage for imports and will exert their political muscle to oppose such a regime.

7. See Slemrod, *supra* note 3, at 7.

taxes, which are similar to sales taxes economically, but are collected at all stages of production.

Like the flat tax, the national sales tax plan would undermine both private employer-based pensions and health insurance. By eliminating any incentives for either, it would threaten employers' provision of both, which is how most families get their retirement savings (other than Social Security) and their health insurance coverage. Both of these plans would also eliminate any incentives for charitable contributions or home ownership, contrary to President Bush's insistence that such benefits be retained.

But despite its serious shortcomings, do not underestimate the political forces behind this so-called "fair tax" movement. They resemble the forces that started the effort to repeal the estate tax in the early 1990s. We now know that the failure to take such a political movement seriously can be very costly to its opponents.⁸

Since all reporting of sales taxes would be done by retail businesses and no individual returns would be required, a national sales tax would offer genuine simplification for American families. The rub, however, is that complete replacement of the income tax with a national sales tax would provide a large tax reduction for the country's wealthiest people. Like the flat tax, a national sales tax that completely replaces the income tax would unacceptably shift the tax burden away from those with the greatest ability to pay to families with less income. This plan is simply not fair. But there is no "truth-in-labeling" requirement in politics.

Thirty years ago, Dan Throop Smith, a Harvard economist who had served as the Treasury Department's top tax adviser during the Eisenhower administration, accepted the invitation of his daughter, a teacher, to visit her one-room school in Montana.⁹ To get a better handle on tax equity, Smith asked three children what would be a fair tax on a family with an income of \$5,000, if a family with an income of \$2,000 paid a tax of \$200.

The first child replied that \$500 would be fair, thereby showing a predisposition for proportional burdens and perhaps a desire to make use of a newly acquired familiarity with percentages.¹⁰ A second child immediately disagreed, adding the comment that the payment should be more than \$500 because "each dollar isn't so important" to the family with the larger income.¹¹ A third child agreed with the second, but with the

8. See MICHAEL J. GRAETZ & IAN SHAPIRO, *DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH* 99-117 (2005) (explaining the ineffectiveness of the resistance to the estate tax repeal movement).

9. Dan Throop Smith, *High Progressive Tax Rates: Inequity and Immorality?*, 20 U. FLA. L. REV. 451, 451-63 (1968).

10. *Id.* at 452.

11. *Id.*

reservation that the additional tax over \$500 shouldn't be "too much more or they won't work so hard."¹² Smith subsequently relayed this story in a scholarly article, adding: "Elaborate theoretical structures concerning diminishing utility and incentives and disincentives are all really refinements of the quasi-intuitive opinions of those children and may not lead to any greater certainty."¹³

Shortly after the publication of my book, *The Decline (and Fall?) of the Income Tax*, which retells Smith's story, my daughter's fifth-grade teacher asked me to visit her classroom to talk about it. While there, I repeated Dan Throop Smith's experiment. I asked the identical question, and, remarkably, the first three students to speak gave the identical answers in exactly the same order. The intuitions about progressive taxation of children of the 1990s in a large New Haven, Connecticut school mirrored precisely those of the Montana children in the 1960s. After I told them that they had given exactly the same answers in exactly the same order as did children more than three decades earlier in a one-room Montana schoolhouse, a number of them wrote to me remarking how "cool," "neat," "amazing," and "weird" that was.¹⁴ One concluded, "I guess that must be fair, if both of the schools got the same answers."¹⁵

These two experiments should serve as a caution to those who believe that the American public will view as fair replacing a progressive tax on income with a flat-rate tax on consumption. That sentiment will last only until the second child speaks.

The current income tax is a horrible mess. But in the course of radically restructuring our tax system, we should not enact a massive tax reduction for the country's wealthiest people—those who least need such relief—while increasing taxes for those with less income or wealth. To avoid such a shift in tax burdens, while making the tax system more favorable to savings, Republican Senator Pete Domenici and Democratic Senator Sam Nunn in the 1990s offered a combination of a value-added tax on businesses and a progressive individual consumption tax as a replacement for the income tax. The Nunn-Domenici plan foundered, however, because of its inability to solve problems of transition from an income tax to the progressive consumption tax and its failure to tax consumption financed with borrowing. In combination, these two problems allowed people with assets or the ability to borrow to avoid the

12. *Id.*

13. *Id.*

14. Michael J. Graetz, *Your Tax Dollars at Work: Why U.S. Tax Law Needs to be Changed*, 48 EMORY L.J. 849, 859 (1999).

15. *Id.*

tax.¹⁶ The personal tax was essentially a personal tax on wages, but by borrowing for consumption and reinvesting the proceeds of asset sales, people could have sheltered even the wage tax. Senators Nunn and Domenici also concluded that it was necessary to retain a number of existing income-tax preferences, including, for example, the exemption for interest on state and local bonds. This created additional opportunities to consume tax-free. The Nunn-Domenici experiment suggests that enacting a coherent progressive personal tax on consumption is probably not politically viable. This is hardly surprising, since no other nation relies on such a tax.

There are many other tax-restructuring options. The Committee for Strategic Tax Reform, led by Ernie Christian and Gary Robbins, for example, has proposed what it calls five easy pieces: (1) lowering capital-gains rates; (2) eliminating the double tax on corporate earnings; (3) allowing 100% of business investment to be expensed; (4) expanding Roth-type IRAs for savings; and (5) moving to a territorial corporate tax that exempts all foreign income.¹⁷ Like the other ideas I have described, this plan would remove tax burdens on wealth or income from wealth and shift burdens to labor income. The reason these particular changes seem easy to their proponents is that they involve only incremental changes in the income tax, and every one of these pieces, except the last, is a major revenue loser. Like virtually all income tax proposals, they offer little promise of genuine simplification. They also are targeted to benefit higher-income people and corporations. Their proponents never describe how they plan to pay for these changes—how to offset the revenue losses—because if they did, these “easy pieces” would become a good bit harder to enact.¹⁸ Perhaps we are simply supposed to have faith that

16. See, e.g., Martin D. Ginsburg, *Life Under a Personal Consumption Tax: Some Thoughts on Working, Saving and Consuming in Nunn-Domenici's Tax World*, 48 NAT'L TAX J. 585, 585-602 (1995); Alvin C. Warren, Jr., *The Proposal for an 'Unlimited Savings Allowance,'* 68 TAX NOTES 1103, 1103-08 (1995).

17. See Cesar V. Conda, *Five Easy Pieces*, NAT'L REV. ONLINE, Sept. 14, 2004, http://www.nationalreview.com/nrof_comment/conda200409140832.

18. To avoid some of the revenue cost of the “five easy pieces,” and perhaps also to prevent the “tax arbitrage” that might otherwise be possible under this plan, see Alvin C. Warren, Jr. & Alan J. Auerbach, Comment, *Tax Policy and Equipment Leasing After TEFRA*, 96 HARV. L. REV. 1579, 1579-98 (1983), some have suggested combining expensing of business investments with the “comprehensive business income tax” (CBIT) idea for taxing businesses offered by Treasury in 1992. See U.S. DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992), available at <http://www.ustreas.gov/offices/tax-policy/library/integration-paper/>. With expensing, CBIT may be just another variation of a subtraction-method VAT, along the lines of the flat tax or David Bradford's “X Tax.” See David F. Bradford, *A Tax System for the Twenty-first Century*, in TOWARD FUNDAMENTAL TAX REFORM,

increases in economic growth will take care of this new, large revenue hole.

A SIMPLE AMERICAN PLAN

We can achieve low tax rates and a much simpler tax system by replacing most of the income tax with a tax on consumption. In the process, we should return the income tax to its pre-World War II status—a low-rate tax on a relatively thin slice of higher-income Americans. Whittling down the income tax could be financed by enacting a VAT, a consumption tax commonly used throughout the world. A VAT imposed at a 10–14% rate could finance an exemption from income tax for families with \$100,000 of income or less and would allow a vastly simpler income tax at a 20–25% rate to be applied to incomes over \$100,000. In combination, these two taxes would produce revenues roughly equivalent to the current income tax (see Table 1).¹⁹ And this proposal, unlike the “flat tax,” the “fair tax,” and other such proposals, is essentially distributionally neutral. It would not dramatically shift the tax burden away from high-income families to middle- and lower-income families. Also, rather than relying on tax structures like the flat tax and progressive consumption taxes, which were invented in ivory towers and are largely untested in today’s economy, this plan combines two of the world’s most common tax mechanisms, while exploiting our nation’s substantial economic advantages.

Here’s the proposal. It contains four pieces, but I don’t claim they’re easy.

The Individual Income Tax. Increase the AMT exemption for married couples to \$100,000 (\$50,000 for singles), and index the exemption for inflation so we never find ourselves back in the position we are in today. Lower the AMT rate to 20–25% and repeal the regular income tax. Everybody seems to want to repeal the AMT; let’s repeal the regular income tax instead.²⁰

11, 11-33 (Alan J. Auerbach & Kevin A. Hassett eds., 2005). Without expensing, CBIT would be a unique form of income tax, taxing interest payments at source rather than residence, unlike any of our tax treaty partners.

19. For further detail, see Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261, 261-310 (2002).

20. If the AMT were to serve as the income tax, certain changes would be necessary. For example, expenses of earning income, including employees’ business expenses and investment expenses, should be deductible. The \$100,000 exemption should make other personal exemptions and credits for children unnecessary. Deductions might or might not be allowed for state and local taxes.

This would free about 150 million families from filing income tax returns. They would have no dealings at all with the IRS. A low flat rate of tax would be imposed on the taxable income of high-income individuals. The income tax that would remain for high-income taxpayers would be shrunken and simplified substantially. The marriage penalties of the existing income tax would be eliminated. Most of the special income tax credits and allowances that now crowd the tax code and complicate tax forms would be repealed. But the deductions for charitable contributions, home mortgage interest and large medical expenses would be retained. In addition, employers would continue to have income tax incentives to provide their employees with retirement savings plans and health insurance. If Congress desires, a deduction could be allowed for state and local taxes. Congress could tax capital gains at the standard 20-25% rate or maintain a lower rate. Likewise, Congress could retain the special 15% rate on dividends or adopt the original 2003 proposal of President Bush, eliminating dividend taxes completely when corporate taxes are paid.

The Corporate Income Tax. Lower the corporate rate to 15-20%, and more closely align book and tax accounting. Only with greater book-tax conformity will we ever really solve the tax shelter problem that has plagued the corporate income tax for decades.

An identical corporate and top individual rate, along with fewer differences between book and tax measurements of income, would allow major simplification of business taxation. Where Congress wants to maintain book-tax differences, such as for depreciation, research and development expenses, and foreign taxes, these differences would be made explicit. The corporate alternative minimum tax would be repealed. By adopting identical tax rates under the individual and corporate income taxes, the income of small corporations could be taxed on a flow-through basis, thereby eliminating the separate corporate tax for many small businesses and taxing their income directly to their owners. This would allow small business income to qualify for the \$100,000 income tax exemption, and the taxation of small-businesses could be greatly simplified. The corporate income tax would apply only to large, publicly held companies.

Enact a Value-Added Tax. To replace the revenues just lost, enact a value-added tax at a 10-14% rate. A VAT has effects similar to a sales tax, but a value-added tax is collected at all stages of production, so it is difficult to evade. This is a realistic tax used by more than 120 countries on five continents.

Businesses with gross receipts of less than \$100,000 annually (which account for nearly 80% of the country's 25 million businesses) should be

exempt from collecting VAT or filing returns. Such an exemption would reduce the number of VAT returns to about 5.5 million. An exemption for small businesses would also relieve them from the costs of compliance, and the tax collector from chasing after small amounts of tax. European VATs tend to impose compliance costs about one-fourth to one-third as large as our income tax.²¹

In order to keep the tax rate as low as possible, the VAT tax base should be broad, covering nearly all goods and services. A broad VAT tax base with a single tax rate would minimize its economic distortions, and limiting exemptions would simplify compliance and administration.²² Expenditures on education and religion would be exempt from the consumption tax, as would much expenditure for health care. However, rather than exempting food or clothing, as many foreign VATs and state sales taxes do to reduce the tax burden on necessities, low-income people should be protected from tax increases through an offset of their payroll tax liabilities.²³

Many countries that have enacted value-added taxes do not require retailers to state separately the amount of tax imposed on the goods they sell; the tax is buried in the price of products. But this weakness is easily cured by Congress simply requiring that the total amount of tax be separately stated whenever goods or services are sold.

There are a variety of methods for imposing and collecting such a consumption tax. The best alternative is a so-called credit- or invoice-method VAT of the sort used predominantly throughout Organization for Economic Co-operation and Development (OECD) nations.²⁴ Experience demonstrates that such a tax works well. Sellers of goods and services collect taxes and receive credits for VAT paid on their purchases. This allows tax revenues to be collected regularly throughout the year from companies at all levels of production, rather than just from retailers,

21. See Slemrod, *supra* note 3, at 7.

22. A broad, but realistic, consumption tax base would include 50-60% of the nation's gross domestic product, less than the percentage of consumption taxed in some nations, but higher than the OECD average, which is about 40% of gross domestic product. See LIAM EBRILLE ET AL., *THE MODERN VAT* 40-42, 43, 46 (2001).

23. Alternately, the payroll tax offset might be combined with some VAT exceptions for necessities.

24. EBRILLE ET AL., *supra* note 22, at 20. A "subtraction-method" VAT, in which value added by each firm is calculated by subtracting allowable purchases from receipts, has often been offered as an alternative. In the United States, this may well be because a subtraction-method VAT looks more like an income tax. Like a credit-method VAT, a subtraction-method VAT must adopt some mechanism to protect low- and moderate-income taxpayers from a tax increase.

thereby easing enforcement.²⁵ A credit-method VAT also facilitates exemptions for small businesses (and for specified goods or services if such exemptions become politically necessary). The key point is this: The consumption tax should be collected only from businesses, and the tax should be imposed on a broad base at a level sufficient to free the vast majority of Americans both from any income tax liability and from any requirement to file tax returns.

Provide a Refundable Payroll-Tax Offset. Replace the earned-income tax credit and protect families with low and moderate income from any increased tax burden under this plan through a refundable payroll tax offset. Providing low- and middle-income workers offsets through the payroll tax withholding system would allow tax returns to be eliminated for these workers without increasing their taxes, while maintaining the EITC wage subsidy. Moreover, payroll tax offsets would put money in low-income workers' pockets when their paychecks are earned rather than through a lump-sum tax refund after year-end, as the EITC now does.

For several reasons, it is not appropriate that this tax relief correspond precisely to that provided by the current EITC. The EITC now contains serious penalties on marriage, which should not be replicated in any new system, and noncustodial parents are now treated as if they have no financial obligations to their children. Further, for families with children, relief greater than that provided by the EITC will be needed to offset any new tax burdens created by a consumption tax. This tax relief and wage subsidy for low-income workers would be administered by having employers adjust their employees' paychecks to provide additional take-home pay. The total amount of the adjustment would depend on how many children the worker has. To avoid an abrupt termination of relief with attendant high marginal tax rates on wages, families with children might be eligible for some tax offset with wages up to about \$50,000.

Calculating this offset to payroll tax withholding would not burden employers; tables would be provided by the IRS showing the amounts of the payroll tax offsets at different wage levels and family sizes. Employees whose payroll tax obligations are not sufficient to cover the adjustment would receive a direct increase in their take-home pay.

Although this take-home pay increase for low-income workers takes the form of a reduction of payroll tax deposits, like the current EITC it would not affect employees' Social Security benefits or the amounts credited to the Social Security Trust Fund. It would be funded from general revenues provided by the VAT.²⁶ Each employee's wages would

25. See EBRILLE ET AL., *supra* note 22, at 15, 20.

26. About two percentage points of a 14% VAT would be dedicated to this purpose.

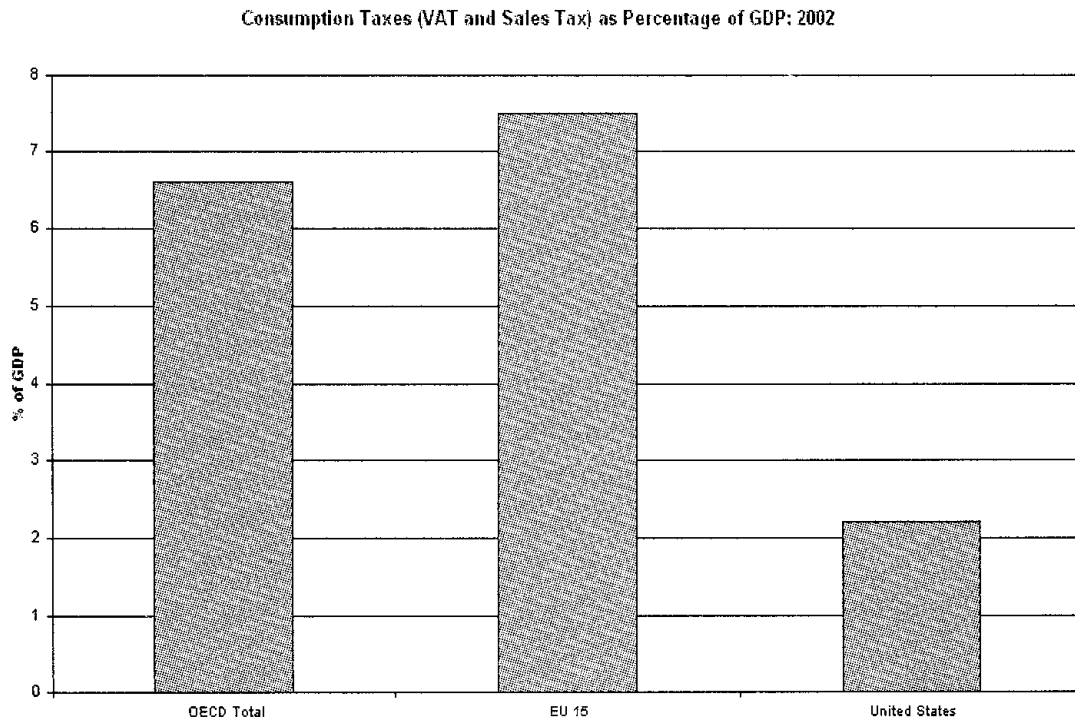
be reported to the Social Security Administration in full, thereby providing all necessary information to maintain the employee's full eligibility for Social Security benefits.

CONCLUSION

This plan is fair and balanced. It is fiscally sound, designed to maintain current federal government revenues. Unlike proposals to replace the income tax completely with either a "flat tax" or a national sales tax and some other proposals, this plan does not entail a substantial tax cut for high-income individuals, or a tax increase for those below the top tier.

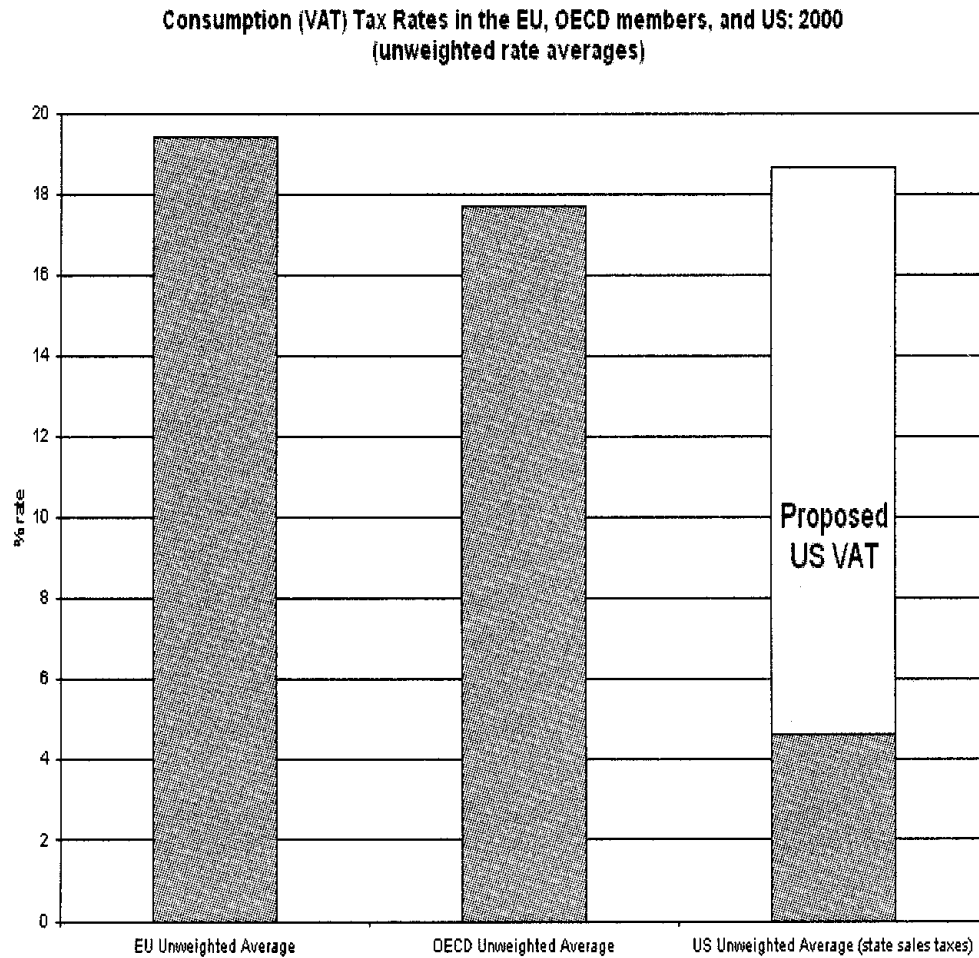
This tax system would make the United States very similar to the average of OECD countries in taxing consumption relative to GDP and in terms of tax rates on consumption (see Figures 2 and 3).

Figure 2: Consumption Tax As A Percent of GDP²⁷



27. Org. for Econ. Co-operation & Dev., OECD Revenue Statistics (2004).

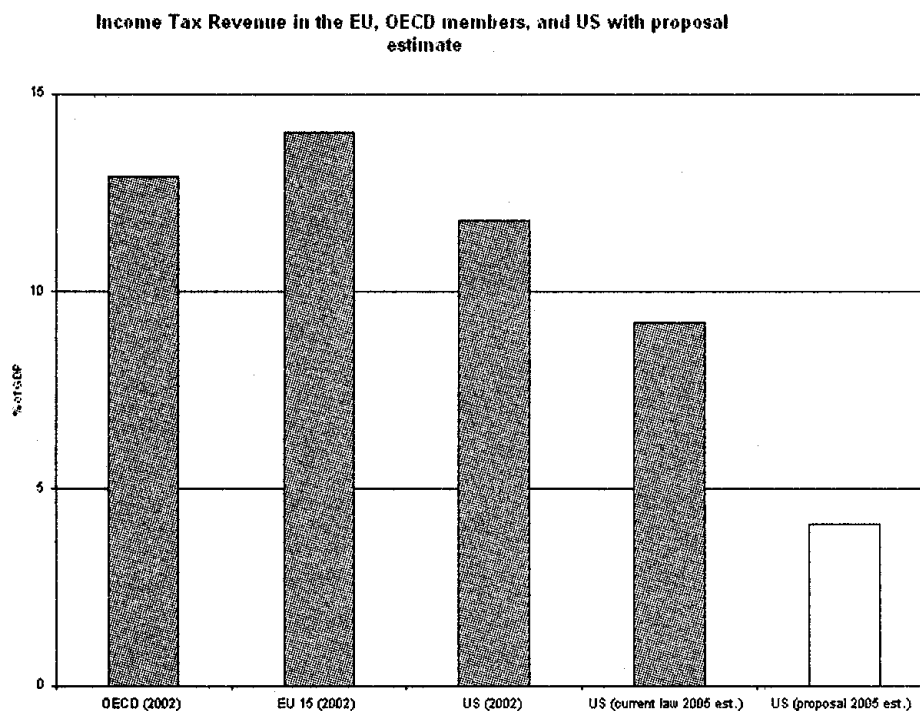
Figure 3: Consumption Tax Rates²⁸



28. ORG. FOR ECON. CO-OPERATION & DEV., CONSUMPTION TAX TRENDS: VAT/GST, EXCISE AND ENVIRONMENTAL TAXES 16 (2001). The computations for the United States are based on data available from the Sales Tax Institute. See <http://salestaxinstitute.com> (last visited Jan. 10, 2002).

Our income tax, however, would be very much smaller—and could be very much simpler—than what people generally face abroad (see Figure 4).

Figure 4: Income Tax Revenue As A Percent of GDP²⁹

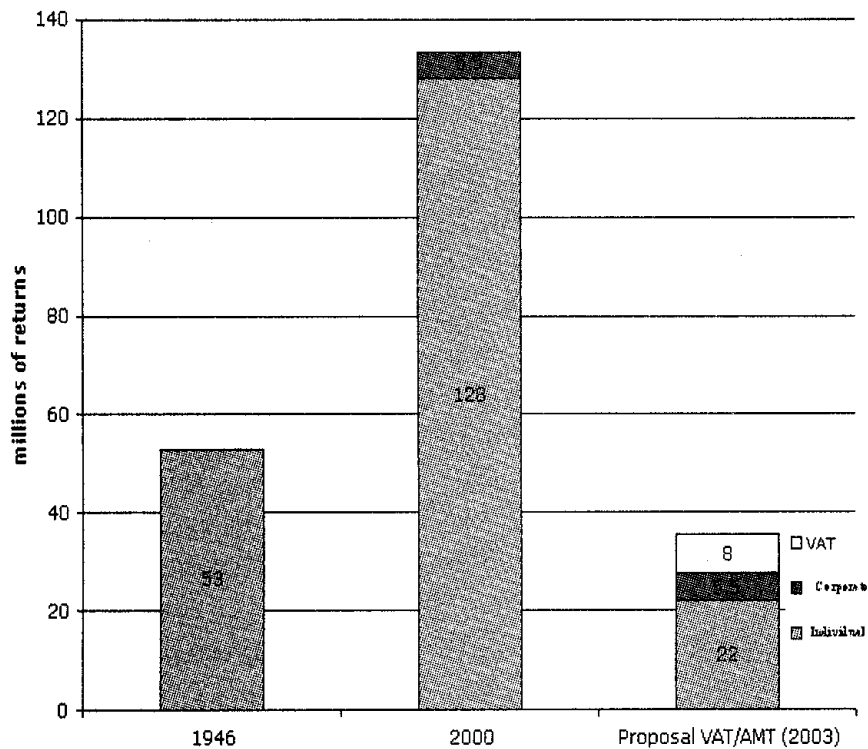


29. Org. for Econ. Co-operation & Dev., *OECD Revenue Statistics (2004)* (reporting U.S. revenue for 2003 as 10.9% of GDP). The U.S. figures for 2005 are the author's estimates.

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

- It would eliminate about 100 million of the 135 million income tax returns that are now filed (see Figure 5). One hundred fifty million people would no longer have to file tax returns. For them, April 15 would just be another day.

Figure 5: Tax Returns: Current Law and Proposal³⁰



30. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES (1956); INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREAS., INTERNAL REVENUE SERVICE DATA BOOK 2000 (2001). GAO has estimated that an exemption for small businesses with gross receipts of \$100,000 or less would reduce the required number of VAT returns from 24 million to 5.4 million. We assume here that such a small business exemption would be included in a VAT and show 8 million VAT returns filed, since some small businesses will opt into the VAT to obtain refunds and to account for growth since the GAO report was published. U.S. GEN. ACCOUNTING OFFICE, TAX POLICY: VALUE-ADDED TAX: ADMINISTRATIVE COSTS VARY WITH COMPLEXITY AND NUMBER OF BUSINESSES 62 (1993).

- It would be far more favorable for savings and economic growth. Most Americans would owe no tax on savings, and taxes on savings and investment would be lower for everyone. We would also maintain incentives for employers to provide both health insurance and retirement savings plans for their employees. The United States would be an extremely attractive place for corporate investments of both U.S. citizens and foreigners. This plan should stimulate economic growth and create additional jobs for American workers, producing substantial long-term benefits for the American economy.
- It eliminates all marriage penalties, something that Congress has so far been unable to do under the current income tax.
- It not only gives the United States a substantial economic leg-up in the world economy, but does so by combining taxes commonly used throughout the world. This system facilitates international coordination and fits well within existing international tax and trade agreements.
- It avoids the difficult issues of transition to an entirely new system that have haunted other proposals to move away from reliance on the income tax.
- It would reduce the IRS workload so that the agency could do its job.

Finally, although Congress will always tinker with the details of taxation, this system promises more stability than the alternatives. I have already said why a pure flat-rate tax on other consumption or income will remain neither flat nor pure for very long. And incremental income tax changes favorable to savings and investment today will be easy for Congress to reverse tomorrow. Moreover, as long as the vast majority of Americans are required to file tax returns, Congress and future presidents will find irresistible a hodgepodge of tax incentives for this or that expenditure or behavior. This is, after all, how the income tax became the mess it is today. But when the vast majority of families pay their taxes only at the cash register, the political payoff from income tax incentives will diminish dramatically.

And—short of a major catastrophe—it is hard to imagine any member standing on the floor of Congress urging a reduction in the \$100,000 exemption to bring more people into the income tax. Last century, it took World War II for this nation to extend the income tax to the masses. Instead, representatives and senators will be clamoring to get more and

more people out from under the income tax.

The greatest threat to the stability of this tax structure is that income or value-added tax rates might rise over time. To protect against the latter, I have urged that we enact a VAT rate high enough (given existing state sale taxes) to leave little room for further increases and use all the money the VAT produces to eliminate income taxation while protecting low- and moderate-income families from a tax increase. For the former, capital mobility in today's global economy offers real protection against individual and corporate income tax rate increases. The trend around the world is toward lower, not higher, income tax rates. Some have, nevertheless, expressed concern that with an income tax limited to higher-income taxpayers, the risk of future rate increases grows. But this risk is fully present under the current income tax: Nearly 54% of its revenue comes from the top 5% of returns with the highest income, nearly two-thirds from the top 10%.³¹ I have also urged enactment of a supermajority voting requirement—60% of both the House and Senate—to raise either consumption or income tax rates, or to lower the income tax exemption. With this protection, the American people could look forward to a simple, fair, progrowth tax system for the twenty-first century.

Here's what the *Economist* said about this plan: "Taken together, Mr. Graetz's plans imply a wholesale change to America's tax system. That may render them politically unrealistic. Nonetheless, the looming AMT crisis suggests that America has a rare opportunity to clean up its tax code. If he is really serious about reform, Mr. Bush should grasp it."³²

31. See STATISTICS OF INCOME DIV., I.R.S., U.S. DEP'T OF THE TREAS., IRS STATISTICS OF INCOME (2004).

32. *A Promising Alternative*, ECONOMIST, Nov. 27, 2004, at 80.

Table 1: Illustrative Summary of Revenues³³

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

		Calendar Year										
		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2003-2012
1	10% VAT	565	596	628	661	696	731	768	807	848	891	7191
	\$100,000 individual income tax exemption/AMT base/25% rate ³⁴	-577	-601	-640	-655	-694	-732	-779	-826	-878	-938	-7320
2	2% VAT	113	119	126	132	139	146	154	161	170	178	1438
	Replace EITC	-36	-36	-37	-38	-39	-41	-42	-44	-44	-44	-401
	Additional funds for tax relief for low- and moderate- low income families ³⁵	-77	-83	-89	-94	-100	-105	-112	-117	-126	-134	-1037
3	1% VAT	57	60	63	66	70	73	77	81	85	89	721
	Base broadening ³⁶	58	58	83	81	75	79	78	75	74	77	738
	Corporate rate reduction to 25%	-88	-89	-117	-117	-113	-117	-118	-117	-117	-121	-1114
4	13% VAT Total rate net	15	24	17	36	34	34	26	20	12	-2	216

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

33. Source: Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261, 304-05 (2002).

34. The proposal would (1) repeal the regular individual income tax, (2) increase the AMT exemption to \$50,000 (singles) and \$100,000 (joint returns), (3) index the AMT exemption, (4) lower the AMT rate to a flat 25%, and (5) phase out the AMT exemption at \$20 for every \$100 in excess of \$100,000 (singles) and \$200,000 (joint returns). (The current AMT phase-out is \$25 for every \$100 over \$112,000 (singles) and \$150,000 (joint returns).) Further broadening the AMT base could reduce the revenue cost of this change.

35. Assumes 2 percentage points of VAT devoted to relief for low- and moderate-income families.

36. A substantial portion of this cost might be funded by broadening the base of the corporate tax.