

A BLUEPRINT FOR TAX REFORM AND HEALTH REFORM

*Leonard E. Burman**

TABLE OF CONTENTS

I.	INTRODUCTION.....	288
II.	ACTION-FORCING EVENTS	290
	A. <i>Expiration of Bush Tax Cuts</i>	291
	B. <i>AMT</i>	292
	C. <i>Short-Term Budget Challenges</i>	293
	D. <i>Retirement of Baby Boomers and Long-Term Budget Problems</i>	293
	E. <i>Other Factors</i>	295
	1. The Income Tax is a Mess.....	295
	2. Concerns About Rising Economic Inequality.....	295
	3. Large Fraction of Households That Do Not Pay In-	
	come	297
III.	REQUIREMENTS FOR REFORM	297
IV.	A POSSIBLE REFORM	300
	A. <i>The Health VAT</i>	300
	1. Health VAT and Government Spending.....	301

* Director, Tax Policy Center and Institute Fellow, The Urban Institute. I thank Lily Batchelder, Bill Gale, Michael Graetz, John Holahan, Stu Kantor, Iris Lav, Kim Rueben, Karl Scholz, Gene Steuerle, Eric Toder, Alan Viard, Bob Williams, George Yin, and participants at the Tax Economists Forum, the National Academy of Social Insurance, and the Virginia Tax Study Group for helpful comments and discussions. Jeff Rohaly helped me figure out the required VAT rate. Julianna Koch, Katherine Lim, and Carol Rosenberg provided valuable research assistance. Views expressed are my own and should not be attributed to the Tax Policy Center or the Urban Institute, its board, or its funders.

2. Health VAT and Progressivity	303
3. VAT and Seniors	303
4. VAT and Economic Efficiency	304
5. Payroll Tax Cut	305
6. Effect on States	305
<i>B. Income and Estate Tax Reform</i>	<i>306</i>
C. Other Issues.....	311
V. CONCLUSIONS AND CAVEATS	312
VI. APPENDIX: REQUIRED VAT RATE TO FINANCE UNIVERSAL HEALTH COVERAGE	313

I. INTRODUCTION

The nation urgently needs tax reform for at least four reasons. First, under current law most of the tax cuts enacted since 2000 are set to expire at the end of 2010 and the Code will revert to that of 2000. In theory, this would trigger what tax cut advocates have called the largest tax increase in history. Neither political party seems inclined to let that happen, so a significant tax revision before 2011 seems almost certain. Second, the baby boomers are beginning to retire and the costs of providing their Social Security and medical care will strain available federal revenues. Third, under current law, the reach of the individual alternative minimum tax (AMT), a pointlessly complicated and unfair element of the current code, is scheduled to mushroom, hitting thirty-two million taxpayers by 2010, up from four million in 2007. Were that to happen, the middle class would scream in protest, but making up for the hundreds of billions of dollars in revenue that the AMT is projected to produce will be a huge challenge. Finally, there is growing public dissatisfaction with our federal tax system, which is complex, riddled with loopholes, and widely perceived to be unfair. It is hard to see how these challenges can be tackled without a major tax reform.

Nonetheless, there are good reasons to be skeptical of a major tax reform happening any time soon. George Yin catalogued a litany of reasons why tax reform is much less likely now than it was in 1986, when the last landmark tax reform was enacted.¹ Committee chairs in

¹ George K. Yin, *Is the Tax System Beyond Reform?*, 58 FLA. L. REV. 977,

Congress have less power than they once did, meaning that tax bills are controlled by leadership that does not have the specialized knowledge or resources to shepherd a complex tax bill through Congress.² Representatives and Senators spend so much time fundraising and running for reelection that they have little incentive or ability to invest in a time-consuming, complicated, and politically risky tax overhaul.³ Consequently, the political environment is poisoned, making the bipartisan effort necessary to accomplish tax reform next to impossible.⁴

To Yin's litany, one could add the likelihood that the next president will be immediately bogged down with the financial crisis and recession as well as Iraq politics. President-elect Obama will also have to spend enormous political capital trying to deliver on the promise of universal access to health care.

So the smart money is on Congress continuing to muddle along, temporarily patching the AMT so that it does not affect too many families, extending some but not all of the Bush tax cuts, squeezing payments to Medicare and Medicaid providers, and hoping that the Chinese continue to hold Treasury bills so that we can continue to ignore the consequences of reckless fiscal policy.

Regardless of these disheartening facts, I would like to present the optimistic argument for why tax reform might happen. Politicians in both parties — and even presidential candidates — understand that the current situation is unsustainable. A new president who had campaigned on a platform of working in a bipartisan way to advance objectives that matter to both parties may be willing to stake political capital on advancing tax reform. Also, the fact that both sides acknowledge that this is a “change election” bodes well for the next president's willingness to take political risks.

A successful tax reform should be designed to address the concerns of both parties. The reformed system will have to maintain progressivity, raise enough revenues to finance the government, and dovetail with plans to provide universal access to health insurance. The tax system should be easy for taxpayers to understand and comply with, and it should be perceived as fair. Tax reform should enhance economic growth compared with the current system, which means lower income tax rates, fewer distortionary loopholes and tax preferences, and lower taxes on the returns to saving and investment.

1019–38 (2006).

² *Id.* at 1019–24, 1029–31.

³ *Id.* at 1025–31.

⁴ *Id.* at 1031–32.

And it should include a credible mechanism to limit the rate of growth of federal spending.

I outline a plan that meets all of those criteria. In brief, it would combine a value added tax (VAT) dedicated to paying for a new universal health insurance voucher with a vastly simplified and much flatter income tax. With a new financing source for health care, income tax rates could be cut sharply — the top rates could be cut to 25% or less. The health care voucher would also offset the inherent regressivity of a VAT, since the voucher would be worth more than the VAT tax paid by most households. Moreover, with the VAT rate (and the price of goods and services) tied to health care spending, the public would have a vested interest in reining in the growth of health care costs. That is, the financing mechanism would help control the fastest growing component of federal spending.

The simplified income tax would be designed so that most taxpayers would not have to file income tax returns. Tax incentives for working and child-related subsidies would be replaced with simplified refundable tax credits along the lines suggested by Michael Graetz,⁵ the AMT would be eliminated, and the plan would also bolster the solvency of Social Security and eliminate the Medicare payroll tax.

In this article, I will discuss in more detail the reasons why tax reform must happen and the prerequisites for successful tax reform, and outline the nature of such a plan.

II. ACTION-FORCING EVENTS

Memos to policymakers that require a decision lead off with an “action-forcing event” — a reason why a decision has to be made. This is a key part of the memo, because decisions carry risks and politicians do not want to make them unless they must.

The action-forcing events that could lead to tax reform include the following:

- the expiration at the end of 2010 of most of the tax cuts enacted since 2001,
- the explosive path of the AMT,
- a likely budget crunch coming within the next ten years if the tax cuts are extended and the AMT reformed or repealed,
- the retirement of the baby boomers and rapidly growing

⁵ MICHAEL J. GRAETZ, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES 174 (2008).

health care costs that threaten the nation with insolvency if not addressed, and

- a host of related factors, including the complexity and inefficiency of the income tax, concerns about rising economic inequality and calls to use the tax system to mitigate it, and the large fraction of households that pay no income tax.

A. Expiration of Bush Tax Cuts

Almost all of the tax cuts enacted in 2001 and 2003 expire at the end of 2010. They include lower marginal income tax rates (the top rate was cut from 39.6% to 35%), a doubling of the child tax credit, a new refundable portion for households with earnings over \$8500 (in 2008), phasing out of the estate tax and its repeal for one year in 2010, marriage penalty relief, and lower tax rates on capital gains and dividends.⁶

It seems unlikely that Congress will simply let the tax cuts expire as scheduled. For one thing, the potential behavioral responses to the one-year estate tax holiday are too ghoulish to contemplate.

But extending all of the tax cuts would be costly, reducing tax revenues from 2008 to 2018 by \$2.4 trillion (Table 1). The benefits from extending all of the tax cuts would disproportionately accrue to households with high incomes (Table 2). With Democrats likely to retain control of Congress, these factors make it unlikely that the tax cuts will simply be extended as a package.

Nonetheless President-elect Obama proposes to make the “middle class tax cuts” permanent⁷ and promised significant other tax cuts.⁸

⁶ Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in I.R.C.); Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (codified as amended in I.R.C.). The 2001 act also increased contribution limits to defined contribution pension plans and IRAs and created a new nonrefundable tax credit for lower-income savers (along with other pension revisions). The Pension Protection Act of 2006 made those provisions permanent. Pub. L. No. 109-280, 120 Stat. 780 (codified as amended in I.R.C.). The Emergency Economic Stabilization Act of 2008 provided for the refundable child tax credit for households with earnings over \$8500 in 2008. *See* Pub. L. No. 110-343, Division C, § 501, 122 Stat. 3765 (to be codified at I.R.C. § 26(d)).

⁷ LEN BURMAN, ET AL., TAX POLICY CTR., AN UPDATED ANALYSIS OF THE 2008 PRESIDENTIAL CANDIDATES’ TAX PLANS: REVISED AUGUST 15, 2008, at 10, 11 tbl.1, 13 (2008).

http://www.taxpolicycenter.org/UploadedPDF/411749_updated_candidates.pdf.

⁸ *Id.* at 10 tbl.1.

In addition, the economic stimulus package likely to be enacted soon after inauguration is sure to contain additional tax cuts.

The candidates have also pledged to be fiscally responsible, although they have left somewhat vague how this fiscal responsibility should be measured. President-elect Obama has promised to abide by Pay-As-You-Go (PAYGO) rules that would require new tax cuts to be offset by tax increases.⁹ If PAYGO is measured relative to a current-law baseline (assuming the tax cuts expire at the end of 2010 and the AMT remains in place), this pledge could severely limit the ability to extend any tax cuts, enact new ones, or advance spending priorities.

B. AMT

The individual AMT is the poster child for pointless complexity in the tax system, but its theoretical revenue-raising potential makes it extremely difficult to reform or repeal. Originally intended to ensure that rich people paid at least some tax, the AMT has morphed into an incomprehensible shadow tax system, poorly suited to its original purpose.¹⁰ The largest AMT “preference item” (generally, defined as deductions allowed under the regular income tax but disallowed under the AMT) is the deduction for state and local income and property taxes — hardly most people’s conception of a tax shelter.¹¹ Personal exemptions are the second largest item.¹²

The AMT’s biggest defect is that, unlike the regular income tax, its parameters are not indexed for inflation.¹³ Therefore, every year more and more people become potentially subject to the tax. President Bush’s tax cuts, which lowered regular income taxes but only offered a temporary fix for the AMT,¹⁴ also roughly doubled the number of taxpayers potentially subject to the AMT through 2010.

Previously, Congress prevented the AMT from affecting too many taxpayers by a series of temporary fixes,¹⁵ but the last one ex-

⁹ Perry Bacon, Jr., *A Nod to the Clinton Administration: Obama Calls for Fiscal Responsibility*, WASH. POST, Oct. 2, 2008, at A4 (quoting Senator Obama as supporting PAYGO).

¹⁰ Leonard E. Burman, *The Alternative Minimum Tax: Assault on the Middle Class*, MILKEN INST. REV., 4th Quarter 2007, at 12, available at http://www.taxpolicycenter.org/UploadedPDF/1001113_Burman_AMT.pdf.

¹¹ *Id.* at 14.

¹² *Id.*

¹³ *Id.* at 16.

¹⁴ *Id.* at 16–17.

¹⁵ *Id.* at 15.

pired at the end of 2008,¹⁶ and they get more expensive every year.

Under current law, more than thirty million people are scheduled to owe AMT in 2009 (Figure 1). If the Bush tax cuts are extended, the number will explode to over 55 million, or about half of taxpayers, by 2018 (Figure 1).

The AMT will, in principle, bring in an enormous amount of revenue over the next ten years — almost \$1 trillion if the Bush tax cuts expire on schedule and twice that much if they are extended (Figure 2). Of course, that revenue bonanza will not materialize because it would mean more and more middle-income taxpayers would become subject to the tax over time. But the fiction of the AMT as a revenue machine masks the size of our budget problems. Given that any revenue-neutral AMT reform would create many winners and losers, it is not clear how it could happen except as part of a major tax reform.

C. Short-Term Budget Challenges

If the Bush tax cuts were allowed to expire on schedule and the AMT took its course, our short-term fiscal situation could be very good. According to the Congressional Budget Office (CBO), tax revenues would generally increase as a share of GDP (Figure 3). Indeed, the CBO projects small budget deficits between 2012 and 2018 under current law, assuming modest spending growth (Table 1).

If, however, the tax cuts, the AMT patch (which basically amounts to indexing the AMT for inflation), and other perpetually expiring provisions, such as the research and experimentation tax credit, are all extended, tax receipts would generally decline as a percentage of GDP through 2014 and remain below their historical norms through the budget period (Figure 3). Including additional interest on the national debt, these tax-cut extensions would add up to over \$5 trillion (Table 1). By 2018, annual deficits would approach \$1 trillion, or about 4.5% of GDP (Table 1). Under this scenario, the national debt would be \$7.4 trillion higher in 2018 than it is now (Table 1). Furthermore, these calculations do not include any costs associated with the financial market crisis and associated recession.

D. Retirement of Baby Boomers and Long-Term Budget Problems

We might take solace in the fact that a deficit-to-GDP ratio of

¹⁶ The Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 102, 122 Stat. 3863 (to be codified at I.R.C. § 55(d)).

4.5% would not be entirely unprecedented. The deficit-to-GDP ratio averaged 4.3% from 1982 to 1993.¹⁷ Kogan and Aron-Dine noted that this was the “*only period in the history of the United States* in which the government consistently ran large deficits — i.e., increased the debt-to-GDP ratio — during a time of peace and prosperity.”¹⁸

There is an even more pressing concern about rising debt now. In the 1980s, the baby boomers’ peak earning years were still ahead of them. Now they are entering retirement. Moreover, medical care costs — and the cost of federal health care programs for the elderly — have risen much faster than the economy, and are expected to continue to do so absent a major change in policy. Rising health care costs and the demographic surge threaten to create enormous long-term budget challenges. CBO projects that if health care expenditures continue to grow at roughly their historical rate, the three main programs for the elderly — Social Security, Medicare, and Medicaid (which pays for nursing home care) — will together cost 18.1% of GDP in 2050 (Figure 4).¹⁹ That is, those three entitlement programs would consume all federal revenues if tax collections remain at historic levels.

If other spending continues at historical levels and revenues do not increase, CBO projects that the national debt could reach nearly three times GDP by mid-century and balloon to more than eight times GDP by 2080 (Figure 5).²⁰ By comparison, the debt-to-GDP ratio was barely over one after World War II, and policies enacted thereafter tamed the debt through the 1950s and 1960s.²¹

As bleak as these long-term projections are, they are in at least one sense wildly optimistic; they assume that the economy will continue to grow at historic rates. However, with such an explosion of public debt, the ability and willingness of foreigners and United States investors to hold United States government debt would quickly be exhausted. Interest rates would increase, raising debt service costs (exacerbating budget deficits) and stifling investment, home sales, and purchases of consumer durables. The economy would grind to a halt.

Of course, this is a perfect illustration of Stein’s Law, “[i]f some-

¹⁷ Richard Kogan & Aviva Aron-dine, *A ‘Mere’ \$300 Billion: Should a \$300 Billion Deficit Be Considered a Victory?*, CENTER ON BUDGET AND POLICY PRIORITIES, June 5, 2006, available at <http://www.cbpp.org/5-22-06bud.pdf>.

¹⁸ *Id.* at 2 (emphasis in original).

¹⁹ CONG. BUDGET OFFICE, THE LONG-TERM BUDGET OUTLOOK 5 tbl.1-2 (2007), available at http://www.cbo.gov/ftpdocs/88xx/doc8884/12-13-LTBO_Testimony.pdf.

²⁰ *Id.* at 6.

²¹ *See id.* at 13 box.1-3.

thing cannot go on forever, it will stop.”²² The only ways to avoid the budget catastrophe are to raise taxes, reduce spending, increase the rate of growth of the economy, or some combination of the three. In my view, that creates an imperative for a tax system that can raise more revenues without taking an undue toll on economic growth combined with restraint on the growth of entitlement spending.

E. Other Factors

1. The Income Tax is a Mess

The AMT is but one indicator of the complexity and inefficiency of the income tax. For the past several decades, the income tax has become the instrument of choice for advancing a host of social and economic goals. The deductions, credits, phase-ins, and phase-outs aimed at advancing these objectives are often ineffective.²³ Moreover, public perceptions about the income tax have changed. Americans once thought the income tax was the fairest tax. Now they perceive it as the least fair levy.²⁴ This has prompted support for radical revisions, such as the flat tax and the national retail sales tax (called the FairTax by its supporters).

The corporate income tax draws special scorn. American companies face among the highest statutory tax rates in the developed world, and yet the revenue yield from the tax is small by comparison with our trading partners. Furthermore, a host of loopholes combined with high marginal tax rates creates both incentive and opportunity for tax sheltering. The corporate tax with its high rates and narrow base cries out for tax reform.

2. Concerns About Rising Economic Inequality

Since the 1970s, the income distribution has been growing steadily less equal. Explanations include the growth of information technology, which substitutes for less skilled labor and raises the rewards to the most highly skilled;²⁵ trade;²⁶ the decline in institutions such as la-

²² Herbert Stein, *Herb Stein's Unfamiliar Quotations: On Money, Madness, and Making Mistakes*, SLATE, May 16, 1997, <http://www.slate.com/id/2561/>.

²³ See C. Eugene Steuerle, CONTEMPORARY U.S. TAX POLICY 251 (2004).

²⁴ Richard Goode, *Overview of the U.S. Tax System*, in THE PROMISE OF TAX REFORM, 8, 14–15 (Joseph A. Pechman ed., 1985).

²⁵ See David H. Autor et al., *The Skill Content of Recent Technological Change: An Empirical Exploration*, 118 Q. J. ECON. 1279, 1322 (2003).

bor unions;²⁷ and the emergence of a winner-take-all society in which top performers earn many multiples of the income of those who perform almost as well.²⁸ It is likely that all of these factors will persist. For that reason, some have called for more progressivity as an antidote to rising economic inequality.²⁹

This view, however, is far from universal. Penner, for example, argues that the tax system is highly progressive when properly measured,³⁰ and the current level of progressivity is broadly consistent with public attitudes.

Bartels reported survey evidence that most voters (52%) thought that rich people paid less tax than they should, 44% thought that poor people paid too much, and only 8% thought the poor should pay more.³¹ About 46% reported that they thought they were overtaxed, although 48% thought they paid about the right amount.³² Only 3% thought they paid too little.³³

Bartels also reports, however, that most of the people who thought the rich should pay more opposed the highly progressive estate tax.³⁴ Slemrod reported evidence from the same survey indicating that a significant number of people favor the flat tax, which would be less progressive than the current income tax; these individuals have the apparent belief that the flat tax would in fact be *more* progressive

²⁶ David J. Richardson, *Home Inequality and Trade: How to Think, What to Conclude*, J. ECON. PERSP., Summer 1995, at 33, 35.

²⁷ See Frank S. Levy & Peter Temin, *Inequality and Institutions in 20th Century America* 35 (M.I.T. Dep't of Econ., Working Paper No. 07-17, 2007).

²⁸ See Ian Dew-Becker & Robert Gordon, *Where Did the Productivity Growth Go? Inflation Dynamics and the Distribution of Income*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY 67, 126 (William C. Brainard & George L. Perry, eds. 2006), available at http://www.brookings.edu/es/commentary/journals/bpea_macro/forum/200509bpea_gordon.pdf.

²⁹ See Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993 (2004); Leonard E. Burman et al., *The Rising Tide Tax System: Indexing the Tax System for Changes in Inequality* (2007) (unpublished manuscript, on file with the Tax Policy Center).

³⁰ See Rudolph G. Penner, *Searching for a Just Tax System* 14, (Tax Pol'y Center, Discussion Paper No. 13, 2004), available at http://taxpolicycenter.org/UploadedPDF/410907_TPC_DP13.pdf.

³¹ Larry M. Bartels, *Homer Gets a Tax Cut: Inequality and Public Policy in the American Mind*, 3 PERSP. ON POL. 15, 19 fig.1 (2005), available at <http://www.princeton.edu/~csdp/research/pdfs/homer.pdf>.

³² *Id.*

³³ *Id.*

³⁴ *Id.* at 16–17.

than the current tax.³⁵

This suggests that taxpayers are confused about the tax system and alternative policies.³⁶ It might mean that if they understood the tax system, they would favor more progressivity. On the other hand, it might mean that if they were better informed, then they would be happy with the current level of tax progressivity or even favor a less progressive tax system.

3. Large Fraction of Households That Do Not Pay Income Tax

Finally, there is a growing chorus of complaints, primarily but not exclusively from conservative quarters, about the large fraction of households that do not owe income tax. The Tax Policy Center estimated that in 2007 more than 30 percent of tax units (households) were in the zero marginal tax bracket or did not file.³⁷ Almost 40 percent of tax units owe no income tax after tax credits.³⁸

The concern is that households who do not owe income tax perceive government to be free and thus will always support new programs, even if they have very little value. Put differently, they have no stake in reducing spending.

III. REQUIREMENTS FOR REFORM

Experience with the Tax Reform Act of 1986 (TRA) suggests that tax reform requires presidential leadership, bipartisan participation, and a lot of luck.³⁹ The president would need to decide early that tax reform is a top priority. Plans for the TRA, signed in October, started in January 1984 when President Reagan instructed the Treasury De-

³⁵ Joel Slemrod, *The Role of Policy Misconceptions in Support for Regressive Tax Reform*, 59 NAT'L TAX J. 57, 64, 66 (2006).

³⁶ See *id.* at 72–73.

³⁷ TAX POLICY CTR., TABLE T07-0086: NUMBER OF TAX UNITS BY TAX BRACKET, 2006–2007 (2007), available at <http://www.taxpolicycenter.org/T07-0086>. Note that they do pay other federal taxes. Households at every income level owe at least some tax when payroll, income, excise, and estate taxes are combined.

³⁸ TAX POLICY CTR., TABLE T04-0102: CURRENT-LAW DISTRIBUTION OF INDIVIDUAL INCOME TAX BY AMOUNT OF INCOME PAID (2004), available at <http://www.taxpolicycenter.org/t04-0102>.

³⁹ See JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM (1987) (describing presidential leadership, bipartisanship, and a number of occasions when TRA appeared to be dead before something happened at just the right time to get the process back on track).

partment to produce a plan for release after the election.⁴⁰ This suggests that for tax reform to be completed by the end of 2010 (because of the expiration of the Bush tax cuts), it would have to be a high priority from the day the next president takes office. Given that Mr. Obama has also promised to make health reform a priority, tax reform would have to be designed in such a way that it would dovetail with health reform, rather than compete for resources and attention.

Why would the president invest scarce political capital in a risky tax reform? First, of course, are the policy imperatives outlined in the previous section, which the president might find compelling. Second, political commentators of all stripes agree that this year's election will produce a mandate for change. The president might decide that there would be political rewards if he or she successfully tamed the income tax and put the nation on a more secure fiscal footing, especially if tax reform were combined with credible restraints on spending.

A second requirement for success is bipartisan investment in the process. If it were seen as a Democratic or Republican initiative, the other party could easily attack the president for the inevitable losers that would arise from any rationalization of the current tax system — especially if revenue increases were part of the package. In 1986, a Republican president, Ronald Reagan, worked successfully with the Democratic leadership of the House as well as the Republicans who controlled the Senate to bring TRA to a successful conclusion.⁴¹

In fact, members of both parties recognize that we are on an unsustainable fiscal path and probably understand that spending cuts alone will not produce fiscal balance. The *Analytical Perspectives* volume of President Bush's FY 2009 Budget had virtually the same grim projection of the effect of extending current policies as produced by the CBO, though the Budget implied that spending cuts alone would suffice to solve the problem.⁴² Republican economist Bruce Bartlett

⁴⁰ For a copy of the Treasury Department's plan, see U.S. TREASURY DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984), available at <http://www.ustreas.gov/offices/tax-policy/library/tax-reform/>.

⁴¹ See BIRNBAUM & MURRAY, *supra* note 39 (mentioning instances of bipartisanship throughout a tale of the passage of the TRA).

⁴² See CONG. BUDGET OFFICE, *supra* note 19, at 1 (noting that entitlements pose "fundamental questions of economic sustainability"); OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT 1–2 (2008), available at <http://www.whitehouse.gov/omb/budget/fy2009/pdf/budget.pdf> (implying that spending cuts alone would solve the fiscal imbalance by 2012 and noting that the growth in entitlement programs was unsustainable).

concluded that tax increases are inevitable and urged his colleagues to consider tax options that would be less injurious to growth than simply increasing income tax rates.⁴³

A requirement for bipartisan participation (and ultimate success) is that the process would have to address the major concerns of both parties. This means, on the Democratic side, it would have to be equitable, help low-income and middle-income households, and guarantee enough revenues to finance an adequate level of government. As noted, tax reform has to be consistent with a program to provide universal access to health insurance.

To win Republican support, tax reform would have to be combined with a credible process to slow the growth of spending. Since entitlement spending accounts for a large and growing portion of spending, control of entitlements must be an integral part of the package. In addition, the reformed tax system should address concerns about the growing number of households that do not pay income tax. Furthermore, a reform proposal should improve the economy. This means that income tax rate cuts need to be part of the package, as they were in 1986.

A final factor key to success in 1986 was a big increase in corporate income taxes (primarily through repeal of the investment tax credit and scaling back of accelerated depreciation). Although economists understand that corporate taxes are ultimately paid by people (investors, workers, and consumers), most Americans were apparently convinced that they would not pay the tax. At one point, corporate CEOs of large companies that would pay much higher taxes as a result of TRA lined up to support the plan arguably because they, personally, would pay much lower income taxes.⁴⁴ This was a pivotal moment that helped lead to TRA's passage.

A large corporate tax increase is probably not in the cards this time. There is no investment tax credit or highly accelerated depreciation to repeal or scale back and, if anything, there is pressure to reduce corporate taxes. It might be possible, however, to introduce a new revenue source that is relatively palatable and widely accepted in the rest of the world — the VAT.

⁴³ See BRUCE BARTLETT, *IMPOSTOR: HOW GEORGE W. BUSH BANKRUPTED AMERICA AND BETRAYED THE REAGAN LEGACY* 175 (2006).

⁴⁴ See BIRNBAUM & MURRAY, *supra* note 39, at 194 (telling the story of how Sentaor Heinz accused the CEOs supporting the TRA of having selfish motives).

IV. A POSSIBLE REFORM

An approach that might meet all of the constraints above would be a combination of a VAT dedicated to paying for health care, similar to the proposal of Emanuel and Fuchs;⁴⁵ individual and corporate income tax cuts, including lower rates, a broader base, and elimination of the AMT; revenues sufficient to achieve budget balance over the short-term and long-term; and a credible process to control spending, especially on entitlement programs. The package as a whole would also have to be designed to maintain or enhance progressivity.

A. *The Health VAT*

A cornerstone of the package is a VAT dedicated to pay for universal access to health insurance. The VAT would finance a universal health insurance voucher that would replace all existing federal and state programs, including Medicare, Medicaid, and SCHIP, as well as tax subsidies for health insurance, the largest of these being the exclusion from income and payroll taxes of employer-sponsored insurance.

A VAT is a tax on consumption, similar to sales taxes levied by states, except that it is collected in stages from each business that contributes to the production and sale of consumer goods.⁴⁶ It is universal in the rest of the industrialized world and thought to be relatively easy to administer. In addition, businesses find few difficulties with compliance.

I estimate that the rate would have to be at least 18% to finance such a voucher program, assuming a very broad tax base and 100% compliance.⁴⁷ Under more realistic assumptions, the rate could reach 25% or more. This makes it imperative that the VAT be combined with effective cost controls from the outset, or that the cost of the vouchers otherwise be limited, as discussed in the next section.

There would need to be trust fund accounting for VAT revenues

⁴⁵ Ezekiel J. Emanuel & Victor R. Fuchs, *A Comprehensive Cure: Universal Health Care Vouchers* (Brookings Inst., Hamilton Project Discussion Paper No. 2007-11, 2007), available at http://www.brookings.edu/~media/Files/rc/papers/2007/07useconomics_emanuel/200707emanuel_fuchs.pdf.

⁴⁶ Yin, *supra* at note 1 (discussing types of VAT and why it is superior on administrative grounds to a national retail sales tax). A national retail sales tax has been endorsed by several Republican presidential candidates, most notably, Governor Huckabee.

⁴⁷ See *infra* Appendix. Emanuel and Fuchs estimate that a VAT rate of approximately 15% could pay for the fully phased in voucher program. Emanuel & Fuchs, *supra* note 45, at 18.

and expenditures, since they will not perfectly match every year. Interest would be paid on positive balances and interest charged if there is a shortfall. The Treasury Department could be charged with estimating the tax rate, rounded to the nearest whole percent, necessary to balance revenues and expenditures over a specified time interval (the rate that minimizes the trust fund balance at the end of the period without producing a deficit). The rate would be adjusted whenever the estimated required rate differs from the current rate by at least one-half of a percentage point.

1. Health VAT and Government Spending

Two main complaints have been leveled at the VAT. One is that it would be a money machine and fuel the growth of government. A second is that it is regressive since lower-income households spend a much larger share of their incomes than higher-income households.

A VAT dedicated to paying for health care, including the new voucher, would seem to address both of these criticisms. The VAT would be reflected in retail prices and the VAT rate would have to increase over time if health care spending continues to grow faster than the economy.⁴⁸ Since everyone would pay the VAT, the higher rate could build widespread support for effective measures to control health care costs. Moreover, the lowest-income 40% of households would have a stake in controlling government spending, addressing one of the major complaints by conservatives regarding the current system.

The overall effect of the program on federal spending will depend on the nature of the health care voucher. Emanuel and Fuchs have proposed that the voucher pay for health care provided through a program like the Federal Employees Health Benefits Program.⁴⁹ They argue that the voucher could squeeze waste out of the system because the federal government would have the market power to require that providers control costs (and the voucher presumably would be combined with other reforms that would reduce ineffective care).⁵⁰ There is also evidence that much of the regional variation in health care costs is not related to differences in health status or quality.⁵¹ By tying

⁴⁸ One of the concerns about the VAT is that it is an invisible component of product prices. This concern might be mitigated by urging or requiring retailers to break out the VAT on sales receipts.

⁴⁹ Emanuel & Fuchs, *supra* note 45, at 7.

⁵⁰ *Id.* at 21–22.

⁵¹ See CONG. BUDGET OFFICE, GEOGRAPHIC VARIATION IN HEALTH CARE

the basic voucher amount to age, gender, and health status, but not regional variation in prices, pressure would be put on providers to conform their standards of care to the best practices.⁵²

Given that most working-age people and their families get health insurance through employers, there would be advantages to designing the voucher so that it could be used in concert with employer-sponsored insurance (ESI), especially for large employers that can provide such insurance relatively cheaply. One option would be to allow the voucher to be transferred to an employer that offers ESI either purchased directly or purchased through the publicly sponsored pool. To minimize adverse selection (employers with healthier-than-average workforces opting out of the public program), the voucher could be set at less than 100% of the cost per worker in the public pool.

A possible way to limit spending and improve the chance for bipartisan consensus would be to make the voucher pay for a high-deductible health insurance plan. Martin Feldstein and Jonathan Gruber proposed a universal voucher tied to plans with a deductible that varied with income.⁵³ There are serious administrative issues to implementing this option (or any means-tested health entitlement), but it could offset the prime complaint about high-deductible plans. The deductible could be set very low for households with low incomes and very high for those with incomes high enough to afford the higher risk. Alternatively, the high deductible plan could be combined with health savings accounts (HSAs), as under current tax law, and the government could contribute all or part of the deductible to the HSA for lower-income families.

Finally, the plan might include process reforms designed to limit the growth of entitlement programs. Penner and Steuerle propose caps and triggers for automatic cuts in entitlements that they claim would take those programs off auto-pilot.⁵⁴ They also propose a super-majority requirement for the enactment of large new entitlement pro-

SPENDING (2008), *available at* <http://www.cbo.gov/ftpdocs/89xx/doc8972/02-15-GeogHealth.pdf>

⁵² Even if this works, there would be issues during a transitional period if providers cannot immediately adapt.

⁵³ Martin Feldstein & Jonathan Gruber, *A Major Risk Approach to Health Insurance Reform*, in 9 *TAX POLICY AND THE ECONOMY* 103 (James M. Poterba ed. 1995).

⁵⁴ Rudolph G. Penner & C. Eugene Steuerle, *A Radical Proposal for Escaping the Budget Vise*, NAT'L BUDGET ISSUES, June 2005, *available at* http://taxpolicycenter.org/UploadedPDF/311192_NBI_3.pdf.

grams.⁵⁵ Enactment of these options might be delayed, however, until policymakers see how well the automatic spending constraint built into the health VAT and voucher work.

2. Health VAT and Progressivity

The new health care voucher paid for by the VAT would be most valuable to low- and middle-income households that either do not currently have health insurance or for which the cost of health insurance is a very large portion of their incomes. Currently, the value of health insurance averages about 8% of compensation for employees who get it at work.⁵⁶ It is a larger percentage for those with lower incomes. Thus, the new health benefit will be worth far more to them than the additional tax paid through the VAT. For high-income people, in contrast, health insurance is only a fraction of income. The VAT will cost much more than the value of the new benefit.

Overall, distributional targets can be met by coordinating the income tax changes with the VAT and the health voucher. A special consideration is that low-income people who currently qualify for free health care through Medicaid or the children's health insurance program, SCHIP, will receive less benefit from the voucher. Since food stamps are indexed for food price inflation and the refundable EITC is indexed to overall inflation, part of any effect of the VAT on prices would automatically be offset, but additional subsidies will be necessary for those with very low incomes.

3. VAT and Seniors

A well-known feature of a VAT is that it is a tax on old capital. This especially affects older people, since they get relatively little benefit from the tax-exemption for new saving under the VAT while everything they buy becomes more expensive. Although this is probably a political disadvantage, since seniors get so much more back in Social Security payments and medical care than they paid into the system, it makes sense to charge those who are able to pay for part of those costs. It is also important to note that those whose income

⁵⁵ *Id.* at 5.

⁵⁶ EIBNER ET AL., CAL. HEALTH CARE FOUND., SNAPSHOT: EMPLOYER HEALTH INSURANCE COSTS IN THE UNITED STATES 2, 5 (2007), available at <http://www.chcf.org/documents/insurance/EmployerHICostsUS.pdf>.

comes mostly from Social Security would be relatively unaffected since those benefits are indexed to inflation.⁵⁷

4. VAT and Economic Efficiency

The VAT is a relatively efficient revenue source. Since it taxes consumption rather than income, it does not discourage saving as does the income tax.

The biggest efficiency gain, though, could come from reductions in income tax rates. The VAT will cover the cost of current health care programs, offsetting federal spending on Medicaid, veterans' health programs, and the portion of Medicare paid out of general revenues. Although part of Medicare spending is covered by premiums and payroll taxes, some \$209 billion in FY 2009 will be financed with general revenues.⁵⁸ Federal spending on Medicaid and other federal health programs adds another \$239 billion.⁵⁹ All told, the income tax would have to finance about \$450 billion less in health spending than it does at present.

In addition, there would no longer be a tax exclusion for employer-sponsored insurance (ESI), a \$168 billion income tax expenditure in 2009. Other potentially superfluous tax subsidies total about \$13 billion.⁶⁰ Thus, the income tax base would become substantially larger. As a result, with the VAT covering health care costs, tax rates could be cut by about a third across the board with no effect on the deficit.⁶¹ That is even before considering the additional revenues that

⁵⁷ See Leonard E. Burman et al., *Towards a More Consistent Distributional Analysis*, 98 NAT'L TAX ASS'N PROC., 226–27 (2005) (noting that households over 65 were less affected by a VAT than younger ones, because Social Security benefits are indexed).

⁵⁸ CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2008 TO 2018, at 57 (2008), available at http://www.cbo.gov/ftpdocs/89xx/doc8917/01-23-2008_BudgetOutlook.pdf.

⁵⁹ *Id.*

⁶⁰ OFFICE OF MGMT. AND BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES ON THE OF THE FY 2009 BUDGET, at 290 tbl.19-1, available at <http://www.whitehouse.gov/omb/budget/fy2009/pdf/apers/receipts.pdf>.

⁶¹ The CBO projects that individual and corporate income tax revenues will total \$1696 billion in FY 2009. *Id.* at 8. After repeal of the ESI exclusion and other health insurance tax expenditures, tax revenues would be about \$1876 billion. Total general revenue financed federal spending on health care is about \$628 billion (including the tax expenditures). Thus, income tax revenues could be cut by 628/1876, or 33.5%, with no net effect on the deficit. These calculations ignore behavioral responses, which are ambiguous. Eliminating the ESI exclusion might encourage some taxpayers to find other ways to shelter wages from tax. On the other hand, lower mar-

2009]

Blueprint for Tax Reform

305

could arise from base broadening.

With lower tax rates, the tax reform could also eliminate the differential between capital gains and other income (as in 1986), which would reduce the incentive and ability of individuals to engage in tax sheltering. More generally, the lower top rate would reduce the incentive for tax avoidance and evasion of all sorts.

5. Payroll Tax Cut

Since health care for the elderly would be financed through the VAT, the Medicare portion of payroll taxes (1.45% on employers and employees) would no longer be necessary. Moreover, elimination of the ESI exclusion would significantly increase contributions to Social Security, substantially bolstering its finances. On the other hand, to the extent that the VAT translates into higher prices, the Social Security trust fund would tend to be devalued. Higher prices would also devalue United States debt, so, on balance, the federal government's balance sheet could improve. Part or all of those savings could be transferred to Social Security, if necessary. Over the long term, the Social Security trust fund will be much stronger because more of wages are included in the Social Security tax base.

6. Effect on States

If the federal government takes over states' obligations for Medicaid, states will avoid an enormous and growing financial obligation. The federal government could ask states to pay a larger portion of other programs they currently share with the federal government. Alternatively, the federal government might forgive the states their current obligations for care for patients who are eligible for both Medicare and Medicaid — a \$56 billion obligation in 2008 — but require a state contribution toward the voucher equal to their state's other Medicaid spending. Even in this case, states' financial exposure would be substantially lower than under current law. The states' windfall might make them less resistant to sensible tax reforms, such as repealing the deductibility of state and local taxes and scaling back or eliminating the use of tax-exempt bonds, both of which are extremely inefficient subsidies.

The proposal could have substantial indirect effects on state and local governments' tax bases and revenues. For the first time, the fed-

ginal tax rates would reduce the incentive for tax avoidance, generating a positive revenue feedback.

eral government would be levying a broad-based national sales tax (although collected in stages rather than all at the point of sale). Numerous issues would exist in coordinating state and local sales taxes with the federal VAT. The simplest way to manage this would be for states to levy their sales taxes exactly as they do now, while the federal government would require businesses to remit VAT due on each stage of production. The combined federal, state, and local tax rates on sales could be well over 30%, however, which might put pressure on states and local governments to reduce or eliminate their sales taxes.

On the other hand, the reduction of federal income taxes might give states room to increase their income taxes to offset any reduction in sales taxes. Also, by eliminating the exclusion for employer-sponsored health insurance, states with income taxes based on the federal definition of income would see an immediate rise in income tax revenues.

Finally, the federal VAT would have ambiguous effects on compliance with state sales taxes. On the one hand, the higher combined federal, state, and local tax rates would encourage more evasion. On the other hand, states could piggyback their enforcement efforts with federal efforts — as they do with state income taxes now — which would tend to improve enforcement and compliance.

B. Income and Estate Tax Reform

The income tax reforms would reflect the traditional recipe: broad base (that is, fewer loopholes and deductions) and lower rates. The AMT would be eliminated. As noted, financing health care with the VAT would allow for significantly lower top marginal tax rates, even while eliminating the AMT. All of this would be accomplished while maintaining or enhancing the overall progressivity of the tax system (including the benefits from the new health care voucher). Simplicity would be achieved by relieving most taxpayers of filing requirements, and vastly simplifying filing for others.

There are several models that have some similarities to this plan. William Gale recently proposed a tax reform including integration of the corporate and individual income taxes for new investment and a VAT sufficient to raise 5% of GDP.⁶² Gale would eliminate the AMT (conditional on the AMT's anti-tax shelter provisions being incorporated into the tax code); eliminate many individual and corporate tax

⁶² WILLIAM G. GALE, BROOKINGS INST., *FIXING THE TAX SYSTEM: SUPPORT FAIRER, SIMPLER, AND MORE ADEQUATE TAXATION 1*, available at http://www.taxpolicycenter.org/UploadedPDF/1001128_fixing_tax_system.pdf.

breaks; improve enforcement; simplify and consolidate tax breaks for education, retirement, and families; provide a new tax credit against payroll taxes on the first \$5000 of earnings; and introduce return-free filing for many taxpayers.⁶³

Michael Graetz has also proposed a VAT, but would use the revenues generated to exempt families with incomes below \$100,000 (\$50,000 for singles) from income tax.⁶⁴ Under Graetz's scheme, the income tax would return to its origins as a tax on those with very high incomes. He would cut top individual and corporate income tax rates and would retain some variant of the refundable child tax credit and EITC to prevent low-income families from suffering a tax increase. Of course, this would require income assessment for such families, so it is not substantially different from Gale's proposal to simplify the tax system so that many low-income and middle-income families do not have to file (their income tax is determined by exact withholding).

Graetz also notes that the exact details of the tax reform will be determined by the political process.⁶⁵ Indeed, he argues that specifying too many details in advance might doom any tax reform plan to failure. TRA was successful in part because President Reagan gave very parsimonious instructions to his tax reformers: cut top tax rates and preserve a subsidy for homeownership. Everything else was on the table and negotiated with Congress.⁶⁶

A drawback of both the Graetz and the Gale plans is that they do not deal with health reform, meaning that either proposal would not be taken seriously in a Democratic administration until after health reform is completed (which could take a long time). Also, an add-on VAT that is not tied to health care might fuel conservatives' concerns that it would be a money machine that could spur the growth of government. Furthermore, Graetz's plan would aggravate conservatives who complain that 40% of Americans owe no income tax. Under Graetz's plan, it would be closer to 90%.

Here is a rough outline of the nature of an income tax reform I believe could capture the best features of the Graetz and Gale plans while addressing bipartisan concerns. The goal would be to enable a return-free filing system for most households, which would require substantial simplification and flattening of the income tax. It is a more

⁶³ *Id.* at 6–10.

⁶⁴ GRAETZ, *supra* note 5, at 67, 201.

⁶⁵ *See id.* at 17–33; GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 111–22, 277–92 (1997).

⁶⁶ BIRNBAUM & MURRAY, *supra* note 39, at 40–41

sweeping proposal than Gale's, which raises political issues as more sacred cows are jettisoned, but it would make simplicity a much higher priority than previous tax reforms have.

There would be two individual income tax rates — say, 15% and 25% (although the actual rates would depend on revenue and distributional targets), and the corporate tax rate would be set equal to the top individual income tax rate (so corporations do not become tax shelters). Personal exemptions and the standard deduction would be eliminated. For all practical purposes, itemized deductions would also become historical artifacts. The mortgage interest deduction would be replaced by a flat 15% refundable tax credit paid directly to lenders. The deduction for charitable contributions would similarly be replaced by a 15% matching grant paid directly to qualifying nonprofits (the United Kingdom does this now). In each case, the match rate could be revised as part of congressional negotiations. Alternatively, taxpayers in the 25% tax bracket could be allowed to elect the deduction instead of the credit.⁶⁷ Education tax incentives should be replaced with an expansion of Pell grants and subsidized student loans. The deductibility for state and local taxes would be eliminated (state governments could use their savings from the elimination of Medicaid to cut income and sales tax rates and increase their share of education financing, allowing local governments to cut property taxes, offsetting the effect of the lost tax deductions).

Roth IRAs and nondeductible IRAs would be eliminated, which would simplify taxpayers' choices and accounting. Contributions to traditional IRAs and charitable contributions could be matched with a federal match, with the option of deductibility for those in the 25% tax bracket. Withdrawals would be subject to a 15% withholding tax (plus a penalty tax for early withdrawals). This would be final withholding for most taxpayers. Higher-bracket taxpayers would have to include distributions in income and would be able to claim a credit for withholding tax paid. Rollover Roth IRAs would also need to be preserved for rollovers from Roth 401(k) accounts.

The savers credit should be converted into a refundable tax credit payable directly to the financial institution. The Service would send taxpayers a certificate every spring indicating their eligibility and credit rate based on information returns for those who do not have to

⁶⁷ This would involve minor additional complexity. It could be implemented by allowing taxpayers to elect a full deduction and adding credits already received to taxes due. For taxpayers who use software or paid preparers, as most higher-income taxpayers do, the additional complexity would be imperceptible.

file and tax returns for those who do, which would be used by the financial institution to claim the credit.

The child tax credit, the child-related portion of the EITC, the adoption tax credit, and the child and dependent care tax credit would be replaced by a \$2000 per child fully refundable tax credit. (Again, the exact amount would be determined based on revenue and distributional targets.) The work subsidy in the EITC would be replaced with a 30% fully refundable payroll tax credit on the first \$10,000 of earnings for each adult worker.⁶⁸ This may seem extremely generous, but the 15% income tax bracket starts on the first dollar of earnings, so the net subsidy compared with current law would be modest.

The eligibility criteria for these new credits would be much simpler than the current child tax credit and EITC since the new credits would not phase out with income or depend to the same extent on living arrangements. (For example, it would not matter which parent claimed a child for the tax credit so long as only one did — something easily verifiable by tax authorities.) The child tax credit amount could also be designed to offset the tax increase due to the VAT for very low income families that currently get free health insurance through Medicaid or SCHIP, since they almost all have children and their expenditures subject to VAT are likely to be relatively small.⁶⁹

Workers with earnings and family incomes below certain thresholds would not be required to file a W-4 withholding form. Their employers would withhold income tax at a 15% rate. Interest, dividends, and withdrawals from traditional pensions, 401(k) plans, and IRAs would be subject to 15% withholding as well. For most taxpayers, this would be final withholding, requiring no additional accounting on tax returns. Other conforming changes, such as eliminating the deduction for alimony and child support payments for donors and taxation of such payments to recipients, would also facilitate the return-free system. For most taxpayers, this simplification would produce the same overall tax burden as under current law, but it would result in higher

⁶⁸ Although the amounts are different because the scope of my proposal is much broader, the idea of replacing the EITC and child tax credit with fully refundable work and child tax credits is similar to a proposal made in Jonathan Barry Forman et al., *Designing a Work-Friendly Tax System: Options and Trade Offs* 8–12 (Tax Pol’y Center, Discussion Paper No. 20, 2005), available at http://www.taxpolicycenter.org/UploadedPDF/411181_TPC_DiscussionPaper_20.pdf.

⁶⁹ Under the parameters specified above, a one-earner couple with two children earning \$10,000 would get about the same refund, net of VAT, as under current law. Higher-income couples would pay more tax, but presumably benefit more, on average, from the new health voucher.

tax in the case where the donor was in the top bracket and the recipient was not.

Up to \$1000 of capital gains (again, the amount is an example) would be exempt from tax every year. All other capital gains would be taxable as ordinary income.⁷⁰ To reach bipartisan consensus, providing a tax break on long-term capital gains may be necessary. As noted, a rate differential between capital gains and other income creates enormous opportunities for tax sheltering, but some view it as important to encourage investment, reduce lock-in (the incentive to delay sales of assets to avoid the tax), and ameliorate the double-taxation currently imposed on corporate income.⁷¹ If capital gains (and dividends) are to be taxed at lower rates, the simplest way would be via an exclusion rather than the alternate rate structure that exists currently. For example, 60% of long-term capital gains and qualified dividends could be included in taxable income, creating a maximum effective tax rate of 15% (60% of 25%).

Under this plan, taxpayers in the 15% bracket would not have to file income tax returns unless they had a large capital gain or some other unusual tax situation. The only complexity would be how to convey the refundable tax credits. Graetz suggests that it could either be done through payroll adjustments by employers (as the advance EITC is done now) or through a debit card — an ATM card that would have the value of refundable credits based on earnings and number of children each year.⁷²

The estate tax is obviously fraught with controversy,⁷³ but a reasonable compromise would be to extend the 2009 exemption of \$3.5 million and top tax rate of 45%. This would exempt all but very wealthy estates from the tax and might defuse the issue politically. The estate tax could also be simplified, for example, by allowing surviving spouses to carry over any unused estate tax exemption from the deceased spouse. This would effectively grant an automatic \$7 million exemption for couples, which would significantly simplify tax planning

⁷⁰ One issue is whether corporate income taxes should be integrated to eliminate double taxation. While this change would be desirable in principle, full integration is relatively rare in the rest of the world and may be hard for voters to comprehend. Given the significant reduction in individual and corporate income tax rates, the economic gains would also be smaller than they would be under the current system.

⁷¹ LEONARD E. BURMAN, *THE LABYRINTH OF CAPITAL GAINS TAX POLICY* 67–77 (1997).

⁷² GRAETZ, *supra* note 5, at 163–64.

⁷³ *See generally* MICHAEL J. GRAETZ & IAN SHAPIRO, *DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH* (2005).

for many. A more sweeping reform would be to convert the estate tax to an inheritance tax as described by Batchelder.⁷⁴

Obviously many details are left out of this short sketch. Gale discusses individual and corporate income tax simplification, base broadeners, and compliance initiatives in more detail.⁷⁵ There would also surely be significant administrative issues in setting up the new credits. In addition, some of the proposals are probably not politically feasible, and there would inevitably be a great deal of redistribution compared with current law. However, the role of the political process is to vet the political and policy issues and balance them out. The key is for the president and congressional leaders to commit to keep the process moving toward the broad goals agreed to at the outset.

C. Other Issues

There are many options to improve the income tax system that could be paired with the health VAT. For example, the income tax reforms outlined here could be replaced by those suggested by Michael Graetz or William Gale with relatively minor modifications. Senator Ron Wyden (D-OR) and Congressman Rahm Emanuel (D-IL) have proposed the Fair Flat Tax Act of 2007, which would simplify tax filing and reduce the number of tax brackets, while recognizing that certain tax breaks are sacrosanct.⁷⁶ If paired with the health VAT, the top individual and corporate income tax rates in that plan could be reduced from the proposed 35% to 25% or less (although refundable tax credits would need to be adjusted for low-income households currently receiving free health care that would be disadvantaged by the VAT).

A practical issue is sequencing of the major reforms proposed here, which include income tax reform, a new tax for the United States (a VAT), and health reform. It is probably an understatement to say that it is unlikely that Congress could accomplish all of this in one term. One option would be to extend some of the Bush tax cuts and index the AMT for inflation through 2012 (or some other fixed but not too distant date). In principle, the components of the reform outlined here could be enacted in stages. The challenge would be sequencing the pieces so that momentum for reform is not derailed

⁷⁴ Lily L. Batchelder, *Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax* (Brookings Inst., Discussion Paper No. 2007-07), available at http://www.brookings.edu/papers/2007/06taxes_batchelder.aspx.

⁷⁵ GALE, *supra* note 62.

⁷⁶ Fair Flat Tax Act of 2007, S. 1111, 110th Cong. (2007).

along the way.

Finally, it might be desirable to phase in the new VAT. A VAT of 20% or more enacted overnight could produce inflation if the Fed accommodates the change by expanding the money supply or a recession if the Fed does not accommodate and wages are sticky. A phased in VAT, possibly paired with phased in reductions in income tax rates, could reduce such transition problems.⁷⁷

V. CONCLUSIONS AND CAVEATS

It is hard to understate the challenges that face would-be tax reformers. First, there is the reluctance of politicians to do anything that creates winners and losers.⁷⁸ Tax reform and health reform will both lead to that result. Second, there is the polarized political environment and basic dysfunctionality of our political institutions.⁷⁹

An even bigger constraint may be the President-elect's campaign promises. Mr. Obama's laundry list of middle-class tax promises and insistence on more progressivity will create a barrier to bipartisan consensus and simplification. Moreover, it is very possible that the economic crisis and foreign policy will consume the new president's energy and political capital and dissipate any momentum for bipartisan cooperation that might come out of the election.

Then again, President-elect Obama has promised a new era of bipartisanship and he gives a really good speech. It would take many excellent speeches to get tax reform enacted.

Nobody thought TRA would happen in 1986, but it did.

⁷⁷ The current economic downturn might create a special opportunity to phase in a VAT with less concern about inflation. Because of very weak demand, there is a risk of deflation, which could encourage consumers to postpone spending (hoping to pay a lower price in the future). This would exacerbate the recession. A VAT proposed to start taking effect in a year could spur consumers to spend more now (to avoid the tax).

⁷⁸ JOEL SLEMRD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES* (3rd ed. 2004).

⁷⁹ Yin, *supra* note 1, at 1029–34.

VI. APPENDIX: REQUIRED VAT RATE TO FINANCE UNIVERSAL HEALTH COVERAGE

The required VAT rate depends on the amount of health expenditures to be financed (i.e., the generosity of insurance coverage provided), the VAT base, and the level of compliance.

COST OF THE VOUCHER

Assuming that the VAT had to pay for all health care costs, including the cost of covering the uninsured, the revenue requirement would be quite large — about \$2.1 trillion in 2007.⁸⁰ The typical full-year insurance coverage for the nonelderly covers 85% of medical spending.⁸¹ Applying that percentage to total medical spending implies that the voucher would cost \$1.8 trillion. The cost could be greater or less depending on the coverage offered, its effect on health spending, and whether it is paired with effective measures to control health care costs.

VAT TAX RATE

To calculate the VAT tax rate, consider the following well-known national income identity:

$$(1) \quad Y = C + S + T,$$

where Y is gross national product, C is consumption, S is net national savings, and T is total taxes net of transfers (federal, state, and local). Decompose personal consumption into non-health spending, C_N , and private spending on medical care and insurance, C_H . Let government health spending be G_H . Equation (1) may be rewritten as

⁸⁰ Henry Aaron, *Covering the Uninsured: Cheap at Twice the Price*, HEALTH AFF., Aug. 25, 2008, available at <http://healthaffairs.org/blog/2008/08/25/covering-the-uninsured-cheap-at-twice-the-price/> (estimating total health expenditures of \$2 trillion); Hadley, et al., *Covering the Uninsured in 2008: Current Costs, Sources of Payment, and Incremental Costs*, HEALTH AFF., Aug. 25 2008, at 412 (estimating that total health expenditures would increase by about \$120 billion if all of the uninsured had health insurance coverage), available at <http://content.healthaffairs.org/cgi/content/abstract/hlthaff.27.5.w399>.

⁸¹ *Id.* at 412 ex.1.

$$(2) \quad Y = C_N + (C_H + G_H) + S + (T - G_H),$$

where $(C_H + G_H)$ is total current medical spending, public and private.

Under the proposal, the uninsured would gain health insurance coverage, and total health spending would increase by G_U . Assuming that S does not change, non-health spending would have to decrease by G_U to satisfy (2).

$$(3) \quad Y = (C_N - G_U) + (C_H + G_H + G_U) + S + (T - G_H),$$

Assume that the VAT tax base includes all personal consumption expenditures plus all health care, $C_N + C_H + G_H$.⁸² Assume also for the moment that the monetary authorities accommodate the new tax with an increase in the money supply, allowing the price of goods to increase by the amount of the tax. At tax rate, t , the VAT base becomes

$$(4) \quad \text{base} = \frac{C_N + C_H + G_H}{1 - t}.$$

Spending covered by the VAT is

$$(5) \quad \text{spending} = 0.85 \frac{C_H + G_H + G_U}{1 - t}.$$

Equating tax (t times base) with spending yields

$$(6) \quad t(C_N + C_H + G_H) = 0.85(C_H + G_H + G_U).$$

Note that the $1-t$ terms cancel out. Solving for t yields

$$(7) \quad t = 0.85 \frac{C_H + G_H + G_U}{C + G_H}.$$

Following the methodology of Gale,⁸³ C is about \$8.9 trillion in 2007 based on the National Income and Product Accounts (Appendix Table 1). The CBO reports that government spending is about 45% of

⁸² This assumption simplifies the algebra. Excluding health care expenditures from the base would not significantly affect the required rate of tax since tax revenues raised on health care simply pay for the government-financed portion of health care expenditures — that is, for the most part, the tax simply represents the government paying itself. (Excluding health care would have a small upward effect on the rate since it would implicitly cut the real share of health care paid directly by consumers.)

⁸³ William G. Gale, *The National Retail Sales Tax: What Would the Rate Have to Be?*, 107 TAX NOTES 889, 905 app. tbl.3 (May 16, 2005).

2009]

Blueprint for Tax Reform

315

total health expenditures,⁸⁴ so G_H is about \$0.9 trillion, implying that the denominator of equation (7) is \$9.8 trillion. The numerator is all health spending, \$2.1 trillion, making the VAT rate $0.85(2.1/9.8)$ or 18%.

The required VAT rate would almost surely be higher for several reasons. First, there would be noncompliance so tax revenues would fall short of theoretical revenues at an 18% rate. Second, the base would almost surely be smaller than all non-health personal consumption expenditures. The estimated tax base is 71% of GDP compared to an average of about 41% for European value-added taxes.⁸⁵ Even if health were excluded from the VAT, the base would be 56% of GDP, well above the European norm.

To the extent that there is noncompliance and the base is narrowed, the rate would have to be commensurately higher.

⁸⁴ CONG. BUDGET OFFICE, LONG-TERM OUTLOOK FOR HEALTHCARE SPENDING 5 (2007).

⁸⁵ Gale, *supra* note 83, at 897.

**Table 1. Effect of Extending Tax Cuts on Receipts and Deficit,
in Billions of Dollars, Fiscal Years 2008-2018**

	2008	2009	2010	2011	2012	2013
Baseline receipts	2548	2720	2881	3178	3451	3619
Extend tax cuts	0	-3	-5	-148	-264	-294
Index AMT	0	-82	-76	-70	-39	-46
Interaction	0	0	0	-17	-61	-68
Other expiring provisions	0	-21	-34	-47	-53	-58
Receipts after tax cuts	2548	2614	2766	2896	3034	3153
Percent of GDP	17.9	17.8	17.9	17.7	17.6	17.5
Baseline surplus or deficit	-407	-438	-431	-325	-126	-147
Minus tax cuts	0	-106	-115	-282	-417	-466
Additional interest on debt	0	-1	-7	-17	-36	-60
Surplus or deficit after tax cuts	-407	-545	-552	-624	-579	-672
Percent of GDP	-2.9	-3.7	-3.6	-3.8	-3.4	-3.7

	2014	2015	2016	2017	2018	2009 -2018
Baseline receipts	3770	3958	4145	4341	4546	36,606
Extend tax cuts	-304	-316	-328	-342	-356	-2359
Index AMT	-54	-64	-74	-86	-99	-691
Interaction	-76	-83	-90	-97	-104	-597
Other expiring provisions	-61	-63	-66	-69	-71	-544
Receipts after tax cuts	3275	3432	3586	3747	3914	32,416
Percent of GDP	17.4	17.5	17.5	17.6	17.6	17.6
Baseline surplus or deficit	-170	-162	-207	-174	-135	-2313
Minus tax cuts	-495	-526	-559	-594	-631	-4190
Additional interest on debt	-87	-117	-150	-186	-226	-888
Surplus or deficit after tax cuts	-752	-805	-916	-954	-992	-7392
Percent of GDP	-4.0	-4.1	-4.5	-4.5	-4.5	-4.0

Source: CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE 5 tbl.1-3, 20 tbl.1-8, 70 tbl.C-1 (2008), available at <http://www.cbo.gov/ftpdocs/97xx/doc9706/09-08-Update.pdf>. Some figures are author's calculations.

2009]

Blueprint for Tax Reform

317

**Table 2. Distribution in 2011 of Benefits
from Extending Bush Tax Cuts set to Expire in 2010.**

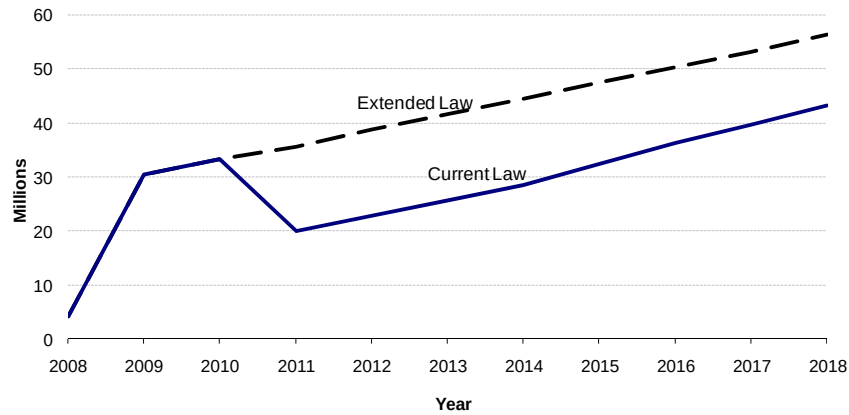
Cash Income Percentile	Percent of After- Tax Income	Share of Tax Cut (Percent)	Average Tax Cut in Dollars
Lowest Quintile	0.4	0.5	41
Second Quintile	2.1	5.3	456
Middle Quintile	2.3	9.7	828
Fourth Quintile	2.2	15.3	1,309
Top Quintile	3.5	68.9	5,904
All	2.9	100.0	1,713
Addendum			
Top 10 Percent	4.0	56.5	9,673
Top 5 Percent	4.7	48.7	16,686
Top 1 Percent	6.7	37.4	64,154
Top 0.5 Percent	7.3	31.6	108,227
Top 0.1 Percent	7.8	18.9	323,621

Source: TAX POLICY CTR., T06-0284 COMBINED EFFECT OF THE 2001–2006 TAX CUTS ASSUMING PERMANENT EXTENSION DISTRIBUTION OF FEDERAL TAX CHANGE BY CASH INCOME PERCENTILE, 2011 (2006), <http://www.taxpolicycenter.org/numbers/Content/PDF/T06-0284.pdf>.

The source includes the following notes:

- (1) Calendar year. Baseline is pre-EGTRRA law. Tax cuts include individual income and estate tax provisions in EGTRRA, JCWA, JGTRRA, WFTRA, AJCA, TIPRA, and PPA.
- (2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>
- (3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
- (4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

**Figure 1. Number of AMT Taxpayers, 2008-2018,
With and Without Extension of Bush Tax Cuts**



Source: Tax Policy Center, www.taxpolicycenter.org/T08-0248

Figure 1 Data

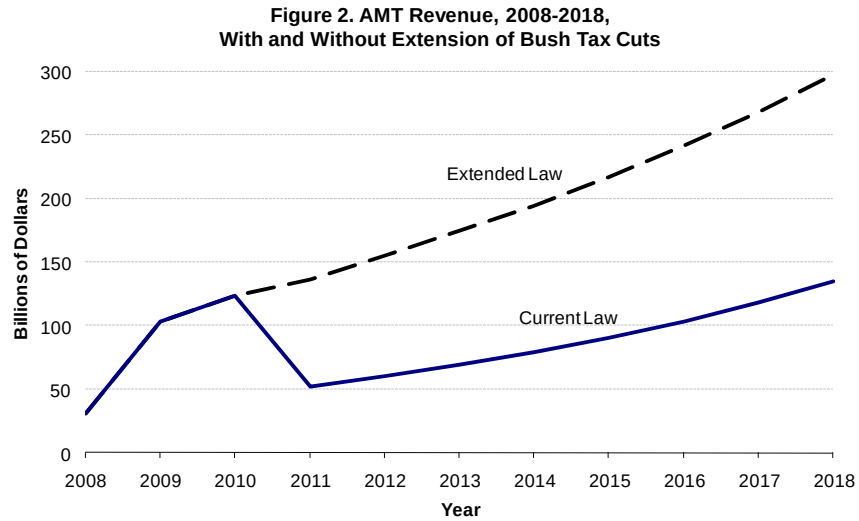
Year	Extended	Current Law
2008	4.1	4.1
2009	30.3	30.3
2010	33.3	33.3
2011	35.5	19.9
2012	38.7	22.7
2013	41.6	25.6
2014	44.4	28.5
2015	47.4	32.3
2016	50.2	36.2
2017	53.1	39.7
2018	56.3	43.2

Source: TAX POLICY CTR., T08-0248 AGGREGATE AMT PROJECTIONS, 2008–2018 (2008)
<http://www.taxpolicycenter.org/t08-0248>.

2009]

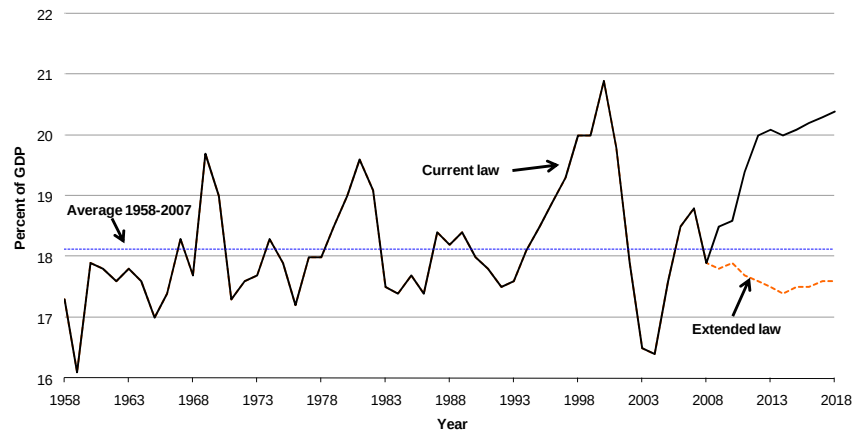
Blueprint for Tax Reform

319

Source: Tax Policy Center, www.taxpolicycenter.org/T08-0248**Figure 2 Data**

Year	Extended	Current law
2008	31.1	31.1
2009	103.3	103.3
2010	123.5	123.5
2011	136.2	52.2
2012	155.5	60.5
2013	174.6	69.5
2014	194.6	78.9
2015	217.4	90.6
2016	241.9	103.5
2017	268.2	118.1
2018	297.6	134.7
sum	1,944.0	966.0

Source: *Id.*

Figure 3. Historical and Projected Receipts: Current vs. Extended Law

Source: Historical Tables, Budget of the U.S. Government, Fiscal Year 2009, CBO The Budget and Economic Outlook: An Update, September 2008, and Tax Policy Center

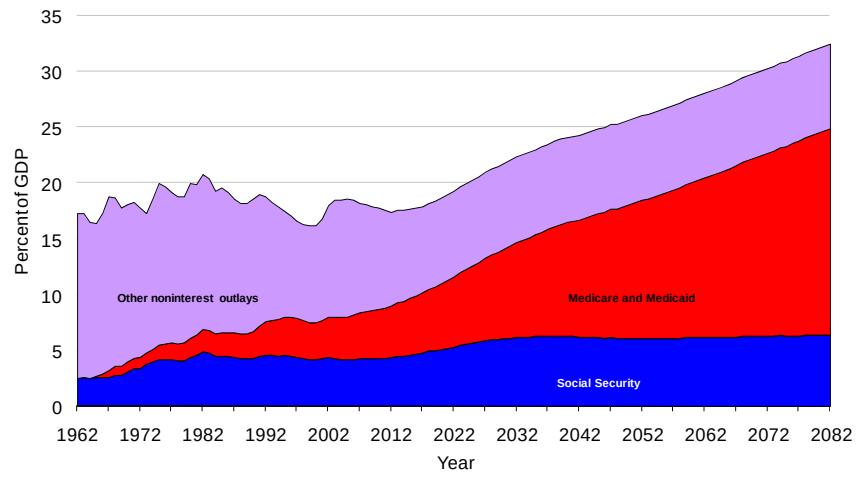
Note: extended law assumes extension of Bush tax cuts, AMT indexing, and other expiring provisions.

Source: Cong. Budget Office, *supra* note 59, at 160 tbl.F-13 (providing data for current law projection and data after 1968); Table 1, *infra*; THE BUDGET FOR HISTORICAL YEAR 2009, HISTORICAL TABLES, OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT 36 tbl.2.4 (2008), *available at* http://www.gpoaccess.gov/eop/2008/2008_erp.pdf (providing data for 1958–1967 and extended law).

2009]

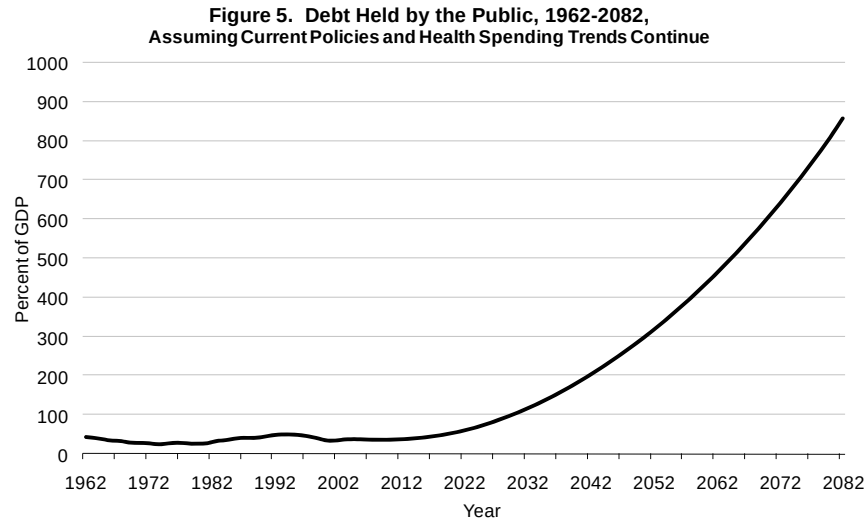
Blueprint for Tax Reform

321

Figure 4. CBO Long-Term Spending Projections

Source: Congressional Budget Office (2007).

Source: CONG. BUDGET OFFICE, *supra* note 59, at 19 fig.1-4.



Source: Congressional Budget Office (2007).

Source: CONG. BUDGET OFFICE, FIGURE 1-2: FEDERAL DEBT HELD BY THE PUBLIC AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT UNDER CBO'S LONG-TERM BUDGET SCENARIOS (2007) <http://www.cbo.gov/ftpdocs/88xx/doc8877/SupplementalData.xls> (providing data underlying graph). See CONG. BUDGET OFFICE, *supra* note 19, at 4 fig.1-2 (providing similar figure).

2009]

Blueprint for Tax Reform

323

Appendix Table 1. Derivation of Private Consumption Tax Base from NIPA Accounts, in Billions of Dollars, 2007

Description of Taxable Item	2007	NIPA Source (Table, Line)
Total Private Consumption Base		
Personal Consumption Expenditures	9710.2	(2.4.5,1)
Less: Education Expenditure	-257.3	(2.4.5,94)
Less: Food Produced and Consumed on Farms	-0.6	(2.5.5,6)
Plus: Purchase of New Homes	353.4	(5.4.5B,36)
Plus: Other Structures	267.3	(5.4.5B,39)
Less: Imputed Rent on Housing	-1063.3	(2.4.5,49)
Less: Imputed Rent on Farm Dwellings	-15.2	(2.4.5,51)
Less: Expenditure Abroad by U.S. Residents	-9.1	(2.5.5,111)
Less: Foreign Travel by U.S. Residents	-113.6	(2.5.5,110)
Plus: Expenditure in U.S. by Nonresidents	122.6	(2.5.5,112)
Plus: Taxable Home Mortgage Interest	147.4	See note 1
Plus: Taxable Nonprofit Interest	4.0	See note 2
Plus: Taxable Personal Interest	171.7	See note 3
Less: State Sales Taxes	-436.5	(3.3,7)
Total	8881.0	

Source: Methodology comes from Gale, *supra* note 83, at 905 app. tbl. 3. Results were updated with 2007 NIPA statistics. BUREAU OF ECON. ANALYSIS NIPA TABLES (2008), available at <http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=5&Freq=Qtr&FirstYear=2006&last year=2008>.

Notes:

(1) *Taxable home mortgage interest* = $A * [(B - C) / B]$, where A = owner-occupied housing interest payments. (NIPA 7.11, line 16). B = average mortgage rate, 1998–2007. ECONOMIC REPORT OF THE PRESIDENT, EXECUTIVE OFFICE OF THE PRESIDENT 312 tbl.B-73 (2008) http://www.gpoaccess.gov/eop/2008/2008_erp.pdf. C = average 10-year Treasury bond rate for 1998–2007. *Id.*

(2) *Taxable nonprofit interest* = $A * [(B - C) / B]$, where A = nonprofit interest payments (NIPA 7.11, line 18). B = average mortgage rate, 1998–2007. ECONOMIC REPORT OF THE PRESIDENT, *supra*, at 312 tbl.B-73. C = average 10-year Treasury bond rate for 1998–2007. *Id.*

(3) *Taxable personal interest* = $A * [(B - C) / B]$, where A = personal household interest payments (NIPA 7.11, line 17), B = imputed consumer interest rate 2007. FED. RES. STAT. RELEASE G.19: CONSUMER CREDIT, JUNE 2008 (Aug. 7, 2008), available at http://www.gpoaccess.gov/eop/2008/2008_erp.pdf. B was calculated by calculating a weighted average of the 48 and 24 month personal loan rates, and the interest rates on all credit card accounts and credit card accounts assessed interest. If those rates are A , B , C , and D respectively and if revolving debt as a percent of total debt outstanding is X and if non-revolving debt as a percentage of total debt outstanding is Y , then the imputed consumer interest rate is: $i = X * (0.5 * C + 0.5 * D) + Y * (0.66 * A + 0.33 * B)$. C = average 3-year Treasury bond rate for 1998–2007. ECONOMIC REPORT OF THE PRESIDENT, *supra*, at 312 tbl.B-73.

