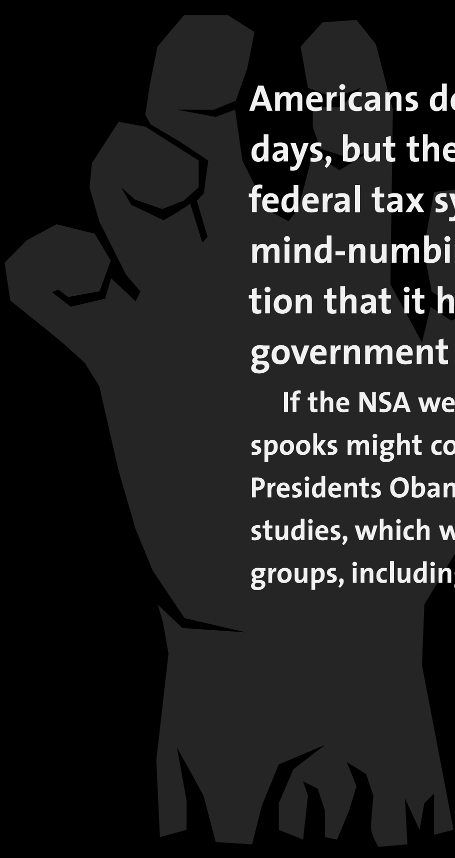
The tax reform that just won't die

[And shouldn't]

BY LEONARD E. BURMAN



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Americans don't agree about much these days, but they apparently all agree that the federal tax system is unfair, inefficient and mind-numbingly complex. And did I mention that it hasn't come close to paying for government in more than a decade?

If the NSA were tracking tax-reform chatter, the spooks might conclude that an overhaul is imminent. Presidents Obama and Bush both ordered reform studies, which were duly prepared. A host of bipartisan groups, including the National Commission on Fiscal

Responsibility and Reform (a.k.a. Bowles-Simpson), have proposed broad cuts in subsidies that are now delivered in the form of deductions, credits and exclusions in exchange for cuts in tax rates and some deficit reduction. Then, too, the chairmen of the congressional tax-writing committees – Democrat Max Baucus in the Senate and Republican Dave Camp in the House – launched an odd-couple public relations tour aimed at building support for tax reform complete with a "Max & Dave" twitter handle, @simplertaxes.

But it's proved to be sound and fury, signifying almost nothing. The commission reports might as well have been delivered by Snapchat – here today, gone today. The Republican leadership put the kibosh on Dave's road show because it wanted to keep attention focused on the rocky launch of Obamacare. President Obama, for his part, tapped Max to be his next ambassador to China, presaging an early exit from the Senate and the tax-reform crusade. Max & Dave stopped tweeting last September. When Dave did deliver a plan, Senate Minority Leader Mitch McConnell wasted no time in pronouncing it dead on arrival.

The fact is, fixing our flawed tax code would be really hard, since any fiscally responsible reform would create losers as well as winners. And if reform is also to make a dent in future deficits this time around, it would have to create a whole lot of the former.

Politicians, of course, do not want to focus on the people whose taxes would go up. They prefer to talk about closing loopholes, as if there were a long list of wasteful tax subsidies that almost everyone wanted to kill. After all, to voters accustomed to absorbing policy wisdom in 30-second bites, broadening the tax base as part of tax reform is just a matter of cutting waste, fraud and abuse. But that's not where the big bucks dwell. And in any event, more often than not, my bridge to nowhere turns out to be your revitalizing-infrastructure plan.

The real gold lies in subsidies like the mortgage-interest deduction, tax-free health insurance, tax-deferred retirement accounts and charitable deductions. Support for reform wanes quickly when the discussion turns to cutting tax incentives to housing or health care or philanthropy.

Some policy strategists think that overall limits on tax breaks would work better than picking them off one at a time. President Obama, for example, proposed to limit the value of core deductions and exclusions to 28 percent of income. And during the 2012 presidential campaign, Mitt Romney floated the idea of limiting the overall value of tax breaks to somewhere between $17,000 and $50,000 per return (the number changed from speech to speech). That would be an even tighter constraint on the rich than Obama's limit, since deductions and credits would offer no additional tax relief once the earner reached the fixed-dollar threshold.

It's possible such backdoor limits could be the secret to success. But they haven't exactly attracted the sort of grass-roots support that could neutralize the financial free speech of the very rich. Indeed, actual proposals to come out of Congress, notably one offered by Sen. Ron Wyden (D-Ore.), would trim tax breaks surgically rather than slip in the overall limits favored by party leaders.

One overall limit does, by the way, have a champion in Congress. The Buffett rule (as suggested by Warren Buffett in lamenting the

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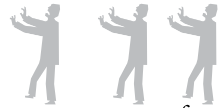
fact that he paid a smaller percentage of his income in taxes than his secretary did) would require big earners to pay a 30 percent tax on their income before deductions. Sen. Sheldon Whitehouse (D-R.I.) wrote it up as a bill, and the president said he more or less supported it. But the Buffett rule sounds suspiciously like the alternative minimum tax – scourge of the upper middle class and the poster child for byzantine complexity in the tax code. An optimist would have to hope that policymakers could do better than that.

THE SIREN SONG OF 1986

Tax reform is not quite impossible. The century-old income tax has been successfully overhauled exactly once, and those who want to try again look to the Tax Reform Act of 1986 for inspiration. But in their book *Showdown at Gucci Gulch*, Jeff Birnbaum and Alan Murray explained that the reform escaped more perils than Pauline. Indeed, the '86 Act's success rested on three fragile legs.

First, there was White House leadership. President Reagan may have backed tax reform in 1984 because of political miscalculation – he reportedly thought that his opponent, Walter Mondale, was about to announce a tax overhaul plan and wanted to beat him to the podium. But once the idea gained momentum, Reagan was there to make a good speech or a strategic phone call when needed. He also didn't micro-manage. He set one overarching goal – a significant cut in tax rates (which had topped out at more than 90 percent back when Reagan was starring in the movie *Bedtime for Bonzo*) – and left the details to the negotiators.

Second, the effort was bipartisan. Reagan, a Republican icon, worked well with two old-



school New Deal Democrats, Tip O'Neill, the House majority leader, and Dan Rostenkowski, chairman of the House Ways and Means Committee. The bill's Senate champion, Bill Bradley (a New Jersey Democrat who had been in the 70 percent-plus tax bracket when he played forward for the New York Knicks) worked closely with the Republican Finance Committee chairman, Robert Packwood.

Tax reform must be bipartisan because it makes proponents sitting ducks in general elections. The Affordable Care Act, which passed without a single Republican vote, provides a cautionary lesson. And tax reform would be even easier for demagogues to pillory than health care.

Third, there was a potential source of revenue to sweeten the pot – a big increase in corporate income tax revenues, primarily gained through repeal of the investment-tax credit and scaling back of accelerated depreciation. Voters looked with favor on closing those perceived loopholes because they didn't understand that a good chunk of corporate taxes is ultimately passed on to workers in the form of lower wages. Arguably more important, the chief executives of large companies lined up to support the plan even though their companies' after-tax profits were at risk – probably because they stood to gain so much from the simultaneous cut in personal income tax rates.

While there is a remote chance of some kind of corporate tax reform, individual income tax reform is out of the question, at least for now. Along with all the usual obstacles, reform ranks low among President Obama's priorities. But "now" isn't a synonym for "never." There will be a new president in 2016, who, like Reagan, might find it expedient to support tax reform during the election campaign and then follow through once the nameplate on the Oval Office is changed.

Bipartisan support seems more of a stretch. But the right kind of plan might just appeal to both sides of the aisle. There's been talk for several years about a "grand compromise" – entitlement reform in exchange for more revenues to adequately fund the discretionary spending programs (like education) favored by Democrats. And tax reform could synergize entitlement reform, as I will explain.

Another good omen is that Senator Wyden, who replaced Senator Baucus as chair of the Senate Finance Committee, has made bipartisanship his modus operandi. Among other accomplishments, he has worked well on Medicare reform with Paul Ryan, who is likely to be the next chair of the House Ways and Means Committee.

The third element of the 1986 package, a fiscal honey pot to sweeten the deal, would be harder to find. There is no investment tax credit or highly accelerated depreciation provision to repeal or scale back; if anything, there is pressure to reduce corporate tax burdens. It might be possible, however – and here's where I'm going out on a limb – to introduce a brand new revenue source that is relatively palatable: the value-added tax.

JUST CLEVER ENOUGH BY HALF

Lawrence Summers, the former Treasury secretary, has joked that Republicans oppose a VAT – a national sales tax – because it's a money machine, while Democrats loath it because it is regressive. We'll get a VAT, he suggested, when Republicans figure out that it is regressive and Democrats discover that it is a money machine.

Summers has a point. Most economists believe that taxes on consumption, like the VAT, are growth-friendlier than income taxes because they don't reduce the incentive to save. That very advantage is what makes the VAT regressive – poor people can't afford to save. Nonetheless, VATs are ubiquitous in Western

Europe (and pretty much everywhere else) because they make it possible to raise a lot of revenue without generating much popular wrath.

I would argue, moreover, that a VAT carefully earmarked to pay for government health care (Medicare, Medicaid, the Children's Health Insurance Program) would not fuel growth in government. Indeed, by putting a price tag for all to see on the fastest-growing component of government spending, it would have the opposite effect.

The idea would be to use VAT revenues to cover federal expenditures for medical care that exceeded the payroll-tax revenues and insurance premiums already dedicated to those programs. (I would not include the subsidies built into the Affordable Care Act, because, among other things, the Congressional Budget Office estimates the law is self-financing.) I would also eliminate the tax-free status of employer-sponsored health insurance – admittedly, no easy sell – raising $300 billion annually in income and payroll taxes, and adding the money to the health care pot. Then I would specify – by statute – that the VAT should be adjusted periodically to cover the remaining deficits of the federal health care federal programs.

Actually, earmarking a VAT to pay for health care is not a new idea. Henry Aaron, the Brookings Institution health guru, suggested an earmarked VAT as one way to finance universal coverage way back in 1991.

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I think there are several advantages to this approach. As noted above, a consumption tax does not distort the trade-off between current and future consumption (the fruits of savings), as an income tax does. And the inherently regressive nature of a VAT could be easily offset with refundable tax credits to those with low incomes – as earlier proposed by Prof. Michael Graetz of Columbia Law School.

Several years ago, the Tax Policy Center estimated that a 6.5 percent VAT as part of a sweeping tax-reform plan could allow a cut in the current top individual income tax rate from 39.6 percent to 27 percent and leave some revenue left over for deficit reduction. A VAT closer to 15 percent would allow much more significant cuts in income tax rates (or more concessions on tax subsidies to build a winning political coalition).

Second, as noted earlier, dedicating a revenue source to pay for health care programs guarantees a revenue stream tied to the component of spending that is most difficult to control. This would reassure credit markets that are growing uneasy with chronic deficits – not to mention the government of China, which owns some $1.3 trillion in U.S. Treasury securities.

Third, earmarked taxes are better tolerated by the public. Though payroll taxes represent a larger burden on most working-age Americans than the income tax, the payroll levy enjoys broad support because most voters favor

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what it pays for (Social Security and Medicare). That tax was reduced for two years in an effort to boost private spending in the recession-bound economy. But the reduction expired at the end of 2012. And in sharp contrast to the pushback for resuming the Bush-era income tax cuts that expired at the same time, there was little protest about reversing the payroll tax cut. A dedicated VAT thus might be more sustainable politically than the alternatives.

It's also worth remembering that a VAT is basically a sales tax – albeit one that is easier to collect, which is why it is the norm in the rest of the world. And surveys suggest that most Americans prefer sales taxes to income taxes.

The dedicated VAT might also restrain spending. A key problem with controlling health care costs is that most people think that someone else pays for it – employers, insurers, or the government. But a tax that rose with the cost of care would create a visible metric of the effectiveness of containment efforts, translating into higher prices for goods and services if those efforts are inadequate.

Voters in this tax-averse country could thus be expected to pressure lawmakers to limit spending in order to avoid tax creep. Indeed, I would dare to hope that the very visible linkage would create the conditions necessary to support a bipartisan consensus on controlling Medicare and Medicaid spending that has so far proved elusive.

Finally, tying a VAT to health care finance would be a humane way to address the concern expressed by some conservatives that almost half of voters do not have skin in the game when it comes to federal spending. A dedicated VAT would mean everyone would see a connection between their own taxes and the main driver of federal spending. And that could be done while preserving the income tax credits that have lifted millions of low-income working families out of poverty.

America's Allergy to the VAT

Despite its prevalence in the rest of the world – every other high-income industrialized country has a VAT – the United States has never come close to enacting one. Al Ullman, the chairman of the powerful House Ways and Means Committee, proposed a VAT in 1979 and was promptly voted out of office. While other factors played a role (he disliked meeting with constituents and was widely seen as arrogant and aloof), Ullman's advocacy of the VAT while sitting in a position where he might have made it happen was perceived as an element in his undoing.

One reason we don't have a VAT is that tax aversion is part of the United States' creation myth. (Recall the Boston Tea Party.) The idea of adding a new tax that could raise hundreds of billions of dollars per year just doesn't sit well with a nation of self-perceived rugged individualists. Some also worry that a VAT would be too efficient in the sense that it could enable expansion in government. They point to evidence from Europe that increases in VAT revenues are followed by increases in government spending.

This doesn't prove that the revenues led to freer spending. It's likely that social democracies adopt the VAT *because* they want to spend more, not vice versa. But VAT critics are convinced that the tax would fuel an explosion in government spending. As the anti-tax lobbyist Grover Norquist likes to put it, "VAT is French for 'big government.'"

Not surprisingly, there is considerable resistance to a VAT in Congress. In response to reports that Paul Volcker, the chairman of President Obama's tax-reform panel, was considering a VAT, John McCain sponsored a Senate resolution opposing a VAT in 2010. It passed by a vote of 85-13, and there's no sign the opposition has slackened since. The Republican Party's 2012 platform stated, "In any restructuring of federal taxation, to guard against hyper-taxation of the American people, any value-added tax or national sales tax must be tied to the simultaneous repeal of the 16th Amendment, which established the federal income tax." Fat chance.

So a VAT seems a non-starter. But other impossible dreams have become law. Alan Viard, an analyst at the conservative American Enterprise Institute and a consumption-tax supporter, points out that the Senate voted 98-0 against taxing Social Security benefits in July 1981 when it got word that Ronald Reagan was considering that step to shore up the program's finances. Just two years later, though, Congress passed the Greenspan Commission's reform package, which included a tax on Social Security benefits.

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The fact is, the combination of population aging and technological change that extends life virtually guarantees that federal spending on health care will increase. Unless we figure out a better way to pay for it, higher income tax rates or ballooning deficits will weaken the economy as the baby boomers reach their dotage. In that bleak scenario, spending on all the other things that government traditionally delivers would get squeezed. And at that point, opposition to a VAT – particularly one dedicated to delivering life-or-death services – could erode quickly. M