PRINCIPLES FOR COMPREHENSIVE INCOME TAX REFORM

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Good morning, Mr. Chairman, Ranking Member Grassley, and Members of the Committee. My name is Daniel Shaviro, and I am the Wayne Perry Professor of Taxation at NYU Law School. Thank you for the opportunity to testify before you today on alternatives for comprehensive reform of the U.S. federal income tax system. My testimony makes three main points:

1) The most fundamental maxim of tax reform is that, holding revenue and distribution constant, we should broaden the base and lower the rates. Politics is always pushing the tax system in the other direction, as taxpayers come in to make arguments about special circumstances that ostensibly call for more favorable treatment. Although these arguments often sound appealing, the long-run effect of special rules is to make the system more complicated, less efficient, and less fair. While base-broadening is therefore fundamental to tax reform, I will argue that we need to be sophisticated in several respects about defining it and implementing it. Moreover, we should clearly distinguish between (a) arguments about the proper definition of base-broadening, which raise technical and economic issues, and (b) "non-tax" arguments for maintaining particular preferences notwithstanding the general case for base-broadening.

2) Second, our rules for taxing business enterprises are badly broken. At the business level, the fact that major corporations commonly report high book income to their shareholders and low taxable income to the I.R.S. is an important diagnostic, suggesting that something is wrong. At the investor level, the disparate tax treatment of corporate debt and equity, while decades old, is becoming ever more problematic. Increasingly, given financial innovation, it simply provides an investor election to pay tax at the corporate rate or one's own rate, whichever is lower. Finally, our system for taxing the outbound income of U.S. multinationals imposes enormous tax planning and transaction costs relative to the revenue raised. Our tax law in this area tries to split the difference between the rival tax policy goals of worldwide taxation and territorial taxation. We have ended up, however, with something that is worse than either. This suggests that the area is ripe for reform.

3) Finally, the tax system needlessly aggravates and complicates the lives of lower and middle income taxpayers. Congress can and should address this, by making filing and compliance less painful, even insofar as taxes paid by such individuals remain approximately constant.

I. GENERAL BACKGROUND

The old Chinese curse, "May you live in interesting times," has perhaps never been more applicable to U.S. tax policy than it is today. We are facing a perfect storm on a number of different fronts. Most obvious are the questions of what to do about expiring tax cuts from 2001 and 2003, the ever more costly and burdensome process of dealing with annual "extenders," and how to respond to the startling rise of the alternative minimum tax (AMT), which may apply to 30 million taxpayers by 2010 if Congress takes no action to prevent this.[1]

From a broader policy standpoint, the biggest long-term challenges are twofold. First, revenues are simply inadequate to meet the long-term spending path of the U.S. government, suggesting that we may be headed for a major fiscal crisis down the road.[2] Congress relied on bipartisanship in making tough budgetary choices from 1982 through 1990, or most of the last era when deficits were so prominent, and clearly that approach helps when painful medicine must be taken. Second, while rising income inequality at the top of the distribution[3] may lead some policymakers to favor increased tax progressivity, a common way of doing this, by increasing taxes on capital income, becomes ever harder as rising worldwide capital mobility makes it easier to shift both the actual location of economic activity and the reported site where income is earned. For example, several recent econometric studies suggest that, due to worldwide capital mobility, corporate income taxes are now mainly borne by labor, rather than capital.[4] Increasingly, the consensus among academic tax policy experts holds that distributional concerns should be addressed through a progressive consumption tax, rather than through the capital income component of the current income tax,[5] but I recognize that this is not a direction in which policymakers currently seem inclined to go.[6]

Even if neither of the long-term challenges relating to fiscal adequacy and progressivity is addressed right away, having a better and more stable tax system in place is a vital precursor to being able to act effectively in the future. Both the instability of current law, and the tax system's generally declining coherence and efficacy since comprehensive tax reform was last addressed in 1986, make a major reform effort extremely desirable. Indeed, the 1986 approach of taking key ideological differences off the table by being both revenue-neutral and distribution-neutral provides an obvious blueprint for facilitating bipartisan cooperation on tax reform. Making the tax system

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[1] See Statement of Leonard E. Burman Before the Subcommittee on Select Revenue Measures, House Ways and Means Committee, March 7, 2007 (available on-line at http://www.urban.org/UploadedPDF/901051_Burman_IndividualAMT.pdf).

[2] See Daniel N. Shaviro, TAXES, SPENDING, AND THE U.S. GOVERNMENT'S MARCH TOWARD BANKRUPTCY. New York: Cambridge University Press, 2007.

[3] See Greg Ip, *Income-Inequality Gap Widens*, Wall Street Journal, October 12, 2007.

[4] See the discussion in William M. Gentry, *A Review of the Evidence on the Incidence of the Corporate Tax*, U.S. Treasury Department, Office of Tax Analysis, OTA Paper 101 (2007).

[5] See Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 Stan. L. Rev. 745 (2007).

[6] Thus, even the most consumption tax-like plan developed by the President's Advisory Panel on Federal Tax Reform in its 2005 report continued an add-on income tax-style component. See the discussion in Daniel Shaviro, *A Blueprint for Future Tax Reform? Evaluating the Reform Panel's Report*, 109 Tax Notes 827 (November 7, 2005).

fairer and more efficient should be appealing without regard to how one thinks about distribution issues or overall revenue needs.

II. BROADENING THE BASE AND LOWERING THE RATES

A. Base-Broadening Generally

The central tax reform principle for decades – and rightly so – has been that Congress should use a broad base and low rates to raise desired revenues, rather than a narrower base that necessitates higher rates. Needlessly high rates are bad in themselves, and gaps in the tax base compound the damage by distorting taxpayer behavior through the encouragement of what would be bad economic choices on a pre-tax basis. Indeed, while gaps in the tax base reduce observed revenues, they actually make the government bigger, rather than smaller, so far as its distorting impact on economic decisions and market outcomes is concerned. For example, taking a government spending program and converting it into a tax preference does absolutely nothing to make the government truly smaller, even if it shrinks officially reported taxes and spending.[7]

Even where government intervention in the economy is desirable, the tax system is often a bad place to do it. For example, the benefit derived from a special exclusion or deduction depends, often perversely, on the taxpayer's marginal rate. Thus, a dollar of home mortgage interest deductions saves you 15 cents if your marginal rate is 15 percent, and 35 cents if it is 35 percent. This special feature of deductions and exclusions – shared by tax credits insofar as they are nonrefundable (i.e., limited to one's overall positive liability) – often has no discernible connection to the policies that ostensibly are being advanced.[8] Moreover, these problems are not limited to tax preferences for individuals, even though marginal tax rates for C corporations are relatively flat. Due to nonrefundability, corporations generally cannot use special incentives if they already have a net loss.[9]

Members of the public often think of base-broadening as increasing horizontal equity. Academic experts, by contrast, tend to think of it as increasing economic efficiency, on the view that the value of a tax preference is likely to be competed away as it draws additional business activity into the tax-favored sector. For a simple illustration, suppose that all taxpayers paid tax at a 30 percent marginal rate, that corporate bonds paid interest at 10 percent that was taxable income to the recipient, and that municipal bonds (as under present law) offered tax-free interest income. It might be natural to think that, if there is a problem with the municipal bond interest exemption, it must relate to fairness as between corporate bondholders (who receive taxable interest income) and municipal bondholders (who receive tax-free interest income). This analysis does not really stand up, however. After all, if corporate bonds offer a 10 percent return before tax

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[7] See Daniel Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 Tax L. Rev. 187 (2004).

[8] See Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 Stan. L.Rev. 23 (2006).

[9] The inability to get any tax benefit from net losses has become an increasing problem for U.S. corporations in recent years, apparently reflecting greater dispersion and volatility in business outcomes. See Alan J. Auerbach, *Why Have Corporate Tax Revenues Declined? Another Look* (2006), available on-line at http://www.econ.berkeley.edu/~auerbach/AJA_CESifo_revised.pdf.

but only 7 percent after tax, then state and local governments should be able to sell bonds (otherwise comparable to the corporate bonds in their terms and risk) that pay only 7 percent both before and after-tax. This eliminates any possible unfairness as between the different bondholders, all of whom are earning 7 percent after-tax. Accordingly, if there is a problem, it must relate to efficiency, reflecting that borrowing is being subsidized (permitting bond issuance at a lower interest rate) in one sector as compared to another.[10]

A real-world analysis of municipal bonds or other tax-favored assets would admittedly be more complicated than this, given the multiplicity of taxpayer marginal rates and differently-taxed assets. Moreover, redefining the key problem caused by tax preferences as one of inefficiency, rather than horizontal inequity, arguably is immaterial since the policy recommendation, in favor of revenue-neutral base-broadening, is the same either way. Nonetheless, it may be helpful to understand the stakes properly, and to see that base-broadening can increase our society's prosperity and productivity by causing pre-tax profitability to guide the allocation of investment, rather than turning on what are often quite debatable intuitions about the importance and definition of horizontal equity.

Neutral taxation as between different activities or industries can be advanced by repealing various income tax preferences,[11] and by making cost recovery rules less biased as between different assets. The main obstacle to achieving greater neutrality is political, rather than reflecting serious disagreement among experts (other than on a handful of issues) about how to define tax neutrality between assets or activities. The places to look for special rules are well-known as well. Both the Joint Committee on Taxation and the U.S. Treasury Department have long published tax expenditure lists that are substantially in agreement, despite various definitional fine points on which they differ.

As applied to individuals, base-broadening potentially targets a number of highly popular items. Consider, for example, the itemized deductions for home mortgage interest and for state and local taxes, along with the statutory exclusion for employer-provided health insurance. However, in addressing these hot-button issues, one should keep in mind the following:

--Under present law, the value to taxpayers of itemized state and local tax deductions is already being undermined by the rising applicability of the alternative minimum tax, which does not allow those deductions. Likewise, existing ceilings on the amount of home mortgage loan principal that can trigger deductible interest expense ($1 million for acquisition indebtedness and $100,000 for home equity indebtedness)[12] are

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[10] I ignore here the possibility that there might be efficiency arguments for subsidizing borrowing by state and local governments, such as by reason of positive spillover effects attributed to local capital investment.

[11] While defining an item as a tax expenditure may depend on whether one adopts an income tax or consumption tax baseline, identifying disparities in treatment does not depend on this. According to leading consumption tax proponent (and former chair of the Council of Economic Advisors) R. Glenn Hubbard, eliminating differential taxation of competing activities and industries may be more important than choosing between income and consumption taxation. See William M. Gentry and R. Glenn Hubbard, *Distributional Implications of Introducing a Broad-Based Consumption Tax*, in James. M. Poterba (ed.), TAX POLICY AND THE ECONOMY, Vol. 11. Cambridge, MA: MIT Press, 1997. This implies that greater inter-asset conformity may generally be worthwhile even if it increases the degree to which the hybrid U.S. system effectively functions more like an income tax and less like a consumption tax.

[12] See Internal Revenue Code section 163(h)(3).

effectively declining in real terms over time due to inflation. These ceilings already are real constraints for at least a few taxpayers in parts of the country where real estate prices are higher. Finally, the strains that rising healthcare costs place on employer-provided insurance plans are causing many plans to become less generous, thereby reducing the value of the income tax exclusion for some taxpayers. In a sense, therefore, all of these tax benefits are already being reduced without Congressional action, suggesting that new rules more directly limiting them could be viewed, to a degree, as a trade-in for what is already happening.

--Repeal is not the only option when addressing these items. Other possibilities include making greater use of dollar ceilings on deductions or exclusions, and reducing (while also possibly making more uniform) the tax benefit per dollar claimed of a given item. For example, both the noted Bradley-Gephardt tax reform plan of the early 1980s[13] that helped inspire the 1986 tax reform, and the 2005 report of the President's Advisory Panel on Federal Tax Reform, proposed converting special deductions into percentage credits (or their equivalent) that would benefit all taxpayers claiming the items only at the lowest applicable positive marginal rate.

B. Base-Broadening With Respect to Capital Income

Inevitably, even in an ambitious and comprehensive effort at income tax reform, not all preferences would be repealed. Political compromises are bound to be necessary, and leading proponents of reform may feel that particular preferences serve sufficiently good purposes to justify their retention. Selecting such items is a delicate task, because it can risk unwinding the entire tax reform process as other political actors demand comparable concessions, but how best to balance these considerations in practice is not a subject on which tax policy experts can claim special expertise.

The taxation of capital income, however, raises some special technical issues in properly defining and applying the base-broadening concept, wholly apart from questions of pursuing broader social policy goals through the tax code. Four points in particular are worth making:

1) As is well-known, an income tax discourages saving and investment relative to immediate consumption, raising questions about whether "base-broadening" is really the right term for having an income tax (with its nominally broader base) rather than a consumption tax. The reason for nonetheless, within an income tax framework, regarding as a preference consumption tax-style treatment (such as expensing) for particular investments is that such treatment biases taxpayer choices between assets. However, general income tax preferences for saving in any form, such as individual retirement accounts (IRAs), are not subject to this criticism. Accordingly, the general economic benefits of base-broadening are not advanced by having smaller, rather than larger, deductions or exclusions for individual retirement accounts. This conclusion is independent of whether one favors encouraging (or reducing discouragement of) retirement saving as a social policy goal.

[13] The Fair Tax Act of 1983, H.R. 3271, 98th Cong., 1st Sess. (1983); S. 1421, 98th Cong., 1st Sess. (1983).

2) One serious design problem with preferences (from an income tax standpoint) for saving or investment – whether they are narrow, like expensing for a particular asset, or broad, like IRA provisions – is that they may fail to have *any* net encouraging effect on saving or investment insofar as they are effectively (but not necessarily detectibly) debt-financed by the taxpayer. Thus, suppose I both (a) put $1,000 in a traditional IRA, generating a $1,000 deduction and annual exclusion of the interest income I earn until withdrawal, and (b) borrow $1,000 through a home equity loan. I have not saved on balance, but I get a $1,000 deduction, the tax savings on which I can use to fund further consumption, and then in subsequent years I can deduct my interest outlay while deferring my interest accrual, generating further tax savings that can help fund further consumption. This is a simple example, but the point is much broader. Allowing interest deductions plus savings and investment incentives (from an income tax standpoint) is a big problem that needs to be better addressed, and not simply through rules that attempt to trace particular uses of borrowed funds to particular outlays. Such rules are inevitably ineffective given the fungibility of money.

3) With respect to the taxation of corporate income, it is important to think about both levels of tax – that levied at the corporate level, and at the shareholder level via the taxation of dividends and capital gains with respect to stock. The better the tax system is operating at the corporate level to measure and properly tax corporate earnings, the less the need to impose tax at the shareholder level. (I further address corporate taxation in section III below.)

4) For capital gains, even leaving aside corporate stock, a further complexity arises because taxpayers holding appreciated capital assets can avoid the tax by the simple expedient of not selling the assets. For sales of such assets, accordingly – unlike for most ordinary income – raising the rate can actually lose revenue even at rate levels that are politically plausible. (This point differs from "supply-side" arguments that have been questioned empirically, because all it relies on is greater or lesser asset turnovers in response to capital gains rate changes.) Depending on the top marginal rate for ordinary income, therefore, there may be a case for a lower capital gains rate.[14] However, the case for a lower capital gains rate might be significantly weakened if taxpayers could not permanently eliminate (as opposed to merely deferring) the tax on asset appreciation via the step-up in basis at death.[15] The treatment of capital assets at death is a key integral part of how the tax system currently bears on capital income, because its incentive effect, discouraging the sale of appreciated assets at any time during one's life, is so pervasive. Congress should therefore seriously consider repealing section 1014 of the Internal Revenue Code, which provides the basis step-up at death.

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[14] This point potentially holds even if the top marginal rate for ordinary income is below the revenue-maximizing rate for capital gains. See Richard L. Schmalbeck, *The Uneasy Case for a Lower Capital Gains Tax: Why Not the Second Best?*, 48 Tax Notes 195 (July 9, 1990).

[15] See Internal Revenue Code section 1014.

III. TAXING BUSINESS ENTERPRISES

In several key respects, our rules for taxing business enterprises are badly broken. Fundamental reform therefore needs to revisit, not just tax preferences, but basic structural features of our rules for taxing the income earned by C corporations and other such large-scale business entities. The following briefly addresses several of the most critical issues.

A. Corporate Tax Sheltering and the Book-Tax Income Gap

Corporate tax sheltering, widely recognized as a big problem in the late 1990s and early 2000s, has not necessarily gone away. One suggestive diagnostic, indicating that it may remain a serious problem, is that the book-tax income gap, or excess of publicly traded companies' reported financial accounting income over their taxable income, remains high.[16] In theory, since accounting income is supposed to be computed more conservatively,[17] the gap should go the other way, with taxable income being higher. Evidently, however, corporate managers' incentives to make book income as high as possible while also trying to save taxes (often through economically wasteful even if technically legal tax planning maneuvers) outweighs any tendency of the tax and accounting rules to push in the opposite direction.[18] A number of different tools can be deployed to address these issues, ranging from increased audit resources, to ensuring that the Internal Revenue Service has adequate legal tools, to making penalties higher and less subject to ostensible good-faith exceptions that in fact merely encourage the procuring of "penalty shield" opinion letters.[19] I have recently suggested that Congress also consider adopting an adjustment to corporate taxable income, as otherwise computed, under which it generally would be adjusted 50 percent of the way towards the taxpayer's reported book income.[20]

B. Corporate Integration and the Distinction Between Debt and Equity

Corporate integration, designed to mitigate or even eliminate the double taxation of equity-financed corporate income, is an approach that most tax policy experts (in my view rightly) continue to favor. As noted above, however, the question of what if any tax should be imposed at the shareholder level importantly depends on how effectively tax is being collected at the corporate level. In addition, however, an approach to partial or complete corporate integration like that under expiring present law, with its special 15 percent tax rate for dividends, is open to the objection that it preserves the longstanding, but economically nonsensical, tax law distinction between debt and equity.[21] Modern

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[16] See, e.g., Joann M. Weiner, *Closing the Other Tax Gap: The Book-Tax Income Gap*, 115 Tax Notes 849 (May 28, 2007).

[17] See, e.g., *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 542 (1979).

[18] See generally Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, forthcoming in Georgetown Law Journal, vol. 97, draft available on-line at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1017073.

[19] See Daniel Shaviro, *Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters*, in Wolfgang Schon (ed.), TAX AND CORPORATE GOVERNANCE. Munich: Springer, 2008.

[20] See id.

[21] Interest payments on debt are generally deductible at the corporate level and treated as ordinary income by recipients, and current interest amounts generally are imputed even if no cash actually changes hands.

financial innovation has made the tax distinction between the two types of instrument ever more porous and manipulable. Insofar as investors can slap whichever label they prefer on whatever sort of investment position they wish to have, the debt-equity distinction amounts to an election to use either the corporation's tax rate (via the use of equity) or one's own (via the use of debt), whichever is lower. It is hard to think of a good rationale for effectively providing such an election.[22]

C. Global Tax Competition and the U.S. Corporate Rate

The U.S. statutory corporate tax rate is among the highest in the world. In an era of increasing worldwide capital mobility, this potentially disadvantages us in two respects. Companies may choose to invest abroad rather than here, where the competing locations are otherwise good substitutes for each other, and companies with multinational business activities have extra reason to try to report their income as arising abroad rather than here. Both of these factors potentially disadvantage the United States relative to other countries, and the former (shifts in real activity) offers the most compelling explanation for recent evidence suggesting that the burden of the corporate tax increasingly is borne by workers, via effects on wages.[23] Lowering the corporate rate is therefore potentially an appealing policy change, subject to adequate consideration of (i) its revenue effects, (ii) the implications for shareholder-level taxation (which is not similarly subject to concerns about taxpayers exiting the U.S.), and (iii) achieving the desired level of overall tax progressivity.

D. Outbound Business Investment by U.S. Multinationals

The tax rules for outbound investment by U.S. multinationals badly need revisiting. Two competing approaches typically dominate policymakers' thinking about the taxation of such investment. The first holds that the U.S. should tax all foreign source income of its resident companies as soon as such income is earned, albeit subject to allowing foreign tax credits.[24] The second holds that the U.S. should instead exempt its

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Dividends on equity, by contrast, are nondeductible at the corporate level, not imputed unless paid, and (under expiring present law) generally are taxed to individual recipients at only a 15 percent rate.

[22] Two existing corporate integration proposals would generally eliminate the tax law distinction between debt and equity. First, the comprehensive business income tax (CBIT) that the U.S. Treasury Department proposed in 1992 would in effect treat debt more like equity, by denying deductions for interest at the business level and making the receipt of both interest and dividends generally tax-free to investors. See U.S. Treasury Department, Integration of the Individual and Corporate Income Tax Systems: Taxing Business Income Once (1992). Second, the business enterprise income tax (BEIT) proposal made by Edward D. Kleinbard, currently Chief of Staff of the Joint Committee on Taxation, would in effect treat equity more like debt, by causing an annual cost of capital allowance generally to be deducted at the entity level and included at the investor level. See Edward D. Kleinbard, *Rehabilitating the Business Income Tax.* Washington, D.C.: Brookings Institution Hamilton Project, 2007.

[23] See Gentry, supra.

[24] This approach is typically supported on either of two grounds. The first is the worldwide efficiency norm of capital export neutrality (CEN), under which it is optimal from a global economic standpoint if U.S. companies invest purely on the basis of pre-tax profitability. The second is the concern, from a U.S. national standpoint, that investment in the U.S. will decline if U.S. companies can lower their tax rates by investing abroad. Recent empirical evidence has tended to contradict this view. See James R. Hines, *Reconsidering the Taxation of Foreign Income* (2007). The issue here differs from that of whether lowering the general U.S. corporate tax rate will affect total U.S. investment, because the U.S. tax rules for outbound investment by U.S. companies affects only such companies, rather than all companies.

companies' foreign source active business income from bearing any U.S. tax.[25] The actual U.S. rules are an amalgam of the two that arguably manages to be worse than either. In brief, we allow deferral of any U.S. tax on U.S. companies' foreign source active business income, earned through their foreign subsidiaries, until it is repatriated or otherwise runs afoul of subpart F of the Internal Revenue Code. Unfortunately, deferral appears to give us the worst of both worlds. Given the available tax planning opportunities, observers generally agree that the current rules' efficiency costs are "extremely high relative to the revenue raised"[26] – almost the definition of a bad tax from the efficiency standpoint. The rules could almost certainly be improved by a combination of (a) repealing deferral and (b) sufficiently lowering the tax rate on foreign source income to offset the increased burden on taxpayers from repealing deferral.[27]

Others have argued that this does not go far enough, and that we should instead exempt such income from bearing any U.S. tax.[28] However, I do not entirely agree, although the fact that we discourage outbound investment by U.S. companies (rather than by other companies) when we tax it needs to be kept in mind. Suppose, for example, that the U.S. Congress decided to change current law on a revenue-neutral basis by either (a) raising the corporate rate but eliminating all taxation of U.S. companies' foreign source active business income, or (b) lowering the corporate rate but repealing deferral. Even assuming no effects on other countries' tax policies, no existing economic model convincingly establishes that one of these two approaches would be better than the other.

IV. EASING BURDENS ON LOWER AND MIDDLE-INCOME TAXPAYERS

Another key aim of fundamental tax reform should be to address pervasive public dissatisfaction with the income tax, which reflects the anxiety and needless burdens (wholly apart from taxes actually paid) that the system currently imposes on lower and middle income taxpayers. As my colleague on this panel, Michael Graetz, has noted, in 1940 the instructions to Form 1040 were just 4 pages long.[29] For the 2007 tax year, they were 155 pages long, and the basic form is supplemented by eleven schedules and

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[25] This approach is typically supported on any of three grounds. The first is capital import neutrality (CIN), under which it is optimal from a global economic standpoint if all savers that might make a given investment face the same tax rate. The second is capital ownership neutrality (CON, holding that it is optimal from a global standpoint if tax considerations do not distort business ownership decisions. (CON can in principle be satisfied by achieving CEN, but in practice it is typically viewed as instead counseling movement towards exemption. See Hines, supra.) The third is national welfare-based concern about U.S. companies' ability to compete with foreign companies when they consider investing abroad.

[26] Marsha Blumenthal and Joel B. Slemrod, *The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications*. In Joel B. Slemrod (ed.), THE TAXATION OF MULTINATIONAL CORPORATIONS (1996), at 48.

[27] See Rosanne Altshuler and Harry Grubert, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, forthcoming in John W. Diamond and George R. Zodrow (eds.), FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS. While such a proposal could be designed to be burden-neutral or revenue-neutral for outbound investment as a whole, inevitably it would have particular winners and losers. Obviously, however, no meaningful (or indeed any) reform would be possible if everyone's burden had to remain the same.

[28] See, e.g., Hines, supra.

[29] Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 Yale L.J. 263, 275 (2002).

innumerable worksheets. What is more, some of the complexities, such as the risk of owing alternative minimum tax even if one avoids all conscious tax planning, are becoming ever more widely applicable. Tax filing is therefore on a path to continue growing ever more burdensome even if the forms and instructions stop growing ever longer.[30]

All this complexity is not just a matter of slaying trees to supply the endless cascades of paper needed for all the forms. It undermines tax compliance and broader public trust. As Joseph Bankman notes, "[t]he average citizen dislikes the tax not because it distorts or discourages investment (although it does), but because it is complicated, because she finds filing expensive, time consuming, and anxiety provoking, and because she believes that complexity (and other factors) allow others to avoid paying their fair share."[31] Addressing this problem, even without major policy or revenue changes, would be surprisingly easy. William Gale, for example, notes that "return-free filing could be achieved for as many as 50 million taxpayers with relatively minor changes in the tax code… [It] already exists in dozens of countries around the world and would eliminate the hassles of filing and compliance for the households least able to cope with them."[32]

The available reform options – several of them complementary rather than mutually exclusive – include the following:

1) Adopt a federal version of the California ReadyReturn pilot program, under which the state government, relying exclusively on information that it had in any event, sent proposed draft tax returns to all who wanted them. This program was a wild success with the taxpayers who participated in it, but lost out in the state legislature due to an unholy alliance between Intuit, the maker of TurboTax, which evidently wanted to keep selling the service that the government was now offering for free, and extreme anti-tax advocates who wanted to make sure that taxpayers would stay as angry at the government as possible (even if this required making them miserable).[33]

2) Eliminate or greatly scale back the alternative minimum tax – assuming that this very costly change is appropriately financed through other changes to taxes or spending.

3) Simplify and consolidate tax breaks for education, retirement, and families,[34] while also addressing the compliance burdens associated with itemized deductions. For example, those for state and local taxes could be reduced sharply without an actual policy change if this were coordinated with scaling back or eliminating the alternative minimum tax. Other possible changes

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[30] Illustrating the ongoing trend towards increased complexity, Graetz, supra at 275, notes that the Form 1040 instruction booklet for 2001 was 122 pages long. In only six years, it has grown by 33 pages, or 27 percent.

[31] Joseph Bankman, *Simple Filing for Average Citizens: The California ReadyReturn.* 107 Tax Notes 1431 (May 31, 2005).

[32] William G. Gale, *Fixing the Tax System: Support Fairer, Simpler, and More Adequate Taxation."* Available on-line at http://www.taxpolicycenter.org/UploadedPDF/1001128_fixing_tax_system.pdf.

[33] See Bankman, supra.

[34] See Gale, supra, for a brief discussion of possible details.

include converting home mortgage interest deductions into refundable tax credits paid directly to lenders, and charitable deductions into matching grants paid directly to qualifying nonprofits.[35] Approaches of this kind have drawn bipartisan support in the past, and were included in both the Bradley-Gephardt tax reform proposal[36] that preceded 1986 tax reform and the more recent work of the President's Advisory Panel on Federal Tax Reform.

4) More dramatically, Congress could consider adopting Michael Graetz's plan to take 100 million taxpayers off the income tax rolls by enacting a huge exemption amount so that the tax only applied to high-income individuals, while replacing the lost revenue through enactment of a broad-based value-added tax (VAT).[37]

V. CONCLUSION

Fundamental tax reform seems almost impossible, but the income tax system is facing enough rising stress points to make doing nothing almost as painful as doing something controversial. Of the three main areas for reform effort that I have addressed, base-broadening is possibly the most painful but also potentially with a huge positive payoff for our society. Reform of the rules for taxing business enterprises has the potential to produce massive improvements even if overall policy (such as the level of taxation of saving or outbound investment) remains approximately the same. Easing burdens on lower and middle-income taxpayers could produce huge political rewards – and deservedly so, if millions of taxpayers' lives have been made a bit easier on and around each April 15 – although there, too, tough choices and the creation of both winners and losers cannot be entirely avoided.

[35] See Leonard E. Burman, *The Urgent Need for Tax Reform and Why It Might Happen* 9 (2008).
[36] Fair Tax Act of 1983, H.R. 3271, 98th Cong., 1st Sess. (1983); S. 1421, 98th Cong., 1st Sess. (1983).
[37] See Michael J. Graetz, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES. New Haven: Yale University Press, 2008. While income assessment of low-income families may remain necessary to continue delivering certain desirable tax benefits, such as variants of the refundable child tax credit and the earned income tax credit, the Graetz plan offers mechanisms that arguably resemble return-free filing.