Case Western Reserve Law Review

Volume 47 | Issue 1

1996

Frontiers of Tax Reform

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BOOK REVIEW

FRONTIERS OF TAX REFORM.
EDITED BY MICHAEL J. BOSKIN.†
STANFORD: HOOVER INSTITUTION PRESS.
PP. XVII - 202. $32.95.

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Radical tax reform is on hold, but dissatisfaction with the current revenue system is so pervasive that the possibility of change won't go away. Of course, if significant change actually occurred, we'd immediately start longing for the good old days.

There's already pining for the Camelot that, conventional wisdom has it, was the Tax Reform Act of 1986.[1] After its enactment, popular and scholarly works praised the unusual public-spiritedness reflected in its passage.[2] Everyone assumes "[m]oney is the

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1. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

2. *See, e.g.*, JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM (1987); TIMOTHY J. CONLAN ET AL., TAXING CHOICES: THE POLITICS OF TAX REFORM (1990). Substantial positive discussion of the 1986 Act can also be found in HEDRICK SMITH, THE POWER GAME: HOW WASHINGTON WORKS (1988). A less starry-eyed view of the politics behind the passage of the 1986 Act is presented in BARBER A. CONABLE, JR.,

engine that fuels much of our politics,"[3] but in 1986, the story goes, money ran out of gas. For one brief shining moment, the Gucci-clad lobbyists were repulsed by Congress, and the public interest was served.

But the 1986 victory, such as it was, came undone. Hence the pining. Michael Boskin, an economist affiliated with Stanford University and the Hoover Institution, and a former chairman of the Council of Economic Advisers, writes in *Frontiers of Tax Reform*, "[T]he implicit 1986 contract for a broader base and lower rates has been dramatically reversed—first in 1990, with a modest increase in effective tax rates (but a whopping break of a political pledge!), and substantially in 1993, when top marginal rates were increased by about one-third!"[4]

In fact, the Tax Reform Act of 1986 was never as virtuous as its proponents suggested. The '86 Act took a lot of low-income people off the income-tax rolls, and that was good for them. But it didn't mean simplification for many of us, except in the most trivial sense—lessening the number of tax brackets.[5] Even had the Act not contained oxymoronic horrors like the passive activity loss rules,[6] it would have been an interpretational challenge. Change is itself confusing. Boskin notes, "In many ways the simplest tax system would be one that was the same year after year after year, facilitating planning and diffusing understanding."[7] And some of the true 1986 simplifications—like eliminating the capital gains preference[8]—bit the dust quickly.

The process that gave birth to the Act was also overpraised. Former Congressman Barber Conable has argued that the process was not that different from business-as-usual and, for that matter, the usual in tax matters is not nearly as bad as people think.[9] The Internal Revenue Code grows complex not because of private inter-

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CONGRESS AND THE INCOME TAX 78-91 (1989).

3. Albert R. Hunt, *Introduction to* BIRNBAUM & MURRAY, *supra* note 2, at xii.

4. Michael J. Boskin, *Introduction to* FRONTIERS OF TAX REFORM xi, xii (Michael J. Boskin ed. 1996) [hereinafter FRONTIERS].

5. Since most taxpayers look at tables to figure out the tax due, whether there are two brackets or 105 doesn't matter. For planners, the critical consideration is the marginal rate, which also doesn't depend on how many brackets there are.

6. Although monstrously complex, the passive activity loss rules in Internal Revenue Code section 469 have been characterized as simplifications, in that they destroyed the tax shelter industry at which they were directed. *See* Stanley A. Koppelman, *At-Risk and Passive Activity Limitations: Can Complexity Be Reduced?*, 45 TAX L. REV. 97 (1989).

7. Boskin, *supra* note 4, at xiii.

8. Having no preference for capital gains is unquestionably a simplification; much (although certainly not all) of the Internal Revenue Code's complexity can be reduced if taxpayers have less incentive to structure their affairs to lower the rate at which income will be taxed.

9. *See* CONABLE, *supra* note 2, at 78-91.

ests asserting their power unchecked, but because of Congressmen acting in good faith (for the most part), trying to treat different cases differently. Conable labels this the "ABC syndrome": since A's case is slightly different from B's, which is slightly different from C's—and so on—each deserves special treatment. One man's loophole is another man's national priority. Tax complexity is a price we pay, Conable argues, for representation and compromise—and for living in a complex society. Thus the breakdown of the '86 Act was neither surprising nor distressing.

Whatever the merits of the '86 Act, Michael Boskin and the other twelve contributors to *Frontiers of Tax Reform*, a valuable collection of papers originally presented at a Hoover Institution conference held in May 1995, are not really interested in going back to 1986. With only a couple of exceptions, the contributors are economists,[10] and they want to start over with a dramatically different tax system. None of them defend things-as-they-are. Although they disagree on particulars, the contributors are in almost complete agreement that a move to a consumption tax is the way to go. Some even think major change is inevitable.[11]

In the last paragraph of *Frontiers*, Harvard economist Dale Jorgenson pretty much sums up the conference:

> [C]hanging the federal tax base from income to consumption is an idea whose time has come. This change will create important new opportunities for growth in the standard of living of all Americans. The traditional objections to consumption as a base for taxation on grounds of fairness have been successfully addressed in the Armey flat tax and the Nunn-Domenici USA Tax proposals. These proposals would create substantial new growth opportunities for the U.S. economy. Both are based on well-established economic ideas and could serve as a point of departure for tax reform legislation.[12]

Jorgenson is writing only for himself, and not all the contributors would agree with everything he says. For example, Cato Institute economist Stephen Moore would hold out, on libertarian grounds, for a national sales tax.[13] But I can imagine a lot of heads at the

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10. The exceptions are Kenneth Kies, a lawyer and Chief of Staff for the Joint Committee on Taxation, and U.S. Representative Bill Archer, self-described as "the first chairman of the Ways and Means Committee to do his own tax return year after year." Bill Archer, *Goals of Fundamental Tax Reform*, *in* FRONTIERS, *supra* note 4, at 3, 4.

11. *See, e.g.*, Stephen Moore, *The Economic and Civil Liberties Case for a National Sales Tax*, *in* FRONTIERS, *supra* note 4, at 110, 118 ("Broad-based tax reform seems almost a political certainty over the next two years.").

12. Dale W. Jorgenson, *The Economic Impact of Fundamental Tax Reform*, *in* FRONTIERS, *supra* note 4, at 181, 194.

13. *See* Moore, *supra* note 11, at 114-19 (arguing that neither the Armey flat tax nor

conference nodding yes, yes, yes, as Jorgenson spoke.

I'm skeptical that any important tax can really be structured so we can use postcards to file our returns, as Robert Hall and Alvin Rabushka suggest in their essay[14]—a condensation of the book that provides the intellectual framework for Representative Dick Armey's flat-tax plan.[15] From their ivory-tower podia, Hall and Rabushka robustly recommend eliminating all non-business (and many business) deductions, effectively turning what looks like an income tax into a consumption tax. Maybe it is politically possible to dispense with interest deductions and interest income, as Hall-Rabushka suggest, and to substitute expensing for the incredible complexities of depreciation allowances.[16] But flat-tax proposals hit the political wall when they consider eliminating deductions for home-mortgage interest and charitable contributions.[17]

Nitpicking aside, everyone agrees that even a less-than-perfect consumption tax could be much simpler than the current income-tax system, and everyone wants simplicity[18]—except those of us who would have to find new professions.[19] As Charles McLure

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the Nunn-Domenici USA Tax proposal adequately addresses the intrusiveness of the current tax code, which is a civil liberties rather than an economic concern).

14. *See* Robert E. Hall & Alvin Rabushka, *The Flat Tax: A Simple, Progressive Consumption Tax, in* FRONTIERS, *supra* note 4, at 27, 31-36.

15. ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995).

16. *See* Hall & Rabushka, *supra* note 14, at 35.

17. Perhaps because of his government experience, Boskin realistically suggests a gradual transition if the home-mortgage-interest deduction is to be eliminated. *See* Michael J. Boskin, *A Framework for the Tax Reform Debate, in* FRONTIERS, *supra* note 4, at 11, 24 (noting that home values reflect the mortgage-interest deduction and that the largest asset for a majority of American families is home equity). He also argues that "the charitable deduction yields more for charities than it 'loses the Treasury' (i.e., it is an efficient way to finance charities)." *Id.* Preserving the deduction would then make sense even under a flat tax.

18. The area of clearest agreement among the contributors is that too much time and energy are devoted to compliance under today's system. Boskin writes that estimates of the compliance burden "range from more than $100 billion to almost $600 billion, with well over 5 billion hours of human effort devoted to that task." *Id.* at 10. Hall and Rabushka add, "Complex tax forms and tax laws do more harm that [sic] just deforesting America. Complicated taxes require expensive advisers for taxpayers and equally expensive reviews and audits by the government." Hall & Rabushka, *supra* note 14, at 29. And Murray Weidenbaum, Washington University economist and another former chair of the Council of Economic Advisers, quotes Robert Eisner: "I am happy to stipulate that we waste many, many billions of person-hours and hundreds of billions of dollars in administering, complying with and seeking to avoid or evade current income taxes." Murray Weidenbaum, *The Nunn-Domenici USA Tax: Analysis and Comparisons, in* FRONTIERS, *supra* note 4, at 54, 62 (quoting ROBERT EISNER, THE PROPOSED SALES AND WAGE TAX: FAIR, FLAT OR FOOLISH? (paper presented to the American Enterprise Institute, Washington D.C.)).

19. Maybe this should concern everyone. What mischief would we tax lawyers and accountants get into if we didn't have a complex law to administer? One might think of the current tax law as a public works scheme: it keeps lawyers and accountants occupied and out of trouble. I am indebted (in a legally unenforceable way) to Jonathan Entin—an

and George Zodrow emphasize in their fascinating essay on the direct taxation of consumption, a consumption tax can be based on cash flow.[20] We therefore could do away with many of the timing rules that have encumbered the income tax, and could avoid (or at least lessen) the distortion of the income-tax base caused by inflation.

Of course, a consumption tax has more than simplification to recommend it. Tufts University economist Gilbert Metcalf argues that the goal of defining income is chimerical; we're fooling ourselves if we think we can do it in an intellectually defensible way.[21] Moving to a consumption tax, particularly a value-added tax, would give us something we *can* define and measure as a tax base. And consumption may well serve as a useful approximation for income. Michael Boskin argues that taxpayers typically smooth out consumption when income fluctuates: "Consumption in any year may well be a better proxy for permanent income than is income in that year."[22]

The most important justification for a consumption tax is that it would further national savings and capital formation, a goal all *Frontiers* contributors endorse. For example, Boston University economist Laurence Kotlikoff emphasizes, "Our country continues to save at a critically low rate and, correspondingly, consume at an extremely high rate."[23] Boskin adds, "[C]apital formation is taxed especially heavily in the United States, relative to other uses of income and relative to our competitors."[24]

Among their many virtues, the essays in *Frontiers* set out the basics of the major consumption-tax alternatives that have been discussed in the past couple of years. Not everything is new—indeed, many of the papers are modifications of previously

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administrative law specialist, for crying out loud—for this interesting thought.

20. *See* Charles E. McLure Jr. & George R. Zodrow, *A Hybrid Approach to the Direct Taxation of Consumption, in* FRONTIERS, *supra* note 4, at 70 (proposing a hybrid consumption tax based entirely on cash flow, including cash flow treatment of borrowing and lending for businesses, but not for individuals). McLure and Zodrow are economists at The Hoover Institution and Rice University, respectively.

21. *See* Gilbert E. Metcalf, *The Role of a Value-Added Tax in Fundamental Tax Reform, in* FRONTIERS, *supra* note 4, at 91, 106.

22. Boskin, *supra* note 17, at 19.

23. Laurence J. Kotlikoff, *Saving and Consumption Taxation: The Federal Retail Sales Tax Example, in* FRONTIERS, *supra* note 4, at 160, 160. Kotlikoff presents interesting data demonstrating that there have been both a redistribution of resources to older Americans and a decline in the propensity of older Americans to save. *See id.* at 163-65.

24. Boskin, *supra* note 17, at 18 (emphasis deleted). *See also* Jorgenson, *supra* note 12, at 181 ("To achieve a more satisfactory growth performance, the tax burden on investment must be reduced substantially."); *id.* at 193 ("[I]ncreases in tax rates for upper-income taxpayers in 1990 and 1993 have nullified many of the growth opportunities for the U.S. economy created by the Tax Reform Act of 1986."). Ah-h-h, the '86 Act. *See supra* notes 1-11 and accompanying text.

published work—but it's good to have the material collected in one place. Hall and Rabushka discuss their flat-tax proposal.[25] Weidenbaum evaluates the Nunn-Domenici USA (unlimited savings allowance) Tax, another form of consumption tax that would use the income-tax structure as a starting point.[26] Several essays consider the value-added tax ("VAT") and other versions of a national sales tax.[27] McLure and Zodrow promote a hybrid direct consumption tax that would pick up characteristics from some of the other proposals.[28] And so on.

The essays, not surprisingly, are of varying quality, but each is worthy of study. Because the authors are mostly economists writing about economics, the reading can be rough going at times. Elsewhere I've written that "[i]t's the prose that makes economics the dismal science,"[29] but the prose is actually quite good here. It's just that the material doesn't lend itself to the literary equivalent of sound bites.

Also not surprisingly, where many of the essays fall down is in their tenuous connection to the real world. The possibility that any of the proposals might be adopted in something like a pristine form is so remote as to be laughable.[30] These are academic agenda-setting pieces, not politicians' proposals. I think the authors know that, but flashes of realism appear only as asides. For example, Hall and Rabushka write, "We have not made concessions to the political pressures that may well force the nation to accept an improved tax system that falls short of the ideal we have in mind."[31] Ronald Pearlman, former Chief of Staff of the Joint Committee on Taxation, recently complained that "[s]o far this debate [about consumption taxes] has taken place in a very academic context."[32] *Frontiers* is exactly the sort of thing Pearlman is referring to.

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25. *See* Hall & Rabushka, *supra* note 14.

26. *See* Weidenbaum, *supra* note 18, at 54 (noting that under the Nunn-Domenici plan, the individual income tax would be converted into a progressive consumption tax while a new business tax would replace both the existing corporate tax and the individual tax on profits from businesses).

27. *See* Metcalf, *supra* note 21; Moore, *supra* note 11; Kotlikoff, *supra* note 23.

28. *See* McLure & Zodrow, *supra* note 20.

29. Erik M. Jensen, *An Economics Book That's Fun To Read*, PLAIN DEALER (CLEVELAND), Feb. 20, 1994, at 11H (reviewing STEVEN E. LANDSBURG, THE ARMCHAIR ECONOMIST (1994)). I also wrote: "Can you imagine the late Orson Welles running the 100-yard dash? That's how most economists write—thump, wobble, thump, wobble. You get nowhere slowly, and you want to throw up at the end." *Id.*

30. *See supra* notes 16-17 and accompanying text.

31. Hall & Rabushka, *supra* note 14, at 41.

32. Louis Lyons, *Pearlman: Transition Problems May Stop Reform, But Not an Add-on VAT*, 72 TAX NOTES 792, 792 (1996) [hereinafter *Pearlman*] (quoting Ronald A. Pearlman).

That the essays suffer from academic otherworldliness doesn't mean that we should resist simplification—certainly we should study ideal models before we return to earthly policy—but we do need to be realistic in evaluating particular proposals. *Frontiers* would have been strengthened if there had been more participation by consumption-tax skeptics; the income tax after all, have its defenders, even among economists.

Major, long-lasting tax reform is likely to founder for two reasons. One is the ABC syndrome described by Barber Conable.[33] Equally important—maybe more important—are the transition problems in moving to an entirely different revenue system. These problems may not be fatal, but they can't be ignored.[34]

The most important essay in this book, dealing with many of the potentially intractable transition problems, is by Princeton University economist, David Bradford.[35] Recognizing that we've had major tax legislation before, Bradford urges us to plow ahead with a consumption tax, but he doesn't minimize the transition difficulties. Bradford has thought hard about such issues as how we should deal with consumption from "old capital," capital that was saved on an after-tax basis under the old tax regime. How should we deal with a taxpayer who acquired depreciable property under the old regime basing his investment decision on a stream of depreciation deductions that will disappear under a consumption tax? And McLure and Zodrow remind us that the United States has entered into a multitude of double-taxation treaties, all of which would have to be renegotiated if the United States changes its tax system.[36] Tough problems.

If we do move toward a consumption tax, what form should it take? In general, the *Frontiers* essays show little enthusiasm for a VAT. A European model VAT is not a simple taxing mechanism,

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33. *See supra* text following note 9.

34. David Bradford writes:

> There seem to be two main attitudes toward transition in connection with major tax reform. One approach is to minimize it in the interest of moving ahead to achieve the reformer's objective. The other is to become intimidated with the problems of transition so that they form a roadblock to change.

David F. Bradford, *Consumption Taxes: Some Fundamental Transition Issues, in* FRONTIERS, *supra* note 4, at 123, 147. Hall and Rabushka discuss how to deal with transition problems, particularly the treatment of depreciation and interest deductions associated with obligations entered into under the existing tax system, but their hearts aren't in it: "Fortunately, this is a temporary problem. Once existing capital is fully depreciated and existing borrowing paid off, any special transitions provisions can be taken off the books." Hall & Rabushka, *supra* note 14, at 41.

35. *See* Bradford, *supra* note 34.

36. *See* McLure & Zodrow, *supra* note 20, at 71.

particularly for a nation in which such a tax would be entirely new. Weidenbaum notes, "Despite the wishes of some of the proponents, under [a VAT], the Internal Revenue Service will not wither away."[37] And there are legitimate concerns about the regressivity of a VAT,[38] although some contributors think those concerns are overstated or can be overcome.[39]

Several *Frontiers* authors are worried that, because a VAT is so politically palatable—after an adjustment period, the tax becomes invisible and therefore painless[40]—it would be enacted not as a replacement for the existing system, but in addition to it. For example, Weidenbaum writes that both the Nunn-Domenici and the Armey-Hall-Rabushka proposals "are similar enough to the existing income tax to avoid the danger that accompanies a sales tax or VAT—the likelihood that Congress will wind up approving both (that was the case with Medicare and Medicaid, which originally

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37. Weidenbaum, *supra* note 18, at 66.

38. It would surprise the man on the street, but there's substantial agreement that the current system is progressive. Boskin writes, "Today the top 5 percent of taxpayers pays almost half of all federal income taxes, and the bottom 50 percent, only 5 percent." Boskin, *supra* note 4, at xii. Moore adds, "[A]fter Ronald Reagan cut income tax rates in the 1980s, the share of income taxes paid by the wealthiest 1 percent of Americans went from 18 percent in 1981 to 25 percent in 1990." Moore, *supra* note 11, at 111 (citing Stephen Moore, *Weighing Reaganomics*, SAN DIEGO UNION, Nov. 10, 1991, at c1, c4, and LAWRENCE LINDSEY, THE GROWTH EXPERIMENT 82-104 (1990)). And Kies writes: "The taxpayers in the bottom 40 percent bracket pay 4.9 percent of the combined income tax and Social Security taxes, assuming all Social Security taxes are paid by the employee. The top 1 percent pays 18.6 percent. The top 10 percent pays about 48.6 percent." Kenneth J. Kies, *Providing Appropriate Information on Tax Reform, in* FRONTIERS, *supra* note 4, at 151.

39. Kotlikoff argues that the "concern [about] the lack of progressivity of a proportional national sales tax . . . has been overstated because progressivity has been measured in terms of annual, rather than lifetime, income." Kotlikoff, *supra* note 23, at 171. A sales tax could be made progressive, he argues, through a refundable credit. *See id.* Moore suggests a rebate of the sales tax paid on the first $5,000 of purchases. *See* Moore, *supra* note 11, at 117. *But see* David G. Raboy, *Consumption Tax Preferential Treatment: Poor Cure for Regressivity*, 72 TAX NOTES 901 (1996) (arguing that preferential treatment for necessities like food does not cure, and in fact may worsen, regressivity problems of consumption taxes).

40. Or if it's visible it's avoidable by not buying affected products. Thomas Cooley wrote in 1876:

> [T]his method enables the government, in the language of Turgot, "to pluck the goose without making it cry out," since those who pay do not perceive, or at least do not reflect, that a part of what they pay as price is really paid as a tax. Montesqueiu says: "There are two states in Europe where the imposts are very heavy upon liquors; in one the brewer alone pays the duty, in the other it is levied indiscriminately upon all the consumers; in the first, nobody feels the rigor of the impost, in the second, it is looked upon as a grievance. In the former, the subject is sensible only of the liberty he has of not paying, in the latter, he feels only the necessity that compels him to pay."

THOMAS M. COOLEY, A TREATISE ON THE LAW OF TAXATION 5 n.3 (Chicago, Callaghan and Company 1876) (quoting MONTESQUIEU, SPIRIT OF THE LAWS, bk. 13, ch. 7).

were developed as alternatives rather than supplements to each other)."[41] Boskin also fears that a VAT might be used as a supplemental diet to feed the omnivorous federal bureaucracy; in other industrialized countries VATs don't replace complex income-tax systems.[42] And transition issues are greatly reduced with an add-on tax. In short, a VAT is *too* politically feasible because it needn't take the place of anything.[43]

Frontiers of Tax Reform has much to feast on, but one quixotic issue is ignored in all the papers. In their essay, McLure and Zodrow draw an important distinction: "Indirect consumption taxes [like a VAT] are levied on business with the expectation that they will be shifted to consumers," while "direct consumption taxes [like the flat tax] are levied 'directly' on the consumption of individuals, commonly through the filing of tax returns."[44] The terms "indirect" and "direct" might remind the non-economist—economists needn't worry about mundane things like the Constitution—of two constitutional provisions that limit congressional power to enact "direct taxes."[45] The way terms are used by economists in 1996 doesn't necessarily tell us anything about the meaning of the Constitution, but neither are modern definitions necessarily irrelevant. Doesn't anyone worry about the constitutionality of unapportioned consumption taxes, especially *direct* consumption taxes?[46]

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41. Weidenbaum, *supra* note 18, at 65.

42. *See* Boskin, *supra* note 14, at 23.

43. *See Pearlman, supra* note 32, at 792 (arguing that a VAT is likely to be added on to our income tax system, in part because there would be few transition problems, and commenting that "in the real world, I don't see a full replacement system. I just don't see it happening.").

44. McLure & Zodrow, *supra* note 20, at 70.

45. *See* U.S. CONST. art. I, § 2, cl. 3 (requiring direct taxes to be apportioned according to population); U.S. CONST. art. I, § 9, cl. 4 (prohibiting direct taxes, except those that are proportional to population). The Sixteenth Amendment eliminated the apportionment requirement for "taxes on incomes," regardless of the source of the income, but by its terms it did nothing to change the requirement for other direct taxes. *See* U.S. CONST. amend. XVI.

46. Well, yes, someone does. *See* Erik M. Jensen, The Meaning of "Direct Taxes:" The Constitutionality of Consumption Taxes (not done yet, but soon).