

Prospects for U.S. Tax Reform

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Current Situation

- Unstable tax environment:
- Many provisions from 2001 and 2003 scheduled to expire at the end of 2010
 - reduced marginal tax rates
 - favorable rates (15%) on dividends and capital gains
 - reduction and elimination of estate tax

Current Situation

- Unstable tax environment:
- Alternative minimum tax (a parallel tax system) growing more intrusive each year because not indexed for inflation
- Temporary corrections getting more and more difficult because need to undo more and more past years of inflation

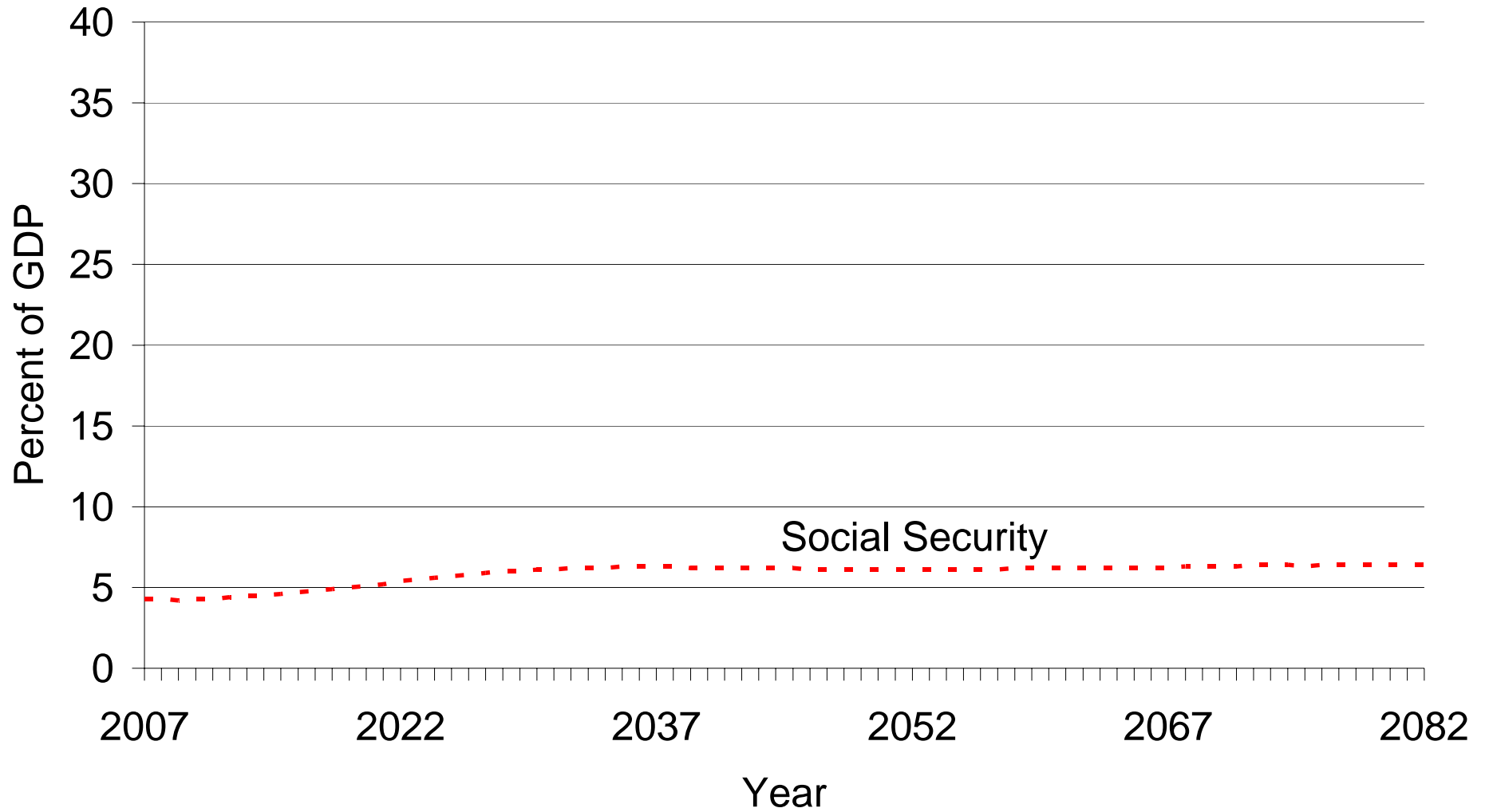
Current Situation

- Unstable tax environment:
- Corporate tax rate (35%) now among the highest in the world and hence under pressure due to tax competition for multinational activities

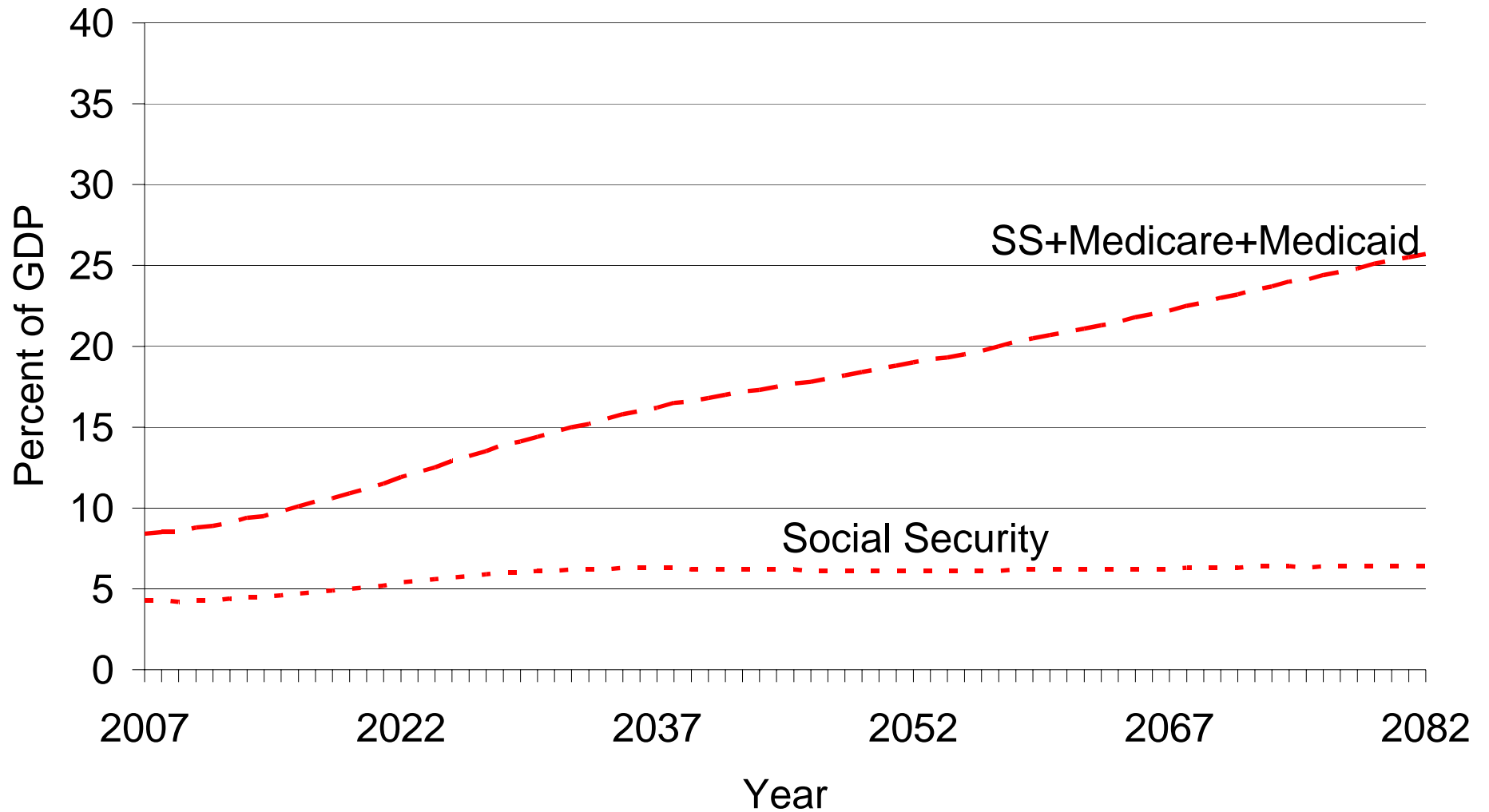
Current Situation

- Unstable fiscal environment:
- Unfunded old-age pension and health care systems projected to have major gaps between taxes and spending over next several decades, due to aging population and rising per capita health spending

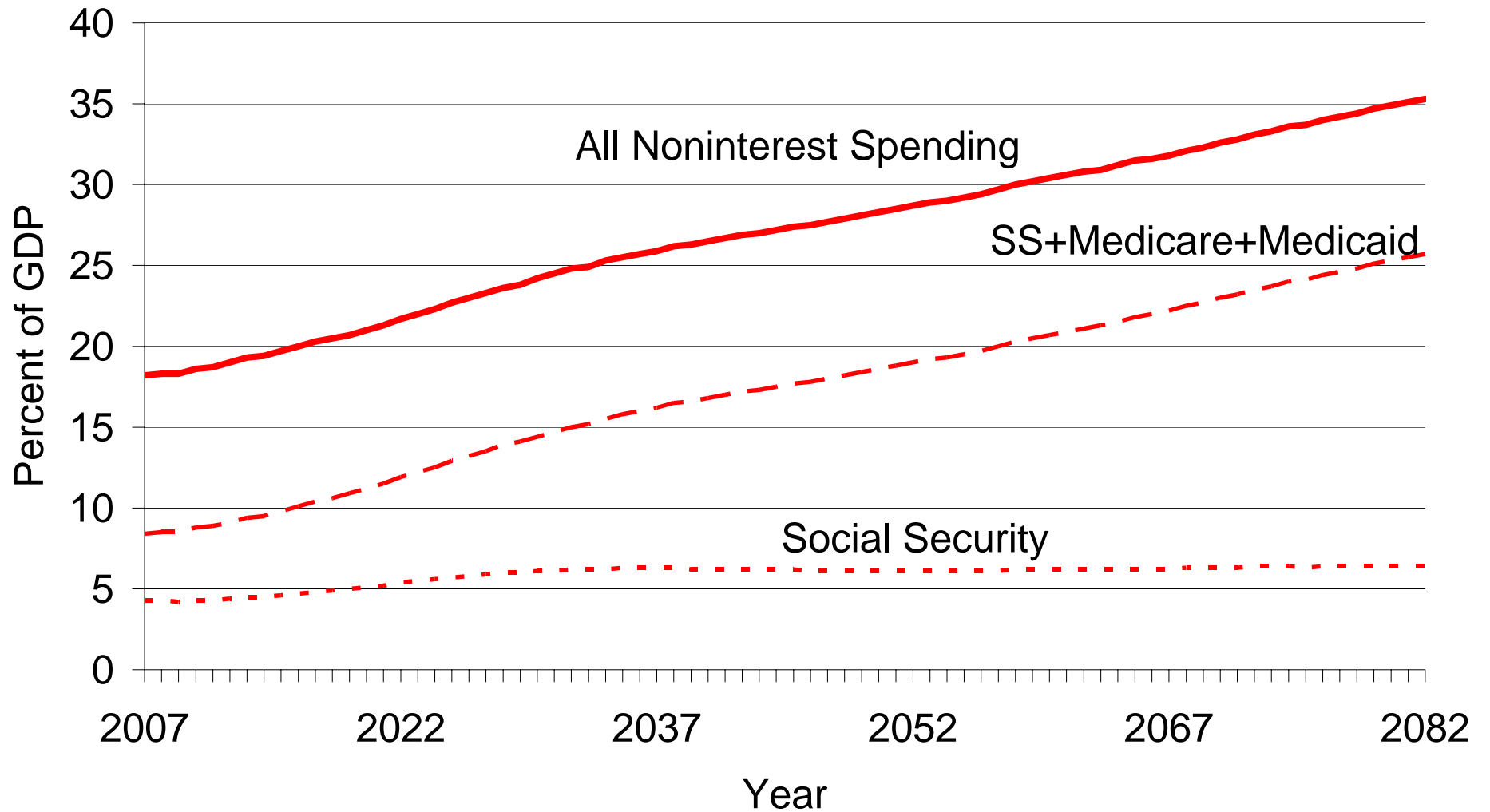
U.S. Federal Spending and Revenue



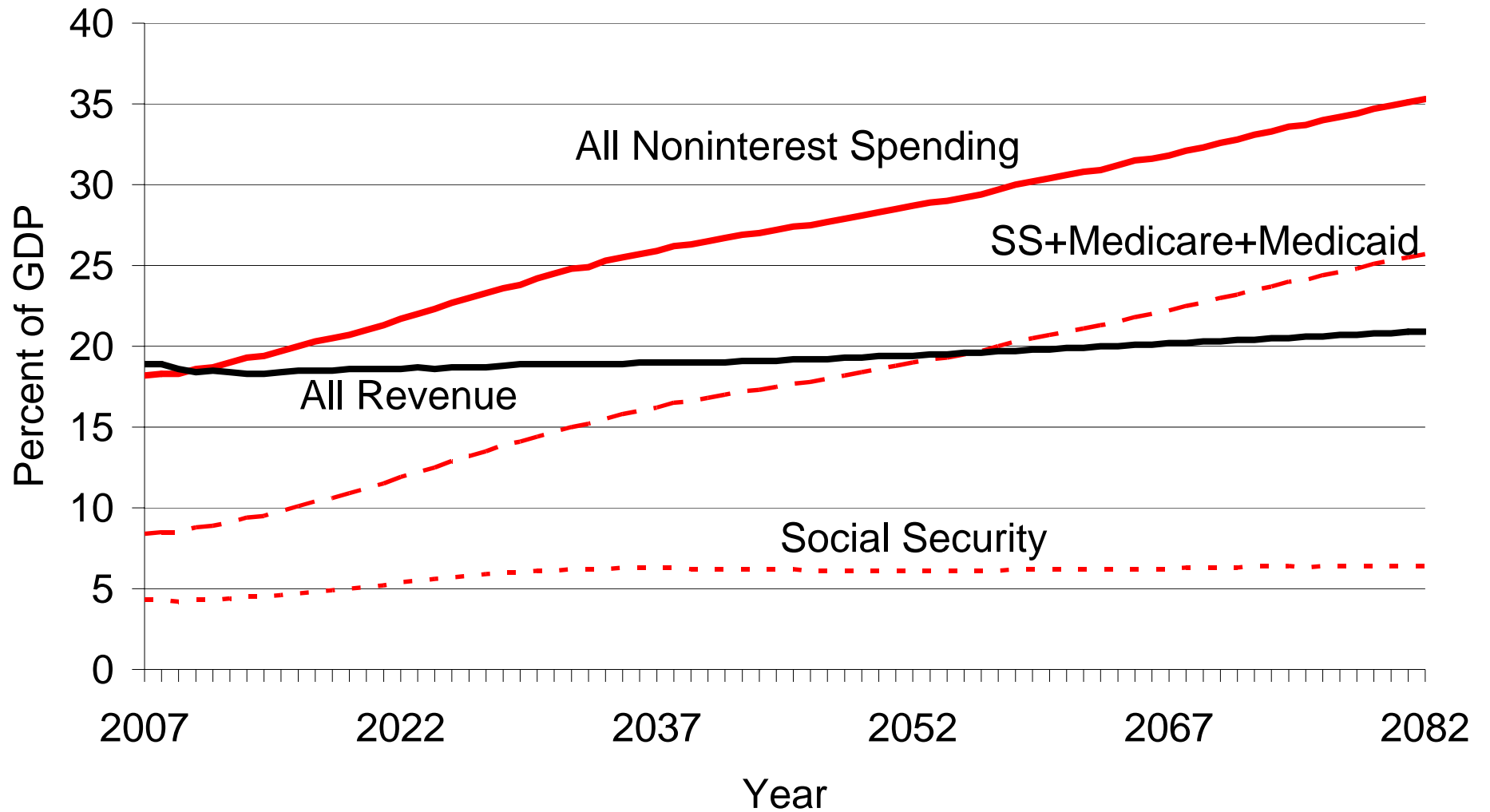
U.S. Federal Spending and Revenue



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U.S. Federal Spending and Revenue



Current Situation

- Summary:
- Tax system can't be left "as is"
 - more permanent system needed
 - certain structural forms likely
 - if growth of benefits is not substantially reduced, tax increases will be needed

Options for Tax Policy

- Several possible paths, even if revenue increases left aside
- Can group by size: small, medium or large
- Little or nothing will happen before 2008 election

Options for Tax Policy

- Small:
 - resolve expiring provisions, probably keeping some and not others, based in part on income
 - permanently change AMT without removing it
 - reduce the corporate tax rate by a few percentage points while broadening the corporate tax base
- On the agenda; nothing accomplished yet

Options for Tax Policy

- Medium:
- Maintain or even lower marginal tax rates by substantial broadening of the tax base
 - reduce or cap tax deductions (mortgage interest, health insurance, state & local taxes, etc.)
 - eliminate AMT
 - not increase taxes on capital income and make less distortionary by removing asset- and finance-based inconsistencies

Options for Tax Policy

- Medium:
- Approach taken by the President's Tax Reform Panel (2005)
 - Proposed two variants, both with these characteristics
 - Both variants also estimated to maintain existing distribution of tax burden, so aimed at being politically feasible, as in 1986
 - One variant reduced capital income taxes by moving toward a progressive consumption tax

Options for Tax Policy

- Large:
- Replace all or part of tax system with a new one
 - Introduce a VAT to replace corporate tax, payroll tax, or income tax for most taxpayers
 - Introduce a progressive consumption tax, possibly based on a VAT, to replace all taxes
 - Introduce a retail sales tax to replace all taxes

Options for Tax Policy

- Large:
- Replace all or part of tax system with a new one
 - All involve replacing capital income taxes with consumption taxes
 - But entirely new taxes face additional resistance and raise problems of transition
 - Retail sales tax has additional administrative problems, and is regressive

Whither the U.S. Tax System

- Small reform most likely
- Large reform promises greatest increase in economic efficiency (perhaps several percent of GDP in the long run)
- But many of the biggest tax distortions could be eliminated through a “medium” reform because they aren’t a necessary part of existing tax system

Whither the U.S. Tax System

- But distortions that are gratuitous from an economic perspective aren't from a political perspective
 - Example: mortgage interest deduction; unfortunately, current housing slump makes reform even more difficult
- So, something must happen, but with small reform, resulting system won't be bad enough to spur larger reform

Whither the U.S. Tax System

- But, if revenue must increase, political incentives for more fundamental reform will grow, since alternative will be a substantial increase in marginal tax rates
- In summary, failure with respect to other elements of fiscal policy may make tax reform success more likely; but this would be many years from now