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Three Versions of Tax Reform

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ESSAY

THREE VERSIONS OF TAX REFORM*

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My subject this afternoon is tax reform, which again rose to the top of the U.S. political agenda during last year's presidential campaign. My principal goal in this lecture will be to explore three different versions of tax reform. In order to provide some context for that exploration, I would like to begin by briefly comparing taxation in the United States to taxation in other industrialized countries, focusing on three attributes of a mature tax system.

The first attribute is the overall level of taxation. Although rarely emphasized in American political discourse, the overall level of taxation in the United States is much lower than in other developed countries. In 1994, the most recent year for which comparative figures are available, the total of all taxes, including social security taxes, at all levels of government in the U.S. was 27.6% of gross domestic product.[1] Of the twenty-eight developed countries that made up the membership of the Organisation for Economic Cooperation and Development (OECD), only Turkey and Mexico had lower overall levels of taxation. The OECD average was 38.4% of gross domestic product, while the European Union average was 42.5%.[2]

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1. *See* ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, REVENUE STATISTICS OF OECD MEMBER COUNTRIES, 1965-1995 74 (1996 ed.).

2. *See id.*

Turning now from the overall level of taxation to a second attribute, the type of taxes imposed, the United States also differs from most other industrialized nations. Once again, looking at 1994, income taxes provided a comparatively high 44.6% of all American government revenue.[3] Social security taxes provided 25.5%, sales and other consumption taxes 17.9%, and property taxes 12%.[4] Most other developed countries rely significantly less on income taxes and significantly more on consumption taxes. On average, for example, consumption taxes constituted 31.9% of the tax revenue of OECD countries in 1994, almost twice the 17.9% in the United States.[5] To a large extent, this difference is explained by the widespread adoption of value-added taxes over the last thirty years throughout the industrialized world, with the notable exception of the U.S.

Focusing now particularly on income taxes, the third and final tax system attribute that I want to emphasize is the relationship between the individual and corporate income taxes. The United States continues to have a so-called classical system of income taxation, under which income earned through corporations can be taxed twice, once when earned by the corporation and again on distribution to shareholders. Over the last thirty years, most other developed countries have integrated their individual and corporate income taxes into a single system that is intended to eliminate or reduce this double burden.[6]

This brief international comparison of tax systems can be summarized as follows: first, taxes in the U.S. are lower than in other industrialized countries; second, the U.S. relies relatively more on income taxes and less on consumption taxes than do other industrialized countries; and, finally, the U.S. is one of very few such countries that continues to levy individual and corporate income taxes that are separate and cumulative.

Given that background, let me now turn to three versions of tax reform in the U.S. In each case, I plan to focus on the intel-

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3. *See id.* at 77.

4. *See id.*

5. *See id.*

6. *See, e.g.*, PETER A. HARRIS, CORPORATE/SHAREHOLDER INCOME TAXATION AND ALLOCATING RIGHTS BETWEEN COUNTRIES 561-789 (1996).

lectual foundations of tax reform, the use of those ideas in the political process, and the level of understanding of the ideas by the tax paying public.

I. IMPROVING AN EXISTING TAX BASE

The first version of tax reform that I want to explore is the regular work of improving an existing tax base. Given the relative importance of income taxation in the United States, it is not surprising that "tax reform" in the U.S. generally has meant refinement and improvement of the income tax.

The seminal American formulation of the concept of income for these purposes is the celebrated definition articulated by the University of Chicago economist Henry Simons in the 1930s.[7] Given the centrality of what has come to be called the Haig-Simons definition of income to our first version of tax reform, it is worth quoting the concept in detail:

> Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning. The *sine qua non* of income is *gain*, as our courts have recognized in their more lucid moments—and gain *to* someone during a specified time interval.[8]

The key idea in this quite abstract formulation is that gains or increases in wealth, from whatever source, constitute the ideal personal income tax base, whether those gains are saved or spent on current consumption. This idea is not, however, directly translatable into an operational income tax, which has always

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7. *See* Richard A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 47 n.7 (1967) (indicating that an earlier version of the concept was proposed by George Schanz in *Der Einkommensbegriff und die Einkommensteuergesetze*, 13 FINANZ ARCHIV 1 (1896) and introduced into American discussion in THE FEDERAL INCOME TAX (R. Haig ed., 1921)).

8. HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

used transactions, such as the receipt of salary or sale of assets, rather than mere changes in value, to trigger taxation.[9]

The Haig-Simons definition was thus but the beginning for our first version of tax reform. The concept had to be translated into operational terms to deal with questions such as the following:

(1) Should fringe benefits be taxed differently from salary under an income tax?

(2) Should capital gains be taxed at a lower rate than other income?

(3) How should capital cost recovery for machinery and equipment be designed under an income tax?

(4) How should the income tax burden be affected by marital or family status?

These and hundreds of similar questions have been addressed in a remarkable outpouring of writing on income tax policy since the end of the Second World War. One of the notable features of this literature is that it has been a joint enterprise of economists and lawyers in the government, in the universities, and in private practice. For example, the House Ways and Means Committee published an important compendium of papers on "broadening the tax base" in 1959.[10] Academic lawyers and economists debated the merits of a "comprehensive tax base" in the 1960s.[11] Important Treasury Department studies of tax reform were published in 1969,[12] 1977,[13] and 1984.[14] The American Bar Association Section of Taxation published an evaluation of the proposed model "comprehensive income tax" in 1979.[15] And

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9. *See* I.R.C. § 61 (West Supp. 1997) (defining gross income in terms of transactions that produce the income).

10. *See* SUBCOMM. ON TAX POLICY, JOINT COMM. ON THE ECON. REPORT, 84TH CONG., FED. TAX POLICY FOR ECON. GROWTH AND STABILITY, (Joint Comm. Print 1955) (analyzing the focus of tax policies and the impact of taxation on income and consumption).

11. *See, e.g.*, BORIS I. BITTKER ET AL., A COMPREHENSIVE INCOME TAX BASE? A DEBATE (1968).

12. *See* HOUSE COMM. ON WAYS & MEANS & SENATE COMM. ON FIN., 91ST CONG., TAX REFORM STUDIES AND PROPOSALS—U.S. TREASURY DEP'T pts. 1-4 (Comm. Print 1969).

13. *See* U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977).

14. *See* U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984).

15. *See* Special Comm. on Simplification, ABA, *Evaluation of the Proposed Model*

the Brookings Institution organized a series of joint tax reform conferences for economists and lawyers in the 1970s and 1980s.[16]

As a result of all this intellectual activity, a broad consensus developed among tax policy professionals about how the income tax could be improved, given the assumption that income was to be taxed. The short version of this consensus is that for reasons of fairness, economic efficiency, and ease of administration, the income tax should ideally make as few distinctions as possible among different categories of income and expenditure. According to the consensus, distinctions generally are to be avoided if they treat similarly situated taxpayers differently, if they distort economic decisions, or if they unduly complicate legal rules or business transactions.

The fullest expression of this view was probably the characterization by Harvard Law School Professor Stanley Surrey, then serving as Assistant Secretary of the Treasury for Tax Policy in the Johnson Administration, of deviations from the ideal as "tax expenditures."[17] Surrey's faith in the consensus view was so strong that he thought legislative deviations from that view should be analyzed as the equivalent of tax receipts that had been collected and then spent on tax-favored activities.

One result of all this work by tax policy specialists was that whenever political conditions ripened, there were legislative ideas already available for tax reform in the sense of improving the income tax by eliminating distinctions among different kinds of income. One important example was the Tax Reform Act of 1969,[18] which followed Surrey's tenure at Treasury, and which eliminated many tax preferences.

Comprehensive Income Tax, 32 TAX LAW. 563 (1979).

16. *See, e.g.*, COMPREHENSIVE INCOME TAXATION (Joseph A. Pechman ed., 1977) (describing methods to broaden the tax base and attempts to lower tax rates); WORLD TAX REFORM: A PROGRESS REPORT (Joseph A. Pechman ed., 1988) (discussing tax reform in other countries and the United States's reaction to such measures).

17. For the most complete development of the concept by its originator, see STANLEY S. SURREY & PAUL R. MCDONALD, TAX EXPENDITURES (1985).

18. Pub. L. No. 91-172, 83 Stat. 487 (1969) (amended 1986).

The most recent example of tax reform in this sense is the Tax Reform Act of 1986.[19] Prior to 1986, the highest individual tax rate was 50%, and the general corporate rate was 46%.[20] Those nominal rates, however, were mitigated by a series of special provisions, including accelerated depreciation for investment in machinery and equipment, as well as preferential treatment of capital gains on certain investments. The tax advantages for some investment activities were marketed as "tax shelters" to investors who had little interest in the tax-preferred business other than the tax advantage.

In the Tax Reform Act of 1986, Democrats interested in broadening the tax base united with Republicans interested in reducing tax rates to implement the fullest application to date of the first version of tax reform.[21] A plethora of special provisions were eliminated, including tax shelters for individual investors from outside tax-preferred businesses. The drive to broaden the tax base by reducing distinctions even led to the elimination of preferential treatment of capital gains, a mainstay of the tax system since 1921. The Act set the top individual rate on all realized income, including capital gains, at 28%.[22] The 1986 legislation, which reflected the typically American penchant for low taxes, initiated a process of reform in many other countries that resulted in lower income tax rates abroad.

The year 1986 marked the high-water mark of the first and traditional American version of tax reform. The top statutory rate for individuals has increased to 39.6%,[23] while the capital gains rate has remained at 28%, reintroducing a preference that congressional leaders have pledged to enlarge during this Congress. President Clinton's budget proposals similarly include a series of new tax expenditures, particularly for education.[24] The

19. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

20. *See* § 804, 83 Stat. 487; I.R.C. § 11(b) (1954).

21. *See* JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS AND THE UNLIKELY TRIUMPH OF TAX REFORM (1987) (describing the bipartisan efforts to pass the Tax Reform Act of 1986).

22. *See* I.R.C. § 1(a)-(d) (West 1988) (defining applicable rates for tax years before 1987).

23. Effective rates can be higher due, for example, to the phase-out of personal exemptions and itemized deductions. *See* I.R.C. §§ 68, 151(d) (West Supp. 1997).

24. *See* STAFF OF THE JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PRO-

traditional view of tax reform is, however, far from moribund. Legislation proposed by Representative Richard Gephardt, the Minority Leader of the House, and a likely Democratic presidential candidate in 2000, is probably the most prominent manifestation of this view today.[25]

What conclusions can we draw about the first version of tax reform, which has been so important in the United States over the last half-century? As one would expect, the process of improvement of the income tax has been continuing and gradual. Among tax policy experts, there has been time to work out the relevant ideas in some detail, allowing a considerable consensus to develop. Among political leaders, there has been regular interest in the subject and episodic implementation, particularly when reform could be coupled with rate reduction. Finally, given the long history of the U.S. income tax, public understanding of these issues has been fairly widespread.

II. INTRODUCING A NEW TAX

I want now to turn to a second version of tax reform. Rather than the incremental improvement of an existing tax, this second version involves the revolutionary introduction of an entirely new tax. The last time such a revolution occurred in the U.S. was the adoption of the Sixteenth Amendment to the Constitution in 1913, which authorized the enactment of the federal income tax that I have been discussing so far.

As you recall from the 1996 presidential election, there are those in public life who argue that the moment has now arrived for another such revolution. They would repeal the income tax enacted in 1913 and replace it with something else. As Steve Forbes put it in the announcement of his presidential campaign: "[S]crap the income tax. Don't fiddle with it. Junk it. Throw it out. Bury it. Replace it with a pro-growth, pro-family tax cut

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VISIONS CONTINUED IN THE PRESIDENT'S FISCAL YEAR 1998 BUDGET PROPOSAL 4-16 (Comm. Print 1997).

25. *See 'Tax Warfare,'* INVESTOR'S BUS. DAILY, July 13, 1995, at B1, *available in* LEXIS, News Library, Arcnws File (printing excerpts from Richard A. Gephardt, A Democratic Plan for America's Economy: Toward a Fairer, Simpler Tax Code, Remarks Before the Center for National Policy (July 6, 1995)).

that lowers tax rates to 17 percent across the board."[26] Although the rhetoric deployed in this version of tax reform is more revolutionary, this second version shares with the first the American preference for low taxes.

If we junk the income tax, what is to replace it? Recall that the U.S. differs from other developed countries in the relative emphasis given income taxation as compared with consumption taxation. Although sometimes packaged differently, the leading proposals for revolutionary change are essentially proposals to eliminate that American specificity by replacing the federal income tax with a consumption tax. Before considering the details of these proposals, let me briefly sketch their intellectual history.

You will recall that the key idea of the Haig-Simons definition of income is that individuals should be taxed on all income, whether saved or spent on current consumption. There is a longstanding, alternative intellectual tradition, according to which income saved should be omitted from the tax base. Thomas Hobbes so argued on the grounds that income saved was left in the "common pool" of society, thereby providing capital that would increase both future production and the future productivity of workers.[27] For Hobbes, it made sense to tax citizens only when they withdrew resources from this common pool. The yardstick for measuring economic well-being for tax purposes would therefore be spending, or consumption, rather than earnings, or income.

John Stuart Mill argued for a similar result on the ground that it was double taxation to tax a wage-earner on both the wages received and the income produced by investing those wages.[28] The American economist Irving Fisher made the same point in terms of present value: the taxes paid by a worker who immediately consumes all his income will be lower in present value than the taxes paid by a worker who saves to consume in

26. Steve Forbes, *Flat Tax Flap: GOP Candidate Promotes 17% Rate as Pro-Growth, Pro-Family*, SEATTLE POST-INTELLIGENCER, Feb. 18, 1996, at E1, *available in* 1996 WL 6436132 (reprinting excerpts from his Presidential Announcement Speech, Remarks Before the National Press Club (Sept. 22, 1995)).

27. *See* THOMAS HOBBES, LEVIATHAN 226 (M. Oakeshott ed., 1960).

28. *See* JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY, bk. V, ch. I, § 4 (Laughlin ed., 1898).

a later period, because the saver will owe additional taxes on the income produced by his savings. Fisher concluded that "such a system of taxation is clearly unjust and discourages the saver, while it encourages the spendthrift."[29]

In 1955, the British economist Nicholas Kaldor published a book entitled *An Expenditure Tax* that rekindled interest in these ideas.[30] Ever since, there has been a lively debate in the tax policy literature about the relative merits of income and consumption taxes.[31]

Before turning to that debate, I want to point out that there are two principal ways to implement a tax on consumption rather than income. The first is transactional. A tax on all retail sales, would, for example, tax annual consumption at a flat rate. The value-added taxes (VATs) that have swept the rest of the world in the last thirty years accomplish the same result by collecting a portion of the tax at each stage of production. One disadvantage of a retail sales tax or VAT is that it is difficult to personalize. Rates cannot be set as a function of an individual's personal or economic situation because the tax is levied on sales, rather than individuals.

The second method of implementing a consumption tax overcomes this difficulty. Recall that under the Haig-Simons definition, income can be thought of as savings plus consumption. Accordingly, personal consumption could be taxed by starting with income and then subtracting all savings.[32] This personal consumption or expenditure tax could be graduated or adjusted for family circumstances, as is the income tax.

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29. IRVING FISHER, THE NATURE OF CAPITAL AND INCOME 253 (1906).

30. NICHOLAS KALDOR, AN EXPENDITURE TAX (1955).

31. *See, e.g.*, WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? (Joseph A. Pechman ed., 1980).

32. For a discussion of the design of such a tax, see DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 75-99 (1986); INSTITUTE OF FISCAL STUDIES, THE STRUCTURE AND REFORM OF DIRECT TAXATION (1978); KALDOR, *supra* note 30; U.S. DEP'T OF THE TREASURY, *supra* note 14; William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979); Special Comm. on Simplification, *supra* note 15.

Given these alternative implementations,[33] consumption tax proponents have argued for the superiority of their tax using the three traditional norms of tax policy: fairness, economic efficiency, and administrative simplicity. The consumption tax is said to be fairer because it does not discriminate against taxpayers, like Fisher's savers, who prefer to defer their consumption. It is said to be economically superior because it does not reduce welfare or discourage savings to the same extent as an income tax, and it is said to be simpler because many of the complexities of calculating income could be avoided. One such simplification would be the elimination of the income tax concept of basis, which would always be zero if all savings were deductible.

Income tax proponents have responded that the consumption tax would be regressive and therefore unfair, because higher income individuals save more. They further argue that the evidence that the income tax actually reduces savings is weak. And they suggest that the income tax could also be much simplified if the first version of tax reform were pursued more assiduously.

Given this background, let us now turn to the two most prominent proposals for radical change by replacing the American emphasis on income taxation with consumption taxation. The first is the "Flat Tax," which was much talked about during the

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33. Under certain circumstances, a third method for implementing a consumption tax would be simply to exempt capital income from the income tax. This approach best can be illustrated with a numerical example. Suppose that you have $1000 in wages. You plan to put the wages in a savings account and consume the annual 10% interest return. Suppose further that we wanted to levy a 30% tax on your annual consumption. Under the first alternative described in the text, you could put the $1000 in the savings account and would have $100 in annual interest and $70 in annual after-tax consumption, having paid a retail sales or value-added tax on your purchases. Under the second alternative, inclusion of your wages in the personal consumption tax base would be offset by the deduction of your savings, so you also would have $1000 in the savings account, which would produce $100 subject to tax each year, again leaving you with $70 in after-tax consumption. Now suppose that capital income was simply excluded from the income tax base. Your wages would be taxed, so you would only have $700 to put in the savings account. But the annual interest on the account would not be taxed, so you would again have $70 in annual consumption after all taxes. This equivalence leads some analysts to argue that a personal consumption tax can be equivalent in present value to a wage tax if tax rates are unchanged. The other conditions necessary for the equivalence to hold are discussed in RICHARD MUSGRAVE, THE THEORY OF PUBLIC FINANCE 262, 266-67 (1959); Graetz, *supra* note 32, at 1601-06.

last presidential election and which has been introduced in Congress by Representative Dick Armey, the Majority Leader of the House of Representatives.[34] The second is the "USA Tax," which was developed under the sponsorship of Senators Pete Dominici and Sam Nunn.[35]

The Flat Tax was originally advanced by two Stanford academics, Robert Hall and Alvin Rabushka.[36] There are two parts to the tax, a business tax and an individual tax. Under the first, all businesses, whether incorporated or not, would include all sales in the tax base and deduct all purchases from other businesses, including purchases of capital equipment. Pausing for a moment at this point, we can ask what is the aggregate base of such a tax? Because all purchases from businesses are also sales by businesses, deductions by the purchasing businesses are offset exactly by inclusions of the selling businesses. Hence the only transactions that are taxed are sales by businesses to nonbusinesses, i.e., retail sales. As far as we have gone, the aggregate base of the Flat Tax is simply retail sales. Indeed, tax specialists would classify the tax as a "subtraction-method" value-added tax.

There is, however, an additional wrinkle to the Flat Tax. Businesses can also deduct wages, which are the only receipts taxed to wage-earners. If these businesses' deductions are fully offset by wage-earners' inclusions, what is the purpose of this wrinkle, given a flat rate of taxation? It is to allow an exemption for a certain amount of wages, in response to the objection that value-added taxes are regressive for lower-income taxpayers. The Flat Tax is accordingly the equivalent of a tax on value-added, plus a government grant to eligible wage-earners to offset the burden of the tax. If you do not remember the tax being discussed this way during the 1996 presidential campaign, it is not because you have forgotten the discussion. Rather, the candidates vaguely referred

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34. *See* H.R. 2060, 104th Cong. (1995).

35. For the most complete description of the proposal by its sponsors, see *USA Tax System: Description and Explanation of the Unlimited Savings Allowance Income Tax System*, 66 TAX NOTES 1485 (1995). The legislative version is S. 722, 104th Cong., which was introduced by Senators Pete Domenici, Sam Nunn, and Bob Kerrey on April 25, 1995.

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

to a Flat Tax, which most of the press and therefore the public assumed was an income tax with flat rates.

The second prominent proposal for radical tax reform is the "USA Tax," which is named after its principal innovation, an Unlimited Savings Allowance. Again there are two taxes, one for businesses and one for individuals. As under the Flat Tax, the business tax is a subtraction-method VAT, but without the wrinkle of a deduction for wages. At the individual level, the designers of the tax have tried to implement a graduated personal consumption tax by starting with the income tax base and then permitting an unlimited deduction for all savings. The USA Tax would thus levy two taxes, one flat and one graduated, on the same general base, personal consumption.

I now want to compare the Flat Tax and USA Tax on several grounds. First, consider rates, which are low and not graduated under the Flat Tax. Under the USA Tax, they are graduated for individuals, with top rates near those of the current income tax rates. What explains this difference? The Flat Tax assumes that all activity in the economy, including legal education at William & Mary Law School, will be subject to a tax rate of, say, 17%. The USA Tax assumes that many of the activities subject to favorable treatment under the current income tax will also be favored under a consumption tax, so its rates are necessarily higher.

Second, consider transition from the existing income tax to a consumption tax. It might help to have in mind a retired wage-earner who is living off savings from her working days. Under an income tax, she would be taxed during retirement only to the extent she earned additional income or withdrew previously untaxed amounts from tax-favored pension plans. The income tax concept of basis assures that she would not be taxed again on income taxed during her working days. Now suppose that a consumption tax is substituted for the income tax. Should our retiree's income tax basis protect her from taxation under the consumption tax? If our answer is no, she will be taxed twice on the same gain. If our answer is yes, then consumption tax rates will have to be higher to make up the lost revenue. The Flat Tax opts for the first solution, which would involve a major shift of tax burden from younger to older Americans. Not surprisingly, this aspect of the Flat Tax was not highlighted during the 1996 presidential campaign in Florida. The USA Tax avoids this shift in tax burden by opting for the second choice, which is another reason its rates are higher than under a Flat Tax.

Now consider international transactions. Should a sales or value-added tax be levied where the item is purchased (on an "origin" basis) or where it is used (on a "destination" basis)? In general, retail sales taxes and VATs are levied on a destination basis, which is the choice made by the USA Tax. The Flat Tax would, on the other hand, apply only to value added in the United States. An American-made car would be subject to taxation in the U.S. on its full value, whereas a foreign-made car sold in the U.S. would be subject to taxation in the U.S. on only the profit made by the American retailer. Although economists think that currency exchange rates would adjust for such differences, it is unlikely that U.S. car manufacturers would agree. Not surprisingly, this aspect of the Flat Tax was not highlighted during the 1996 presidential campaign in Michigan. Once again, the press and public seemed quite unaware of how the proposed tax would actually work.

Finally, consider complexity. The Flat Tax is simple, but that is in part because many of the most difficult problems, such as intergenerational and international issues, have been assumed away. The USA Tax, on the other hand, is quite complicated, largely because it stumbles on a key problem of consumption tax design, which is that consumption out of borrowed funds should be taxed. This result is unsurprising under a retail sales tax or a VAT, because the tax is due whether the purchases are funded with wages, savings, or borrowings.

Under a personal consumption tax, which starts with income and subtracts savings, the result is less automatic, because borrowed money is not included in taxable income. Under the Haig-Simons definition we began with, borrowed funds are not income, because they do not increase the borrower's net wealth. If we want to tax consumption, however, borrowed funds have to be included in the tax base. If those funds were saved, then the net tax result would be zero, because the deduction for savings would offset the inclusion of borrowings. The designers of the USA Tax thought, perhaps correctly, that the American taxpaying public would not understand the inclusion of borrowed funds in the tax base, so they constructed a very complicated and probably unworkable system to limit deductions to amounts saved in excess of borrowings.[37]

Given President Clinton's reelection, neither the Flat Tax nor the USA Tax is very likely to be enacted during the next few years. But, these ideas are no less moribund than is the first version of tax reform. I would expect that there will be presidential candidates in 2000 who will again propose revolutionary tax reform along these lines.

What conclusions can we draw regarding this second version of tax reform, which seems to have become important in presidential politics? Like the first version of tax reform, this version is based solidly on a longstanding intellectual tradition, which prefers consumption taxes to income taxes. Given the traditional American emphasis on income taxation, however, there has not always been time for tax policy specialists to develop the relevant ideas in the detail necessary for actual legislation in the U.S. Among political leaders, there has been episodic interest, particularly on the part of leaders who want to distinguish themselves by proposing a revolutionary form of tax reduction. Indeed, these proposals would replace one form of American specificity (heavy reliance on income taxes) with another (virtual elimination of income taxes), while other countries continue to depend on a mix of taxes. Finally, among the press and general public, there seems to be a high degree of confusion about what is actually under discussion.

III. RELATIONSHIPS BETWEEN TAXES

Let me now turn to a third version of tax reform, which involves rationalization of the relationships *between* two tax bases. A number of possibilities come to mind, such as the relationship between income and social security taxes, or between state and federal taxes. I want to focus today on the relationship between the federal corporate and individual income taxes.

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37. *See generally* Alvin C. Warren, Jr., *The Proposal for an "Unlimited Savings Allowance,"* 68 TAX NOTES 1103 (1995) (discussing the main aspects of the USA Tax and criticizing certain elements of the tax).

As I mentioned earlier, the United States has long had a "classical" income tax system, under which income is taxed to corporations and shareholders as distinct taxpayers. Interest paid to suppliers of corporate debt capital is deductible by the corporation, but dividends paid to shareholders are not. Taxable income earned by a corporation and then distributed to individual shareholders as a dividend is thus taxed twice, once to the corporation, and again to the shareholder on receipt of the dividend. As a result, the current regime is often characterized as a "double tax" system.

The actual U.S. tax system is considerably more complex. For example, some income earned through corporate enterprise is taxed only once, at the corporate level. This is the result for corporate taxable income distributed as dividends to tax-exempt shareholders, such as pension funds and charitable endowments. Other income earned through corporate enterprise is taxed only once, at the investor level. This occurs when corporate earnings are distributed as deductible interest payments to taxable debtholders. Finally, some income earned through corporate enterprise is not taxed in the U.S. at either the corporate or investor level. This is the result for deductible interest paid to certain foreign and tax-exempt holders of U.S. corporate debt.[38] Accordingly, corporate income is sometimes taxed twice in the U.S., sometimes once, and sometimes not at all.

The current U.S. system of taxing corporate income distorts several economic and financial choices, of which the following four are usually considered the most important.

1. U.S. investors are discouraged from investing in new corporate equity because of the additional burden of the corporate tax, distorting the allocation of capital between corporate and noncorporate investment.

2. U.S. corporations are encouraged to finance new projects by issuing debt or using retained earnings, rather than by issuing new stock, in order to avoid an additional level of tax. The resulting higher debt levels may increase the costs of financial distress.

38. *See* I.R.C. § 871(h) (West Supp. 1997) (exempting interest paid to foreign holders of portfolio debt).

3. There can be a tax incentive to retain or distribute corporate earnings, depending on the relationships among corporate, shareholder, and capital gains tax rates. For example, if the corporate and capital gains rates are sufficiently low relative to shareholder rates on ordinary income, the tax system encourages retention of earnings by U.S. corporations to take advantage of the lower rates.

4. The tax system encourages U.S. corporations to distribute earnings in tax-preferred transactions, such as stock repurchases that give rise to capital gains, rather than by paying dividends.

"Integration" of the corporate and individual income taxes has come to mean eliminating the double burden of the corporate and individual income taxes, where it exists, and substituting a system in which investor and corporate taxes are interrelated in a manner that eliminates or reduces the foregoing distortions.[39] The goal is to produce a uniform levy on capital income, whether earned through corporate enterprise or not.

The basic argument for integration is economic. The classical corporate tax increases the cost of capital for U.S. companies, discourages new equity investments in corporate enterprise, and encourages the issuance of corporate debt. According to the Treasury, the U.S. tax burden on corporate capital, as compared with residential housing, has resulted in a much lower ratio of corporate to residential investment in the U.S. than in other industrialized countries.[40]

Thirty years ago, the corporate tax systems of most other major developed countries were similar to ours. In the last three decades, however, most of our major trading partners have fully or partially integrated their individual and corporate income taxes, usually through a shareholder credit for previously paid

39. The literature on integration is vast. For a discussion of two recent proposals (with extensive bibliographies) for integration in the United States, see ALVIN C. WARREN, JR., FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL CORPORATE INCOME TAXES: REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (American Law Institute, 1993) [hereinafter 1993 ALI STUDY]; U.S. DEP'T OF THE TREASURY, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS—TAXING BUSINESS INCOME ONCE (1992) [hereinafter 1992 TREASURY REPORT].

40. *See* 1992 TREASURY REPORT, *supra* note 39, at 5.

corporate taxes. In so doing, they have reduced the economic distortions that continue to exist in the U.S.[41]

While integration has been discussed periodically in the U.S., this discussion has not been identified with any political party or movement. The Treasury Department has developed integration proposals in both Democratic and Republican administrations, and the House of Representatives included a small step toward integration in its version of the Tax Reform Act of 1986. Professional groups, including the American Law Institute, have also developed proposals to eliminate the double taxation of corporate income in the U.S.[42]

One might have thought that the reaction of the U.S. corporate community to such proposals would be unbridled enthusiasm, particularly in a period of increasing international competition and given the American predilection for low taxes. In fact, with rare exceptions, corporate management remarkably has been uninterested in proposals that would eliminate the double taxation of corporate income distributed to shareholders as dividends. Given the choice, corporate management seems to prefer corporate tax reductions through reduced rates or accelerated capital cost deductions, rather than structural changes that would reduce the biases of our corporate tax.

I cannot fully explain this disinterest. Some analysts suggest that even in the competitive American capital markets, corporate management simply does not act as a steward of shareholder interests.[43] On this view, management may actually prefer some versions of the double tax, which discourage the distribution of corporate income, providing management with a pool of capital free of the rigors of the capital markets. Another possible explanation is that well-informed taxpayers can mitigate the

41. Countries with fully or partially integrated tax systems include Australia, Canada, France, Germany, Italy, and the United Kingdom. For a recent comparison of integration systems, see HARRIS, *supra* note 6, at 561-789.

42. *See* 1993 ALI STUDY, *supra* note 39; TAX DIV., AMERICAN INST. OF CERTIFIED PUB. ACCOUNTANTS, STATEMENT OF TAX POLICY 10, INTEGRATION OF THE CORPORATE AND SHAREHOLDER TAX SYSTEMS (1993).

43. *See, e.g.*, Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 368 (1995) (suggesting that the gap between corporate ownership and management affects the integration debate).

burden of the double tax. One important development in this regard has been the creation by state legislatures in recent years of a new business form, the Limited Liability Company, which allows closely held companies to obtain the advantages of limited liability without being subject to the federal income tax on corporations.[44] Even public companies, which cannot escape the corporate tax in this way, have been more aggressive in finding ways to distribute earnings as deductible interest payments or as share purchases taxed as capital gains.[45] Finally, some would argue that much of the burden of the existing tax system has already been capitalized in share prices, meaning that at least some of the burden may have been borne by previous owners of shares. In spite of these explanations, it is something of a mystery why the United States remains one of the very few industrialized countries that has not integrated its individual and corporate income taxes.

In the absence of support from corporate management, there has been very little interest in corporate tax integration on the part of political leaders. The third version of tax reform is thus characterized by a detailed elaboration of the relevant ideas by tax policy specialists, disinterest on the part of political leaders, and, I think it is fair to say, almost complete ignorance on the part of the general public.

IV. CONCLUSION

To summarize, I have spoken today about three versions of tax reform: improvement of an existing tax, replacement of an existing tax by something radically different, and rationalization of the relationships between taxes. In the United States, those three versions of tax reform have been manifest in the long-standing movement to broaden the income tax base, in recent interest in substituting consumption taxation for income taxa-

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44. *See, e.g.*, Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393 (1996) (discussing the benefits of the Limited Liability Company for tax reform).

45. *See, e.g.*, Laurie Bagwell & John B. Shoven, *Cash Distributions to Shareholders*, 3 J. ECON. PERSP. 129 (1989) (discussing the problems with using noncash dividends and advocating the increased use of cash distributions as a replacement).

tion, and in proposals to integrate the individual and corporate income taxes. In all three cases, the American preference for lower taxes has been manifest.

Tax policy experts have served an important function in developing the ideas necessary for all three versions of tax reform. However, the expert tax policy community has sometimes done an inadequate job of communicating the content of these ideas to the public (particularly about current proposals for revolutionary reform) and to the country's corporate and political leadership (particularly about important relationships between individual and corporate taxes).

Happily, it is not too late to correct these deficiencies. All three versions of tax reform remain unfinished. And for those of you who are interested in the revolutionary version, the next presidential election is only a few years away.