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Book review

A make-over for the tax code

BY STEVE CHARNOVITZ

The Decline (and Fall?) of the Income Tax
By Michael J. Graetz
W.W. Norton & Co.

The looming April 15 deadline is focusing attention on the complexities of the federal income tax. Some congressional leaders are proposing a complete overhaul of the tax code. To help inform this evolving debate, Michael Graetz, a professor of law at Yale, has written a timely book, "The Decline (and Fall?) of the Income Tax."

Mr. Graetz supports congressional action to overhaul the tax system. And he is convinced that change is coming. As he sees it, "the American people are angry at the way income is taxed . . . angry at the way the tax law gets written, and angry at how the tax law is administered."

A tax code should be guided by three principles, according to Mr. Graetz: fairness, simplicity and sound economic policy. The latter principle includes factors influencing peoples' decisions to save and to work.

There always will be tension among the three principles, because various segments of the public will value them differently. Mr. Graetz is influenced by the fiscal vision of Adam Smith who, in the "Wealth of Nations," suggested that citizens should be taxed "as nearly as possible in proportion to their respective abilities, that is in proportion to the revenue which they respectively enjoy."

The current tax code falls short on all three counts. Regarding fairness, the book contains chapters on the marriage penalty, tax shelters and tax fraud. Regarding simplicity, Mr. Graetz details several provisions in the tax code that are virtually impossible to comply with. For example, parents may take the child-care credit only if the child-care center complies with all applicable laws. Yet how are parents to know?

The book contains a realistic discussion of the economic impact of the income tax. Mr. Graetz's main point is that economists really don't know the answers to basic questions about how taxes shape behavior, but that doesn't stop a small army of economists and statisticians from supplying lobbies with forecasts.

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The author is at his best when he discusses the political dynamics of tax policy making. He has inside knowledge there, having served as deputy assistant secretary for tax policy during the Bush administration. He states bluntly: "Politicians in this country have long viewed the tax law as something of a playground." Budget rules make things worse by subordinating tax simplicity to short-term revenue goals.

One interesting concept introduced by Mr. Graetz is tax "stability." To avoid continuous change, tax law ought to be based on more than just ephemeral compromise.

He views replacing the income tax with a consumption tax as "truly radical," and tries to analyze it rigorously with regard to fairness, simplicity and economic impact. Although the fairness of a consumption tax can be debated, Mr. Graetz believes the public will perceive it as unfair once people understand that all investment income escapes taxation until it is spent.

As evidence, he points to the fact that neither of the leading proposals — the Nunn/Domenici "USA" tax and the Forbes/Armey "flat" tax — are characterized as consumption taxes by their sponsors. Instead, they are styled as "income" taxes, despite a failure to tax major sources of income.

Consumption taxes might generate economic benefits, but globalized markets make forecasting uncertain. One problem is that domestic saving does not necessarily translate into domestic investment. Another is that, unlike a European-style value-added tax, a flat tax would still apply to exports (but not to imports). As Mr. Graetz explains, "domestic businesses undoubtedly will resist rules that impose a U.S. tax on the full retail price of products manufactured in the United States but tax only the dealer mark-up of products manufactured abroad."

Because of these problems, Mr. Graetz advocates a hybrid reform. He would apply the income tax only to high-income individuals, and then at a flat rate between 20% and 25%. To replace the lost federal revenue, he would establish a value-added tax of 10% to 15%. He also suggests that Congress slash corporate tax rates and enact a simplified income tax code applicable only to small businesses.

Although Mr. Graetz acknowledges the traditional "American exceptionalism" of doing everything our way, he points out that the internationalization of the world economy has made it more difficult for any country to enact a tax system radically different from those elsewhere. To date, however, congressional tax writers have paid little attention to this.

Although written for the general audience, this book is an enlightening resource for tax policy specialists as well. Mr. Graetz brings a dry subject to life with funny anecdotes and clear examples. It would be a good handbook for congressional activists who aspire to do more than nibble around the edges of the income tax.

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