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**TAX REFORM IMPLICATIONS OF
THE RISK OF A U.S. BUDGET CATASTROPHE**

Daniel Shaviro*

Preliminary Draft

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I. THE UNDERLYING PROBLEM

The United States is currently on an unsustainable long-term fiscal path.¹ This conceivably could lead to a catastrophic budget crisis in which “no one is willing to lend to the U.S. government at any interest rate. Essentially, the Treasury holds a debt auction and no one shows up.”² The upshot in such a dire scenario would be either actual or implicit default on U.S. government bonds, in the latter case via hyperinflation. Either would potentially trigger sufficient global macroeconomic disruption to “make the 2008 financial crisis look like a Sunday school picnic.”³

The factors giving rise to this risk of a budget catastrophe are like a Matryoshka doll, one nestled inside the next. Superficially or at the outermost layer, the problem is demographic and technological change.⁴ Life expectancies are rising,⁵ there was somewhat of a “baby bust” in the

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¹ See, e.g., Leonard E. Burman, Jeffrey Rohaly, Joseph Rosenberg, and Katherine C. Lim, *Catastrophic Budget Failure*, 63 Nat’l Tax J. 561 (2010); Daniel N. Shaviro, *1986-Style Tax Reform: A Good Idea Whose Time Has Passed*, 131 Tax Notes 817, 828-830 (May 23, 2010).

² Burman et al, *supra*, at 574.

³ Shaviro, *1986-Style Reform*, *supra*, at 829.

⁴ However, alongside the background demographic and technological causes of the long-term U.S. fiscal gap, a number of major budget policy decisions since the turn of the century have made things significantly worse – in particular, the decisions to enact the Bush tax cuts, wage two major wars, and enact a Medicare prescription drug benefit, in each case with no financing whatsoever.

⁵ See, e.g., Julian P. Cristia, *Rising Mortality and Life Expectancy Differentials By Lifetime Earnings in the United States* (2009).

aftermath of the post-World War II baby boom,⁶ and healthcare costs are growing faster than the economy although yielding genuine improvements in health outcomes.⁷ So current programs such as Social Security, Medicare, and Medicaid – but the latter two in particular – face worse long-term fiscal prospects than they would under different demographic and technological circumstances, causing the overall picture to be one of budgetary unsustainability.

Yet these trends are both visible far in advance and well-known. In principle, they could easily be addressed through some combination of slowing projected spending growth and increasing projected revenues. And even if such adjustments are to a degree painful relative to staying on the current course if this were feasible, the need for them carries no implication whatsoever of the need to risk a budget catastrophe.

That brings us, however, to the second Matryoshka doll, political economy. To make the painful changes that are necessary, one needs an at least moderately well-functioning political system. Adverse changes that disappoint people who were relying on the continuation of existing law or policy are hard to implement without cooperation between significant elements of both the Democratic and Republican parties' leadership. Embrace of adverse changes by one side acting alone would expose it to devastating political attack by the other side. Moreover, perhaps neither party should be expected to act unless enough of the powerful interest groups to which it answers are sufficiently on board.

Attracting sufficient support for a budget deal that would be ambitious enough to restore long-term fiscal solvency is inherently a challenging enterprise. Even if everyone recognizes that some sort of deal is necessary, any actual deal will leave some groups worse off than a hypothetical alternative deal in which someone else had to sacrifice more instead. Insofar as

⁶ See, e.g., N. Gregory Mankiw and David N. Weil, *The Baby Boom, the Baby Bust, and the Housing Market*, 19 *Regional Science and Urban Econ.* 235 (1989).

⁷ See, e.g., Daniel Shaviro, *WHO SHOULD PAY FOR MEDICARE?* 76 (2004).

multiple independent actors individually or collectively have an effective veto, prospective dealmakers face a holdout problem, akin to that which a local government would face if it wanted to build a road and did not have eminent domain powers.

These problems are not inherently insoluble, of course. In the 1980s, Democrats and Republicans repeatedly agreed to budget deals that required various stakeholders to accept terms they partly disliked and that in principle could have been improved from their perspectives.⁸ But the less the common ground between the parties, the harder this is to accomplish. Over the last two-plus decades, the Republican Party's march to the extreme right has greatly increased the difficulty of finding common ground at the leadership level, even leaving aside the challenge of selling a deal to one's stakeholders.

In particular, when Republicans unconditionally reject any tax increases whatsoever, and indeed repeatedly demand further huge tax cuts, the model that underlay multiple bipartisan deals in the 1980s is effectively ruled out. Yet the fundamental problem may go deeper than party strategies. I increasingly fear that social and intellectual discord in our society have grown so great, and have so radically undermined cooperative norms at the political party, interest group, and individual voter levels, that productive bargaining over apportionment of the pain of restoring long-term fiscal sustainability simply cannot be done any more. The Republicans' evident willingness in mid-2011 to force a completely voluntary and unnecessary federal debt default, unless they were paid sufficient ransom (a strategy that Republican leaders have proudly announced that they are eager to repeat) is case in point. I thus am personally skeptical that the U.S. political system will prove up to the challenge, and conclude instead that broader social and

⁸ During the Reagan Administration, the important bipartisan tax and budget deals that were enacted included the following: (1) a deficit-reducing tax increase in 1982, (2) a Social Security fix with benefit cuts and tax increases in 1983, (3) a deficit-reducing tax increase in 1984, (4) the Gramm-Rudman Hollings Balanced Budget Act in 1985, (5) comprehensive tax reform in 1986, and (6) the Medicare Catastrophic Coverage Act in 1988 (although the parties were forced by widespread public opposition to repeal this act the following year).

political dysfunction make the unthinkable (an essentially voluntary default) not just possible but perhaps even likely.⁹

This brings us to the third and innermost Matryoshka doll. Suppose my fears are correct. Should one not expect financial markets to begin responding to the danger? If investors grew increasingly nervous, one might expect U.S. borrowing rates gradually to rise. While this would not be good news as such, at least it would offer a signal, helping to encourage a course adjustment before the U.S. debt-to-GDP ratio reaches the stratosphere. To date, however, the much-feared “bond vigilantes” have been largely silent about the long-term problem. This may partly have reflected a short-term flight to quality. For example, however little one should trust the U.S. dollar over the long run, the Euro’s prospects appear even worse.

Might a wise and farsighted optimism also be at work, however? What direct evidence is there that the U.S. political system *won’t* eventually solve things in time? After all, it has never catastrophically failed before, with the very different (and by now distant) exception of the political breakdown that led to the Civil War. And a standard view of well-functioning financial markets, underlying the efficient capital market hypothesis and epitomized in much of the law and economics literature, would hold that people with money at stake must have rationally concluded (based on all available information) that the threat of a U.S. credit market event is not very significant after all.

“The markets know best” might have been a more credible position before the 2008 financial crisis. However, after the shocking collapse of a global real estate bubble, coming only a few years after the much smaller (but still telling) rise and collapse of an Internet stock bubble, it is reasonable to fear that financial markets may be getting it badly wrong yet again. The

⁹ See Daniel N. Shaviro, TAXES, SPENDING, AND THE U.S. GOVERNMENT’S MARCH TOWARD BANKRUPTCY 116-147 (2007) for a broader discussion of the political economy of fiscal gap politics.

scenario in which U.S. government bond prices turn out (at least ex post) to have been sustained by a price bubble that suddenly and discontinuously collapses is hard to dismiss, especially given concerns that fundamentally skewed incentives in the financial sector, encouraging market actors to pursue short-term profits while disregarding downside tail risk, are still in place.¹⁰ Hence the point that, if severe pessimism is at least potentially justified, the third and innermost Matryoshka doll in the march to a U.S. budget catastrophe will prove to have been a financial markets problem.

Even without grounds for concern about a catastrophic credit market event, there would be ample reason to place the U.S. government's budget on a sustainable long-term path as soon as possible. An initial point relates to the advantages of "smoothing" the implementation of adverse changes. As I have discussed elsewhere, both tax rate increases and healthcare and other spending cuts tend to have rising marginal disutility in each discrete period (such as a year). This tends to make it good policy (at least as a baseline approach) to try to spread the pain across all periods, rather than waiting until immediate change is unavoidable.¹¹ Moreover, while our extremely slow recovery from the "Great Recession" and the continuation of high unemployment levels strongly indicate postponing the implementation of adverse changes that would curtail current consumer demand, this does not mean that we should postpone determining and announcing future changes, which would aid people's long-term planning. Accordingly, while the threat of a budget catastrophe may be the most important reason for acting sooner rather than later to correct our budgetary path, it is far from being the only reason.

¹⁰ See, e.g., Douglas A. Shackelford, Daniel N. Shaviro, and Joel B. Slemrod, *Taxation and the Financial Sector*. 63 Nat'l Tax J. 781 (2010).

¹¹ See Daniel N. Shaviro, *The Long-Term U.S. Fiscal Gap: Is the Main Problem Generational Inequity?* 77 G.W.U. L. Rev. 1298 (2009).

It thus is worth asking how tax-side changes to the federal budget could help contribute to restoring fiscal sustainability. The rest of this paper divides this question into two categories, pertaining first to the existing income tax and then to some possible new tax instruments.

II. THE EXISTING INCOME TAX

A. Base-Broadening's Budgetary Potential

The most obvious and appealing way to achieve budgetary improvement through the existing income tax would be through base-broadening. Numerous preferential rules for particular types of consumption, business activity, or saving create uneven treatment across these broad categories, typically with little in the way of a persuasive policy rationale. Substantial base-broadening would therefore be desirable even in the absence of a potential budget catastrophe.

When one adds in the threat of such a catastrophe, the case for base-broadening becomes truly compelling. What is more, it could potentially bring about an enormous improvement in our long-term fiscal outlook. According to the Tax Policy Center, items that are officially defined as "tax expenditures" (a term I further discuss below) will increase the budget deficit by almost \$1.3 trillion in 2011, rising to more than \$1.7 trillion in 2016.¹² Even if one believes, as I have argued elsewhere, that some of the items on the list are not actually properly defined as tax expenditures, and/or ought not to be repealed,¹³ this still leaves considerable scope for budget-improving changes that would independently be good policy. The problem in making significant budgetary progress through base-broadening is simply one of political will and achieving consensus.

¹² See Donald Marron, *How Large Are Tax Expenditures?*, available on-line at <http://www.taxpolicycenter.org/UploadedPDF/1001526-Expenditure-Estimates.pdf>.

¹³ See Shaviro, *1986-Style Reform*, *supra*, at 823.

Even if such progress were otherwise available, however, it would raise in some circles the question of whether wide-ranging tax expenditure repeal, unless accompanied by other, revenue-losing tax changes, would involve excessive reliance on the “tax” rather than the “spending” side of the budget to pivot back towards fiscal sustainability. I therefore next consider how tax expenditure repeal should relate to concern about this distinction.

B. What Does It Mean to Raise “Tax Revenues”?

Debate about the relative extent to which deficit reduction should rely on tax increases as opposed to spending cuts has been politically important for decades. The issue used to be one of what balance to reach between the two types of changes. More recently, however, Republicans, under what I would call the malign influence of lobbyist and political activist Grover Norquist, have shifted to a stance of no-increased-revenues absolutism.¹⁴

The underlying set of concerns that people across the political spectrum have in mind when they debate the extent (if any) to which tax revenues should increase is relatively clear. Higher taxes are thought to imply a larger government, or one that goes further beyond what Robert Nozick called the “minimal” contours of enforcing contracts and protecting individuals against violence, theft, and fraud.¹⁵ The problem, however, is that official revenue measures are not well related to the underlying substantive dispute about the appropriate size of government.

The clearest and best-known illustration of the fundamental disconnect between officially measured revenues and the size of government is presented by tax expenditures. Thus, consider the exclusion from taxable income (and from wages for payroll tax purposes) of employer-provided health insurance. If my marginal tax rate is 35 percent, then permitting me to exclude

¹⁴ See, e.g., Alison Fitzgerald, “No-Tax ‘Zealot’ Norquist Emerges as Barrier to U.S. Debt Deal,” Bloomberg, May 24, 2011, available on-line at <http://www.businessweek.com/news/2011-05-24/no-tax-zealot-norquist-emerges-as-barrier-to-u-s-debt-deal.html>.

¹⁵ See, e.g., Robert Nozick, *ANARCHY, STATE AND UTOPIA* 26 (1968).

the value of a \$10,000 policy is equivalent to taxing me on this income and handing me a \$3,500 health insurance subsidy that would be classified as government spending. With that structure, however (which would more straightforwardly reflect the exclusion's primarily allocative purpose),¹⁶ both tax revenues and government spending would officially be \$3,500 higher, causing the government to seem larger than under the actual policy even though the end result would be exactly the same.

Once we recognize that the exclusion for employer-provided health insurance is best viewed as hidden or indirect government spending,¹⁷ it becomes reasonably clear that repealing the subsidy makes the government smaller. Use or non-use of the tax system as a delivery mechanism for the subsidy should not affect this conclusion, even though it will determine whether repeal of the subsidy increases officially measured tax revenues.

The disconnect between officially measured revenues and the size of government has important implications for the design of tax reform. For nearly thirty years, the dominant tax reform design has emphasized revenue neutrality, to be achieved by offsetting the revenue gain from base-broadening by lowering income tax rates. During consideration of the Tax Reform Act of 1986, Democrats and Republicans alike viewed revenue neutrality as a device permitting them to table their ongoing dispute concerning the proper size of government. They were intellectually mistaken, however, given that (as tax expenditure analysis helps show) revenue neutrality is merely a semantic, rather than a substantively meaningful, concept.

While the myth that revenue neutrality is substantively meaningful may have proven useful in 1986, we should not be fooled by it today. Since tax expenditure repeal is best viewed

¹⁶ See Shaviro, *1986-Style Tax Reform*, supra, at 823.

¹⁷ "Spending" is not always synonymous with "allocative policy." For example, welfare benefits provided under the Temporary Aid to Needy Families (TANF) program is no less primarily distributional in character than levying an income tax.

as in substance a spending cut rather than a tax increase, the only good reason to package it with tax rate reduction is if one happens to support the latter change entirely on its own merits. To be sure, if one starts from a decision to cut rates, then a 1986-style package has a budgetary rationale, at least compared to standalone rate-cutting, inasmuch as it provides financing. However, the same would be equally true of packaging the rate cuts with military withdrawal from Afghanistan.

Accordingly, even if substantial budgetary gains were available via the repeal of tax expenditures but one wanted to avoid increasing the size of government, there would be no implication that rate cuts – reducing the budgetary gain – should be adopted. Given, however, that rate cuts not only may be considered appealing for their own sake, but conceivably could be part of an overall package that restored fiscal sustainability, I next examine whether rationales other than “revenue neutrality” could support rate-cutting under current circumstances

C. The Case Against Cutting Individual Income Tax Rates Even if the Base is Substantially Broadened

Until such time as there is very substantial improvement in the prospects for long-term U.S. fiscal sustainability, it would verge on recklessness to give any serious consideration to significant tax rate cuts, including extension of the 2001 Bush tax cuts. Indeed, this would be true even if the overall enactment was budget-neutral due to base-broadening, given the lost opportunity that this would represent to improve the long-term picture by repealing tax preferences. Thus, under present circumstances, what I call “1986-style tax reform,” in which a package of base-broadening is adopted with the goal of being budget-neutral and perhaps also distribution-neutral, simply does not make sense.¹⁸

¹⁸ See Shaviro, *1986-Style Reform*, supra.

The most obvious change in circumstances since 1986 is budgetary. Although deficits were a major policy concern in the mid-1980s, the long-term fiscal picture was far less dire. Accordingly, the massive political effort that was needed to eliminate well-entrenched special interest tax benefits could reasonably be justified, despite the critique that it might crowd out deficit reduction efforts. Today, the extreme danger of a budgetary catastrophe that our political system may be ill-suited to stave off makes the same strategy considerably riskier and more dubious.¹⁹

In addition, the efficiency gains available from reducing the marginal tax rates faced by individuals were far greater in 1986 than now, given that, at the time, the top rate was 50 percent, whereas today it is only 35 percent.²⁰ In general (all else equal), the lower the rate that one starts from, the smaller the efficiency gain from reducing it. In addition, while the 1986 tax reform process showed that base-broadening and rate reduction may be political complements, from the standpoint of efficiency they are better viewed as substitutes.²¹ Base-broadening tends to reduce the elasticity of taxable income, thereby potentially increasing the optimal tax rate if one is trading off concerns of distribution against those of efficiency.²²

A further important change in circumstances since 1986 relates to that era's goal of making the overall tax reform package roughly distribution-neutral as between people at different income levels. Once again, the idea was to take a source of political dispute off the table, so that Democrats and Republicans could cooperate with regard to issues as to which they did potentially agree. While this potentially can make sense, changes in U.S. income distribution

¹⁹ See Shaviro, *1986-Style Reform*, supra, at 818-819, 842.

²⁰ The top marginal rate for corporations has also declined significantly since the run-up to the Tax Reform Act of 1986, from 46 percent then to 35 percent now. Arguably, however, other countries' corporate rate decreases since then, along with rising global capital mobility, have increased the efficiency benefits that would result from further corporate rate reduction.

²¹ I am grateful to Aviva Aron-Dine for bringing this point to my attention.

²² See, e.g., Emmanuel Saez, Joel Slemrod, and Seth H. Giertz, *The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review* (2010).

since 1986 should make people who regard high-end income concentration as potentially a serious social problem far more reluctant today than were their predecessors to countenance significant tax rate reduction. Simply put, individual rates at least as high as today's 35 percent top rate may be needed, in an era when people at the top have so significantly pulled away from everyone else, if one believes that people's welfare importantly depends on relative as well as absolute income levels.

The following two tables, which I reproduce here (along with some of the accompanying discussion) from a recent article, help to show how significantly high-end income concentration has increased since 1986.

TABLE 1²³

TOP DECILE (AND ABOVE) INCOME SHARES WITHOUT CAPITAL GAINS

Year	Top 10% Income Share	Top 5% Income Share	Top 1% Income Share	Top 0.1% Income Share	Top 0.01% Income Share
1986	34.57	22.59	9.13	2.87	1.00
2008	45.60	33.36	17.67	7.77	3.34
% Increase in Share Since 1986	31.9	47.7	93.5	170.7	234

Source: Facundo Alvaredo, Tony Atkinson, Thomas Piketty and Emmanuel Saez, *The Top Incomes Database* (data for U.S.), <http://g-mond.parisschoolofeconomics.eu/topincomes/>.

²³ Reproduced from Shaviro, *1986-Style Reform*, supra, at 834.

TABLE 2²⁴

TOP DECILE (AND ABOVE) INCOME SHARES WITH CAPITAL GAINS

Year	Top 10% Income Share	Top 5% Income Share	Top 1% Income Share	Top 0.1% Income Share	Top 0.01% Income Share
1986	40.63	29.49	15.92	7.40	3.34
2008	48.23	36.52	20.95	10.40	5.03
% Increase in Share Since 1986	18.7	23.8	31.6	40.5	50.6

Source: Facundo Alvaredo, Tony Atkinson, Thomas Piketty and Emmanuel Saez, *The Top Incomes Database* (data for U.S.), <http://g-mond.parisschoolofeconomics.eu/topincomes/>.

Neither of these two tables is above criticism in its treatment of capital gains. Table 1, by excluding them, avoids the “bunching” problem of effectively mischaracterizing people who have an unusually high-income year by reason of selling an appreciated asset that has gained value over many years. Table 2, by including them, uses a broader measure of economic gain but subject to the bunching problem. Neither includes the income from holding appreciated assets that have not been sold. Thus, neither table would properly include in the top stratum some individuals who clearly belong there, such as the “founders of hugely profitable companies who are made rich by the stock appreciation but can live well by borrowing against the stock value and thus have no need to either pay themselves high salaries or sell their stock before death.”²⁵ The problem, of course, is that detailed data about income from unrealized asset appreciation is unavailable.

More generally, however, as Emmanuel Saez notes, “the income composition pattern at the very top has changed considerably over the century [with] an explosion of top wages and salaries [T]op income earners today are not ‘rentiers’ deriving their incomes from past wealth but rather are ‘working rich,’ highly paid employees or new entrepreneurs who have not yet

²⁴ Id.

²⁵ Id.

accumulated fortunes comparable to those accumulated during the Gilded Age.”²⁶ For high-earners in the top 1 percent of the income distribution, the enactment of a package that combined tax expenditure repeal with tax rate reduction, and that was designed to be distribution-neutral as to a broader swathe of high-earners, would likely offer a significant tax cut. This reflects that such individuals typically gain less from tax expenditures, relative to income, than those immediately below them, for two main reasons. First, at very high income levels, expenditures on the subsidized activities tend to decline as a share of income. For example, someone who is earning \$10 million per year is unlikely to own a home ten times as expensive (or with a mortgage ten times as high) as that owned by someone earning \$1 million per year. Second, in some cases the tax law places relevant dollar ceilings on the amount of benefit that a given taxpayer can claim. For example, Internal Revenue Code section 163(h)(3) places a \$1.1 million limit on the mortgage loan principal that can generate deductible interest expense.²⁷

In sum, I believe that the sharp increases since 1986 both in high-end income concentration and in the danger of a budget catastrophe suggest that rate cuts for high-income individuals, even if financed by base-broadening, would be undesirable. At least as to the income taxation of individuals, it is long past time to consign the 1986 tax reform model, in which base-broadening inevitably is accompanied by rate cuts, to the dustbin of history – which is to deny neither that it was an excellent idea in its time²⁸ nor that its timeliness might return some day.

D. What About Budget-Worsening, But Otherwise Potentially Desirable, Tax Reform?

²⁶ Emmanuel Saez, *Striking It Richer: The Evolution of Top Incomes in the United States (Updated with 2008 Estimates)* at 4 (footnote omitted).

²⁷ See Eric J. Toder, Benjamin H. Harris, and Katherine Lim., *Distributional Effects of Tax Expenditures* (2009).

²⁸ See Shaviro, *1986-Style Reform*, *supra*, at 820-821.

If budgetary (along with distributional) concerns suggest not cutting individual income tax rates at any time in the near future, what about other tax reform ideas that would lose revenue? A short answer would be that our current fiscal situation tends to weigh against adopting any of them. This is one of the problems with being on an unsustainable fiscal course that involves a risk of budgetary catastrophe – it reduces our flexibility to adopt what might otherwise be unambiguously good policy changes, given that moving further away from long-term balance is potentially so dangerous.

Nonetheless, I would not argue that *no* such changes should be adopted until the long-term U.S. budget situation has significantly improved, given that this might mean forgoing otherwise feasible improvements to the tax system. Rather, I would just argue that any such changes should be contemporaneously fully financed – although, even so, the long-term budget situation might be slightly worsened via the use of “low-hanging fruit” that could otherwise have been used to improve our long-term fiscal prospects²⁹ – and that the risk of diverting political effort from budgetary improvement must also be kept in mind.

With these caveats in mind, the main potentially revenue-losing tax reform ideas that might be worth considering despite the dire federal budget situation, and that in its absence clearly would merit serious attention, include the following:

1) Replacing the income tax with a progressive consumption tax – In academic tax policy circles, recent years have seen a shift towards “an emerging new consensus (widespread if not universal) that an ideal consumption tax is unambiguously superior to an ideal income tax, taking into account concerns of both efficiency and distribution.”³⁰ The two main models for a progressive consumption tax are (a) the X-tax, which essentially is a value-added tax (VAT) with

²⁹ See *id.* at 818.

³⁰ Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 *Stan. L. Rev.* 745, 747 (2007).

wages being deducted by businesses and included by workers, rather than ignored, so that progressive rates can apply to them, and (b) a consumed income tax, which would look somewhat like the existing income tax except that all saving would be deducted while borrowing was included in “income.”³¹

To be sure, the emerging consensus, even assuming that it is correct, does not automatically establish that a real-world consumption tax, comparably progressive to the existing income tax, would be superior in practice despite the political compromises that inevitably would accompany its actual enactment.³² However, one reason for optimism that a replacement consumption tax would be an improvement is that it would not have to deal with the realization requirement, thus permitting significantly reduced statutory and tax planning complexity.³³

Shifting from income to consumption taxation may be budget-negative if statutory tax rates stay the same. After all, a well-designed consumption tax, unlike a well-designed income tax, excludes annual returns to saving from the tax base. However, as Joseph Bankman and David Weisbach have noted, it can be misleading to view the consumption tax base as “narrower,” given the basic bias in an income tax against later consumption relative to sooner consumption. The “broader” base in an income tax simply means that the tax rate for consumption rises as one defers engaging in it, whereas a properly functioning consumption tax imposes the same tax rate on consumption in all periods.³⁴ Thus, while it is true that shifting to a consumption tax might be budget-negative if one kept everything else the same, a better

³¹ See Daniel N. Shaviro, *Replacing the Income Tax With a Progressive Consumption Tax*, 103 Tax Notes 91, 93-96 (2004).

³² On the imperfections that actual enactment of a consumption tax replacement for the income tax might make likely, see Daniel Shaviro, *Simplifying Assumptions: How Might the Politics of Consumption Tax Reform Affect (Impair) the End Product*, in John W. Diamond and George R. Zodrow (eds.), *FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS* (2008).

³³ See Shaviro, *Replacing the Income Tax*, *supra*, at 94.

³⁴ See Joseph Bankman and David A. Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 Stan. L. Rev. 1413 (2006).

comparison might involve nominally increasing the tax rate so that consumption on average faced the same tax rate as before.

The risk of a budgetary catastrophe affects the analysis in two main ways, apart from the obvious point that focusing on the tax base shift might divert attention from the arguably more urgent problem of restoring fiscal sustainability. First, when shifting from an income tax to a progressive consumption tax, it is natural to think (1986-style) in terms of budget neutrality and distributional neutrality, in order to offer a clean comparison along the key dimension that is being changed. However, given both the dangerousness of our current fiscal course and the clear conceptual distinction between tax base choice on the one hand and the use of the tax system to deliver targeted benefits on the other hand, this arguably should be done relative to an income tax that has been shorn of the tax expenditures that Congress is willing to eliminate.³⁵ Second, the possibility (discussed in section III below) that a VAT would be enacted in the course of moving towards long-term budgetary balance might need to be considered as part of the tax reform process. At least if the VAT-like X-tax structure is used, administrative coordination between that system and a newly enacted VAT might need to be considered.

2) Corporate tax reform – In the last few years, broad support across the political spectrum has emerged for lowering the U.S. corporate tax rate, at least if this can be done as part of a budgetarily responsible broader package (such as one with offsetting corporate or business sector-related base-broadening). The key rationale is that the U.S. now has one of the world's highest statutory corporate tax rates. This may be nationally disadvantageous – for example, by reason of its encouraging multinationals to shift taxable income out of the U.S. – even if,

³⁵ Cf. 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 (1997) (noting that replacing the income tax with a consumption tax could be thought of as a two-stage process, in which one first repeals income tax preferences and then switches to a consumption base).

reflecting tax preferences or tax planning opportunities, the effective U.S. corporate tax rate is more in the mainstream.

In addition, given that equity-financed corporate income is potentially double-taxed (at both the entity and shareholder levels), whereas that which is debt-financed effectively faces U.S. taxation at most once, parity between the corporate and individual rates creates a significant aggregate bias in favor of debt financing. Tax experts have long condemned this bias, but in the aftermath of the 2008 financial crisis, which reflected high levels of corporate leverage, it may look even worse than it did before.³⁶ Against this background, reducing corporate rates relative to individual rates may reduce the tax code's aggregate debt bias, by making equity finance tax-preferable in more circumstances.

Despite the widespread support for corporate rate reduction, there is a good argument that it should take a backseat to other reform proposals that are similarly motivated. In particular, consider proposals to adopt either (1) an allowance for corporate equity (ACE), providing the equivalent of an interest deduction with respect to corporate stock, or else (2) an allowance for corporate capital (ACC), providing a uniform cost of capital deduction, for corporate debt and equity alike, without regard to actual interest paid. I have argued elsewhere that U.S. corporate tax reform should prioritize these proposals relative to considering corporate rate reductions.³⁷

Either way, even if the change was financed by corporate or business-sector base-broadening, the “low-hanging fruit” argument makes its adoption potentially budgetarily disadvantageous. Again, this is not to say that one of these reforms should not be adopted, but

³⁶ See Shackelford, Shaviro, and Slemrod, *supra*; International Monetary Fund, Fiscal Affairs Department, *Tax Biases to Debt Finance: Assessing the Problems, Finding Solutions*, May 3, 2011 (prepared by Rudd A. de Mooij).

³⁷ See Daniel Shaviro, *Should corporate tax reform efforts prioritize an “allowance for corporate equity” (ACE)?*, available on-line at http://www.law.nyu.edu/ecm_dlv4/groups/public/@nyu_law_website_faculty_faculty_profiles_dshaviro/documents/documents/ecm_pro_068214.pdf.

once again we see how an unsustainable fiscal path reduces policy flexibility and makes what might otherwise be clear improvements harder to endorse wholeheartedly.

3) International tax reform – Albeit with less consensus, there has also been a discernible increase in recent years in both political and academic support for lowering the U.S. tax burden on outbound investment by U.S. multinationals, and perhaps even for exempting from U.S. tax their foreign source active business income.³⁸ This shift in sentiment reflects that other countries, such as the United Kingdom and Japan, have been moving towards exemption, and that rising global capital mobility may reduce the U.S.’s ability to benefit from taxing resident multinationals’ foreign source income.³⁹ Once again, however, even if one still favors the change on balance,⁴⁰ budgetary concerns clearly do not help.⁴¹ One way of addressing them in part, while also potentially increasing economic efficiency, would be to eliminate U.S. companies’ windfall gain from the shift to exemption by imposing a one-time transition tax on their pre-enactment foreign earnings that have not yet been taxed here.⁴²

III. SOME POSSIBLE NEW TAX INSTRUMENTS

If Congress ever decides seriously to address the long-term U.S. fiscal gap on the revenue side, new tax instruments may well play a significant role, both because there are several plausible candidates and in view of longstanding income tax preferences’ political entrenchment.

The following are some very brief observations on several of the leading candidates.

³⁸ See Daniel Shaviro, *Fixing the U.S. International Tax Rules* (2011).

³⁹ See Daniel Shaviro, *The Rising Tax-Electivity of U.S. Corporate Residence*, forthcoming in Tax Law Review.

⁴⁰ My own view is that the case for exempting U.S. multinationals’ foreign source income is weaker than that for what I call “burden-neutral” elimination of foreign tax credits and “deferral” for foreign subsidiaries’ foreign source income. See *id.*

⁴¹ It is possible for a shift to exemption for foreign source income to increase U.S. tax revenues, if accompanied by changes to the rules defining U.S. source income. See, e.g., Harry Grubert and John Mutti, TAXING INTERNATIONAL BUSINESS INCOME: DIVIDEND EXEMPTION VERSUS THE CURRENT SYSTEM (2001). Even in this scenario, however, exemption for foreign source income is budget-negative relative to making the same changes to the source rules while retaining a positive tax rate for U.S. companies’ foreign source income.

⁴² See Shaviro, *Rising Tax-Electivity*, *supra*. Lowering the corporate rate likewise raises a transition issue with respect to earnings that accrued but were not taxed pre-enactment, while ACC and ACE raise such an issue if applied to pre-enactment equity.

1) Value-added tax (VAT) – Nearly 150 countries around the world employ a VAT, and the U.S. is the only exception among countries of significant size.⁴³ Its widespread use reflects “such virtues as [its] being the best method of taxing general consumption, its neutral treatment of exports, and its revenue-raising capacity.”⁴⁴ Many commentators believe that VAT adoption is likely to be crucial in the U.S. to restoring fiscal sustainability and perhaps even making tax reform more affordable.⁴⁵ VATs still attract criticism in U.S. academic debate, both on the right for being potentially *too* effective a revenue-raising tool⁴⁶ and on the left for being (at least as considered in isolation) regressive.⁴⁷ Nonetheless, arguably the main obstacle to their adoption in the U.S. is simply the overwhelming public and political distaste both for tax increases of any kind, and more generally for taking seriously the need to make hard choices in order to avoid a fiscal catastrophe.

An optimistic scenario might hold, however, that VAT adoption will become feasible and even likely at some point, either in direct response to a full-blown budget crisis or as part of a 1980s-style grand bargain between Democrats and Republicans in which both the revenue and outlay sides of the federal budget are seriously addressed. Conceivably, VAT enactment might be accompanied by efforts to “earmark” the revenues so that they could only be used for particular purposes, such as to fund entitlements spending, in the hope that this would limit any

⁴³ Sijbren Cnossen, *A VAT Primer for Lawyers, Economists, and Accountants*, in Tax Analysts, THE VAT READER: WHAT A FEDERAL CONSUMPTION TAX WOULD MEAN FOR AMERICA 23 (2011).

⁴⁴ Kathryn James, *Exploring the Origins and Global Rise of VAT*, in Tax Analysts, THE VAT READER: WHAT A FEDERAL CONSUMPTION TAX WOULD MEAN FOR AMERICA 19 (2011). A key advantage of the VAT over retail sales taxes (RSTs), which many U.S. states and localities use, is that a VAT’s offsetting taxes and refunds for inter-business sales, which RSTs simply ignore, helps governments to combat evasion. See Shaviro, *Replacing the Income Tax*, *supra*, at 93.

⁴⁵ See, e.g., Michael J. Graetz, *VAT as the Key to Real Tax Reform*, and Reuven S. Avi-Yonah, *The Political Pathway: When Will the U.S. Adopt a VAT?*, both in Tax Analysts, THE VAT READER: WHAT A FEDERAL CONSUMPTION TAX WOULD MEAN FOR AMERICA 19 (2011).

⁴⁶ See, e.g., Douglas Holtz-Eakin, *The Case Against VAT*, in Tax Analysts, THE VAT READER: WHAT A FEDERAL CONSUMPTION TAX WOULD MEAN FOR AMERICA 19 (2011).

⁴⁷ See, e.g., Jane G. Gravelle, *The Distributional Case Against a VAT*, in Tax Analysts, THE VAT READER: WHAT A FEDERAL CONSUMPTION TAX WOULD MEAN FOR AMERICA 19 (2011).

inclination to dissipate the budgetary gain through increased outlays. Earmarking is always a challenging proposition given that money is fungible, but it can conceivably have an effect if political actors regard as meaningful the distinction between general and earmarked revenues.

If the U.S. adopts a VAT, adopting a proper design from the start is important, as “mistakes made at introduction are hard to undo.”⁴⁸ Many experts agree that a well-designed VAT should reach a broad measure of domestic consumption, with a single positive rate for all items and a fairly high threshold for requiring businesses to participate.⁴⁹ Exempting “necessities” such as food, in the hope that this would make the VAT more progressive, not only increases complexity and inefficiency, but is poorly-targeted as distributional policy, since “[i]n absolute terms, the benefit ... accrues mainly to middle and high-income consumers who buy more expensive varieties of food.”⁵⁰

(2) Carbon and other energy taxes – At least with adequate global cooperation, a well-designed carbon tax⁵¹ could address global warming while also raising revenue, most likely starting at well over \$100 billion per year.⁵² Carbon taxes, like other Pigovian pollution taxes that put a price on the negative externalities created by economic actors that otherwise (since not priced by the market) would cause them to have suboptimal incentives, can actually increase efficiency, rather than increasing aggregate distortion in the manner of even a well-designed income or consumption tax. Moreover, while cap-and-trade systems, such as that which the U.S.

⁴⁸ Michael Keen, *What Do (and Don't) We Know About the Value Added Tax? A Review of Richard M. Bird and Pierre-Pascal Gendron's The VAT in Developing and Transitional Countries*, 47 J. Econ. Lit, 159, 169 (2009).

⁴⁹ See id. at 160-161; Cnossen, *supra*, at 48-49.

⁵⁰ Cnossen, *supra*, at 49. From a design standpoint, several recently adopted VATs, such as those in New Zealand, Singapore, and South Africa, provide a much better model than the older European VATs, which generally include multiple rates. Id. at 48-49.

⁵¹ On carbon tax design issues, see Gilbert Metcalf and David Weisbach, *The Design of a Carbon Tax*, 33 Harv. Envtl. L. Rev. 499 (2009). Metcalf and Weisbach conclude that a well-designed carbon tax “can easily cover 80% of U.S. emissions and can likely cover almost 90% with a modest additional cost.” Id. at 556.

⁵² See Robert N. Stavins, *A Meaningful U.S. Cap-and-Trade System to Address Climate Change*, 32 Harv. Envtl. L. Rev. 293, 302 (2008) (addressing potential revenues under a cap-and-trade system).

Congress recently considered, are in principle potentially interchangeable with carbon taxes, the latter are widely viewed as likely to be economically and administratively preferable in practice.⁵³

It is conceivable that a carbon tax would also be budgetarily preferable to cap-and-trade at the time of adoption. When cap and trade systems are adopted or seriously considered, it is common for emission permits at least initially to be given away to existing producers, rather than sold at auction – even though “economists across the political spectrum have condemned free permit allocation as a pernicious combination of inefficiency and inequity.”⁵⁴ While political pressures to favor the energy industry might be expected either way, to a large extent “the support for free permit allocation rests on an artifact of labeling. “‘Cap and trade with free permit allocation’ and ‘carbon tax with all revenue used to make transfer payments to [energy companies’] shareholders are two labels for the same underlying policy,” but only the latter attracts “no support.”⁵⁵

Absent the enactment of a general carbon tax, narrower energy taxes could also increase efficiency while raising significant revenue. It has been estimated, for example, that the optimal gasoline tax would be twice as high as that currently imposed in the U.S.,⁵⁶ though largely due to negative externalities from driving, such as the effect on congestion, wholly apart from carbon emission.⁵⁷ Increasing coal excise taxes might also be significantly better than doing nothing, although both the efficiency benefits and the revenue potential of carbon taxation are reduced when the tax base is narrower.

⁵³ See Metcalf and Weisbach, *supra*, at 502 n. 11.

⁵⁴ Alan D. Viard, *Don't Give Away the Cap-and-Trade Permits!*, 123 Tax Notes 613 (2009).

⁵⁵ *Id.*

⁵⁶ Ian W.H. Parry & Kenneth A. Small, Does Britain or the United States Have the Right Gasoline Tax?, 95 Am. Econ. Rev. 1276, 1277 (2005).

⁵⁷ Metcalf and Weisbach, *supra*, at 528.

3) Financial transactions tax (FTT) – The idea of levying a tax on certain financial transactions, such as secondary trading of equity shares, has been around for many decades. In recent years, however, it has received renewed attention, due both to its apparent revenue potential and the hope that it might address ostensibly harmful excess liquidity in capital markets and thus, for example, reduce price volatility and the formation of bubbles.⁵⁸ For example, an FTT of 0.5 percent on U.S. equity trades – assuming it functioned effectively, which might involve considerable difficulty given the likely need to apply it to transactions using derivatives – might raise \$28 billion or more, according to recent estimates.⁵⁹ If such a tax, as a side effect, were to “curtail short-term speculation, thereby reducing wasted resources, market volatility, and asset mispricing,”⁶⁰ then it might be viewed as no less Pigovian in character than a carbon tax or other pollution tax.

Unfortunately for this hopeful view of FTTs, a recent study by Thornton Matheson concludes that “[t]here is no convincing evidence that [they] lower short-term price volatility,” and indeed they might increase it by discouraging and reducing trades.⁶¹ In addition, an FTT would “reduce security values and raise the cost of capital for issuers, particularly for issuers of frequently traded securities.”⁶² More generally, FTTs are misdirected from a Pigovian standpoint since, even if securities trading activity can in some cases involve resource waste⁶³ or create negative externalities (such as by increasing volatility or contributing to bubbles), it is not bad generally. Indeed, higher trading levels can have positive as well as negative spillovers, such as by

⁵⁸ See generally Thornton Matheson, *Taxing Financial Transactions: Issues and Evidence*, IMF Working Paper 11/54 (2011); Douglas A. Shackelford, Daniel N. Shaviro, and Joel Slemrod, *Taxation and the Financial Sector*, 63 *Nat’l Tax J.* 781, 796-797 (2010).

⁵⁹ See Matheson, *supra*, at 11 (Table 3).

⁶⁰ *Id.* at 12 (describing without endorsing the claims of FTT proponents).

⁶¹ *Id.* at 37.

⁶² *Id.*

⁶³ While there is no externality insofar as investors trade too much from the standpoint of their own self-interest, one could think of this as an “internality” problem, like discouraging myopic consumers.

increasing liquidity and permitting transaction counterparties to realize surplus by trading at market prices that differ from their own reservation prices. A better instrument to address malfunctioning financial markets would seek to target the particular types of trading that are thought to be especially problematic.

4) Financial activities tax (FAT) – In the aftermath of the 2008 financial crisis, many have taken the view that the financial sector (a) is too large, (b) generates excess profits (including amounts paid out as high-level executive compensation) that reflect either monopoly rents or the upside of undue risk-taking, and/or (c) imposes costs on the rest of society through the period Hobson’s choice between bailing out insolvent firms or suffering adverse macroeconomic shocks.⁶⁴ The staff of the International Monetary Fund (IMF) recently offered an innovative new tax proposal, involving the imposition of a financial activities tax or FAT that, depending on its design, could address one or more of these problems while also potentially raising significant revenue.⁶⁵

Although FAT variants differ, the basic idea might be to impose a tax on financial firms’ net cash flows, as determined without subtracting high-end (such as executive) compensation. Thus, the tax base might resemble that under an income tax except that all business outlays (other than nondeductible high-end compensation) would be expensed, rather than being in some cases capitalized. The rationale for expensing would be to impose tax only on financial firms’ extra-normal returns,⁶⁶ which might be thought to indicate the presence either of monopoly rents or of heads I win, tails you lose” risk-taking. The rationale for not deducting high-end compensation would be that executives and other highly compensated employees, rather than

⁶⁴ See Shackelford, Shaviro, and Slemrod, *supra*, at 787-792.

⁶⁵ See Staff of the International Monetary Fund, *A Fair and Substantial Contribution by the Financial Sector: Final Report for the G-20* (June 2010).

⁶⁶ Expensing for business outlays generally results in exempting the normal rate of return on investment. See, e.g., Shaviro, *Replacing the Income Tax With a Progressive Consumption Tax*, *supra*.

shareholders, were likely to be the ones actually capturing extra-normal profits and making unduly risky bets that reflected their skewed incentives.

Such an FAT could potentially raise significant revenue. The IMF Staff estimates that its annual tax base might equal 2.8 percent of U.S. gross domestic product (GDP).⁶⁷ This suggests that an FAT with a rate of, say, 15 percent could raise more than \$60 billion per year.⁶⁸ Obviously, there would be major design challenges to consider, such as defining the set of financial firms to which it applied (preferably including those that were embedded in predominantly non-financial firms).⁶⁹ What is more, the U.S. financial industry's staggering economic and political power might make adoption of the FAT extremely challenging even if the U.S. political environment were not otherwise so rabidly hostile to revenue-raising. Nonetheless, the FAT clearly deserves to be on the list of new tax instruments that the U.S. should consider, partly as an independent matter of sound fiscal design but all the more so if the revenues could help forestall a U.S. budget catastrophe.

IV. CONCLUSION

Despite the demographic causes of the long-term U.S. fiscal gap, only severe dysfunction in our political system, abetted by malfunctioning and discontinuously responsive global financial markets, could lead to a U.S. budget catastrophe. Unfortunately, the risk of disaster appears to be alarmingly high. The rising danger has implications both for income tax reform and for the possible adoption of new tax instruments.

For income tax reform, the main implication is that base-broadening should be undertaken without accompanying 1986-style tax rate reduction. The threat of a fiscal

⁶⁷ See IMF Staff Report, *supra*, at 70, Table A-6, Column 6.

⁶⁸ Projected U.S. GDP for 2012 is \$15.8 trillion.

⁶⁹ See Shackelford, Shaviro, and Slemrod, *supra*, at 800.

catastrophe also raises concern about otherwise desirable but potentially revenue-losing reforms, such as to the rules for corporate and international taxation.

A number of tax instruments not currently used in the U.S. might be appealing even if the reform that included them was revenue-neutral overall. These include a value-added tax (VAT), a carbon tax, and a financial activities tax (FAT), although in my view a financial transactions tax (FTT) would not have comparable merit. All of these instruments potentially gain appeal if they could be used to ease the political prospects for raising overall U.S. tax revenues, and thus for reducing the risk of a budgetary catastrophe.