

**“The U.S. Tax System in International Perspective”:
A Review of the 2006 *Economic Report of the President’s Tax Chapter*¹**

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What can you say about a tax reform proposal that died?

This was the challenge facing the writers of the chapter on taxation for the 2006 *Economic Report of the President* (hereafter *ERP*). One year ago, the *ERP* included a chapter entitled “Options for Tax Reform” that began with the section heading “Why Do We Need Tax Reform?” and proceeded to lay out the available options that it suggested could make the U.S. tax system simpler, more equitable and efficient. In making the case for tax reform, that chapter set the stage for the impending work of the President’s Advisory Panel on Tax Reform while being careful to leave the President’s options open until the Panel reported. The 2005 chapter twice included the phrase “The President has not endorsed any specific proposal, and this chapter does not advocate the adoption of any particular prototype for reform.” In case the reader didn’t get the message the first two times, the chapter concluded with a reminder that “The President has not endorsed any specific proposal.”²

That was then. In November, 2005, the Tax Reform Panel issued its report, so one might have anticipated a follow-up chapter in this year’s *ERP* evaluating the Panel’s

¹ I am grateful to Rosanne Altshuler, Bill Gale, Kevin Hassett and Joel Slemrod for comments on an earlier draft.

² Slemrod (2005) provides a critical evaluation of the 2005 chapter.

recommendations and laying out the Administration's plans for pushing the tax reform process forward. But the Administration appears to have lost interest in tax reform at some point between the Panel's creation and the filing of its report. Thus, the 2006 *ERP*'s chapter on taxation devotes remarkably little space to the Panel's report; what little discussion the chapter does offer seems tacked on and largely unrelated to the chapter's main thrust, like an obituary included along with the news. There is just a passing mention of the Panel's work early in the chapter, a paragraph near the end of the chapter describing the Panel's activities and an accompanying text box that concludes that the Panel's two proposals "deserve serious consideration and more comprehensive analysis" (p. 122) but offers not the slightest hint that either will be forthcoming from the Administration. Stepping back from last year's theme that tax reform was imperative and that many concrete options were available, this year's chapter expresses the modest aim of providing "a broader context for evaluating these [the Panel's two proposals] and other potential reforms." (p. 107)

What can we learn from the failure (to date) of the most recent go at tax reform and from this year's choice of topics, particularly the decision to compare the U.S. tax system's characteristics to those of other leading economies? The retreat from tax reform might be attributed in part to last year's collapse of the Administration's plans for Social Security privatization. The major distractions of foreign policy no doubt played a role as well. But another explanation for the loss of enthusiasm for tax reform, and also for the decision to focus attention in this year's tax chapter on the international context, is the pressure of the growing U.S. fiscal imbalance, as represented by the shift from surpluses to deficits in the current decade and forecasts of truly staggering deficits in the years to

come. The U.S. fiscal imbalance has contributed to a large current account imbalance that increases our political sensitivity to foreign competition; hence the attention to the international context. At the same time, the fiscal imbalance has, for some, cast the crusade for tax reform as a quaint diversion from confronting the specter of exploding entitlement programs, even though tax reform and fiscal responsibility can be complementary activities; with revenue likely to rise as a share of GDP from its current share, so will marginal tax rates and the marginal deadweight loss from taxation, as well as the potential welfare gains from reducing the tax system's distortions through tax reform.

As one reads through the *ERP* in its entirety, the fiscal imbalance's footprints are everywhere. Chapter 3, entitled "Saving for Retirement," discusses the looming problem facing the Social Security system, noting that the system's funding gap through 2080 is an estimated \$4 trillion in present value; Chapter 4, "Improving Incentives in Health Care Spending," discusses the magnitude of the unfunded liabilities of Medicare and Medicaid, providing estimates of the huge tax increases or benefit cuts that would be needed to close the gap in funding just for the Health Insurance portion of Medicare; and Chapter 6 considers the impact of very low rates of government saving and national saving on international flows, granting that "Most economists agree that fiscal deficits will, all else equal, lead to an increase in the country's trade and current account deficits." (p. 141)

The *ERP* is not simply an academic document, though; it must also pass through an Administration's political filters. As a result, perhaps, there is on occasion a surprising happy spin amidst the sober warnings and bad fiscal news. Chapter 6,

discussing the historically large U.S. current account deficits, might have been entitled “The U.S. Current Account Deficit,” but through the magic of the international accounts identity it has shifted focus and become “The U.S. Capital Account Surplus,” presenting a review of why the United States is such an excellent place to invest. The *ERP* also sidesteps issues that, while relevant, would be awkward to discuss. The chapter on health care spending promotes various policy initiatives to rein in rapidly growing public and private health care expenditures, but includes not a single reference to the recently enacted Medicare prescription drug benefit, which has greatly increased Medicare’s long-run cost and has an estimated unfunded liability that is nearly as large as that of Medicare’s Hospital Insurance component and substantially larger than the unfunded liability of the Social Security system.³

Another example of possible political influence on language may be found in the review of Social Security in Chapter 3, where care is taken not to refer to the government bonds held in the Social Security trust fund as “assets” of the system that lessen its long-run funding gap, as they indeed do. Rather, they are called IOUs, as in “the Trust Fund’s IOUs will run out by 2041” (p. 80), presumably to avoid undercutting the President’s call, thus far unheeded, to establish a system of personal accounts that do not rely on a public trust fund.

In the midst of all the *ERP*’s references to the U.S. fiscal imbalance and its effects, Chapter 5 offers a reasonably peaceful respite. True, the skunk makes a cameo appearance at the garden party in the form of a text box entitled “Fiscal Challenges

³ According to the 2005 Medicare Trustees Report, the present value of general revenues that would be required to fund the prescription drug benefit over the infinite horizon is \$18.2 trillion (Table III.C22), nearly as large as the \$24.1 trillion infinite-horizon funding gap for the Hospital Insurance program (Table III.B10). According to the 2005 Social Security Trustees Report, the unfunded liability for Social Security over the infinite horizon is \$11.1 trillion (Table IV.B6).

Ahead,” which reinforces the message contained elsewhere in the *ERP* that exploding entitlement programs cannot be sustained without “massive tax increases” or the “near-elimination of all government programs outside of entitlements.” (p. 114) As with the discussion of the Tax Reform Panel’s recommendations, though, this text box seems pasted into the chapter. Moreover, although the gravity of the situation is accurately reported, there is no hint either here or anywhere else in the chapter that the series of tax cuts adopted beginning in 2001 has anything to do with the unfolding U.S. fiscal imbalance;⁴ nor is the recent rapid growth of defense and non-defense discretionary spending mentioned.⁵ The problem is traced solely to the projected growth of Social Security, Medicare and Medicaid, although once again there is no reference to the contribution of the recent introduction of a Medicare drug benefit to the size of Medicare’s unfunded liability.

There is also virtually no mention in the chapter of a central and largely novel element of tax policy during the Bush Administration, the sunset, under which tax cuts expire after a specified date. For example, all of the provisions in the large 2001 tax cut are scheduled to expire at the end of 2010, and the 2003 reductions in tax rates on dividends and capital gains expire after 2008, even though there were no coherent tax policy reasons advanced at the time of passage for making these provisions temporary.

⁴ Auerbach, Gale and Orszag (2004) estimate that the 2001 and 2003 tax cuts plus the cost of making these tax cuts permanent would increase the fiscal gap by 2.2 percent of GDP through 2080 and over an infinite horizon. In present value, the tax cuts widen the fiscal gap by \$11 trillion through 2080 and \$18 trillion over an infinite horizon.

⁵ According to CBO (2006), defense discretionary spending rose from 3.04 percent of GDP to 4.02 percent of GDP during the four fiscal years between 2001 and 2005. All other discretionary spending grew from 3.41 percent of GDP to 3.85 percent of GDP. As non-defense homeland security spending accounted for 0.21 percent of GDP in fiscal year 2005, less than half the growth in non-defense spending can be attributed to the growth of homeland security spending, even if that spending is assumed to have been zero in fiscal year 2001.

The chapter contains just a passing statement about the President's wish to make the 2003 tax cuts permanent, without going into any explanation of why the tax cuts were temporary in the first place. While sunsets may reflect rational behavior on the part of politicians seeking to work around the existing budget restrictions and procedures⁶, they have contributed gratuitous uncertainty to the economic environment that is difficult to reconcile with the usual objectives of tax reform to raise revenue as simply and efficiently as possible.

Nor is there any substantive discussion in Chapter 5 of the individual Alternative Minimum Tax (AMT), which has become a major tax policy headache. Because of its lack of bracket indexing, the AMT, once aimed at a small group of high-rollers, is encroaching on a larger and larger fraction of the taxpaying population each year, a process accelerated by the 2001 tax cuts, which reduced tax liabilities under the regular income tax but not under the AMT. The years since 2001 have witnessed a continuing struggle with temporary fixes, a permanent solution to the AMT involving too large a cut in revenue to appeal to lawmakers.⁷ The only mention of the individual AMT in Chapter 5 is in the text box discussing the Tax Reform Panel's work, noting that the Panel's two recommended plans each would have repealed the AMT.

The material that *is* contained in Chapter 5 is broken down into three main sections. The first, "Fundamental Choices in Tax Systems," aims to present, at a very general level, the options available in choosing a tax system and the criteria that should be used in selecting among these options. The chapter's second main section, "U.S. Tax

⁶ See Auerbach (2006).

⁷ For further discussion of the mechanics of the AMT, see Burman, Gale, and Rohaly (2003) and CBO (2004).

Policy in International Perspective,” summarizes the choices we have made thus far, and how our choices compare to those made by the OECD and G-8 countries, particularly in light of recent tax changes in many of these other countries.

The third main section of the chapter, “U.S. Tax Reforms: Past, Present, and Future,” reviews the state into which the tax system has evolved in the years since the Tax Reform Act of 1986, a period that, in a startling rhetorical flourish, is described by a subheading as “Twenty Years of Tax Reform” (p. 119). If tax reform is what the past two decades have given us – with many pieces of legislation that have narrowed the tax base and increased disparities in the treatment of different industries, assets, and types of transactions – then maybe we don’t need more tax reform. Curiously, the only potential reform proposal this section singles out for discussion is one that was not mentioned at all in last year’s survey of alternatives and then was explicitly rejected by the Tax Reform Panel: the Comprehensive Business Income Tax (CBIT) originally put forward by the Treasury in the early 1990s (U.S. Department of the Treasury 1992) as a method of taxing business income in a less distortionary manner than under the present system. Finally, this section of the chapter touches briefly on the Panel’s two proposals.

The chapter concludes its evaluation of the U.S tax system in comparison to those of other leading economies that “international differences could endanger the ability of the U.S. economy to attract capital in a world where capital is increasingly mobile.” (p. 123) It is not clear how this conclusion relates to the material in Chapter 6 that argues that U.S. capital inflows are so strong in part because of the favorable climate the U.S provides for inbound investment. As Chapter 6 does not offer the U.S. tax system as one of the reasons for capital inflows, perhaps what is implied by the two chapters together is

that the United States attracts so much capital not because of our tax system, but rather in spite of our tax system; or, perhaps, the editors of the *ERP* didn't catch the inconsistency between the two chapters.

The last sentence of Chapter 5 is hard to dispute:

Any reform of the U.S. tax system should aim to improve the performance of the U.S. economy and to spread the burden of financing government spending simply and fairly. (p. 123)

But it is not clear how this summation relates to the rest of the material in the chapter.

What are the fundamental choices of tax policy? The chapter distinguishes between the choices of tax rate and tax base. Like the corresponding chapter in last year's *ERP*, Chapter 5 of the 2006 *ERP* emphasizes the distinction between income and consumption as a key choice with respect to the tax base. The chapter also focuses this year on the distinction under the income tax between worldwide and territorial taxation – whether to tax income of U.S. residents, wherever that income is earned, or to tax the income earned in the United States, regardless of who earns it. As to the choice of tax rates, the chapter highlights the equity-efficiency trade-off of progressive taxation, as well as the distortions associated with differential taxation of different investment activities. It also emphasizes the difference between statutory and *effective* tax rates on activities, the latter taking into account provisions that cause the base to deviate from its standard definition.

While these general points are straightforward and not controversial, some of the chapter's more detailed statements in relation to these basic points are far less clear. On the subject of income versus consumption taxation, the chapter twice refers to the U.S. system as a hybrid of income and consumption taxation, citing the fact that it “excludes

significant portions of the return to savings from the tax base” (p. 108) and suggesting that as a result of such provisions, “some of the taxes collected through the U.S. income tax system, and those of other countries, might be thought of as taxes on consumption.” (p. 115) There are two things wrong with this conclusion.

First, a system that includes some income tax provisions and some consumption tax provisions does not necessarily simulate a system that is part income tax and part consumption tax, for example a combination of a broad-based income tax and a broad-based value-added tax (VAT). Under the latter approach, an individual’s returns to saving would be taxed uniformly at the income tax rate. Under a system like the current U.S. system that shields some investments from tax while taxing others and permitting interest deductions, returns to saving can face a wide variety of effective tax rates and taxpayers can exploit the inconsistencies in the treatment of different assets and liabilities by engaging in tax arbitrage without doing any net saving at all.

Second, there is an important distinction between eliminating taxes on capital income and imposing a consumption tax. While both approaches leave marginal investments facing no taxes in present value, eliminating capital income taxes provides large windfalls to owners of existing assets that make the tax system not only less progressive but also less efficient, because the windfalls must be financed through additional distortionary taxes. Even under conditions for which a move to consumption taxation may produce efficiency gains, eliminating capital income taxes, or adopting a consumption tax with generous transition relief, may not, because the windfalls provided to existing assets must be paid for with higher distortionary marginal tax rates.⁸

⁸ See Auerbach and Kotlikoff (1987), Auerbach (1996), and Altig et al. (2001).

The last fundamental tax policy choice the chapter discusses is between worldwide and territorial taxation of foreign source income. This enormously complex and increasingly important issue is covered in one short paragraph, which concludes that U.S. companies, paying both host-country and domestic taxes, may face competitive disadvantages abroad relative to companies from countries that tax on a territorial basis and therefore impose no additional taxes on foreign source earnings. This conclusion is modified by the key phrase “all else being equal” (p. 111) but the reader gets no sense of the importance of this qualification or of what is being held equal. While the literature on the optimal taxation of foreign source income provides some conditions under which a small country might wish to eschew taxes on foreign source income (e.g., Slemrod et al. 1997), such conclusions are model dependent and the United States is not small.

This discussion of one aspect of U.S. and foreign tax policies leads into the chapter’s next section, which offers a more comprehensive comparison of U.S. and foreign tax systems. The main message of this section is that marginal tax rates have been falling abroad and that this threatens to make the United States less competitive.

The section highlights four recent trends in international tax policy: reduced taxes on wage and salary income; reduced tax rates applied to corporate income; reduced taxation of capital income under the personal income tax; and increasing popularity of flat rate income tax schedules. The section says that some of the marginal rate reductions were accomplished by base broadening; as the fourth of these policy trends suggests, reductions in marginal tax rate progressivity may have been a factor as well. The other possible ways to reduce marginal rates include reductions in the size of government, a shift toward other types of taxes, notably consumption taxes, or simply reducing revenues

and rolling liabilities forward, the preferred U.S. method at the moment. A breakdown among these potential sources of foreign marginal rate reductions would have been helpful, because the implications are different for trends in the overall distortions facing economic decisions. For example, an increase in consumption taxes raises the effective tax rate on wage and salary income; and, as the chapter itself points out, “the costs of government borrowing must ultimately be financed by tax revenues” (p. 108), so the future marginal tax rate increases need to be taken into account.

With the dust settled, the United States now finds itself relying less heavily on consumption taxes than do other OECD countries but not imposing unusually high personal income tax rates, in part because we raise less revenue than most as a share of GDP. The chapter is silent about the choices that have led to higher government revenues abroad, in particular the more generous social safety nets, despite the fact that decisions about how to raise money and what to do with the money raised should not be independent. In particular, the use of consumption taxes often seen as regressive might be viewed as less bothersome if accompanied by a generous system of transfer payments.

But while the U.S. tax rate on corporate income has fallen over the years, corporate tax rates abroad have fallen more, leaving the United States with a high rate by international standards. The chapter notes that the pattern of falling statutory corporate tax rates abroad has been accompanied by a broadening of corporate tax bases, “resulting in little change in effective average rates.” (p. 118) Other recent studies (e.g., CBO 2005) offer the same general picture, that the U.S. statutory corporate tax rate is now high by international standards, while the effective rates facing investment in the United States, taking depreciation and other relevant provisions into account, are not. The section

draws the conclusion that with this pattern of falling statutory rates, “the United States risks becoming less competitive in attracting capital.” (p. 118) But if only the statutory U.S. corporate tax rate is high, and not the effective tax rate facing investment, then why should this conclusion follow?

Possibly the idea is that companies may shift capital in order to shift other complementary activities that do not receive investment incentives; for such other activities, the statutory tax rate is more relevant than the effective tax rate. Or perhaps companies may shift capital simply to facilitate the shifting of reported profits to countries with low statutory tax rates, placing some capital there to make the reporting of large profits less implausible. These are both responses explored in the recent literature⁹, but the issue is not simply the treatment of capital flows *per se*. The message is relevant, though, even if the implications are not clearly drawn in the chapter. It may become increasingly difficult and distortionary for the U.S. to tax capital income as time goes by, meaning that tax reforms aimed at shifting the burden away from capital income without sacrificing the other objectives of tax policy should be on the agenda. Either of the Tax Reform Panel’s two suggested plans would take modest steps in this direction. But their reception thus far and the lack of new direction in this year’s *ERP* cannot leave one optimistic that help is on the way, either to improve the U.S. tax system’s efficiency or its capacity to finance government spending.

⁹ See, e.g., Devereux and Griffith (1998) and Desai, Foley and Hines (2002).

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