2017

Comment on 'Fundamental Tax Reform: A Comparison of Three Options'

James R. Hines Jr.
University of Michigan Law School, jrhines@umich.edu

Publication Information & Recommended Citation
Hines, James R., Jr. "Comment on 'Fundamental Tax Reform: A Comparison of Three Options'." In *The Economics of Tax Policy*, edited by Alan J. Auerbach and Kent Smetters, 369-374. New York: Oxford University Press, 2017.

The Economics of Tax Policy

Edited by Alan J. Auerbach

and

Kent Smetters

OXFORD
UNIVERSITY PRESS

COMMENTARY ON CHAPTER 11

James R. Hines Jr.

Alan Viard's chapter, "Fundamental Tax Reform: A Comparison of Three Options" is a thoughtful, even-handed, and most worthwhile contribution to the analysis of major reforms that, if adopted, would move the tax system strongly in the direction of taxing consumption. The chapter nicely illustrates the complexity of the tax reform problem by exposing a range of available reform options, with an accompanying range of welfare implications. Even among tax reforms with common objectives, there can be strongly differing economic and distributional consequences. Furthermore, otherwise-similar reforms can and do appeal to very different political constituencies.

The economic arguments in favor of consumption taxation are by now well known, and rest largely on the potential to avoid the distortions that income tax systems create by compounding taxes on normal returns to longer-term investments. The inefficiency of existing taxation carries two implications for the desirability of tax reform. The first, and most direct, potential benefit of moving in the direction of a consumption-oriented tax system is that such a reform can improve resource allocation and thereby generate economic benefits that, in concept, can be widely shared among the population. The second potential benefit is more subtle and less commonly noted. It is that by decoupling the taxation of the normal return to investment from the taxation of other types of income, the tax system acquires design flexibility that permits the imposition of greater tax progressivity without producing the economic distortions that would accompany taxing capital income at damagingly high rates.

Both of these benefits make tax reform attractive, though it is noteworthy that realizing either requires the adoption of sensible plans that balance competing interests and benefits to different groups in the population. Identifying the effects of tax reform on the welfares of different groups in the population is indeed part of the chapter's point. It is worth stressing, however, that in order to obtain the available benefits of tax reform, and to generate the political support that a major tax reform requires, it is necessary for reform advocates and others to design reforms with these considerations in mind. One of the challenges of tax reform lies in crafting plans that appropriately address the concerns and interests of different groups, including those in the future as well as the present.

11C.1 REFORM TRANSITIONS AND REFORM ROBUSTNESS

The chapter rightly devotes attention to transitions from the current system of taxing income to alternatives that would tax consumption. Transitions are conceptually complicated and therefore analytically challenging, more so even than comparisons of the steady states of idealized potential reforms. Naturally, there are potential winners and losers from any reform, and it is often possible to craft reforms with features that mitigate distributional consequences—not perfectly, but enough to offer what may be rough justice.

Usually transition relief is predicated on the idea that a tax reform will be in place forever, which is entirely unrealistic, even in the case of a "fundamental" reform such as one that would move the system in the direction of taxing consumption. Experience confirms that tax reforms have finite life: tax reforms are followed by subsequent reforms, and these by yet further reforms. Furthermore, the direction of post-reform change cannot be predicted with certainty, since while it may be the case that in subsequent years governments decide to undo some previous reforms, the opposite also happens. For example, some of the reforms introduced by the US Tax Reform Act of 1986 were dampened or even reversed by subsequent US tax legislation, making these 1986 reforms temporary, and offering evidence of a form of regression to the mean in tax policy. But the world's experience with value added taxes (VATs) is the opposite, since most countries adopted VATs at low rates that were later increased, thereby effectively doubling down on the initial reforms that introduced the VATs.

Given that any tax reform is temporary, and that specific reforms may be partially or entirely unanticipated, many believe that the calculation of transition relief that makes taxpayers whole may require an estimate of how long a reform will be in place, and an estimate of what had been expected, and what policies and prices would have prevailed in the absence of reform. It is difficult to say with certainty because in order to know what information is needed it is critical to understand what function transition relief is intended to serve. Alas the literature is uniformly vague on this subject, in part reflecting the unrealistic premise that any contemplated reform will be the last time the government ever changes the tax laws.

Viewed from the standpoint of frequent, or at least episodic, tax reforms, it is possible to take a more principled stand on the subject of appropriate transition relief. The standard, and static, optimal tax problem as formulated by Ramsey, Mirrlees, and others has the government choosing tax laws and tax parameters to maximize social welfare. Once the policy is chosen, agents are informed of the government's choices and make their own decisions accordingly. One could imagine insisting on transition relief in this setting, in which the transition is understood to be the movement from a diffuse and unspecified tax policy to the one that the government chooses; but that is not how transition relief is typically understood, and there appears to be little support for the notion that taxpaying individuals in a Mirrlees- or Ramsey-style optimal tax setting are entitled to relief. The primary reason why taxpayers in these settings do not receive relief is that they are not blindsided by the policy the government adopts: taxpayers are fully aware of the tax environment, whether or not it is favorable to them, and behave accordingly.

This reasoning suggests that transition relief is a function of the element of surprise rather than the design of the tax system or the nature of the burdens that different taxpayers bear. Individuals who accurately predict the course of tax changes are not surprised when they happen, and have little if any claim for relief. Those who are surprised do have a claim based on the difference between the welfare they would have enjoyed if the government had told them what was coming, and the welfare they get with the policy surprise; though one might ask why this case differs from other economic surprises, such as changes in market prices or other economic conditions. It is widely accepted that it is incumbent on market actors to anticipate future developments in the economy; might the same be true of future developments in tax policy?

It is illustrative to consider a setting in which the government credibly announces that in twenty years it will introduce a VAT along with monetary policy that together implies a 20% rise in nominal prices. Young workers just entering the labor force would then be aware that any income they earn over the next twenty years and save for retirement will have 20% less purchasing power than otherwise, and presumably their labor supply and saving decisions will adjust accordingly. This may be unwelcome news, and may be perceived as unfair compared to the tax burdens of other generations, but it will not be a surprise when the VAT in fact is introduced twenty years hence. Would these workers be entitled to transition relief? They would seem to have a weak case for relief, no more than others whose economic situations or dates of birth or other circumstances led to heavier than average tax burdens. In the Mirrlees optimal nonlinear income tax model workers at different income levels face higher or lower tax rates based in part on how responsive to taxation is the labor supply of other workers at different points in the income distribution. From the standpoint of any one taxpayer, the tax burdens implied by these population characteristics may seem arbitrarily high or low, and the reality that the government chooses the tax schedule to further noble goals may offer cold comfort to those who feel aggrieved; but taxpayers facing high rates of Mirrlees taxation have little case for relief. The same reasoning applies to those who are warned in advance that a VAT is coming.

Of course, in reality major tax reforms are not perfectly anticipated, and as a result there are those who face unexpected burdens. More specifically, as the Viard chapter notes, the introduction of consumption-style taxes tends to impose unanticipated burdens on older generations and others who have accumulated significant saving in advance of the reform. Viewed from the perspective of one-time tax reform, these burdens are lump sum taxes; viewed from the perspective of frequent tax reforms, these burdens have incentive effects that are characteristic of any other taxes, with income and substitution effects that very likely discourage saving and certainly produce economic inefficiencies. Governments are well advised to treat transition effects this way in evaluating and crafting reforms.

For example, if once every twenty years a government will introduce a reform that imposes a 30% tax on the value of accumulated capital, then this policy is roughly equivalent to imposing a regular property tax of 1.5% per annum. This is likely an undesirable tax policy, since it is almost surely dominated by income and consumption tax alternatives, but it may be an intrinsic aspect of introducing what would otherwise be a desirable reform. The costs of implementing such a capital tax can be weighed against any benefits of the contemplated reform, understanding that the reform will not be in place forever. In this framework, the function of any transition relief is to change the ex ante incentive effects created by adopting a reform strategy, as well as to change the ex post consequences of reform. As long as the government is not deceptive—as long as it is understood that the tax system may be reformed, and that reform will create winners and losers—then adherence to customary principles in setting tax policy should create outcomes that have the same claim to fairness as any other optimal tax policy. True, market actors will need to anticipate the frequency and nature of tax reforms, but this is just one of many future economic conditions that economic actors must anticipate in order to make rational decisions.

Back to the example of an infrequent reform that imposes a 30% tax on the value of accumulated capital, one could imagine offering transition relief to capital owners that would have the effects of reducing the disincentive to accumulate capital during the years between reforms, and addressing some of the undesired welfare consequences of reforms. One difficulty is that there may not be tax instruments available that would tailor this relief so that it is delivered to all of the affected taxpayers and not to others, so the government may need to resort to blunt tools, such as providing tax benefits to low-income elderly taxpayers who might be most adversely affected by consumption-oriented tax reforms. These corrective gestures can be evaluated on their own terms for their effects on incentives and welfare, but they should not be evaluated on a one-time basis, given the prospects for frequent subsequent tax reforms.

11C.2 TAX REFORM ROBUSTNESS

The chapter offers valuable suggestions about the extent to which fundamental tax reforms are robust to errors, modification or subsequent changes. Realistically, tax reforms are seldom implemented the way that they are conceived by academics, so it is useful to consider the potential values of partial reform, reforms that fail to incorporate full information, or reforms that are gradually introduced, or introduced and subsequently repealed. As the chapter notes, the United States might benefit from the introduction of a VAT (and an accompanying reduction in other taxes) that at the time of introduction seemed permanent but that, for political or other reasons, wound up lasting only three years—though the possibility of such limited persistence may influence the desirability and design of any accompanying transition relief.

It is worth further considering to what extent there are experimental versions of any of these fundamental reforms, and the nature of information that might be gleaned from pilot tax reform programs. It is safe to say that we do not have full information about the practical realities of some of these consumption-oriented tax reforms in the US context, but how best to gather such information is still rather uncertain. One question raised by some of the chapter's analysis is whether such information gathering is better directed at tax policy analysts, who are uncertain of some of the behavioral effects of the reforms, or the general public, who may seek reassurance that the reforms are workable and fair.

The political process has its own dynamics, ones that typically entail adopting tax reform plans that differ in significant ways from the stark versions implied by theory. This reflects many considerations, including political realities, but also including that academics overlook important practical considerations and may discount significant distributional consequences of reforms. Furthermore, academics and politicians make mistakes. Reform alternatives are commonly evaluated on the basis of their projected effects, but it is surely also valuable to evaluate reform options based on the extent to which they are robust to plan changes, mistakes, politically driven carve-outs, and initially misjudged revenue needs that make it necessary to change provisions subsequently.

11C.3 THE POLITICS OF TAX REFORM

Chapter 11 offers interesting nuggets about the political attractiveness of tax reform alternatives, though fundamental consumption-oriented tax reform may fare better with American voters than some advocates fear is the case. There are controversial tax alternatives over which voters are understandably divided; and there are complicated analytical features of these tax alternatives that are seldom publicly discussed in much depth, and about which many voters may not have very well developed opinions. Despite this unpromising background, the politicians who voters elect very often implement reasonable tax policies, and it may be that sound tax alternatives play better in elections than the low level of public discourse would otherwise suggest. Just as economic actors very often adopt close to optimal plans without explicitly embracing economic methodology, voters may surprise analysts in their ability to evaluate the desirability of tax alternatives. If so, it bodes well for the prospects of fundamental tax reform, and suggests that substance rather than optics should guide the design of such reform.

Of course, politics is still politics. A question that must be asked of fundamental tax reform, or any other large legislative reform, is whether there are sufficiently large coalitions of winners from fundamental tax reform, with sufficiently large (perceived) gains, that they can overcome the natural inertia of the system. And more generally, the benefits of fundamental tax reform should be compared not to existing taxes, but to existing taxes that are improved with modest reforms that may be more feasible than fundamental reform. If the choice lies between wholesale reform and devoting a portion of the available political energy to modest fixes to the current system, it is worthwhile knowing just how much more one gets from the larger reforms, and how long the benefits are apt to persist once reform is implemented.

There are other uncertainties. If the fundamental tax reform project is a twenty-, or thirty-, or fifty-year plan, then it is difficult to know how much additional revenue will be needed compared to what is available from current taxes. Surely future revenue needs are different—and quite possibly greater—than what the government now collects. If this is true, then one of the compelling justifications for fundamental tax reform could be that the need to finance entitlements and at least some non-entitlement spending in the future entails such significant tax increases compared to today that more radical, and more efficient, alternatives need to be considered. This suggests that it may be most fruitful to think more broadly about a fundamental tax reform strategy rather than a package of specific alternatives, a strategy that includes ongoing information gathering and education, and the evolution of reform plans. Given the way the world works, there is an exciting future for tax reform efforts.