

### Session 3

Speaker: Alan Auerbach (University of California, Berkeley)

#### Outline of the speech

This paper reviews “The Tax Reform Act of 1986 (TRA86),” the most significant tax reform in the United States since World War II. As there was no consensus concerning the level of tax revenues and distribution of tax burden (degree of progressiveness), the reform was implemented under the condition that they remained unchanged. The reform was aimed at the promotion of simplicity, (horizontal) fairness, and economic growth. In particular, the following was introduced: (1) lowering of the marginal income tax rate, (2) lowering of the corporate tax rate, (3) broadening the tax base through abolishment of tax deductions, (4) capital income tax increase to maintain unchanged the distribution of tax burden, and an increase in labor income tax deductions. As a result of this reform, it cannot be said that the target of simplification was achieved, but horizontal fairness was improved. The corporate tax rate fell, but this effect was offset by the abolishment of subsidies. As a consequence, the effective tax rate did not drop significantly. Although this exerted a positive effect on the labor supply, the effect was small. Besides, the increase in capital income tax exerted negative a influence on savings. The distribution of tax burden was supposed to remain unchanged, but in reality the income gap widened. With regard to the neutrality of tax revenues, the shift from the income tax to corporate tax was expected, but, in fact, what

we have seen is an increase in individual tax revenues, and a reduction in corporate tax revenues. There were a number of narrow legislative changes since 1986 that picked off pieces of the TRA86 outcome, but the targets of simplification, effectiveness, and other factors are maintained even now. Many proposals now relate to tax in consumption (national sales tax, flat tax, personal consumption tax). The rate of progressiveness and transition-period problems are important subjects worthy of examination. But many of these simplifications and improvements in efficiency - in fact most of them - have nothing to do with the adoption of a consumption tax. You could design a very simple income tax that would have the same benefits. TRA86 tried to accomplish several contradictory targets simultaneously, and this invited confusion. It is necessary to make use of the above-mentioned lesson in the following tax system reforms.

Commentator: Yasushi Iwamoto (Hitotsubashi University)

- There are too many political and economical goals in case of the tax system reform. The Liberal Democratic Party, the Ministry of Finance, and the Council for Economic and Fiscal Policy look at different directions. The negotiations are two-stage games.

- The Japanese political situation associated with the tax system reform is more severe than that in the United States. The Japanese ruling party has extensively relied on the power of interest groups, and the offsetting power of coordinating overall interests has been weak in Japan. So a desirable direction of political reform is to

strengthen the coordination ability of the Cabinet.

- The Japanese tax system reform came under the influence of TRA86, but this influence was only partial. For example, the tax system reform of 1989 was aimed at tax revenue neutrality through the adoption of a consumption tax and a cut in income tax and corporate tax. At the same time, the marginal tax rate was reduced and income tax deductions were increased. Furthermore, in 1999 there was permanent tax cut. In this manner, the recent tax system reforms reduced the marginal income tax rate and corporate tax rate and preserved the various types of tax deductions.

- The situation in Japan and the United States with respect to tax system reform is a stark contrast. In the United States TRA86 reduced the marginal tax rate and broadened tax base, but it was unstable. Now the United States is considering replacing the income tax by some form of consumption tax. Japan failed to broaden the tax base in the direct tax, but succeeded in indirect taxes by introducing the consumption tax. The main difference between the tax system reforms in Japan and the United States is the presence of the consumption tax.

- In Japan the main goal of introducing the consumption tax was not efficiency gain and shift of tax base, but the attractiveness of a new broad tax base. It is helpful to reduce the budget deficit by introducing a new tax, and it is helpful to finance future increasing expenditures in the long run. Today's situation is really a double

taxation, with income taxes and consumption taxes. Do we evaluate a tax system that employs different tax bases?

- At present the consumption tax rate is low and the problems are not obvious, but the future of consumption tax is problematic.

- The current Council for Economic and Fiscal Policy plan contains a combination of immediate permanent tax cuts and later permanent tax cuts; it is revenue-neutral in the long run. But this plan means a temporary tax cut. How effective is it to revitalize?

- Finally, I would like to summarize the questions. First, how do we provide a politically stable tax system that does not hurt economic efficiency? How do we provide a political system that creates an economically desirable tax system. How will the discussion in the United States progress regarding the introduction of a consumption tax. What do you think about the future of Japan's consumption tax? Moreover, I would like to hear some comments on tax cuts to stimulate the economy in the short run.

Commentator: Takeo Doi (Keio University)

- How is the tax reduction implemented by President Bush in 2001 evaluated? This tax reduction was carried out rather hastily; we can only assume that there was another equally good approach. What is the biggest problem with this tax reduction?

- How will the United States pursue tax reform in the future? The

introduction of a consumption tax can be suggested as a radical tax system reform. What political strategy is supposed to be used if a consumption tax is introduced? Besides, how should the tax system be changed if a consumption tax cannot be introduced?

- In the United States, capital gains taxes were increased to the maximum rate by TRA86. In Japan, tax reform of 2003 is expected to take the form of a real tax increase when Japan abolishes tax withholdings at the source and moves to tax separation upon declaration. However, there is a possibility that the tax increase will make the purchase of stocks more difficult, and capital gains will not increase. Does this tax increase hinder the Japanese economy under the present situation of dropping share prices?

- In Japan, revenue-neutral reform is easily accepted for political reasons. However, as there may be an error in the preliminary estimation of tax revenues due to changes in the behavior of economic agents induced by the reform, there is a possibility that the neutrality of tax revenues would not be achieved eventually. In this case, there are two possibilities from the standpoint of feasibility. Is it preferable to make the tax revenue forecast correctly reflect errors, and to carry out a tax system reform that we can correctly label as tax revenue-neutral? Or is it better, when there is a desirable tax system and we cannot necessarily count on achieving a political consensus, to fudge the numbers a bit so they are politically easy to swallow, and to introduce the reforms and at least be able to economically achieve the desirable tax reform, even

if the result is not effectively tax revenue-neutral?

- The Japanese government plans tax system reform that will focus on the broadening of the tax base and tax cuts in national corporate taxes like TRA86. What sort effect we can expect by these kinds of changes in Japan's tax system?

(Tajika)

- There was a positive error in the personal income tax that had to do with more incentives to work, and more compliance.

- In connection with the capital income tax, the discussion about capital flight and corporate inversion is not enough. Can comprehensively taxing capital income survive such a situation?

(Kashyap)

- The previous paper argued that the marginal tax rate cut affected the labor supply of the super-rich class, but in the United States there is pretty active disagreement.

- Concerning the problem of tax revenues estimation bias, in the United States even if everybody believes there's some responsiveness, but we can't agree on how much, we coordinate on zero. This leads to growth of the fiscal deficit (predicted value).

(Kotlikoff)

- Until aging of the population is considered, the growth of economic

efficiency due to the introduction of a consumption tax is not significant. Nevertheless, we overlook the fact that social security expenses tend to grow due to the aging of the society. The consumption tax has a big role to play in terms of spreading the burden across the generations of paying off the old liabilities, and I think there are considerable efficiency gains to be had from that.

(Ihori)

- You are saying that the labor supply effect was relatively small, simply because the effective marginal tax rate didn't decrease significantly. If the effective marginal tax rate did reduce significantly, are you saying that labor supply effect would be very large? There is an income effect and a substitution effect competing with one another, so even if the effective marginal tax rate did decrease substantially, it unnecessarily means that labor supply would be highly simulated.

(Kashyap)

- I think the merit of simplification by the adoption of a flat tax, regardless of whether it is a consumption tax or anything else, is that you need not look into who paid for it. However, this merit will disappear if you introduce two marginal rates.

(Auerbach)

- As Professor Iwamoto said, I think it's a good approach to try to understand how any political process generates a good or bad economic outcome. The reason is that it also might give us some

insights into how we might improve the process.

- In regard to how to stimulate the economy under the present situation of deflation and huge fiscal deficit, it is pretty obvious, and this is something that a lot of people are thinking. I am not sure the U.S. tax reform experience says anything about this. Even if the huge fiscal deficit constrains any tax cuts, I think there are other methods to stimulate demand.

- As was pointed out by Professor Doi, I don't really provide much of an evaluation of the 2001 tax legislation of the United States. I think it had both good and bad elements. Among the worst were that it produces a revenue target by ignoring interactions between some provisions. Moreover, the point that the tax cut period is restricted to 10 years is also a problem.

- On the biases in revenue forecasts, there is a debate right now that should take into account the full measure of expected economic responses. It's a question that takes very large errors into account in a political process, where none of the people understand what a standard error is.

- TRA86 did not put in question the corporate inversion. At that time the individual inversion was a problem. Nevertheless, now the corporate inversion is a major problem and it might be more of a problem in the future. In particular, multinational corporations; it

does indeed raise the question of whether capital income taxation at the business level is viable in the world where money moves around. It's isn't really fully on the agenda yet in the tax reform discussion.

- As to the question of whether the marginal tax rate cut affected the labor supply of the supper rich class: There's a higher responsiveness of income at the top of the income distribution than can be explained by labor-supply response. It's possible that the elasticity of income with respect to the tax rate will increase as a result of a shift of taxation target items.

- In case of effective marginal tax rate decrease, both income effect and substitution effect are small.

- As to the flat tax, you lose a lot of the simplicity by having two marginal rates instead of one. But at the treatment of capital income, what's been taxed are cash flows. And cash flows are much easier to measure than income.