

Alan Greenspan: The tax system

Testimony by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the President's Advisory Panel on Federal Tax Reform, Washington, DC, 3 March 2005.

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The President has assembled a very able panel to address an issue that is both important and exceptionally challenging.

The U.S. economy is the world's most dynamic and flexible, and the federal government's system for raising revenue must not hinder the processes generating that economic success. However, since the exemplary 1986 reform, the tax code has drifted back to be overly complicated and burdened by higher marginal rates and by many special provisions that have undesirably narrowed the tax base. Changes since the 1986 act have been largely incremental without the appropriate all-encompassing context that broad reform brings to the table. It is perhaps inevitable that, every couple of decades, drift needs to be addressed and reversed.

I believe some useful lessons can be learned by examining earlier systematic reforms of the tax code, such as those of 1954, 1969, and 1986. Among those reforms, the 1986 effort is widely regarded as having been the most successful of the post-war era. This success was achieved, in large measure, I believe, because the reform hewed to an explicit set of principles. I am not suggesting that today's reform should follow the specifics of the 1986 reform. Both the economic and fiscal conditions, as well as the existing state of the tax system, have changed in important ways since that time, and some aspects of the framework that worked well in 1986 may be inappropriate today. Nevertheless, I believe that a number of the principles underlying that reform are still applicable.

A defining feature of the 1986 reform was the broadening of the tax base and the lowering of tax rates, and it is widely believed that these changes enhanced economic efficiency. High tax rates (whether the base is income or consumption) exacerbate the distortions that taxes invariably create. Moreover, distortions arise when similar activities are subject to different tax treatments. Such distortions reduce economic efficiency as households and businesses respond to the tax code rather than to underlying economic fundamentals. Lowering tax rates by broadening the tax base generally will reduce the costs of such distortions, which are approximately proportional to the square of the tax rate. Over the years, economists have disagreed about the size of the efficiency gains that might be achieved from a broader base and lower rates, but there can be little doubt regarding their positive effect.

The 1986 reform also strove to achieve a measure of comity in the tax code, by treating taxpayers in similar circumstances in a roughly comparable manner and by maintaining progressivity in the tax system. In addition, the 1986 reform broadly applied the constraints of revenue and distributional neutrality, which appear to have facilitated bipartisan coalition building. Setting rough distributional neutrality as a rule of the game limited the number of losers created and likely made sacrifices in the name of efficiency easier for different groups of taxpayers who knew that losses would be relatively limited.

Of course, public views about the fairness of proposed changes to the tax code will surely play a significant role in the current debate, and these views will be driven by perceptions of the fairness of the current tax system. The standards by which the public judges fairness are deeply rooted in judgments of whether, and which, incomes are the consequence of individual effort. The contours of economic policy since the nation's founding have closely followed changing standards of fairness over time.

Simplification of an overly complex structure was another important accomplishment of the 1986 reform. Unfortunately, tax code drift since 1986 has evolved to a point where taxpayers are again confronted with great complexity. Indeed, an individual taxpayer may have difficulty even knowing his or her marginal tax rate because of the overlapping web of deductions and exemptions and the provisions that attempt to limit those deductions and exemptions. And many taxpayers are now required to compute their liability under two systems - the regular income tax and the alternative minimum tax. Such challenges also affect lower-income households, who face the complexities of the Earned Income Tax Credit. A simpler tax code would reduce the considerable resources devoted to

complying with current tax laws, and the freed-up resources could be used for more productive purposes. Thus, greater simplicity would, in and of itself, engender a better use of resources.

A principle that I believe is important now - but appears not to have weighed so heavily on those involved in the earlier reforms - is predictability in the tax code. By this I mean creating a tax system in which households and businesses can look into the future and have some reasonable degree of certainty about the future tax implications of decisions made today. Just as price stability facilitates economic decisionmaking by limiting the potential distortions from unanticipated changes in the price level, some semblance of predictability in the tax code also would facilitate better forward-looking economic decisionmaking by households and businesses.

Given the expertise on this panel and the ultimate responsibility of the Congress and the President for the tax system, I would not presume to suggest the best specific path for reforming the tax system. However, past experience suggests that as the panel's work gets under way, one of the first decisions that you will confront is the choice of tax base; possibilities include a comprehensive income tax, a consumption tax, or some combination of the two, as is done in many other countries. As you know, many economists believe that a consumption tax would be best from the perspective of promoting economic growth - particularly if one were designing a tax system from scratch - because a consumption tax is likely to encourage saving and capital formation. However, getting from the current tax system to a consumption tax raises a challenging set of transition issues.

In 1986, tax reformers considered a consumption tax base and, despite the arguments in favor of such a system, they decided to enhance the comprehensiveness of the income tax system then in place. Circumstances are different today, and the right choice will require assessing anew the tradeoffs between complexity, fairness, and economic growth.

The choice of the tax base and other provisions of the code must also be taken in light of coming demographic changes. I believe that, as the baby boom generation begins to retire in a few years, it will become increasingly important for the nation to boost resources available in the future through greater national saving and enhanced incentives for participation in the labor force. The tax system has the potential to contribute importantly to those goals, and, at a minimum, tax reform should not hinder the achievement of those objectives.

Finally, fundamental, thoroughgoing tax reform will require tradeoffs among competing objectives and will create both winners and losers. In the past, these difficult choices were facilitated by bipartisan cooperation. In the 1954 reform, congressional support was bipartisan, and President Eisenhower signed the legislation. In the 1969 reform, efforts were started under President Johnson but were completed during the Nixon Administration. Similarly, in 1986, President Reagan worked with Democratic congressional leaders to see reform through.

I am confident that this panel can lay the groundwork for another historic reform and can get this process started off on the right foot. Thank you for the opportunity to share some thoughts with you today. I look forward to the results of your deliberations.