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Reinventing the Wheel:
What We Can Learn From the Tax Reform Act of 1986

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In 2010, when former Senate Finance Committee Chair Sen. Max Baucus was beginning his push toward tax reform, he held a hearing featuring veterans of the great tax reform of 1986.[2] The main conclusion from this hearing was that Congress has changed too much since then to make a repeat of 1986 likely. We are now five years later, Sen. Baucus is the US Ambassador to China, and no tax reform appears likely in the immediate future, thus confirming what the veterans told the Chair in 2010.

Nevertheless, I believe that the Tax Reform Act of 1986 (TRA 86) offers some useful lessons for the current tax reform effort, less on process (because of the aforementioned changes in Congress) but more on substance. Specifically, I think TRA 1986 is a useful model because:

(a) It suggests that individual rates on ordinary income can be cut if the tax rate on capital gains is increased;

(b) It suggests that overall revenue neutrality can be achieved by cutting taxes on individuals and increasing the effective tax rate on corporations (while reducing the nominal corporate rate);

(c) It suggests that corporate/shareholder integration is unnecessary.

What follows elaborates on these suggestions.

1. Individual Tax Reform

Before 1986, the top individual tax rate on ordinary income (including dividends) was 50% and the capital gains rate was 20%. TRA 86 reduced the top individual rate to 28% and increased the capital gains rate to 28%.

Currently, the top individual tax rate is 39.6%, but in some locations (e.g., New York City) it is above 50%.[3] The capital gains and dividends rate is 23.8% (including the Affordable Care Act tax on net investment income). Thus, we are close to the pre-TRA 86 rate structure for individuals.

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[1] Irwin I. Cohn Professor of Law and Director, International Tax LLM Program, the University of Michigan. I would like to thank…

[2] http://www.finance.senate.gov/hearings/hearing/?id=1d2a7636-5056-a032-5282-4bb7cf0d5078

[3] Len Burman has calculated that if one takes the 80% reduction of itemized deductions for the wealthy (IRC section 68) into account, the top marginal tax rate on ordinary income in NYC can be as high as 67%. This is close to the rate in 1980 (70%), which most observers thought we would never see again. [cite]

What is the problem with high tax rates on the rich? After all, the US has a significant inequality problem, which was exacerbated by the Great Recession since 95% of the growth of the economy since 2008 inured to the benefit of the top 1% (by income). Our Gini coefficient is higher than that of every other member of OECD, and is as high as China's and close to other large developing countries like Brazil.[4]

Moreover, public finance economists have recently rediscovered the appeal of redistribution via high tax rates. Diamond and Saez have calculated an optimal top marginal tax rate of 73%, and Kinderman and Krueger suggest 91% would be acceptable.[5]

Tax lawyers tend to be more skeptical.[6] There are three reasons not to return to such high tax rates on the rich. First, at some rate the labor/leisure distortion does have some bite. Second, the rich have traditionally found ways to avoid high tax rates, especially if the tax rate on capital gains and dividends is set lower than the rate on ordinary income. Third, the rich can expatriate.

a. Labor/Leisure

Traditionally, public finance economists have tended to oppose very high top marginal tax rates because they induce people to work less and we cannot force them to choose labor over leisure. The traditional optimal tax model even suggests that the rate at the top of the income distribution should be a bit lower than rates on lesser incomes, to induce people in the middle brackets to rise to the top.[7]

The debate about progressivity in taxation has a long and rich history. In 1952, when tax rates were steeply progressive, Walter Blum and Harry Kalven published a classic article entitled The Uneasy Case for Progressive Taxation.[8] Blum and Kalven used most of the article to demolish systematically all previous arguments for progressivity made in the name of "ability to pay" and "equal sacrifice."[9] In the end, they concluded that any remaining case for progressivity must be made in the name of redistribution,

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[4] [cite]

[5] Diamond and Saez, The Case for a Progressive Tax, 25 J. Economics Perspectives 165 (2011); Fabian Kindermann and Dirk Krueger, HIGH MARGINAL TAX RATES ON THE TOP 1%? LESSONS FROM A LIFE CYCLE MODEL WITH IDIOSYNCRATIC INCOME RISK, NBER Working Paper 20601, http://www.nber.org/papers/w20601 (2014).

[6] See generally Edward Kleinbard, We Are Better Than This (2014).

[7] [cite]

[8] Walter J. Blum & Harry Kalven, Jr., The Uneasy Case for Progressive Taxation, 19 U. Chi. L. Rev. 417 (1952).

[9] Id. at 445-86. The basic problem with previous arguments in favor of progressivity was that they depended on interpersonal comparisons of utility or well-being, which, as Blum and Kalven pointed out, are not feasible. Id. at 476. This problem is addressed in the more recent optimal tax literature by introducing the social welfare function, discussed below.

or an inherent objection to social inequality, but without explaining what makes inequality objectionable. This is the same type of "aesthetic" argument that motivated Henry Simons' oft-quoted conclusion in *Personal Income Taxation* (published in 1938 at the height of New Deal progressivism) that sharply graduated rates are defensible only because there is something inherently "unlovely" about inequality.[10]

Blum and Kalven's skepticism about graduated rates remained the standard view among legal theorists until 1987. In that year, just after the progressive rate structure had been demolished in TRA 1986, Joseph Bankman and Thomas Griffith published an article that has shaped the progressivity debate among legal scholars ever since.[11] Bankman and Griffith's main contribution was to introduce into the legal literature optimal tax theory, developed by economist James Mirrlees in his Nobel Prize-winning work in the early seventies.[12]

Optimal tax theory seeks to answer the following question: Given that income taxes generate a disincentive effect on work, what is the ideal tax and transfer system if the ultimate goal is to maximize the sum of the utilities of individuals with identical preferences? To answer this question, optimal tax theory makes a series of assumptions regarding the distribution of income-earning ability in society, the rate at which the marginal utility of income declines, and how much less the imposition of an income tax causes individuals to work. Having made these assumptions, optimal tax theorists then derive the desirable combination of taxes and transfers from a specified social welfare function. This function can be either strictly utilitarian (i.e., maximizing the sum of individuals' utilities without assigning weights) or more weighted toward the welfare of the poor. At the extreme is the Rawlsian maximin function, in which the goal is to maximize the welfare of the least-well-off member of society.

The problem for advocates of progressive taxation is that most tax structures derived from optimal tax theory are not marginal-rate progressive. For example, Bankman and Griffith's article, even though it is cast as a defense of progressive income taxation against Blum and Kalven, actually proposes a regressive marginal rate structure. The progressivity in their proposal comes entirely from its combination with a demogrant (a universal payment to all residents) which makes the average tax rate progressive. But as Larry Zelenak and Kemper Moreland point out, average rates are less important than marginal rates when it comes to taxing the rich. If the tax system consisted of a $ 10,000 demogrant and a 30% flat tax, the average rate would be progressive, but Bill Gates would pay taxes at just under 30%, and we could not increase his rate without increasing everyone else's. Fundamentally, "graduated rates permit much greater flexibility in average rate distributions

[10] Henry C. Simons, Personal Income Taxation 19 (1938).
[11] Joseph Bankman & Thomas Griffith, Social Welfare and the Rate Structure: A New Look at Progressive Taxation, 75 Cal. L. Rev. 1905 (1987).
[12] James Mirrlees, An Exploration in the Theory of Optimum Income Taxation, 38 Rev. Econ. Stud. 175 (1971).

than does a flat tax with a demogrant or an exemption."[13] In addition, as Zelenak and Moreland also point out, demogrants are unlikely in the United States on political grounds, and, without demogrants, the progressivity of Bankman and Griffith's proposal disappears.[14]

Other optimal tax writers have likewise proposed regressive tax rate structures.[15] Mirrlees' original work in 1971 concluded that the optimal tax structure is approximately linear (with an exemption) and has tax rates between 20% and 30%.[16] Slemrod, Yitzhaki, Mayshar, and Lundholm investigated a two-bracket system and concluded that for most assumptions, the optimal tax structure features a top marginal rate that is lower than the first marginal rate, although the combination with a demogrant assures average rate progressivity.[17]

The reason why optimal tax theory generally rejects progressive marginal rates is as follows. While the assumed declining marginal utility of income supports redistribution, any countervailing efficiency losses apply only at the margin (the point at which the taxpayer chooses between work and leisure). Since high tax rates on inframarginal income do not impact work decisions, they raise revenue for redistribution without any efficiency cost. Thus, there should be high tax rates at a range in which there are many taxpayers for which the range is submarginal, relative to the number of taxpayers at the margin within that range (i.e., the middle class). But the tax rate should be low in the income range where there are mostly marginal taxpayers - i.e., the higher income ranges.[18] Therefore, as Matti Tuomala has noted, "one of the main conclusions to be drawn from the Mirrleesian optimal non-linear income tax model is that it is difficult (if at all possible) to find a convincing argument for a progressive marginal tax rate structure throughout."[19]

Larry Zelenak and Kemper Moreland have mounted a vigorous defense of progressive marginal rates against the optimal tax critique. They point out that the above conclusions rest crucially on several untested assumptions, and if these assumptions are relaxed, progressive marginal rates can be

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[13] Lawrence Zelenak & Kemper Moreland, Can the Graduated Income Tax Survive Optimal Tax Analysis?, 53 ***Tax*** L. Rev. 51, 59 (1999).

[14] Id. at 60-62.

[15] Most strikingly, Seade and Sadka have shown that under certain assumptions, optimal tax analysis concludes that the marginal tax rate at the highest level of income should be precisely zero. The reason for this surprising finding is that raising the marginal tax rate at the very top of the income distribution above zero distorts the labor supply decision of the highest earner but raises no revenue. Slemrod, supra note 2, at 11 (citing Efraim Sadka, On Income Distribution, Incentive Effects, and Optimal Income Taxation, 43 Rev. Econ. Stud. 261 (1976); and Jesus Seade, On the Shape of Optimal Tax Schedules, 7 J. Pub. Econ. 203 (1974)). As Slemrod points out, this conclusion is not very interesting because it applies only precisely at the top of the income distribution, not near the top. Id. at 12. Numerical calculations by Mirrlees suggest that zero is a bad approximation to the optimal marginal tax rate even within most of the top percentiles. Mirrlees, supra note 40, at 195. But this result assumes no migration, as discussed below.

[16] Joel Slemrod (ed.), Does Atlas Shrug (2000) at 10.

[17] Id. at 12 (citing Joel Slemrod et al., The Optimal Two-Bracket Linear Income Tax, 53 J. Pub. Econ. 269 (1994)).

[18] Zelenak & Moreland, supra note 41, at 54-55.

[19] Matti Tuomala, Optimal Income Tax and Redistribution 14 (1990).

> accommodated within optimal tax theory. Specifically, they point out that optimal tax theory can be consistent with progressive marginal rates if (1) demogrants are ruled out on political grounds; (2) concern with relative position (envy) figures into the social welfare function; (3) taxation serves as a form of insurance against wage uncertainty; (4) high income taxpayers are less responsive to the work disincentive effect of taxation; (5) the distribution of ability in the population is more unequal than is usually assumed; and/or (6) the labor market consists in large part of winner-take-all competitions.[20]
>
> Most of these modifications to the standard assumptions seem plausible.[21] However, as Zelenak and Moreland point out, their argument merely means that taxing the rich at higher rates is possible under an optimal tax analysis, not that it is indicated:
>
> > Regardless of the results of any simulation, optimal tax analysis can never prove that the income tax should have progressive marginal rates. Even if a simulation indicated gradual rates were optimal, and even if the simulation's factual assumptions were unassailable, an opponent of progression could still dismiss the results by rejecting the philosophical basis of the simulation. If the premises of the simulation are utilitarian or Rawlsian, no amount of sophisticated mathematics will convince someone who objects to those premises.[22]

This is the basic problem confronting the new optimal tax results as well.[23] Moreover, to non-optimal tax adherents like me, there is something strange about results that indicate

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[20] Zelenak & Moreland, supra note 41, at 56-57; see also Martin J. McMahon, Jr. & Alice G. Abreu, Winner-Take-All Markets: Easing the Case for Progressive Taxation, 4 Fla. *Tax* Rev. 1 (1998) (defending progressive taxation in a winner-take-all society).

[21] Some of them are supported by evidence in Joel Slemrod (ed), Does Atlas Shrug (2000). See the findings on labor-leisure substitution in Moffitt & Wilhelm, supra note --, at 221, and the relative position argument in Robert H. Frank, Progressive Taxation and the Incentive Problem, in Does Atlas Shrug?, supra note --, at 490, 498-503.

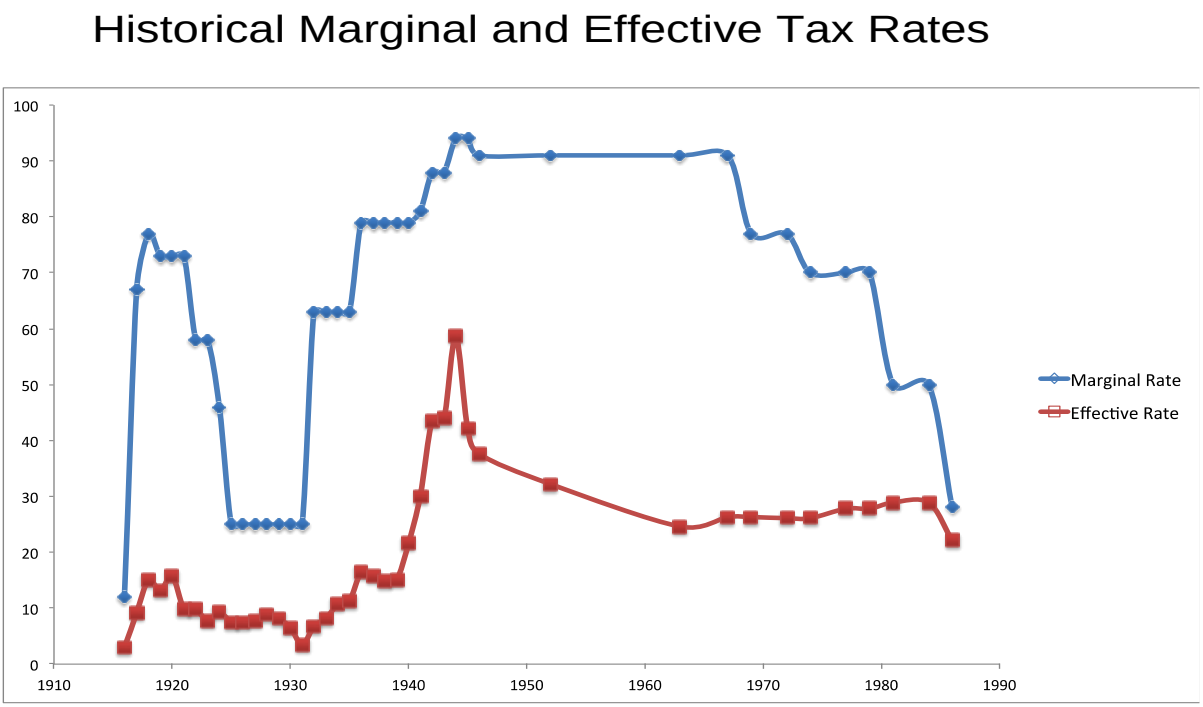
[22] Zelenak & Moreland, supra note --, at 90. The same criticisms apply to simulations that recommend a regressive structure.

[23] Other recent contributions to this debate are two chapters in the UK Mirrlees Review, a comprehensive analysis of the UK tax system that resulted in two thick volumes, *Dimensions of Tax Design* (review and analysis) and *Tax by Design* (recommendations) [cite]. Interestingly, these two volumes reach opposite conclusions regarding the desirability of taxing the normal return to capital (they agree that taxing rents is desirable). The chapter on capital income taxation in the first volume, by Banks and Diamond, summarizes recent economics literature and concludes that the case for not taxing capital income is not at all obvious in light of the many possible roles that capital income taxes might play. Banks and Diamond point out that the efficiency gains from moving to a consumption tax rely on not having any transition relief, which may be politically impossible; that the distortions of taxing capital may be minimized by the fact that a capital income tax may only reach the risk-free rate of return; that market imperfections may make capital income taxation more attractive; and that capital income may be an indicator of ability, even given labor income. In addition, it can be argued that taxing the returns to saving, by discouraging private saving, can help implement progressive labor income taxes by making it more painful for people with high ability not to work.
In the second volume of the Mirrlees Review, the editors summarize these findings by stating that—

that a 91% tax rate will have no or minimal effect on labor/leisure. The assumption seems to be that the rich are such workaholics that they will never cease working hard even if they only get to keep 9 cents from every dollar. Really? This runs counter to the empirical evidence about their efforts to avoid taxes legally, to which we turn next.

b. Tax avoidance

It is well known that the rich can avoid high tax rates more easily than middle class people because they can to a larger extent control the timing of their income (delaying income and accelerating deductions, except when they know tax rates will likely rise as in late 1992 or in 2012), as well as its character (converting high taxed ordinary income to lower taxed capital gains and, recently, dividends). Historically the results can be seen in the following table of the effective tax rates on the top 1% of the income distribution:



Source: Brownlee, in Slemrod (ed), Does Atlas Shrug (2000).

All of these arguments are well founded in economic theory. They justify levying some tax on the normal return to capital, though not necessarily at full income tax rates, as in a comprehensive income tax. However, there are several reasons to be cautious in applying these arguments immediately to policy.[cite]

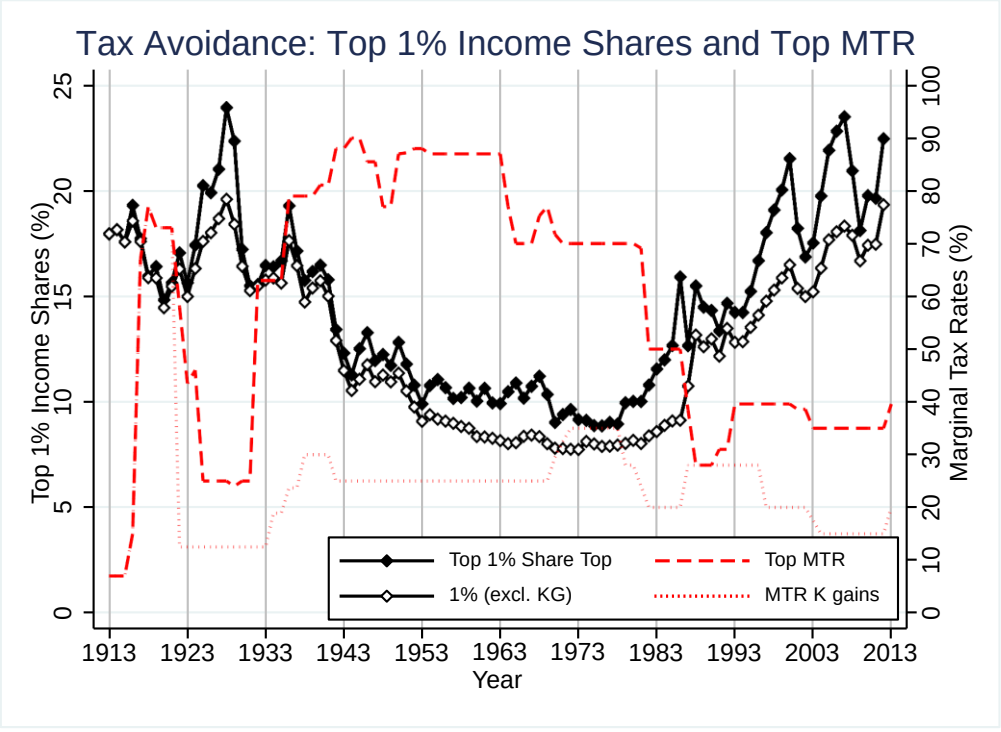
These reasons for caution, the editors argue, are that it is hard to know what the capital income tax rate should be, and not clear that having a small positive capital income tax rate provides sufficient benefit to justify the complexity of implementation. Thus, the editors of *Tax by Design* recommend not taxing the normal return to capital, contradicting the recommendation by Banks and Diamond in *Dimensions of Tax Design.* In my opinion, this severely limits the progressivity that can be achieved through the income tax, because taxing only labor income (or equivalently taxing only consumption) cannot reach the unconsumed income of the rich, which is their main source of power. See Avi-Yonah, Why Tax the Rich [cite].

This table clearly shows that the rich have always been able to pay significantly less tax than the non-rich. In fact, other than during WWII, when not paying tax was presumably unpatriotic and the effective tax rate was as high as 58.6%, the rich remarkably were able to pay tax at not more than a 30-40% rate regardless of the statutory top tax rate.

Brownlee's results only go as far as 1986. In 1986, the tax rate on both OI (including dividends) and KG was set at 28%, and many loopholes were closed (e.g., by the enactment of the passive activity loss rule (IRC 469), which eliminated the traditional leveraged tax shelter industry). I would therefore guess that the effective and statutory rates were closer in the 1986-1997 period than earlier or later.

The KG rate was cut to 20% in the late 1990s, followed by a further cut to 15% in 2001, and the dividend rate was set at 15% in 2003, while the OI rate rose to 31% in 1991 and to 39.6% in 1993, and even after the 2001 tax cuts it remained relatively high at 35%. As a result I would expect that a large gap between top statutory and effective rates on the top 1% has reopened from at least 1997 onward. As Warren Buffett famously says, he does pay a lower effective tax rate than his secretary, and the same applies to Mitt Romney vs. most American voters.

Saez tries to argue that this is not necessarily true by pointing to the following table:



Source: Saez (2014).

This table shows first that the share of income earned by the top 1% from 1913 to 2013 was U shaped, with more going to the top in the period before the New Deal and after Reagan than between 1933 and 1981. Second, this U shape is the opposite of the shape of top marginal tax rates on ordinary income, suggesting to Saez that inequality can be reduced if we return to pre-1981 rates (70%). Finally, Saez argues that tax avoidance cannot be effective against such high rates because the same U curve can be seen if we exclude capital gains, even though the capital gains tax rate was much lower. This indicates to him that the rich cannot effectively avoid high tax rates by converting OI to KG.

But this argument runs counter to Brownlee's data, which show low effective tax rates on the rich in the period from 1945 to 1986, so that the correlation is spurious: The reason inequality was less in this period was not because of the high statutory OI rates.[24] Moreover, the tax shelters of the pre-1986 era depended more on leveraging and deferral than on conversion (classically, you borrow 99% of the cost of property, obtain interest and depreciation deductions, and then sell. This works as a shelter because of timing even if recapture prevents you from treating the sale proceeds as capital gains).[25]

Ed Kleinbard argues in his new book that it is futile to address inequality by taxing the rich, at least as long as we have an income tax imposed in one country rather than a global wealth tax, as proposed by Piketty.[26] Ed worked for many years in one of the best tax practices in NYC, and I think he knows what he is talking about. It is not possible to prevent the rich from avoiding high tax rates, especially if they only apply to ordinary income. But can we apply high rates to capital gains?

c. Capital Gains

As the above table shows, capital gains have been taxed at a lower rate than ordinary income since 1921, with a brief exception from 1986 to 1991. Is that inevitable?

There are four reasons why we may want to apply a lower rate to long-term capital gains than to ordinary income. The first three stem from the realization requirement. If capital gains are only taxed upon realization, then (a) there is a "lock in" effect because taxpayers are reluctant to sell appreciated assets and trigger the capital gains tax, (b) some of the gain, especially on long-term assets, is illusory because we do not index basis to inflation; and (c) "bunching" the entire gain in one year (upon realization) may cause taxpayers to move to a higher tax bracket in a progressive tax system.[27]

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[24] One reason may have been labor unions, another a better public education system, and a third less globalization.

[25] [cite]

[26] [cite Kleinbard, Piketty]

[27] See George K Yin, Principles and Practices to Enhance Compliance and Enforcement of Personal Income Tax, 31 Va. Tax Rev. 381 (2012) (Pg 399)

None of these reasons strike me as entirely persuasive, because they can all be dealt with by the relatively simple method of adopting a mark to market tax regime. Under mark to market or accrual taxation, there is no lock in effect because taxpayers pay tax (and basis increases) on the annual fluctuation in value of their assets. There is no gain due to inflation because all assets are taxed currently. And there is no bracket creep because there is no bunching of gain in the year of sale.

As David Miller and others have shown, such a mark to market system is perfectly feasible for most assets, because valuation and liquidity are not an issue for most asset types.[28] The big exception is owner occupied housing, but we exempt most such housing gains from capital gains tax in any case.[29]

The fourth reason rests on the assertion that cutting capital gains taxes helps capital formation and increases investments. I have seen no persuasive empirical evidence that this in is fact the case.[30] Recent studies in behavioral economics have suggested that institutional factors matter more in promoting savings than the tax rate on capital income, and that a series of specific tax-favored savings promotion schemes may be as or more effective in promoting savings as a broad-based consumption tax.[31]

However, as a practical matter, it seems unlikely that we will abandon realization, because most voters have a strong aversive reaction to paying tax on "phantom" income, and the volatility of the stock market means that neither they nor the government can easily rely on gains being permanent. A taxpayer will be unhappy if he does not trust the government to give him a refund if this year's gains turn into next year's losses, and the government would be wary of having to refund taxes it has collected. Most taxpayers other than securities dealers are not eager to be governed by mark to market, as the experience under the elective regime of IRC 1296 shows.

If we cannot abandon realization, then lock in in particular is a good reason to maintain capital gains low (bunching can be dealt with by averaging devices, and inflation by indexing, but lock in is practically inescapable in a realization-based system).[32] But if capital gains rates are low, we should not raise the ordinary income rates too high, because that leads to conversion transactions and endless pressure on the various anti-conversion provisions in the Code (sections 302-6, 1258-60, etc).

Thus, as Bill Andrews has said, realization is indeed the Achilles heel of the progressive income tax: If you have realization, you must have low capital

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[28] See David S Miller, A Progressive System of Mark-to-Market Taxation, 109 Tax Notes 1047 (2005) (Pg 1056).

[29] Id., at 1052, 1053.

[30] Bernheim, supra.

[31] Banks and Diamond, supra; Chris Sanchirico, Do Capital Income Taxes Hinder Growth, ILE Research Paper 13-6 (2013).

[32] But see Auerbach.

gains rates, and if you have low capital gains rates, you must have low ordinary income rates to prevent conversion. Thus the 1986-1991 rate schedule with a top rate of 28% for all income looks appealing, because at such low rates lock in is less of an issue (and bunching is dealt with).[33]

d. Mobility

Another reason we cannot tax the rich too much is that they are mobile. The optimal income tax results that indicate high marginal tax rates at the top assume a closed economy with no migration. If one assumes migration is possible the top marginal tax rate is zero (if the elasticity is high) or a low rate (if it is medium).[34]

Empirically, for high earners, who earn the vast bulk on income from capital, the restrictions on legal migration are almost non-existent. Most countries in the OECD welcome rich migrants.[35] About 340,000 income taxpayers have left France each year since 2000 to relocate to countries with lower income taxes like the UK, Luxembourg, Switzerland, the US and Canada. Before migrating, these individuals paid three times more taxes than the average French taxpayer.[36] In 2005, 145,000 taxpayers left Germany for the same reason.[37]

And what are the tax consequences of migration? For low earners migrating out of the US, the result is to legally escape all US taxation.[38] The payroll tax does not apply to US citizens and residents who move permanently overseas and work for non-US employers.[39] A VAT, since it is destination based, can likewise be avoided by simply moving offshore. And under section 911 of the Code, the first $92,900 of earned income of US citizens living overseas is exempt from US income tax, which covers the vast majority of the US middle class who only have labor income.[40]

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[33] See below for a discussion of dividends.

[34] See Blumkin, Sadka and Shem-Tov, International Tax Competition, CESifo Working Paper 3820 (2012) (arguing for a top rate of 0% in an open economy model) and Lehmann, Simula and Trannoy, Tax Me If You Can, Q. J. Urban Economics (2014) (the optimal top marginal tax rate varies with various assumptions regarding the semi-elasticity of migration from one tax jurisdiction to another).

[35] OECD, International Mobility of the Highly Skilled, 2002; F. Docquier and A. Marfouk, International Migration by Education Attainment, 1990-2000, in International Migration, Remittances and the Brain Drain, World Bank 2005; Andrew Halkyard, Tax Incentives and the Migration of Skilled Labour: Another Tax Expenditure or a Failure of Tax Residence? 11 eJournal of Tax Research 23 (2013).

[36] Simula and Trannoy, 163. For an empirical study of the relationship of taxes to migration by highly skilled sports players see Nolan Kopkin, Tax Avoidance: How Income Tax Rates Affect the Labor Migration Decisions of NBA Free Agents, J. Sports Economics (Nov. 5, 2012); Henrik Kleven, Camille Landais and Emmanuel Saez, Taxation and International Migration of Superstars: Evidence from the European Football Market, NBER Working Paper 16545 (2010).

[37] Ibid.

[38] However, these taxpayers face higher non-tax barriers to migration than highly skilled individuals, so they are unlikely to migrate en masse. Razin and Sadka, supra.

[39] See Internal Revenue Service, Publication 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad, found at http://www.irs.gov/pub/irs-pdf/p54.pdf

[40] See Internal Revenue Service, Foreign Earned Income Exclusion Requirements, found at http://www.irs.gov/businesses/small/international/article/0,,id=96817,00.html.

For high earners, migration by itself is insufficient, because the US uniquely taxes its citizens on worldwide income even if they live permanently overseas.[41] I do not like this rule and have argued that it should be changed, but it is unlikely to be modified because it has been entrenched in US income tax law since the Civil War.[42] But upper income US citizens can still escape taxation by simply moving and then going to a US consulate and relinquishing their US citizenship. Since they can easily obtain citizenship in other OECD countries because all countries welcome rich migrants, the costs of such a move are not very high. A US passport is not more valuable, and in some ways less useful, than an EU, Australian or Canadian passport.[43]

Paradoxically, these costs have been diminished rather than increased by a legal change enacted in 2008 to make tax-motivated expatriation harder. Before 2008, to avoid continued taxation as a US resident, the expatriating citizen had to show a non-tax reason for expatriating. That proved to be easy and as far as I know the IRS has not been able to prevail in any case brought under Code section 877 before 2008.[44] Code section 877A, enacted on a bipartisan basis in 2008, imposed an exit tax on rich expatriates: Any wealthy US citizen who moved abroad and renounced citizenship is now subject to a deemed sale of all their assets. The result can be seen in the following table, which shows how many US citizens gave up their citizenship in each year since 1998:

YEAR	NUMBER	SOURCES
1998	450	63 Fed. Reg. 42906 (Aug. 11, 1998); 63 Fed. Reg. 56696 (Oct. 22, 1998); 64 Fed. Reg. 3339 (Jan. 21, 1999); 64 Fed. Reg. 48894 (Sept. 8, 1999); 65 Fed. Reg. 15041 (Mar. 20, 2000)
1999	435	64 Fed. Reg. 19858 (Apr. 22, 1999); 64 Fed. Reg. 38944 (July 20, 1999); 64 Fed. Reg. 56837 (Oct. 21, 1999); 65 Fed. Reg. 5020 (Feb. 2, 2000)
2000	432	65 Fed. Reg. 35423 (June 2, 2000); 65 Fed. Reg. 48913 (Sept. 24, 2001); 65 Fed. Reg. 50050 (Aug. 16, 2000); 65 Fed. Reg. 80494 (Dec. 21, 2000)
2001	491	66 Fed. Reg. 48912, 48917 (Sept. 24, 2001); 67 Fed. Reg. 11374, 11375 (Mar. 13, 2002)
2002	503	67 Fed. Reg. 193621 (Apr. 22, 2002); 67 Fed. Reg. 47889 (July 22, 2002); 67 Fed. Reg. 66456 (Oct. 31, 2002); 68 Fed. Reg. 4549 (Jan .29, 2003)

[41] See Michael K Kirsch, Taxing Citizens in a Global Economy, 82 N. Y. U. L. Rev. 443 (2007) (Pg 445)
[42] Id., at 449; Reuven S. Avi-Yonah, The Case Against Taxing Citizens, 58 Tax Notes Int'l 389 (May 3, 2010).
[43] Acott Andrew Bowman, Should I Stay or Should I Go? Tax Considerations in US Expatriation, 86-Oct Fla.B.J. 48 (2012).
[44] See Steven J Arsenault, Surviving a Heart Attack: Expatriation and the Tax Policy Implications of the New Exit Tax, 24 Akron Tax J. 37 (2009) (Pg 46).

2003	569	68 Fed. Reg. 23180 (Apr. 30, 2003); 68 Fed. Reg. 44840 (July 30, 2003); 69 Fed. Reg. 61906, 61910 (Oct. 21, 2004)
2004	631	69 Fed. Reg. 61907, 61908, 61909 (Oct. 21, 2004); 70 Fed. Reg. 5511 (Feb. 2, 2005)
2005	761	70 Fed. Reg. 23295 (May 4, 2005); 70 Fed. Reg. 68511 (Nov. 10, 2005); 71 Fed. Reg. 6312 (Feb. 7, 2006); 71 Fed. Reg. 68901 (Nov. 28, 2006)
2006	278	71 Fed. Reg. 25648 (May 1, 2006); 71 Fed. Reg.50993 (Aug. 28, 2006); 71 Fed. Reg.63857 (Oct. 31, 2006); 72 Fed. Reg.5103 (Feb. 2, 2007)
2007	470	72 Fed. Reg. 26687 (May 10, 2007); 72 Fed. Reg. 44228 (Aug. 7, 2007); 72 Fed. Reg. 63237 (Nov. 8, 2008); 73 Fed. Reg. 7631 (Feb. 8, 2008)
2008	231	73 Fed. Reg. 26190 (May 8, 2008); 73 Fed. Reg. 43285 (July 24, 2008); 73 Fed. Reg. 65036 (Oct. 31, 2008); 74 Fed. Reg. 6219 (Feb. 5, 2009)
2009	741	74 Fed. Reg. 20105 (April 30, 2009); 74 Fed. Reg. 35911 (July 21, 2009); 74 Fed. Reg. 60039 (Nov. 19, 2009); 75 Fed. Reg. 9028 (Feb. 26, 2010)
2010	1391	75 Fed. Reg. 28853 (May 24, 2010); 75 Fed. Reg. 69158, 69160 (Nov. 10, 2010); 76 Fed. Reg. 7907 (Feb. 11, 2011)
2011	1780	76 Fed. Reg. 27175 (May 20, 2011); 76 Fed. Reg. 46898 (Aug. 3, 2011); 76 Fed. Reg. 66361 (Oct. 26, 2011); 77 Fed. Reg. 5308 (Feb. 2, 2012)
2012	932	[cite Fed Reg]
2013	3000	[cite Fed Reg]

What is clear from this table is that expatriations went down in 2008 (when the law was being considered in Congress), and then increased dramatically. The average expatriation rate in 1998-2008 was 477. The average expatriation rate in 2009-2013 was 1443, over three times as much.

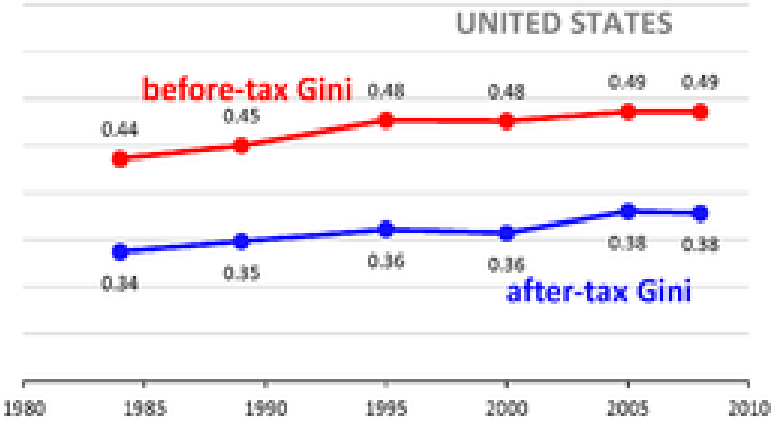
The reason for this increase was that after 2008 expatriation was no longer a shameful act. Instead, it became an act with a price set by the government. Rich US citizens living overseas could make the calculation: Is the current exit tax I have to pay more or less than the present value of my future US taxes, both income and estate tax, taking into account the likely future trend of US tax rates and the tax rate in the country I live in? In many cases, the argument for expatriating became overwhelming, despite patriotic misgivings.

Of course, these numbers for the US are minuscule (EU numbers seem much higher). But that is true with a top marginal rate of 39.6%. If the tax rate were set at 73% or 91%, as some of the optimal tax literature now argues, it seems

very unlikely that we will not see mass expatriations of the rich. In addition, we will lose many talented migrants who hope to come to the US and become rich, but are not willing to pay such high tax rates.

e. Conclusion

For all of these reasons, I believe the current top rates are too high.[45] Moreover, they demonstrably do not contribute much to reducing inequality: The before and after tax Ginis in the US have moved up in parallel to each other from 1986 onward, despite all the variation in the top marginal income tax rate in this period.



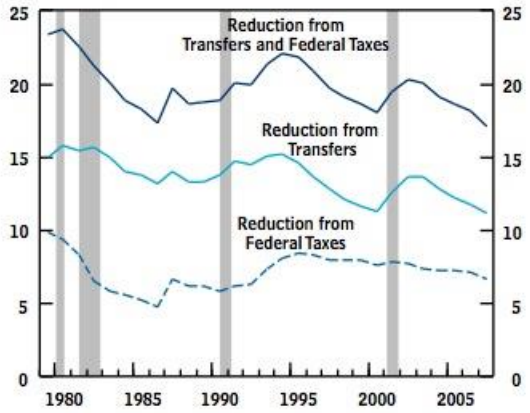
Moreover, most of the reduction in inequality is due to transfers rather than taxes:

[45] Another reason supporting flatter rates is that it reduces marriage penalties and bonuses under our system of taxing family units.

Figure 12.

Reduction in Income Inequality from Transfers and Federal Taxes

(Percentage reduction in Gini index)



If we want to reduce inequality, the answer is to support and expand the transfer programs (Social Security, Medicare, Medicaid, EITC, Food Stamps) which as the table above shows are counter-cyclical (the fluctuation is due mostly to recessions) rather than try to further tax the rich. High marginal tax rates at the top are counter productive, and the 28% top rate of 1986 is fine, as long as it applies to all income (ordinary as well as capital).[46] This is true for the other OECD members that have lower Ginis: The reason is not that they tax the rich more, since income from capital is typically subject to much lower rates, but that they have a much larger tax base including the VAT.[47]

2. Corporate Tax Reform

Since reducing the top individual rate to 28% is presumably a revenue loser even if we raise the capital gains and dividends rate to 28%, how can we raise more revenue (assuming a VAT is off the table)? The solution, like in TRA 86, is to tax corporations more.

Before TRA 86, the corporate rate was 46%. TRA 86 reduced the rate to 34% but nevertheless raised revenue by expanding the base. The current rate, 35%, is the highest in OECD, and because corporations are more mobile than individuals and

[46] The special case of dividends is discussed below.
[47] Kleinbard.

> can shift their income more easily, we should reduce it to 28% (the same as the top individual rate, so that the choice between C corporations and pass through entities is not distorted) while raising the dividend and capital gains rate of individuals to 28%.
>
> At the same time, however, we should raise more revenue from corporations by (a) eliminating accelerated depreciation, (b) eliminating the domestic manufacturing deduction (section 199), and (c) taxing US-based multinationals currently on all income with no deferral or exemption. These are the three largest corporate tax expenditures.
>
> The first two reforms are easy because even corporate CEOs have conceded in Congressional testimony that their decision to invest is not affected by these provisions, so they are pure "corporate welfare."

The third reform is necessary because the current approach (taxing only the US profits with deferral of foreign profit) has led to massive tax avoidance. There are two trillion dollars in untaxed profits of US-based MNEs in low tax jurisdictions, and taxing them and future foreign profits will pay for the reduction in individual rates.

There are three common critiques of this proposal. First, it is said that it violates certain economic neutrality norms and is therefore less efficient that territoriality (i.e., the US only taxing the income of the multinational earned within it). Second, adopting the proposed global tax approach is said to harm to competitive position of US multinationals. Third, adopting the proposed approach will, it is said, provide an incentive for US multinationals to shift their residence to tax havens.

However, if the US were to abolish deferral, it is very likely that other G20 countries (all of which have corporate tax rates above 20% and in which over 90% of multinationals are based) will follow suit, in which case the counter-arguments fail. This is what happened after other US international tax reforms such as the foreign tax credit, CFC rules, transfer pricing rules, PFIC rules, FIRPTA, the branch profit tax, earnings stripping, limitations on benefits, and (unfortunately) the portfolio interest exemption and check the box: US tax reforms were copied by other countries. The G20/OECD BEPS project should facilitate this kind of coordination.

There are three types of neutrality arguments that apply to cross-border investment. The two traditional ones are capital export neutrality (CEN) and capital import neutrality (CIN). CEN requires neutrality in the location of investment between the residence and source jurisdictions, and therefore supports taxing multinationals on a global basis as envisaged above. CIN requires neutrality between two different investors in a third jurisdiction (which is assumed to impose no tax) and therefore requires territoriality if the other jurisdiction taxes on a territorial basis.

It is often said that CEN and CIN are mutually incompatible in a world with different tax rates, and therefore a choice must be made. Traditionally, CEN was regarded as more

important than CIN because investment locations were shown to be more sensitive to tax rates than the rate of savings, and CIN was considered to affect the rate of savings in each resident jurisdiction. But in the current environment where the tax rates of most G20 countries have converged, if the above proposal is adopted and the G20 follow the US lead it is possible to achieve both CEN and CIN simultaneously.

A new variant of the neutrality argument is capital ownership neutrality (CON), which focuses on the multinational itself and not on its investors. It is said that multinationals exist because of ownership advantages that render them more efficient than their competitors. If one multinational is subject to a higher effective tax rate than a competitor because of global taxation, then it may be forced to forego an investment in a third country even if it is the more efficient one. But if the proposed US approach is adopted by the G20, then all likely competitors will be taxed in the same way and CON can be preserved as well.

Historically, the main argument against adopting the Kennedy proposal and similar unilateral proposals is that they would put US-based multinationals at a competitive disadvantage because multinationals from other countries are not subject to the same type of rule. I have always found this argument less than persuasive for several reasons: (1) It is not clear that competitiveness is a meaningful economic concept, or that the US as a country should care particularly about the competitiveness of multinationals resident in it (as opposed to the competitiveness of the US economy as a whole or of its population).[48] (2) The same argument was made in 1961, where US-based multinationals clearly dominated the globe, as in more recent years when their position was less dominant. (3) There is no evidence that current US rules, which deviate from the global norm of territoriality and impose tax on some foreign-source income of US-based multinationals, have injured those multinationals in any significant way. In fact, empirical studies suggest that EU-based multinationals and US-based multinationals pay similar effective tax rates even though the former benefit from territoriality and the latter do not.[49]

But even if competitiveness is a valid argument (and it clearly carries weight among politicians), if the G20 follow our lead it loses its force. As stated above, over 90 percent of multinationals are resident in G20 countries. Under these circumstances, there will be no competitive disadvantage to any residence country that adopts the global approach unless it stems from its domestic corporate tax rate. As suggested above, the US is an outlier in this regard because its corporate tax rate of 35 percent is significantly above the OECD average. In the context of adopting such a reform the US can and should reduce its rate to 28%.

The last argument against taxing multinationals on a global basis is that the tax can be avoided by shifting the residence of the multinational to a jurisdiction that does not impose such a tax. In fact, we are currently in the midst of another wave of 'inversions', or corporate expatriations out of the US.

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[48] See Sanchirico, As American As Apple, Inc.
[49] Avi-Yonah and Lahav.

But this argument assumes that there are other jurisdictions that the multinational can move to. If all G20 countries adopt the proposal, most of the likely destinations disappear (again, assuming this is coupled with a reduction in the US corporate tax rate). There are good business reasons why the headquarters of almost all multinationals are in G20 countries, and those reasons will militate against a move outside the G20.

A move to a tax haven may be possible if residence is defined as place of incorporation. But corporate residence should be defined as location of the corporate headquarters, and those are much less likely to be movable to tax havens because corporate management are not likely to want to relocate there and other facilities that usually follow the headquarters location, such as research and development, cannot easily be moved there. For the same reasons, it is unlikely that new multinationals can be founded in tax havens outside the G20 countries.[50]

I thus believe that funding for reductions in the top individual rate to 28% can be found by raising the rate on capital gains and dividends to 28% and by cutting the corporate rate to 28% but eliminating the large corporate tax expenditures.

3. Corporate/Individual Integration

   The last lesson from TRA 86 has to do with its repeal of *General Utilities* doctrine, which enabled corporations to avoid corporate tax on a distribution of appreciated assets, thus bolstering the classical system of shareholder/corporate taxation. This runs contrary to the view of most tax academics that integration of the corporate and shareholders taxes is preferred (Warren, 1980), which has been partially implemented by the adoption of a lower rate for dividends in 2003.

   Historically, there have been three reasons advanced for countries to adopt corporate/shareholder integration and thus overcome biases in the classical system (Graetz and Warren, 1998):

1. Under the classical system, there is a bias to conduct business in non-corporate forms, to avoid double taxation of corporate income (although this is mitigated if the individual rate exceeds the corporate rate, since in corporate form the individual tax can be deferred).

2. Under the classical system, there is a bias to avoid dividend distributions and instead retain earnings, thus avoiding the double tax (this bias is exacerbated when the individual rate exceeds the corporate rate);

3. Under the classical system, there is a bias in favor of capitalizing corporations with debt (producing deductible interest) rather than equity (producing non- deductible dividends).

[50] Marian.

None of these arguments are completely convincing, which may be a reason why the US has maintained the classical system from 1936 to 2003, and indeed strengthened it in TRA 1986 (for other reasons see Bank, 2002; Arlen & Weiss 1995).
First, the alleged bias against the corporate form is mitigated to the extent the top individual rate exceeds the corporate rate, as it generally did until 1986, and by the absence of strong provisions to prevent retentions in the domestic context.[51]

In addition, under current rules, the classical system applies primarily to large, publicly traded corporations, while small, closely held businesses are able to avoid the double tax even if they are in corporate form for non-tax purposes (by choosing to be taxed as S corporations or by incorporating as Limited Liability Companies, which are treated as pass-through entities for tax purposes). It is doubtful if there is sufficient substitutability between the two forms of business for the double tax to create much deadweight loss from the bias toward non-corporate form. Most estimates of the deadweight loss from this bias are quite low. For example, Goolsbee (2002) found that an increase in the corporate tax rate by 10% reduces the corporate share of firms by 5-10% and the corporate share of sales and employment by 2-6%. Goolsbee concluded that "[t]he impact of tax rates is an order of magnitude larger than previous estimates... and suggests a larger DWL from corporate taxation, but is still relatively modest." As Goolsbee says, previous empirical studies found much lower DWLs (contrary to the theoretical predictions of high DWLs in the model employed by Gravelle and Kotlikoff, 1989). The double tax is a price large businesses have to pay for access to the public equity markets and the liquidity that accompanies such access.

Finally, to the extent that the corporate tax can be shifted to consumers or to labor, the bias disappears, and the Treasury's 1992 integration study and many others have suggested that considerable shifting can take place (Graetz & Warren, 1998; see also Mulligan, 2002; Fullerton & Metcalf, 2002; Judd, 1985; Homma, 1981; Grieson, 1975; Feldstein, 1974, all refining the classic work of Harberger, 1962, who predicted a shift primarily to other capital). The bias reappears if non-corporate businesses can likewise shift the individual tax burden, but it seems plausible that the shifting potential of large multinationals is larger than that of small, closely held businesses (Fullerton & Metcalf 2002; Harberger 1995; Mutti & Grubert 1985). [update]

Second, the bias in favor of retentions is reduced when (as both before and after 2003) the individual rate on dividends is not significantly higher than the corporate rate.[52] In addition, this bias was mitigated before 2003 by the ability of corporations to redeem

[51] If the corporate rate exceeds the individual rate, as it did from 1986 to 1993, there is an incentive for C corporations to convert to S corporations or LLCs. While the publicly traded partnership rule (adopted in 1987 precisely to prevent publicly traded C corporations from converting) deals with this for most C corporations, I would nevertheless equate the top corporate and individual rates (departing from the 1986 rate structure) to avoid this bias.

[52] This is another reason to equate the dividend and corporate rate. Traditionally, when the top rate was significantly higher than the corporate rate, this led to increased retentions, but the weapons adopted by Congress to address this issue (the accumulated earnings tax and the personal holding company rules) are not very effective, the first because it depends on taxpayer motivation and the second because it only applies to closely held corporations with primarily passive income.

shares from shareholders at the favorable capital gains rate through share repurchases, and by the fact that numerous shareholders are tax exempt or corporate (and thus do not pay a full tax on dividends). Even when the tax rate on dividends is the same as that on capital gains (as has been the case since 2003), capital gain transactions may still be preferred for the ability to offset basis. That is why many US corporations have adopted structured redemption programs addressed to their taxable individual shareholders.[53] Other corporations retain all their earnings, but it is not clear that this is primarily tax motivated (corporations used to pay dividends under the same rules in the past). Admittedly, more corporations were paying dividends in 2003 than in previous years, but this trend began before 2003 (Norris, 2003), and again it is not clear that this is primarily tax motivated. Finally, there is an unresolved debate among economists whether the dividend tax is capitalized into the price of the shares. If it is, then the retention bias applies only to new equity, but new equity is unlikely to pay dividends for non-tax reasons (Fuest and Huber 2000; Boadway and Bruce 1992; Bradford 1981).

Third, the bias in favor of debt and against equity is a general problem of the income tax, which should not be addressed only in the corporate tax area (Warren, 1993; Bradford 1981; Stiglitz 1973). Moreover, even to address it just for corporations it is necessary to make dividends not exempt, but rather deductible, a form of integration that is never adopted (in part because it would automatically extend integration to foreign and tax-exempt shareholders; see Grubert and Mutti, 1994, Avi-Yonah and Chenchinski 2011). If integration takes the normal forms of imputation or dividend exemption, there is still a difference in treatment between interest and dividends that can be manipulated. For example, if interest is taxed at the corporate level but dividends are not, clientele effects will still exist (tax exempts will hold bonds and taxable shareholders stock, and taxable investors will purchase stocks and then use derivatives to construct a portfolio that is economically equivalent to an investment in bonds (Warren, 1993)). Neither of these problems arises if both interest and dividends are deductible or (as under the Treasury's CBIT (Comprehensive Business Income Tax) model, Treasury, 1992) both non-deductible, but neither of these seems to be a practical option politically.

In sum, it is unclear whether there are significant domestic efficiency gains associated with integration. The presumed gains (Treasury, 2003) depend on assumptions regarding the incidence of both the corporate tax and the dividend tax that most economists regard as unproven (Burman, Gale and Orszag, 2003).

In addition, even if one accepts the validity of all the biases generated by the classical system set out above, all of them need to be offset by the countervailing biases created by integration in the international context. From a theoretical perspective, two situations need to be considered: when the source country is integrationist and the residence country classical, and when the source country is classical and the residence country integrationist.

[53] Another reason is that foreigners are taxable on dividends but not on capital gains, and many hedge funds are located in tax havens, which has led to a large increase in redemptions over dividends after the capital gains and dividend rates were equated in 2003.

a. Classical residence country and integrationist source country.

If a portfolio investor residing in a classical country invests in shares of a company of an integrationist country, the resulting bias depends on the form of integration. If the source country grants integration in the form of dividend exemption, the classical country investor would not benefit since the classical country would tax him on the dividend without allowing a foreign tax credit for underlying corporate taxes. A domestic investor in the source country would be subject only to the corporate tax, while the classical country investor would be subject to the corporate tax, any foreign withholding tax on dividends, and the residual classical country tax.

If the source country grants integration by way of imputation credits, the key issue is whether such credits are extended to foreign investors (by treaty or otherwise). If (as is typical) the credits are not extended to foreigners, a domestic investor in the source country would only be subject to tax at his or her individual rate, while the classical country investor would be subject to tax at the corporate level, any withholding tax on dividends, and the residual classical country tax. Whether the combination of these taxes exceeds the source country tax on domestic investors depends on how high the source country rates are (it is conceivable, for example, that a combined tax on the classical country investor of 60% would be matched by the single level source country tax on a domestic investor).

If imputation credits are extended to classical country investors, a different bias arises. In that case, both domestic source country and classical country investors in a foreign corporation would be taxed the same by the source country, but the cost of imputation credits to classical country investors would be borne by the source country, while any tax on the dividend would be collected by the classical country. From a classical country perspective, moreover, there would be a bias in favor of investing in source country corporations and against investing in classical country corporations, since only dividends from the former would carry the imputation credits. Such a bias would not be eliminated by the classical country taxing the dividends in full, since the investor would still receive an imputation credit check from the source country not available for her classical country investment.

b. Classical source country and integrationist residence country

If the integrationist residence country grants integration by way of dividend exemption, presumably the exemption would apply to dividends from the classical country as well as from domestic corporations (this is true for many dividend exemption countries, including generally the US, but not for others). In that case, a bias is created in favor of foreign investors in classical source country companies, since foreign investors would be exempt from tax on the dividend (unless a classical country withholding tax applies or is designed to offset this problem, but such taxes are generally reduced by treaty or avoided by other

devices). By contrast, a classical country domestic investor would be taxable on the dividends in full.

If the foreign country grants integration by way of imputation credits, there will be no credits available for a foreign investor who invests directly in a classical country company. In that case, there will be a bias in favor of the foreigner investing in her own country's domestic corporations. This bias may be partially eliminated if credit is given for classical country taxes to a domestic portfolio investor in a domestic company with classical country source income. But, similar to the case of a dividend exemption, that would create a bias in favor of foreign investors in such companies over classical country investors in a domestic classical country corporation.

Thus, from a theoretical perspective, as long as there are both classical and integrationist countries in the world, integration creates biases that do not arise in a world with only classical countries (Zee, 2002; Avi- Yonah, 1996; Harris, 1996; Ault, 1992). Theoretically, the biases could also be eliminated in a world in which all countries practiced integration and extended its benefits to foreign investors and investments, but this seems a very unrealistic scenario, which is certainly not fulfilled under present conditions (Australia used to do this, but reverted to the norm under revenue pressure).

From a theoretical perspective, there seems to be no reason to assume that the biases created by integration from an international perspective are less important than the biases created by the classical system from a domestic perspective. Further empirical work is needed on this issue, expanding the initial work by Grubert and Mutti (1994). This is particularly important since the international biases may be gaining in importance as cross-border portfolio investment grows, while (as discussed above) there are reasons to doubt the importance of the latter. This is the reason why many countries (e.g., Germany and the U.K.) have recently been restricting integration (Vann, 2003). If the whole world reverted to the classical system, the international biases would be eliminated.

These arguments suggest that the US should resume taxing dividends as ordinary income. That is particularly true if capital gains are taxed as ordinary income as recommended above, because the best reason for the current 20% rate on dividends is that this is the rate for capital gains and therefore there is less pressure to distinguish capital gains from dividends.[54]

4. Conclusion

This paper has suggested that as we consider tax reform in 2015 and beyond, we should revert to some of the positive features of TRA 86, updated to reflect increasing globalization. Specifically:

[54] As noted above, raising the rates on dividends and capital gains and reducing the rate on corporations also makes sense if corporations are more mobile than individuals.

a. The top individual rate, the KG rate and the dividend rate should be set at 28%;

b. The corporate rate should also be set at 28%;

c. US resident corporations should be taxed on global income with no deferral or exemption.

These reforms are not enough to address our long-term deficit problem; they are designed to be revenue neutral overall, like in TRA 86. In the longer term we need a VAT, but that is a task that must wait for bolder political leadership than we currently appear to have.

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