TAXATION IN THE 21ST CENTURY

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I AM VERY GRATEFUL FOR THE OPPORTUNITY TO keynote this plenary session of the National Tax Association's annual meeting. First as a scholar and then as a policy maker, I have closely followed the work of the community that gathers each year for these meetings. Thinking back to my first experiences with the *National Tax Journal* as I took my first course in Public Economics from the late Richard Musgrave and Martin Feldstein, I am struck by how much more sophisticated discussions of tax policy are today relative to a generation ago.

And in my eight years at the Treasury, I have seen what a difference the kind of work done by members of the NTA can make. Of course, at any instant much of the tax policy debate is shaped by near term political imperatives, by interest groups, and the results of public opinion polls. But over time, academic work on tax policy has a profound impact. It frames the norms of neutrality that we use as benchmarks in tax policy discussion. And, it is academic research that undergirds the analytical tools—the tax expenditure budget, distribution tables, tax simulation models, and approaches to assessing revenue impacts that provide the frame every debate over tax policy.

I was very glad to receive this invitation to speak about the future of tax policy because questions of taxation are of profound importance to our country's future. The famous words of Oliver Wendell Holmes: "Taxes are the price we pay for civilization" are engraved into the IRS building. If, as I believe, Holmes is right, the decisions we make about tax policy will shape the way our civilization evolves.

THE 21ST CENTURY ECONOMY

This morning, I want to take a nontraditional approach to thinking about tax policy and by focusing on the radical changes in the economy rather than the internal imperatives of the tax system as a driver of reform. I take this approach because I believe in terms of their importance for the U.S. economy and society, the tax issues raised by the changing economy are of profound importance and require far more attention from tax experts than they have yet received.

The standard approach to thinking about desirable tax policy assumes that taxpayers, be they individuals or businesses, are actors in a reasonably well-functioning market economy and that the objective is to raise necessary levels of revenue for the government to undertake a set of public objectives that from the point of view of tax policy are taken as predetermined. It then lays out a set of objectives for the tax system—typically values like economic efficiency and neutrality, fairness, or progressivity, and simplicity, or administrability, and contemplates how they can best be achieved.

It is in these general terms that the virtues of the Haig-Simons income definition, various consumption tax alternatives, flat taxes in their many variants have been advocated and in these terms that the tax community typically assesses tax reforms and thinks about the future of the system. While the conclusions differed, the arguments of Stanley Surrey, of Treasury's 1976 *Blueprints for Tax Reform*, of proponents of the 1986 Tax Reform Act, and of the most recent Presidential Advisory Panel on Tax Reform, are all couched in these terms.

And yet I have always been struck by a certain timeless character to tax policy debates that seek to identify ideal approaches to taxation as if there was a timeless ideal tax system that society could implement with sufficient reflection and political will. It seems more realistic to assume that as the nature of economic life is transformed by the twin forces of globalization and technological change—appropriate approaches to taxation should change as well. If war is too important to leave entirely to generals, perhaps tax policy is too important to leave to tax experts.

GLOBALIZATION AND TECHNOLOGICAL CHANGE

It appears increasingly likely that the technical changes associated with information technology and knowledge as a major source of value are changing the nature of our economy in qualitative as well as quantitative ways. Most observers now agree that information technology is behind the unexpected acceleration in productivity growth that the United States has enjoyed over the last decade. Possibilities for exchange and cooperation at a distance have multiplied exponentially with the increasing importance of services and the establishment of the Internet. Alan Greenspan (1999) famously noted the de-massification of the GNP—the value of what is being produced keeps going up, but the mass of what is being produced goes down.

Increasingly, we are also seeing a deeper kind of trade, what Gene Grossman (2006) and his colleagues have referred to as trade in tasks, rather than trade in goods. The international division of labor is extending from different countries specializing in the production of different goods to different countries specializing in different tasks that combine together in the production of an ultimate consumer or investment good. The same organization is performing various tasks in different places to take advantage of lower cost labor. For example, U.S. financial firms are now able to engage in much more in-depth analysis of companies because ranges of tasks that involve sorting through large piles of documents to learn about those companies are now performed in India, where the wage is a tenth of what it costs someone to perform the task in the United States.

Even more fundamentally, as discussed in Delong and Summers (2001), the rise of knowledge goods is changing the nature of market competition. In traditional economic analysis it is assumed that the cost of producing a good increases as the volume of its production increases due to diminishing returns. With knowledge goods like software or pharmaceuticals or video entertainment, the situation is very different. There are large fixed costs of development, but once these costs have been incurred, the cost of producing more of the good is very low. This changes fundamentally the nature of market competition and makes Schumpeter's notion of "temporary monopoly power" central to the functioning of the economy. It implies that an increasing share of what we measure as profits will represent the return to entrepreneurship and innovation rather than investments in physical capital.

The combination of information technology and the rise of knowledge goods, which make international integration possible to a greater extent than ever before, and dramatic economic policy reforms in major developing countries are radically altering the global economy. I am convinced that when the history of our time is written 300 years from now the rise of Asia will be the story that stands out. At rates of growth that have now prevailed for well over a decade, living standards have the prospect of climbing a hundred-fold within a single human lifespan in China and Asia. Think about it – 7 percent a year growth, doubling every ten years over 70 years – or seven doubles – that is a factor of 128. That is – if you add China, and India, and other parts of Asia that are growing considerably in similar ways – 40 percent of humanity. They called it the *Industrial Revolution*, because all of a sudden, for the first time in human history, it was reasonable to think that living standards could as much as double in a single lifetime. We are talking today about a factor of a hundred.

This is an event that ranks in human history in terms of importance, I believe, alongside the Renaissance and the Industrial Revolution. As we are already seeing, it is transforming almost every aspect of the global system. There is a story I heard recently that I think illustrates the point quite well. It turns out that several years ago there was an epidemic of manhole covers being stolen in major cities throughout the world (*BBC News*, 2004). All of a sudden, people started complaining that manhole covers were gone. The reason was traced back to a skyrocketing price of scrap metal, which was, in turn, traced back to demand in China. So these impacts are everywhere, in ways expected and unexpected.

Just how integrated the global economy will become is far from clear and will depend on many factors, not least is the strength going forward of the political commitment to open markets. But it is not unreasonable to suppose that a generation from now China will have surpassed the United States as the world's largest economy with India not far behind the United States (Wilson and Purushothaman, 2003), that nearly half the workers in the United States will be in jobs where they are subject to serious competition from outsourcing (Blinder, 2006), and that manufacturing workers as a share of the U.S. labor force will have fallen below 10 percent of the labor force (U.S. Congressional Budget Office, 2004).

IMPLICATIONS FOR THE DISTRIBUTION OF INCOME

While different observers would assess the impact of technology and globalization in different terms, I think it is reasonable assumption that they are likely to be profound. What are the likely economic implications if these trends continue? There are three potentially very large groups of winners.

First, those who are the proximate beneficiaries of rapid growth in the developing world who are going to see their standards of living rise as much as a hundred-fold will benefit from globalization. Second, those with a variety of exceptional abilities who can now use the new availability of high-skill low-wage labor to lever their efforts and those who can benefit from having a larger market for their products will benefit from globalization. Third, with increases in the rate of structural change and increases in the openness of capital markets, the opportunities to profit from the financing of investment and the spreading of risk have never been greater. It is noteworthy that the financial services sector accounted for 26.7 percent of the profits of the S&P 500 in 2006.

But there is a vast global middle that lacks – or worries that it lacks – the capacity to effectively compete to take advantage of the opportunities presented by globalization and technology and that does not wish to compete with low-wage countries on labor costs. And that group – the global middle – is increasingly anxious as it experiences increased pressure on wages and job security. It takes relatively little solace in the reduced prices of consumer goods. And it increasingly feels alienated from the interests of large corporations that can invest and profit anywhere and so see their welfare as increasingly dependent on the global rather than the domestic economy.

All of this is leading to profound changes in the distribution of income in the United States and in where risks are being borne. In 1979 the top 1 percent of the population received 9.3 percent of the total income in the United States, about the same amount earned by the bottom 25 percent. In 2004, the most recent year for which data is available, the top 1 percent earned 16.3 percent of total income, more than the bottom 40 percent of the population combined.

There is a more dramatic way of highlighting increases in inequality. In 1979, the mean income for individuals in the top 1 percent of the income distribution was approximately 33 times what the average person in the bottom 20 percent earned. By 2004, the average person in the top 1 percent earned more than 81 times as much as the average person in the bottom 20 percent (Tax Policy Center).

Equally pronounced have been changes in risk-bearing patterns. Financial markets today diversify financial risk better than ever before and are unprecedentedly tranquil if one looks at predicted volatilities as inferred from options, credit spreads, or the multiples applied to rents or earnings in valuing assets. At the same time, as work by Jacob Hacker, Elizabeth Warren, and others highlights, the risks borne by typical families have risen as the labor market has become more volatile, employer pension and health insurance arrangements have changed, and families have become less stable.

Now, I think it is fair to say that these trends have not gone unnoticed. One of the themes in the mid-term elections that just took place was a sharp increase in what might be referred to as economic nationalism – a desire to impose protection, resist integration, and avoid the trends I have been describing. At the same time that this distemper has risen in the United States, and has risen in western Europe, there has been an equal degree of concern about the dangers that if the global system becomes more closed – as it did in the late 1920s and early 1930s – the political consequences will be profound.

There is much of this that cannot be changed, and probably should not be changed. But I tried to ask myself an additional question – which I want to talk about in the remainder of these remarks – and that question is: If you take as a given that responding to these fundamental societal changes is a central imperative of policy, in what respect should tax policy thinking be influenced by all of this? Where does it amplify the message that tax professionals normally give, and where might it lead them to give a somewhat different message than they otherwise would? I would highlight three areas that require greater attention, and are becoming an increased area of focus because of these concerns.

The first is corporate taxation, and particularly, the effective taxation of corporate income. There are a set of phenomena and long-standing concerns that are interrelated, and that I am not sure I am able to parse with precision. There is a substantial and growing gap between reported income as reported to shareholders, and income as it shows up on tax returns. The phenomena of corporate tax shelters – of which I became convinced while in the government – were pervasively mis- and underestimated by the federal government. I found myself living for a time, as Secretary of the Treasury, in a kind of dual reality. I would be concerned with this problem, and I would ask the revenue estimators what we would do if we closed the such and such loophole, and they would say, "Well, that is really speculative, and it is really hard to know that."

And I would ask what they thought their estimate was, and they would say they could not commit because they had not done their estimation procedure, which would take six months. So I would say, "Well where do you think it will come out?" And they would say, "$700 million."

Then I would speak with somebody at the IRS, or in the Justice Department, and ask them what they were working on, and they would be closing a single instance of the abuse I was talking about, with a predicted revenue gain of $1.2 billion dollars. So we do not know fully what the magnitude is, some of this undoubtedly shows up in the book income taxable income tax distinction, but not all of it.

Transfer pricing is a related phenomena of tax havens: again, I do not know just what the right estimates are. I was struck by a chart (Figure 1) in a forthcoming paper by Reuven Avi-Yonah and Kimberly Clausing (2006). It looked first at where the profits were of majority-owned affiliates of U.S. firms, and the leading country is the Netherlands with 14 percent of the worldwide profit of U.S. firms, followed by Bermuda, and Ireland, with Luxembourg and the Caribbean also significantly leading Japan, and France, and Germany.

Now, the traditional theory of this phenomenon – as I learned it when I was a student – would have emphasized tax competition. And the standard theory of tax competition is that economic activity moves to places with low tax rates. Sure enough, the places where a lot of profits are to be found do, indeed, have very low tax rates. The corporate rate in the Netherlands, for example, is 5 percent. But what is striking is that it is not that large amounts of economic activity are migrating to these places.

The next chart (Figure 2), drawn from the same source, illustrates where the jobs were in the majority-owned affiliates of U.S. firms, looks more or less as you would expect – with the United Kingdom, Canada, Mexico, Germany, France, Brazil, China, Australia, Japan, and Italy. So what is illustrated is that there is a tremendous amount of moving of income to places with low taxable incomes – low corporate tax rates.

What is the right answer to this question? What is the right combination of more aggressive pursuit of corporate tax shelters, recognizing the imperative of publicly equating, and perhaps basing taxes on book income, as well as taxable income? What is the right approach to considering formula apportionment or some other device for reducing the shell game of moving income from jurisdiction to jurisdiction?

I am not sure I have the answers. What I do know is that the broad public sees the following syllogism: There is globalization – it is helping them and not us, first of all. Second, all the elasticities are higher now than they used to be, and therefore, we need to tax us, not them, in response. All those

Figure 1

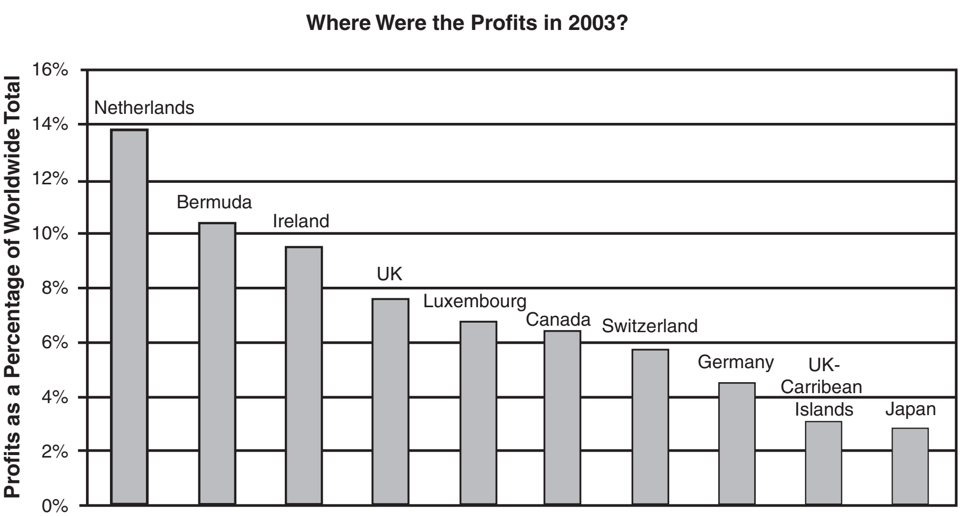
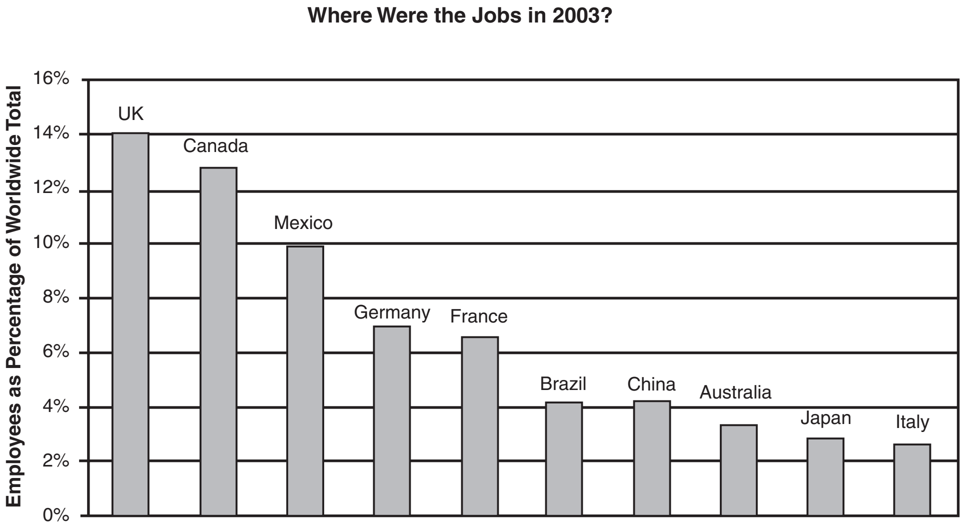


Figure 2



that find that syllogism unreasonable are not wrong. The imperative for figuring out how to address this seems to me to be critical.

There is a second large area that is also a traditional concern, and a preoccupation of taxpayers. That is the question of tax compliance, and measuring effectively the progressivity in tax compliance. Everybody knows that this is an important revenue issue. What I am going to highlight here is that this is an important progressivity and fairness issue as well. I have looked at three sources of income – labor income, in which most of the income is not received by those at the very high end, and where there is near perfect compliance; capital income, where a large part of the income is received at the very high end and where underreporting begins to be significant; and business income, where underreporting is most serious, and where the concentration is at the highest end of the income distribution (Table 1).

So this is clearly an issue of progressivity. But the absolute numbers here are also quite large. Exactly what is attainable in terms of increased revenue is not clear. But no one should be confused about the stakes in this issue. To get a sense of the magnitude of the problem in terms of current revenues and revenues over the course of the next 10 years, I aged the estimates of the 2001 tax gap the IRS put out early this year and grafted that onto the next decade, simply by using estimated total tax revenues. Many know how to do it in more sophisticated precise ways and my purpose was not exactitude, but rather to get a sense of the precise magnitude here.

The numbers are astonishingly large. I project the gross tax gap over the next decade will be $5.8 trillion dollars. The net tax gap – that is the net of late payments and enforcement efforts and the like – will be, I predict, $4.9 trillion dollars. If one is able to close only a tenth of that gap, it is a very large issue relative to the total federal budget, and relative to the other changes in tax policy that closing even a small portion of the gap would make possible. It bears emphasis that the federal government and the IRS concluded on the basis of very fragmentary information that the quality of compliance had declined by about 10 percent from 1988 until 2001 (U.S. Department of the Treasury, 2005). So the notion of reversing that deterioration does not seem something that is unimaginable given the stakes involved.

That sense is reinforced by information that you have all seen, in one way or another, on various measures of effort to collect taxes. Now, it is certainly true that computerized matching is, in many cases, an effective alternative to face-to-face audits, and that enforcement is proceeding more efficiently in other ways than it once did. But I do

Table 1

Sources of Income and Underreporting

Source of Income	*2006 Total*	*Percent Earned by Top 1/10 of 1% (2006)*	*Percent of Taxes Due Underreported (based on IRS study of 2001 data)*
Labor	$5.9 trillion	3.5% of all labor income	1% tax underreporting
Business	$659 billion	22.8% of all business income	43% tax underreporting
Capital	$1.0 trillion	36.6% of all capital income	8% tax underreporting

Source: Urban-Brookings Tax Policy Center, IRS data; author's calculations.

not see how anyone can look at the level of decline in the effort to collect taxes that is shown in Figure 3, and especially enforcement at the very high end, in the face of the general trends that we are describing, with anything but dissatisfaction. What about corporate returns? Again, in the face of what others see as an epidemic of corporate tax shelters, it seems to me very difficult to constructively rationalize the pattern of audits in Figure 4. If one looks at similar measures for large corporations, the picture is not different.

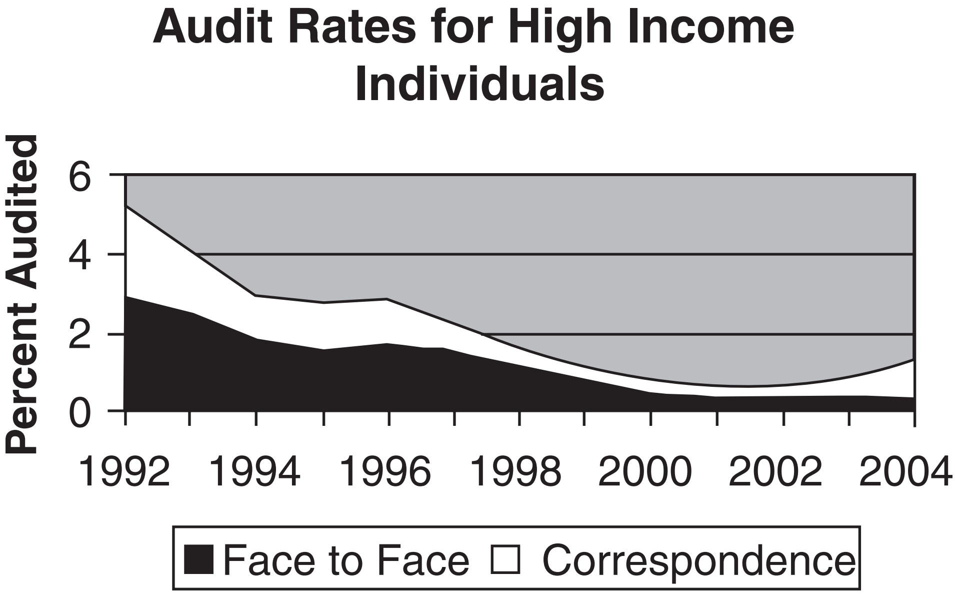
Again, I see my role here as to set off discussion, rather than to provide answers. But it defies belief that with the right political will and commitment, the same information technology that is being effectively applied to permit the division of tasks across continents, cannot be applied to lead to a higher fraction of income received in showing up on tax returns than was the case 15 years ago.

Here, too, I would suggest another issue for the technical community to consider. While I was at the Treasury, I lost an argument roughly every six weeks regarding scoring of enforcement. It is a matter of high conviction and conscience for many that gains in revenue from increased enforcement should not be scored. There are good reasons for that, mostly going to the abuse that's taken place when people have used them as plugs to fill budget gaps in the past. I respect and appreciate that argument.

On the other hand, the fact that efforts to improve and enforce taxes that will reduce budget debts, but instead every year are scored as measures that will substantially increase budget deficits – because costs are counted and increased revenue is not – exerts a very powerful impact on the magnitude of those efforts at very substantial cost to both the fisc and to the morale of the tax enforcers and ultimately to the sense of fairness the tax system engenders in the taxpaying public.

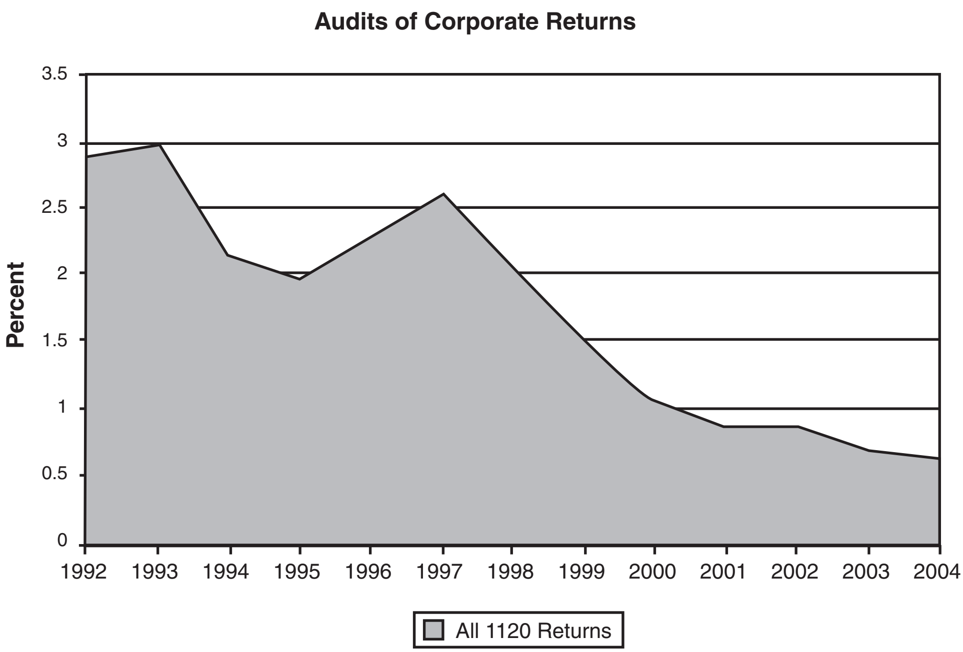
The third dimension, which I believe the global changes that are occurring needs to influence the public policy debate with respect to the tax system, is benefits for what might be called regular families. It is the traditional view in the tax policy community – defended extraordinarily ably by the Treasury and Joint Committee staffs in Republican and Democratic eras alike – is that the tax system should have as its goal raising revenue. And, that if one wants to support higher education, or help people take care of their children, or support communities, then that is why we have

Figure 3



Transactional Records Access Clearinghouse, Syracuse University

Figure 4



Transactional Records Access Clearinghouse, Syracuse University a federal government with cabinet departments, and a very large budget that can be used for those purposes. That is a highly legitimate and compelling argument. It has historically tended to be a losing argument as often as it has tended to be a winning argument.

The question I want you to pause on – stepping back from the imperatives of taxes — is the following: Imagine you had never thought about this question before, and you observed that countries – and their political leaders – felt with validity that there were a range of economic security issues bearing on families that needed to be addressed. Now imagine that there existed a system in the country that collected – every year – comprehensive and reliable economic information on families and their situation. And the question that was posed was should you use that mechanism for administering universal benefits to the universal set of people who participated in it? Or, should you set up entirely separate mechanisms to support child care, support savings, support tuition benefits for those going on to higher education?

If that was the question that was posed, I do not think the answer would be obvious that separation was warranted. If you ask what is the cost per dollar of revenue collection, or revenue expended through the tax system or the administration, it is in the low pennies, if that, per dollar. If you do a similar calculation for any administered benefit, the cost is more than an order of magnitude greater.

I do not hold a particular brief for any particular tax expenditure program. A number of them, such as increased incentives for savings or expanded eligibility for the EITC have been suggested by, among others, the Brookings Institution. But at a moment when the central global challenge goes to economic insecurity of ordinary families, it seems to me that it is very important for the tax community to think about how the tax system can be used in ways that are responsive to the global pressures that are exerting pressure locally. I suspect that this kind of thinking may require some greater flexibility with regards to our taboos about tax expenditures. It may require some greater flexibility in our traditional concerns about refundability.

I have suggested here three areas: tax expenditures and refundability that benefit middle class families, more effective enforcement of the tax system – particularly where corporate taxpayers are involved – and reconsideration of corporate taxation, and the beneficiaries of corporate income taxation, in light of the changes that globalization is bringing. Whether these precise proposals or areas are the right ones to study, should, I believe, be a matter of very active debate. What I believe with a much higher conviction is that the tax community will serve this country very effectively if it places its deliberations in the context of the very large global changes that are under way. Thank you very much.

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