INTERVIEW WITH
PROFESSOR MICHAEL J. GRAETZ

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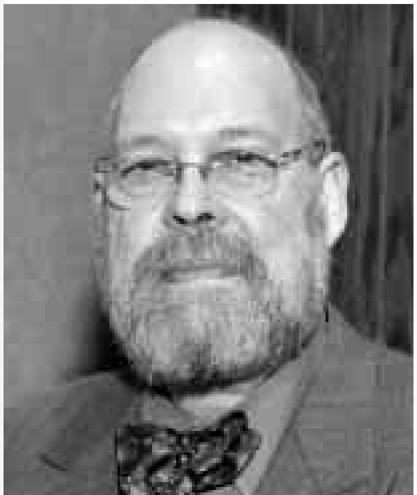

PROFESSOR MICHAEL J. GRAETZ

INTRODUCTION: Michael J. Graetz is Justus S. Hotchkiss Professor of Law at the Yale Law School. He served as Deputy Assistant Secretary of the Treasury for Tax Policy from 1990 to 1992. Professor Graetz has written a new book with Ian Shapiro entitled *Death by a Thousand Cuts: The Fight over Taxing Inherited Wealth* published in March 2005 by Princeton University Press.

Q The estate tax affects only the richest two per cent of people in a country that prides itself on being the most democratic in the world. How did it become an object of such popular loathing?

A Repeal advocates managed to portray repeal as a righteous moral cause by presenting the tax as an unfair "double tax" on thrift and hard work. They also tapped into unbounded American optimism, appealing to the many people who believe either that they are going to get rich or that their children are. And repeal proponents took brilliant tactical advantage of the fact that no compelling moral arguments were made on the other side of the issue. Opponents of repeal failed to make any case for the moral unfairness of giving a huge, unearned, windfall benefit to the Paris Hiltons of this world. Had they done so, they might have argued that a failure to tax large inheritances undermines the American ideal of equality of opportunity. Instead they responded to moral arguments with math, attempting to move people with the observations that "only the richest two percent pay the tax" and "you won't pay it." This is a losing strategy in American politics.

Q You write that the movement to repeal the estate tax or "death tax" consists not of the super-connected super-rich, but largely of people who might not even be affected by it. Who exactly are these people and why did they work so hard to repeal it?

A They were largely small business owners and farmers, supplemented by people whose assets grew rapidly in the 1990s—dot-com millionaires, baby boom beneficiaries of the escalation in housing prices, and the like. The estate tax threshold of $1 million was low enough to cause them real concern. But they could easily have been taken care of by increasing the exemption to $3 to $5 million or so (double for a married couple) right away, as the repeal opponents eventually proposed. But by then it was too late; control of the movement had shifted inside the beltway, where ideological anti-tax activists, such as Grover Norquist, strongly preferred any version of total repeal, including this one, which is not achieved until 2010 and sunsets in 2011. This gives little, if any, security to many of those who pressed for repeal in the early and mid-1990s, though it may undermine the legitimacy of the tax—forcing proponents into the position of re-instituting it. Or so those who crafted the result in 2001 hoped. Notice that this gamble is more worthwhile the richer you are. For billionaires, an increase in the threshold to $3 or even $6 million is chump change; for them it's better to get a foot in the door for total repeal, hoping to make it permanent later. By contrast, for many farmers and small businessmen a $3 million or $6 million exemption is the whole enchilada. That tells you something about whose interests prevailed here.

Q In addition to your new book, "Death by a Thousand Cuts," you have written books attempting to explain federal taxes and social security to the general reader; for example, in 1997 you wrote "The Decline (and Fall?) of the Income Tax." Are you hopeful that the public will be able to make good choices about tax and social security issues?

A I am not impressed with the quality of public discourse about important public policy issues today. Most people do not read books like those that I have written. They rely instead on thirty-second commercials to make up their minds about complex financial issues. So while I am not terribly optimistic about the public's input on these issues, I do hope that there will be forums for more careful and complete debate.

Q Your 1997 and 1999 books discussed proposals to invest some part of FICA contributions in private accounts in the stock market. Do you endorse the President's current proposal that sounds somewhat similar, and why?

A I think private accounts have an important role to play in providing retirement security, particularly as the population ages. One of the key questions is what exactly will be the baseline social security benefit that will go along with these private accounts. So far, the President has not yet told us exactly what he has in mind. Until we know that, I am not sure anyone can answer this question confidently. In addition, there are many other issues awaiting answers in order to be comfortable with a private account proposal. For example, will these private accounts be converted into annuities at retirement, and if so will the annuities be inflation indexed? At the moment, the private market does not have a good mechanism for providing long-term inflation-indexed annuities. And insurance companies are now regulated by the states, not the Federal Government. Can we live with that if they are providing the annuities for private accounts? Issues like these seem important to me, and we will have to wait to see how the answers unfold.

Q Your books raise questions about the function of Treasury bonds that are held by the social security "trust fund". Would you explain whether or why the "lock-box" is a fiction and how early in the history of Social Security do you think the policy makers knew this?

A For a long time the Social Security system was essentially a pay-as-you-go system. There was no real accumulation of funds in the Social Security trust fund. Only after the 1983 revisions to Social Security was there any real effort to build up surpluses in the trust fund. And those surpluses are therefore a phenomenon of the past two decades. I think what we have learned during this period is that Congress is incapable of resisting using those funds to finance the general operations of the Federal Government. Therefore the surpluses are not contributing to additional national savings. Instead, they are simply keeping the overall federal deficits lower than they might otherwise be. This is one reason that I think that if we are going to have genuine pre-funding of social security, or a build up of national savings to finance social security benefits or retirement benefits over time, it is going to have to be done in the form of private accounts rather than in some government account, regardless of what the government account is invested in.

Q Your books suggested adopting a 10-15% VAT, excluding incomes below $100,000 from the income tax, and applying a flat 25% income tax rate to income over that amount. Do you still think that would work? Would you retain the FICA tax? Do you think adoption of a VAT is within the realm of political possibility in the near term?

A Yes, I do think it would work. In fact, it is one of the few major changes in our nation's tax system that offers a realistic prospect of real reform because it would be both revenue neutral and essentially distributionally neutral in the sense that it would not shift the tax burden down the income scale as would complete replacement of the income tax with either a flat tax or a national sales tax, as others have proposed. Here is what *The Economist* said a few months ago about this plan:

> Taken together Mr. Graetz's plans imply a wholesale change to America's tax system that may render them politically unrealistic. Nonetheless, the looming AMT crisis suggests that America has a rare opportunity to clean up its tax code. If he is really serious about reform, Mr. Bush should grasp it.

Unsurprisingly, I think *The Economist* got it just right. Your second question was about the FICA tax. I do retain the FICA tax although my plan includes a refund of FICA taxes as a way of protecting low and moderate income taxpayers from any tax increase due to the value added tax and also as a way of replacing the Earned Income Tax Credit. The great advantage of this plan is that it would relieve 150 million people from the burden of filing tax returns and would eliminate 100 million income tax returns that the IRS now receives. So this would be a major simplification of the existing system. And it also would be much more favorable to savings and economic growth than the existing system.

Q Consumption taxes, like the VAT, are usually said to promote savings, and therefore investment, which is thought to stimulate economic growth, resulting in the proverbial rising tide that raises all boats. What are your thoughts on that?

A The plan that I have proposed, which combines a consumption tax in the form of a value added tax with a much smaller income tax than we now have, is a system that would eliminate taxes on savings for most people and would reduce taxes on savings and investments for everyone. In that sense, it would be much more conducive to economic growth than the current system. The United States, in my view, has failed to take advantage of its unique position as a large developed country with a low tax burden relative to the size of its economy. If you look at the rest of the world, what you find is that our consumption taxes, which are now limited to only the state sales taxes and a handful of excise taxes on things like tobacco and gasoline, are much smaller than consumption taxes throughout the rest of the world. But our income tax is about the same size as those abroad, and, in fact, our income tax rates on investment (including the corporate rate) are higher than they are in many countries around the world. So by lowering the income tax rate to 25% and whittling the income tax down so it applies only to Americans with incomes over $100,000, my plan would put our consumption tax—both in terms of its rate and as percentage of the economy—in line with the rest of the OECD and make our income tax much smaller. I think all economists would agree that this kind of system would be much more favorable to long-term economic growth than the current system.

Q Did the comparison that you just made count the FICA taxes as a type of consumption tax and if not, why not?

A The FICA tax is a tax on wages, which makes it not quite an income tax and not quite a consumption tax. The other countries in the OECD also have wage taxes to fund their social insurance programs. And most of them have wage taxes at higher rates than ours. I leave the FICA tax off the table for two reasons: First, I think the wage tax works reasonably well, and, second, when you look at Social Security benefits along with the tax, we have a system that actually is reasonably progressive. The question of what, if anything, to do with FICA taxes—for example, whether the wage base should be raised—is a question that ought to be addressed in the context of Social Security solvency rather than in the context of tax reform, assuming that Congress is going to keep these two issues separate.

Q Are you troubled by a complete change to a consumption tax such as a VAT?

A Yes, I am troubled by the proposals to replace the income tax completely with a national retail sales tax or a flat-rate consumption tax. The reason is that both of these ideas would shift the tax burden away from people who are most able to pay down toward middle-income people who are less able to pay. My proposal maintains the progressivity of the existing system by having people with high incomes pay not only the consumption tax but also a relatively low-rate income tax.

Q What role do you believe the attacks Congress made on the IRS in the late 1990s played in the declining respect for the tax law you describe in your 1997 book?

A Some of the attacks on the IRS contributed to the public's declining respect for the income tax and fueled efforts by some politicians to "get rid of the IRS," which I regard as a fantasy. But I think that the decline in respect for the income tax is also grounded in a whole host of other events, many of which are more important. For example, I think that the rise in corporate tax shelters and the publicity about them has made people feel that high income individuals and well-advised corporations can readily avoid paying income tax and therefore, has made them wonder whether they are being foolish to pay the taxes that they owe. I also think that the overwhelming complexity of the income tax, so that no one can sit down and figure out exactly what they owe the government and why, is another major factor. Most people used to prepare and file their own returns. Today, commercial operations, like H&R Block or Jackson-Hewett, or computer programs, such as TurboTax, sit between individuals and their government when people file their returns. That, I think, diminishes not only people's respect for the tax but also their feelings of connection to their government. So I think that a large combination of factors has contributed to the decline in respect for the tax law. This decline is extremely pronounced if you look at attitudes from polling data among younger people, who are more and more willing to say that they do not feel any moral obligation to pay the government the taxes they owe. I believe this is one reason the current system is unsustainable and unstable, and why we need a major tax reform.

Q As Deputy Assistant Secretary for Tax Policy you were responsible for published guidance. Do you believe the Treasury's methodology for issuing published guidance works well, and if not how would you change it?

A I think Treasury took an important step in the right direction by creating a new deputy assistant secretary for regulations and appointing Eric Solomon to that post. This ensures that the Office of Tax Policy will always have its attention focused on getting regulations out the door even when legislative matters fully occupy the assistant secretary. The real problem, of course, is that Congress has been enacting legislation at a pace that makes it impossible for the IRS and Treasury to keep up. And typically new legislation multiplies complexities rather than eliminating them. When Congress, for example, insists that it matters where a company roasts coffee beans to know whether it qualifies for a domestic manufacturing tax break, the real surprise is that the guidance process works as well as it does.

Q You sit in a special place from the viewpoint of tax academia, with Boris Bittker and Marvin Chirelstein having gone before you (and both being still around). What is your view of the role of tax academics in the U.S. tax arena?

A Boris Bittker rightly became famous for his remarkable treatises, which synthesized and, with extraordinary grace and clarity, explained the law for generations of tax lawyers. Marvin Chirlestein's books on income taxation and contracts have performed a similar function for thousands of law students. Others of their generation—notably Harvard's Stanley Surrey and Virginia's Edwin Cohen—played important roles in formulating the nation's tax policy. While many academics today write books for students and seek to improve the law—Joe Bankman's recent efforts to create a return-free income tax for many California families is an important example—academics today rarely produce great treatises. There are several reasons for this, including the complexity of the tax law and the specialization of tax practice, as well as the fact that law faculties today do not value treatise writing as highly as they once did. So explaining the tax law now generally falls to practitioners. Tax law professors are primarily engaged in other forms of serious scholarship, which may be very important for understanding and improving the tax system, but which do not have a similar immediate pay-off to the tax bar. This has resulted in a disconnect between the profession and the academy. The real challenge going forward is how to bridge this gap. That will require commitment and creativity from both sides.

Q Can you comment on the recent passing of David Bradford?

A David Bradford's tragic death is a great loss, not only for me personally, but for anyone interested in tax policy. I first met David nearly 30 years ago when he was at the Treasury working on what would become Blueprints for Tax Reform, which remains essential reading for anyone interested in a personal progressive tax on consumption. And David and I talked most recently only a few weeks before he died about various aspects of articles we were writing on tax reform. Throughout all the years I knew him, David was among the most honest, serious, talented and thoughtful public finance economists I have ever met. He was genuinely interested in the law, wanting to know how things really work in practice. He was always open to new ideas and remarkably generous in sharing both his time and expertise. He was also a very good listener. David was a mensch; he will be sorely missed. ■