THE GRAETZ TAX REFORM PLAN AND THE TREATMENT OF LOW-INCOME HOUSEHOLDS

by Robert Greenstein and Iris Lav

A tax reform plan designed by Yale Law School professor Michael Graetz would replace much of the income tax with a Value Added Tax. The plan would essentially repeal the regular income tax, retain the Alternative Minimum Tax, and establish a $100,000 exemption from the AMT for married filers so that no couples with incomes under $100,000 would owe any income tax. (The exemption would be set at $50,000 for single filers.) The plan also would lower the AMT tax rate and cut the corporate tax rate to 25 percent. In place of the lost personal and corporate income tax revenue, a broad-based Value Added Tax would be established, with a rate set somewhere between 10 percent and 14 percent.

Whatever its other pluses and minuses, the plan could pose significant problems for low- and moderate-income households. There are three key issues here. First, the proposed changes in the income tax would result in the elimination of the Earned Income Tax Credit and the refundable portion of the Child Tax Credit, both of which provide substantial support to low-income working families with children. Second, the imposition of the VAT would increase the prices of goods and services that low-income families (along with other families) consume. Third, the proposed plan may result in the loss of significant amounts of state government revenue; if that occurred, it would likely lead to state reductions in various benefits and services on which low-income families rely (and possibly also to increases in state taxes, which tend to be regressive).

In his Yale Law Journal article setting forth his proposal, Graetz identifies many of these concerns and attempts to come up with solutions to them. He states as a goal of the plan that it be distributionally neutral (as well as revenue neutral) and avoid making low-income households worse off. These would be attractive features of a tax reform plan. The solutions he outlines to these problems, however, are far from adequate. Much more work would be needed on the plan to develop solutions. As explained below, in some key areas, viable solutions do not appear to be available.

I. Elimination of the Earned Income Tax Credit

The EITC and the refundable component of the Child Tax Credit both offset other taxes that low-income working families owe, particularly payroll taxes, and provide a wage supplement to these families. The tax benefits that these credits provide are substantial. A married family with two children that makes $15,000 a year receives credits totaling approximately $5,000. A single parent with two children who earns $15,000 receives credits of more than $4,800.

Repealing these credits would result in the loss of these benefits. In addition, the establishment of a broad-based VAT would result in the application of a new 10 percent to 14 percent tax on many of the purchases these families make and thus would impose as much as several thousand dollars a year in new taxes on them.

To address these problems, Graetz suggests a new low-income tax credit. His description of the credit is somewhat sketchy, however. Neither his Yale Law Journal article nor subsequent pieces that he has written explain much about how such a credit would work.

In a footnote to the Yale Law Journal article, Graetz suggests, as an illustration of how the credit might work, that the credit could be set at $2,000 per child for earners with incomes under $20,000; at $1,500 per child for those earning between $20,000 and $30,000; and at $1,000 per child for those earning between $30,000 and $50,000. Such amounts would be insufficient for millions of low-income families. For a single parent with two children who earns $15,000, for instance, this would amount to a credit of $4,000, or about $800 less than what the family would lose from repeal of the EITC and Child Tax Credit. A credit of that size thus would not only provide less than the current EITC and Child Tax Credit for this family, but also would offer no relief from the large new consumption taxes such a family would pay as a result of the VAT.

To avoid making these families poorer, a substantially larger credit would be needed. This is a conclusion with which Graetz evidently concurs; he has said that the credit levels in his footnote were intended only to be illustrative. Graetz has made it clear his intention to provide a credit of sufficient size both to compensate for the loss of the EITC and to protect low-income workers from a tax increase as a result of the VAT. He proposes that an amount much larger than the cost of the current EITC be devoted to accomplishing this.\(^2\) His plan offers little information, however, about how to achieve this goal.

He does include a brief discussion about how the credit would be administrated. Given that his proposal would eliminate the need for millions of families to file income taxes, Graetz proposes that the credit be provided to workers in their paychecks through “negative withholding.” Employers would take money they are withholding in payroll taxes and use it to pay for credit amounts they would add to the paychecks of workers who earn less than $50,000. As described in more detail below, this shift of administrative responsibilities from the IRS (which administers the current refundable tax credits) to employers would have large ramifications.

Overall, while Graetz acknowledges many of the issues his proposal would pose for low- and moderate-income households, he provides insufficient information to evaluate whether he has

---

\(^2\) Graetz proposes to set aside funds equal to what a two percent VAT would raise to hold low-income families harmless (and larger amounts if necessary).
offered a meaningful solution to these problems. Essential details related to the credit and the administration of it are missing, raising questions as to whether the credit could actually be implemented in a manner that adequately protects low-income and moderate-income households and is politically viable.

Determining Which Families Are Eligible

The Graetz proposal relies on employers to administer a low-income credit through “negative withholding” and would try to target the credit to specific categories of families based on their earnings and the number of children they have. This creates a fundamental problem, because the desired targeting would require information that typically is not available to employers (and that many employees may be reluctant to share with their employers).

For instance, how is an employer to know how many children an employee has and whether an employee’s spouse or ex-spouse (or a working grandparent who lives with the parent and children as part of a three-generation family) is separately claiming the family’s children? The IRS has the ability to cross-check children’s Social Security numbers, make sure they are valid, and see if a child is being claimed by more than one adult before a credit is paid. The IRS routinely conducts such cross-checks. Individual employers, by contrast, do not have the ability to perform these functions and would not be able to prevent duplicate claiming of the same child. It is well known that when the IRS instituted more rigorous procedures to check on the existence of children being claimed for tax purposes, millions of children disappeared from the tax rolls.

In correspondence with the authors of this piece, Graetz suggests that the IRS could still check the Social Security numbers of children who are claimed for the credit. This suggests that a system would be needed under which employers submit the SSNs to the IRS for approval. Such a process would raise a host of questions. It could delay credit withholding payments, particularly in cases where questions arise. Mismatches could occur due to typos in numbers or names. Would credit payments be withheld in such cases until the mismatch is cleared up? How much effort would employers put into assisting employees in resolving mismatch issues? What would the IRS do — and what would employers do — if two or more workers claimed the same children? If credit payments have been delayed for some weeks or months during such processes but the matter is ultimately resolved, would the employer provide retroactive credit payments? In short, whether such a system is workable is unclear.

The following three examples help to illustrate some of the difficulties and unresolved questions about this approach:

- Two-earner families, where both workers earn less than $50,000. In this situation, Graetz is not clear whether one or both of the workers would be eligible to claim the credit, although he implies they both would be. If his intention is that each parent gets to claim the children — that is, each child in the family would be claimed twice for purposes of receiving the credit — this would represent a significant shift in tax policy. Graetz argues that giving the credit to both parents would recognize and help fund a non-custodial parent’s child support obligations and reduce marriage penalties, both worthy goals. But double counting of children is prohibited under current law, and it is hard to imagine that Congress would support such a shift.
This approach also raises other issues. If each parent could count a family’s children for the credit so that the children were claimed twice, the result would go far beyond eliminating marriage penalties and confer a windfall bonus on married filers. Moreover, different married families with the same total income would be treated differently — if both parents earned $40,000, they could presumably claim their children twice, but if one parent earned $60,000 and the other parent earned $20,000, they could only claim the children once. Such inequities are among the reasons that Congress would be unlikely to agree to a structure that allowed each parent to claim the same children. In addition, it would be virtually impossible for employers to prevent non-custodial parents who are failing to pay child support from claiming and receiving the credit for their children.

- Two-earner families, where only one worker earns less than $50,000. In this situation, the question is whether the credit would go to families that have combined family earnings of more than $50,000 and, potentially, of hundreds of thousands of dollars. In some places, Graetz says the credit would be provided to families with earnings up to $50,000. In other places, he suggests the credit would go to all employees with earnings up to $50,000, regardless of a family’s total earnings. He explains in one footnote that in the interest of simplicity, he would apply a type of “rough justice” that would permit the lower-earning spouse to receive the credit even though “this might allow offsets to some who do not deserve them — an investment banker’s spouse who works at Wal-Mart, for example...” Again, it is unclear whether Congress would support this lack of targeting. It would be virtually impossible for an employer to enforce targeting, given that an employer would have no information about the earnings of the employee’s spouse.

- A worker with two jobs, where the combined earnings are more than $50,000. As long as one of the jobs pays less than $50,000, the worker would presumably get the credit, as the employer would not have information about the worker’s earnings from the second job. It is possible, in fact, that such a worker would get the credit twice — once from each employer.

Further problems arise with regard to people who receive substantial increases or decreases in earnings during the year. A worker who earns modestly below $50,000 and is receiving the credit may receive a pay increase, take a new job, or add a temporary second job late in the year and climb above the $50,000 level for the year. Such a worker will receive the bulk of the credit anyway. But another worker who is paid at an annual rate of more than $50,000 and then is laid off in the latter part of the year — and who consequently has annual earnings below $50,000 — would receive no credit at all. (The worker would have been paid at a rate above $50,000 while employed and then have been unemployed and had no employer to provide the credit.) There is no shortage of examples such as these.

Another set of problems may relate to children over 18 with serious disabilities and to full-time students aged 19 – 24. Disabled children of any age (not just those under 19) and full-time students aged 19 – 24 may be claimed for the EITC. Tax preparers can help low-income tax filers understand whether their children meet these EITC eligibility criteria. (About 70 percent of EITC claimants use commercial preparers.) Most employers (especially smaller ones) would not want to master the IRS rules in this area. This presents a dilemma. If these features of the EITC are not replicated under the new credit, a considerable number of low-income working families could face substantial benefit reductions and tax increases. If these features are replicated, misclaims in this area could increase.
This system also is unlikely to work well for the self-employed. Graetz notes that “For low-income self-employed independent contractors, relief would have to be obtained through reduced estimated tax payments. This would require a year-end reconciliation through some form of tax return.” That system could be problematic, as many self-employed people with low or moderate incomes would qualify for a credit that exceeded the estimated payments they would owe. Such individuals would not owe income tax, so their estimated payments would be limited to their payroll tax obligations.

Although Graetz says that the negative withholding system would be extremely simple for employers, basic nuts-and-bolts issues appear not to have been thought through — or to be easily resolved. The result of these various problematic aspects of employer administration of the credit would likely be high rates of error and misdirected payments, serious equity problems, and a disturbingly large volume of double payments for children. (See the box on the top of the page for a discussion of the problems in using a worker’s earnings, rather than a family’s income, in determining eligibility for the credit.) Such problems almost certainly would far exceed those in the Earned Income Tax Credit, which uses tax filers’ annual income from all sources (including the income of both spouses in the case of joint filers) to determine eligibility and credit amounts. Those problems might weaken the political viability of the credit over time and make it subject to sharp criticism and proposals to pare it back.

3 The EITC has a significant error rate, but this is due in large part to its effort to target very precisely. The principal cause of EITC errors revolves around the difficulty of precisely enforcing, with regard to separated and divorced families and families where the child lives for part of the year with another relative, the requirement that a parent may not claim a child unless the parent lives with the child for more than half of the year. The EITC has not been found to have significant problems with regard to large amounts of EITC payments going to people with income far above the EITC income limits. By contrast, Graetz’s proposal does not appear to contain any mechanism to target his child-based credit to the parent who is the primary caretaker of the child, to ensure that children are not claimed twice, or to preclude large numbers of families at high income levels from receiving the credit. (It also may be noted that in his Yale Law Journal article, the EITC overpayment rate is mistakenly overstated by about 20 percentage points.)
To address these problems, the Graetz plan might be modified either by having the IRS (rather than employers) administer the credit or by requiring workers who receive the credit to file forms with the IRS after the end of the year as part of a year-end reconciliation process. Both of those approaches would have significant downsides of their own. If the IRS were to administer the credit, low-income families would have to pay higher taxes throughout the year as a result of the VAT and be compensated after the year was over. In addition, millions of Americans would still effectively have to file a tax return. If the IRS conducted a year-end reconciliation process, millions of low-income households could owe amounts to the IRS — frequently totaling in the thousands of dollars — that they would find difficult to pay and the IRS would find difficult to collect.

"Negative Withholding" May Pose Cashflow Problem for Some Firms

Another issue is whether employers would have sufficient cash from payroll tax withholding to add the credit amounts to the paychecks of workers who earn less than $50,000. The majority of employers should have sufficient funds from payroll tax withholding to do this. But a substantial number of employers might not have sufficient funds; for them, the amounts they had to pay out in credits might exceed the payroll taxes they withheld. Moreover, as the credit was made larger (so that it was adequate to protect low-income families both from the loss of the EITC and Child Tax Credit and from new taxes under the VAT), the number of firms that do not withhold enough in payroll taxes to cover the costs of the new credit would increase. For firms with predominantly low-wage workforces or with only a few employees, all of whom are paid modest wages, this could be a significant problem.

Graetz says in a footnote to his article that it would “be rare for an employer to have an overall negative withholding balance.” This judgment, however, is impossible to make. Since Graetz has not determined how large the credits would be, the percentage of workers who would receive them (due to unresolved questions about families versus individual workers and about the claiming of children) and other such questions, his contention that employers would have a negative withholding balance only in rare instances appears to be an unsubstantiated assertion. It may well be incorrect, particularly for small businesses.

Graetz also says that in cases where the credits that an employer would need to pay would exceed its payroll tax deposits, the employer could be provided a refundable credit against its income taxes. It is not clear how this would work, as many such small employers would not have to file income tax returns under the Graetz proposal because of the $100,000 exemption. Similar problems might arise for local government agencies or non-profit organizations that have relatively low-wage workforces; such entities do not pay employer income taxes.

Finally, some day laborers, farm workers, and migrant workers already have problems simply obtaining W-2s from their employers. Currently, they at least can claim credits to which they are entitled on their tax returns. Placing their employers in control of their eligibility for a tax credit and accurate payment of the credits does not seem realistic or desirable.

For instance, in the example above of a family with $15,000 of income, the employer would withhold $1,148 in payroll taxes but would have to provide $4,000 to replace the EITC/CTC and additional amounts (possibly another $2,000 or more) to cover VAT costs.
Would Employers Pay Less in Wages?

Another question is whether use of negative withholding on a broad scale — under which workers paid less than $10 an hour would get a large additional amount added to their paychecks (with people earning $10 to $25 an hour also having additional amounts added) — would lead some employers to pay somewhat lower wages than they otherwise would. On the one hand, research indicates that the Earned Income Tax Credit does not have this effect. On the other hand, the credit that Graetz proposes would differ from the EITC in two important ways. First, fewer than one percent of EITC recipients receive the EITC by having employers add it to their paychecks; the EITC is largely invisible to employers. The opposite would be the case with Graetz’s credit. Second, many workers paid less than $30,000 by an employer do not get the EITC (or get only a tiny EITC), because the income of their tax filing unit — including the income of a spouse — exceeds the EITC income limits or they do not have qualifying children. If Graetz’s credit is provided to all workers with earnings below some threshold level, regardless of the filing unit’s total income or the presence of children, it could be easier for employers to take the credit into account in setting wage levels. Whether the credit would have such an effect is unclear.

Loss of State EITCs

Seventeen states have state Earned Income Tax Credits that provide $1.3 billion in benefits to 4.6 million low-income working households. State EITC’s generally are tied to the federal EITC and are set as a specified percentage of the federal EITC. Elimination of the federal EITC thus would terminate most current state EITCs.

It generally would not be feasible for states to establish a new state credit as a percentage of the new federal credit that would replace the EITC. First, there would no longer be federal income tax returns on which people would show their federal credit amount, so it would be difficult for states to administer a state credit tied to the federal credit. Nor could states provide such a credit by having employers use payroll tax withholding to come up with the funds to provide the credit to low-income workers in their paychecks, since there is no state payroll tax liability.

II. Other effects of higher prices stemming from a VAT

Some low-income individuals, including those who cannot work due to disabilities or who cannot find employment when the economy is weak or because they have extremely low skill levels, are aided by government benefit programs. Graetz argues that federal benefit programs that contain annual cost-of-living increases would automatically adjust to cover the increases in prices for goods and services that would result from a VAT. This is correct for years after the first year in which the VAT was in effect. (The standard-of-living of families relying on benefit programs with a COLA would be reduced, perhaps significantly, in the initial year of the VAT because cost-of-living adjustments have a lag; price increases in one year are reflected in the COLA for the following year. The COLA for the year following the year in which the VAT was implemented would then be very large.)

The problem, however, is that much or all of the income of some poor families comes from benefits that are not indexed to inflation — such as cash assistance to poor families with children provided through the Temporary Assistance for Needs Families block grant, rental assistance provided through various low-income housing programs such as the Section 8 housing voucher program, and assistance with high energy bills that is provided through the low-income home energy assistance program. (The last two of these programs are discretionary programs, rather than entitlements.)

Graetz recognizes this problem and states that for grant programs directed to low- and moderate-income people that are not indexed, "some increases in benefits would have to be legislated." But that is easier said than done. Given budgetary constraints, ceilings on appropriations levels, and the current priorities of Congress, the likelihood is low that these programs would be increased sufficiently to offset the added tax burdens that a VAT would place on these families.

Furthermore, some low-income individuals are assisted primarily by state or local cash assistance programs (such as general assistance programs) rather than federal programs. In addition, unemployment insurance benefits are set by each state and financed with revenues from unemployment insurance taxes levied on employers. The likelihood that these benefits would be increased sufficiently to offset the VAT also is low.

III. Effect on State and Local Governments

The Graetz proposal does not make specific assumptions about which purchases would be exempt from the VAT; it simply assumes that the base of the VAT would equal about 50 percent of GDP. (The Yale Law Journal article does suggest that education and religion and some health services should be exempt.) This raises the question of whether the VAT would be applied to purchases made by state and local governments, which buy goods and services ranging from books, paper, and food to janitorial services, all of which presumably would be taxable under the VAT.

If purchases by state and local governments are taxed, the increased cost to these governments would have to be compensated in some way. Would the federal government provide a subsidy to states and localities equal to the VAT they would pay? Graetz does not appear to have factored such a subsidy into the costs that the VAT would have to offset. Or would states and localities have to raise their own taxes to pay the VAT?

It is difficult enough politically to raise taxes at the state and local level to pay for basic services. It likely would be more difficult to raise state and local taxes if the purpose of the tax increase were to offset a new federal tax. Furthermore, as discussed below, because of the regressivity of most state and local tax systems, any such new taxes would likely fall heavily on low- and moderate-income families.
Even if all state and local government purchases were exempt from the VAT, Graetz’s proposed changes in federal taxes would pose a series of other difficult problems for state and local governments.\(^6\)

- If states conform to the $100,000 federal income tax exemption he proposes, they would have to replace the lost state income tax revenue with revenue from sales and excise taxes. The recent history of state taxation and competitive pressures among states suggest that few (if any) states would be able to compensate for the lost revenue by raising state income tax rates on high-income residents. Moreover, state and local taxes already are regressive in most states; increasing sales and excise taxes to replace the lost revenue would increase the degree of regressivity.

- If states wanted to maintain broad income taxes, they could encounter serious difficulties. All but a few states use federal definitions of income, exclusions, and deductions, and taxpayers complete their state income tax returns by copying information from their federal returns. With a radically changed federal income tax system and most taxpayers no longer required to file a federal return, states would face significant obstacles. Each state would have to develop its own definitions and rules for its income tax. Of particular concern, states would face major compliance problems. Although W-2 forms and 1099s would still exist, the IRS would have no reason to employ its document-matching system (which currently compares W-2s, 1099s, mortgage interest statements and similar documents to the information on federal tax returns) for people below $100,000 who are no longer filing federal income tax returns. As a result, the information that the federal government now shares with states on the discrepancies that its document-matching system finds would no longer be available for the bulk of people who file state income taxes (those with incomes below $100,000). The gap between actual income and the income reported to states could grow substantially. The incidence of non-filing of state income tax returns also would be likely to increase, since states no longer would have the federal data base against which to check the tax returns they received.

- In addition, the combined rate of the federal VAT and state sales taxes would be problematic and could engender consumer resistance. Graetz’s article seems to consider only state sales taxes and suggests that the combination of sales taxes and the VAT would not be higher than European levels. But local sales taxes in 35 states are an important revenue source for counties and municipalities. Vertex, Inc., a Web-based company that provides sales tax information to companies, calculates that the average combined state and local sales tax rate in 2004 was nearly 8.6 percent. In a number of states, the combined sales tax rate is close to 10 percent. Consumers in many states thus would be facing a combined VAT and sales tax rate at the cash register approaching 25 percent.

- At a minimum, the high combined rate could pose a problem for states if and when they faced a need to raise sales tax rates. With various costs and responsibilities having been shifted to states over time, states and localities have regularly turned to sales tax rates to increase revenues when needed. In 1970, the average state sales tax rate was 3.5 percent; by

---

\(^6\) The Graetz proposal allows for the possibility of setting aside revenue equal to what a one percent VAT would raise for the purpose of maintaining the deductibility of state and local taxes in the revised income tax. It does not, however, address the issues discussed here.
2003 it was 5.2 percent. A federal VAT of 10 percent to 14 percent could preempt the ability of states and localities to increase sales tax rates when needed.

Of course, part of the need to increase sales tax rates has stemmed from erosion of the revenue base, as a result of the failure of most states to apply the sales tax to services. If states could conform to the federal VAT, that situation might be improved. But state conformity to the proposed VAT would pose difficulties of its own for states. Piggybacking on a federal VAT would raise a host of questions about the state in which a sale is taxable. In Canada, where three provinces do conform to the federal VAT, the federal government distributes the revenue to the provinces in proportion to estimated consumer spending. Few states in the United States would find such an abdication of their autonomy and control acceptable. Moreover, states in the United States are in a different situation than Canadian provinces, because Canada guarantees a level of revenue to provinces if their own revenues fall short.\(^7\)

Finally, there is the issue of local sales taxes. A paper presented at a recent tax reform conference by Charles McLure, a former deputy assistant Treasury secretary for tax policy who is now at the Hoover Institution, suggests that local sales taxes could not readily be coordinated with a federal VAT. While McClure believes there would be advantages for states in coordinating with a federal VAT, he doubts that states could do it for this and other reasons. He concludes that most states would likely maintain their own retail sales taxes as a result.\(^8\)

IV. Other effects of eliminating income taxes for most workers

Another question is whether eliminating income taxes on the majority of workers and substantially lowering the corporate tax rate would have the effect of reducing employer-provided pension coverage and health insurance. Households that no longer pay income tax would no longer secure an income tax advantage from participating in coverage, and the deductions that corporations would receive for making pension and health care contributions would be worth less (because corporate income would be taxed at a lower rate).\(^9\)

V. Long-term revenue growth

Graetz suggests that his plan be accompanied by enactment of a requirement that any future legislation that would raise tax rates for either the VAT or the income tax, or lower the exemption level for the income tax, require 60 percent of both the House and the Senate to pass. Such a proposal, which Graetz reiterates in a chapter he has written for a just-published American Enterprise Institute book on tax reform, seems irresponsible in light of the enormous fiscal challenges the nation faces with the baby boomers’ retirement approaching. Such a provision would make damaging levels of deficits and debt more likely over time. It also would make it likely that there would be deeper cuts over time in basic assistance programs for low-income families.

\(^7\)Canada also has several types of programs to protect low- and moderate income families from undue burden. In short, Canada operates under a very different federal system.


One question is whether revenue growth would be slower over time under a system that replaced a large part of the income tax with a consumption tax than under a reformed income tax (e.g., one that broadened the income tax base and simplified the income tax system). In the absence of other policy changes to offset the decline in progressivity from replacing part of a progressive income tax with a VAT, revenue growth would tend to be slower under a VAT. Graetz proposes that there be accompanying policy changes to retain the progressivity of the current system, but as explained above, this is easier said than done. If the tax system as a whole became less progressive, revenue growth would tend to be slower.

Over a long period of time, even a very small difference in the annual growth rate of revenue can make a substantial difference in revenue levels. Given the unprecedented deficits that the nation faces in future decades — and the accompanying need for both spending restraint and revenue enhancement — this is a concern.