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LUCK AND TAX POLICY

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Woodworth Memorial Lecture

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Good afternoon!

Thank you so much for coming here today. Special thanks to Professor Lobenhofer and Dean Crago of the Ohio Northern University Pettit College of Law for hosting this year's Larry Woodworth lecture. I am incredibly honored to have been asked to speak at this annual event, and I am humbled to join the ranks of those who have spoken as part of this lecture series.

I attended the first Woodworth lecture in 1995, where Professor Michael Graetz spoke on income tax. I have also attended many of these lectures over the last twenty years, and found them all to be interesting, enlightening, and, at times, provocative. So, I have my work cut out for me today.

I have a strong affinity for Larry Woodworth, though I never got to meet him in person. When I served as an economist on the staff of the Joint Committee on Taxation, there were many stories about Larry's time as Chief of Staff—how he worked with Members of Congress and their staffs, his ideas for a well-functioning tax system, and how he consistently worked to achieve those ideals.

When I was at the Treasury Department in the Office of Tax Policy, every day Larry Woodworth looked down at me from the wall of pictures of previous Assistant Secretaries, starting with Stanley Surrey. If pictures could talk, I imagine the advice I would get from Larry Woodworth would

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go something like: "help ensure the tax system is fair and that it works well for the American public." That is what I have tried to do.

My topic today is the role of luck in tax policy and I will address this topic in three distinct ways. The first way is somewhat introspective and involves thinking about how I ended up working in the field of tax policy, noting that life takes many twists and turns. Many of the decisions I faced were characterized by large amounts of uncertainty, and I made these decisions with only vague notions of the ultimate consequences. Many times, seemingly random or serendipitous events occurred that led me in new and different directions or opened new opportunities that had been unknown or unavailable beforehand. I suspect that many in this room have had similar experiences.

The second way focuses on the tax legislative process and the notion that successful enactment of legislation is seldom guaranteed. Again, fortuitous circumstances help shape opportunities, and decisions often are made under conditions of uncertainty. In this environment, the true outcomes may be in doubt right up until the legislation passes, and the ultimate effects of the legislation may not be known until many years later.

The third way focuses on the design of tax systems, looking at how tax policy choices can take into account the myriad ways that uncertainty underlies economic outcomes, and hence, incomes and tax liabilities. In designing a tax system, policymakers should incorporate these basic uncertainties into the process to more realistically accommodate the workings of the economic system and to predict the likely outcomes.

With that brief introduction, let me start with the first part: a bit of introspection on how I wound up doing tax policy work and how unlikely it seems to me that I ended up on this particular career path and in a position to be speaking with all of you today.

First, we probably all can think back to when we were kids and what we thought we would be doing as a career when we were older. My friends and I had a bunch of these dreams—astronaut, teacher, athlete, doctor, truck driver, cook, carpenter, and so on. But not one of us thought when we were ten or twelve years old that we would wind up doing tax policy for a living. That just did not seem to be in the set of possibilities. As I think back upon my own career journey, I am amazed at what a crooked path it took.

One of my first memories involving career choices came when I was around twelve years old and living in central New Jersey. I was good in elementary school math, and some teachers took to giving me extra problem sets and recommending books that I should check out of the library. But my uncle had a different idea. He recognized that a person who was good with numbers could have many career paths, and he became convinced that I should be a bookmaker, taking bets from the working class in Jersey City, New Jersey on sporting events, horse racing, and the daily number (this was before off-track betting and state-run lotteries became a reality).

I remember pondering this possibility for a while, but was eventually dissuaded by tales indicating that a life in organized crime was dangerous and not all that glamorous. So, I did not actively pursue my uncle's suggestion, but clearly this was a decision made under considerable uncertainty, having only the barest understanding of the future consequences.

Other career paths presented themselves: becoming a public-school math teacher like some early role models, becoming an accountant like another uncle, or working on the docks like some relatives. Over the years, hundreds of decisions made under uncertainty tipped the scales one way or another.

I left New Jersey to go to Michigan State University to study finance, which seemed close enough to accounting that I could see a career path in a profession similar to my uncle, the accountant. I enjoyed my time at Michigan State, got a really good education, and in my senior year, I applied for a wide range of jobs. The top two choices I had at the end of the process included a job that focused on making loans to businesses at the Small Business Administration, and a job at General Motors (GM) as an entry level tax accountant. The position at GM paid about $5,000 more per year (which was a huge differential at that time), so I moved to Detroit and began to work in tax compliance. Again, this was a choice made under considerable uncertainty, with uncertain future implications.

After a couple years at GM, I got the urge to get an MBA degree and shift to a true finance position in a firm or a bank. I took the GMAT exam and applied to Stanford University, largely because they had a well-known program and because the campus was in California. Again, this was a decision under uncertainty. Stanford Graduate School of Business wrote back, invited me to apply to the Ph.D. program in business, and then accepted me. So, I went to Stanford and entered into a mathematical economics program which was mislabeled "Business, Economics, and Public Policy." So, my career path took a turn toward theoretical economics, focusing on game theory and decision-making models.

In my second year of graduate school, I agreed to serve as a Research Assistant for Charles Schultze, who was from the Brookings Institution and was visiting Stanford for a year. The next year, he recommended me as a Research Assistant to Joe Pechman, who was an acknowledged expert on taxation from Brookings, and who also was spending a year at Stanford. Joe Pechman rekindled my interest in taxes. By then it was becoming clear that it was a series of random events and decisions made under uncertainty that got me to that place.

After finishing my dissertation, I became an Assistant Professor at Carnegie Mellon University, in the School of Urban and Public Affairs. One of my colleagues there, Bob Strauss, thought I should spend some time working at the Congressional Joint Committee on Taxation, as he had done several years prior. He arranged an interview for me with the Joint Committee on Taxation staff and I wound up taking a leave of absence to work on tax policy for a Congressional Committee. But it was fortuitous that I wound up teaching at a school where one of my colleagues acted as a facilitator with the staff at the Joint Committee on Taxation.

That is how I got to start serious work on tax policy issues. However, I did take another detour to work on energy issues with a particular emphasis on climate change. Late in the Clinton Administration, I was working at the Department of Energy as head of the Energy Information Administration when I got a call from a head hunter who was looking for someone to lead the research operations at the Internal Revenue Service (IRS), and to serve under then-Commissioner Rossotti. Truthfully, I had little interest in working at the IRS, but several of my students from Carnegie Mellon had gone to work for American Management Systems, which was headed by Charles Rossotti, and they raved about him. So, I figured an interview with Commissioner Rossotti would at least be interesting and I applied for the position. After meeting with Commissioner Rossotti, we both thought the position would be a good fit, and I became the Director of Research, Analysis, and Statistics at the IRS—or what I playfully called the IRS's "egghead division." From that point on, I was well on my way to a career path in tax, but again, it was a series of random events and decisions under uncertainty that got me to shift onto this career path.

The bottom line is that there were perhaps hundreds of decisions I made along the way that pushed me in some direction or another, and many of these decisions were made under conditions of uncertainty, where the consequences could not be determined with any degree of clarity. Many times throughout my life, random events and specific individuals with outsized influence, helped push me onto the tax policy career path in ways that can only be described as fortuitous. In all these ways, luck has played a key role in getting me to work in tax policy and to be able to help shape tax policy, hopefully for the better.

Introspection makes clear to me that luck was a key factor in having me wind up working in the area of tax policy and in shaping my career path. And, I am sure that luck played a similar role in many of the career journeys of those in this room, for seldom does one's life follow a straight line. More likely, it is a path characterized by twists and turns which are affected to a large extent by fortune or luck.

Now, I would like to turn to the second topic for the evening: the role of luck, fortune, or serendipity in the enactment of tax legislation. Successfully enacted legislation needs three components:

1) Recognition of a problem;

2) Identification of potential solutions – this can be an iterative process; it also can proceed ahead of identifying specific problems or legislative vehicles, in the sense that this step can be simply anticipating the types of problems to be encountered in the future and coming up with a range of possible solutions that can be deployed if necessary; and

3) Development of political coalitions to support one of the identified solutions.

These components all need to be completed in reasonable proximity in time to one another or there is little chance that legislation can be successfully enacted.

And while the legislation when enacted may be characterized by supporters as reform, it may not always share the classic properties of true reform. In tax, those properties would be embodied in legislation that makes the tax system more efficient, more equitable, simpler, or ideally, some combination of the three. Sometimes, steps intended to result in basic reform may have unintended consequences and perhaps move the tax system in the wrong direction. This can be especially true when viewed after the passage of time.

For example, in January 1969, Treasury Secretary Joseph Barr informed Congress that 155 high income taxpayers (defined as those with income of at least $200,000) paid no individual income tax.[1] The public and Congress were outraged and Congress responded by creating legislation to address this situation.[2] Treasury and congressional staff developed possible ways to address this outrageous issue, and Congress responded by creating an add-on alternative tax that took certain tax preferences (such as lower-taxed capital gains income), and applied a specific tax rate to these preferences.[3] This new tax on preference items was added to regular income tax liability in order to move the 155 zero-tax taxpayers (and other similarly-situated

1. JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM 14 (1987).

2. *See id.* (noting that the disclosure prompted a mass amount of indignant mail to members of Congress).

3. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 301, 83 Stat. 487, 580-86.

lightly taxed high income individuals) into a position where they paid a significant amount of income tax each year.[4]

This legislation had all three components:

1) The problem recognized by Secretary Barr;

2) A potential solution identified based on some of the causes of low or zero effective tax rates on high-income individuals (e.g., low-taxed capital gains income, very large itemized deductions relative to adjusted gross income, and certain business expenses in excess of economic cost); and

3) Development of a political coalition of members of Congress who bargained over the details of the legislation so that a working majority saw fit to include this in the Tax Reform Act of 1969.[5]

The resulting compromise was modified in the 1970s.[6] When the 2001 and 2003 tax cuts were enacted, ordinary income tax rates were reduced substantially and more preferential tax rates were introduced for long-term capital gains and qualified dividend income.[7] As a result, the number of alternative minimum tax (AMT) taxpayers increased dramatically.[8] The upshot is that many taxpayers in the $200,000-$500,000 annual income range are subject to today's AMT because they have some combination of state and local taxes, personal exemptions, miscellaneous business expenses, and tax-preferred capital gains income. Of the 5 million or so current AMT taxpayers, a majority are in the $200,000-$500,000 annual income range. And while the AMT still ensures that over 100,000 taxpayers with incomes over $1 million per year pay additional income tax, it has become a very imperfect tool for the policy job Secretary Barr and the Congress set out to address.

The point of this anecdote is that while there was a fortuitous set of circumstances leading up to the enactment of what would become the AMT, the results from the distance of a few decades indicate that it was not the successful type of tax reform that was intended.

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4. *See* Richard D. Hobbet, *Transitional Mechanisms to Facilitate Tax Reform*, 35 L. & CONTEMP. PROBS. 818, 831 (1969).

5. *See id.* at 835-37 (discussing the legislative history underlying the Tax Reform Act of 1969).

6. *See* BIRNBAUM & MURRAY, *supra* note 1, at 14-15.

7. Jason Debacker et al., *Rising Inequality: Transitory or Persistent? New Evidence from a Panel of U.S. Tax Returns*, BROOKINGS PAPERS ON ECON. ACTIVITY 67, 107 (Spring 2013).

8. *See* Lori Montgomery, *Alternative Minimum Tax Targeted*, WASH. POST (Nov. 11, 2016), http://www.washingtonpost.com/wp-dyn/content/article/2006/11/10/AR2006111001800.html (noting that there was nearly an increase of 100,000 families paying the tax in 2006 compared to 2003).

A second example is the Tax Reform Act of 1986. Last year was the 30th anniversary of its passage and many articles and reviews were written describing its path to passage and the economic and tax policy consequences of its enactment. But, the definitive account of the 1986 Tax Reform Act to my mind remains *Showdown at Gucci Gulch*.[9] The book details the ups and downs of the tax reform process and illustrates the three prerequisites I mentioned earlier for tax reform to be enacted.

Observers had pointed out many problems with the Tax Code in the mid-1980s. Statutory rates seemed high, especially compared to amounts collected, meaning that effective tax rates were quite a bit lower than the statutory marginal rate schedule. This was indicative of a proliferation of special deductions and exclusions that had been put into the Tax Code over many years. Moreover, a whole tax shelter industry had arisen and flourished, luring high income people to invest in non-economic projects that promised large after-tax returns. The existence of this industry weakened the integrity of the tax system in the eyes of the public. Since the vast majority of taxpayers did their tax returns each year by hand, taxpayers felt that the Tax Code had gotten too complex for ordinary Americans.

Faced with these perceived problems, many policy makers and outside observers developed their own potential solutions. The Treasury Department developed a coherent and consistent framework for reform.[10] Senators found common ground on proposals that removed special tax benefits (broadened the tax base) and used the resultant revenue to substantially lower tax rates.[11] Congressional and Administration staff hammered out approaches that were roughly consistent with notions of horizontal and vertical equity, containing dozens of provisions that, taken together, led to rough revenue neutrality (over the three-year budget window in use at the time).[12] These efforts defined the multi-dimensional space of feasible reform options.

Then it was up to the master legislators in Congress and the Reagan Administration strategists to push, prod, cajole, and make the necessary tradeoffs so that a bipartisan majority would approve the bill. There were many times this process could have faltered, but in each case, there was a fateful discussion, an unexploited political trade, or an outside push from an unlikely source in the business or public policy community to get things

9. *See generally* BIRNBAUM & MURRAY, *supra* note 1 (extensively detailing the nuances of tax the tax reform process).

10. DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT (1984).

11. BIRNBAUM & MURRAY, *supra* note 1, at 5.

12. *Id.* at 17.

back on track.[13] Clearly, fortune shone on the fate of the Tax Reform Act of 1986 over and over again as it avoided a series of perils and followed an unsteady path toward enactment. This is not to say that hard work, creativity, and determination did not play a major role in the enactment of this landmark bill, but rather to acknowledge that all the stars lined up for the Tax Reform Act of 1986. Luck is one component that helped propel it toward enactment, where it stands as the tax policy accomplishment of a generation.

At various times since 1986, it has appeared that another major tax reform plan was at hand, only to have those hopes dashed time and time again. The most recent instance was the 2012 to 2014 period. Virtually all observers agreed that the United States business tax system no longer worked well in a globalized economy where large amounts of revenue generated by firms were premised on the existence of valuable intellectual property. All agreed on the salient fact that, while the United States may have been a low corporate income tax country after the 1986 Tax Reform Act became law, the intervening decades saw every other country reduce corporate income tax rates to the point where the United States was perceived as a "high tax" country. This perception was based on the maximum statutory tax rate, even though effective or average tax rates for United States-based multinationals tended to be significantly lower. So, the problems were recognized.

As part of the "identifying solutions" component, the Obama Administration released the President's *Framework for Business Tax Reform* in February 2012, and provided additional detail in subsequent annual budget submissions.[14] Chairman Camp released his detailed tax reform plan a little later, after extensive consultations with members of Congress, business representatives, and others in the tax policy community.[15] Both approaches would have modernized the United States business-tax system, broadened the tax base, and brought down the maximum statutory tax rate.[16] In this sense, the business components of the tax reform plans were broadly similar, describing a hybrid tax system for multinational firms, partway between a pure territorial tax system and the

13. *See id*. (summarizing that Congress, Reagan, and the Finance Committee could all stop the tax reform).

14. *See* THE WHITE HOUSE & DEP'T. OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM (Feb. 2012).

15. *See* COMM. ON WAYS AND MEANS, Tax Reform Act of 2014: DISCUSSION DRAFT SECTION-BY-SECTION SUMMARY (2014); *see also* Dave Camp, *Woodworth Memorial Lecture: Prospects for Tax Reform: We Need it Now*, 42 OHIO. N.U. L. REV. 517 (2016).

16. *See* THE WHITE HOUSE & DEP'T OF THE TREASURY, *supra* note 14; *see also* COMM. ON WAYS AND MEANS, *supra* note 15.

existing United States system of worldwide taxation with deferral.[17] The similarities also included a tax rate significantly below the current thirty-five percent rate and numerous base-broadening measures to help pay for the overall reform package.[18]

But unlike 1986, luck was not with Chairman Camp and the political stars did not align.[19] No amount of political maneuvering could put together a majority coalition that could agree on a particular legislative path. So, this reform effort was abandoned in large part due to the bad fortune of being surfaced during a very difficult political time period. Given the political situation, there was no way to pull together a reliable bipartisan coalition to agree on the difficult tradeoffs necessary to enact tax reform.

What does this mean for our present situation? The problem of a suboptimal business tax system still exists and there is widespread agreement that it needs to be modified and updated. Several possible solutions have been identified. Now the difficult work of crafting political coalitions has begun. It is still too early to tell if a majority coalition can get behind one or another of the possible solutions, or whether one of these solutions will lead to true tax reform where the resulting system is more efficient, fair, and/or simple than the current one. One thing I truly believe, is that it will take a significant amount of good luck or good fortune for Congress to enact true tax reform in the next year or so.

Now, let me turn to the third focus of my talk today: the way that a recognition of the effects of luck can feed into the design of tax policy. Let us start by considering how incomes are determined. A simple model might say that an individual's income is a function of three components:

- Skills possessed by an individual that are valued in the market – more skills or a higher level of skill tends to be associated with higher income, all else equal;
- The level of effort expended by the individual – more effort expended by the individual tends to be associated with higher incomes, all else equal; and
- A random component that can lead to higher incomes (if the individual is lucky) or lower income (if unlucky).[20]

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17. *See* THE WHITE HOUSE & DEP'T OF THE TREASURY, *supra* note 14; *see also* COMM. ON WAYS AND MEANS, *supra* note 15.

18. *See* THE WHITE HOUSE & DEP'T OF THE TREASURY, *supra* note 14; *see also* COMM. ON WAYS AND MEANS, *supra* note 15.

19. *See* Danny Vinik, *Paul Ryan Just Made Tax Reform Harder*, NEW REPUBLIC (April 1, 2014), https://newrepublic.com/article/117223/paul-ryans-2015-budget-sets-impossible-goals-tax-reform (noting the failure of Chairman Camp's plan).

20. *See* Debacker et al., *supra* note 7, at 128; *see also* Hal R. Varian, *Redistributive Taxation as Social Insurance*, 14 J. PUB. ECON.49, 49-50 (1980).

In a simple model, one can think of these three components being multiplied together (though more complicated, functional forms can be introduced). If the random variable has an expected value of one, then in the simple model (where the three components are multiplied) an individual's income, on average, will reflect their innate skills and their level of effort. (It might help one's intuition to think of skills being measured by an expected hourly wage or salary and the effort expended equal to hours worked; the random variable would then generate either higher wages (for lucky individuals) or lower wages (for the unlucky).)

Income as actually observed in this model would have the luck component already built in when income is observed, and it would not be possible for the tax authority to disentangle all the effects. On average, the highest incomes would be earned by those with the highest skill levels, who had worked the hardest, and who had been the luckiest. But there would be no way to precisely separate out the effects of each component.

This observation about randomness is not a new phenomenon. In tax literature, it goes back decades.[21] In a provocative new book titled *Success and Luck*, Robert Frank discusses the links between chance and economic success and how the effects are magnified immensely in a globalized economy characterized by "winner-take-all" or "modified winner-take-all" outcomes.[22] Frank also notes that the impact of almost trivial advantages can be magnified over the course of lifetimes, leading to very different outcomes for individuals who seemingly had been very nearly equally situated at some point in their lives. Many recent papers have focused on economic mobility and people's economic prospects based on their parents' economic situations, the area where they live, or whether they were born into poverty, and these might be viewed as other dimensions of luck.[23]

In designing an optimal income tax system, economists usually trade off the efficiency of raising revenue (where inefficiency is measured by the distortive effects of a tax system) and the equity outcomes generated by the tax system. Typically, the result is a tax system where the marginal tax rates on individuals do not excessively deter those with the greatest skills from contributing the most effort to generate income (and also to grow the overall size of the economy and contribute to the public good). And in this system, average tax rates tend to grow with income to ensure that most

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21. *See* Varian, *supra* note 20, at 49 (noting that randomness in income simply cannot be ignored).

22. *See generally* ROBERT H. FRANK, SUCCESS AND LUCK: GOOD FORTUNE AND THE MYTH OF MERITOCRACY (2016).

23. *See* Raj Chetty et al., *Is the United States Still the Land of Opportunity? Recent Trends in Intergenerational Mobility*, 104 AM. ECON. REV. (PAPERS & PROC.) 141, 142, 144-45 (2014); *see also* Debacker et. al., *supra* note7, at 135, 138-39.

taxpayers contribute to the common good in a way consistent with their ability to pay taxes. But when there is no uncertainty involved, the optimal tax system will try to have a zero marginal tax rate on the last dollar earned by the highest income person (because that will reflect the highest skill level in the population) in order to maximize the size of the economic pie available to support public goods.

But when randomness is introduced into this sort of model, a potential insurance role for the income tax system emerges, where very high incomes are the result of a combination of skills, effort, and good fortune. Similarly, in this type of model, the lowest incomes are an indication of bad luck. The income tax system, acting as an insurance mechanism, would seek to offset some of these random effects by progressively taxing higher incomes through an increasing marginal tax rate schedule, while simultaneously subsidizing lower incomes, perhaps through something like the current law earned income tax credit or another form of a work credit or through transfer payments.

In this sort of a model, a progressive income tax system does two things:

> (1) It serves an equity role by financing public goods and providing for transfer payments or tax credits by assessing relatively higher tax burdens on those with the greatest ability to pay, or those with the highest incomes; and
>
> (2) It serves an insurance role by taxing the lucky more than the unlucky to pay for public goods and to finance transfers to the less fortunate.

The combination helps to push against income inequality. These design considerations point out the three-dimensional balancing act the income tax system accomplishes. The progressive rate structure will create a labor or effort disincentive at the margin, and so marginal rates will not go so high as to dissuade large amounts of productive labor effort. The rate structure needs to raise enough revenue to pay for public goods and insurance provided, while meeting the equity goals of society.

This three-dimensional tradeoff is what policymakers need to evaluate in designing tax reform plans. If income inequality is increasing over time, then maybe the insurance component of the income tax system should be emphasized more. The resulting tax rate schedule may be more progressive than today's, though the degree of progressivity should be tempered so that marginal income tax rates on those with the highest incomes do not act as a major labor disincentive.

To broaden the model a little bit, the characterization of luck need not be an annual feature. It could be the case that one's choice of profession and the compensation for being in that profession has a luck component that changes over time.

For example, a journeyman baseball player today earns a salary that puts him into the top one percent of earners. Fifty years ago, the same type of journeyman player would have had a salary that placed him quite a bit lower in the income distribution, though solidly in the upper-middle class. This facet of earnings ability for a baseball player today reflects the good fortune of coming of age, during a time of strong demand for these services and a relatively strong bargaining position for baseball players.

This situation stands in contrast to a high school graduate who works at a non-union factory, who fifty years ago could aspire to a comfortable middle-class existence on the market contributions of one-wage earner. The comparable person today faces a much more difficult earnings situation due to coming of age in a very challenging economic environment, an example of bad luck in timing.

A similar approach can underlie the thinking behind the estate tax. If very large estates are generated in part by an ongoing series of lucky outcomes, and if these fortuitous outcomes are not subject to tax annually at progressive rates, then an argument can be made for an effective estate tax to provide some measure of inter-temporal insurance. A well-thought-out estate tax program, coupled with smart investments in early childhood learning or development, could help blunt some of the long-term effects of random occurrences of good or bad fortune.

A similar set of factors may also underpin the distribution of business incomes in the modern globalized economy. Traditional models focus on the expected after-tax return to capital as the key determinant of investment decisions. If there is a random component to earnings, with a wide dispersion and long-lasting effects, then a more sophisticated analysis may be needed. If the big winners in the globalized economy are those companies that develop a blockbuster drug, a widely-adopted software product, or some other type of disruptive technology that cannot easily be copied, then the ultimate return to these investments far exceeds the risk-adjusted rate of return to capital used in the initial investment decision. In a sense, the best-seller drug is the result of an uncertain Research and Development (R&D) process that generates enormous returns, large enough to offset the costs of unsuccessful R&D efforts undertaken by the firm.

It would be quite difficult for the tax system to disentangle the luck components from the routine returns on a firm's investments. Current approaches to corporate taxation generally take the position that the tax authority acts as a kind of "silent partner" with the firm. In this characterization, the relatively flat rate of tax applied to corporate earnings applies to the large incomes that occur on the upside (when fortune smiles on the firm) and loss offsets of some form are allowed on the downside (when firms are unlucky). This approach makes economic sense if you think that the owners of firms can essentially self-insure through the capital markets. In this case, it is unnecessary for the corporate income tax system to have a specific insurance component, whether provided through progressive tax rates or otherwise.

This has been a whirlwind tour through three aspects of how luck and tax policy interact. The first aspect looked at how the tax policy profession gets populated and the role that luck and serendipity play in determining career paths. Obviously, this has implications for non-tax employment as well, but I think it serves as a good illustrative case, and one that many of us can attest to via introspection (though all of us may not want to undertake that exercise).

The second aspect is the role that luck plays in the successful effort to enact real tax reform. In a sense, the stars have to align favorably for tax legislation to be enacted:

- The problem to be addressed must be recognized;
- Potential solutions must be identified; and
- Political support for an identified solution must be obtained.

The process can falter at any one of these stages, due to bad timing, unbridgeable differences, or just misfortune in the overall legislative process. And when tax reform legislation does get enacted, there is no guarantee that these reforms will be durable or recognized as reform in future years. The creation of the AMT stands as a cautionary tale of tax reform attempts gone awry.

In contrast, the 1986 Tax Reform Act stands as a relatively durable example of successful reform, even though the subsequent decades have seen significant amounts of reform whittled away. As the coming year unfolds, we will see whether the current effort to reform the Tax Code is fortunate enough to be viewed as true reform, which improves the workings of the Tax Code.

Finally, the third aspect focused on the situation where luck plays a significant role in determining the incomes and wealth of individuals. In these cases, a progressive income tax system can provide a measure of income insurance, by essentially taxing more the income of luckier individuals and delivering lower taxes, or even transfers, to those who are unlucky. The design goal is to balance the effects of equitable treatment of taxpayers and the provision of income insurance against the efficiency aspects of the marginal income tax rates on labor supply decisions and capital supply or saving decisions of individuals.

The same kind of intuition may also apply to the estate tax, where the insurance provided through the tax system involves the lifetime effects of differential luck or fortuitous events. If these differential effects build on each other over time, then it may be likely that very large estates have a large component of luck built into them. In this case, a well-designed estate tax program can function as a valuable social insurance delivery mechanism.

My goal today was to be a bit provocative and to ask you to think about common topics from a slightly different perspective than is normally the case. Hopefully, these three topics caused you to reconsider, at least a little bit, the role that luck plays in our lives, our legislative processes, and in our tax systems.

Thanks again to the people from the Ohio Northern University Pettit College of Law who invited me here today. And thank you so much for your attention this evening.