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Remarks on The President's Advisory Panel on Tax Reform

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The President's Advisory Panel on Tax Reform took on a very difficult task—to disentangle the complexities, sources of unfairness and economic distortions in current tax policy, and provide proposals for reform—and its final report is admirable in its intent and accomplishment (President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005). The Advisory Panel's starting point was the President's instructions to "emphasize simplicity, fairness and remove impediments to growth", age-old and widely accepted foundations of tax reform. In light of concerns about the complexities of the tax system, budget deficits and distributional issues, the Panel began with the following premises: the Alternative Minimum Tax (AMT) should be eliminated, the reforms should be "revenue neutral" under accepted "static" budget scorekeeping rules, and the combined reform package should not materially alter the current distribution of the tax burden. Within these constraints, the Panel developed two reform packages, the Simplified Income Tax Plan and the Growth and Investment Tax Plan, that are not perfect, but either would be superior to the current tax system in terms of simplicity, reducing disincentives to save and boosting economic growth. Unfortunately, the polarized political environment in Washington and the President's low approval ratings likely will forestall progress toward much needed tax reform.

The Advisory Panel's Considerations in Tax Reform

The President's Advisory Panel Report integrates three traditional approaches to tax reform. The first involves identifying the wide array of deductions, exemptions, credits and tax preferences that are the sources of complexities, unfairness and economic distortions. The Report follows the general framework established in *Blueprints for Tax Reform*, published in 1977 by the U.S. Treasury Department (under the direction of the late David Bradford), in which the variety of tax preferences are analyzed within the context of a comprehensive income tax and a consumption-based tax. Second, the Panel makes extensive use of the concept of "tax expenditures". This concept, first spelled out in detail by the Congressional Budget Office in 1977, establishes that exemptions, deductions, credits and other tax preferences that narrow the tax base or otherwise reduce federal tax receipts should be "treated like any direct spending program, and should be evaluated by policymakers based on objective criteria, such as their cost, the distribution of their benefits, overall effectiveness, and the appropriateness of administering them through the tax system." (Advisory Panel Report, pp. xvi-xvii). Although using a comprehensive income tax as the basis for such analysis and estimates of foregone tax

receipts is flawed in certain ways, it does provide a valuable benchmark for evaluating the budgetary and economic impacts of tax preferences. Third, the panel incorporates the impact of its tax reform recommendations on the distribution of taxes and incomes. The distributional aspects of tax policy, which have not always been well understood, have always been a major driver of the debate on reform.

Achieving pro-growth tax reforms within the constraints of achieving revenue neutrality while eliminating the AMT, and not materially altering tax and after-tax income distributions, was no easy task, and involved many suboptimal tradeoffs. Eliminating the AMT is estimated to reduce tax receipts over the 10-year projection period by $1.3 trillion. The offsetting "revenue gainers" involve largely tax base broadening reforms that eliminate tax preferences. The Advisory Panel's proposed base broadening would generate sufficiently large increases in projected tax receipts that marginal tax rates could be reduced while maintaining revenue neutrality. Moreover, the Panel abided by "static" budget scorekeeping practices, which did not reflect the tax receipt-enhancements of certain pro-growth reforms.

The Panel argues that the complexities and expanding applicability and burdens of the AMT and the confusion it generates justify its elimination. The AMT, a separate tax system that runs parallel to the individual income tax system, will apply to 21.6 million taxpayers in 2006. By 2015 it is estimated to affect an estimated 50 million taxpayers and collect more tax receipts than the income tax system. The AMT—originally conceived to make sure all households pay taxes, "regardless of their tax shelters and avoidance efforts" –has grown into a system that is needlessly complex, opaque and full of distortions, and its impacts go way beyond its original intent. Much of the AMT's complexities stem from the back-and-forth calculations required by taxpayers who must determine whether the AMT applies to them. It is not indexed for inflation, involves an onerous marriage penalty, does not provide personal exemptions, does not allow state and local taxes to be deductible, and has phase-out exemptions that create four different marginal tax brackets. It imposes the highest tax burdens relative to the individual income tax system on upper-income households, particularly those with big families that live in high-tax states. Interestingly, despite its distortions, the AMT, considered separately, is closer to a comprehensive income tax than the current income tax system, but the Panel decided that it would be best to scrap the AMT and reform the income tax system rather than the other way around.

Reform Proposals

Both of the Advisory Panel's reform options lower marginal rates on personal income from current rates that were legislated in 2001, maintain or reduce current tax rates on dividends and capital gains, and eliminate or significantly modify tax preferences that are the major sources of complexity. Thus, with the exception of estate taxes, these options eliminate the uncertainty about the scheduled phasing out of the tax cuts enacted in 2001-2003. The Growth and Investment Tax Plan goes further than the Simplified Income Tax Plan in reducing the tax burden on saving and investment, and moving the tax base closer

to a consumption-based system. Accordingly, it is more growth-oriented. Table 1 provides a comparison of the two reform options with the current tax code.

Both options would simplify the tax code by: repealing the AMT; replacing the personal exemption, standard deduction and child credit with a streamlined Family Credit; replacing the Earned Income Credit with a new Work Credit; streamlining current savings plans for retirement, health and education with a new Save for Family account; and modifying the tax treatment of social security benefits. Both options effectively eliminate the marriage penalty. In addition, both options simplify taxes on businesses, in part by streamlining recordkeeping for small businesses and allowing expensing of most business investment, and by modifying the international tax system and eliminating the corporate AMT.

The sizeable projected losses of tax receipts measured from current law that would occur by eliminating the AMT would be offset by several base-broadening changes, including: state and local taxes would no longer be deductible; the deductibility of mortgage interest would be replaced by a credit of 15 percent of interest on principal residences based on measures of average housing values in different regions; the exclusion of employer-provided health insurance would be capped; and the accrued appreciation in life insurance policies and annuities would be included in taxable income. These simplifications would reduce some glaring economic distortions, encourage personal saving and improve economic efficiency.

The deductibility of state and local taxes is an expensive drain on federal tax receipts and an inefficient and unfair method of subsidizing state and local governments. It distorts local spending decisions and requires residents of low–tax jurisdictions to subsidize high-tax ones. It is available only to tax itemizers and its benefits are proportional to marginal tax rates. It is not available to taxpayers who are subject to the AMT. Eliminating the deductibility would raise federal tax receipts by an estimated $46.2 billion in 2005 and $185.8 billion during the five year projection period 2005-2009, according to the Joint Committee on Taxation (*Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009*, January 12, 2005). It would make state and local residents more directly bear the burden of their local government spending and make those local decisions more transparent. Moreover, it would eliminate the unfair distributional aspects of the current deductibility.

The current exclusion of employer contributions for employee health insurance is the source of many inefficiencies in health care and is the largest source of foregone revenues in the system. According to the Joint Committee on Taxation, the exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums reduces tax receipts by $78.6 billion in 2005 and a total of $493.1 billion during 2005-2009. It encourages purchase of more expensive health insurance than would occur otherwise. It provides by far the largest share of benefits to higher income taxpayers who tend to work for businesses that offer health insurance. It does not benefit taxpayers who are not covered by health insurance. The Advisory Panel identified several benefits of the exclusion, however, and recommended capping it at $11,500 for

families and $5,000 for individuals, which is roughly the national average of health insurance premiums. This would significantly reduce the magnitude of foregone tax receipts, and would continue to subsidize health care, just not the most expensive and comprehensive insurance, since it would reduce the current inclination of businesses to expand employee compensation in the form of health insurance.

The current deductibility of mortgage interest up to $1,000,000 (plus an extra $100,000 of home equity loans) reduces tax receipts by an estimated $72.6 billion in 2005 and a total of $434.2 billion cumulatively during the five-year projection period 2005-2009, according to the Joint Committee on Taxation. It subsidizes homebuyers (of primary and secondary residences) and leads to excess investment in real estate and underinvestment in corporations. This constrains business investment. Moreover, this deduction provides the greatest benefits to higher income taxpayers. By reducing the real estate tax subsidy, the Panel addresses a major source of economic distortion, loss of tax receipts and unfairness.

The Simplified Income Tax Plan's proposed changes to business taxation emphasize simplification, adjustment to depreciation and clarification of international tax systems. Small businesses would continue to be taxed at individual tax rates and their taxable income would be calculated using a simplified cash-basis, including expensing of all new investment. This would dramatically cut recordkeeping requirements and the costs of tax compliance. By lowering the after-tax costs of new capital, it would stimulate both small business creation and expansion. For large businesses, the Simplified Income Tax Plan would replace the current 8 marginal tax brackets with a single rate of 31.5 percent (lower than the current highest rate of 35 percent), simplify accelerated depreciation schedules and modernize asset classifications to better reflect the current capital stock, and treat interest paid and received similar to current law. The international tax system would be a worldwide system with deferral of business profits and foreign tax credits.

The Growth and Investment Tax Plan would more aggressively reduce corporate tax burdens. It would impose a single tax rate of 30 percent and allow expensing of all new investment. It would not allow interest paid to be deductible (except for financial institutions) but would not tax interest received. The international tax system would change to destination-based, with border tax adjustments. This plan would reduce the after-tax cost of capital more than the Simplified Income Tax Plan and also put the tax treatment of debt and equity financing on equal footing. Under current tax law, the average effective tax rate on equity-financed corporate investment is substantially higher than debt-financed investment. According to the Advisory Panel's calculations, the average effective tax rate on corporate income generated by debt-financed corporate investment is actually negative because the benefits of deducting interest and accelerated depreciation exceeds income, while the average effective tax rate on income generated by equity-financed corporate investment is extraordinarily high (Tax Reform Commission Report, p. 100). These reforms would stimulate investment and business expansion, and eliminate the current tax incentive to debt finance, which should stem potentially disruptive excess leveraging.

Good Economics, Unfriendly Politics

The economic advantages of these tax reforms are clear. Reducing the double taxation of saving and simplifying and creating uniformity among the various savings plans (IRA, Roth IRA, Coverdell educations savings accounts, Health Savings Accounts) would increase incentives to save rather than consume. Removing the tax bias against saving is long overdue in light of the decade-long decline in the rate of personal saving and concerns about the high current account deficit. Easing the double taxation of corporate income and lowering the after-tax costs of new capital would reduce distortion of business decisions. It would encourage investment, business expansion and job creation. In particular, allowing small businesses to expense investment spending would facilitate entrepreneurship. Equalizing the tax treatment of debt and equity, as accomplished by the Growth and Investment Tax Plan, would result in healthier debt-equity ratios.

The current tax code not only violates simple principles of fairness, efficiency and simplicity, it is also inconsistent with two other fundamentals of sound tax policy, predictability and transparency. The numerous scheduled phase-outs of marginal tax rates and other key provisions that were incorporated into the tax cut legislation of 2001-2003 as part of the political bargaining process undercut any sense of permanence and predictability. This uncertainty distorts decisions to consume, save and invest (and, some would say, live or die). The Panel's reform options would remove the phase out uncertainties (except for estate taxes) and convey a sense of permanence. The complexities of the tax code not only drive up costs of compliance, they create uncertainties that distort private decisions and adversely affect economic performance. Examples abound: individual taxpayers who are uncertain about whether they will be subject to the AMT or the income tax system are unable to calibrate *ex ante* expected after-tax rates of return on select saving and investment decisions; low-income individuals who are baffled by the complexities of the earned income credit and the overlapping savings plans all-too-frequently make uneconomic decisions; and business investment and financial plans are distorted by the hard-to-understand international tax system. Simplifying the tax system and making it more transparent and understandable would enhance the ability of households and businesses to make sounder decisions, reduce the costs of compliance, and enhance the credibility of the fiscal policymakers.

In light of the glaring faults of the current tax system and the Advisory Panel's very useful analysis and sound reform options, why was its Report received so coolly? The answer is primarily political. The environment in Washington is highly polarized, as debate still rages over the efficacy of the Bush tax cuts, the distributional aspects of the tax system and the sources and implications of budget deficits, however confused and political. Combined with the President's low approval ratings, this undercuts the policymaking environment. It's hard to cut through the political rancor in Washington, but during occasional rational moments, political opponents agree that the current tax system is flawed, the increasingly burdensome impact of the AMT looms large, and elimination of select tax preferences would be highly beneficial. But remember, enactment of the highly successful Tax Reform Act of 1986 was a bipartisan affair, orchestrated by President Reagan, who demanded lower tax rates, and leading Democrat

Bill Bradley, Chairman of the Senate Finance Committee, who favored removal of tax preferences and base-broadening. Presently, until interest in positive reform takes priority over making the opposing political party look bad, forward progress on tax policy will be unlikely, and solid efforts by the Advisory Panel on Tax Reform will be relegated to interesting reading.

The Current Tax System	
Provisions	**Current Law (2005)**
Households and Families	
Tax rates	Six tax brackets: 10%, 15%, 25%, 28%, 33%, 35%
Alternative Minimum Tax	Affects 21 million taxpayers in 2006; 52 million taxpayers in 2015
Personal exemption	$3,200 deduction for each member of a household; phases out with income
Standard deduction	$10,000 deduction for married couples filing jointly, $5,000 deduction for singles, $7,300 deduction for heads of households; limited to taxpayers who do not itemize
Child tax credit	$1,000 credit per child; phases out for married couples between $110,000 and $130,000
Earned income tax credit	Provides lower-income taxpayers refundable credit designed to encourage work. Maximum credit for working family with one child is $2,747; with two or more children is $4,536
Marriage penalty	Raises the tax liability of two-earner married couples compared to two unmarried individuals earning the same amounts
Other Major Credits and Deductions	
Home mortgage interest	Deduction available only to itemizers for interest up to $1.1 million of mortgage debt
Charitable giving	Deduction available only to itemizers
Health insurance	Grants tax-free status to an unlimited amount of premiums paid by employers or the self-employed
State and local taxes	Deduction available only to itemizers; not deductible under the AMT
Education	HOPE Credit, Lifetime Learning Credit, tuition deduction, student loan interest deduction; all phase out with income
Individual Savings and Retirement	
Defined contribution plans	Available through 401(k), 403(b), 457, and other employer plans
Defined benefit plans	Pension contributions by employers are untaxed
Retirement savings plans	IRAs, Roth IRAs, spousal IRAs – subject to contribution and income limits
Education savings plans	Section 529 and Coverdell accounts
Health savings plans	MSAs, HSAs, and Flexible Spending Arrangements
Dividends received	Taxed at 15% or less (ordinary rates after 2008)
Capital gains received	Taxed at 15% or less (higher rates after 2008)
Interest received (other than tax-exempt municipal bonds)	Taxed at ordinary income tax rates
Social Security benefits	Taxed at three different levels, depending on outside income; marriage penalty applies
Small Business	
Tax rates	Typically taxed at individual rates
Recordkeeping	Numerous specialized tax accounting rules for items of income and deductions
Investment	Accelerated depreciation; special small business expensing rules allow write-off of $102,000 in 2005 (but cut by ¾ in 2008)
Large Business	
Tax rates	Eight brackets: 15%, 25%, 34%, 39%, 34%, 35%, 38%, 35%
Investment	Accelerated depreciation under antiquated rules
Interest paid	Deductible
Interest received	Taxable (except for tax-exempt bonds)
International tax system	Worldwide system with deferral of business profits and foreign tax credits
Corporate AMT	Applies second tax system to business income

How the Tax Code Would Change		
Provisions	**Simplified Income Tax Plan**	**Growth and Investment Tax Plan**
Households and Families		
Tax rates	Four tax brackets: 15%, 25%, 30%, 33%	Three tax brackets: 15%, 25%, 30%
Alternative Minimum Tax	Repealed	
Personal exemption Standard deduction Child tax credit	Replaced with Family Credit available to all taxpayers: $3,300 credit for married couples, $2,800 credit for unmarried taxpayers with child, $1,650 credit for unmarried taxpayers, $1,150 credit for dependent taxpayers; additional $1,500 credit for each child and $500 credit for each other dependent	
Earned income tax credit	Replaced with Work Credit (and coordinated with the Family Credit); maximum credit for working family with one child is $3,570; with two or more children is $5,800	
Marriage penalty	Reduced; tax brackets and most other tax parameters for couples are double those of individuals	
Other Major Credits and Deductions		
Home mortgage interest	Home Credit equal to 15% of mortgage interest paid; available to all taxpayers; mortgage limited to average regional price of housing (limits ranging from about $227,000 to $412,000)	
Charitable giving	Deduction available to all taxpayers (who give more than 1% of income); rules to address valuation abuses	
Health insurance	All taxpayers may purchase health insurance with pre-tax dollars, up to the amount of the average premium (estimated to be $5,000 for an individual and $11,500 for a family)	
State and local taxes	Not deductible	
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans	
Individual Savings and Retirement		
Defined contribution plans	Consolidated into Save at Work plans that have simple rules and use current-law 401(k) contribution limits; AutoSave features point workers in a pro-saving direction (Growth and Investment Tax Plan would make Save at Work accounts "prepaid" or Roth-syle)	
Defined benefit plans	No change	
Retirement savings plans	Replaced with Save for Retirement accounts ($10,000 annual limit) available to all taxpayers	
Education savings plans Health savings plans	Replaced with Save for Family accounts ($10,000 annual limit); would cover education, medical, new home costs, and retirement saving needs; available to all taxpayers; refundable Saver's Credit available to low-income taxpayers	
Dividends received	Exclude 100% of dividends of U.S. companies paid out of domestic earnings	Taxed at 15% rate
Capital gains received	Exclude 75% of corporate capital gains from U.S. companies (tax rate would vary from 3.75% to 8.25%)	Taxed at 15% rate
Interest received (other than tax exempt municipal bonds)	Taxed at regular income tax rates	Taxed at 15% rate
Social Security benefits	Replaces three-tiered structure with a simple deduction. Married taxpayers with less than $44,000 in income ($22,000 if single) pay no tax on Social Security benefits; fixes marriage penalty; indexed for inflation	
Small Business		
Tax rates	Taxed at individual rates (top rate has been lowered to 33%)	Sole proprietorships taxed at individual rates (top rate lowered to 30%); Other small businesses taxed at 30%
Recordkeeping	Simplified cash-basis accounting	Business cash flow tax
Investment	Expensing (exception for land and buildings under the Simplified Income Tax Plan)	
Large Business		
Tax rates	31.5%	30%
Investment	Simplified accelerated depreciation	Expensing for all new investment
Interest paid	No change	Not deductible (except for financial institutions)
Interest received	Taxable	Not taxable (except for financial institutions)
International tax system	Territorial tax system	Destination-basis (border tax adjustments)
Corporate AMT	Repealed	