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by Leonard E. Burman and William G. Gale

# A Preliminary Evaluation of the Tax Reform Panel's Report

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## I. Introduction

The President's Advisory Panel on Federal Tax Reform issued its final report on November 1, 2005.[1] Established on January 7, 2005, by an executive order from President Bush, the panel was given the following charge:

> to submit . . . a report with revenue neutral policy options for reforming the Federal Internal Revenue Code. These options should: (a) simplify Federal tax laws to reduce the costs and administrative burdens of compliance with such laws; (b) share the burdens and benefits of the Federal tax structure in an appropriately progressive manner while recognizing the importance of homeownership and charity in American society; and (c) promote long-run economic growth and job creation, and better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the United States in the global marketplace.

In its 272-page report, prepared with the technical assistance of Treasury Department staff, the nine-member panel unanimously endorses two options for reforming the tax system: a simplified income tax (SIT) and a hybrid consumption and income tax called the "growth and investment tax" (GIT).[2] The plans have many features in common. In a nutshell, the plans would repeal the alternative minimum tax, cut back on existing deductions, credits, exclusions, and exemptions, and reduce the tax rate on capital income. The GIT would reduces the tax burden on capital income by more than the SIT.[3]

This report summarizes and offers a preliminary evaluation of the panel's proposals, and discusses the overall effect on revenue, distribution, and growth, with the following principal conclusions:

- The report contains a number of interesting and important proposals that would generally move the structure of the tax system in the right direction, with simpler rules, a broader base, generally lower effective marginal tax rates, and more consistent treatment of different types of income. Perhaps the most notable and welcome contribution of the report is the continual emphasis on simplification.
- In some cases, however, the proposals contain design flaws, and for several of the broadest proposals (especially relating to business and international issues), the report omits important details.
- The biggest problem with the report, however, is its assumed baseline. Tax proposals are typically compared to a baseline, which usually is current law over the next 10 years. The panel's 10-year baseline, however, includes very large, regressive tax cuts relative to current law. The baseline assumes not only that the recent (2001-2004) tax cuts, which are currently scheduled to expire in 2010 or earlier, are made permanent, but that the proposals in the president's most recent budget are enacted, including the creation of new, large, tax-free saving accounts. The choice of that baseline makes the revenue, distribution, and growth implications of the proposal appear much more favorable than they would be relative to a current-law baseline.
- Despite the complete absence of revenue tables in the report, it is apparent that the panel's proposals not only dramatically cut tax revenues compared

[1]The President's Advisory Panel on Federal Tax Reform (2005). The panel was chaired by former Sen. Connie Mack, R-Fla., cochaired by former Sen. John Breaux, D-La., and included as members former Rep. William Frenzel, R-Minn., Elizabeth Garrett, Edward Lazear, Timothy Muris, James Poterba, Charles Rossotti, and Liz Ann Sonders. The report and other information about the panel are available at http://www.taxreformpanel.gov.

[2]The panel made a critical decision early on to seek consensus for its recommendations. By giving each panel member veto power, however, that decision almost guaranteed that radical reforms could not be recommended.

[3]The panel chose not to endorse a partial replacement of the income tax with a value added tax (Graetz 2002). The panel explicitly rejected the retail sales tax as a replacement for part or all of the income tax system, noting that the rate calculated by proponents suffered from a mathematical/logical mistake, that the required rate would thus be very high, and that enforcement of a sales tax at such a rate would be very difficult. (Gale 2005 reaches similar conclusions.)



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with current law, but also significantly reduce long-term revenue, even relative to the low-revenue baseline employed. The panel's proposals would also exacerbate the long-term financing problems faced by Social Security and Medicare by undermining a significant source of revenue for the trust funds. To make the panel's proposals revenue-neutral in 2015 relative to current law would require at least a 16 percent increase in marginal tax rates over those proposed by the panel, or substantially more base broadening.

- The panel's claim that the proposals would be distributionally neutral is also less meaningful than it might appear because the proposals are compared to a baseline that assumes the existence of a variety of large, regressive tax cuts that do not exist. Moreover, the distributional measures employed in the report can be very misleading.
- The report claims the proposals would raise economic growth, but the reported effects are quite large relative to other estimates in the literature and, even if the estimates are accurate, they compare the proposals with the baseline, not with current law. Indeed, considering their effect on long-term deficits and hence on national saving, the proposals are as likely to reduce economic growth as to increase it, relative to current law.

Section II offers preliminary remarks about tax reform. Sections III and IV describe and offer perspectives on the specific elements of the ''SIT'' and the ''GIT,'' respectively. Sections V through VIII examine the implications of the proposals for revenue, distribution, growth, and simplification. Section IX concludes by discussing some items that were omitted from the report.

## II. Tax Reform

Although there is widespread agreement that tax policy should raise adequate revenues to finance the government in as fair, efficient, and simple a way as possible, there is equally widespread agreement that the current system falls short of those goals. In recent years, those shortcomings have arguably become worse as an increasing number of complex provisions were added to the code, increasingly sophisticated and bold sheltering schemes have proliferated, and revenues and distributional burdens have shifted sharply.

Besides those general concerns, three other issues may motivate or force tax changes. The first is the individual AMT, which operates in parallel to the regular income tax, and which is widely regarded as overly complex and ineffective at advancing its original goal of reducing tax shelter activity. Because the AMT is not indexed for inflation, it will affect increasingly more households, and in particular more middle-class households, over time unless the law is changed. Although fewer than 4 million taxpayers are affected in 2005, 19 million will face the AMT in 2006 if a temporary increase in the AMT exemption expires as scheduled. To avoid that, legislators are likely to continue to extend the higher AMT exemption, but the cost of that option will rise inexorably over time and sooner or later significant reform of the AMT will be required or the AMT will become the de facto tax system for most Americans. The AMT could be reformulated in a revenue-neutral manner, repealed, or substantially scaled back. The latter two approaches, however, would likely require a significant overall set of reforms to offset the adverse revenue and distributional implications (Burman, Gale, and Rohaly 2005).

An equally important driving issue for reform is the scheduled expiration in 2010 or sooner of all of the Bush administration's tax cuts. Making those tax cuts permanent would reduce revenues by $1.2 trillion over the next decade relative to current law (by the administration's estimates, by more according to the Congressional Budget Office). That would require draconian reductions in government spending or increases in other taxes to balance the budget (Gale and Orszag 2005). As a result, that should be a first-order issue in tax reform, not an assumption that is swept under the rug, as in the panel's baseline.

A third motivating factor for reform is the imminent retirement of the baby boomers, which will place unprecedented demands on the federal budget through Social Security, Medicare, and Medicaid. To the extent the nation needs to raise additional revenue to finance those programs, it is even more important that the tax system be reformed in a simple, fair, and efficient manner.

***Although there are numerous reasons to consider tax reform, the path to tax reform is difficult because tax reform is inescapably linked to a wide variety of issues.***

Although there are numerous reasons to consider tax reform, the path to tax reform is difficult because tax reform is inescapably linked to a wide variety of issues. Tax policy, for example, is closely related to debates about the appropriate *size* of government. In the long run, the level of revenues collected needs to roughly equal the level of spending. As a result, judgments about tax reform depend critically on views about the roles and effects of public policies.

Likewise, tax policy is intricately linked to the *structure* of government. Tax policy *is* social policy. For example, the earned income tax credit and the child tax credit are the largest cash assistance programs for working families (bigger than temporary assistance for needy familes (TANF) or food stamps); the largest low-income housing construction and rehabilitation program is the low-income housing tax credit; virtually all new assistance for higher education over the past 10 years has been delivered through tax credits and deductions. Some of those programs may be both socially desirable and efficiently run through the tax system, but others may not. With so many social programs embedded in the tax code, however, tax reform is closely linked to the generosity and stability of the social safety net. For example, while it may be true that the low-income housing tax credit is a more expensive way to provide affordable housing than vouchers, is eliminating the credit good policy, absent an expansion in vouchers? In that sense, meaningful tax reform should also include a reexamination of the level and composition of social spending.

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**Table 1. Current vs. Proposed Rate Brackets for Singles and Married Couples, 2006**

| Current Law | | | | |
|---|---|---|---|---|
| **Rate** | **Single** | | **Married Filing Joint** | |
| 10% | $0 | $7,550 | $0 | $15,100 |
| 15% | $7,550 | $30,650 | $15,100 | $61,300 |
| 25% | $30,650 | $74,200 | $61,300 | $123,700 |
| 28% | $74,200 | $154,800 | $123,700 | $188,450 |
| 33% | $154,800 | $336,550 | $188,450 | $336,550 |
| 35% | $336,550 | or more | $336,550 | or more |
| **Proposed** | | | | |
| **Rate** | **Single** | | **Married Filing Joint** | |
| 15% | $0 | $39,000 | $0 | $78,000 |
| 25% | $39,000 | $75,000 | $78,000 | $150,000 |
| 30% | $75,000 | $100,000 | $150,000 | $200,000 |
| 33% | $100,000 | or more | $200,000 | or more |

*Note:* Current-law income thresholds are in terms of taxable income, which is adjusted gross income less personal exemptions, the standard deduction or itemized deductions (whichever is greater), and other above-the-line deductions (like contributions to traditional IRAs). The amounts are Tax Policy Center projections. Proposed income thresholds are in terms of a measure akin to AGI minus charitable contributions in excess of 1 percent of income. However, the family tax credit is intended to replicate the effects of the personal exemption for lower-bracket taxpayers (as well as the preferential rates available to head of household returns, which are not shown above).

The panel's report deals with those issues to varying extents. Both proposals would repeal the AMT. As noted above, in calculating its "revenue neutral" baseline, the panel assumes that all of the previous Bush administration tax cuts are made permanent and even that the administration's other proposed tax cuts are enacted. The panel's recommendations ignore the implications for tax policy of the growing entitlement spending that is virtually certain to occur; in fact, as explained below, the proposals would significantly increase the long-term deficit in the Social Security and Medicare programs. And, while the panel proposes numerous changes to (and usually cuts in) social policy initiatives in the tax code, it does not propose replacing any of the tax subsidies with spending initiatives.

## III. Simplified Income Tax

The major statutory features of the Simplified Income Tax proposal are described in tables 1 above and 2 on the next page, which are taken from the panel's report. (Note that many of the provisions discussed below are also included in the Growth and Investment Tax proposal, discussed in section IV.)

### A. Tax Rates and Marriage Penalties

The proposal would eliminate the bottom and top tax brackets, reducing the total number from six to four.[4] The top bracket would fall from 35 percent to 33 percent. Starting in 2011 (after the tax rate reductions enacted between 2001-2004 are set to expire), the drop would be even more precipitous — from 39.6 percent to 33 percent. As under current law, rate bracket thresholds would be indexed for inflation.

The proposal would set all of the rate thresholds for couples equal to twice the thresholds for singles. Under current law, the two lowest rate brackets, which include almost 80 percent of tax return filing units, are already set to eliminate marriage penalties so the proposal affects only the highest-income one-fifth of households.[5] The proposal also eliminates income phaseouts for all credits except the refundable tax credits (another source of marriage penalties discussed in Section III.B), and would thus eliminate marriage penalties for almost everyone except low-income households. That approach to marriage penalty relief is simple, but it is quite costly, creates significant new singles penalties, and is regressive — virtually all the benefits go to high-income households.

A more fiscally responsible and arguably more equitable solution would be to require married couples to file returns as singles, a rule adopted by many developed countries. That would eliminate almost all bonuses (couples might still be able to shift income between spouses to lower their tax liability) and would eliminate all penalties. It would, however, be significantly more complex. Because more couples currently receive bonuses than face penalties, that option would likely raise revenues relative to current law holding tax rates constant.[6]

[4]Reducing the number of tax brackets, by itself, is not much of a simplification. Most taxpayers look up their tax liability in a table or use tax software that generates it automatically. The presence of fewer brackets may, however, help taxpayers understand their marginal tax rate better.

[5]*See* Table T04-0104, *available at* http://www.taxpolicycenter.org/estimates.

[6]Tax rates could be adjusted to achieve any particular revenue target, however, under any approach to marriage penalty relief. In the proposal, tax rates are increased on many singles, to offset the cost of increasing marriage bonuses for couples as discussed below.



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**Table 2. Summary of Major Provisions in Simplified Income Tax Plan**

| Provisions | Proposal |
|---|---|
| **Households and Families** | |
| Tax Rates | Four tax brackets: 15%, 25%, 30%, 33% |
| AMT | Repealed |
| Personal exemption, head of household filing status, standard deduction, child tax credit | Replaced with family credit available to all taxpayers: $3,300 credit for married couple, $2,800 credit for unmarried with child, $1,650 credit for singles, $1,150 credit for dependent taxpayer; additional $1,500 credit for each child and $500 credit for each other dependent (itemized deductions eliminated) |
| Earned income tax credit | Replaced with work credit (and coordinated with the family credit); maximum credit for working family with one child: $3,570; with two or more children: $5,800 |
| Marriage penalty | Reduced. All tax brackets, family credits, and taxation of Social Security benefits for couples are double those of individuals |
| **Other Major Credits and Deductions** | |
| Home mortgage interest | Home credit equal to 15% of mortgage interest on debt up to 125% of average regional price of housing (limits ranging from about $227,000 to $412,000); home equity debt not deductible |
| Charitable giving | Deduction for contributions in excess of 1% of income; rules to address valuation abuses |
| Health insurance | Nongroup health insurance deductible, up to the amount of the average premium (estimated to be $5,000 for an individual and $11,500 for a family); employer-paid premiums in excess of caps are taxable compensation |
| Education | Education credits and deductions repealed; taxpayers can claim family credit for some full-time students; save for family accounts (see below) |
| State and local taxes | Not deductible |
| **Individual Savings and Retirement** | |
| Defined contribution plans | Consolidated into save at work plans that have simple rules subject to current-law 401(k) limits; AutoSave encourages participation and higher contributions |
| Defined benefit plans<br>Individual retirement accounts | No change. Replaced with save for retirement accounts ($10,000 annual limit) — available to all taxpayers |
| Education savings plans<br>Health savings plans<br>Saver's credit | Replaced with save for family accounts ($10,000 annual limit); backloaded accounts that could be used for education, medical, new home costs, and retirement; available to all taxpayers; refundable saver's credit available to low-income taxpayers |
| Dividends received | Dividends of U.S. companies paid out of domestic earnings are tax-free |
| Capital gains received | Exclude 75% of corporate capital gains from U.S. companies (effective tax rate would vary from 3.75% to 8.25%) |
| Interest received (other than tax-exempt municipal bonds) | Taxed at regular income tax rates |
| Social Security benefits | Replaces three-tiered structure with deduction; married taxpayers with less than $44,000 in income ($22,000 if single) pay no tax on Social Security benefits; eliminates marriage penalty; indexed for inflation |
| **Small Business** | |
| Rates | Taxed at individual rates (top rate of 33%) |
| Recordkeeping | Cash basis accounting |
| Investment | Expensing (except for land and buildings) |
| **Large Business** | |
| Rates | 31.5% |
| Investment | Simplified accelerated depreciation |
| International taxation | Territorial tax system |
| Corporate AMT | Repealed |

*Source:* President's Advisory Panel on Federal Tax Reform (2005) and Tax Policy Center.

Marginal tax rates for many married couples would be lower under the proposal than under current law (especially considering that the individual AMT, which disproportionately hits couples, would be repealed), but higher-income singles and heads of household could face much higher marginal tax rates. To take a very simple example, a single person with $100,000 of wage income and no itemized deductions under current law would be in the 33 percent tax bracket under the proposal, compared with 28 percent under current law. (See Table 1 on preceeding page.) The high marginal tax rates on singles are an inevitable consequence of the approach to marriage penalty relief

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adopted here. That is, the cost of marriage-penalty relief for high-income couples is offset by increasing taxes on singles.[7]

## B. Family and Work

**1. Family credit.** The proposal would replace the standard deduction, personal exemption, head of household filing status, and child tax credits with a ''family credit'' equal to $1,650 for singles, $3,300 for married couples, $2,800 for unmarried individuals with dependents (formerly known as heads of household), and an additional $1,500 per dependent child (child 18 or under, or full-time student 20 or under), and $500 per other dependent (including children who are full-time students and 21-23 years old). The credit would not phase out with income, unlike the current child tax credit and personal exemption. That proposal would significantly simplify the claiming of family-related tax subsidies.

The generosity of the proposal relative to current law would vary depending on family composition and the usage of currently tax-subsidized services. For example, in 2006 a married couple with two children aged 16 and under would receive a credit of $6,300, which would exempt the first $42,000 of income from taxes. By comparison, under current law, the family would qualify for a standard deduction of $10,300, four personal exemptions of $3,300 each, and $2,000 in child tax credits, which would also exempt about $42,000. If the children were aged 17 or 18, the family would be better off under the proposal than current law because they would not currently qualify for the child tax credit but would qualify for the family credit. Other child-related subsidies, however, like the child and dependent care tax credit, the adoption credit, the tax exclusion for employer-provided child-care assistance, and a tax credit for employer provided daycare facilities would all be eliminated, so families who use those subsidies could face higher taxes.

**2. Work credit.** A new refundable work credit is designed to produce a similar tax benefit as the current EITC and the refundable portion of the child tax credit for families with up to two children. The credit has two portions. The basic work credit equals the amount by which the family credit exceeds income tax liability; that is, it makes the family credit partially refundable for lower-income households. The basic work credit is limited to 7.65 percent of earnings up to $412 ($5,386 of earnings) for a household with no children, 34 percent of earnings up to $2,120 ($6,235 of earnings) for families with one child, and 40 percent of earnings up to $3,200 ($8,000 of earnings) for families with two or more children. As earnings rise, income tax liability increases faster than the credit, thus driving the refundable portion to zero.

The second part — a so-called additional credit — is available for families with children. It phases in starting at the top of the income ranges for the basic work credit. It equals 34 percent of earnings above $6,235 up to a maximum credit of $1,450 for families with one child, and 40 percent of earnings in excess of $8,000 up to a maximum credit of $2,600 for families with two or more children. The additional credit phases out at a rate of 12.5 percent of income over $17,000 for single tax returns and $21,000 for married couples filing joint returns.

The maximum refundable work credit (including both portions) at the point when it starts to phase out is $3,570 for a family with one child and $5,800 for a family with two or more children. By comparison, the maximum combined EITC and refundable child tax credit in 2006 will be about $5,000 for a family with two children. The work credit would penalize larger families, however, because the maximum refundable credit does not increase with family size beyond two children. Under current law, a refundable credit of up to $1,000 per child is allowed for an unlimited number of children, constrained only by the taxpayer's earnings.

The phase-in rates match the EITC phase-in rates exactly, but the phaseout rate is somewhat lower. In part, that offsets the fact that marginal income tax rates for low-income households are higher under the proposal than under current law because the 10 percent bracket is eliminated. Eligibility criteria for the work credit are also simpler than for the EITC, which should reduce the error rate.

> ***The phase-in formula for the work credit would create some bizarre incentives and new complexity.***

Also, the work credit would create marriage penalties. Like the EITC under current law, the work credit for married couples phases out at an income level far less than double the rate applying to singles ($21,000 for married couples versus $17,000 for singles). Thus, a low-income working parent can lose eligibility for the work credit (or receive a smaller credit) if she marries another worker, even if her spouse has modest income. In addition, because the family credit reaches a maximum for families with two children, couples in which each spouse has children could lose tax credits by virtue of being married.

Finally, the phase-in formula for the work credit would create some bizarre incentives and new complexity. The work credit phases in with the lesser of labor income or taxable income. That means that taxpayers in or near the phase-in region for the work credit could be penalized if they took deductions from taxable income (discussed below) like charitable contributions above 1 percent of income or health insurance. Each dollar of deductions would generally reduce tax by 15 cents, but it would reduce the work credit by much more — 40 cents — for tax return filers in the phase-in region. As a result, those low-income filers would lose 25 cents per dollar of deductions claimed. They could avoid the penalty by not claiming the deduction in the first place. Some others

[7]That approach, which is basically returning to the tax norm of the 1950s and 1960s, could precipitate a backlash among singles. Marriage penalties were created for some couples after a single woman named Vivian Kellems created a group called War Widows of America to protest the higher tax bills that applied to singles relative to married couples with similar incomes (Graetz 1997). In the future, with the aging of the population, an increasing share of singles will be widows or widowers.

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with labor incomes above the end of the phase-in range would benefit by limiting their deductions to no more than the amount by which labor income exceeds the top of the phase-in range. Although tax software might make those calculations automatically, the calculations would not be simple for low-income filers who prepare returns by hand. Also, the value of deductions — and thus, the incentive to make charitable contributions or purchase health insurance — could depend critically on a household's total income, which might be hard to predict before filing a tax return. The complexity could be avoided by making the credit a function of ''total income,'' which is income before deductions, rather than taxable income, although that would presumably increase the cost of the credit. (It is possible that the panel had that approach in mind all along — that is, that the use of ''taxable income'' rather than ''total income'' was an oversight.)

### C. Formerly Itemized Deductions

The proposal would eliminate the standard deduction and itemized deductions. Several current itemized deductions would be modified and made available to all taxpayers; other current itemized deductions would be eliminated.

**1. Housing.** Under the proposal, the mortgage interest deduction would be replaced with a 15 percent credit for interest payments on a loan used to buy, build, or substantially improve a taxpayer's primary residence. The limit on the creditable loan amount would be reduced from $1 million of acquisition indebtedness under current law to a cap based on the local Federal Housing Administration mortgage limit divided by 0.76, which would vary between about $227,147 and $411,704 at current levels. Refinanced loans would also qualify for the credit, but only up to the outstanding balance of the original loan. If the homeowner refinances for more than the loan balance, the additional amount would be eligible for the credit only to the extent that the funds were used to substantially improve the home, subject to the overall limit. To minimize disruptions of the housing market, the new credit would be phased in over five years.

The proposal would retarget the tax subsidy for owner-occupied housing at moderate-income households who need more help to afford housing. Under current law, the largest subsidies go to taxpayers with high incomes because they have large loans and they are able to deduct mortgage interest at the highest marginal tax rate. Many middle-income homeowners do not itemize deductions, and even those who do itemize may receive less benefit because their itemized deductions scarcely exceed the standard deduction.[8] In fact, to the extent that the mortgage interest deduction causes high-income people to bid up the price of land, some low- and moderate-income homeowners may actually pay more for housing, even accounting for any tax benefits, than they would in the absence of the subsidy. By leveling the playing field, and extending the credit to all homeowners rather than just itemizers, the credit improves the odds that middle-income households benefit. The report estimates that the number of mortgagors who would be able to obtain subsidies for those payments will rise from 54 percent under current law to more than 80 percent under the proposal.

The proposal does create some unnecessary complexity and undesirable incentives.[9] The amount of deductible interest depends on the original loan amount. If the original loan exceeded the limit, only a portion of the interest on that loan would be creditable, even if the loan balance eventually falls below the applicable limit.[10] That creates complexity for mortgage lenders, who would have to report on the portion of interest that is creditable. It could also create inequities. Two households living in identical houses might have identical current, outstanding loan balances and interest payments, but the household that purchased the home first would qualify for a smaller tax credit.[11] The owner of the first home would also face a small marginal incentive to move to be able to claim a credit against more mortgage interest. A better rule would be to set the limit based only on the current mortgage balance.

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[8]For example, suppose a family donates $1,000 to charity, pays $3,000 in state and local taxes, and pays $7,000 in mortgage interest. Because the family's total itemized deductions of $11,000 exceed the standard deduction of $10,300, it would itemize, but owning the home reduces taxable income only by $700 ($11,000 minus the $10,300 standard deduction that they could claim if they did not own a home). At a 15 percent marginal rate, the subsidy will amount to 1.5 percent of interest paid. By comparison, a taxpayer in the 35 percent bracket who

**(Footnote continued in next column.)**

would itemize even if he did not own a home (for example, because of state and local taxes) would receive a subsidy equal to 35 percent of interest paid, or more than 20 times as much as the moderate-income family.

[9]Note also that the ideal taxation of owner-occupied housing would be to tax ''imputed rent'' (if it could be measured) and allow deductions for mortgage interest and other expenses (including depreciation). Imputed rent is the rent that a home could garner in the rental market. Under that regime, owner-occupied housing would be taxed the same as rental housing, removing an important tax distortion. It would also not discriminate among homeowners based on their ability to finance the home themselves with equity (see *infra* note 11). However, the economist's ideal has never appeared compelling to most people and it would be difficult for the IRS to administer and for taxpayers to comply with.

[10]For example, if the original loan amount was $500,000 and the geographically applicable loan limit was $300,000, only 60 percent of interest payments would be creditable, even after the outstanding principal was paid down over time and fell below $300,000.

[11]For example, the homeowner in *supra* note 10 could claim a credit for only 60 percent of the interest on a current loan balance of $300,000 while a new neighbor who took out a loan of $300,000 could claim all of his interest for purposes of the credit. Moreover, because the mortgage limit would increase over time with housing prices, the new purchaser would generally be able to claim a larger amount of acquisition indebtedness for purposes of the credit than the older homeowner. That is, the new neighbor might be able to take out a loan of $400,000 and claim all of the interest for purposes of the credit (assuming median home prices had increased by one-third since the earlier homeowner purchased his house).



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Another issue is whether the loan cap should vary by geographic region. The fact that house prices vary by region is not actually an appropriate justification. Higher housing prices typically represent greater value of the underlying land. Higher land values reflect (at least in part) the amenities of living in an area and the underlying demand for the land. If a household chooses to live in a desirable location (where "desirable" is measured by the price of land), that is no reason for the federal government to provide a subsidy. Housing construction costs also differ by region and affect house prices, but that does not justify a geographically-varying cap either. Basic living expenses and the cost of rearing children vary by geographic area, but no one believes the child credit should vary across areas, nor does the panel propose that the family credit vary spatially. Similarly, health costs vary a great deal across the country, but the panel did not recommend region-specific health insurance caps. Finally, to the extent that the mortgage interest subsidy is capitalized in housing prices (and evidence that shows the subsidy has no effect on homeownership rates implies that it must have effects on housing prices), allowing regional variations in the cap would exacerbate regional differences in housing costs. It would be more appropriate to set a single national cap on the applicable creditable mortgage that does not vary by region. That would also be consistent with the treatment of capital gains on housing under current law and as proposed by the panel (discussed below).

The panel would increase the amount of capital gain that can be excluded from tax on sale, subject to tighter rules about occupancy. Under current law, married homeowners can exclude up to $500,000 of capital gain (singles up to $250,000) on home sale. The limit is not indexed for inflation and does not vary with local housing prices. The proposal would increase the limits to $600,000 and $300,000, respectively, and index them for inflation. The change is warranted as the capital gains tax can keep people in larger or more expensive homes than they need or want, which produces a real misallocation of resources. Capital gains on housing in excess of those limits would be taxed at ordinary income tax rates.

***Some observers are concerned that the limits on housing tax subsidies would cause the housing market to decline. However, keeping housing prices inflated is not a valid objective of tax policy.***

Some observers are concerned that the limits on housing tax subsidies would cause the housing market to decline. However, keeping housing prices inflated is not a valid objective of tax policy. Moreover, changes in the value of the mortgage interest deduction occur all the time. The value of the deduction is determined by tax rates and interest rates. In 1980 mortgage rates averaged 12.7 percent and the highest marginal tax rate was 70 percent, so the deduction was worth up to 8.9 percentage points of the loan balance each year. In 2005 mortgage rates are about 6 percent and the highest tax rate is about 35 percent, so the deduction is worth up to 2.1 percentage points of the loan balance in each year. Converting the deduction to a 15 percent credit reduces its value to 0.9 percentage points (less if the mortgage is capped). Given the changes during the last 25 years, that is a small adjustment.

The proposal would enhance economic efficiency. The current tax system encourages excessive investment in housing and too little in other forms of capital. By capping the interest eligible for subsidy and replacing the deduction with a credit, the proposal would significantly reduce the incentive to over-invest in housing. Higher-income households whose mortgages exceed the limits would, on the margin, be paying all of the interest cost with after-tax, rather than pretax, dollars.[12] That is, there would be no tax incentive to purchase large or extravagant housing.

The proposal would apparently end tax subsidies for rental housing, most notably the low-income housing tax credit. Arguably, direct subsidies, like housing vouchers, would be a far more efficient way to help low-income renters (Burman and McFarlane 2005). The panel, however, does not propose that the money saved by eliminating the credit should be used for that purpose.

**2. Charitable contributions.** The proposal would allow any taxpayer to deduct charitable donations in excess of 1 percent of income.[13] The 1 percent floor reduces record-keeping requirements for those with small contributions and also reduces the revenue cost of extending the deduction to current nonitemizers. Effectively, a tax increase on current itemizers finances all or part of the cost of extending the deduction to current nonitemizers.[14]

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[12]Note that high-income households who can purchase housing with equity would receive a similar tax advantage as exists under current law. For example, if they take money out of interest-bearing accounts to finance their home purchase, they will save the tax that would otherwise have been due on the interest income. That is economically equivalent to a mortgage interest deduction. The only solution to that problem would be to tax the imputed rental value of owner-occupied housing (and allow a deduction for interest paid, taxes, and depreciation as for rental housing). (*See supra* note 9.)

[13]In addition, tax-exempt charitable donations could be made directly from IRAs. The proposal also includes various measures aimed at improving compliance. There would also be a provision allowing taxpayers to sell appreciated assets and donate the proceeds to charities within 90 days without recognizing a taxable capital gain. The intent is to reduce the incentive to donate appreciated property, for which a charity has no use. (Under current law, taxpayers can avoid recognizing a capital gain on appreciated property by donating it to charity. However, if they first sell the property and donate the proceeds, they would owe tax on any accumulated gain.) That provision could end up exempting a lot of capital gain from tax for wealthy taxpayers with much appreciated property and many charity donations, and tracing the proceeds of asset sales earmarked for charity could be problematic.

[14]The proposal might even be revenue-neutral, but, as noted, Treasury has not released its revenue estimates for any of the proposals.

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Allowing a deduction in excess of a floor also maintains a marginal incentive to donate for most taxpayers, especially for large donors.

**3. Eliminate the deduction for state and local income and property taxes.** One of the most significant base broadeners in the package is the repeal of the deduction in the individual income tax for state and local income and property taxes.[15] That raises several issues. We discuss business deductions for state and local income and property taxes in Section III.I.

The individual deduction is often defended on ability-to-pay grounds because the taxes directly reduce household income. State and local taxes, however, largely pay for services that households consume, like schools, roads, and parks. If the tax payments buy services, they ought to be part of taxable income. A household that paid $15 a month to a private company for garbage collection would not expect a deduction. Nor should a household that pays the same amount in taxes for the local government to collect the trash.

The deduction is also defended on the grounds that essential state and local services, like police and fire protection and ''first-responder'' capability (to terrorist attacks), create externalities and hence ought to be subsidized by the federal government. Likewise, many state and local spending programs offer benefits that aid the poor rather than direct services to taxpayers. See, for example, Krueger 2005. Those may be compelling arguments for a federal spending subsidy, but they have little to do with any plausible justification for an itemized federal income tax deduction for state and local income and property taxes. Under current law, (a) the benefit of the deductions accrues only to itemizers, who are largely homeowners — it is not clear why renters should not also receive the subsidy for state and local income taxes; (b) the largest subsidies go to states whose residents have the highest incomes — that is, those with the largest and most robust tax base and highest ability to pay taxes;[16] (c) the subsidy is available only for income and property taxes, but not (after 2005) for other taxes, even though other taxes may help finance the spending that generates externalities; and (d) the subsidy is available for all state and local revenue raised by income and property taxes, whereas it should be available only for the revenue that is used to pay for spending that generates externalities. A better approach would be to expand direct aid to states for education, police, and so forth, based on the externalities noted above.[17]

Some question the logic of disallowing deductions for taxes that support public goods purchased by governments while retaining deductibility of contributions for public goods supplied by charitable organizations. The argument in favor of such a policy is that charitable contributions are voluntary and a subsidy may be warranted to reduce the incentive for citizens to ''free ride'' — that is, reap the benefits of charity without paying for them. In contrast, state and local taxes are mandatory for residents so free-ridership is not possible.

The deduction is also sometimes defended on the grounds that it helps prevent a race to the bottom, in which states cut taxes (and social services to the poor) as a way to attract high-income families. In principle, allowing taxpayers, especially those with high incomes who face higher marginal tax rates, to deduct state and local taxes lessens their resistance to providing an adequate level of social services. Evidence, however, suggests that the deduction has had little effect on states' taxing decisions. The Tax Reform Act of 1986 eliminated the deduction for state and local sales taxes, but there was little perceptible effect on the level or composition of state taxes.[18]

Moreover, it is worth noting that under current law, the AMT is slated to eliminate much of the effects of the state and local tax deduction. By 2010 only 21 percent of taxpayers would benefit from the deduction.

The proposal would retain the tax-exempt status of state and local revenue bonds. By exempting those bonds, states are able to raise funds for public investments at lower cost than they would on the taxable bond market, but the subsidy is highly inefficient. The interest rate differential between taxable and tax-exempt bonds of comparable risk is significantly less than the top marginal tax rate (the size of the subsidy to high-income investors). The difference is a pure windfall to investors that does not aid state and local governments. Retaining the subsidy may also be viewed as logically inconsistent with the repeal of deductibility for state and local taxes. However, the value of the subsidy would decline in part because of the large tax-deferred saving plans that the plan would offer. Taxpayers who can shelter all of their assets in those accounts would have little interest in state and local bonds, which pay lower interest rates.

**4. Eliminate other deductions.** The proposal would eliminate the deductions for extraordinary medical expenses (in excess of 7.5 percent of adjusted gross income), uninsured casualty losses, employee business expenses, and other miscellaneous itemized deductions. In principle, the medical expense deduction is less necessary because the proposal would also allow individuals to deduct the cost of health insurance (discussed below),

[15]A deduction for sales taxes was also allowed under legislation enacted in 2004, but the provision is temporary and expires at the end of 2005.

[16]That concern could be mitigated by treating state and local taxes the way the panel recommends treating home mortgages.

[17]The natural response to that suggestion is that Congress and the administration do not want to increase spending. That may be true, but it is also worth considering how convoluted a tax program that subsidized externality-producing state and local programs would have to be: It would have to subsidize all state and local tax payments, but only to the extent that those tax payments were used to finance externality-producing activity. To ensure that everyone received the subsidy, it would have

**(Footnote continued in next column.)**

to be in the form of a refundable credit. That seems less likely to occur than an increase in spending that could be easily identified with policy goals.

[18]*See* Feldstein and Metcalf (1987) and Rueben (2005). States that tie their own income tax to the federal income tax would also be affected by, or required to change their tax system to accommodate, many of the other changes in the tax base that are proposed. The net effect of those changes on the states is difficult to sort out at this stage.

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but there will surely be cases in which extraordinary uninsured medical expenses reduce taxpayers' ability to pay tax. Similarly, as Hurricane Katrina has shown, acts of nature can cause crushing uninsured expenses, which would be hard to deny as reductions in ability to pay taxes. Also, some miscellaneous itemized deductions, like contingent legal fees, clearly reduce net income. A meaningful measure of ability to pay taxes should deduct those expenses from legal settlements before the settlement is added to net income, but that is not generally the rule under current law. (It is not clear if the proposal would change that treatment.) And it is difficult to justify eliminating deductions for employee business expenses.

### D. Social Policy

Besides the policies directly affecting family and children, noted above, the panel proposes significant changes to health and education policies.

**1. Deductions for health insurance.** Currently, employers may provide health insurance to their employees as a tax-free fringe benefit. That is, the value of the employer's contribution is not included in compensation and thus exempt from both income and payroll taxes. The current subsidy has been criticized on both efficiency and equity grounds.[19] Because the value of the tax subsidy (basically, the product of the employee's marginal tax rate and the insurance premium) grows with the generosity of the health insurance plan provided and with the marginal tax rate, there is an incentive for excessively generous coverage, especially for higher-income households. That coverage, however, reduces or eliminates any incentive for covered people to economize on medical spending. That so-called moral hazard problem is implicated in the tremendous growth of medical expenditures in recent decades. The subsidy is poorly targeted because high-income people, who have the strongest incentive to acquire health insurance even absent a tax subsidy, receive the largest subsidy via the tax exclusion. Moreover, individuals whose employers do not provide health insurance — and who often face high premiums in the individual nongroup market — argue that it is inequitable to allow the tax subsidy only to those covered by employer-sponsored insurance.

On the other hand, the employer exclusion has surely been a factor in the widespread availability of health insurance through employers; about two-thirds of workers are covered by their own or a spouse's employer-sponsored insurance. Advocates of the status quo argue that employment is a natural way for people to combine to get insurance because people generally choose employers for reasons unrelated to their health status. That is, the employer group mitigates another problem in the health market — adverse selection — the tendency of people to most value insurance if they expect that their expenses will be greater than average, which can cause insurance premiums to become prohibitive absent some kind of effective pooling mechanism.

The panel recommends capping the exclusion for employer-provided health insurance at $11,500 for families, $5,000 for individuals, and allowing a deduction for purchase of nongroup health insurance.[20] Employer contributions in excess of the caps would be included in employees' taxable compensation. The caps would be indexed for inflation. In principle, the proposal would retain an incentive for employers to offer health insurance, but also encourage the provision of relatively inexpensive policies because the marginal cost of premiums would not be subsidized.[21] However, because general price inflation is significantly less than health cost inflation, the proposal would mean that a smaller and smaller share of health insurance premiums would be excludable over time. In the long run, there could be little incentive for employers to offer health insurance. (If health cost inflation continues to far outstrip general price inflation, the proposal would likely raise substantial revenue over time — far more outside the budget window than in it.)

The proposal would also allow individuals to deduct the cost of health insurance policies they buy up to the caps. That is attractive on equity grounds, and the Treasury Department estimates that it would increase insurance coverage by over 1 million individuals. But there could be adverse effects instead. If individuals can obtain similar tax benefits for nongroup insurance as they get for insurance provided through employers, the value of the fringe benefit would decline, especially for healthy employees with relatively high incomes (who qualify for the biggest subsidy).[22] If, as a result, young and healthy people pressure employers to drop health insurance coverage (and increase wages), and employer-sponsored health insurance coverage declines, older and less healthy workers may find individual nongroup insurance to be prohibitively expensive, even after the tax deduction. Also, small employers may find that they can cover themselves and their families and still qualify for a tax deduction, without providing the costly fringe benefit to their employees. The consequence would likely be that many workers who lose employment-based coverage may not be able to afford to purchase insurance outside of work. The result could actually be fewer people covered by health insurance.

Finally, as noted in the report, the current exclusion or an individual deduction is an ''upside down'' subsidy, giving the largest benefits to the highest-income households. Converting the exclusion to a flat-rate credit could better target the subsidy (as for home mortgage interest). Moreover, a deduction or nonrefundable tax credit is of no use to the low-income workers who are least likely to have employment-based coverage (because they are not

[19]For analysis of the tax treatment of health insurance, see Burman, Uccello, Wheaton, and Kobes (2003).

[20]For a discussion of health insurance tax caps, see Burman and Rogers (1992).

[21]Note that high premiums do not necessarily correspond to more generous health insurance policies. Premiums vary a great deal across regions, by size of risk pools (small employers pay more per worker than large employers, all else equal), and based on the risk characteristics of the people being insured. A fixed cap (not adjusted for risk characteristics or employer size) would make insurance much more costly for employees of small companies and companies with many high-risk workers.

[22]*See* Burman and Gruber (2001).

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taxable). President Bush has proposed a refundable tax credit for low-income individuals targeted at those who most need help in affording insurance coverage, although his credit would apply only in the individual nongroup market. A refundable tax credit could be designed to be more progressive than the current employer exclusion and better targeted at those who need help.

The panel would also eliminate the deduction for most other fringe benefits, which seems appropriate. Fringes tend to be complex and regressive. Some are probably counterproductive, like the exclusion for payments of out-of-pocket medical expenses out of so-called flexible spending accounts. That subsidy encourages spending on unnecessary medical expenses (think new eyeglasses purchased at the end of the year) and is difficult for the IRS to enforce. There is no reason why firms shouldn't offer those benefits or employees choose to use them. But there is equally no reason why the federal government should subsidize those activities.

**2. Eliminate all education subsidies.** The proposal would eliminate the HOPE tax credit (a credit against tuition and fees incurred in the first two years of college), the lifetime learning tax credit (available for any post-secondary education), the education deduction, the deduction of student loan interest, the exclusion for so-called section 529 (college saving) plans, and education savings accounts. Instead, the family credit would include some benefits for college students, and families could pay education costs out of the tax-free "save for family" accounts (discussed below). Those changes generally make sense. The current panoply of benefits for higher education is redundant, confusing, and poorly targeted. There is also evidence that much of the benefit of the tax credits is absorbed by higher-education institutions in the form of higher tuition bills. However, a better option might be to apply the money saved from eliminating the tax subsidies to increased funding for Pell Grants, which help low-income students, and student loans.

### E. Taxation of Social Security Benefits

Under current law, a portion of Social Security benefits is included in the taxable income of taxpayers with income above particular levels. The taxable portion phases in at a 50 percent rate over a particular income range and 85 percent for higher incomes until 85 percent of benefits is included in tax. The income tax collected at the 50 percent rate is allocated to the Social Security Trust Fund; the additional 35 percent collected at higher incomes is allocated to the Medicare Trust Fund.

The thresholds were intentionally not indexed for inflation in 1983 to raise revenue to fund the Social Security system over time. (That is similar to the idea that the panel put forward to allow the health insurance cap to rise with general price inflation rather than with medical care inflation.) Also, the phase-in rules are complicated. The main problem, however, is that the phase-in formula effectively amounts to an income-tax surcharge of 50 percent or 85 percent in the phase-in ranges. That means, for example, that a retiree who is nominally in the 25 percent income tax bracket can face an effective tax rate of 46.25 percent (1.85 x 25 percent). That discourages working, saving, and reporting income.

Unfortunately, the panel's report does not even mention that distortion and would not eliminate it for people affected by the phaseouts. Instead, the panel would slightly simplify the calculation of taxable Social Security benefits by replacing the current formula for inclusion with a somewhat less convoluted deduction. The phase-in rate would be a flat 50 percent of benefits, meaning that the phase-in range would be larger than under current law.[23] It would eliminate a marriage penalty by making the exempt amount of Social Security benefits for couples twice the level for singles, and it would index for inflation the thresholds for taxation of benefits.

As a result of the indexation for inflation, the proposal would substantially reduce revenues over the long run. Furman (2005) estimates that the provision would cost the Social Security and Medicare trust funds about $1 trillion (in present value terms) over the next 75 years, exacerbating their solvency problems.

In fact, there are several ways to simplify the taxation of Social Security benefits and eliminate the high effective tax rates without undermining the Social Security and Medicare trust funds. For example, a simple solution would be to include a fixed percentage of benefits in income for all Social Security recipients while protecting lower-income seniors from tax via a flat deduction. The receipts from the Social Security surtax could be allocated to the trust funds to match the current transfer scheme in present value. To mimic the time pattern of current law and minimize tax increases on current seniors, the flat deduction might be fixed in nominal terms (that is, not indexed).[24]

### F. The AMT

The panel would repeal the individual AMT. There is much to be said for that policy, as the AMT is needlessly complex, inefficient, and inequitable, includes large marriage penalties, and hits families with children especially hard. It does not even accomplish its original goal of making sure that affluent households pay tax — households with income above $1 million are substantially less likely to owe AMT than those with merely high incomes. Moreover, while the AMT falls mainly on high-income households now, it will increasingly encroach on the middle class over time.

Repealing the AMT, however, is both expensive and regressive. Policymakers and the public may well decide that the sacrifices required to repeal the AMT, in terms of other tax increases, are not worth the costs, especially given that most of the benefits of AMT repeal will accrue to high-income households.

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[23]The proposal would phase in at a 50 percent rate (in terms of income) until 85 percent of benefits are included. Because some benefits are phased in at an 85 percent rate under current law, benefits phase in faster than under the proposal.

[24]Note that the scheme would create many winners and losers, but so does the tax reform panel's proposal. The panel's proposal would hurt current singles and help current married tax filers in the short run, although it would cut taxes on almost all seniors in the long run (with a commensurate revenue loss).

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Rather than being repealed, the AMT could be retargeted at very high-income taxpayers and aggressive tax shelterers. Burman, Gale, and Rohaly (2005) consider an option that would allow dependent exemptions and personal nonrefundable tax credits, eliminate the AMT exemption phaseout, and index the exemption from its 2005 level starting in 2006. Those reforms could be paid for by increasing the 28 percent AMT bracket to 33.5 percent (which would increase taxes only for those with incomes above the AMT exemption phaseout, an income level of $330,000 for couples after 2005) and eliminating the preferential rates for capital gains and dividends under the AMT. Because the differential in tax rates between capital gains and dividends and other income is the linchpin of most individual tax shelters, including gains and dividends in the AMT base would discourage tax sheltering.[25]

Under current law, this option would raise about $9 billion over the next 10 years.[26] The option would be highly progressive, cutting overall taxes on those with incomes under $500,000 and raising taxes on higher income filers. It would reduce the number of AMT taxpayers in 2010 by 90 percent — 99 percent for those with incomes between $50,000 and $75,000. It would reduce the number of AMT taxpayers among those with incomes between $500,000 and $1 million by 8 percent and would more than double the number of taxpayers with incomes exceeding $1 million subject to the tax.

In contrast, repealing the AMT entirely, as the panel proposes, would reduce revenues by $670 billion under current law, or $1.2 trillion if the Bush tax cuts are made permanent (consistent with the panel's baseline).

### G. Targeted Saving Accounts

The proposal would replace the existing panoply of saving options with three saving vehicles and a refundable savers credit. ''Save at work'' accounts would unify the rules for all employer-provided defined contribution and 401(k)-type plans and would encourage ''automatic'' structures.[27]

Tax-preferred saving outside of employer-provided plans would be accomplished via ''save for retirement'' and ''save for family'' accounts. Save for retirement accounts would replace all non-work-based retirement saving plans (for example, IRAs and Keoghs), tax-preferred annuities, executive deferred compensation plans, and so forth, with a Roth IRA structure. The accounts would have no income eligibility limits and could receive up to $10,000 (or wages, whichever is lower) in contributions per year. Contributions would not be tax deductible, but funds could be withdrawn tax-free and penalty-free on death, disability, or turning 58. ''Save for families'' accounts would replace all other tax-preferred savings accounts (for example, Coverdell education savings accounts, 529 (college saving) plans, health saving accounts, and so forth) with a similar Roth structure that would have no income eligibility limits and allow each account to receive $10,000 per year in contributions, with funds withdrawn tax-free and penalty-free for health, education, purchase of a primary home, or retirement. Up to $1,000 per year could be withdrawn tax-free for any purpose (for example, hardship, vacation, and so forth). Other nonqualified withdrawals would be subject to tax on accumulated earnings plus a 10 percent penalty tax.

The savers credit would be made refundable, with the match rate set at 25 cents for every dollar contributed to a tax-preferred account up to $2,000. Married couples with qualifying accounts in each spouse's name could claim tax credits for each account. The credit would phase out between $15,000 and $25,000 of income for singles and $30,000 and $40,000 for married couples.

> ***The panel's proposals on saving mix some very good ideas with some very unattractive ones.***

The panel's proposals on saving mix some very good ideas with some very unattractive ones. The proposal to encourage automatic 401(k) structures builds on research that shows that participation and contribution choices in 401(k) plans depend on how options are framed for participants. If participation is automatic, while allowing workers the choice of opting out, many more workers ''choose'' to participate than if they have to make a positive election. Similarly, decisions about contribution levels, investment allocations, and whether to roll over a pension into a new tax-free retirement account may well depend on whether optimal decisions are made by default or have to be elected. In automatic 401(k)s, each of those choices would be set at defaults that were pro-saving and prudent. Employees could still override those choices, but unless they act the default choices would prevail. Thus, for example, workers could be automatically enrolled, have their contribution levels automatically rise over time as their salaries rose, have their funds automatically invested in a balanced, low-cost investment fund, and have balances automatically rolled over into tax-preferred accounts when they leave a job. (See Gale, Iwry, and Orszag (2005) for additional discussion.)

The savers credit proposal would make the credit more understandable; evidence suggests that this would raise take-up of the credit (Duflo et al. 2005a, b). Making the credit refundable would usefully target it toward lower-income households who otherwise would not receive any incentive to save. The proposal would also get rid of the ''cliff'' structure of the current savers credit, under which, in some circumstances, a $1 increase in

[25]Indeed, income from capital gains was the single largest AMT preference item before the 1986 act taxed those gains at the same rate as ordinary income and eliminated the preference. When the differential in rates of taxation on capital gains versus other income increased after 1986, capital gains were not reestablished as an AMT preference. As a result, the current AMT does not generally close loopholes created by the preferential taxation of capital gains (Burman, Gale, and Rohaly 2005).

[26]The option might raise more revenue in the context of the SIT because individual-level taxation of capital gains and dividends would decline under the proposal relative to current law.

[27]There are no proposed changes to defined benefit plans.

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contributions to tax-preferred saving can generate an increased government match of several hundred dollars.[28]

The new expanded tax-free savings accounts, however, are ill-advised. First, they are regressive relative to current law, and they would mainly involve removing the income eligibility limits and raising overall contribution limits. Second, they would reduce the attractiveness of the employer-based pension system. In particular, the very generous contribution limits and income eligibility rules for the save for retirement and save for family accounts would discourage some small and medium-size employers from offering pensions. (If, for example, a married business owner with two children can set aside $60,000 per year tax-free, why bother setting up a 401(k) plan for the business's employees?) Third, they would not generate much in the way of new saving. Evidence suggests that most contributions to tax-preferred accounts by very-high-income households come from existing taxable accounts, rather than new saving, and the accounts would provide a large and growing tax shelter (especially if the estate tax is permanently repealed). The resulting decline in pension coverage noted above would likely reduce overall participation rates in employer-based tax-deferred saving plans, among precisely the low- and middle-income households who both need to save for retirement and for whom contributions to tax-deferred accounts represent new saving. Fourth, the proposals represent a massive budget gimmick — they have little or no revenue loss over the next few years, but massive revenue losses in the future. Burman, Gale, and Orszag (2003) estimated that future revenue losses attributable to a similar proposal for lifetime and retirement savings accounts could amount to 0.5 percent of gross domestic product or more on an annual basis.[29] That would be the equivalent of a $50 billion per year tax cut in today's economy. Another proposal in the report to allow taxpayers to roll over balances in traditional IRAs into save for family accounts would increase revenues in the short run at the expense of much bigger revenue losses in the future. (Burman, Gale, and Orszag 2003.) The panel considers the three saving proposals to be linked, but they could be easily separated. In particular, paring back the Roth limits to $4,000 (the current limit) would be a good idea. Similarly, replacing the panoply of targeted savings accounts with a small (say, $2,000 per year) save for family account would be a meaningful simplification without generating huge new tax shelter opportunities.

Two additional comments: First, the panel would restrict the tax preferences for life insurance and deferred compensation, which is a welcome change in itself. That would close sizable loopholes in the current tax code. Second, the panel appears to have missed an opportunity to repeal existing tax rules that encourage or subsidize workers who invest their 401(k) contributions in their own employer's stock — a risky proposition that has resulted in catastrophic losses for workers when their employers fail (as, for example, when Enron failed).

### H. Interest, Dividends, and Capital Gains

The panel would retain the taxation of interest receipts as ordinary income, but would change the individual income tax treatment of dividends and capital gains. The share of a corporation's dividends that would be taxable to the individual recipient is equal to the share of the corporation's worldwide income that would be taxable in the United States (including all domestic income and foreign passive income). All realized capital gains would be taxed as ordinary income except gains on corporate stocks (technically, equity in ''large'' businesses, as defined below) held more than one year, which would receive a 75 percent exclusion (and so would be taxed at a maximum rate of 8.25 percent).[30]

Those proposals are the individual side of the panel's proposals for corporate integration. On the corporate side, the panel would remove almost all corporate tax expenditures, except for accelerated depreciation, and as discussed below, would move to a territorial system, in which foreign profits would not be subject to tax in the United States. The hope is that, by eliminating corporate tax expenditures and taxing dividends to the extent that foreign income is not taxed, the proposals would reach the twin goals of taxing all corporate income once and taxing that income only once.

The proposal seems likely to achieve the goal of taxing corporate income at most once — that is, in eliminating the remaining double taxation that exists. The only possible source of double taxation would be on capital gains on corporate stock, but any such ''double taxation'' would be tiny, because the statutory tax rate on capital gains would be so low, and also because the ability to defer gains realizations and to match the timing of realizations of gains and losses reduces the effective tax rate even further.

It is less clear, however, whether the proposal would be successful in the goal of taxing all corporate income at least once. While the proposal eliminates corporate tax expenditures, it retains the deductibility of interest that is the source of so much tax mischief. It is not apparent, and

[28]Under current law, for example, a married taxpayer with AGI below $30,000 would receive a 50 percent credit on all contributions, whereas the same taxpayer with AGI between $30,000 and $32,500 would receive a 20 percent credit on all contributions. As a result, a married taxpayer who had made a contribution of, say, $500 and had AGI of $30,100 would receive a credit of $100 (20 percent of $500). If the couple contributed another $100 to a traditional IRA, AGI would fall to $30,000 and the entire $600 of contributions would receive a 50 percent credit, so the household would obtain $300. Thus, an additional $100 contribution would net the household an extra $200 in credits.

[29]The original 2003 proposal for retirement saving accounts and lifetime saving accounts (LSAs) would have limited annual contributions to $7,500 per year, compared with $10,000 in the panel proposal. But LSA balances could be withdrawn for any purpose, so participation rates in LSAs would be substantially higher than in save for family accounts. As a result, the earlier proposal would plausibly have generated more tax avoidance than the panel's Roth accounts.

[30]The treatment of capital gains on housing is discussed in Section III.C above.



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the panel does not explain, how the proposals would reduce corporations' ability to finance transactions in a way that largely reduces or eliminates tax liability, based on careful manipulation of debt and equity instruments. (See Kleinbard (2005) for discussion of how that can occur under the current system.) Also, the proposal discussed below, to tax only domestic-source income will provide corporations with potentially huge new opportunities to shelter domestic income in foreign tax havens.

Another concern with the corporate integration proposal is the granting of dividend tax relief and capital gains relief on the return to already existing capital. There is little reason to give that relief to owners of old capital, who bought their shares knowing they were subject to double taxation and hence paid less than they would have had to under an integrated system. There is almost no efficiency or equity purpose to the windfall gain provided, and the loss in revenue requires higher tax rates with a corresponding efficiency cost. It is possible that an immediate reduction would improve the short-term reallocation of capital, but those effects seem small relative to the costs involved. Also, with an increasing share of equity shelterable over time because of the large Roth saving vehicles noted above, the biggest reduction in the effective tax rate on dividends and capital gains from the proposals to cut dividend and capital gains taxes would come in the short run. In the long run, the rates would fall anyway because of the increase in tax-sheltered accounts. As a result, while the dividend and capital gains tax cut provisions provide windfalls, they would do little to spur economic growth. In its discussion of the GIT proposal, the panel proposes taxing the windfall gains that would accrue on the transition to the new system. It is unclear why a similar proposal is not offered under the SIT to tax the windfall gains of existing holders of stocks and recipients of dividends.

The corporate integration proposal also generates interesting questions for investors trying to allocate their assets to tax-preferred and taxable accounts. Essentially, there would be less reason to hold equity in tax-preferred accounts under the proposal than under current law.

Finally, given the generous Roth IRA treatments and the reduction in taxes on dividends and capital gains, a reasonable question is how much capital income would be taxed at all at the individual level under the proposal.

### I. Business Taxes

One of the more sweeping (but much less detailed) parts of the panel's report would change the taxation of businesses in several fundamental ways. Under the panel's proposals, businesses would be divided into three categories — small, medium, and large — with different rules for each.

Small businesses (with annual revenues up to $1 million) would report income based on cash flow accounting. That appears to imply that interest payments and state and local tax payments would be deductible. Small businesses would expense all investments, except buildings and land. Their profits would be taxed at ordinary individual income tax rates, rather than at the lower statutory rates on capital gains and dividends. Small businesses would be required to have a business bank account. The bank and the business's credit card company would send an annual account summary to the business and the IRS.

Medium-size businesses (annual revenues up to $10 million) would depreciate rather than expense their investments, but would have only four categories of assets, and would have greatly simplified depreciation and inventory reporting rules. Profits would be taxed at ordinary individual income tax rates.

Large businesses, with annual revenues above $10 million, would face a flat 31.5 percent tax rate on a base that eliminates almost all corporate tax expenditures, including the deduction for state and local taxes. Owners of those corporations could obtain dividend relief to the extent that the firms' income is subject to U.S. taxation. Note that this would require those firms to publicly report their domestic and foreign income, which would be a plus in itself. Large partnerships as well as corporations would pay tax under this regime, eliminating the incentive to organize as a partnership rather than a corporation. Smaller businesses could choose to pay the tax and get the dividend exclusion benefit.

Those proposals provide innovative options and could potentially simplify many aspects of business income taxation, but they also raise a number of issues.

First, the plan leaves in place the existing rules distinguishing, or attempting to distinguish, debt from equity. That is a major source of complexity in the current code and it means that, as noted above, it may not be possible to tax all corporate income at least once. A crucial implication is that, despite the large number of changes to the taxation of business income (and housing income as noted above), there is very little change under the SIT in the *relative* taxation of owner-occupied housing, corporate investment, and noncorporate investment (Figure 6-4, p. 130, in the report). Large differences — and the distortions they imply — would still remain. Some of the effects estimated by the panel appear to be puzzling, or at least surprising. Owner-occupied housing, already favored in the current system, would face a *lower* effective tax rate under the SIT (presumably because the effect of extending the mortgage credit to more lower- and middle-income households exceeds the effect of capping the level and rate at which high-income households can benefit). Perhaps even more surprisingly, the effective tax rate on noncorporate businesses would *rise* and would be about 18 percent, despite the more generous depreciation rules for small and medium-size businesses described above.

Moreover, it appears that the data reported in Figure 6-4 focus only on federal taxes. But recall that the proposals would repeal the state tax deduction for large companies; that means that the net effective tax burden would fall by less than reported in the table and could actually rise for some corporations.[31]

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[31]Precise calculations of effective tax rates are not available, but calculations of statutory rates can give a flavor of the effects. For example, the proposed statutory federal marginal tax rate on corporate income, 31.5 percent, would be 10 percent lower than the current 35 percent rate, but corporations would lose the

**(Footnote continued on next page.)**



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Under the proposal, small businesses (as defined above) would be able to expense investment as well as deduct interest payments. That creates negative effective tax rates on investments. In the discussion of the GIT, for example, the panel report (p. 164) notes that: ''allowing both expensing of new investments and an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable, just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity.'' That is exactly what would happen under the SIT for small businesses.

Also, there will be an incentive for proprietors to try to channel compensation through closely held corporations and recharacterize it as tax-free dividends. Even if some of the profit is taxed at the company level, it would be taxed at less than the top individual income tax rate (a 31.5 percent corporate rate versus a 33 percent maximum individual income tax rate).

Another potentially significant concern is that the differing tax rules by level of receipts, combined with the fact that delineating the boundaries of a ''business'' is a malleable concept in practice, lead to obvious questions and concerns about how businesses are defined, how and whether one can create a new business, how one firm that is changing size over time qualifies for tax status, and so forth. (See Shaviro 2005.)

Finally, the treatment of state and local income and property tax payments merits discussion. The proposal would raise a substantial amount of revenue by eliminating the deduction for large businesses. However, to the extent that state and local taxes are payments for services provided by the public sector, business tax payments *should* be deductible. Using the example in the state and local discussion above, if an individual paid for a company to remove the trash, it would not expect a deduction, but for a business the same purchase of garbage collection would (and should) qualify as a deductible expense. Thus, to the extent that subfederal payments are buying services, they should be deductible for businesses. Likewise, for owners of rental property, property taxes are a cost of doing business and should be deductible.

### J. International Issues

The proposal would move the U.S. income tax to a territorial system: Active foreign business income would not be subject to U.S. taxation, nor would the expenses associated with generation of the income abroad be deductible. Foreign passive income would be subject to U.S. taxation (and would be included in the calculation, for dividend tax purposes, of the share of total corporate income that was subject to U.S. taxation).

The proposal is not described in any detail in the report; that is why the sheltering opportunities are described above as ''potentially huge.'' The workings of a territorial system in general depend sensitively on the strictness of the allocation rules for income and expense. Clearly, firms would have incentives to shift income offshore and shift expenses onshore. The ability to limit those transactions is open to question. Of particular concern, given the discussion in the report, is the fact that active foreign income would apparently not have to be taxed in the foreign country to be exempt from U.S. tax. (For more discussion, see Sheppard 2005.)

The proposal would also define a firm as a U.S. company if its main operations were in the United States, even if its headquarters are not. It is hard to see why that is not already U.S. law.

## IV. Growth and Investment Tax Plan

The panel's second proposal is called the GIT plan. For tax aficionados, the plan can be described as David Bradford's X tax, plus an individual-level 15 percent surcharge on capital income. For nonexperts, the plan will look like a confusing mélange of provisions.[32]

### A. Introduction and Common Features

Table 3 on the next page shows that almost all of the features described in sections III.A to III.G would be the same under the GIT, except for tax rates, which would be set at 15 percent, 25 percent, and 30 percent, with the brackets shown in Table 4 on p. 1364.

The other exception is that the save at work accounts (that is, 401(k) plans) would be converted to being Roth-style accounts for which the contributions are not deductible and the withdrawals not taxable. That change may appear innocuous, but it is quite insidious. It would have no effect on long-term revenues (or could possibly hurt long-term revenues, because the effective amount that can be sheltered in a Roth plan is larger than the effective amount that can be sheltered in a traditional, front-loaded plan with the same contribution limit (see Burman, Gale, and Orszag 2003). But it would have the effect of raising hundreds of billions of dollars within the 10-year budget window (because the deductions for 401(k) contributions would be denied) but losing the same hundreds of billions of dollars (or more) in present value in revenues beyond the 10-year budget window (because the taxation of 401(k) withdrawals would be eliminated). Thus, long-term revenue under the GIT would be even lower than long-term revenue under the SIT, as discussed below. Also, because the deduction for 401(k) contributions is denied under this plan, the GIT would ''look'' more progressive than it is if the distributional analysis examines current-period tax revenues. Thus, switching the save at work accounts to backloaded generates misleading results for the revenue and distributional effects of the GIT.

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deduction for state and local taxes under the proposal. As a result, the combined state and federal statutory rate — assuming a state corporate income tax rate of 5 percent — would fall from 38.25 percent under the current system (0.35 +(1-0.35)*0.05) to 36.5 percent (0.315+0.05) under the proposal, a decline of just 4.5 percent. For manufacturers, who currently face a 32 percent rate, the combined federal and state statutory rate would be higher under the proposal than under current law.

[32]Deloitte Tax LLP Tax Policy Services Group (2005) raises the issue of whether the X tax is constitutional. We do not explore that issue here.

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| Table 3. Summary of Major Provisions in Growth and Investment Tax Plan | |
|---|---|
| **Provisions** | **Proposal** |
| **Households and Families** | |
| Tax Rates | Three tax brackets: 15%, 25%, 30% |
| AMT | Same as SIT |
| Personal exemption, head of household filing status, standard deduction, child tax credit | Same as SIT |
| Earned income tax credit | Same as SIT |
| Marriage penalty | Same as SIT |
| **Other Major Credits and Deductions** | |
| Home mortgage interest | Same as SIT |
| Charitable giving | Same as SIT |
| Health insurance | Same as SIT |
| Education | Same as SIT |
| State and local taxes | Same as SIT |
| **Individual Savings and Retirement** | |
| Defined contribution plans | Same as SIT, except backloaded |
| Defined benefit plans | Same as SIT |
| Individual retirement accounts | Same as SIT |
| Education savings plans, health savings plans, savers credit | Same as SIT |
| Dividends received | Taxed at 15% |
| Capital gains received | Taxed at 15% |
| Interest received (other than tax-exempt municipal bonds) | Taxed at 15% |
| Social Security benefits | Same as SIT |
| **Small Business** | |
| Rates | Sole proprietors taxed at individual rates (top rate of 30%); other small businesses taxed at 30% |
| Recordkeeping | Business cash flow tax |
| Investment | Expensing |
| **Large Business** | |
| Rates | 30% |
| Investment | Expensing |
| International taxation | Border-adjusted |
| Corporate AMT | Same as SIT |
| *Source:* President's Advisory Panel on Federal Tax Reform (2005) and Tax Policy Center. | |

## B. Interest, Dividends, and Capital Gains

A major difference between the GIT and the SIT is that interest, dividends, and capital gains would be taxed at a flat 15 percent rate under the GIT. This provision would likely end up taxing little capital income, in part because the Roth saving incentives described in Section III.G above would be available under the GIT to shelter large amounts of capital income. In addition, however, the presence of those taxes could create the need for anti-deferral rules, because businesses could otherwise shelter income from the capital taxes by retaining the funds in the business (see Shaviro (2005) for further discussion). In endorsing the GIT rather than the X tax, the panel may well have been responding to the need to address perceptions of fairness — namely, that under the X tax, capital income tax is collected at the firm level, and individuals receiving that income would not send a check to the government. For purposes of a document outlining tax options, however, it probably would have been more helpful to focus on the merits and drawbacks of the X tax as a stand-alone tax.

## C. Businesses

The easiest way to think of the business tax in the GIT is as a 30 percent subtraction-method VAT that also allows deductions for wages and other compensation. Investments would be expensed. Interest and other financial inflows would not be taxed, nor would deductions for interest payments be allowed. The coupling of expensing with repeal of interest deductions is essential for reasons discussed above. Losses would be carried forward with interest. There are a number of well-known difficulties in taxing financial services under such a tax, which the report discusses but does not resolve.

## D. International

The panel recommends implementing the GIT as a destination-based tax, under which exports would be exempted from the tax and deductions for import costs would be denied. It argues that this would reduce transfer pricing issues. It also recognizes, however, that those border tax adjustments might be viewed as illegal

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**Table 4. Tax Rates Under the Growth and Investment Tax Plan**

| Rate | Unmarried | | Married | |
|---|---|---|---|---|
| 15% | $0 | $40,000 | $0 | $80,000 |
| 25% | $40,001 | $70,000 | $80,001 | $140,000 |
| 30% | $70,001 | or more | $140,001 | or more |

*Source:* President's Advisory Panel on Federal Tax Reform (2005), Table 7.3.

under the General Agreement on Tariffs and Trade (even though they are legal under an analytically similar VAT).

### E. Transition

To ease transition burdens, the panel would offer an import tax credit that is phased out over time, and would offer transition relief to holders of existing mortgages, holders of existing depreciation allowances, and those who have deductible interest payments. It also suggests the taxation of windfall gains that arise from this proposal (that is, for people receiving interest payments).

## V. Revenue Effects

### A. Show Me the Money!

The first bullet point in the report's executive summary states that ''the fundamental purpose of our tax system is to raise revenues to fund government'' (p. xi). One might naturally think, then, that the report would pay significant attention to revenue issues and discuss the revenue effects openly and consistently. If so, one would be disappointed.

> ***One might naturally think that the report would pay significant attention to revenue issues and discuss the revenue effects openly and consistently. If so, one would be disappointed.***

There are, in fact, no revenue tables in the 272-page report. Also, there are a number of statements that are simply wrong. A letter that is addressed to the Treasury secretary and is signed by all nine members of the reform panel states that ''our recommendations have been designed to raise approximately the same amount of money as the current tax system.'' That is simply a false statement (unless the ''current system'' is defined to mean not current law, but also a number of tax cuts that the president has proposed and Congress has repeatedly rejected, including some provisions that have never been U.S. law and would in fact represent significant departures from all previous tax law). As discussed below, the recommendations would raise about $1.4 trillion less than the current system over the next decade, by the administration's own estimates. The misleading claim of revenue neutrality is repeated on p. 42 and again on p. 149.

The panel attempts to downplay the loss in revenue by pointing out that the administration's baseline revenue is only 1 percent below the CBO's baseline revenue. That is comparing apples and oranges, though. The comparison with CBO says nothing about the effects of the proposals on long-run receipts and a lot about the return of ''Rosy Scenario'' to Office of Management and Budget. The administration's baseline is so bountiful because administration forecasters assume higher growth than the nonpartisan CBO and make a variety of other assumptions as well. Both the administration and the CBO project that the baseline used by the administration would cut taxes by at least $1.4 trillion over the next decade relative to current law and would reduce revenues in 2015 by $300 billion, or more than 1.5 percent of GDP.[33]

The shoddy treatment of revenue analysis in the report is disturbing, especially given the panel's own admission that the primary purpose of a tax system is to raise revenues, and it mars an otherwise constructive report. The mere fact that the panel does not want to indicate the revenue effects of its proposals should raise red flags. Perhaps all of the misstatements about revenues are merely typos. One could be more certain that those gross misstatements about such a fundamental issue were mere oversights if the report had been more open about the revenue estimates elsewhere in the report and had not tried to obfuscate the issue with misleading ''apples'' to ''oranges'' comparisons of CBO and administration baselines. But in the absence of any revenue tables in the report, and a series of misleading statements in the report, one has to wonder what is going on. In short, although the panel may have been required to use a particular baseline, it was not required to obfuscate or confuse the revenue discussion.

### B. Analysis

As a result of those issues, although the executive order required that the plans be ''revenue neutral,'' the report's claim that the plans are revenue-neutral needs to be taken with a very large grain of salt. A proposal can be revenue-neutral only relative to some other option and over some time period, and every proposal — even for a tax cut — is ''revenue neutral'' relative to some baseline. Thus, a ''revenue neutral'' proposal can represent a big tax cut relative to the current system if the chosen baseline incorporates such a tax cut. For example, if the baseline is a world with no taxes, a proposal that eliminated all taxes would be ''revenue neutral.''

The panel understood ''revenue neutral'' to mean over the next 10 years and relative to a baseline that *assumes that all of the recent Bush tax cuts are made permanent and all of the president's budget proposals are enacted.* The latter includes retirement saving accounts and lifetime saving accounts, which represent massive increases in Roth-style accounts for retirement saving and for any form of saving.

That merits several comments. First, it means the reform plans would raise significantly less revenue than current law. Making the Bush tax cuts permanent and enacting the other changes would reduce revenues by $1.4 trillion over the next decade and by about $300

[33]*See* OMB (2005, Table S-9) and CBO (2005).



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billion in 2015 alone, relative to current law. Over the next 75 years, making the tax cuts permanent would reduce revenue by more than three times the shortfall in Social Security and would require reductions in federal spending that are well beyond the realm of anything that has been enacted, proposed, or even discussed in recent years (Gale and Orszag 2005). So even if the panel's plans met their own revenue baseline, they would fall far short of current-law revenue. Whether to enact tax cuts of the magnitude implied by the baseline is a central issue in tax policy, not an assumption to be swept under the rug.

Second, the panel says that the revenue profiles from its proposals would be flatter over time than the baseline it uses. Although there is no evidence presented to support that assertion, it seems plausible. Revenues grow as a share of GDP under the panel's baseline because the AMT is assumed to take in more and more revenue over time. By repealing the AMT, the panel either had to find another revenue source that rose significantly over time, or had to have a flatter time profile of revenues. If it indeed is a result of the panel's proposals, the flatter profile has two important implications. First, it means that even if the plans are revenue-neutral relative to the baseline used over the next decade, the plans raise *less revenue in 2015* than the baseline would, and hence would raise less in all future years beyond the 10-year window. Thus, the plans would exacerbate the long-run fiscal gap, even relative to the low revenue baseline used. A second implication of the flatter profile is that tax revenues would have to *rise* in the near future under the panel's proposals relative to the baseline. That required short-term tax increase may be why the panel chose to obfuscate its revenue estimates. A president who has signed the "no new taxes" pledge and politicked relentlessly on the need for more tax cuts might find it politically uncomfortable to have a panel that he appointed be seen as recommending tax increases in the next few years.

Finally, the plans have two enormous budget gimmicks that would lose substantial additional amounts of revenue in the out-years. One is inflation-indexing the threshold for taxation of Social Security benefits. That would drain about $1 trillion in present value from the Social Security and Medicare trust funds over the next 75 years, substantially worsening the financial status of those programs (Furman 2005). The other gimmick is the massive increase in backloaded Roth saving vehicles noted above and the option to rollover existing IRAs into the new backloaded accounts.[34] Those two gimmicks would increase the extent to which the panel's proposals fell short of even its own revenue baseline in the years beyond the budget window. The report also mentions that moving to a border-adjustable system (taxing imports and exempting exports) in the consumption tax would raise revenue over the next decade. That occurs, however, only because the nation is currently running massive current account deficits. In the future, as the country runs surpluses (before considering interest) to pay back the debt it has accrued, border adjustability would turn into a massive revenue loser.

Revenue effects matter because government spending has to be paid for and because it is easy to develop elegant plans that don't raise much revenue. Meaningful policy analysis usually makes "apples to apples" comparisons. For example, it would require *at least* a 16 percent increase in marginal tax rates for either of the panel's plans to raise as much revenue in 2015 as current law would (using the panel's proposed tax base).[35] That would raise the top individual rate in the SIT, for example, from 33 percent to 38.3 percent, and it would raise the corporate rate from 31.5 percent to 36.5 percent. In both cases, those rates would be higher than currently prevailing. Given the fierce debates that have accompanied shifting the top rate from 39.6 percent to 35 percent over the past few years, a shift in the top tax rate from 33 percent to 38.3 percent, along with similar increases in the other rates, could well fundamentally alter views of the tax reforms. Also, a plan that raises less revenue than the current system could affect economic growth adversely through its effect on deficits and could affect the inter- and intragenerational distribution of resources through its effect on other spending or tax policies.

## VI. Distributional Effects

The report claims the plans are distributionally neutral, but again that appears to be misleading — at least in the long run. One reason why is that the baseline assumes the recent tax cuts are made permanent, which already creates a significantly more regressive baseline than current law. And the baseline assumes that very large, tax-free saving accounts are created that would allow a family of four to shelter up to $60,000 per year in saving. Thus, the panel has chosen a baseline such that by 2015 (the end of the budget window) distributional neutrality would require a huge tax cut for the highest-income taxpayers relative to current law.

The other reason the reported distributional effects are suspect is that the distributional measures used are misleading. One measure employed is the percentage change in taxes paid, which treats a reduction in taxes from $2 to $1 as a bigger tax cut than a reduction from

[34]Other factors may appear at first glance to work in the opposite direction, but they may not be realistic. For example, indexing the health insurance cap to consumer price inflation, rather than health cost inflation, would tend to offset some portion of the long-run revenue losses, but that provision is unlikely to be politically sustainable over the long run. Also, although revenues from the AMT would rise as a share of GDP for a long time under current law, projections of future revenues typically hold revenues constant as a share of GDP after the 10-year budget window. Hence, those projections already assume an AMT fix, or at least an adjustment that stops the growth of AMT revenue as a share of GDP.

[35]According to the CBO (2005), the corporate and personal income tax would raise 11.9 percent of GDP in revenues under current law and 10.3 percent of GDP under the Bush budget proposals. Thus, to raise the same amount of revenues, assuming no microbehavioral offsets, would require rates to rise roughly by 16 percent = ((11.9/10.3)-1) assuming the president's budget proposals were enacted. Recall from above, however, that the panel's proposals would raise less revenue in 2015 than the president's budget would. Hence, marginal rates would have to rise by more than 16 percent.

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$200,000 to $101,000. The right way to record a change from $1 to -$1 (or a change from -$1 to -$2) in taxes paid is not clear at all using that metric. Another measure used in the report is the share of taxes paid. In situations in which revenue levels are changing, that can be misleading too. For example, suppose the panel proposed a new system under which the richest person pays $1 in tax and everyone else pays nothing. The logic of using ''share of taxes paid'' would say that the richest person ends up paying 100 percent of all federal taxes under the new system, way up from the tiny percent he paid under the earlier system. So, by the panel's flawed criteria, the proposal would be more progressive than the current system. That conclusion would be nonsense, of course: Because we currently have a progressive tax system, the proposal would clearly give the biggest tax cuts to the wealthy. A better approach would be to look at the percentage change in after-tax income and to compare reforms that are revenue-neutral in a meaningful sense.[36]

Also, because of the backloaded nature of the Roth proposals, the long-term distributional effects would be significantly more regressive than the short-term effects. (Burman, Gale, and Orszag (2003) provide estimates of the magnitude of those effects for Roth accounts with smaller limits than those proposed by the panel.)

## VII. Growth

The panel estimates that the SIT would raise the size of the economy by up to 0.5 percent over 10 years, up to 1 percent over 20 years, and up to 1.2 percent in the long run. Those effects seem implausibly large. The SIT does not significantly reduce statutory marginal tax rates on labor income (and may raise them for some people when the removal of the deduction for state and local taxes is taken into account). Moreover, as noted above, the SIT does not significantly reduce effective marginal tax rates on investment or reduce the dispersion between corporate, noncorporate, and housing investments very much, according to the panel's own results. As a result, the impetus for more or better-allocated investment would be small. Thus, it is hard to see where those growth effects come from.

The panel reports that the GIT would have even bigger effects, raising the size of the economy by 1.8 percent over 10 years, 3.6 percent over 20 years, and up to 4.7 percent over the long term. Those effects seem quite large relative to the existing literature. Altig et al. (2001) report that a Hall-Rabushka flat tax, with transition relief, would raise GDP by 0.5 percent after 15 years and 1.9 percent after 150 years. The GIT should generate *smaller* long-term growth effects than that for three reasons. First, Bradford's X tax, with transition relief, would generate smaller effects on long-term growth than the flat tax with transition relief. (That is because the X tax has a higher business tax rate than the flat tax and raises more of its revenue from businesses, so that transition relief provides a larger windfall gain for old capital under the X tax than under a flat tax that raises the same revenue. Because more transition relief reduces long-term growth, the X tax with transition relief should have smaller long-term effects with transition relief. Altig et al., however, do not report any results for the X tax with transition relief.) Second, the GIT is a combination of an X tax with transition relief and a surcharge on individual capital income. The report itself shows that the surcharge reduces economic growth relative to an X tax with transition relief. Third, the flat tax estimates in Altig et al. occur for a completely clean tax base, whereas the GIT maintains a number of subsidies that require higher tax rates than otherwise. Thus, for all three reasons, a growth estimate consistent with Altig et al. would suggest a long-term growth effect for the GIT that is significantly less than 0.5 percent after 15 years.[37]

Finally, the estimates of growth for the SIT and GIT are made relative to the panel's baseline, not relative to current law. As a result, the net effect of moving from current law to the panel's proposals would be the sum of (a) enacting the president's budget proposals, and (b) enacting the panel's proposals. Available evidence suggests that making the president's tax cuts permanent would reduce long-term growth in the absence of other policy changes (see Gale and Orszag (2005) for citations). Thus, the net effect of moving from current law to the panel's proposals could well be negative.

More generally, the panel's proposals would generate rising deficits over time relative to standard projections (which assume current law for the next 10 years and constant revenues/GDP after that) and would even generate rising deficits relative to the baseline the panel employed, for reasons noted above. Those deficits will reduce national saving and future capital income of American households, thus reducing future national income. (See Gale and Orszag (2005) and Furman (2005) for further discussion.) Thus, it is by no means evident that enacting the proposals would end up raising long-term growth.

## VIII. Simplification

One of the fundamental themes of the report is the need and ability to simplify tax rules. Unlike the political system, the panel proposals consistently emphasize simplicity over other possible considerations. We believe that is an auspicious direction for reform.[38] Many of the proposals discussed above would greatly simplify tax filing, especially for returns with family, work, child, and saving issues. For businesses, the new system proposed

[36]Gale, Orszag, and Shapiro (2004) discuss distributional measures in more detail.

[37]The report notes that if tax rates were raised in the short run, during the transition period, the long-run effects of the proposals on growth would not be affected by provision of transition relief. If that assumption had been made in the analysis, it could explain the divergence between the panel's estimates and the literature. However, discussion with the panel's staff confirms that the panel did not make that assumption in estimating the long-term growth effects. Moreover, if it had, it would be implicitly adopting the notion that tax hikes now could increase long-term growth, which is not a notion that the Bush administration is likely to want to hear.

[38]However, as we noted in Burman and Gale (2001), the ''golden opportunity'' to simplify taxes was in 2001, when large projected budget surpluses would have made it possible to compensate the losers.

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in the SIT or GIT could potentially be much simpler, but the proposed rules may also add complications and in any case are not fleshed out in much detail. The same is true of the rules regarding international activity.

In most places where the panel did not opt for the simplest options, there appear to have been good reasons. For example, the panel proposes eliminating the standard deduction and making deductions available to all taxpayers. One of the more significant simplifications of the Tax Reform act of 1986 was to increase the standard deduction so that many fewer households had to itemize deductions. Although that was a simplification for many households, taxpayers may view their inability to receive a specific benefit from deductions for charitable contributions and mortgage interest as unfair. The panel recognized that and decided in this case to accept some complexity to advance perceptions of fairness.[39]

In other areas, however, simplification may be hard to come by. Graetz (1997) offers a chilling example of how complicated taxes can become for ''ordinary'' taxpayers. Our impression is that Graetz's Joe Sixpack would still face significant, although lessened, complexity under the SIT or GIT. For example, he would still have to keep track of housing expenses for the room he rents out, and household payroll taxes for his maid. Likewise, the retention of differential treatment of debt and equity in the SIT will maintain considerable complexity in the code.

Other simplifying provisions in the report are simply not likely to last, if they could be enacted in the first place. Another Hurricane Katrina would reinstate the casualty loss deduction. The removal of an income adjustment for alimony payments, as the panel proposes, would essentially renegotiate every alimony agreement in the country and would likely be changed back very quickly.[40]

Perhaps more surprising for a report that emphasizes simplification and administrative considerations, are the paths to simplification that were not taken. There is no discussion of increased withholding at source, no suggestion for increased spending on IRS enforcement and regulation, no discussion of return-free systems or other methods to simplify filing, and no discussion of process reform in Congress. The panel may well have felt that all of those issues were out of its charter, but it showed considerable flexibility and creativity in examining the options it chose to consider and could have found reasonable ways to introduce those topics as well.

[39]This could, however, have the effect of making return-free systems more difficult to implement. It is not an insuperable problem, however. The United Kingdom gets around the problem in the case of charitable deductions by providing a subsidy directly to the charity at the lowest marginal tax rate, which applies to most taxpayers. Higher-bracket taxpayers may claim a full deduction (less the credit amount) by filing, but that is unnecessary for most taxpayers. Similarly, the mortgage tax credit could be provided directly through mortgage lenders.

[40]And some of the touted simplifications are overstated: Our favorite is the reduction of the number of lines on the tax form by combining the reporting of income from Schedules C, E, and F onto one line instead of three.

## IX. Comments and Conclusions

Besides the policies advocated above, the panel's report is notable for what it rejected and what it omitted. As mentioned earlier, the panel did not recommend a value added tax to replace part of the existing tax system but it did conclude the idea was worthy of further consideration. That does not rule out the idea of adding a VAT in the future to pay for entitlement spending, of course, but the panel did not endorse that idea either. In sharp contrast, the panel explicitly rejected the notion of replacing the income tax system with a national retail sales tax.

Other less dramatic policies were also omitted from the report. There is, for example, no discussion of the payroll tax, even though it imposes the largest burdens of any federal tax for most households and, taken in isolation of the benefits it finances, is significantly regressive. While one might claim that the payroll tax was beyond the purview of the panel, the panel did propose altering the taxation of Social Security benefits in a way that has a direct effect on the Social Security and Medicare trust funds. Thus, some creative efforts to integrate payroll and income taxes or to exempt the first segment of payroll from such taxation would have been relevant.

Nor does the report discuss the estate tax, even though it is the most progressive tax and is scheduled to be repealed for at least one year (2010). Estate tax repeal could well open up significant income tax loopholes that would need to be addressed. Likewise, conversion of the estate tax to an inheritance tax, under which inheritances were included in taxable income, is an appealing concept that could usefully have been addressed here. Regardless of one's view on the best tax on intergenerational transfers, a careful integration of estate, gift (possibly inheritance), and income taxes would be a welcome direction for policy and would have been an appropriate subject for reform discussions.

***The two options offered by the panel may have compromised too much for an initial offering.***

The two options offered by the panel may have compromised too much for an initial offering. A main purpose of the report, in our view, is to educate the public about what is necessary to reform the tax system and the advantages and disadvantages of different options. To that end, the best options might have been a truly comprehensive income tax that taxes all income at the lowest rates that could meet revenue and distributional targets, and a comprehensive consumption tax designed the same way. Broadly, the key difference between those two options is that an income tax would tax the normal return to capital and a consumption tax would not. In fact, the panel proposed an income tax that exempts a large share of capital income, and a consumption tax with a supplemental capital income tax. That is, each proposal represents an option that shares many of the flaws of the other (that is, the income tax is less progressive and the consumption tax is less efficient than it might be) and it

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is well known that combinations of income and consumption taxes lead to problems.

The proposal includes many potentially justifiable cuts in spending programs run through the tax system, including the low-income housing tax credit, the deduction for state and local taxes (aid to states), and the elimination of education tax subsidies. However, the debate about cutting those programs should include a discussion about spending programs that would work better. Otherwise, the case for those cuts is much less compelling.

Nevertheless, our overall impression is that the panel did address a great number of important and difficult reform questions in careful and creative ways. The resulting set of proposals will serve to provide a platform and framework for constructive discussions of tax reform in the future. Indeed, even the best conceived of tax reform plans does not get enacted immediately in full. Treasury's pathbreaking *Blueprints for Basic Tax Reform* was released by a lame-duck Ford administration in January 1977. But it inspired several congressional proposals for tax reform by members of both parties and ultimately led to the most successful reform of our generation, the Tax Reform Act of 1986. We hope that the panel's report will yield a similarly good outcome down the road.

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