The Tax Reform Proposals: Some Good Ideas, but Show Me the Money

Who can doubt that the U.S. needs a better tax system? We need simple and consistent rules, adequate revenues to finance government spending, equitable tax burdens across and within economic groups, and favorable incentives for productive activity.

On top of these ongoing concerns, we currently need to deal with the imminent explosion of the alternative minimum tax, the looming expiration of all recent tax cuts, and the inconvenient fact that unless we cut future entitlement spending dramatically, we will need to raise substantially more revenue in the future than we have raised in the past.

Leonard Burman is Senior Fellow at the Urban Institute. William Gale is the Arjay and Frances Fearing Miller Chair, Brookings Institution. The authors are Co-Directors of the Urban-Brookings Tax Policy Center (www.taxpolicycenter.org).

The President's Advisory Panel on Federal Tax Reform recently released two plans. The first is the simplified income tax (SIT). The second is a combination of a consumption tax (based on the late David Bradford's X-tax) and an individual-level surcharge on capital income. Both plans would make tax rules simpler and more consistent, eliminate the AMT, eliminate most tax expenditures, and cut the effective tax rate on capital income. The second plan reduces capital taxes by more than the first does, but both plans combine features of income and consumption taxes.

The plans creatively blend old and new ideas and the overall report has the potential to usefully stretch the boundaries of the public debate and lay the groundwork for future reform discussion.

All of this comes with an enormous caveat, though. The Panel compares its proposals to a tax system that is *not* based on current law, but rather that starts with current law and then *assumes* that massive, regressive tax cuts take place. Relative to this straw-man baseline, the Panel claims its proposals would be revenue-neutral, distributionally-neutral, and growth-enhancing. Relative to the real world, though, the effects likely are far less auspicious.

The simplified income tax plan

The SIT would replace numerous family provisions with a family credit and refundable work credit. This would simplify tax calculations for low-income households.

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The Panel would convert the mortgage interest deduction to a 15 percent credit, reduce the cap on eligible interest payments, subject to adjustment for regional variation in housing prices. These changes would increase by 60 percent the number of people who benefit from mortgage subsidies—mostly lower- and middle-income households. By expanding the scope of the subsidy to these groups, the proposed credit could have more impact on homeownership rates than the current, skewed subsidy.

The proposed repeal of the state and local tax deduction will create howls of protest, much as the limitations on mortgage interest deductions, but by 2010 under current law there would be very little effective deduction anyway, because the AMT would take it back for many high income taxpayers and most others do not itemize deductions, as Kim Rueben, an Urban Institute economist, has shown.

On the saving side, the panel would encourage automatic or opt-out 401(k) plans and restructure the saver's credit to be refundable and to phase out gradually with income. These proposals would make saving simpler and more lucrative for low- and middle-income households. Evidence suggests that such households need to save more for retirement and that, unlike the higher-income households who currently garner most tax subsidies for saving, their contributions to tax-preferred saving plans are more likely to constitute new saving (rather than asset shifting).

On the other hand, the proposals would massively expand Roth IRAs. A family of four would be able to contribute $60,000 per year to back-loaded saving plans for retirement, health, education, and housing. As Peter Orszag and we have explained, such changes would be extremely regressive and would be unlikely to raise saving very much. Only high-income, high-wealth taxpayers would benefit from eliminating income limits and raising contribution limits. Evidence suggests that such households are much more likely to use these accounts as tax shelters than as avenues for new saving. In addition, the proposals could make the employer pension system less attractive for business owners and thus reduce pension coverage among low- and middle-income households. Finally, the proposals would not be massive budget gimmicks. They have little revenue loss over the next few years (because contributions would not be deductible), but substantial losses in the long-term (because withdrawals are not taxable). The proposal also includes a rollover provision that would cost about $1.30 in lost future revenue (in present value) for every dollar raised in the short run, as Orszag and we showed in prior research.

Both proposals would repeal the AMT, a complex and inefficient tax. Repeal, however, is both expensive and regressive (because eliminating the AMT would allow many high income filers to pay lower taxes). It would be possible to redesign the AMT in a manner that is revenue-neutral and return the AMT to its original purpose of closing tax shelters, as Jeff Rohaly and we have shown. When policy makers and the public see the policy changes required to regain the revenue lost from AMT repeal, they may well opt to retarget the tax rather than repeal it.

The SIT would exempt individual taxation of corporate dividends to the extent that the firm's profits are taxable in the United States. Capital gains on corporate stock would get a 75-percent exclusion. In exchange for these

reductions, the corporate tax base would be broadened substantially, eliminating virtually all special deductions and credits. That is, the panel aims to take seriously the "tax all corporate income once" part of corporate integration schemes as well as the "tax it only once" part that tax cutters like to emphasize. The plan would impose individual rates ranging from 15 to 33 percent, and a top corporate rate of 31.5 percent.

But there is no reason for the plan to give dividend 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 under an integrated system. There is no efficiency or equity purpose to the windfall gain provided, and the loss in revenue requires higher rates and a resulting loss of efficiency everywhere else. Nor is it clear that the SIT would tax all corporate income once, since it leaves intact the tax differences between debt and equity that create so much tax mischief.

The plan offers new and interesting models to streamline and simplify business taxation, with different rules for small (revenue less than $1 million), medium (revenues less than $10 million) and large companies. These may be the most fundamental changes in the report. Additional details are needed to assess these features, however, as obvious avoidance strategies appear to be feasible.

The plan would also move to a territorial system, under which the U.S. would not tax firms' active foreign business income or allow deductions for foreign expenses. Again, the devil is in the details, but this could be an improvement over the current system, especially under tight rules for allocating income and expenses, and under the panel's proposal to determine a firm's residency by the location of its main operations, not its titular headquarters. A concern, however, is that under the proposal foreign income would be exempt from U.S. taxation even if it were not taxed abroad. This would vastly increase incentives to relocate income to tax havens.

The growth and investment tax plan

There is a broad, but not universal, consensus among public finance experts that if we go to a consumption tax, the X-tax is the way to go. The X-tax is just the Hall-Rabushka flat tax with graduated tax rates on wage income. One way to get to the X-tax from the SIT is to drop all taxation of capital income at the individual level, and, at the business level, change depreciation to expensing, eliminate deductions for interest payments and the taxation of interest income. As the panel emphasizes, the link between expensing and removal of interest deductions is critical for well-designed reform, since doing the first without the second would generate negative effective tax rates on capital (that is, huge tax shelter opportunities). There are some changes to rates relative to the SIT and transition relief is provided to generate the "progressive consumption tax" in the panel report. Because the report aims to provide new ideas, not necessarily legislative proposals, the options would have been quite clear had the report stopped at this point, and simply portrayed the progressive consumption tax as an alternative to the SIT.

Instead, in order to reach a unanimous vote, the panel changed the progressive consumption tax in several ways, including adding back a 15 percent tax on individuals' interest, dividends and capital gains; and retaining the backloaded savings accounts mentioned above.

The resulting mix—the Growth and Investment Tax—is difficult to characterize and hence will confuse the public.

Revenue

The report's claim that the plans are revenue-neutral needs to be taken with a truckload of salt. (Curiously, the report goes through 272 pages without reporting a single revenue estimate and manages to state incorrectly on three different occasions (in the letter to Treasury Secretary Snow, and on pages 42 and 149) what its revenue assumptions actually are.) The Panel's plans are only revenue neutral with respect to a hypothetical world, not with respect to current law.

A proposal can only be revenue neutral relative to some other option and over some time period. Thus, a "revenue-neutral" proposal can represent a big tax cut relative to the current system if the baseline is chosen cleverly. For example, if the baseline is a world with no taxes, then a proposal that eliminated all taxes would be "revenue-neutral" with respect to that baseline.

The panel made its proposals revenue-neutral over the next 10 years relative to a baseline that assumes both that the enacted Bush tax cuts, which are currently scheduled to expire after 2010 or earlier in some cases, are made permanent and that all of the other tax cuts in the President's budget are enacted, including very large Roth IRAs and Lifetime Saving Accounts. Congress has repeatedly rejected making the tax cuts permanent, even when it thought large budget surpluses loomed on the horizon, and it has rejected the other proposals for three years running. Enacting the proposals noted above would reduce revenues by $1.4 trillion over the next decade, relative to current law. Over the next 75 years, they would reduce revenue by more than three times the shortfall in social security and would require draconian cuts in government spending. Whether to enact a tax cut of this magnitude (and the resulting spending cuts) is a central issue in fiscal policy and not an assumption to be swept under the rug, especially when, even under current law, the nation faces huge current and projected government deficits.

In the long run, though, the proposals would not even be revenue-neutral relative to the Bush-budget baseline. The panel asserts that the revenue profiles from its proposals would be flatter over time than the Bush policy baseline. This means that even if the plans are revenue-neutral relative to the Bush-budget baseline over the next decade, the plans raise less revenue in 2015 than the Bush-budget baseline would, and hence would raise less in all future years beyond the 10-year window. (Note also that a flatter revenue profile means that the plans would have to raise more revenue in the next few years than the President's budget—that is, there would have to be short-term tax increases.)

Moreover, 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. This 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 as Jason Furman of New York University has pointed out. The other gimmick is the massive increase in back-loaded Roth saving vehicles noted above. In a particularly egregious move, the GIT plan is only made "revenue-neutral" by converting all front-loaded 401(k) plans to back-loaded Roth

401(k)s. This is purely a timing gimmick: it would raise revenue in the current 10-year period but would lose revenue after that.[1]

Distributional effects

The report also claims the plans are distributionally neutral, but again this appears to be misleading. One reason why is that the baseline assumes the existence of new large regressive tax cuts. The other reason, perhaps not well understood by non-specialists, is that the particular measures used to report distributional effect are misleading.

One misleading measure is the percentage change in taxes paid. This treats a reduction in taxes from $2 to $1 as a bigger tax cut than a reduction from $200,000 to $101,000.

Another misleading measure used in the report is the share of taxes paid. Why misleading? Shares will not be a good measure when comparing two tax systems that raise different amounts of revenue, as is true of the current system and the Panel's proposals. For example, suppose the panel proposed a new system under which the richest person pays $1 in tax and everyone else pays nothing. Under the proposed system, the richest person would pay 100 percent of all federal taxes, way up from the tiny percent he/she paid under the current system. Using the "share of taxes paid" criterion, the Panel would claim that the proposal is more progressive than the current system. This conclusion would be nonsense, of course. A better measure would be the percentage change in after-tax income, measured for revenue-neutral tax changes relative to current law.

Growth effects

The Panel estimates that the SIT would raise the size of the economy by up to 0.5 percent over 10 years and up to 1.2 percent in the long run, while the GIT would expand the economy by 1.8 percent over 10 years, and 4.7 percent in the long run. These estimates seem enormous compared to recent results in the literature.

David Altig and coauthors 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. This 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. Since more transition relief reduces long-term growth, the X-tax with transition relief should have smaller long-term effects than the flat tax with transition relief. Altig and co-authors, 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 and co-authors occur for a completely clean tax base, whereas the GIT maintains a number of subsidies that require higher tax rates than

[1] The report also mentions that moving to a border-adjustable system (taxing imports and exempting exports) in the GIT plan would raise revenue over the next decade. This occurs, however, only because the nation is currently running massive current account deficits. In the future, as we run surpluses (before paying interest costs) to pay back the debt we have accrued, border adjustability would turn into a massive revenue loser.

otherwise. Thus, for all three reasons, a growth estimate consistent with Altig et al (2001) would suggest a long-term growth effect that is significantly less than 0.5 percent after 15 years for the GIT and is even smaller for the SIT.

Finally, the Panel's proposals would generate rising deficits over time, even relative to the low-revenue baseline the Panel employed, for reasons noted above. These deficits will reduce national saving and future capital income of American households, thus reducing future national income. Thus, the proposals might even lower long-term growth relative to current law.

Conclusions

The President's panel offers a promising set of tax reforms. The big problem, though, is that the proposals raise far less revenue than current law, and fall even shorter as compared to what is needed to close the current and projected budget gaps. Revenue effects matter because it is easy to develop elegant plans that don't raise much revenue. Meaningful policy analysis requires "apples to apples" comparisons. 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. So that alternative—plus adjustments to remove the other budget gimmicks mentioned above—would be the relevant plan to consider, not what the panel proposed.

One other concern is that the Panel may have compromised too much in its choices. The most useful report to help clarify public choices would put forward the best income tax and the best consumption tax option. Instead, the Panel outlined an income tax with massive exemptions for saving, and a consumption tax with a capital income surcharge, both of which are combinations of the two systems.

Nevertheless, the panel's report is not, and is not intended to be, the final word, and it does offer a useful base from which to structure future reforms. Any actual reform, though, will have to have rates sufficient to raise the revenue we need. The Panel's plan falls far short of that simple but crucial goal.

Letters commenting on this piece or others may be submitted at http://www.bepress.com/cgi/submit.cgi?context=ev

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Erratum

On page 2, column 2, the "not" in the sentence "Finally, the proposals would not be massive budget gimmicks," is a typographical error. The sentence should read "Finally, the proposals would be massive budget gimmicks."