

TAX REFORM FOR GROWN-UPS

By Joel Slemrod and Katherine Blauvelt

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Two days after his re-election, President Bush announced that he intended to spend his political capital on an ambitious domestic agenda, topped by reforms of both Social Security and the federal tax system. Although the framework of his Social Security plan was already well-known, he steered clear of endorsing specific tax reforms, instead anointing a Presidential Advisory Panel to outline alternatives.

Although some analysts condemned the President's decision to distance himself from the tax reform deliberations, the idea of a bipartisan expert commission to address a contentious issue like the restructuring of the tax system is not necessarily a bad one. Indeed, such commissions are as old as the Republic: President Washington appointed a three-member fact-finding group to help defuse the 1794 Whiskey Rebellion in Pennsylvania. And such commissions have sometimes succeeded in giving politicians the breathing room needed to behave like statesmen -- the 1983 Greenspan Commission on Social Security, which recommended raising payroll taxes and paring benefits in order to bring the system into (temporary) balance, is often cited as an example.

The tax reform panel, created in January 2005, had a bipartisan, middle-of-the-road flavor, lacking outspoken advocates of radical tax reform and not obviously stacked to favor a certain outcome. It was co-chaired by two savvy former Senators--Connie Mack (R-Florida) and John Breaux (D-Louisiana). The remaining seven members included prominent academics (James Poterba of MIT, Edward Lazear of Stanford, Elizabeth Garrett of the University of Southern California), a former Congressman from Minnesota who had served on the House Ways and Means Committee (Bill Frenzel), the chief investment strategist at Charles Schwab (Liz Ann Sonders), a former chairman of the Federal Trade Commission (Tim Muris), and the previous IRS Commissioner (Charles

Rossotti). Throughout its ten-month work life, the panel took seriously its directive to solicit diverse views, holding 12 public meetings around the country. The substantive work of the committee took place in four (non-public) working groups, each focusing on a different tax reform option.

The panel report's release was postponed twice -- the second time due to Hurricane Katrina. Finally, on November 1, it was handed over to Treasury Secretary John Snow and made available to the public. Secretary Snow cagily said that Treasury would "use it as a starting point for recommendations that we will make to the President."

"Tax-Overhaul Blueprints Elicit Tepid Responses," trumpeted the *Wall Street Journal* the next day. Key Congressional Republicans received it noncommittally, with Senate Finance Chairman Charles Grassley of Iowa saying that certain ideas were "bound to be politically unpopular," and ranking Senate Finance Democrat Max Baucus lamenting that it "will not satisfy our hunger for reform and simplification." Almost no one expects Congress to consider tax legislation that is a carbon copy of the panel's proposals—this year or ever.

That's hardly a surprise. Pres. Bush's tax initiatives to date have all been tax cuts. Tax reform, as the executive order creating the tax panel affirms, is an entirely different animal. The plan (or plans) devised by the experts could not explicitly use net tax cuts to make reform politically palatable. However, the panel was implicitly allowed to reduce the revenues generated over a decade by a trillion dollars compared to current law because the "revenue-neutral" policy baseline in the panel's marching orders assumes that the 2001 and 2003 tax cuts will be made permanent and that other costly budget proposals, including considerably expanded tax-free savings accounts, will become law.

The charge to the panel also required that at least one policy option had to be based on the current income tax system, and that all options had to simplify compliance, distribute the tax burden in "an appropriately progressive" manner, and promote growth and job creation while "recognizing the importance of homeownership and charity in American society." This latter phrase was widely interpreted as code for preserving some tax

preferences for mortgage interest and charitable contributions, and thus limits two potentially important ways to broaden the tax base.

Early in their deliberations, the panel decided to interpret delivering “appropriate” progressivity as not tampering with the current distribution of the tax burden. It also decided that it would only recommend tax plans that attracted consensus among panel members. This had significant implications that we discuss below.

The Nitty Gritty

The report offers two alternative reform proposals without tipping its hat toward one or the other: the Simplified Income Tax Plan (SIT) and the Growth and Investment Tax Plan (GIT). Although they differ in important ways, what captured headlines were aspects the two plans share—namely, the restructuring of deductions much loved by the middle class.

Both would replace the existing mortgage interest deduction for those who itemize with a 15 percent credit available to all taxpayers, and reduce the cap on mortgage debt eligible for tax preferences from \$1 million to about \$400,000. And both would extend the charitable deduction to all taxpayers -- not just itemizers -- but only to the extent the contributions exceed one percent of a taxpayer's income. Employer-paid health insurance premiums costing over \$11,500 for a family policy would be taxed as income to the employees. Both plans would also eliminate deductions for state and local taxes for both individuals and businesses.

These restructuring proposals, while no doubt upsetting to some beneficiaries and their political representatives, are hardly radical. The President asked for tax reform that is simple, fair, and pro-growth. And by these criteria, it is difficult to justify a subsidy to owner-occupied homes that happen to be financed by borrowing -- and even more difficult to justify the form of the current tax break, which is highest for those with the largest incomes. Likewise, equalizing the implicit subsidy for charitable giving also makes sense.

Limiting the tax preference for health insurance would give many people an incentive to make insurance purchase decisions based on the actual cost of the benefit, although critics fear it would erode our system of employer-provided insurance. Abandoning the deduction for state and local taxes is certain to touch a political nerve. Indeed, the tax preferences are defended as a way to account for the positive national spillover effects of state and local spending on education, highways and the like. However, as with the mortgage interest and charitable deduction, the form of the current subsidy makes little sense.

The fact that many tax-reform aficionados support these kinds of changes doesn't, of course, make them popular or easy to transform into law. Sen. Charles Schumer of high-tax New York called it—before the report was officially released-- a “pernicious proposal...that would slap a \$12 billion tax on New Yorkers.” Associations of realtors and home builders were upset, too, warning that the mortgage interest proposals could mean “the value of the nation's residential property could decline 15 percent or more” and labeling them as “the biggest tax hike for homeowners ever considered.”

Anticipating such attacks, panel members emphasized that the proposals be considered as a package. For example, both proposals would repeal the individual and corporate alternative minimum tax (AMT), thereby benefiting the same sort of taxpayers who would be hurt by eliminating the state and local tax deduction. The AMT, originally enacted to ensure that the rich could not use shelters to reduce their tax liability to shockingly low rates, now takes a bite out of some four million taxpayers. And, if left unchanged, it would affect over 21 million people in 2006 and 31 million in 2010.

Other panel proposals are sensible and uncontroversial. For example, both plans would replace the current hodgepodge of personal exemptions, standard deductions and child credits with a simpler system of credits, and replace the earned income tax credit and low-income child credit with a simplified work credit. The myriad tax-advantaged savings plans available – most notably, individual retirement accounts and 401(k) plans -- would be replaced by three streamlined savings plans and a savings credit for low-income workers that, combined, would allow a family of four to get tax breaks on up to \$60,000 per year in savings deposits. The infamous 1040 tax form would shrink from 75 lines to

32 lines, and the assorted worksheets, schedules, and other attachments would be trimmed from 52 to 10.

The panel report tackles another venerable tax reform topic--the taxation of corporations. Most economists believe that income derived from corporate earnings should not be taxed at a different rate than other income, as may happen under the current tax system because of tax levied first on the corporation and then on dividends and capital gains corporations generate for individuals. By the same token, the way corporations raise capital should not be distorted by the tax structure, as it is now by the fact that corporate interest payments are deductible but dividend payments aren't.

The 2003 tax cut moved in this direction by offering a tax break on personal income from corporate dividends. The panel's Simplified Income Tax proposal would go further, eliminating taxes on dividends paid out of domestic corporate earnings that are first subject to the corporate income tax, and excluding three-quarters of capital gains on the sale of stock in American corporations (but not other assets) from taxable income.

In an effort to ensure that a single level of tax is maintained, the tax preference for dividends would be limited to income on which corporate taxes have already been paid. However, the report does not properly address problems that facilitate abusive tax shelters today, and the proposal to tax only domestic income will exacerbate the incentive to use intra-company "transfer pricing" to shift income to subsidiaries in low-tax foreign jurisdictions. Note, too, that the single income tax levied at the corporation level would not differentiate by the marginal tax rate of the shareholders who get the dividends, and thus would sacrifice progressivity for simplicity.

Time for a Consumption Tax?

The elephant in the tax panel's deliberation room was whether to propose the abandonment of what is nominally an income tax (but is, in fact, an awkward hybrid) with a tax on consumption alone. This would have been the preference of many economists, both because it does not penalize savings and can be simpler to implement.

Consumption taxes come in different guises. The one most familiar to Americans is the retail sales tax, levied by 45 states and many municipalities. Most other countries levy value-added taxes (VAT), which are collected at each stage of production and distribution rather than solely from retailers. To economists, the essence of a consumption tax is that no tax is levied on normal returns to saving. Put this way, what might otherwise seem like a radical change does not seem so radical, given the fact that the myriad preferences for saving and investment in the current law already reduce the effective tax rate on capital to about 15 percent.

Moving to a consumption tax could have radical consequences for the distribution of after-tax income, but this would depend on the tax rate structure and how the transition is handled. The panel report spends much ink on the virtuous cycle that moving to a consumption tax could trigger: lower taxes on saving and investment, they argue, would increase capital accumulation, which would increase productivity growth, which would be reflected in higher wages. The report also outlines the standard arguments of proponents that a consumption tax is fairer (because it does not discriminate against savers) and simpler (because income is inherently more difficult to measure and, therefore, to tax efficiently and equitably).

The panel rejected a retail sales tax as a replacement for the income tax on the grounds that it would generate a more regressive distribution of the tax burden and, most compellingly, would cause insuperable administrative difficulties if levied at the historically unprecedented rates (probably over 30 percent) needed to replace all income tax revenues.

A working group outlined a proposal for a VAT (under which all businesses would pay tax on the difference between their sales receipts and the cost of their inputs purchased from other businesses) that would be levied as a supplement to a version of the SIT with lower rates. But the panel ended up rejecting the VAT on the grounds that it would operate as a “hidden” tax, encouraging policymakers to raise rates because taxpayers would not notice the burden. As Grover Norquist, the anti-tax lobbyist, has put it, “VAT... is French for ‘big government’.”

In fact, a VAT need be no more hidden than a sales tax since retailers could be compelled by law to post the rate. The greater (but often unspoken) fear of many conservatives is that a VAT would be too efficient a revenue-raiser, lowering not only the perceived cost of government but the actual cost of government. This is an awkward argument to embrace for a panel charged with making the tax system simpler and more efficient.

The panel also flirted with a variant of the flat tax first proposed by Robert Hall of Stanford University and Alvin Rabushka of the Hoover Institution and championed by sometime presidential candidate Steve Forbes. This tax looks much like the current income tax, in that it levies separate taxes on individuals and businesses. In fact, it is a value-added tax with one critical change. With a VAT, businesses cannot deduct payments to their workers in calculating tax liability; with a flat tax, businesses can deduct these costs, but workers owe tax at the same rate on their wages and salaries.

A moment of reflection should be enough to convince you that moving wages and salaries from the business tax base to the individual tax base at the same rate is of no long-term consequence. It would, though, mean that employees would have to file tax returns, adding to compliance costs.

On the plus side, this difference would make it much easier to fine-tune a progressive distribution of the tax burden. In the original Hall-Rabushka proposal, progressivity is achieved through deductions adjusted for family size, so that no personal tax is due unless labor income reaches a certain level. Further progressivity could be introduced simply by having graduated tax rates on wages and salaries – an approach championed by the late Princeton University economist David Bradford, which he dubbed the “X Tax.”

The panel’s alternative plan, the Growth and Investment Tax proposal, is a somewhat ungainly cousin to the X Tax. Like the X Tax (and the flat tax), the GIT would allow all businesses to deduct plant and equipment costs in the year the cost is incurred. And like the X Tax, the GIT would not permit businesses to deduct interest payments from taxable income. Unlike the X Tax, but consistent with the charge to the panel, the GIT would

feature the tax credit for mortgage interest, the deduction for charitable contributions, and some other preferences.

While keeping the base from being as clean as it could be, these features would not eviscerate the essence of a consumption tax. What would muck up the GIT is that dividends, interest and capital gains would be taxed at a 15 percent flat rate. To be a true X-Tax style of consumption tax, there must be no personal tax on capital income at all.

Accordingly, the panel calls the GIT a “blended” system. But it is, in fact, an awkward hybrid. Although some panel members clearly favored a true consumption tax with no personal tax due on capital income, others were concerned about the apparent unfairness of subjecting wages to personal taxes while excluding dividends, interest and capital gains. A true consumption tax proposal was thus sacrificed to the panel’s self-imposed need for consensus.

This is unfortunate in that it obscures the most fundamental choice about tax structure— income tax versus consumption tax. On the other hand, if the opposing panel members’ instincts reflect the public’s view, proposing a pure consumption tax would have been a waste of time. The fact that both of the panel’s proposals are hybrids—an income tax framework with generous tax-preferred savings accounts that would eliminate taxes on the savings of most Americans, and a consumption tax framework with tax on capital income flows at the personal level—suggests that “pure” tax systems are not politically viable.

The Fine Print

Both proposals include scores of less-noticed but potentially important changes to the tax system. For example, the SIT would eliminate taxes on income from foreign direct investment. And the GIT would implement “border adjustability,” under which export revenues would not be taxed and payments for imports would not be deductible – and thereby putting U.S. tax law at loggerheads with its obligations under World Trade Organization rules.

The SIT would divide all businesses into three categories based on sales, with different rules for each. For example, the smallest (sales of less than \$1 million) would be able to treat all capital outlays as expenses, while the largest (sales greater than \$10 million) would be subject to the corporate tax regardless of whether they were legally organized as corporations, partnerships, or other forms. Under the GIT, all businesses other than sole proprietorships would face a flat 30 percent rate; today, by contrast, the income of non-corporate entities is generally considered part of individual income, and thus is taxed at a rate lower than 30 percent for all but high-income business owners. Small businesses would be required to keep business bank and credit accounts, summaries of which would be reported to the IRS.

What to Make of the Reform Plans

How do the panel's proposals stack up against their own stated own criteria of making the tax system simpler, fairer, and more pro-growth?

Chairman Mack said the leaner tax form could cut the annual cost of compliance from \$140 billion to \$40 billion, but that seems an exceedingly generous estimate. The report claims that most simplification would occur on the business side, and certainly small businesses would benefit from a tax accounting system that is similar to their regular bookkeeping regimes. Moreover, the rationalization of the deductions, credits, saving and education preferences is long overdue. The shorter Form 1040 would thus surely be a plus. But many of the provisions eliminated in the plans to cut down the number of lines and worksheets currently affect a very small portion of the population—for example, the District of Columbia First-Time Homebuyer credit.

Other provisions would actually add to compliance costs – among them, extension of the credit for mortgage interest and the deduction for charitable contributions to the two-thirds of taxpayers who now do not itemize, and a new requirement that non-profit organizations report donations of over \$600. Some new provisions, such as the gradual phase-out of the mortgage interest deductions and depreciation allowances, would be complicated. And the panel admits it did not flesh out ways to implement some

proposals, such as how to tax financial institutions under a tax system (the GIT) that, in principle, would exempt all financial flows from the tax base.

Are the proposals pro-growth, or at least good for the economy? The report refers to computer simulation exercises suggesting that over two decades the GIT would raise GDP by about four percent, and the SIT by about one percent. But these figures come from unrealistically (although necessarily) simplified models of the American economy, and thus should be taken with a grain of salt. It's fair to say, though, that most economists agree that moving to a consumption tax would provide a modest but significant boost to growth.

Note, too, that the simulations do not account for the reality that reducing the arbitrary tax preferences for particular goods and services and particular modes of production would increase efficiency -- and thus national income. In this context, eliminating the tax preference for debt financing and capping deductible health benefits would be positive developments. So is the prospect of cleaning up the myriad special tax breaks for this and that industry, thereby expanding the tax base sufficiently to allow a substantial reduction in the corporate tax rate.

With regard to fairness, the panel decided early on that Congress should decide the distribution of the tax burden and thus designed its proposals so that, by income group, people would “pretty much” pay the same amount as they do now. Whether that makes the distribution “appropriately” progressive is partly a value judgment. Indeed, one panel member remarked at a public hearing that the current tax system is not sufficiently progressive, implying that the proposals of the panel are not sufficiently progressive, either. Horizontal equity—the degree to which those with similar means face similar tax burdens—would probably be improved by the elimination of some tax breaks that are worth a lot to some taxpayers and very little to others.

Another important criterion for evaluating a tax system—whether it raises sufficient revenue—was absent from the panel's charge. Indeed, the panel was required to come up with plans that had no net impact on revenues. Whether the proposals are, in fact,

revenue-neutral is unclear, given that the baseline against which revenue neutrality is evaluated assumes that all the President's tax-cutting budget proposals become law—lowering the target-- and that the widely unpopular AMT is not fixed—raising the target. All in all, matching current-law revenues might well require somewhat higher rates than the report suggests.

More important, by ruling out revenue increases, the tax panel proposals duck the question of who will pay later for what we are spending now. Nor does the report address the fact that budget deficits result in lower national saving, and thus reducing the deficit is arguably a more effective way to boost saving than what the tax plans do--reducing taxes on saving and investment.

What's Next?

One panel member remarked that he wasn't losing any sleep worrying they were "writing tax law." Indeed. The attractions of AMT repeal, slightly lower rates, and fewer tax forms will surely not be strong enough to lure Congress away from tax-breaks-as-usual. Yes, the self-employed are frustrated with their tax burden, and yes, nearly two-thirds of taxpayers feel the need to hire a professional to prepare their returns. But a sizeable portion of taxpayers would be outraged by the loss of mortgage interest deductions, college tuition credits, etc. And many probably fear that, a few years after their tax breaks are axed in the name of broadening the base, tax rates would rise again. Asking Americans to support tax reform could thus be like asking teenagers to eat plenty of green vegetables – pain is hard to sell without the prospect of immediate gain.

Nor has the Bush administration prepared the American people for any kind of fiscal sacrifice. What other president has pushed through big tax cuts in the face of a costly war and record spending for everything from hurricane relief to Alaskan bridges to nowhere? This is important because history suggests that a necessary, though not sufficient, condition for a blue-ribbon commission's political success is a high level of prior presidential interest in the subject. Tax reform inevitably produces losers as well as

winners, and the losers screech louder than the winners crow. Thus proposals that aren't buttressed by considerable political capital from the White House aren't likely to go far. Nor does the record of the country's last tax reform effort offer much reason for optimism. In the Tax Reform Act of 1986, radically lower individual tax rates (from 50 to 28 percent at the top) facilitated by a shift to corporate taxes, made giving up some deductions and other breaks an easier sell. Even so, the effort never would have succeeded without the full commitment of President Reagan and a bipartisan Congressional coalition.

What's more, it is far from clear that the public perceived any benefit from these Herculean efforts. Four years after the reform, only 9 percent of taxpayers said the change had made for a fairer distribution of the tax load, while 37 percent said reform made the burden less fair and about half said that simplification made little difference. The politician most associated with the tax reform movement of the 1980's, Finance Committee member Bill Bradley, faced a fierce reelection challenge in 1990 and barely made it back. Senator Finance Committee chair Robert Packwood, who shepherded tax reform through the Senate, downplayed this role in his own successful reelection campaign.

In the view of Senate Finance Committee Chairman Chuck Grassley, the President "has the greatest bully pulpit in the country. He can do more to build a national consensus on tax reform than anyone else." The 2006 State of the Union address would be the natural moment for President Bush to make such a commitment, if he were so inclined. If he does not, we may recall the words of Senator Edward Kennedy, who once said "it seems as though most Presidential commissions are merely so many Jiminy Crickets chirping in the ears of deaf Presidents, deaf officials, deaf Congressmen, and, perhaps, a deaf public."

One prospect worse than inaction would be to peel off the most likeable provisions in the report, further adding to the deficit and even degrading the efficiency of the current tax system. The report criticizes one such scenario, in which businesses are allowed to write off investments immediately, but can still deduct interest payments. This combination,

which has been touted by some influential Washington insiders, is consistent with neither an income tax nor a consumption tax, and would open new tax shelter opportunities.

Such an outcome could hardly be blamed on the tax panel, though. Indeed, the panel should be commended for many of its innovative proposals and for its generally frank discussion of the pros and cons of its proposals. It treats the American public like grown-ups with its recognition of the tradeoffs that must be made in the design of tax policy: a simpler tax system may mean settling for rougher justice; a progressive tax system may sacrifice some growth, and so on. It rejects supply-siders' demands for "dynamic scoring" of the revenue impacts of tax changes, which would obscure the true fiscal consequences with excessively rosy assumptions about the proposals' impact on economic growth.

The best that can be hoped for is that the proposals will focus attention on both the need for tax reform and the inherent tensions between tax equity, efficiency and simplicity. As panel member and former Congressman Bill Frenzel remarked at the last panel's last meeting, "We don't have to achieve nirvana right now. What we need to do is set a direction so that over the years, America can keep improving its tax system. And I think we're on the way to doing that."

We like to believe he's right.