GOOD IDEAS — AND BAD ONES — FROM THE PRESIDENT'S ADVISORY PANEL ON TAX REFORM*

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IN NOVEMBER, 2005, THE PRESIDENT'S ADVISORY Panel on Tax Reform released its plan for tax reform. The report presented two proposals: an income tax reform, and a consumption tax reform. While no immediate action arose from the report of the President's Advisory Panel on Tax Reform, there are many aspects of the recommendations that might be considered in future reforms. Other recommendations, upon consideration, may be seen as less than desirable.

Two fundamental problems/observations occur in examining the proposal as a whole. First, the plan lacks detail in many areas that will be, at the minimum, politically charged issues and whose solutions may undermine some basic parts of the proposal. Among these omissions include not addressing minor, yet important, itemized deductions, such as medical expenses and casualty losses. The plan to abandon itemized deductions (by eliminating taxes and extending charitable deductions and mortgage interest credits to all taxpayers) would leave these deductions in limbo. There are other above-the-line deductions (such as moving expenses and alimony) that are not addressed. Another problem was the failure to recognize the full scope of transition losses with the consumption tax proposal.

Second, although related to the first issue, the plan seemed to make proposals that were major changes but were revenue losers of questionable merit, which made it much harder to craft a revenue neutral proposal.

For both of these reasons there are some cases where one might argue that only part of a feature has merit — where cherry-picking is a good idea.

The remainder of this comment is divided into ideas to consider in future reforms, which constitutes the bulk of this discussion, followed by proposals that are uncertain, and negative aspects. As noted towards the end of the report, the possibilities of adopting a consumption tax seem remote, so that the discussion largely relates to the income tax alternative.

*The views in this paper do not represent the views of the Congressional Research Service.

IDEAS TO CONSIDER IN FUTURE REFORMS

There are a number of individual tax changes that could be included in future tax reform efforts. One of them is a revenue loser, but the others would be base-broadening revenue changes.

PROVISIONS LOSING REVENUE: REPEAL OF THE AMT

The revenue loser is the proposal to repeal not only the individual alternative minimum tax (AMT), but also the corporate AMT. There is no question that the individual AMT, because it is not indexed, has grown into a serious problem, affecting many taxpayers who, although they have high incomes, are certainly not the original wealthy targets of the AMT. The reach of the AMT could be fixed with a permanent patch. But there is a question of whether the current AMT makes any sort of policy sense. Ironically, the major target for the original individual AMT, capital gains preferences, is no longer included in the AMT base, and the highest income taxpayers are also not included. When capital gains were taxed as ordinary income in 1986, the effects on high-income taxpayers were dramatically reduced. The lower capital gains tax rates enacted in 1997 and 2003 (in the latter case for dividends as well) were also allowed under the AMT. Without this preference, most high-income individuals pay the regular tax. The individual AMT no longer serves its original purpose and, short of reintroducing the capital gains preference, there seems little point to it.

What has been ignored in the discussion of the individual AMT is the corporate AMT. The corporate AMT has become much less important over time because most of the items are timing differences that tend to fade away. In addition, tax lives (but not methods) were conformed between the regular tax and the AMT in 1997, and small corporations were exempted. There was a proposal to eliminate the corporate AMT at the end of 2001, but that approach failed, in part because the purpose of the legislation was an investment stimulus and the repeal of the corporate AMT was probably not an effective stimulus. Nevertheless, the corporate AMT suffers from the same general problem of the individual AMT, in that it would be more appropriate to address tax preferences directly. Moreover, to maintain an AMT for corporations and not for unincorporated business and small corporations is not very defensible as a matter of tax policy.

The corporate AMT also, however, is somewhat more complicated to eliminate, because most of the preferences involve timing. For this reason, AMT in excess of regular tax could be credited in the future if regular taxes were above the AMT; otherwise asset depreciation could effectively be less than or more than cost. One detail in any tax reform, not addressed by the Advisory Panel's proposals was whether and how quickly those AMT credits were to be recovered.

PROVISIONS TO GAIN REVENUE

Limiting Itemized Deductions

The proposal eliminates itemized deductions as such. Of the three major existing itemized deductions, it repeals state and local taxes, converts the mortgage interest deduction into a capped credit, and extends charitable contributions to non-itemizers with a floor.

While some aspects of the plan have merit, the elimination of itemized deductions does not seem a desirable option. No one is denied itemized deductions; rather there is an option for a standard deduction that is better. Itemized deductions as an alternative to the standard deduction therefore contribute an important element of simplification for taxpayers. Extending the mortgage interest benefit to non-itemizers adds to economic distortions in favoring home purchase and complicates tax returns and, while converting it to a credit may have some merit, it was a battle that did not need to be fought. Similarly, while subsidizing charitable contributions may or may not be a good idea, the vast majority of charitable contributions are concentrated among higher income individuals who would continue to itemize in any case. Finally, it seems unlikely that a practical plan could dispense with some of the other itemized deductions not mentioned: excessive medical expenses and catastrophic losses. Again, itemized deductions as an alternative to the standard deduction permits taxpayers to recover these extraordinary costs and losses without complicating the tax returns of most individuals with minor costs.

If state and local tax deductions are eliminated, which is likely to be a desirable, although politically difficult, move, many fewer taxpayers will itemize in any case. (Gravelle and Gravelle, 2007, however, make the case that the restriction should also extend to corporate deductions for state income taxes). But for a more modest reform, the use of floors and ceilings could improve the tax system. Floors contribute to simplifying the system and are appropriate when marginal incentives are desirable or when relief from extraordinary costs is desired (as is the case for medical expenses and casualty losses). The charitable contribution deduction also lends itself to application of a floor because it eliminates the need for many people to keep track of small contributions, probably helps improve compliance, and yet preserves the incentive effect for the vase majority of contributions. A percentage of income floor could also be seen as a signal for what society regards as a minimum level of giving. Similarly, a ceiling is appropriate for the mortgage interest deduction (a larger one already exists), although the complexity of location-specific ceilings seems to make that aspect questionable. Moreover, it is curious that, given the general cost-of-living effects that cause tax burdens to vary by location, this one aspect should be singled out for a differential.

Other provisions

The plan also proposes a ceiling on employer's health insurance deductions, but also expands the deduction for those not covered by an employer plan. Capping health insurance deductions could prevent excessive use of the tax benefit and encourage coverage with higher deductibles and co-pays, which could improve the health insurance market. Adding a deduction for those not covered by an employer plan would probably miss those in need most and undermine employer plans that are the best solution we have, short of national health insurance, for dealing with adverse selection.

Another fringe benefit issue that may be considered in future reforms is to require the default in employer savings plans to be participation rather than non-participation, and to require growth in contributions over time. Evidence suggests that behavior is affected by default rules and such an approach could encourage additional savings.

The proposal to eliminate the tuition tax credit and the plethora of special education savings plans also seems desirable as a simplification move. The weakness of the tuition credit is not so much that such general tuition assistance is not desirable, but rather that it should be handled through a grant program. If such a grant program is not to be provided as a substitution, there is a case for retaining the credit and making it refundable. The case for preserving special education savings plans, which largely benefit higher income families, remains weak even in the absence of a spending alternative.

Of the business tax reforms, one that might be partially considered relates to the treatment of income invested abroad. The Panel elected a territorial system for active investments (with current taxation of passive ones), but disallowed the portion of parent company deductions associated with this exempt income. Yet, economic theory generally suggests that a worldwide system of taxation would be more economically efficient. An alternative option that should raise revenue and improve economic efficiency would be to apply this allocation of deductions in the current system as long as income is not repatriated. Such a proposal was included in Ways and Means Committee Chairman Rangel's tax reform proposal (H.R. 3970, introduced in 2007).

Other Positive Contributions of the Proposal

Although not a specific proposal for consideration, the rejection in the report of the Fair Tax (National Retail Sales Tax) and Value Added Tax, or VAT was a useful contribution to the debate. My own view is that any true consumption tax proposal is not feasible because of transition problems, but the one that is most likely to be feasible is the flat tax, which is essentially a VAT with the wage portion taxed at the individual level. (The Panel's proposal is actually an X-tax with the wage portion subject to graduated rates). Even in this case, the transition problems are virtually overwhelming but, unlike the Fair Tax and the VAT, this approach does not create the major macroeconomic adjustment problems that arise from shifting the source of tax collection to businesses, who will not be able to pay the tax in many cases unless prices rise or wages and other costs fall — in a word, inviting both inflation and recession.

The Panel actually deemed the macroeconomic transition effects as secondary, but they did acknowledge them. Other issues, such as distributional concerns and, in the case of the Fair Tax, administrative concerns are also important barriers to adoption of these taxes.

UNCERTAIN REFORMS

Several of the proposals in the Panel's plan may merit discussion but may not necessarily be desirable. For example, converting pension plans to Roth-type plans, where tax exemption is conferred by exempting earnings but there is no up-front deduction on contribution or tax on withdrawal, has one important advantage: the assets in the plan are available on retirement without additional taxes. My concern is that individuals, when considering the size of their pension assets or income, do not account for the tax due and may not save enough. Converting to Roth IRAs is, however, something of a budget scam, raising revenue in the short run and losing it in the long run. Because of the Roth proposals the plan is not revenue neutral.

A second proposal that may merit consideration but is uncertain is to allow cash accounting for small businesses. Such a proposal adds to the favorable (and distorting) benefits for small business, but it also involves some significant administrative and simplification benefits.

The proposal to allow simplified depreciation (with mass accounts so individual tracking of property is not necessary) would be an improvement, but it would be at the cost of changing the depreciation system again and complicating affairs for some period of time. It is not clear that the benefits are worth the costs.

NEGATIVE ASPECTS

As noted above, it is probably not a good idea to eliminate itemized deductions and probably not possible. This problem is symptomatic of a general problem in the proposal: the lack of attention to small detailed items that nevertheless are likely to be retained in any tax reform. It is unlikely that our tax system will discard deductions for excessive medical costs or casualty losses. In a related vein, there is not enough attention to details that will be problematic, such as the tax treatment of alimony and the deduction of moving expenses.

Finally, I think it would be better to spend revenues lowering marginal rates (corporate and individual) instead of in expanded, but restricted savings accounts that are sometimes infra marginal and which are complicated. In addition, under the income tax plan with dividends and capital gains essentially exempt, these plans will largely favor interest income. Since debt financed investment is already excessively tax-favored and probably subject to negative tax rates in many cases, this approach is an inefficient one. Of course, it is likely that the entire package of savings accounts raises revenue from the shift to a Roth plan, even with expanded accounts, so that eliminating both would not really yield any additional revenue, but making the revenue consequences more transparent would be desirable on its own.

Most of this discussion is of the income tax proposal, because there are such barriers to consumption tax shifts. There are two serious problems with the consumption tax proposal and the exploration of it. The first is that the study does not fully deal with transitional issues. Although it proposes some transition relief for depreciable assets, the transition problem with inventories is not addressed at all. Yet with more than $1 trillion in inventories, this is probably the most serious transition problem of all. Secondly, the distributional analysis treats the consumption tax proposal in the same manner as an income tax (allocating the business portion to capital income and the wage portion to labor), rather than assigning it to consumption (as they have done for the Fair Tax and the VAT). There is no perfect rule in this case, but the incidence of a consumption tax is quite different from that of an income tax, and the distributional consequences dramatically different (Burman, Gravelle, and Rohaly, 2006).

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