THE RECOMMENDATIONS OF THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM: A TWO-YEAR RETROSPECTIVE*

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THE PRESIDENT'S ADVISORY PANEL ON FEDERAL Tax Reform delivered its report to the Secretary of the Treasury in November 2005. The panel offered two sets of broad recommendations designed to improve the efficiency of tax collection, simplify the tax code, preserve the distribution of tax burdens across income classes, and promote economic growth. The Simplified Income Tax (SIT) is a modified version of the current income tax structure, while the Growth and Investment Tax (GIT) is a consumption tax – income tax hybrid that combines a household-level tax on capital income with a cash-flow type tax on business enterprises.

Each of the plans was presented as an integrated whole, but the panel recognized from the outset that the political process and the associated public policy debate would create strong pressures to "cherry pick." In discussing the proposals, the panel members emphasized the dangers of selective adoption of individual provisions. The GIT, for example, proposed expensing of new capital outlays. Panel members tried to link adopting the expensing provisions with repealing the deductibility of business interest payments, and underscored that adopting the former without the latter would generate negative effective tax rates on new investment. Just as positive effective tax rates discourage investment and result in an inefficiently small capital stock, negative effective tax rates lead to over-investment and corresponding distortions.

A number of the specific proposals that were incorporated in the SIT and the GIT could, in contrast to the expensing recommendation, be part of an incremental initiative to reform the income tax system. While the benefits from adopting a unified plan are likely to be substantially greater than the benefits of piecemeal adoption, there are some attractive components of the two reform proposals that bear careful scrutiny. This short paper begins with a brief discussion of why the Panel's proposals received so little political attention, moves on to discuss specific reforms that would be attractive even as stand-alone policy changes, and concludes with a plea for more tax policy researchers to think about operational issues associated with tax reform proposals.

WHY SO LITTLE ATTENTION?

Neither the SIT nor the GIT has received much policy attention in the two years since the Panel reported. In part, this may reflect the demands of other policy priorities which have claimed the attention of Congress and the president. In part, however, some of the responsibility rests with the nature of the Panel's recommendations. Permanent repeal of the Alternative Minimum Tax (AMT) is a centerpiece of both the SIT and the GIT proposals. Such repeal creates a substantial revenue deficit over the 10-year budget window. To fill this deficit and make both the SIT and the GIT revenue neutral, the Panel therefore embraced a wide range of base-broadening, revenue-raising tax provisions. The least popular components of the two reform proposals, including tighter limits on the deductibility of home mortgage interest, a cap on the value of employer-provided health insurance that could be excluded from taxable income, and the elimination of the deduction for state and local income and property taxes, are examples of such policies.

Developing popular support for revenue-neutral fundamental tax reform is never easy. Doing so for the Panel's recommendations proved particularly difficult because the taxpaying public had never faced the full impact of the AMT. Yearly "patches" to the tax code, raising the income thresholds at which the AMT would affect taxpayers, had reduced both the revenue yield of the AMT and the number of taxpayers affected by it. In 2005, when the Panel released its report, approximately four million taxpayers faced the AMT. If Congress had not enacted an AMT patch, there would have been more than twenty million additional AMT filers. Yet most prospective AMT filers, who the

*I am grateful to Rosanne Altshuler for helpful comments

Panel recommendations were designed to rescue from the snares of the AMT, were unaware of their predicament. These taxpayers were not excited by the prospect of AMT relief, but when they learned that their current mortgage interest deduction might be limited or that their employer-provided health insurance might be taxed, they reacted in a very negative way. This fundamental tension between future benefits and current costs probably doomed the Panel's recommendations to political failure from the outset.

The problem of front-loaded pain and back-loaded benefits was compounded by another feature of the AMT. Under the Panel's baseline assumption that the 2001 tax cuts would be made permanent after their current expiration dates, AMT revenues as a share of GDP rise over time. The Panel labored to make both the SIT and the GIT revenue neutral over a 10-year budget window, but it did not impose year-by-year revenue neutrality. The revenue under both the SIT and the GIT was consequently front-loaded relative to current law. The higher taxes associated with base-broadening provisions, such as the limit on the mortgage interest deduction, would be faced immediately under both the SIT and the GIT, while the pain of the AMT under the current system would not appear for several additional years. This meant that taxpayers faced certain immediate pain in the form of higher taxes, and uncertain future benefits that depend on future AMT status. This pocketbook calculation seems to have dominated any discussion of the potentially favorable effect on either the SIT or the GIT on tax simplification, or the favorable long-term economic growth that simulation models predicted for both plans.

PROMISING DIRECTIONS FOR INCREMENTAL REFORM

The next two years will raise interesting possibilities for tax reform. The scheduled expiration of the 2001 tax cuts, the continuing need to find a way to reduce the scope of the AMT, and long-term fiscal pressures associated with growing entitlement program burdens will generate a constant discussion of tax policy options. Even if fundamental tax reform does not receive active discussion, there is likely to be a drumbeat of interest in incremental tax reform. Once the current round of stimulus is passed, the emphasis on PAYGO rules in Congressional budgeting will place a premium on finding ways to raise revenue with minimal distortion. The tax policy community should always be attentive to policy changes that could enhance the efficiency of the tax code with little or no revenue loss. A number of the components of the SIT and the GIT deserve consideration in the context of such incremental reform discussions.

Limiting the Exclusion of Employer-Provided Health Insurance

The Panel proposed capping the amount of employer-provided health insurance that is excluded from the individual income tax base. Standard price theory suggests that the current exclusion of the value of such insurance from the definition of taxable income encourages insurance purchases, particularly among households in the highest income tax brackets for whom the exclusion is most valuable. The current tax treatment leads to more aggregate spending on health insurance, and more spending on health care than one would expect if purchases of health insurance were not tax-favored. Capping the exclusion, perhaps in tandem with a gradual phase-down in the cap amount, would be an important step toward reducing the tax-induced distortion in the health insurance market.

There are two important uncertainties associated with reform of the tax treatment of employer-provided health insurance. One is whether taxing employer-provided insurance would affect the growth rate or just the level of health care spending. The links between insurance coverage and the rate of medical innovation, which appears to be an important driver of long-term cost growth, are unclear. The second uncertainty concerns how the reduction in health insurance spending would be divided between purchases of less generous policies by those who would retain insurance and changes in the number of households with insurance coverage. The elasticity on the intensive margin, the generosity of policies, is likely to be greater than the elasticity on the extensive (coverage) margin. Nevertheless, one concern with any step that pares back the favorable tax treatment of employer-provided health insurance is that it will result in a larger number of uninsured households. One approach to preserving incentives for lower-income households to retain their insurance coverage would be to tax the value of employer-provided insurance at the difference between a taxpayer's marginal income tax rate and a base exclusion rate, perhaps the lowest income tax bracket rate. If the base rate was 10 percent, for example, a taxpayer in the 10 percent income tax bracket would not face any income tax liability on employer-provided health insurance, while a taxpayer in the 25 percent bracket would be taxed at 15 percent on the value of this insurance.

Simplifying Saving Incentives

The Panel recommended substantial simplification of the current structure of tax-deferred saving incentives. These programs move the current tax system away from a classical income tax and toward a hybrid between an income tax and an expenditure tax, since they provide many households with the opportunity to earn the pretax return on their saving as they would in an expenditure tax environment.

There are currently four major retirement saving vehicles available to broad segments of the taxpaying population: traditional and Roth Individual Retirement Accounts (IRAs), and traditional and Roth 401(k) plans. Access to IRAs is universal, although income limits preclude deductible contributions by households with incomes above certain thresholds. An individual taxpayer's access to regular and Roth 401(k) plans depends on whether her employer offers these retirement saving plans. Coverage is very high at large employers, but it remains modest at smaller firms.

The principal difference between traditional and Roth saving programs is the timing of the tax payments on contributions to these accounts. In traditional accounts, the taxpayer receives a tax deduction when funds are contributed to these accounts, but is fully taxable on withdrawals. This is the so-called "exempt – exempt – taxable" model for tax-deferred saving. With the Roth variants, contributions are made from after-tax dollars, but withdrawals are untaxed. This is the "taxable – exempt – exempt" structure. In both the Roth and traditional structures, the "inside build up," the return on assets held in the account, is untaxed. The textbook equivalence of traditional and Roth accounts depends on a constant path of marginal tax rates. When tax rates are lower at the point of contribution than at the time of withdrawal, Roth accounts dominate traditional ones, and vice versa.

In addition to the four major vehicles for tax-deferred accumulation, many taxpayers currently save through a variety of other accounts that permit accumulation at pretax rates. These include 403(b) plans, 457 plans, Keogh plans, Education Saving Accounts, and Health Saving Accounts. For many households the combination of these various accounts permits most of their long-term wealth accumulation to take place in an expenditure tax environment. However, the complex patchwork of different programs makes it difficult for taxpayers to track their accumulating wealth, and there is a substantial risk that confusion and complexity may discourage participation in some of these programs. The Panel recommended consolidating these plans into three simple structures – Save at Work, Save for Family, and Save for Retirement. A strong case could be made for even further simplification. The Panel's goal was to replace a balkanized structure of incentives with a simpler structure that would be easier for taxpayers to understand and that would be potentially more effective in encouraging saving. This could be done in a number of ways – the suggestions offered by the Panel provide one way to move forward.

The current proliferation of saving incentive programs is supported by a set of varied constituencies that either benefit from specific programs, or that are particularly suited to delivering the financial services needed by participants in each market niche. Moving toward a cleaner hybrid structure that brings together elements of an income and an expenditure tax requires transcending these narrow group interests and focusing on the long-term goal of eliminating the tax distortions associated with saving and investment.

Recognizing Geographical Differences in Taxable Capacity

The cost of living differs substantially across states and localities. House prices, the cost of medical care, and other costs vary – yet the tax system largely ignores these differences. The Panel proposed explicitly linking the level of some deductions to the location-specific costs facing a taxpayer. Both the SIT and the GIT indexed limits on the mortgage interest deduction to regional house price levels, subject to both minimum and maximum constraints. Just as many employers who recruit employees to communities with high house prices provide some additional compensation to offset these costs, the tax code could recognize that the real purchasing power of a given nominal income differs across places. The tax code today generally ignores local economic conditions. One exception to this rule is the schedule of place-specific cost-of-living allowances for individuals who are working away from home.

The suggestion that the tax code might recognize place-specific costs of living represents a more substantial break with traditional tax reform proposals than many of the Panel's other suggestions. This set of proposals warrants discussion, but the Panel recognized that there are both benefits and costs to more explicit geographical indexing of the tax system. The primary benefit is that by recognizing cost-of-living differences the tax system would come closer to placing similar tax burdens on taxpayers with comparable taxable capacity. At present, a high-income earner who lives in a high cost location faces the same progressive rate structure, with break points at the same nominal income thresholds, as a taxpayer with the same nominal income but a much higher real income as a result of living in a lower cost area. Adjusting the tax system for place of residence would address this inequity.

At the same time, however, making the tax system location-specific would create potentially powerful incentives for taxpayers to establish tax homes in high-cost areas, thereby allowing them to claim larger deductions and to reduce their tax liability. There would be new demand for the IRS to police location abuses. The Panel's proposal to allow location-specific deductions for mortgage interest did not encounter this problem, since mortgage interest is tied to a particular property so the problem of assigning a place of residence does not arise. Linking the level of other deductions to a place of residence might be more problematic.

Tax Expenditures

One of the two proposals, the SIT, recommended restructuring many current tax deductions as credits. This would eliminate the current pattern in which a high-income taxpayer in a high marginal tax bracket receives a larger proportional subsidy than a more modest income taxpayer. Moreover, under the current system those who do not itemize receive no subsidy at all – which raises further equity issues, and implies another source of disparity in the price effects of the tax code for different taxpayers. One can imagine a case for differentiating subsidy rates if the elasticity of taxpayer behavior varies by income or covaries with other observable attributes that are related to marginal tax rates. The Panel retained a deduction for charitable giving on the grounds that the elasticity of giving with respect to the after-tax price may be greater for high- than for low-income households, but it did not find a similar justification for other deductions. Even in this case, the empirical evidence is more likely to be suggestive than compelling.

Replacing deductions with credits seems likely to receive substantial discussion if and when policy makers search for higher revenues. The credits preserve tax incentives to encourage activities that historically have been deemed worthy of subsidy, but do so at rates below those in the current system. It may also make sense to consider deduction floors, which deny deductions for expenditures up to a certain amount but make outlays above such levels deductible or eligible for a credit.

The choice between credits and deductions opens a more general discussion of tax expenditures. Because existing tax expenditures have identifiable and often vocal beneficiaries, any proposal to trim or eliminate a current tax expenditure provision is greeted with immediate opposition. Yet there is often very limited evidence on the efficacy of these provisions in achieving their stated objectives. The various tax expenditures for owner-occupied housing illustrate this point. While reducing the user cost of owner-occupied housing is likely to increase the share of households who chose to own rather than rent, many current tax provisions are likely to affect the quantity margin, the amount of house consumers choose to purchase conditional on owning, rather than the tenure choice margin of whether to rent or to own.

Subject to the constraints imposed by its charge, the Panel attempted to start fresh with respect to tax expenditures. It adopted the presumption that such provisions should be eliminated unless there was strong evidence to warrant continuation. In this way the Panel's approach tried to follow in the tradition of the Tax Reform Act of 1986, and to adopt a broad-based approach to tax expenditure reduction rather than a focused elimination of particular provisions. Even without such general reform, it would be constructive to develop a more systematic review process for tax expenditures.

Business Tax Reform

Both the SIT and the GIT were designed to reduce distortions created by the taxation of corporate capital income. The SIT proposed a form of corporate tax integration, reducing the difference between the combined investor and corporate tax on dividends and interest payments. The GIT adopted a more sweeping approach, moving toward cash-flow taxation of corporations. Expensing for all new capital outlays, which is a core ingredient of the cash-flow approach, provides neutrality across investments in different asset types. Incremental reform could constructively embrace improving neutrality across either forms of finance or different asset categories. There are a range of possible reforms within the corporate income tax structure. As noted earlier, however, selectively implementing some of the business taxation proposals, such as adopting expensing without limiting interest deductions, could introduce new sources of inefficiency to the tax system.

THE TRANSITION PROBLEM

One issue that emerged as central in the Panel's discussions, but was not addressed with much specificity in its final report, concerned the transition from the existing tax regime to a modified system. Transition considerations can have a potentially dramatic influence not only on the distributional effects of a tax reform but also on its ultimate efficiency effects. The Panel recognized that changing the tax treatment of capital expenditures, particularly with an expensing proposal like that in the GIT, would trigger a host of revaluations in the markets for capital goods. Its discussions were also informed by recent research that highlights the importance of transition relief in determining the long-run impact of tax reform on economic growth. Yet the Panel did not offer specific recommendations with regard to transition relief. Instead, it included provision for a "transition relief fund" in its revenue estimates of the GIT, and left the details to the political process.

Some might criticize this decision, with some merit, as having sidestepped one of the most fundamental issues in tax reform. However, there is remarkably little in the scholarly literature to guide policy makers in designing transition relief. Economists are tempted to distill all transition relief into summary measures such as the net financial effects on taxpayers in different circumstances. That approach neglects concerns such as perceived fairness that may be viewed as important in the actual design of relief provisions. It is also very difficult to completely summarize the economic effects of a tax reform, particularly when asset values may be affected by the legislation. This makes it difficult to offer ex ante recommendations with regard to the specific amount of transition relief that should be provided to taxpayers in various circumstances.

Even if the Panel had devoted more attention to the design of transition relief, it would have had little chance of altering the political fate of its recommendations. The timing mismatch between pain and gain in the reform proposals, and the resulting appearance of substantial cuts in broad-based deductions without corresponding benefits from large tax rate reductions, were the key factors driving the political reception of the reforms. This does not imply, however, that further discussion of transition issues in the Panel's report would not have been extremely helpful. A more in-depth discussion of these issues may have provided a starting point for the academic community to develop and explore creative strategies for achieving transition relief while not losing all of the long-run efficiency benefits of reform.

A FINAL LESSON: THE NEED FOR FULLY ARTICULATED PROPOSALS FOR REFORM

One of the key challenges of working under a tight deadline to deliver a report that proposes to reform the entire individual and corporate income tax system is the need to fill in details concerning the specific implementation of broad plans. If one proposes integration of corporate and individual income taxes, for example, how will dividends that can be traced to the earnings of U.S. firms' foreign subsidiaries be treated? How can such tracing be done? What about dividends from foreign firms that are paid to U.S. taxpayers? Dividends paid by U.S. firms to foreign investors? On questions like these, and dozens of others, the Panel needed to make decisions and propose specifics. In some cases our outstanding staff found prior policy proposals that offered detailed guidance with regard to implementation issues, but in many cases we were not so lucky. This experience suggests that when researchers offer proposals for reforming the current tax system, they should spend more time considering the details of implementation and describe those details, perhaps in an appendix to their paper. A deeper literature with such well-crafted proposals to draw on will make the task of the next tax reform commission much easier.

Reference

The President's Advisory Panel on Federal Tax Reform. *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System.* Washington, D.C., 2005.