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ANALYSIS OF TAX REFORM PANEL PROPOSALS (PART 1)

This is the first of a series of four papers that will examine the proposals of the President's Advisory Panel on Federal Tax Reform. The Panel's report is entitled *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System.*[1] The President charged the Panel with developing recommendations for an improved tax system that would increase the level of economic activity and incomes, be revenue neutral, be simpler than the current system, and be appropriately progressive. He also asked for at least one plan that resembled the current income tax, with incentives for home ownership and charitable contributions. The papers will explore how well the report's tax plans conform to basic tax principles, and how well they would serve to promote a more robust economy and meet the President's other goals.

The first paper will provide some background on the basic principles of taxation, and review how the current income tax retards economic growth by interfering with saving and investment decisions and creating other economic distortions. It will discuss how the Panel handled the question of what tax base, income or consumption, is better for growth, and how the Panel proposed to correct the distortions created by the current code. The second paper will discuss how the guidelines in the President's charge to the Panel limited the tax reform options available for consideration, how they affected the recommendations, and how they might have been handled differently. The third paper will look at some numerical estimates of the effects of the tax proposals on the cost of using physical capital, a good indication of the plans' impacts on capital formation and GDP. The fourth paper will discuss how the reform plans deal with international tax issues.

Two basic concepts vital to understanding taxation

What is income? Income is correctly understood to be the earned reward for supplying labor and capital services to the market. Except in rare instances, income closely matches the value of the effort and services provided by individuals to produce additional output.

Income is a net concept: revenues less the cost of generating those revenues. To obtain a realistic measure of a person's income, the full value of all costs of earning revenues (including education expenses, saving, and investment outlays and other business expenses) should be subtracted from revenues. Only that revenue that exceeds these costs should be taxable.

Who pays taxes, and with what? In reality, only people pay taxes, and all taxes are paid out of income. Goods and services do not pay taxes; businesses do not pay taxes. Taxes collected by businesses fall on the income of the businesses' shareholders or other owners, lenders, workers, or customers in the form of lower returns, lower wages and/or higher prices.

Two purposes of a sound tax system

Raising revenue. A sound tax system must raise revenue to pay for government goods, services and activities.

"Pricing" government. A sound tax system must let people know what they are being charged for government goods and services so that, as taxpayers and voters, they may decide in an informed manner how much government activity they wish to support with their votes.

Four attributes of a sound tax system

The four key attributes of a sound tax system include neutrality, visibility, fairness, and simplicity.

Neutrality: A neutral tax is one that does not distort people's behavior because it does not change the relative attractiveness of one economic activity versus another. No tax is utterly neutral; even a flat rate income or consumption tax discourages work relative to leisure. However, a tax system can come closest to neutrality by measuring income correctly and imposing an equal, low rate on all uses of income by all income producers. Neutral taxation minimizes the distortion of economic activity and the harm to economic growth that taxes produce. It also results in a far simpler tax with lower costs of compliance and enforcement than the current system. Some neutral systems are highly visible and transparent, which helps to increase confidence in the fairness of the system. The current tax system is far from neutral, as will be explained later in this paper.

Visibility: A visible or transparent tax system is one that lets taxpayers see and feel taxes directly so that they are clear as to how much government costs and who is paying for it. Visibility is necessary for voters to determine effectively if government spending is providing benefits that exceed its costs. Taxes are most visible when they are collected directly from people out of income (properly defined and measured). Visibility requires that revenues not be collected from taxes buried in business transactions. Visibility also requires that as many people as possible be subject to tax, excepting only the very poor, so that they can see that government is not a free good. It should not be possible for a majority of voters to shift a disproportionate share of the tax burden onto a minority of taxpayers.

Fairness: Fairness requires that people pay taxes commensurate with their income. Income is the earned reward for contributing to the production of goods and services. This fact, combined with the principle of equal treatment under the law, strongly urges that a proportional (single-rate) tax on income is the fairest. Disproportionate taxation is not fair to producers. Charity requires that the very poor be relieved of the tax burden, but insofar as possible, everyone should contribute something to the communal efforts of government. The tax system should not be used as an instrument of wealth and income redistribution or social engineering. Equality of opportunity should be a guiding force in our tax system, not equality of outcomes.

Simplicity: A simple tax system is one based on a clear, well-defined tax base with few special exceptions, treatments, or rules beyond those needed to measure income accurately. Much complexity in the current tax code stems from its non-neutral treatment of income from capital, and its taxation of income from foreign sources offset by a tax credit for foreign taxes paid. Neutral (consumption-based) taxes imposed only on domestic activity (territorial taxation) are inherently simpler than the current non-neutral income tax imposed on worldwide income. Simplicity should mean making tax filing easier by cleaning up the complexity of the tax code. It should not mean making tax filing easier by dropping large numbers of people from the tax rolls, or eliminating periodic tax filing by individuals in favor of having businesses act as tax collectors. Such measures harm visibility and merely shift the burden of a complex tax system to businesses, which must pass the costs on to consumers, workers, and savers. Some small effort by the citizens in paying tax is a fundamental requirement of a tax system that

informs the citizen-voters about what government is doing, enabling them to fulfill their civic responsibility in a democratic society.

Biases in the current tax code

The Tax Panel tried hard, within its restrictions, to eliminate many of the obstacles to economic efficiency found in the current tax system. It will help in understanding the Panel's proposals to review some of these tax biases.

The current tax code is far from neutral. It taxes some income at higher rates than other income through two main devices. First, it employs graduated tax rates on taxable income. Second, it imposes multiple layers of tax on some types of income by adding the same income repeatedly to the tax base, or by overstating the amount of income earned, while excluding some other types of income from tax altogether.

Graduated rates. When consumers call for an extra unit of output, it can be provided at lowest cost if the most efficient producer delivers the goods. Where income is proportional to output, the most efficient suppliers of output tend to have the greatest incomes. Placing a higher tax rate on a more efficient producer than a less efficient producer, as with graduated tax rates, may cause the former to produce less and divert production to the less productive source, reducing the total output available and driving up the cost to consumers. Graduated rates penalize efforts to raise one's future income, such as getting an education, saving, and investing. They further punish education by taxing people more heavily if they stay in school longer and squeeze their lifetime earnings into fewer working years.

Multiple taxation of saving and investment. At the federal level there is usually only one layer of taxation on income used for consumption, but at least four layers of possible tax on income that is saved, with similar taxes at the state and local levels.

After-tax income used for consumption generally faces no additional federal tax (except for a few distorting excises) as people enjoy the use of their purchases (e.g., eating the bread after buying a loaf, watching a stream of programming after buying a television). However, if after-tax income is used for saving, which is the purchase of assets that provide an income stream, there is an added federal tax on the income stream (interest, dividends, capital gains, or proprietorship earnings) that people enjoy after the purchase of the assets.

This second layer of tax on income used for saving that is not imposed on income used for consumption is the *basic income tax bias against saving*. The basic bias can be eliminated by correctly treating saving and investment as costs of earning income, which means giving them the sort of tax treatment afforded pensions, IRAs, 401(k) and 403(b) plans, Keough plans, SEPs, and other saving-related arrangements currently in the tax code. That is, either defer taxes on income that is saved until it is withdrawn for consumption, or tax income up front before it is saved, but exempt the returns from further taxation (as with a Roth IRA or tax-exempt bond). For investment outlays and purchases of inventories, allow a deduction of the full cost in the year the outlay is made (expensing), rather than depreciation over time.

Taxation of Schedule C corporate income at the corporate level in addition to the shareholder level is a third layer of tax on income that is saved. Whether the after-tax corporate income is paid out to the shareholders as a taxable dividend, or reinvested to raise the value of the business, creating a taxable capital gain, corporate income is taxed twice in addition to the original tax on the saving used to buy the stock. Neutrality requires that this corporate bias be eliminated by one means or another, taxing the income either at the shareholder level or the business level, but not both.[2] The transfer tax on estates and gifts is either a third or fourth layer of tax on income saved (since most of an estate is saving that has

already been taxed twice in the case of interest-earning assets, or thrice in the case of corporate assets, or, if placed in a tax-deferred pension, will be subjected to the heirs' income tax). The estate and gift tax has no place in a neutral tax system.[3] (Additional layers of tax beyond these four levels can result from taxation of inter-firm dividends, and taxation of certain family trusts where the assets have also been subjected to the corporate tax.)

Exclusions from income. In other instances, economic income is excluded from tax altogether. Three of the largest examples are the value of shelter services provided by owner-occupied housing, the health insurance premiums paid by employers or the self-employed, and the personal exemptions.

What is the best tax base, income or consumption?

The Panel devoted much of its effort to addressing the key question of tax reform: "What should be taxed?" That is, what is the appropriate tax base? Getting the tax base right is the heart of any pro-growth tax reform. Tax experts have wrestled with this issue for decades, and it is central to the economic literature on tax policy.

There are two main concepts of what should be taxed, income or consumption. They differ primarily as to their treatment of saving and investment.[4]

By conventional definition, a pure income tax would incorporate the basic tax bias against saving; it would fall on income used for saving and on the returns to the saving. However, it would not pile additional taxes on corporations and estates. Investment in equipment, buildings, and intangibles (e.g. software and copyrights) would be depreciated over time, not counted immediately as an expense.

A pure consumption-based tax (also called a "saving-consumption neutral" tax or "consumed-income tax") would eliminate all the tax biases against saving and investment, offsetting the additional layers of tax on income that is saved by one means or another. Under a consumption-based tax (of which there are several varieties and labels), income that is saved is either tax-deferred until it is used for consumption, or the saving is taxed up front and the returns on the saving are not subject to additional tax. An investment outlay is counted as an expense immediately in the year it is made. There would be no double taxation of corporate income, and estates would not be taxed (but inherited tax-deferred assets would be taxed when the heirs spend the money).

The terminology "income" versus "consumption" is something of a misnomer. A good case can be made that consumption is a better measure of income than what we call "income" under current tax rules. Income is properly a net concept, revenue less the cost of earning the revenue. Saving and investment are costs of earning future income, and should be recognized as such. The optimum tax base for a family would then be revenue less net saving (saving less borrowing), or for a business, revenue less costs, including investment. In either calculation, the remaining aggregated tax base would be the total amount of national income used for consumption, hence the term "consumed-income tax".

This distinction between the two tax bases, income and consumption, is the key to understanding the various plans that the Panel developed.

Income as the tax base. The concept behind the comprehensive income tax is the 1930s brainchild of Professors Henry Simons and Robert Haig. They sought to define as income, and to tax, the *increase in a person's ability to spend* over the course of a year. Ability to spend includes current earnings plus any change in the value of one's existing assets, whether or not the earnings or valuation changes were realized in cash or whether the spending actually occurred. The rise in ability to spend would include cash wages and non-cash fringe benefits. In pure form, the income tax would fall immediately on any current income that is saved and on the returns to the saving as soon as they were earned, including interest and dividends received by

lenders and shareholders, increases in the value of homes and stock (capital gains) even if the assets were not sold, and the imputed rent on owner-occupied housing. (In practice, it is hard to tax accrued but unrealized capital gains, and most income taxes let them be deferred until the assets are sold. Imputed rent is not taxed, but neither can the homeowner depreciate the property.)

Simons understood that his system was not saving-consumption neutral. He viewed taxing saving and the returns to saving as a way to introduce additional progressivity into the tax system and to permit additional income redistribution. His definition of taxable income was chosen to further a social objective, not to be economically neutral or optimal.[5] In pure form, the Haig-Simons tax would not include a tax on corporate income in addition to the tax on dividends and capital gains. Having both constitutes a form of double taxation that was too egregious even for Simons and Haig.

The comprehensive income tax would allow businesses to deduct costs from revenues to determine net income. However, for assets whose use extends over more than one year, the deduction of the costs would be spread over the lives of the assets. Each year, the income tax concept would only regard as a cost, and allow a deduction for, the decline in the value of the assets during that year (so-called economic depreciation). It would allow depreciation, rather than a deduction for the full value of the asset at the time it is purchased, because, in theory, the asset could be sold at any time to raise money for consumption to the extent that it still held value, so only the decline in the value represents a reduction in spending power. Depreciation is part of the basic tax bias against saving and investment. Money used to buy an asset is tied up in the asset while it is held, and cannot be used for other purposes. This is the *opportunity cost* of having the asset, which depreciation and the income tax fail to take into account. Put another way, delaying the write-off of the asset reduces the present value of the deduction, which is eroded by the time value of money and inflation. The real value of the deduction is less than the up front cost, thus overstating the earnings of the asset over its useful life, and boosting the effective tax rate on its real income. This distortion does not occur in tax systems with immediate expensing.[6]

A tax based on the Haig-Simons concept of income is not saving-consumption neutral. It falls more heavily on saving and investment than on consumption, and makes saving and investment relatively less attractive than consumption compared to a no-tax world.[7] Professor Irving Fisher protested that this feature of the income tax would discourage private saving and capital formation. Professor Simons argued that the government could counter the adverse effects on private saving and investment by running budget surpluses (so-called government saving). Simons was wrong on that point. Even if the government were to run surpluses routinely (which it certainly does not), the increase in the after-tax cost of private saving and investment due to the tax biases would depress the desired private sector capital stock. Government surpluses would not boost the private sector capital stock beyond desired levels; the surpluses would instead be matched by a decrease in private saving.[8]

Consumption as the tax base. By contrast, a comprehensive consumption tax base would tax income only insofar as it is used for consumption (or better put, would recognize that saving and investment are costs, and are not part of net income). A consumption-based tax could be collected either at the business level or at the individual level. If collected at the business level, as with a value added tax (VAT) or business activities tax, the tax would be imposed on business revenues less all costs, including full immediate expensing of investment outlays (rather than depreciation). If collected via a retail sales tax, the tax should not be imposed on investment goods and services. Under the Hall-Rabushka "Flat Tax", income from saving is taxed at the business level, after expensing, while wages are taxed on individual returns. Individuals would not receive a deduction for saving nor owe additional tax on the returns (a *returns-exempt treatment* like that

allowed today for a Roth IRA or tax-exempt bond). If instead the tax on income from saving were also collected at the individual level, saving and reinvested earnings from saving would be tax deferred, and any withdrawals from saving would be taxable (a *saving-deferred treatment*, resembling a tax system with a universal deductible IRA or 401(k) plan). There would then be no business tax. A system might be designed to collect part of the total consumption-based tax via one type of neutral tax and part by another (such as part by a sales tax and part by a consumed-income tax.) If both parts are neutral, then the total system will be neutral as well.

As the Panel pointed out, these consumption-based taxes are sometimes called "neutral" or "saving-consumption neutral" taxes, because a dollar earned and spent today and a dollar earned and saved for future consumption are taxed alike in terms of present value, and the tax does not make saving and investment relatively less attractive than consumption compared to a no-tax world.[9] Economists generally acknowledge that a neutral tax system would result in a higher level of capital formation and per capita output and income than would the income tax, and would also be simpler than the income tax in a number of ways.

<u>The Panel's recommendations for tax reform in broad outline</u>

The Panel's report points out many problems with the current tax system. The tax system is unnecessarily complicated. It has no coherent definition of taxable income. It is a hodgepodge of special provisions than seek to promote some activities or uses of income over others. It imposes different tax rates on different types of productive assets, on different forms of business (corporate and non-corporate), and on investment inside and outside the country. It subjects the foreign income of U.S. firms to U.S. tax in a manner that places them at a disadvantage relative to their foreign competition. The Panel proposed remedies for as many of these problems as feasible within the boundaries imposed by the President.

The Panel report is a competent update of Treasury's 1976 *Blueprints for Basic Tax Reform*.[10] The Panel report, like the *Blueprints*, describes two relatively pure approaches to taxation, one based on income, the other on consumed-income. The best way to keep one's perspective while reading each of the Panel's recommendations is to keep in mind 1) which tax base is being used as the starting point, and 2) which tax biases are being removed in the given plan.

The Panel noted that the current tax system is a hybrid of the two tax concepts, containing elements of the income and consumption bases. It begins as a broad-based income tax which imposes multiple layers of taxation on income used for saving and investment, but it contains provisions that treat some amounts of saving and investment as they would be treated under a saving-consumption neutral system (or consumption-based system). These provisions include pension arrangements, regular and Roth IRAs, and tax-exempt bonds.

The Panel discussed the concept of switching from the taxation of income to the taxation of consumption. It briefly described four alternative consumption-based tax systems: the retail sales tax, the value added tax (VAT), the Flat Tax, and the consumed-income tax.[11] Rather than adopt either a pure income tax or a pure consumed-income tax, the Panel chose to remain with compromise systems, one a bit closer to the income tax, one a bit closer to the consumed-income tax.

The Panel unanimously endorses two specific, hybrid approaches to taxation. The first, the Simplified Income Tax (SIT), is basically a simplified and less distorting version of the current progressive income tax. It largely addresses the heaviest, and therefore the most damaging layer of tax bias against saving and investment, in that it seeks to eliminate the double taxation of corporate income insofar as the income was subject to the U.S. corporate tax. It retains depreciation and the multiple taxation of ordinary saving. Like the current hybrid tax, the SIT partially offsets the basic

income tax bias against saving by including a number of limited saving incentives of the sort that would be universal in a consumption base. However, the SIT would consolidate and simplify the many saving arrangements in current law and, taken together, allow larger contributions with fewer restrictions on eligibility.

The second proposal endorsed by the Panel is a modified version of a progressive consumption-based tax called the Growth and Investment Plan (GIT). In unmodified form, as a pure consumed-income tax, it would have eliminated both the tax bias against corporate income and the basic income tax bias against saving. Income from saving and investment would have been taxed once, in a neutral manner (with expensing) at the business level, with no additional tax on saving at the individual level. However, the plan was modified, largely for appearances sake, to retain an additional low rate tax on capital income at the individual level, offset in turn by allowing the saving arrangements offered in the SIT. This modification reinstates some of the basic income tax bias against saving, some double taxation of capital income, and a good deal of the complexity of the current system as well.

The Panel also discusses in detail what a clean version of a consumed-income tax might look like, but did not give it a unanimous endorsement. The clean version would correct all of the basic income tax bias against saving by avoiding the additional layer of tax on capital income at the individual level that the Panel added to its modified consumed-income tax.

The Tax Panel's simplified income tax[12] – details and analysis

The Panel's simplified income tax (SIT) would eliminate the individual and corporate alternative minimum taxes (AMT). It would end various marriage penalties by making certain dollar amounts in the tax system twice as large for married couples filing jointly as for single filers (including the amounts that define the tax brackets, and certain income thresholds in the taxation of Social Security benefits). The SIT would eliminate many of the phase-outs in the current tax system that have the effect of boosting marginal tax rates above normal statutory levels.[13] The Panel would pay for these changes by repealing or capping most itemized deductions and exclusions, replacing them with a variety of family, work, and home owners' credits.

The SIT would consolidate and streamline savings plans for individuals and depreciation classes for businesses, move to a territorial tax system, and nearly eliminate the double taxation of corporate income where U.S. taxes were paid (for U.S. firms, but not for foreign multinational firms operating in the United States). It would lower the tax burden on capital and thereby boost GDP by several percentage points compared to old law (pre-2001 law, post 2010 law if the 2001 and 2003 tax cuts are allowed to expire), and would do so to a somewhat greater extent than would be achieved by simply extending the 2001 and 2003 tax reductions permanently.

Individual tax under the SIT: There would be four marginal rates, of 15%, 25%, 30%, and 33%. A family credit would replace personal exemptions and the standard deduction. A 15% home ownership credit would replace the current mortgage interest deduction. The amount of mortgage interest eligible for the credit would be limited by a cap that would vary by region. (The Panel suggests the limit would apply to mortgages exceeding 125% of the average purchase price of homes in a county as determined by the FHA.) A work credit would replace the earned income tax credit (EITC) and the child credit.

Under current law, deductions are generally of more value the higher one's tax bracket, and are of value only if one itemizes. By contrast, credits are of equal value to all taxpayers, whatever their tax bracket, and the Panel would extend the credits to all taxpayers. Thus, the proposed home ownership credit would be less valuable than the current law mortgage interest deduction to people with very large mortgages or who are in tax brackets higher than 15 percent, but would be of major benefit to people

with small mortgages, who do not now itemize, or who are in the lowest tax brackets.

Most itemized deductions would be eliminated, including that for state and local taxes.[14] A charitable deduction would be allowed for amounts over 1% of income. Fringe benefit exclusions would be gone except for health insurance, which would be capped at about the current average policy value, or $11,500 per family, and $5,000 per single filer, and would be indexed for CPI-inflation. The proposed cap would limit the exclusion now enjoyed by workers with the highest current benefit packages, but it would be fully available to the self-employed, and would be extended to individuals who have no health coverage at work and who do not benefit from the current exclusion. The cap would reduce the distorting marginal subsidy to additional medical outlays for those with the most generous policies. The extension to people not covered at work would reduce the tax bias against the individual insurance market. Taxation of Social Security benefits would be simplified, but there would still be an income threshold above which benefits would become taxable. Consequently, as other income pushes a retiree above the threshold, there would still be an implicit tax rate spike on other retirement income.[15]

Tax-favored saving vehicles for individuals under the SIC: The plan would have three saving arrangements. 1) A Save at Work Account would consolidate current tax-deferred defined contribution plans such as 401(k)s, 403(b)s, SEPs, SIMPLEs, and Keoughs. Contribution limits would match those of current 401(k)s. The contributions would be tax deductible, as under 401(k)s, and contributions and earnings would be taxed upon withdrawal. The Panel plan would further encourage saving by letting businesses offer an automatic enrollment option with an opt out. There would be no changes for defined benefit plans. 2) A Save for Retirement Account would replace current individual retirement arrangements such as regular and Roth IRAs. It would be back-ended as under a Roth IRA, with the saving done after-tax. It would have a $10,000 annual contribution limit. Everyone would be eligible; there would be no income phase-out like the one in current law. 3) A Save for Family Account would also be Roth style with a $10,000 annual contribution limit and no income phase-out. It would replace the current education and health saving accounts. Withdrawals would be restricted to medical costs, education, buying a primary home, retirement income, and $1,000 a year for any purpose. Low income savers would get a refundable 25% match of up to $500 (i.e., on up to $2,000 saved) deposited directly into the savings account.

The combined deduction limits on the retirement and family accounts would be significantly larger than those on the plans they replace. The added room to contribute would make it more likely that millions of additional savers would receive neutral tax treatment on their saving at the margin (where it affects the incentive to add to saving), relieving them of the basic tax bias against saving inherent in the income tax. Those who save enough to "max out" even on such expanded accounts would still face that bias on additional saving.

Taxation of ordinary personal saving (outside of tax-favored accounts) under the SIT: Interest would be taxed at ordinary tax rates. Certain eligible dividends and capital gains on U.S. corporate shares would be taxed at reduced rates to provide a crude offset to the double taxation of U.S. corporate income by the U.S. corporate income tax. Other capital gains, such as those on bonds, real estate, and collectibles would be taxed at ordinary income tax rates. Rather than eliminate the corporate tax (the cleanest way to end the double taxation), the Panel decided to reduce the taxation of ordinary dividends and capital gains at the individual level (outside of tax favored saving plans) where the underlying corporate income had been subject to the U.S. corporate tax. The relief would go a bit further than the similar concept in current law, under which eligible dividends and capital gains are taxed at a rate of 15 percent.

The Panel SIT plan would exclude from tax all dividends paid out of U.S. earnings of U.S.

corporations, and 75% of capital gains on U.S. shares (producing capital gains tax rates of 3.75%-8.25%, assuming the marginal tax rates on ordinary income specified in the plan). The difference between dividends and capital gains was put in for administrative convenience. It was estimated that U.S. businesses, on average, get about 75% of their reinvested retained earnings (that boost share prices and generate capital gains) from U.S. source income, and 25% from abroad. Of course, some firms, such as airplane and software exporters, and international automotive and energy companies, may get much more of their retained earnings from foreign operations. At the other extreme, many U.S. businesses have no foreign income at all. This is an inherently inaccurate compromise, all to avoid the clean approach of ending the corporate tax, or passing business income through to shareholders or partners.

The Panel proposes to keep the relief from the double taxation confined to situations where U.S. tax was paid on the corporate income. To that end, capital gains on shares of foreign companies would not get the 75% exclusion, and would be fully taxable at ordinary tax rates, on the theory that the gains due to reinvested earnings of foreign companies were never subject to the U.S. corporate tax. The exclusion of dividends paid by U.S. multinational businesses would be limited to the portion of the dividends that came from the businesses' U.S. earnings. U.S. multinational firms would have to inform their shareholders of the amount of each dividend that is U.S. based and eligible for exclusion.

Furthermore, the dividend relief would only apply to income received from U.S.-headquartered businesses, and would not apply to income from firms headquartered abroad, not even if they offer shares on U.S. stock exchanges (ADRs), and not even if they are foreign multinationals that earn some of their income in the United States. General Motors shareholders would get the full benefit of reduced taxes on GM's U.S. earnings, but Toyota shareholders would not get relief on Toyota's U.S. earnings, even though Toyota produces cars, earns income, and pays corporate tax here. The Panel felt that, because the SEC and IRS lack authority to oversee reporting arrangements of foreign companies, it would be too difficult to ensure accurate reports from foreign businesses about the breakdown of their global income between that which was subject to U.S. tax and that which was not. Perhaps the Panel also wanted to reduce the cost of the corporate tax relief out of concern for revenue neutrality, or to introduce a bit of an edge for keeping saving within the United States. Whatever the rationale, this discrimination against foreign firms that invest in the United States will not go down well with our trading partners, may conflict with various international tax and trade agreements, and makes no economic sense.

It would be easier and cleaner to reduce the U.S. corporate tax layer by ending the U.S. tax at the corporate level. That approach would not leave the proposal open to the charge of discrimination against foreign businesses. It would also be better tax policy in that a tax at the individual level is more visible and transparent to the taxpayer. Unfortunately, that relief would offend people who mistakenly think that businesses do, or can, or should pay tax. That may be why the Panel, as the Administration and the Congress did in 2004, opted to provide the relief from the double taxation on the individual tax form. Another reason for the Panel's choice of method may have been that it is cheaper to end the corporate double tax only for taxable shareholders. Non-profit organizations pay no tax on dividends and capital gains. Leaving the corporate tax in place at the level of the firm would collect one layer of tax on the portfolio income of the non-profits. This sharply reduces the distinction between the non-profits and ordinary shareholders.

Note that reducing the tax rate on shareholders' dividends and stock-related capital gains could have been viewed instead as extending the offset to the basic tax bias against saving, rather than offsetting the double taxation of corporate income. As such, it would have been reasonable to apply it to all dividends and capital gains on securities (including

bonds), undepreciated real estate, and other undepreciated assets. This would be natural in a consumed-income tax. In the income tax setting, the Panel chose to regard it as an offset to the U.S. corporate tax. Also, in the spirit of an income tax, the SIT would not offer the corporate tax relief to tax-favored saving arrangements, on the theory that, under an income tax, saving and its returns should both be taxable, and the tax favored arrangements are already giving more relief than a pure income tax would tolerate. So, wherever the SIC provides relief from the basic tax bias against saving, it would not also grant relief from the double taxation of corporate income. Catering to these popular prejudices and misconceptions greatly complicates the Panel's effort to reduce these tax biases.

As under current law and tax treaties, individuals who own shares in foreign companies outside of tax-favored saving arrangements would be allowed a foreign tax credit for foreign individual income taxes withheld on the dividends and capital gains they earn on such shares.

The Panel did not deal with the estate and gift taxes because they were not in the mandate given the Panel by the President. This is unfortunate. An asset's current value is just the present value of its expected future after-tax earnings. A tax on the asset is equivalent to a tax on its future income, and the estate and gift taxes are just income taxes paid in a lump. The estate and gift tax is a fourth layer of tax on saving, and should be eliminated.

Business taxation under the SIT: Current law treats various types of businesses (proprietorships, partnerships, LLCs, S corporations, and regular "C" corporations) very differently for tax purposes, in ways that make no economic sense and that distort behavior. The Panel tries to reduce these distinctions to some degree. In the SIC, it does so by grouping businesses by size rather than by type.

The SIT would continue to tax sole proprietorship income on individual tax returns, and would continue to treat small LLCs, partnerships, and S corporations (those with revenue less than $10 million) as pass-through entities, with the income subject only to the individual income tax on the owners. They would be taxed at the graduated individual tax rates. Rules governing contributions, allocation of income, distributions, and liquidations would be made more uniform for these four types of small business entities.

For businesses with more than $10 million in revenue, the SIT would end the distinction between pass-through entities (LLCs, partnerships, and S corporations) and the C corporations that are subject to the current corporate tax. Under the SIT, all such businesses would pay the flat business tax rate, which would be 31.5 percent, and the owners would then get the dividend and capital gains relief described above. Smaller businesses could opt for this treatment as well. Note that the former pass-through entities would lose access to the lower bracket individual tax rates on their first dollars of income.

The plan would end the corporate AMT, a plus. The SIT would also end the R&D credit, the deduction of state and local taxes, the rehabilitation credit, the lower corporate tax rate on manufacturing, and other special "breaks". Not all of these simplifications are good policy. In particular, state and local taxes are obviously business expenses. In the *Blueprints For Basic Tax Reform*, the business deductions for these taxes were retained.

Business accounting would be simplified under the SIT, especially for the smallest businesses. *Business under $1 million in revenue* would use cash accounting for inventory and expensing of equipment, but would depreciate buildings. They would be required to have a separate bank account and credit card for the business to keep its finances separate from the personal finances of the owners. Bank and credit card companies would report the client businesses' inflows and outflows to the IRS.

Business with revenue $1 million - $10 million would enjoy a simpler form of depreciation.

Equipment would be depreciated in two classes, and structures in two classes (residential and commercial/industrial). Inventory accounting would be as under current law (not expensed until sold). *Businesses with over $10 million in revenue* would employ the same four depreciation classes.

The nature of the depreciation deductions would make them less generous than under current law. There would be fewer categories, with percentage write-offs each year, rather than fixed asset lives. Although the percentage write-offs would look similar to those allowed now, they would not be a percent of the original purchase price, but a percent of the remaining asset value in the category. There would be no definite end to the write-off of an asset's cost; it would taper down as long as there were assets being added to the pot. However, if the company sold off everything in the category, it could recognize the remaining unclaimed cost. The less valuable cost recovery provisions offset some of the tax relief on capital from the lower corporate tax rate and the relief from the double taxation of corporate income. Nonetheless, as will be discussed in the third paper in this series, the tax burden on capital is reduced under this plan, and some added growth would occur.

International business income would be treated very differently from current law. The SIT would be territorial. Non-financial multinationals would not be taxed on active foreign business income, only on passive income (such as portfolio investment). There would be no foreign tax credit on repatriated active foreign income. There would be a foreign tax credit on taxable passive income. Financial institutions actively lending or insuring abroad would not be taxed on passive portfolio income, as it is their active business, and would not need a foreign tax credit. Foreign issues will be covered in more depth in the fourth paper in this series.

<u>The Panel's "Progressive Consumption Tax" and Its Modified "Growth and Investment Tax Plan"[16] – Details and Analysis</u>

Progressive Consumption or Consumed-income tax. In *pure* form, a consumption-based tax is the simplest of all, and adopting one in lieu of the current system would do the most to raise GDP. In the Panel's pure version of a progressive consumption tax, individuals would pay tax on wage, pension, and taxable Social Security income on individual tax forms at graduated rates. Proprietors' income would be taxed on personal tax forms at graduated rates, but all earnings of capital from other types of businesses would be taxed at the business level at one flat rate before being paid to partners or shareholders. Small pass-through entities that enjoy the lower bracket rates available to proprietorships under present law would lose that advantage. Individuals would not be subject to further taxes on their savings income (and would get no deduction for contributions to saving).

Businesses and proprietors would expense equipment, structures, and inventory investment, rather than depreciate them. There would be no deduction for interest, because there would be no subsequent tax on the lenders, and this is the place to tax returns on debt-financed capital investment in this type of tax. (Financial firms, however, would be taxed on fees and interest received, but deduct interest paid and other costs. This is the only way to correctly measure the income they earn on their intermediation services, which they charge for by means of the spread on the interest rates they charge borrowers and pay depositors.)

This version of a pure consumed-income tax is much like a VAT, except that wages would be deducted by businesses and taxed on individual tax forms. It is similar to the Hall-Rabushka "Flat Tax",

but with several tax rates. The Panel views this consumed-income tax as a tax on consumption by U.S. residents, and therefore recommends making it border adjustable like a VAT or sales tax. That is, it would be rebated on exports and imposed on imports. The taxation of wages at the individual level, which is not done under a sales tax or VAT, might cause the plan to run afoul of World Trade Organization rules on what taxes are eligible for border adjustment. The international aspects of the tax will be treated more fully in the fourth paper in this series.

The Panel estimates that a pure consumed-income tax could be constructed with roughly the current distribution of the tax burden with tax rates of 15%, 25%, 35%. The business rate would also be 35%. Individuals would get the same credits, charitable deductions, and health exclusions as in the SIT proposal. The marriage penalty and AMTs would be repealed in this system as well.

Growth and Investment Tax. At least two members of the Panel were not willing to endorse a pure consumed-income tax. Therefore, to achieve a second plan with unanimous endorsement, the Panel proposed a *modified* form which they called the Growth and Investment Tax. The GIT would impose a 15% tax on interest, dividends, and capital gains on the individual's tax form, in addition to the tax on the same income at the business level. This was done to prevent the (incorrect) *appearance* that recipients of capital income were not being taxed. (Remember, the income would be taxed at the business level before being sent on to the owners).

The revenue from the added tax on saving would be used to lower the top marginal individual tax rate to 30%, instead of 35%. Proprietorships would be taxed on individual tax forms. All other small and large businesses would pay a flat rate of 30%, instead of 35%. The added tax on saving would also be partly offset by allowing the same saving plans as in the Panel's SIT proposal, which would otherwise not be needed in a pure consumed-income tax system. (The Save at Work plan in this system would be back-ended, or Roth style, rather than the deductible version in the SIT.)

The GIT has several drawbacks. It adds back much of the complexity of record keeping for capital gains and reporting of capital income inherent under an income tax that is eliminated in a pure consumed-income tax. The need for the special saving plans also add complexity. Outside of the saving plans, the tax rate on saving is again higher than on consumption, at least for some assets, in spite of expensing. Although the revenue from the 15% individual tax on income from saving would be used to lower the top marginal individual and business tax rates, the combined individual and business tax rates on capital income would be higher than under the pure consumed-income version. Less capital formation would be possible. Restoring some of the current tax bias against saving sacrifices much of the added growth that the consumed-income tax should have provided relative to the simplified income tax. After the tax rate adjustment, there is virtually no difference in the distribution of the tax burden across income quintiles between the GIT and the progressive consumption tax, so nothing is gained, and much is lost, by this cosmetic compromise.

VAT, Sales Tax Considered But Rejected

The Panel discussed but rejected two more sweeping saving-consumption neutral reforms.[17] One would have added a 15% VAT to a 15% corporate tax and a 15% personal income tax. The Panel felt that adding a VAT would impose extra administration and compliance costs, and would add complexity in its interaction with state and local sales taxes. It likewise rejected replacing personal and corporate income taxes with a national retail sales tax due to similar considerations, as well as the appearance of a high tax rate (because retail sales taxes are shown as a percent of the tax-exclusive price of the goods and services, rather than as a percent of the tax-inclusive price). These alternative tax systems, while saving-consumption neutral, are harder to make progressive than a consumed-income tax.

Conclusion

The President's Advisory Panel on Federal Tax Reform, ably assisted by the Treasury staff, conducted a thoroughly professional review of the tax system, and presented a number of reform options in its report, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System.* The report is a landmark document. On the plus side, it is firmly grounded in much of the best tax research of the past thirty years. It reawakens public awareness of that work, and lends credence and respectability to efforts to bring about meaningful reform. It demonstrates that a much simpler and more pro-growth tax system is feasible without radically altering the perceived distribution of the tax burden or starving the government of needed revenue. It points out in plain English the biases in the current tax system against saving and investment, and the economic advantages for the entire population of a tax regime that is less punitive of capital formation and entrepreneurial effort. To a considerable extent, the report cuts through the emotional and political haze that obscures tax discussions, and focuses instead on the real technical issues of taxation and economics that need to be better understood if a good tax reform is ever to be enacted.

On the minus side, the Panel was restricted in what it could recommend by the constraints under which it was operating, including a Presidential charge to maintain revenue neutrality and progress-ivity, and certain analytical conventions that restricted its options. These include maintaining revenue neutrality without taking account of the economic growth induced by lowering taxes on saving and investment, and maintaining the current apparent distribution of the tax burden without fully taking into account the benefits to labor of additional capital formation. To maintain revenue and to achieve unanimity in a politically sensitive area, the Panel made some questionable compromises with optimum policy. The proposed rate structures are still quite high and steep to achieve distribution targets, there was not unanimous agreement on eliminating all of the income tax bias against saving, and the estate and gift tax was not addressed. There is unnecessary complexity in some of the proposed systems. The international provisions require more work. The Panel is to be commended, however, for describing its assumptions and constraints clearly, and providing some tantalizing information on their consequences. It also presented alternative approaches that did not receive unanimous endorsement, but which are extremely instructive and might offer a guide to bolder, cleaner reforms.

The Panel's discussion is a good starting point for a big push for tax reform. The effort would be made easier if it were accompanied by restraint of federal spending, the adoption of dynamic scoring to recognize the benefits to the federal budget from a larger economy, and a revised method of constructing burden tables that incorporates the benefits to the work force of additional capital formation. Such changes could lead to a more sweeping reform involving a net tax cut, flatter rates, and a purer form of consumed-income tax.

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President and Executive Director

Endnotes

1. President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, available on the Internet at www.taxreformpanel.gov.

2. See Department of the Treasury, Office of the Assistant Secretary for Tax Policy, *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once*, January 1992.

3. For a further explanation of the biases against saving in the current income tax, see Stephen J. Entin, "Fixing The Saving Problem: How The Tax System Depresses Saving, And What To Do About It," *IRET Policy Bulletin*, No. 85, August 6, 2001, available at ftp://ftp.iret.org/pub/BLTN-85.PDF. Also see David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, Department of the Treasury, January, 1976, more readily available as *Blueprints for Basic Tax Reform, Second Edition, Revised* (Arlington, VA: Tax Analysts, 1984).

4. See *Panel report*, pp. 152-154.

5. For a fuller discussion of Simons's views, see Stephen J. Entin, "Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax?," *IRET Policy Bulletin*, No. 88, September 10, 2004, available at ftp://ftp.iret.org/pub/BLTN-88.PDF. Also, see Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago, IL: University of Chicago Press, 1938).

6. See James R. Kee, "Introductory Discussion Of The Basic Concepts Of Depreciation And Expensing," *IRET Policy Bulletin*, No. 75, March 10, 1999, available at ftp://ftp.iret.org/pub/BLTN-75.PDF. Also see Entin, IRET Policy Bulletin 85, *op. cit.*

7. See *Panel report*, pp. 152-156, and Entin, IRET Policy Bulletin 85, *op. cit.*

8. See Entin, IRET Policy Bulletin 88, *op. cit.*

9. See *Panel report*, p. 21, and Entin, IRET Policy Bulletin 85, *op. cit.*

10. Bradford, *Blueprints*, *op. cit.* Also see Bradford's X-Tax work, for example, "Tax Reform: Waiting for a New Consensus of the Experts," *Tax Notes*, May 18, 1998, p. 899 ff.

11. *Panel report*, pp. 37-40.

12. *Panel report*, chapters 5 and 6.

13. See Michael A. Schuyler, "Phase-Outs Increase Tax Rates and Tax Complexity," *IRET Policy Bulletin*, No. 83, March 12, 2001, available at ftp://ftp.iret.org/pub/BLTN-83.PDF.

14. Bradford would allow a deduction for state and local income taxes, but would allow a deduction for other state and local taxes only if they were business expenses. Bradford's proposed treatment of income taxes is reasonable because they return very little identifiable benefit to a specific taxpayer, and should be treated as deductible transfer payments, or, insofar as they support education, as deductible investment in human capital. He would not allow a deduction for property taxes on owner occupied housing or mortgage interest because the imputed rent is not taxed. Bradford's proposed treatment of property taxes is not justified. It is true that the imputed rent is not taxed, but neither is the homeowner allowed to depreciate the property. It would be better to regard the local property taxes as transfer payments or investment outlays, and allow the deduction. Much of the local property tax goes to the public schools. Education is a cost of human capital formation, and of earning future income, and should be a deductible investment. Water and sewer charges are more like consumption spending, but many jurisdictions bill them separately, and they are not deductible.

15. See Schuyler, IRET Policy Bulletin 83, *op. cit.*, and Stephen J. Entin, "The Economics of Taxation and the Issue of Tax Reform," page 11 and Chart 18, April 24-27, 2003, available at ftp://ftp.iret.org/pub/EntinNewOrl-2003.PDF.

16. *Panel report*, chapter 7.

17. *Panel report*, chapters 8 and 9.

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.