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ANALYSIS OF TAX REFORM PANEL PROPOSALS (PART 2): LIMITATIONS PLACED ON THE PANEL SHAPED THE OUTCOME

Introduction

The President's Advisory Panel on Tax Reform issued its report in November, 2005. Many observers felt that the Panel's proposals looked too much like the existing income tax, and were disappointed that the reforms were not more sweeping. Before being too critical of the Report, however, it is important to remember that the Advisory Panel was operating under a number of legal and practical constraints. This paper will examine the constraints the Panel faced and their ramifications in some detail. In spite of the restrictions placed upon it, the Panel produced a work of high quality that will prove to be a major contribution to the tax literature.[1]

The Panel's Proposals

The Advisory Panel's report is entitled *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*.[2] The Panel recommended improvements in the tax system that would lead to significant gains in production and income, while greatly simplifying many aspects of the code.

The Report provided an excellent discussion of two distinct concepts of the tax base — "broad-based income" versus consumption or "consumed income". It described three alternative tax systems for individuals and businesses (two of which received the Panel's unanimous endorsement) that would be simpler and more pro-growth than the current income tax:

• The *simplified income tax* would expand and consolidate personal saving arrangements and simplify business depreciation of capital assets. Marginal tax rates would be 15%, 25%, 30%, and 33% for individuals. The top corporate tax rate would be 30 percent. Outside of the saving plans, corporate income would be partially relieved of double taxation by excluding from individual taxable income those dividends paid out of U.S.-taxed corporate income, and by an exclusion of 75% of capital gains on U.S. stock held longer than a year. Exemptions, deductions, credits, and other code complexities would be eliminated, consolidated, or simplified.

• The *growth and income plan* is presented as a largely consumption-based alternative. It would move to full expensing of capital investment for equipment, rather than depreciation. Its individual tax rates would be 15%, 25%, and 30%, and the top corporate rate would be 30%. However, it would keep a 15% tax on interest, dividends, and capital gains at the individual level in addition to the tax on the same income at the corporate level. The personal tax on saving would be partly offset by having the same saving plans as in the simplified income tax proposal, which would otherwise not be needed in a consumption-based system.

• The full-blown *consumed income tax* (which had wide support on the Panel but was not unanimously endorsed) would do the most for growth and simplicity. All earnings of capital would be taxed at the business level, after full expensing. There would

be no added taxation of capital income at the individual level. Its individual tax rates would be 15%, 25%, and 35%.

All three plans would eliminate the individual and corporate alternative minimum taxes (AMT) and the marriage penalties.

Criticisms leveled

The Panel's report disappointed some in the tax policy community who were hoping for a more radical overhaul of the tax system.

- Advocates of higher taxes on the rich were disappointed that the Panel did not provide for greater income redistribution. At the other end of the philosophical spectrum, advocates of a flat, or at least flatter, tax were put off by the degree of graduation in the proposed marginal rates.

- There was also criticism that the supposedly revenue-neutral tax rates were just too high across the board, with apparently no adjustment made for the tax revenue that would result from additional growth of the economy that the reforms would induce.

- People favoring the simplicity of eliminating tax filing by individuals were put off by the failure to endorse a national retail sales tax or value added tax (VAT), which would be calculated and remitted solely by businesses.

- Reform of taxation of international income was touched on only briefly, and in limited detail.

The Panel's Charge

President Bush created the Advisory Panel by Executive Order on January 7, 2005. The Executive Order stated:

> The purpose of the Advisory Panel shall be to submit to the Secretary of the Treasury ... a report with revenue neutral policy options for reforming the Federal Internal Revenue Code. These options should:
>
> (a) simplify Federal tax laws to reduce the costs and administrative burdens of compliance with such laws; (b) share the burdens and benefits of the Federal tax structure in an appropriately progressive manner while recognizing the importance of homeownership and charity in American society; and (c) promote long-run economic growth and job creation, and better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the United States in the global marketplace."
>
> At least one option submitted by the Advisory Panel should use the Federal income tax as the base for its recommended reforms.[3]

The Panel was under the general oversight of the Secretary of the Treasury, and the Treasury Department provided its technical support. These charges and arrangements constrained the Panel as to the changes it could recommend. For example, the Panel was informed that any plan it offered must raise roughly the same revenue as the current income tax (revenue neutrality) from roughly the same people (if the current system is taken to be "appropriately progressive"), must assume roughly the same level of economic activity and income (Treasury "static" revenue estimation methodology), and must maintain current tax incentives for homeownership and charitable giving. To meet these conditions, any income-tax-based plan would have to look much like the current system.

Growth charge

The President's call for a pro-growth reform was not a restriction on the Panel. On the contrary, it gave the Panel the mandate to focus on and recommend reductions in the relatively high tax rates imposed on income from capital in the current tax

code. The focus on growth helped the Panel put redistributionist pressures into perspective. It is what led the Panel to recommend sweeping expansion of retirement and family saving arrangements in the Simplified Income Tax Plan, and the expensing provision and the reduction or elimination of the double taxation of corporate income in the Growth and Income Plan and the Progressive Consumption Tax Plan.

Some members ultimately balked at endorsing the most pro-growth of the reform possibilities under serious consideration (the Progressive Consumption Tax Plan). Nonetheless, that plan (and other saving-consumption neutral systems such as the VAT and the sales tax) would not have received the detailed attention it got in the Report if growth had not been the main consideration of the Panel.

Revenue neutrality constraint

The President's Executive Order required that the Panel's plans be revenue neutral. Making a tax reform revenue neutral may sound simple, but it is not. Revenue neutrality is a slippery concept. What revenue baseline or revenue targets should be used? Over what time horizon? What are the assumptions in the baseline regarding tax provisions that are scheduled to expire under current law? Should the economic changes that the tax reform might induce, and the revenue changes associated with the economic changes, be factored into the estimates?

Baseline target. The Administration's revenue projection in its 2005 budget baseline assumed $17.4 trillion in federal individual and corporate income tax revenues over ten years. It assumed that the changes enacted in 2001 and 2003 for the ordinary income tax would be made permanent. However, it assumed that the temporary increase in the alternative minimum tax exempt amount (the AMT "patch"), designed to prevent the number of taxpayers subject to the AMT from jumping from 4 million to nearly 22 million in 2005, would end after 2005 (raising taxes by about $34 billion on 2006 income, and by increasing amounts thereafter). (The AMT patch has since been extended through 2006 as a result of the tax reconciliation bill enacted in June, 2005.)

The CBO baseline for the same period projected very similar total individual and corporate income tax revenues (about $17.5 trillion), but with different assumptions.[4] Like the Administration, CBO assumed that the AMT relief would end after 2005. However, within that estimate, CBO assumed that the 2001 and 2003 tax reductions would be allowed to expire, involving nearly $1.3 trillion through 2015. Offsetting that revenue gain, CBO had somewhat lower GDP numbers in the outyears than the Treasury, and some differences in technical assumptions. The combined effect of these differences resulted in baseline numbers that were only about a percent different from the Treasury figures.

These baseline constructs are clearly somewhat uncertain, and vary significantly as the economic and technical assumptions change. The Panel, knowing that the Administration would use its own baseline in evaluating the Report's recommendations, assumed the Administration baseline.

Added cost of AMT repeal. The Panel was also determined to eliminate the AMT. Congressional sentiment concurred. The AMT adds greatly to the complexity of the tax system. Furthermore, if one has designed the "correct" tax system, with appropriate deductions and definitions of income, there can be no reason to have a second, and, by definition, "incorrect" system in place at the same time. Complete repeal of the AMT would cost $1.2 trillion over ten years, which was added to the revenue target that the Panel's tax plans had to provide.

Keeping the (rising) AMT money in the revenue target, rather than assuming either a continuing "patch" or elimination matched by spending restraint, necessitated higher marginal tax rates than otherwise. Figure 4.1 in the Panel Report shows that paying for repeal of the AMT would require a roughly

Impact of AMT Repeal on Current Law Marginal Rates						
Current law marginal rate	10%	15%	25%	28%	31%	35%
Rate with AMT repeal	11%	17%	28%	31%	33%	39%

From Tax Panel Report, Fig. 4.1, p. 43.

10 percent increase in current-law marginal tax rates across the board, and one may assume that the repeal had the same impact on the rate structure in the Panel's reform plans.

Revenue scoring straightjacket. Treasury staff provided the panel with revenue estimates for the various tax proposals under consideration. Treasury estimation techniques were used throughout. Considerable work and time were involved. The Panel had no opportunity to consult with other governmental or academic sources of revenue estimates, although it is not clear how much these sources would have been able to help due to time constraints. There were no "second opinions", and no way for the Panel to analyze or comment on the assumptions and methods used by the Treasury, some of which tend to give odd or counter-intuitive results.

Changes in tax rates and rules induce changes in the behavior of taxpayers. The Panel Report describes the degree to which Treasury estimators acknowledge behavioral and economic changes resulting from tax changes when they do revenue estimates.[5] Treasury revenue estimators (and Congressional revenue estimators as well) use what they (and the Report) call "conventional" or "microdynamic" analysis, as opposed to "dynamic" or "macrodynamic" analysis.

Some tax-induced changes in taxpayer behavior occur at the "micro" level. These include timing or avoidance reactions, such as postponement of taking a capital gain if the capital gains tax rate were raised, reduction in consumption of items hit by excise taxes, purchase of more tax free bonds and fewer taxable investment assets if tax rates were to increase, or giving away more money under the gift tax annual exempt amounts to avoid a higher estate tax. Such avoidance activities are acknowledged and become a part of the revenue estimate for such tax changes. These changes are assumed not to have any major effect on aggregate economic activity or levels of income. (In fact, they do create some distortion and deadweight loss, however.)

Tax changes may also affect "macro" level behavior, such as willingness to work and hire and the amount of capital formation in the country. Such behavior changes certainly affect the over-all level of economic output, productivity, employment, wage income, and income from capital. These "macro" behavioral changes are explicitly ignored by Treasury (and Congressional) revenue estimators. This shunning of what may be by far the most significant economic effects of tax changes has led critics of the approach to brand it as "static" analysis ("micro-dynamics" not withstanding). One reason given for ignoring macroeconomic consequences of tax changes is that economists are not in unanimous agreement as to the magnitude of these effects (although they are certainly not zero). Factoring in any such adjustments might lead to controversy. Treasury, therefore, does not make such adjustments.

Whatever arguments are avoided by this non-macrodynamic (or "static") procedure come at a very high price. Some of the reforms recommended by the Panel would be expected to have a significant effect on the level of economic output and incomes, resulting in noticeable revenue reflows to the Treasury. Indeed, improving the economy was one of the charges laid on the Panel by the President, and

attaining that objective was one of the chief reasons why the Panel's proposals focused so strongly on reducing tax biases against saving and investment. The revenue reflows from acknowledging the growth of income would have allowed a significant reduction in the tax rates that could have been recommended to provide a revenue neutral outcome.

Although the Panel and the Treasury revenue estimators did not do dynamic scoring of the tax proposals, the Panel did ask the Treasury to estimate the effect of the lower tax rates on capital on economic activity. After all, one of the instructions given to the Panel by the President was to enhance economic performance. How else could they demonstrate that they had achieved that objective? Treasury used three different economic models to generate a range of growth estimates for each plan, and made its best guess for each. Some of the models are more attuned to the realities of the modern, integrated global economy than others. (We will analyze these results in more detail in a later paper.) The Simplified Income Tax Plan was estimated to raise real GDP in the long term by 1.2%; the Growth and Investment Tax Plan by 4.8% and the Progressive Consumption Tax Plan by 6%.

Under current tax rates and rules, with the current-law degree of progressivity, an across-the-board increase in income of 1 percent would raise tax revenues by about 1.8 percent. This represents the ratio of marginal to average tax rates. Growth of income generates a huge revenue windfall for the Treasury. The Panel's tax plans were designed to keep roughly the same progressivity as current law. One may assume, therefore, that the elasticity of revenues with respect to income growth would be roughly the same under the three tax plans as under current law.

On that assumption, we calculate that the Simplified Income Tax Plan should raise individual income tax revenues by about 2.2%; the Growth and Investment Tax Plan by about 8.6%; and the Progressive Consumption Tax Plan by about 10.8%. Accordingly, we estimate that the tax rates projected for these plans could be lower by at least these percentages, as shown in the following table, and still be revenue neutral. The lower rates, in turn, would encourage even more economic growth, and permit additional rate trimming. Because the Progressive Consumption Plan would do the most for growth, its top rate could be reduced the most, and

Revenue Neutral Marginal Tax Rates As Presented Under the Panel Plans And If Dynamic Scoring Had Been Adopted

Marginal tax rates in the Simplified Income Tax Plan as proposed	15%	25%	30%	33%
After growth effects	14.7%	24.5%	29.4%	32.3%
Marginal tax rates in the Growth and Income Tax Plan as proposed	15%	25%	30%	n.a.
After growth effects	13.7%	22.8%	27.4%	n.a.
Marginal tax rates in the Progressive Consumption Tax Plan as proposed	15%	25%	35%	n.a.
After growth effects	13.4%	22.3%	26.8%	n.a.

Marginal rates from Tax Panel Report, Tables 6.3, 7.3, and 7.6. Rates after allowance for growth estimated by author.

could go from being the highest to the lowest top rate among the three proposals.

Appropriate progressivity

Meeting this vague requirement is a daunting tax. People have been arguing about the right degree of progressivity and the correct distribution of the tax burden for years. Worse, the concepts are generally misdefined and mismeasured.

What degree of progressivity is "appropriate"? The Executive Order required the Panel's proposals to be "appropriately progressive". What is appropriate in that regard is a matter of opinion. Opinions differ over how much income redistribution is needed in order to be "fair" to the poor, and how much can be tolerated while remaining "fair" to the people who generate the income by working and saving. Then there is the added question of what redistribution may do to total economic activity, and what that, in turn, may do to the incomes of wage earners and savers at various income levels.[6]

The "fairness" question has no scientific answer, and the Panel could have debated it long past their deadline. To resolve the issue quickly, the Panel assumed that the current level of progressivity and the current distribution of the tax system reflected society's consensus on the matter. It decided to present reform plans that keep a similar degree of progressivity as current law, as measured by the distribution of the tax burden across income classes, as presented in "burden tables" developed by the Treasury.

What is the tax burden, and what would a tax change do to it? Beyond the question of the appropriate degree of progressivity of the tax system and the distribution of the tax burden are two other key issues: 1) how to measure the tax burden in the first place, and 2) how to determine how the burden shifts as a result of the effect of the tax rates and tax base on the economy and on people's incomes.

The correct measure of the tax burden is how much the imposition of the tax changes people's after-tax incomes. The burden must reflect not only the tax payments, but the changes in pre-tax income induced by the tax or tax change. However, changes in the economy, in pre-tax wages and profits, and in employment, are not included under static revenue estimation methodology. As a result, the so-called burden tables commonly computed by the Treasury, the Joint Tax Committee of the Congress, the Congressional Budget Office, and many tax policy groups are not burden tables at all. Rather, they are tables of initial tax incidence. The tables report what the changes in tax liability would be for taxpayers of various income levels and family situations assuming there would be no changes in what they earn or in what they buy as a result of the tax.

Furthermore, the tables are not good incidence tables. The initial incidence assumptions are arbitrary and inconsistent with what is known about labor and capital markets. They assume that income taxes are passed back to the workers and investors who produce goods and services, with no impact on consumers of the products. They assume that consumption taxes are passed forward to the consumers of the taxed goods and services, with no impact on the producers. Economists know that any type of tax affects both producers and consumers.

The corporate tax is another sticking point. Savers and investors may react to a business tax by reducing the amount of their income devoted to saving and investing, and switching to consumption. Less capital is formed, raising returns to the remaining capital to cover the tax, while reducing wages. Alternatively, in an open economy, savers and investors may locate their capital abroad instead of in the United States, depriving U.S. workers of capital and lowering their wages. For both reasons, it is appropriate to view the burden of the corporate income tax and most individual taxes on saving as being shifted to U.S. workers. The Treasury instead assumes that the tax falls on the owners of capital,

an assumption used in the main body of the Panel Report.

The Tax Panel made some effort to address this issue by asking the Treasury to produce a second set of distribution tables on the assumption that the corporate income tax is split evenly between workers and owners of capital. In the Appendix, the Panel Report shows the distribution under this alternative assumption for the existing corporate tax, but assumes that changes in the corporate tax under the proposals would be borne by owners of capital in the short run, while acknowledging that there would be some shift toward labor in the longer term. There were no tables presented showing full shifting of the corporate tax to workers.[7]

The key point to these observations is that government revenue estimators routinely misstate the burden of the existing tax structure and misrepresent its progressivity, and that they must, therefore, be misstating the change in the burden and progressivity of any proposals to reform the system. In particular, proposals that reduce tax rates on saving and investment are more progressive and beneficial to the work force than reported under the "micro-dynamic" or "conventional" methods commonly employed.

Simplicity

Much of the complexity of the tax system comes from the treatment of capital income and foreign source income. For people whose income is primarily wages or simple interest, and who do not itemize deductions, neither the income tax nor the consumed-income tax is particularly complicated. Some complexity is introduced into either type of system whenever various credits and redistribution arrangements are included. However, the Panel was able to streamline the major credits and programs that encourage work and saving, and that apply to families. For these reasons, the Panel felt no great need to push on to more drastic changes in taxation beyond the progressive consumption tax plan.

Nonetheless, the Panel described two other plans that also have a so-called "consumption" base[8] and are often praised for simplicity. These are the value added tax (VAT) and national retail sales tax. These plans can be quite simple in that they are collected at the business level and would require no filing by most individuals (unless they were owners of non-corporate businesses). They can become complicated if they are not imposed uniformly on all goods and services. They can vary in complexity according to the compliance method chosen. They are not well suited to measure and tax the income of the financial services industry.

The VAT and sales tax have other characteristics that the Panel found unappealing, such as possibly being too easy to raise and possibly interfering with state sales tax collections. It is harder to make them progressive than is true for other types of taxes. The progressivity issue might have been mitigated had they been considered as replacements for the payroll tax, but that was beyond the Panel's mandate. For these and other reasons, the Panel did not give these systems the same prominence as the main proposals. Nonetheless, the Panel suggested further study of a VAT/income tax combination, and might have done more with this approach if time had permitted. We will discuss the VAT proposal in a later paper.

Deadlines: Hurry Up and Wait

The Panel was formed in January, 2005, and was initially instructed to complete its report by July 31, 2005. Six months is a very short time in which to study, redesign, and write up a set of new tax systems. Rather near the due date, the deadline was extended first to September 30, 2005, and then to November 1, 2005, as other policy issues moved to the front burner at the White House and the Congress. However, the Panel had perforce completed most of its work by July, and was able only to refine its presentation in the added weeks.

Consideration of the international aspects of the proposals suffered the most from lack of time. The

definition and tax treatment of foreign source income are among the most complicated parts of taxation, and the Panel ran out of time in dealing with them. The Panel suggested switching from global taxation (the current practice of taxing a resident's or business's worldwide income, offset by a foreign tax credit) to taxing only the income generated within the United States (a territorial tax system). The analysis presented in the Report was sketchy, and there were some questionable assumptions about some of the details of such a system. These will be discussed in a subsequent paper. Nonetheless, the Panel was broadly correct in its contention that a territorial tax system with expensing could be simpler and more favorable to U.S. capital-intensive industries than current law.

Legal requirements

The Panel was created by Executive Order, and was therefore subject to the requirement of the Federal Advisory Committee Act that any meetings held by a quorum of the Panel be open to the public. This raised the cost of the Panel's work, and made it more difficult. Much of the work of the Panel consisted of becoming more familiar with detailed workings of the tax code and the alternatives in the tax literature, activities that did not merit the cost of a public meeting.

Most members of the Panel were expert in some areas of taxation or other, and were expected to work on such areas in subgroups to prepare proposals for the full Panel. This was the only way the Panel could cover the entire tax code in the short time available. However, when any subgroup had to draw on the advice of a member not in the subgroup, they had to be careful not to have "too many" members in the same room. On occasion, the failure of one subgroup to brief others caused some duplication of effort. When subgroups did report their findings to the other members of the Panel, it was often the first time the other members had seen the ideas, and their initial reactions and questions had to be exposed in open meeting.

The public meeting requirement interfered with the frankness of the discussion, and laid open partially formed ideas to attack by interested parties. By contrast, the 1983 National Commission on Social Security Reform (the Greenspan Commission) was created by law with a specific exemption from the open meeting requirements. That very touchy subject could not have been successfully addressed by the Members of Congress and others on the Commission if it had not been able to meet in private.

Conclusion

The President's Advisory Panel on Tax Reform labored under a number of Presidential instructions and legal restrictions that limited what it could achieve. It was dependent on the finite resources of the Treasury for revenue estimates, and was tied to the Treasury's current methodology and its ability to generate estimates in a timely manner. Nonetheless, the Panel did a creditable job of presenting the case for significant tax reform and creating tax plans deserving serious consideration. Its Report is one of the clearest and best-written documents in its field.

If another Panel is convened, it would be helpful to give it more time to work, the privacy necessary for a frank discussion of sensitive issues, more access to better and speedier revenue estimation from a variety of sources, and the freedom to address other areas of the tax system.

In the meanwhile, it is important for the Treasury to proceed with its dynamic analysis project, initiated under Secretary John Snow. Treasury needs the capability to determine more accurately and speedily the economic consequences of a wide variety of proposed tax changes, not only as a service to any future Panel, but also as an aid in formulating future Administration tax policy and vetting Congressional tax proposals.

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Endnotes

1. For a discussion of how the proposals conform to basic tax principles and how they stack up against the tax systems most discussed in the tax literature, see Stephen J. Entin, "Analysis Of Tax Reform Panel Proposals (Part 1)," *IRET Congressional Advisory*, No. 198, January 19, 2006, available on the Internet at ftp://ftp.iret.org/pub/ADVS-198.PDF.

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

3. White House, "Executive Order: President's Advisory Panel on Federal Tax Reform," January 7, 2005, with Amendments on June 16, 2005 and September 30, 2005, accessed on the Internet at http://www.taxreformpanel.gov/executive-order.shtml.

4. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, January 2005, p. 8, accessed on the Internet at http://www.cbo.gov/ftpdocs/60xx/doc6060/01-25-BudgetOutlook.pdf.

5. *Panel Report*, pp. 45-46.

6. From a strictly economic perspective, there is an answer to what is an optimal tax system. It is one that minimizes the damage to the total level of output and income, and which minimizes the distortion of the type of economic output and who produces it. It would allow the economy to continue to produce as much as possible of what consumers want in the most efficient manner. Such a system would not impose a higher rate of tax on one producer than another, which would distort what is produced and force output to shift from the lowest marginal cost pattern of production to a higher cost pattern. Such a system would also not place higher tax rates on income used for saving than on income used for consumption, because that would reduce the equilibrium capital stock and reduce wages and incomes across the board. For a fuller discussion of these issues, also 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 on the Internet at ftp://ftp.iret.org/pub/BLTN-88.PDF.

7. See *Panel Report*, Appendix pp. 257-263. Also see Entin, "Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax?" *op. cit.*

8. All the so-called "consumption-based" tax systems (consumed income tax, VAT, sales tax, and "Flat Tax") are really taxes on income properly defined. The broad-based income tax falls more heavily on income used for saving then on income used for consumption, because it fails to recognize that saving is a cost of earning future income, i.e., it ignores the time value of money. The various "consumption-based" taxes are in fact all saving-consumption neutral taxes on income, collected at different points in the production process. They either allow a deferral of income that is saved until it is withdrawn for consumption, or tax the income that is saved up front and exempt returns on the saving. That is, they tax either the returns on saving or the amount saved, but not both.

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.