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Grading the President's Tax Reform Panel's Plan

by Laurence J. Kotlikoff

The President's Advisory Panel on Federal Tax Reform was guided by two outstanding economists, Edward Lazear and James Poterba, and an equally impressive former IRS commissioner, Charles Rossotti. They deserve great credit for recommending critical improvements to our tax system. The list includes eliminating the Alternative Minimum Tax (AMT), limiting mortgage and health insurance tax subsidies, eliminating the deductibility of state and local taxes, rationalizing deductions, exemptions, tax credits and retirement account options, and reducing the taxation of saving. If these reforms are implemented with transition rules that don't give away the store, our tax system will be more efficient and, in many ways, more equitable.

That's the good news. The bad news is that even were the Panel's proposals adopted, our tax system would remain complex, expensive to administer, highly inimical to working, and still rather inimical to saving. So, as much as I like the plan, the best grade I can give it is a B+. I'm a tough grader, so a B+ is very good. But the proposals could have been better.

Fewer and Fairer Deductions. The Panel's reforms would eliminate personal exemptions and itemized deductions, and the standard deduction, Child Tax Credit, Earned Income Tax Credit and marriage penalty. In their place, the Panel offers just two credits: a Family Credit and a Work Credit. The result is simpler and fairer.

Take mortgage interest. The current system encourages over-investment in housing, in a highly regressive way. Someone in the 35 percent tax bracket pays, on net, only 65 cents of every dollar spent on mortgage interest, whereas someone in the 10 percent bracket pays 90 cents and someone who doesn't itemize pays 100 cents. In essence, we are encouraging wealthy taxpayers to buy larger and ever more expensive homes, while giving only modest tax relief to low- and middle-income homeowners. Under the proposed reform, all taxpayers will, on net, pay 85 cents of every dollar spent on mortgage interest up to a relatively low maximum.

The ability to deduct state and local taxes is also arbitrary and regressive. The system benefits taxpayers in states that have income taxes, but gives much less relief in states that rely more on sales taxes. Further, the system fosters overspending by states and localities who know that a good portion of the taxes they levy will effectively be paid for by the federal government. Dropping state and local tax deductibility is long overdue.

The current tax treatment of health insurance is similarly flawed. People with employer-provided insurance can purchase it with pretax dollars (avoiding both income and payroll taxes), while the self-employed get a simple deduction and everyone else gets left out in the cold. The largest subsidies go to the highest income earners and those with the most lavish health plans. Under the panel's suggestions, everyone would get the same tax relief, regardless of how the insurance is purchased. The deduction would be capped at about the average cost of insurance.

The Work Credit will replace the quite complex Earned Income Tax Credit (EITC), and it appears to provide better work incentives. The withdrawal of the EITC as income rises adds up to 22 percentage points to low-income workers' effective marginal tax rates. The Work Credit will add only 12.5 percent, although it applies to a wider range of earnings.

A Better Way to Encourage Saving. Our current retirement/medical/educational saving account system is also in need of radical overhaul. We have 401(k)s, 403(b)s, IRAs, Roth IRAs, 529 plans, Simplified Employee Pensions (SEPs), Health Savings Accounts (HSAs), Medical Savings Accounts (MSAs), Flexible spending Accounts (FSAs), Health Reimbursement Agreements (HRAs), SIMPLEs, Keogh Accounts, Thrift Savings Plans, Retirement Savings Contribution Credits, etc. The Panel wipes these all out and substitutes three similar and straightforward plans — Save at Work, Save for Retirement and Save for Family — all with high contribution limits. Because these accounts are set up like Roth IRAs, there are absolutely no taxes levied on any income they earn. Refundable tax credits will directly help poor people save.

Lower Tax Rates on Capital. Thanks to the combination of corporate and personal income taxes, high-income individuals now pay roughly 47 cents in taxes for every extra dollar earned on their savings. Under the Panel's proposal, their effective marginal tax rate will fall to 15 percent. The reasons are two.

First, *all* capital income, including interest, rent, capital gains and dividends, earned outside of retirement accounts would be taxed at 15 percent at the personal level.

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Second, businesses will be able to immediately write off all new investment instead of having to depreciate it over many years. Consequently, firms will be able to pass on to households the full pre-tax return on the investment. Households will then pay 15 percent, if their holdings are outside retirement accounts, and zero if their holdings are inside retirement accounts. Overall, businesses will see their top marginal rate fall from 38 percent to 30 percent and zero percent if earnings are reinvested. The Panel also would eliminate the deductibility of business interest payments, thus eliminating the current bias toward debt financing.

So what's not to like? Well here are four problems.

Problem: Tax Rates on Labor Are Still Too High. Most American workers will pay 30 percent or higher total effective marginal federal tax rates, taking into account their income tax bracket, the 15.3 percent employer plus employee FICA tax, and the marginal (12.5 percent per dollar) loss of the Work Tax Credit for workers above that Credit's claw-back thresholds.

Problem: Wage Tax or Consumption Tax? Both a wage tax and a consumption tax avoid taxing saving. The difference is that taxing consumption, either directly or indirectly, taxes what's used to make purchases, namely, existing wealth and current and future wages. In contrast, taxing just wages exempts any burden on current wealth holders.

To see this distinction, think about a retail sales tax, which is the most straightforward way of taxing consumption. If you have wealth and spend it, you pay the sales tax. If you save your wealth and spend it in the future, you also pay sales taxes. The same holds true if you earn money by working. If you spend your earnings immediately, you pay sales taxes immediately. If you save your labor earnings, you'll pay the sales tax whenever you do spend it.

By contrast, a tax on wages lets current wealth holders completely off the hook. And since most current wealth holders are members of older generations, the transition to a system with more wage and less consumption taxation shifts the tax burden onto the young for the benefit of the elderly. The young end up paying higher wage tax rates than would otherwise be the case.

The Panel certainly understands this issue, but still felt compelled to exempt much of existing wealth from taxation by grandfathering old depreciation allowances. This clear sop to old investment is tucked away on page 172 of the Panel's report. A second sop is lowering the corporate tax rate, which helps old investment, but not new investment. The effective tax rate on new investment will be zero regardless of the corporate tax rate thanks to the proposed 100 percent expensing.

Problem: Inadequate Treatment of Health Insurance. The most important problem in our health care system is that for more than six decades the tax law has subsidized third-party insurance and penalized self-insurance. Health Savings Accounts (HSAs), available since 2004, are a step in the direction of tax parity.

There is nothing wrong with limiting the tax subsidy for health insurance. There is also nothing wrong with a Roth IRA approach. What is wrong is to treat third-party insurance and self-insurance differently. The tax panel wants to abolish HSAs and replace them with an all-purpose Roth-type saving account. At the same time, it would allow continued deductibility for third-party insurance (subject to a cap). This means that people could buy third-party insurance with pretax dollars, but would have to self-insure for those same expenses with after-tax dollars. That would perpetuate the error imbedded in more than 60 years of tax policy.

Problem: Still Too Much Complexity. If all of the Panel's changes were enacted, the system will still be way too complex. Politicians will be as free to add and hide special interest provisions in the future as they have in the past. The Panel's plan is bold and visionary on many fronts. But it is starting with sausage and ending up with sausage, albeit with fewer ingredients.

Conclusion: Getting a Better Grade. As good as the Panel's recommendations are, they could be better. The NCPA study, "Tax and Social Security Reform: Thinking Outside the Box," shows how the current system could be replaced by a flat tax, sales tax or value added tax. I'm particularly partial to the federal retail sales tax proposal known as the FairTax. Done correctly, we could have a fairer, more efficient tax system that taxes consumption and is also progressive.

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