Simple, Fair, and Pro-Growth:

Proposals to Fix America's Tax System

Report of the President's Advisory Panel on Federal Tax Reform

November 2005

The President's Advisory Panel on Federal Tax Reform

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The President's Advisory Panel on

Federal Tax Reform

www.taxreformpanel.gov

November 1, 2005

The Honorable John W. Snow
Secretary of the Treasury
The Department of the Treasury
1500 Pennsylvania Avenue
Washington, DC 20220

Dear Mr. Secretary:

President George W. Bush formed this Panel to identify the major problems in our nation's tax code and to recommend options to make the code simpler, fairer, and more conducive to economic growth. The Panel heard from nearly 100 witnesses and received thousands of written comments. Together, these witnesses and these comments described the unacceptable state of our current tax system. Yet this tax code governs virtually every transaction in the world's largest economy, affecting the daily lives of nearly 300 million people.

Our tax code is rewritten so often that it should be drafted in pencil. Each year, the tax code is adjusted to meet multiple policy goals – some are broadly shared, but many are not. Myriad tax deductions, credits, exemptions, and other preferences may be a practical way to get policy enacted, but it is a poor way to write a tax code. Whether the government spends more or extends a special tax break, the effect is the same: everyone else must pay higher taxes to raise the revenue necessary to run the government.

During the past few decades, panels have been formed repeatedly, legislation introduced annually, and hearings scheduled regularly to study our tax code and recommend changes. In 1986, a bipartisan effort yielded the last major tax reform legislation. But because of the ever-present tendency to tinker with the tax code, we must redouble our efforts to achieve fundamental reform.

Since the 1986 tax reform bill passed, there have been nearly 15,000 changes to the tax code – equal to more than two changes a day. Each one of these changes had a sponsor, and each had a rationale to defend it. Each one was passed by Congress and signed into law. Some of us saw this firsthand, having served in the U.S. Congress for a combined 71 years, including 36 years on the tax-writing committees. Others saw the changes from different perspectives – teaching, interpreting, and even administering the tax code. In retrospect, it is clear that frequent changes to the tax code, no matter how well-intentioned, ultimately undermine the integrity of the code in real and significant ways.

As we moved forward with recommendations for reform, we followed the President's instructions to emphasize simplicity, fairness, and to remove impediments to growth. Achieving all of these principles is no easy task. We recognized from the start of our meetings that while it is relatively straightforward to point out flaws in a tax system and to express a desire for change, it is much more challenging to settle on a specific solution. There are difficult trade-offs. While we have differed at times and we may not all agree with every word in this report, we all fully endorse it.

We unanimously recommend two options to reform the tax code. We refer to one option as the Simplified Income Tax Plan and the other option as the Growth and Investment Tax Plan. Both of them are preferable to our current system. Both satisfy the President's directive to recommend options that are simple, fair, and pro-growth.

The Simplified Income Tax Plan dramatically simplifies our tax code, cleans out targeted tax breaks that have cluttered the system, and lowers rates. It does away with gimmicks and hidden traps like the Alternative Minimum Tax. It preserves and simplifies major features of our current tax code, including benefits for home ownership, charitable giving, and health care, and makes them available to all Americans. It removes many of the disincentives to saving that exist in our current code, and it makes small business tax calculations much easier. It also offers an updated corporate tax structure to make it easier for American corporations to compete in global markets.

The second recommended option, the Growth and Investment Tax Plan, builds on the Simplified Income Tax Plan and adds a major new feature: moving the tax code closer to a system that would not tax families or businesses on their savings or investments. It would allow businesses to expense or write-off their investments immediately. It would lower tax rates, and impose a single, low tax rate on dividends, interest, and capital gains.

As directed by the President, our recommendations have been designed to raise approximately the same amount of money as the current tax system. The issue of whether the tax code should raise more or less revenue was outside of our mandate. Regardless of how one feels about the amount of revenue required to fund our government, all should agree that the tax system needs a solid and rational foundation.

We recognize that our report is just the beginning of the process to fix our broken tax system. The hardest work lies ahead. As a bipartisan Panel, we have heard from witnesses and elicited proposals from members of both major parties. We hope that the Administration and the Congress will carry forward this spirit of bipartisanship.

The effort to reform the tax code is noble in its purpose, but it requires political willpower. Many stand waiting to defend their breaks, deductions, and loopholes, and to defeat our efforts. That is part of the legislative process. But the interests of a few should not stand in the way of the tax code's primary goal: to raise funds efficiently for the common defense, vital social programs, and other goals of shared purpose. If we agree the goals serve us all, we must also agree that the costs must be fairly borne by all.

This report aims to give voice to the frustrated American taxpayer and to provide a blueprint for lasting reform. We look forward to a national debate and a better tax system.

Connie Mack, III, Chairman

John Breaux, Vice-Chairman

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Table of Contents

Executive Summary

President George W. Bush created the President's Advisory Panel on Federal Tax Reform in January 2005. The President instructed the Panel to recommend options that would make the tax code simpler, fairer, and more conducive to economic growth.

Since then, the Panel has analyzed the current federal income tax system and considered a number of proposals to reform it. During the course of the Panel's work, some themes emerged that guided its deliberations:

- We have lost sight of the fact that the fundamental purpose of our tax system is to raise revenues to fund government.
- Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers.
- The current tax system distorts the economic decisions of families and businesses, leading to an inefficient allocation of resources and hindering economic growth.
- The complexity of our tax code breeds a perception of unfairness and creates opportunities for manipulation of the rules to reduce tax. The profound lack of transparency means that individuals and businesses cannot easily understand their own tax obligations or be confident that others are paying their fair share.
- The tax system is both unstable and unpredictable. Frequent changes in the tax code, which often add to or undo previous policies, as well as the enactment of temporary provisions, result in uncertainty for businesses and families. This volatility is harmful to the economy and creates additional compliance costs.
- The objectives of simplicity, fairness, and economic growth are interrelated and, at times, may be at odds with each other. Policymakers routinely make choices among these competing objectives, and, in the end, simplification is almost always sacrificed. Although these objectives are often in tension, meaningful reform can deliver a system that is simpler, fairer, and more growth-oriented than our existing tax code.

With these themes in mind, the Panel evaluated a number of reform proposals to find out whether they would meet the President's goals for current and future generations of Americans. After 12 public meetings in five states and Washington D.C., the Panel reached consensus to recommend two tax reform plans. The Panel's recommended plans, labeled the Simplified Income Tax Plan and the Growth and Investment Tax Plan, include the following major features:

- Simplification of the entire tax system and streamlined tax filing for both families and businesses.
- Lower tax rates on families and businesses, while retaining the progressive nature of our current tax system.
- Extension of important tax benefits for home ownership and charitable giving to all taxpayers, not just the 35 percent who itemize; extension of tax-free health insurance to all taxpayers, not just those who receive insurance from their employers.
- Removal of impediments to saving and investment.
- Elimination of the Alternative Minimum Tax, which is projected to raise the taxes of more than 21 million taxpayers in 2006 and 52 million taxpayers by 2015.

The two plans differ in the taxation of businesses and capital income. Although they use different approaches, the plans share a common goal of providing simple and straightforward ways for Americans to save free of tax and lower the tax burden on productivity-enhancing investment by businesses.

A table outlining both tax reform plans follows this summary.

The Panel also developed and considered a progressive consumption tax plan that would be administered using the infrastructure of our familiar tax system, but was unable to reach a consensus to include it as a recommendation. The Panel also considered ideas for a value-added tax and a national retail sales tax, and decided not to recommend either approach.

The Simplified Income Tax Plan and the Growth and Investment Tax Plan put forward by the Panel achieve the goals set by the President in a number of ways.

They reduce complexity by:

- Allowing every taxpayer to use a simple tax form, which is less than half the length of the current Form 1040.
- Combining 15 different tax provisions for at-work saving, health saving, education saving, and retirement saving into three simple saving plans.
- Eliminating a complicated set of phase-outs that leave taxpayers wondering whether they are eligible to benefit from numerous provisions.
- Replacing a confusing, full-page worksheet for seniors reporting Social Security income with a simple computation that is no more than six lines.
- Replacing the complicated rules for small business with a system that is based on the records their owners already keep.

They improve fairness by:

- Ensuring that tax benefits are easily understood and accessible, thereby increasing confidence in the tax system.
- Making most tax benefits available to all taxpayers, not just the 35 percent who itemize.
- Shifting some tax preferences from deductions, which tend to benefit high-income households, to tax credits, which benefit all taxpayers equally.
- Reducing marriage penalties by ensuring that the rate brackets, the Family Credit, and the taxation of Social Security benefits for married couples are twice the amounts for singles.
- Transforming the earned income tax credit and savers credit into provisions that are more accessible and beneficial to low income taxpayers.
- Closing loopholes and eliminating special tax breaks that allow the well-advised to avoid paying their fair share.
- Maintaining the progressive nature of our tax system.

They promote economic growth by:

- Reducing the double-tax on corporate profits earned in the United States.
- Promoting savings throughout our economy, especially at the household level.
- Equalizing the tax treatment of several forms of corporate financing, raising the incentives for companies to issue equity rather than debt to finance growth.
- Reducing the likelihood that households or businesses will alter economic behavior because of special tax preferences or benefits.
- Lowering the top marginal rates on individuals and businesses.
- Reducing the paperwork burden for small businesses, and providing them an immediate write-off for all purchases of new tools and equipment.
- Updating our international tax system.

These benefits will follow only from a fundamental reform of the tax code. In isolation, some of the recommended pieces may be controversial, but taken as a whole, they accomplish the Panel's objectives. Each plan is designed to be comprehensive and should be viewed as an integrated package. The Panel believes that without large-scale changes, and continued commitment to avoiding complexity and special tax breaks, the tax code will become even more confusing, unfair, and damaging to our economy. We urge the Administration and Congress to consider these recommendations carefully and to move forward with reform.

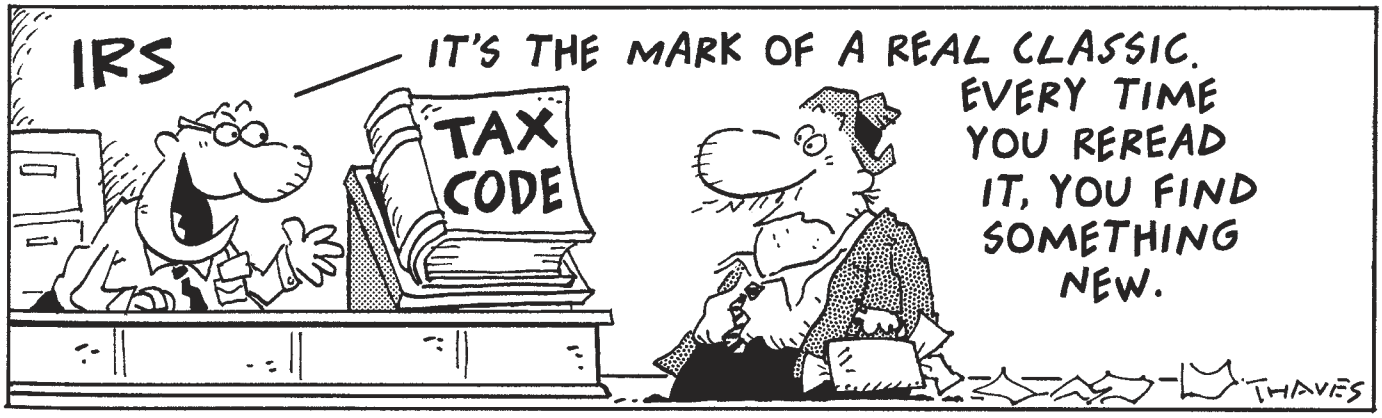
The Current Tax System	
Provisions	**Current Law (2005)**
Households and Families	
Tax rates	Six tax brackets: 10%, 15%, 25%, 28%, 33%, 35%
Alternative Minimum Tax	Affects 21 million taxpayers in 2006; 52 million taxpayers in 2015
Personal exemption	$3,200 deduction for each member of a household; phases out with income
Standard deduction	$10,000 deduction for married couples filing jointly, $5,000 deduction for singles, $7,300 deduction for heads of households; limited to taxpayers who do not itemize
Child tax credit	$1,000 credit per child; phases out for married couples between $110,000 and $130,000
Earned income tax credit	Provides lower-income taxpayers refundable credit designed to encourage work. Maximum credit for working family with one child is $2,747; with two or more children is $4,536
Marriage penalty	Raises the tax liability of two-earner married couples compared to two unmarried individuals earning the same amounts
Other Major Credits and Deductions	
Home mortgage interest	Deduction available only to itemizers for interest up to $1.1 million of mortgage debt
Charitable giving	Deduction available only to itemizers
Health insurance	Grants tax-free status to an unlimited amount of premiums paid by employers or the self-employed
State and local taxes	Deduction available only to itemizers; not deductible under the AMT
Education	HOPE Credit, Lifetime Learning Credit, tuition deduction, student loan interest deduction; all phase out with income
Individual Savings and Retirement	
Defined contribution plans	Available through 401(k), 403(b), 457, and other employer plans
Defined benefit plans	Pension contributions by employers are untaxed
Retirement savings plans	IRAs, Roth IRAs, spousal IRAs – subject to contribution and income limits
Education savings plans	Section 529 and Coverdell accounts
Health savings plans	MSAs, HSAs, and Flexible Spending Arrangements
Dividends received	Taxed at 15% or less (ordinary rates after 2008)
Capital gains received	Taxed at 15% or less (higher rates after 2008)
Interest received (other than tax-exempt municipal bonds)	Taxed at ordinary income tax rates
Social Security benefits	Taxed at three different levels, depending on outside income; marriage penalty applies
Small Business	
Tax rates	Typically taxed at individual rates
Recordkeeping	Numerous specialized tax accounting rules for items of income and deductions
Investment	Accelerated depreciation; special small business expensing rules allow write-off of $102,000 in 2005 (but cut by ¾ in 2008)
Large Business	
Tax rates	Eight brackets: 15%, 25%, 34%, 39%, 34%, 35%, 38%, 35%
Investment	Accelerated depreciation under antiquated rules
Interest paid	Deductible
Interest received	Taxable (except for tax-exempt bonds)
International tax system	Worldwide system with deferral of business profits and foreign tax credits
Corporate AMT	Applies second tax system to business income

How the Tax Code Would Change		
Provisions	**Simplified Income Tax Plan**	**Growth and Investment Tax Plan**
Households and Families		
Tax rates	Four tax brackets: 15%, 25%, 30%, 33%	Three tax brackets: 15%, 25%, 30%
Alternative Minimum Tax	Repealed	
Personal exemption	Replaced with Family Credit available to all taxpayers: $3,300 credit for married couples, $2,800 credit for unmarried taxpayers with child, $1,650 credit for unmarried taxpayers, $1,150 credit for dependent taxpayers; additional $1,500 credit for each child and $500 credit for each other dependent	
Standard deduction		
Child tax credit		
Earned income tax credit	Replaced with Work Credit (and coordinated with the Family Credit); maximum credit for working family with one child is $3,570; with two or more children is $5,800	
Marriage penalty	Reduced; tax brackets and most other tax parameters for couples are double those of individuals	
Other Major Credits and Deductions		
Home mortgage interest	Home Credit equal to 15% of mortgage interest paid; available to all taxpayers; mortgage limited to average regional price of housing (limits ranging from about $227,000 to $412,000)	
Charitable giving	Deduction available to all taxpayers (who give more than 1% of income); rules to address valuation abuses	
Health insurance	All taxpayers may purchase health insurance with pre-tax dollars, up to the amount of the average premium (estimated to be $5,000 for an individual and $11,500 for a family)	
State and local taxes	Not deductible	
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans	
Individual Savings and Retirement		
Defined contribution plans	Consolidated into Save at Work plans that have simple rules and use current-law 401(k) contribution limits; AutoSave features point workers in a pro-saving direction (Growth and Investment Tax Plan would make Save at Work accounts "prepaid" or Roth-syle)	
Defined benefit plans	No change	
Retirement savings plans	Replaced with Save for Retirement accounts ($10,000 annual limit) available to all taxpayers	
Education savings plans	Replaced with Save for Family accounts ($10,000 annual limit); would cover education, medical, new home costs, and retirement saving needs; available to all taxpayers; refundable Saver's Credit available to low-income taxpayers	
Health savings plans		
Dividends received	Exclude 100% of dividends of U.S. companies paid out of domestic earnings	Taxed at 15% rate
Capital gains received	Exclude 75% of corporate capital gains from U.S. companies (tax rate would vary from 3.75% to 8.25%)	Taxed at 15% rate
Interest received (other than tax exempt municipal bonds)	Taxed at regular income tax rates	Taxed at 15% rate
Social Security benefits	Replaces three-tiered structure with a simple deduction. Married taxpayers with less than $44,000 in income ($22,000 if single) pay no tax on Social Security benefits; fixes marriage penalty; indexed for inflation	
Small Business		
Tax rates	Taxed at individual rates (top rate has been lowered to 33%)	Sole proprietorships taxed at individual rates (top rate lowered to 30%); Other small businesses taxed at 30%
Recordkeeping	Simplified cash-basis accounting	Business cash flow tax
Investment	Expensing (exception for land and buildings under the Simplified Income Tax Plan)	
Large Business		
Tax rates	31.5%	30%
Investment	Simplified accelerated depreciation	Expensing for all new investment
Interest paid	No change	Not deductible (except for financial institutions)
Interest received	Taxable	Not taxable (except for financial institutions)
International tax system	Territorial tax system	Destination-basis (border tax adjustments)
Corporate AMT	Repealed	

Chapter One

The Case for Reform

Frank and Ernest



If you were to start from scratch, the current tax code would provide a guide on what to avoid in designing an income tax system. Instead of a sleek and simple system designed to raise revenue for our national defense, social programs, and other vital public services, we have a system so complex that almost $150 billion is spent each year by U.S. households, businesses, and the federal government, just to make sure taxes are tallied and paid correctly. This is more than the sum spent each year on televisions, household electricity, or cereal. Instead of a system that ensures that all pay their fair share, we have a system so confusing that two million taxpayers collectively paid over $1 billion more in taxes by making a wrong decision about the basic choice of itemizing or taking the standard deduction, according to a recent study. Instead of a tax system that draws revenue efficiently from the base of the nation's considerable economy, we have a tax code that distorts basic economic decisions, sets up incentives for unwise or unproductive investments, and induces people to work less, save less, and borrow more. By some estimates, this economic waste may be as much as $1 trillion dollars each year.

The father of modern economics, Adam Smith, said the free market is the "invisible hand" guiding every economic event. In today's U.S. economy, the tax code is the true force. The tax code penalizes savings, contributes to the ever-increasing cost of health insurance, and undermines our global competitiveness. The tax code touches all of life's major events: It tells us the best time to be born, the best time to marry, and the best time to retire.

In short, our current tax code is a complicated mess. Instead of clarity, we have opacity. Instead of simplicity, we have complexity. Instead of fair principles, we have seemingly arbitrary rules. Instead of contributing to economic growth, it detracts from growth. Time and again, witnesses told the Panel about these failings in the tax code.

Complexity

There is no clearer proof of the complexity of the tax code than the collective anxiety felt by Americans every April as the tax filing deadline approaches. For many, filing taxes consists first of procrastination. Then there is the inevitable search for slips of paper containing once-meaningful but now unintelligible financial transactions. Then comes the maze of lengthy instructions complex enough that even highly schooled professionals have to reread the directions several times. Those directions send taxpayers on a search through baffling schedules and detailed worksheets requiring many illogical and counterintuitive computations. And in the end, most taxpayers give up, and visit a tax preparer who promises to make sense of the whole process - for a price.

No matter how much you earn, chances are you do not clearly understand how to figure out your taxes. A recent poll of those with an annual income of $20,000 or less (usually the families with the simplest tax forms) showed that about 80 percent found the tax system either very complex or somewhat complex. That figure rises to nearly 100 percent for taxpayers with incomes exceeding $150,000. The process is so bad that one-third of Americans surveyed believe that completing the annual tax return is more onerous than actually paying large amounts of money in taxes.

To determine something as basic as figuring out the tax implications of having a child, you need to review numerous rules and complete many separate sets of computations. Figuring out whether you can claim the child tax credit, for example, requires the skills of a professional sleuth: You need to complete eight lines on a tax form, perform up to five calculations, and fill out as many as three other forms or schedules. Further research, reading, and computation may be needed to determine whether you can claim head of household filing status, an exemption for a dependent, the child and dependent care credit, the earned income tax credit, or tax credits related to your child's education, to name only some of the possibilities.

Last year, Americans spent more than 3.5 billion hours doing their taxes, the equivalent of hiring almost two million new IRS employees – more than 20 times the agency's current workforce. If the money spent every year on tax preparation and compliance was collected – about $140 billion each year or over $1,000 per family – it could fund a substantial part of the federal government, including the Department of Homeland Security, the Department of State, NASA, the Department of Housing and Urban Development, the Environmental Protection Agency, the Department of Transportation, the United States Congress, our federal courts, and all of the federal government's foreign aid. On average, Americans spend the equivalent of more than half of one work week – 26 hours – on their taxes each year (not to mention the amount of time they work to pay the taxes themselves).

In 2003, about 60 percent of household filers gave up trying to do the work themselves and hired a preparer. About a quarter relied on a computer and purchased software. A small fraction got help from volunteers. And 13 percent of Americans completed their own calculations and filed their taxes the old-fashioned way: with pen and paper.

Complying with the tax code is frequently more burdensome for those with the least ability to pay. For example, the earned income tax credit (EITC) is an important initiative, provided through our tax code to help low-income working families move out of poverty. The EITC differs from other entitlement programs in that it is only available to lower-income workers. Initially, EITC benefits increase as an individual's earnings increase, but then the benefits phase out at higher income levels. These rules are so complex that nearly three-quarters of those families claiming it hire a tax preparer. This makes little sense: These families typically earn less than $35,000. The extra cost of paying a preparer to claim the EITC benefit may offset a significant portion of the benefit itself – and to the family struggling to stay out of poverty, those dollars are scarce. Policy experts regularly praise the EITC's effectiveness, but as a matter of tax administration, it is complicated and inefficient.

The tax code places an undue burden on another critical sector of our society: the small businesses that create a majority of new jobs in our economy. The 31 million taxpayers who reported self-employment income or employee business expenses spent an average of 45 hours and $360 in out-of-pocket compliance costs, compared with 20 hours and $105 in out-of-pocket costs for the 103 million Americans who did not report self-employment income. Studies have found that the smaller the business, the higher the cost of complying with the tax code per dollar of revenue.

Confusion and Unfairness

Did I pay too much? Did I pay too little? Who will notice? These three questions play out in the minds of all taxpayers when they file their forms by April 15 each year. And as journalists and tax analysts have repeatedly shown over the years, rarely will two tax preparers working on the same tax return come up with the same amount of taxes due. There is little confidence that we really know how much we should be paying in taxes in any given year. It is not just a matter of doing arithmetic. According to a recent survey, more than two-thirds of respondents incorrectly answered basic filing questions about the tax implications of selling a home, claiming a dependent, saving for education and retirement, receiving capital gains, and paying the Alternative Minimum Tax. To be sure, some of these issues are complex. But our tax code should aspire to be clear and transparent, not allow confusion to multiply. Taxpayers should be able to understand the tax code's basics.

The result of this fog of ignorance typically isn't overpayment, which occurs occasionally, but underpayment, which happens regularly. This underpayment is measured by what is known as the "tax gap." The tax gap represents the difference between the tax that taxpayers should pay and what they actually pay on a timely basis. The IRS estimates that in 2001, between $281 and $322 billion went unreported on individual and business tax returns. This translates to a tax hike of more than $2,000 each year for honest taxpayers. Research shows non-compliance has been steadily rising over the past two decades, a troubling indicator that our tax code's growing complexity is inviting more cheating.

But taxpayers think that with the myriad of targeted exclusions, deductions, and credits, others may not be paying their fair share – so why should they? Some call this "the cheat or chump syndrome." In addition, clever tax advisors mine the complexity of the tax code to develop and market tax shelters and other schemes clearly designed to manipulate the tax code's hidden loopholes for their clients' exclusive benefit. The perception that the tax code is unfair and easily manipulated undermines voluntary compliance – the foundation of our tax system.

An Arbitrary and Unequal System

A tax code, like any law, should rest squarely on the notion that it will remain largely the same, from year to year, from person to person. In a court of law, there is an expectation by the judge, jury, and all other parties that the law will be equally and fairly applied based on well-established and consistent judicial principles. Yet our tax code shares few, if any, of these features.

Taxpayers cannot plan ahead. The tax system is a kaleidoscope of shifting credits, rates, and benefits because many of the tax code's most prominent features – the tax rate for ordinary income, the child tax credit, the lower tax on dividends and capital gains – may shift wildly from one year to the next, and in some cases simply expire. For example, tax relief passed by Congress in 2001 and 2003 is scheduled to fade away. While some believe Congress will not allow this to happen, no one can say for sure. As Box 1.1 indicates, all individual tax rates are scheduled to rise. The lowest bracket, currently set at 10 percent, will disappear and the top tax rate will climb from 35 to 39.6 percent after 2010. The child tax credit and the deduction for IRA contributions will be cut. Taxpayers have recently seen their taxes on dividends and capital gains reduced but will see them sharply increased in 2008, when those taxes are scheduled to rise again.

Box 1.1. Commonly Applicable Income Tax Provisions Scheduled to Expire

- Reduced Individual Tax Rates on Ordinary Income
- Marriage Penalty Relief
- Increased Child Tax Credit
- Increased IRA Contribution Limit
- Reduced Individual Tax Rate on Dividend Income
- Reduced Individual Tax Rate on Capital Gains
- Investment Incentives for Small Business

This uncertainty has clear effects. If you own a small business and are contemplating an investment in new equipment, the tax provision that quadruples the portion of that investment that can be written-off immediately is an incentive to go forward with the investment. Yet because of the scheduled expiration in 2007 of this provision, your decision to invest may be rushed. Such an investment – timed as it is to a provision in the tax code rather than to economic fundamentals – may turn out to be ill-advised and waste economic resources. In any case, the tax code's constant phase-ins and phase-outs are a nuisance at best, and a negative force at worst, in the daily economic lives of American families and businesses.

The tax code treats similar taxpayers in different ways. Taxpayers with the same income, family situation, and other key characteristics often face different tax burdens. Such differing treatment creates a perception of unfairness in our tax code. For example, taxpayers in states with high state and local income and property taxes receive higher deductions than taxpayers who live in lower-tax states with fewer state-provided services. Taxpayers with substantial employer-provided health insurance benefits receive in-kind compensation that is not taxed, while taxpayers who buy the same health insurance on their own usually pay tax on the income used to purchase the insurance. And Social Security benefits are taxed at a higher rate for married seniors than for those not married. How much or little taxpayers pay in tax is sometimes dependent on where they happen to live, the choices made by their employers, and whether they are married.

The differences in treatment are not always set by design. Rather, the different amounts similarly situated taxpayers often pay is sometimes a reflection of the tax code's complexity. While some taxpayers may take advantage of special provisions that are available to them, others do not. Someone who claims legal credits and deductions has done nothing wrong, yet unequal outcomes suggest that our tax code unfairly benefits those with the time and resources to make sense of it. This situation conflicts with basic principles of equity and erodes public confidence in the system.

The tax code treats similar income differently. As part of our system of progressive taxation, income is taxed at increasing rates as a taxpayer's annual income increases. This creates a tax rate called the "marginal rate." The marginal tax rate is the rate paid on the last dollar of income earned – it measures how much tax you pay on additional,

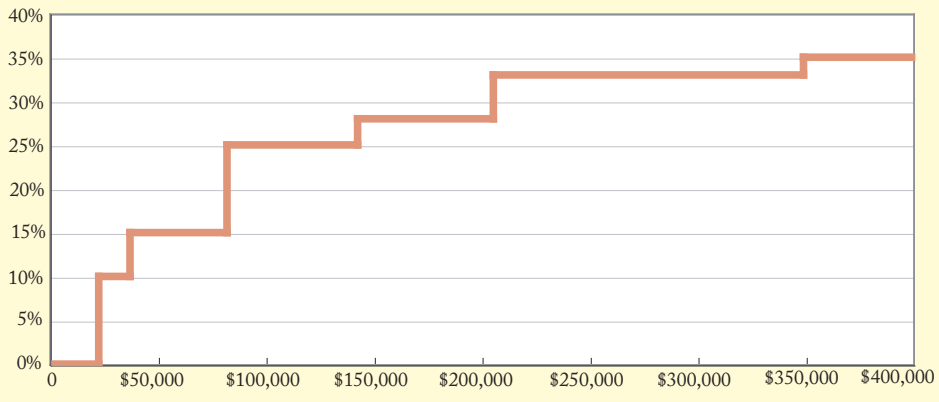
or marginal, income. The basic tax rate schedule taxes the first $7,300 of taxable income for single individuals at a 10 percent rate. The next $22,400 is taxed at a 15 percent rate. Each block of income is taxed at a higher marginal rate, until a taxpayer reaches the $326,450 level, above which income is taxed at the highest rate of 35 percent.

At first glance, this appears to be a fairly straightforward approach to taxation, but it is not so simple in reality. The effective marginal tax rate can differ substantially from the schedule of basic tax rates described above. This element is complicated by various exclusions, deductions, and credits, and the web of accompanying phase-ins and phase-outs. Some credits and deductions are available to people only when they earn more or less than a certain amount of income. The idea behind setting a limitation on the income one can earn before claiming certain deductions and credits is to target the benefits to those perceived to have the greatest need. But that creates a set of counterintuitive and counterproductive economic consequences that may keep many families from trying to earn more than they currently do.

Let's say you are just offered a great job at $120,000 a year. You are married with one child and your current salary is $80,000. You take the job, right? Not necessarily. The increase in salary might cause you to lose some of the child credit – and subject you to other provisions that increase your total tax bill even more, such as the Alternative Minimum Tax. In all, the pre-tax jump in your new salary may be $40,000, but it could end up costing you an extra $9,203 in tax – meaning that your salary would rise by 50 percent while your tax liability would increase by 140 percent. Not surprisingly, some workers figure this out quickly and avoid taking on work that may pay more, simply because of how the tax code penalizes that extra effort.

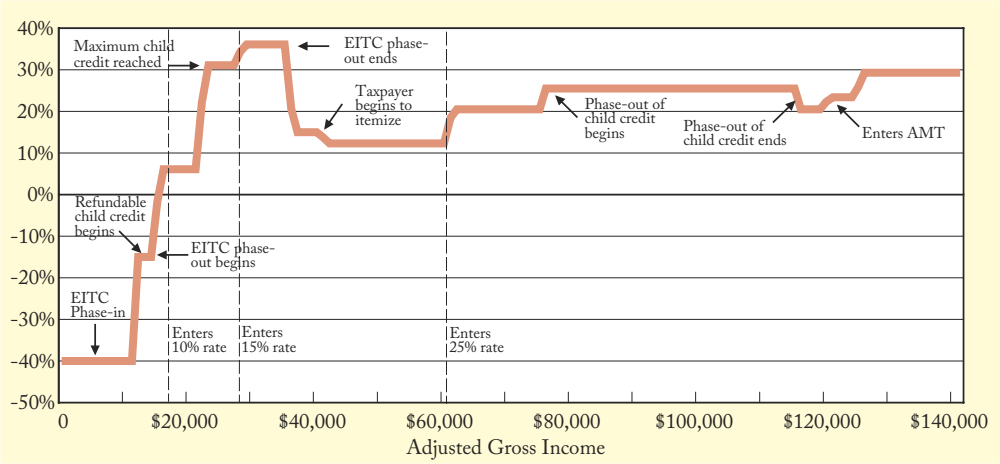
Two charts below illustrate the problem for a hypothetical taxpayer – a single mother with two children. Figure 1.1 shows how she would face a gradually increasing tax rate as she earned additional income if the tax system consisted only of our current schedule of basic tax rates described above, plus the standard deduction and personal exemption.

Figure 1.1. Tax Rate Schedule for a Hypothetical Head of Household with Two Children in 2005



In contrast to this system, Figure 1.2 illustrates the reality of our current system. Low-income taxpayers face very high marginal tax rates, even higher than those with substantially larger incomes. Moreover, even small changes in income can cause large changes in marginal tax rates. For example, our single mother with two children enjoys a *negative* tax rate on each extra dollar of earnings up to $11,000 because she receives a $40 tax credit for every $100 earned through the EITC. As she earns more, however, her tax rate rises sharply. At an income level of $25,000, she pays $31 of tax on each additional $100 earned. So instead of receiving $140 in total wages and tax benefits for each extra $100 earned, she now receives only $69 on every extra $100 of earnings. Figure 1.2 shows how this taxpayer's tax rate shifts as she moves up the economic ladder – and not always in the way you would imagine.

Figure 1.2. Marginal Effective Federal Income Tax Rates for Hypothetical Head of Household with Two Children in 2005



Note: Calculations are for a head of household with two children under 17. Itemized deductions are assumed to be 18 percent of income.
Source: Department of the Treasury, Office of Tax Analysis.

This shifting treatment of one's last dollar of income – far more complex than the basic tax rate schedule – catches many taxpayers by surprise. Yet this shifting treatment does not affect only low-income workers. For example, a married couple with $87,000 of income – somewhat above the national average – and a child in college would be eligible for a tax credit, known as the HOPE credit, to offset education expenses. But if this family has an additional $20,000 in gains from selling stock to pay tuition, they would no longer be eligible for the HOPE credit. Guided by a tax advisor, this family could hold off on selling the stock to maintain HOPE credit eligibility. That is clearly to the family's benefit: The HOPE credit's value, at up to $1,500, is certainly a tidy return for keeping the the stock in their investment account for an extra year. Because the tax code uses income to determine a family's eligibility for federal assistance – and views wealth as immaterial – this family receives a benefit that a less well-advised family does not.

It could be that some well-meaning lawmaker wanted to avoid handing out federal tax credits to high-earning families. But even the best intentions cannot guard against the law of unintended consequences. One such consequence is handing a tax credit to a family that didn't really need it and would have sent their child to college anyway. In this case, the government spent money on a tax benefit that did not change the behavior that it was designed to affect – and thus provided a windfall to the family. Another unintended consequence is that these credits may lead to a higher cost of education for those who do not receive the credits. There is some evidence, for instance, that the credit may encourage colleges and universities to increase tuition, thereby capturing some of the benefit of the credit. A third consequence is that everyone else's taxes are higher.

The Tax Code in Our Lives

Earlier in this chapter, we referred to the "invisible hand," as described by Adam Smith. He observed that the invisible hand of free markets is the force through which individuals and businesses put economic resources to their greatest value. The tax code, however, gets in the way of free commerce and reduces our economic capacity in countless ways. Take health care, for instance. Our tax code treats health care benefits with great deference; they are not treated as income, so those companies that offer health insurance coverage do so as a tax-free benefit to their employees. But that generosity removes many incentives for cost controls, driving up health care costs for everyone, including those whose employers do not offer the same benefits. With virtually no low-cost option for health insurance available, many go without. This situation – a nation divided between those with "Cadillac" insurance coverage and those with none – is exacerbated by our tax code.

The tax code reaches into daily events, and by multiplication of rules and conditions, makes itself into an economic hazard. Yet there are examples of the tax code's failure to account for economic progress when it does occur. In the case of our technology industries, we have a sector of the economy larger in size than health care, and crucial to future job growth and living standards. These technology-based industries depend heavily on how our tax code defines the useful life of all technology. These definitions, laid out in depreciation schedules, permit purchasers of computers and other high-technology equipment to take a deduction against their income for the cost of that equipment over a period of time. The depreciation schedules for technology have always been a source of some controversy; companies routinely discard new computers and other technological equipment after only three years while the depreciation schedules call for a five-year lifespan. Why? Congress based the current depreciation schedule for computers on studies of the useful lives of surplus government typewriters from the late 1970s. Only in our tax code can a late-1970s typewriter be viewed as the same as a high-end, multimedia laptop.

Consider the tax code's impact on savings and consumption: Jack and Jill both earn a dollar and pay 25 cents in taxes on it. Jack spends his 75 remaining cents, while Jill saves it. If Jill's savings gather interest of 20 cents over the next ten years, she will have 95 cents in her savings account. But she will have to pay taxes on the interest income of 20 cents – an extra 5 cents in taxes. In short, Jack pays 25 cents in taxes on his money, while Jill ends up paying 30 cents – simply because she saved while he did not. While the difference may not matter much, spread throughout a $12 trillion economy and tens of trillions of economic decisions (including decisions about how to save for education, health, and retirement), the tax penalty on savings has enormous effects. The nation's personal savings rate, for example, is less than 2 percent. The low savings rate can be explained by many factors, and the tax code is hardly the sole culprit. However, if we want to improve the savings rate, eliminating the tax penalty on savings might be an obvious place to start.

In short, the tax code presents an obvious target for change. Its complexity, lack of clarity, unfairness, and disproportionate influence on behavior lead taxpayers to frustration and many reformers to other lines of work. But we cannot leave this work undone. Without reform, the tax code will consume more energy, more time, more worry, and more economic resources. The effort to reform this complicated mess starts with understanding how we got here. Our tax code has been shaped by goals other than simplicity, by intentions other than helping the taxpayer plan ahead, and by objectives other than expanding our economy. Years of active meddling may have left our tax code in shambles, but it has taught us a valuable lesson: If we are not simplifying our tax code, it is likely to become more complex, more unfair, and less conducive to our economy's future growth. Reform is the only thing that works.

Box 1.2. The Alternative Minimum Tax: A Cautionary Tale

The Alternative Minimum Tax (AMT) is a vivid example of why our tax code is dysfunctional. The minimum income tax, the predecessor to today's AMT, was first enacted in1969 after reports showed a few hundred very wealthy Americans not paying income taxes. Like the minimum income tax of 1969, the AMT is intended to ensure that taxpayers pay at least some income tax and share in the cost of maintaining our government.

But the AMT has a significant flaw: Its definition of high income was never indexed for inflation. Thus, the threshold for AMT liability in 2006 – $45,000 in income for married couples after allowing for AMT deductions – is nearly the same as the $40,000 threshold that was in place in 1982, when the AMT first came into effect. If this figure had been inflation–adjusted, the exemption would be $82,000. Today, many middle-income Americans are above that $45,000 exemption level.

The failure to index AMT income levels for inflation is significant. The AMT, whatever its original strengths and weaknesses, was for many years only a problem for a few thousand high-income families. Now, it is a headache for nearly four million American families and, as shown in the chart below, is projected to affect more than 50 million taxpayers by 2015.

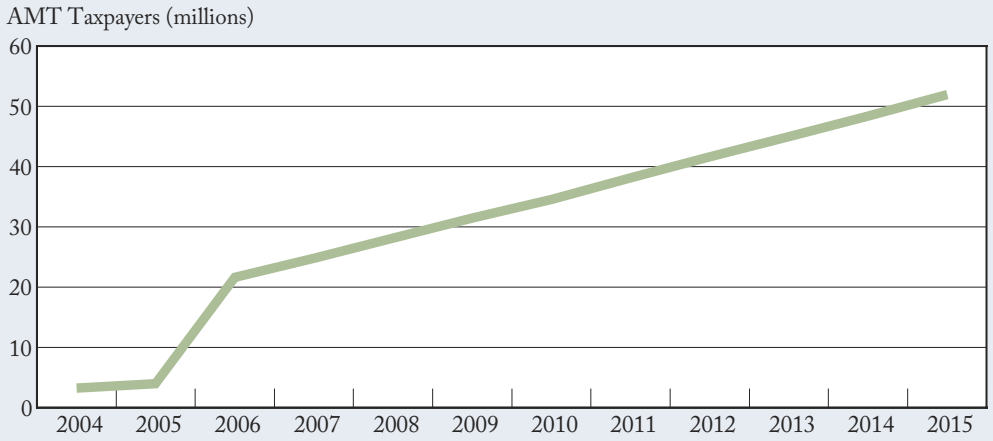
The AMT constitutes a second, parallel tax structure that has its own exemptions, tax rates, and tax credits, and that employs a definition of income broader than that of the regular income tax. Certain deductions available in the "regular" tax code are not available to AMT taxpayers. Taxpayers who have families are especially hurt by the AMT; the marriage penalty is worse under the AMT, and the child-related benefits are lower.

Because of the growing reach of the AMT, millions of taxpayers must now fill out a 12-line worksheet, read 8 pages of instructions, and complete a 55-line form to determine whether they must pay the AMT. Only after making this separate set of calculations to see which tax-owed figure is higher, can a taxpayer file a return – paying the higher amount. Not surprisingly, many taxpayers seek expertise in navigating this maze – 75 percent of AMT taxpayers hire a professional to do their returns for them.

So far, lawmakers have dealt with the problem by passing temporary fixes or "patches" to the AMT to limit its reach on most middle-income families. But after 2005, when the current fix expires, the number of taxpayers projected to be affected by the AMT will rise sharply from 4 million in 2005 to 21.6 million in 2006. Not only will these taxpayers be required to make a second set of calculations to determine their AMT liability, but they will also pay an average of $2,770 more in taxes. By 2015, 52 million taxpayers – 45 percent of all taxpayers with income tax – are projected to be affected by the AMT.

The AMT will increasingly affect upper-middle-income taxpayers – 13 percent of taxpayers with incomes between $100,000 and $200,000 will pay their taxes under the AMT system in 2005, but just one year later, more than 75 percent of taxpayers in this income group will do so.

Taxpayers Subject to the AMT



Note: Assumes 2001 and 2003 tax cuts are made permanent and the temporary AMT provisions are allowed to expire in 2005.
Source: Department of the Treasury, Office of Tax Analysis.

Perhaps not surprisingly, the individual AMT has failed to achieve its goal of making sure all well-to-do Americans pay taxes. The Treasury Department projects that in 2006, in spite of the AMT over 6,600 taxpayers with income greater than $200,000, and over 1,300 taxpayers with income over $700,000, will pay no tax through various combinations of legitimate tax avoidance. What began as a vehicle to focus fairness on a handful of taxpayers has turned into a complex, unfair, and inefficient burden on millions of Americans; few, if any, of those paying the AMT are the intended targets of the tax. The AMT is a salient example of a policy or government program gone astray with unintended consequences carrying malign impacts.

In addition, the corporate AMT subjects many corporations to a second, parallel tax. Like the individual AMT, the corporate AMT has been used to pare back, rather than repeal, tax benefits by partially penalizing businesses that claim tax incentives. Under the corporate AMT, corporations are required to keep an entirely different set of books and records and to calculate their tax liability under two very different complex sets of rules – the regular income tax rules with rates up to 35 percent and the corporate AMT rules with rates up to 20 percent – and then pay the larger of the two amounts.

The corporate AMT is an accounting and administrative nightmare that requires businesses to recompute many deductions using less generous rules. Two witnesses described to the Panel how the existence of these two radically different tax codes with dozens of complex differences between them makes rational tax planning, administration, and compliance exponentially more difficult. In addition, the corporate AMT may exacerbate economic downturns by making corporations that are realizing losses under the regular income tax pay additional taxes when they are losing money.

Chapter Two
How We Got Here

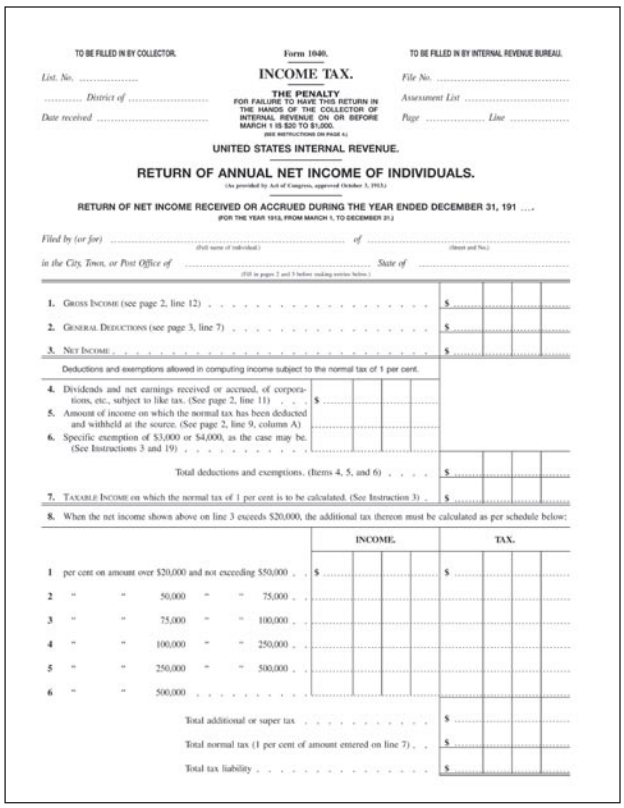
The tax system is closely intertwined with American society; it not only reflects events of the day, but also shapes the society in which we live. It has broad effects – some intentional and some accidental, some short term and some long term. Over the years, many trends have contributed to the problems in our current system. To appreciate the Panel's options for reform, it is useful to understand the broad historical outlines of the U.S. tax system.

Among the most important trends that have marked the federal income tax since its inception have been its ever growing reach; not only has it steadily affected increasing numbers of Americans, but it is now used to carry out a multitude of policy objectives that go well beyond merely collecting revenues needed to fund our government. And as the tax code has developed, little effort has been given to comprehensively examining the system to make sure that it is simple, efficient, and transparent.

There are already many comprehensive histories of the tax code, and this report does not attempt to duplicate, or even summarize, those works. Instead, this chapter highlights historical developments relevant to the Panel's work.

For much of its history the United States did not have an income tax. Except for a brief period during and immediately after the Civil War, the nation relied almost exclusively on tariffs – taxes on imported goods – to support government functions. A lively constitutional debate, including a decision by the Supreme Court in 1895, weighed against the creation of an income tax.

But in 1913, the Sixteenth Amendment was ratified, ending all debate about whether an income tax was constitutional. A few months later, Congress enacted an income tax. At its inception, less than 1 percent of Americans paid the individual income tax. Most Americans were exempt from paying the tax because their income did not exceed a relatively high threshold, and even those who were subject to the tax paid at modest rates. By the 1920s, tax rates had increased and a majority of government revenue came from income taxes that helped fund what was still a small federal government.



TO BE FILLED IN BY COLLECTOR. Form 1040. TO BE FILLED IN BY INTERNAL REVENUE BUREAU.

List. No. .....
..... District of .....
Date received .....

INCOME TAX.

THE PENALTY
FOR FAILURE TO HAVE THIS RETURN IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE ON OR BEFORE MARCH 1 IS $20 TO $1,000.
(SEE INSTRUCTIONS ON PAGE 4.)

File No. .....
Assessment List .....
Page ..... Line .....

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME OF INDIVIDUALS.
(As provided by Act of Congress, approved October 3, 1913.)

RETURN OF NET INCOME RECEIVED OR ACCRUED DURING THE YEAR ENDED DECEMBER 31, 191 ....
(FOR THE YEAR 1913, FROM MARCH 1, TO DECEMBER 31.)

Filed by (or for) ..... of .....
(Full name of individual.) (Street and No.)
in the City, Town, or Post Office of ..... State of .....
(Fill in pages 2 and 3 before making entries below.)

1. Gross Income (see page 2, line 12) . . . . . $
2. General Deductions (see page 3, line 7) . . . . . $
3. Net Income . . . . . $

Deductions and exemptions allowed in computing income subject to the normal tax of 1 per cent.

4. Dividends and net earnings received or accrued, of corporations, etc., subject to like tax. (See page 2, line 11) . . . . $
5. Amount of income on which the normal tax has been deducted and withheld at the source. (See page 2, line 9, column A) .....
6. Specific exemption of $3,000 or $4,000, as the case may be. (See Instructions 3 and 19) . . . . . .

Total deductions and exemptions. (Items 4, 5, and 6) . . . . $

7. Taxable Income on which the normal tax of 1 per cent is to be calculated. (See Instruction 3) . . $

8. When the net income shown above on line 3 exceeds $20,000, the additional tax thereon must be calculated as per schedule below:

	INCOME.	TAX.
1 per cent on amount over $20,000 and not exceeding $50,000	$	$
2 " " 50,000 " " 75,000		
3 " " 75,000 " " 100,000		
4 " " 100,000 " " 250,000		
5 " " 250,000 " " 500,000		
6 " " 500,000		

Total additional or super tax . . . . . $
Total normal tax (1 per cent of amount entered on line 7) . . $
Total tax liability . . . . . $

1913 Form 1040

The income tax was initially a "class tax" paid mostly by wealthy Americans. But during the 1930s, the federal government established withholding of payroll taxes in order to fund the new Social Security system, thereby creating a means to collect income tax from the many Americans who receive wages from an employer.

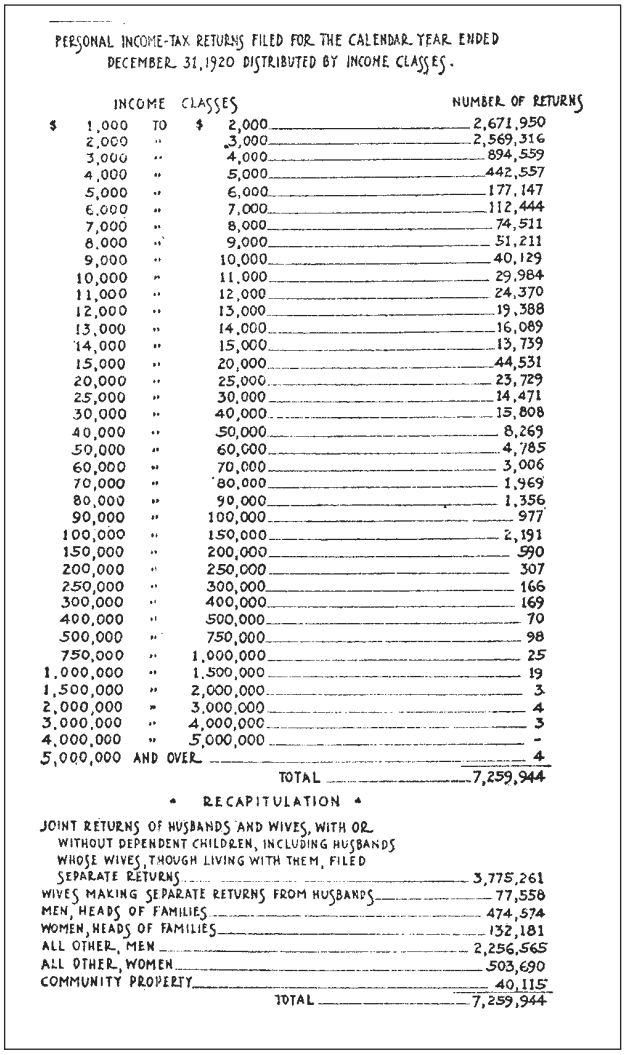
World War II created a pressing need for greater government revenues, and the income tax was greatly expanded to fill the shortfall. The threshold for paying taxes was dramatically reduced, subjecting millions of families to the income tax for the first time. At the same time, wage withholding was expanded to require employers to collect not only Social Security taxes, but also income taxes on employees' wages. By the end of World War II, almost 75 percent of Americans were subject to the income tax, compared with only 5 percent in 1939. The income tax had been transformed from a "class tax" on the wealthiest Americans into a "mass tax" paid by most Americans to fund what had become a substantially larger federal government.

Unlike the aftermath of previous wars, such as the Civil War and World War I, when income taxes were either abolished or reduced, the end of World War II did not prompt the federal government to lower tax rates. Instead, the federal government continued to use receipts from the income tax to maintain much of its wartime size. The income tax remained a major factor in America's economy, and unintended consequences became a hallmark of tax policy.

During the war, the National Labor Relations Board followed an earlier IRS ruling that excluded employer-paid health insurance from income and exempted employer-paid health insurance from wage and price controls. As a result of this decision, employers looking to attract and keep talented workers made greater use of health insurance benefits and other non-cash wages. When World War II ended and price controls were removed, health insurance remained a tax-favored form of compensation for the vast majority of Americans. The decision to exclude health care benefits – originally made when the tax code affected only a small fraction of Americans – had far-reaching consequences, which are detailed later in this report.

Starting in the 1960s, another broad trend in tax policy accelerated: the use of the tax code to achieve policy goals other than raising government revenue. Rather than the largely unintended consequence of some earlier tax writing efforts, this trend reflected a deliberate intent. It strengthened throughout the 1960s and 1970s, with the creation of individual retirement accounts (IRAs) in 1974; the earned income tax credit (EITC), which provides low-income working Americans with a tax benefit, in 1975; and 401(k) retirement accounts in 1978.

Tax changes motivated by non-tax economic or social policy goals became so commonplace that, beginning in 1974, provisions in the tax code to promote these goals were tracked in a "tax expenditure budget." A tax expenditure is a tax incentive that provides special tax treatment to a particular type of activity. Many of these tax incentives could have been structured as a direct government spending program. Either way, it costs the government money to provide benefits, which must be financed with higher taxes elsewhere. Over the past several decades, the number and estimated cost of tax expenditures has grown considerably.



PERSONAL INCOME-TAX RETURNS FILED FOR THE CALENDAR YEAR ENDED DECEMBER 31, 1920 DISTRIBUTED BY INCOME CLASSES.

INCOME CLASSES			NUMBER OF RETURNS
$ 1,000	TO	$ 2,000	2,671,950
2,000	"	3,000	2,569,316
3,000	"	4,000	894,559
4,000	"	5,000	442,557
5,000	"	6,000	177,147
6,000	"	7,000	112,444
7,000	"	8,000	74,511
8,000	"	9,000	51,211
9,000	"	10,000	40,129
10,000	"	11,000	29,984
11,000	"	12,000	24,370
12,000	"	13,000	19,388
13,000	"	14,000	16,089
14,000	"	15,000	13,739
15,000	"	20,000	44,531
20,000	"	25,000	23,729
25,000	"	30,000	14,471
30,000	"	40,000	15,808
40,000	"	50,000	8,269
50,000	"	60,000	4,785
60,000	"	70,000	3,006
70,000	"	80,000	1,969
80,000	"	90,000	1,356
90,000	"	100,000	977
100,000	"	150,000	2,191
150,000	"	200,000	590
200,000	"	250,000	307
250,000	"	300,000	166
300,000	"	400,000	169
400,000	"	500,000	70
500,000	"	750,000	98
750,000	"	1,000,000	25
1,000,000	"	1,500,000	19
1,500,000	"	2,000,000	3
2,000,000	"	3,000,000	4
3,000,000	"	4,000,000	3
4,000,000	"	5,000,000	-
5,000,000 AND OVER			4
		TOTAL	7,259,944

RECAPITULATION

JOINT RETURNS OF HUSBANDS AND WIVES, WITH OR WITHOUT DEPENDENT CHILDREN, INCLUDING HUSBANDS WHOSE WIVES, THOUGH LIVING WITH THEM, FILED SEPARATE RETURNS	3,775,261
WIVES MAKING SEPARATE RETURNS FROM HUSBANDS	77,558
MEN, HEADS OF FAMILIES	474,574
WOMEN, HEADS OF FAMILIES	132,181
ALL OTHER, MEN	2,256,565
ALL OTHER, WOMEN	503,690
COMMUNITY PROPERTY	40,115
TOTAL	7,259,944

Internal Revenue Service, Statistics of Income, 1920

Even when Congress and the Administration corrected certain problems in the tax code, they often created other problems at the same time. For example, in 1981, Congress passed and President Reagan signed a tax bill that indexed tax brackets for inflation, ending what was called "bracket creep." Bracket creep occurred when inflation pushed up taxpayers' wages. Because tax brackets were not adjusted for inflation, this amounted to an inflation-aided tax hike every year, even if a taxpayer's purchasing power stayed the same or actually fell. Furthermore, lawmakers were able to spend the proceeds from these higher taxes without having to actually vote to increase rates.

While fixing the bracket creep problem, the 1981 tax bill also included various narrowly tailored tax incentives, and these special interest provisions, including further benefits for real estate investment, helped drive greater use of tax shelters. By 1982, one poll showed that 86 percent of Americans believed that most higher-income people got out of paying much of their taxes by hiring tax accountants and lawyers who showed them how to use loopholes in the tax law, while lower and middle-income people simply took the standard deduction and paid what they owed.

In his 1984 State of the Union address, President Reagan called on the Treasury Department to prepare a plan to overhaul the entire tax code. After two years of analysis, debate, and bipartisan compromise, President Reagan signed the Tax Reform Act of 1986. The 1986 Act reduced the top marginal individual tax rate from 50 percent to 28 percent and increased the standard deduction. The top corporate tax rate was reduced from 50 percent to 34 percent.

The 1986 Act broadened the tax base by repealing more tax preferences than had been eliminated in all tax legislation enacted between 1913 and 1985, including the long-term capital gains exclusion, the investment tax credit, the two-earner deduction, state and local sales tax deductions, and the deduction for credit card interest. Deductions for passive losses, medical expenses, business meals and entertainment, and miscellaneous expenses also were limited. These changes and others made by the 1986 Act simplified the tax code, broadened the income tax base, allowed for lower marginal tax rates, and curtailed the use of individual tax shelters.

While the 1986 Act was a historic event, it did not produce a lasting transformation of the tax system. The 1986 Act left in place or added various complicated tax benefits, including such items as exclusions for employer-provided fringe benefits, state and local tax deductions, tax-deferred annuities, new mortgage interest deduction rules, and complicated rules for determining alternative minimum tax liability. Many point to the 1986 Act as the high point of contemporary tax reform – and they may well be right – but its limitations suggest that truly sweeping comprehensive reform faces formidable political obstacles.

The reforms of the 1986 Act were intended to create a simpler, more stable, and pro-growth federal income tax system based on lower rates and more uniform taxation of all sources of income, while retaining a progressive tax rate structure. But since 1986, the promise of a more simple and sustainable system has been undone. Throughout the 1990s, income tax rates rose, and many special individual and business tax provisions were enacted, narrowing the tax base. The piecemeal addition of these new benefits was shaped by new budget rules aimed at forcing lawmakers to limit the scope of tax legislation. Rather than limiting the number of new provisions, however, the budget rules led to a greater use of phase-outs, restrictions, and eligibility criteria that compounded the complexity of the tax code.

During the 1990s, the EITC was revised to account for family size and was extended to cover low-income single workers with no children. A higher level of Social Security benefits became subject to tax, and a complicated three-tier system was enacted for calculating how much would be taxed. On the business side, Congress increased the corporate tax rate from 34 percent to 35 percent and either created or extended a number of special provisions for the energy sector, low income housing, research and development, and tax-free employee fringe benefits.

In 1997, Congress again enacted new tax credits for children and for education. A new type of retirement vehicle – called a Roth IRA – was created along with a new education savings account. Joining the medical savings accounts created in 1996, these accounts were the first of a slew of new provisions to promote savings, each with its own rules and limitations. The piecemeal addition of savings incentives with complicated rules made it increasingly hard for ordinary Americans to navigate the system while still allowing for well-advised taxpayers to take advantage of the code's many loopholes.

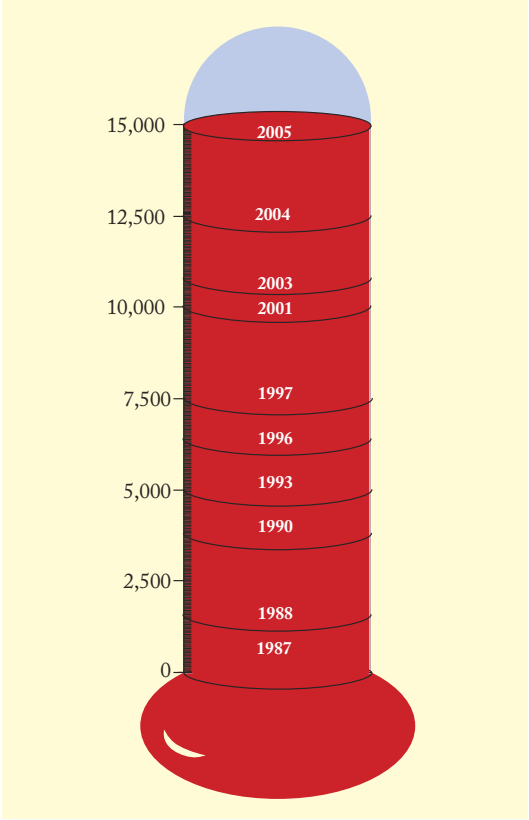
A number of significant changes to the tax code have been made in the last few years. Tax relief passed in 2001 lowered individual tax rates, doubled the child tax credit, raised limits for retirement plan contributions, provided marriage penalty relief, and introduced a deduction for college expenses and yet another education savings account. Two years later, further tax relief was signed that reduced the taxation of both dividends and capital gains to a uniform top rate of 15 percent, and increased the amount of depreciation or expensing that companies could take for business purchases. All of these provisions – rates and others – are temporary and expire over the next six years, substantially undermining the durability of the tax code and the certainty taxpayers need for planning.

Just last year, Congress enacted a "use it or lose it" tax holiday to encourage multinationals to bring back previously untaxed foreign earnings, and a special tax deduction targeted at domestic manufacturing. The manufacturing deduction is another example of a provision that is targeted at a specific type of activity, but that creates complexity for everyone. The provision allows businesses to deduct net income from the sale of goods, software, and film and sound recordings if they are manufactured or produced within the United States. To take advantage of the benefit, businesses need to allocate all of their receipts and expenses between those activities that are eligible for the preference and those that are not. Provisions like these are also difficult to administer. One witness observed that the prohibition on movies with sexually explicit content places IRS agents in the awkward position of screening movies to determine whether they qualify for the deduction.

Even as the Panel was conducting its deliberations, lawmakers continued to enact additional tax breaks for certain industries. Yet again, greater value was placed on creating targeted tax breaks than on establishing broad-based provisions that would apply to all businesses.

Today, our tax system bears little resemblance to the simple, low-rate system promised by the 1986 reform effort. Since 1986, there has been nearly constant tinkering – more than 100 different acts of Congress have made nearly 15,000 changes to the tax code, as shown in Figure 2.1. A number of new credits, deductions, and exemptions have been extended or layered on top of long-standing incentives in the tax code for such goals as encouraging savings, charity, and homeownership. A growing maze of tax rules and incentives target narrow classes of individuals; phase-outs, contribution limits, and complicated eligibility criteria circumscribe the scope of older programs. Changes in the global economy, including increasingly sophisticated financial instruments, the free flow of capital across borders, a globally competitive marketplace, and the expanding role of intangible assets in producing business income, have also made it harder to establish the rules required to accurately measure tax liability and fairly enforce the income tax.

Figure 2.1. Tax Law Changes Since 1986



Our tax code is in dire need of reform. Not only has it failed to keep pace with our growing and dynamic economy, frequent changes have made it unstable and unpredictable. History demonstrates that in the absence of a concerted effort to reform the tax system, it will become more complex and ungainly. Meaningful reform requires a comprehensive and forward-looking examination of our tax system. The Panel has been presented with a historic opportunity to do just that. The following chapters describe the Panel's findings, along with proposals designed to put our country on a path towards a better tax system for current and future generations.

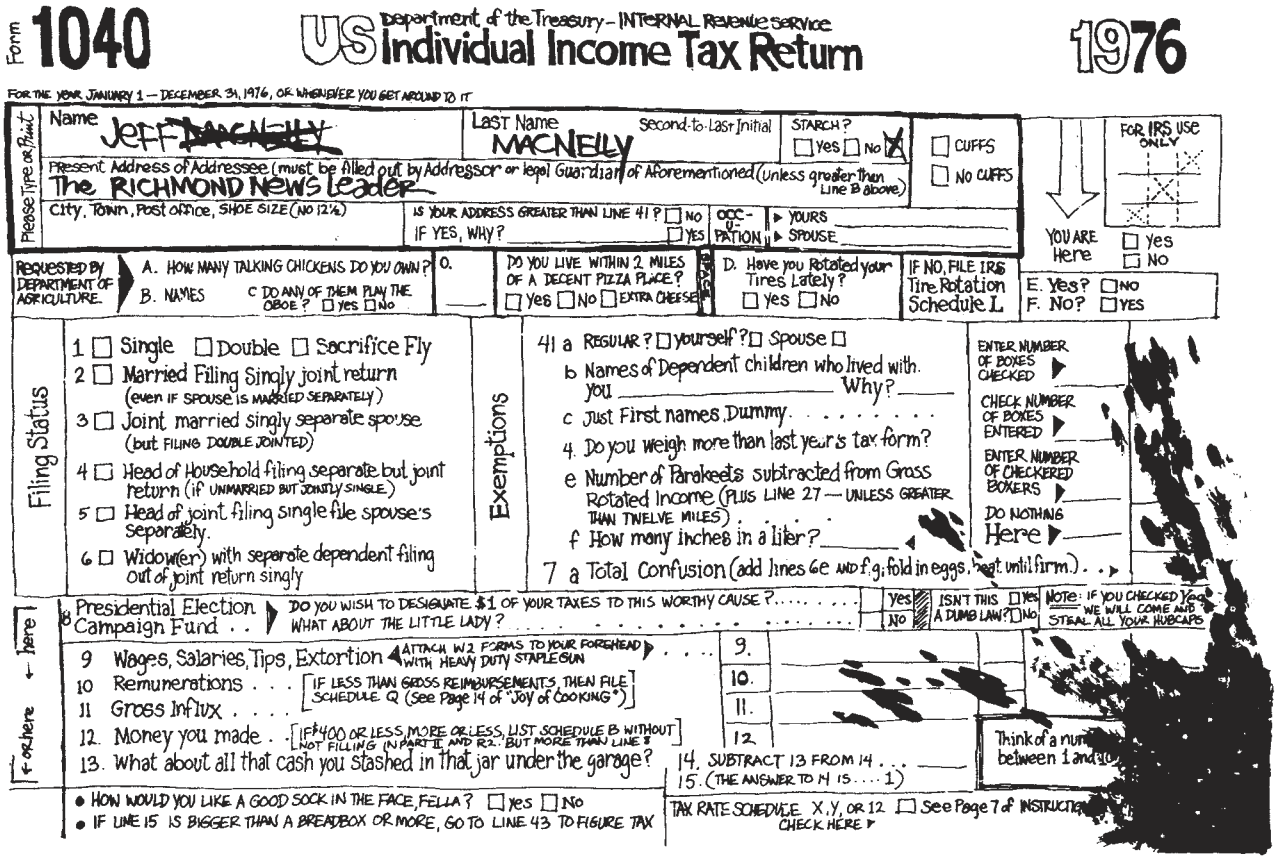
Box 2.1. International Trends

A wave of tax reforms has swept across the world in the last two decades. Since the United States reformed its tax system in 1986, almost every major developed economy has engaged in fundamental tax reform. The Panel heard that a common theme of these reform efforts was an attempt to lower tax rates and broaden the tax base.

Some countries have adopted flatter personal income tax systems by reducing the number of tax brackets in their systems. A number of countries in Eastern Europe – including Estonia, Georgia, Latvia, Slovakia, and Russia – have adopted a single uniform rate for taxing personal income. Other countries, such as Finland, Norway, and Sweden have moved towards dual personal income tax systems under which wage income is taxed at progressive rates and capital income (dividends, interest, etc.) is taxed at a single low rate. Countries have also lowered their corporate income tax rates and provided other tax relief for capital income. Finally, almost all developed economies and many developing ones have adopted a modified sales tax known as a value-added tax, or VAT.

Chapter Three

Tax Basics



Courtesy of www.jeff-macnelly.com

As the Pulitzer Prize-winning cartoon that opens this chapter suggests, our income tax system has become a running joke. Many Americans do not understand what determines their tax liability and why it may differ from their neighbors' tax bill. Few can understand why our tax returns require us to make the calculations that they do. Tax lawyers and scholars who testified at our meetings conceded even they do not understand the inner workings of the tax system. But understanding the mechanics of tax computation – under either our current system or other potential systems – is crucial to reforming the tax code. This chapter explains how to analyze the tax code – not just from the perspective of the government, but from the point of view of the taxpayer. It goes through the basic steps involved in calculating a tax bill (shown in Figure 3.1) to explain our current tax code and alternative tax systems. This brief tour will introduce important concepts used throughout the remainder of the report.

Designing a tax system involves choices. Defining the "tax base," or what will be taxed, setting a rate structure, and deciding how taxes will be collected determines much more than how much an individual or family pays. These decisions have consequences

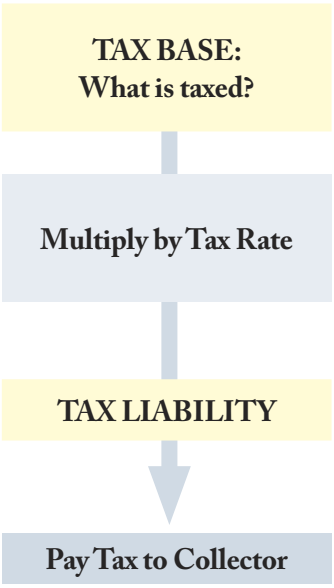
for how different economic activities are taxed or "what is taxed," how the tax burden is distributed across taxpayers, what are the administrative and compliance costs of the system, and how our tax system interacts with our $12 trillion economy.

The Tax Base

The ***tax base*** is the pool of economic activity from which tax revenue is gathered. All else being equal, the broader the tax base, the more revenue a tax system will collect at a given tax rate.

A ***comprehensive income tax base***, which is perhaps the broadest tax base, would include all forms of income. Most people think of income strictly in terms of wages. But a comprehensive measure of income also includes anything that allows you to spend more, either now or in the future. Capital gains and losses, dividends, rental income, and royalties all represent income that does not come in the form of wages.

Figure 3.1. Calculating the Taxpayer's Bill



Income can also include noncash increases to wealth, such as health care insurance or other fringe benefits provided by an employer. Some components of income are accruals that do not involve any current cash flows. For example, a stock that has risen in value allows its owner to spend more in the future, and so the increase in value every year should be considered income even if the asset has not been sold. In a comprehensive income tax base, the increase in value of all assets, including homes, would be subject to taxation. In the case of housing, homeowners would also have to declare as income the value they receive by living in their houses rather than renting them out – something economists call "imputed rental income." All expenses incurred in earning income would be subtracted from the base. Most agree that this construct – recognizing income not just as real but as potential – makes the comprehensive income tax base extremely difficult to implement in practice.

Comprehensive taxation of business income is similarly complex and difficult to implement. Businesses would include all sources of income (receipts from sales, returns on financial assets, etc.) and subtract all expenses incurred to earn income. While it is relatively easy to measure and subtract the cost of inputs that are used up during the year they are purchased, it is much more difficult to properly account for the cost of durable inputs, like machinery, that last for more than one tax period. A consistent definition of income would require that the business be allowed to subtract the decrease in economic value of machinery and other assets including "intangible" assets, such as advertising and copyrights. After all, this decrease in value, called ***economic depreciation***, represents an economic cost to the firm. Measuring economic depreciation for different assets is extremely difficult and is one of many intractable complexities encountered when using income as a tax base.

Is income the only possible tax base? Income is only one way to define a tax base. Another approach is to tax the value of goods and services that individuals purchase or consume. This approach is referred to as using a ***comprehensive consumption tax base***. The major distinction between a consumption tax base and an income tax base is the treatment of savings. Under the comprehensive consumption tax base, people are not taxed until they spend. Under the comprehensive income tax base, they are

taxed from the moment they earn anything – including the returns on saving and investment. As a result, many experts view the comprehensive consumption tax base as better for saving and capital formation, a key determinant of labor productivity and future living standards.

Some proponents of the comprehensive consumption tax base call it a "neutral tax system" because it treats a dollar spent today the *same* as a dollar saved and spent tomorrow. An individual who earns a dollar today, pays taxes on those wages, and then consumes the after-tax proceeds will not pay any further taxes. The earnings would be taxed only once under the consumption tax. In contrast, under an income tax, someone who earns the same amount today and pays the same taxes on wage income, but then decides to save the after-tax proceeds will be subject to a future tax on the investment income generated by this saving.

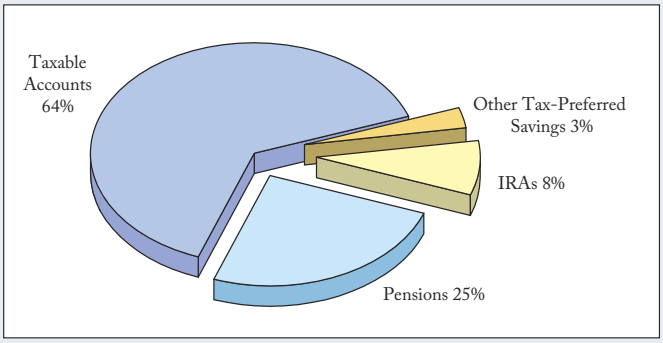
Under a consumption tax, businesses would subtract the cost of all purchases from other businesses, including an immediate write-off, known as "expensing," for all business assets. Similar to an individual's treatment under a consumption tax base, businesses would not include returns on financial assets, nor would they deduct their financing costs. As is explained later in this chapter, this is one way, but not the only way to tax consumption.

What tax base does the U.S. system use? Our tax base does not follow either model. As illustrated in Chapter One, it most closely resembles an income tax base system, but does not include certain forms of both cash and noncash income that would be part of a comprehensive income tax base. For example, employer contributions to health plans are not taxed in our current system. These ***exclusions*** significantly narrow the base. For example, the value of all noncash employee benefits in 2002 was approximately $1.1 trillion – equal to about 10 percent of the total size of the economy. Only a small fraction of that amount was subject to tax.

The current system also deviates from a pure income tax by excluding significant amounts of investment income through tax preferences for savings. This feature of our tax system resembles, or moves it towards, a consumption tax. In fact, over one-third of the proceeds from household savings are effectively exempt from taxation – meaning that these financial assets receive the equivalent of consumption tax treatment (see Box 3.1). The other two-thirds of household savings are taxed as they would be under an income tax. Several economists who testified before the Panel said that the current tax system is based on neither a pure income nor a pure consumption tax, but is really a ***hybrid tax system*** – a tax system with both income tax and consumption tax features.

Box 3.1. Taxes and the Return on Household Financial Assets

Relative to a pure income tax, the current U.S. tax system reduces the tax on the return to saving through tax-preferred savings accounts (e.g., IRAs, pensions, and college savings accounts), faster write-off of investment (e.g., expensing and accelerated depreciation), and lower tax rates on dividends and capital gains. As shown below, over one-third of the return on household financial assets is effectively exempt from taxation (excluding the effects of the corporate tax).

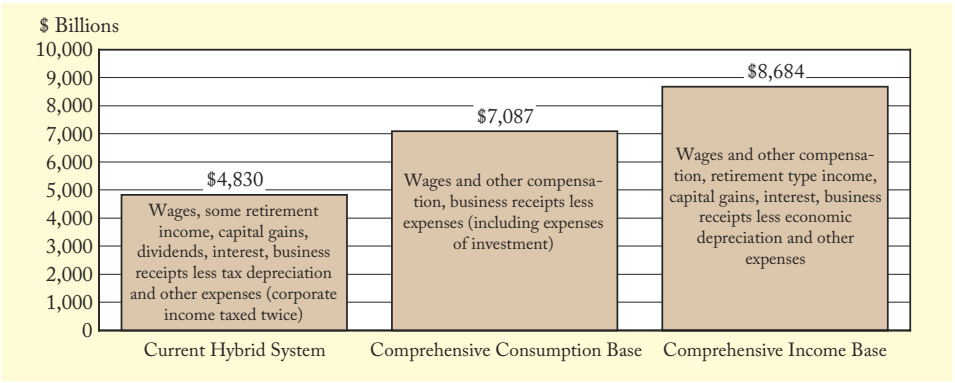


Source: Department of the Treasury, Office of Tax Analysis.

There are also some features of the current tax system that are inconsistent with both an income tax and a consumption tax. The lack of taxation on the implicit rental value of owner-occupied housing is an example. This tax provision is consistent with neither income nor consumption taxation. The double taxation of corporate profits - once when earned at the corporate level and again at the individual level when received by shareholders - is another example.

As summarized in Figure 3.2, our hybrid tax system has a much smaller tax base than it would under either a comprehensive income tax or a comprehensive consumption tax. Various exclusions, deductions, and credits leave the current hybrid tax base about half as large as a broadly defined income tax base. Our tax system also relies on depreciation rules that generally provide a more rapid, or accelerated, write-off of investment than on rules that try to replicate economic depreciation.

Figure 3.2. Alternative Tax Bases, 2001

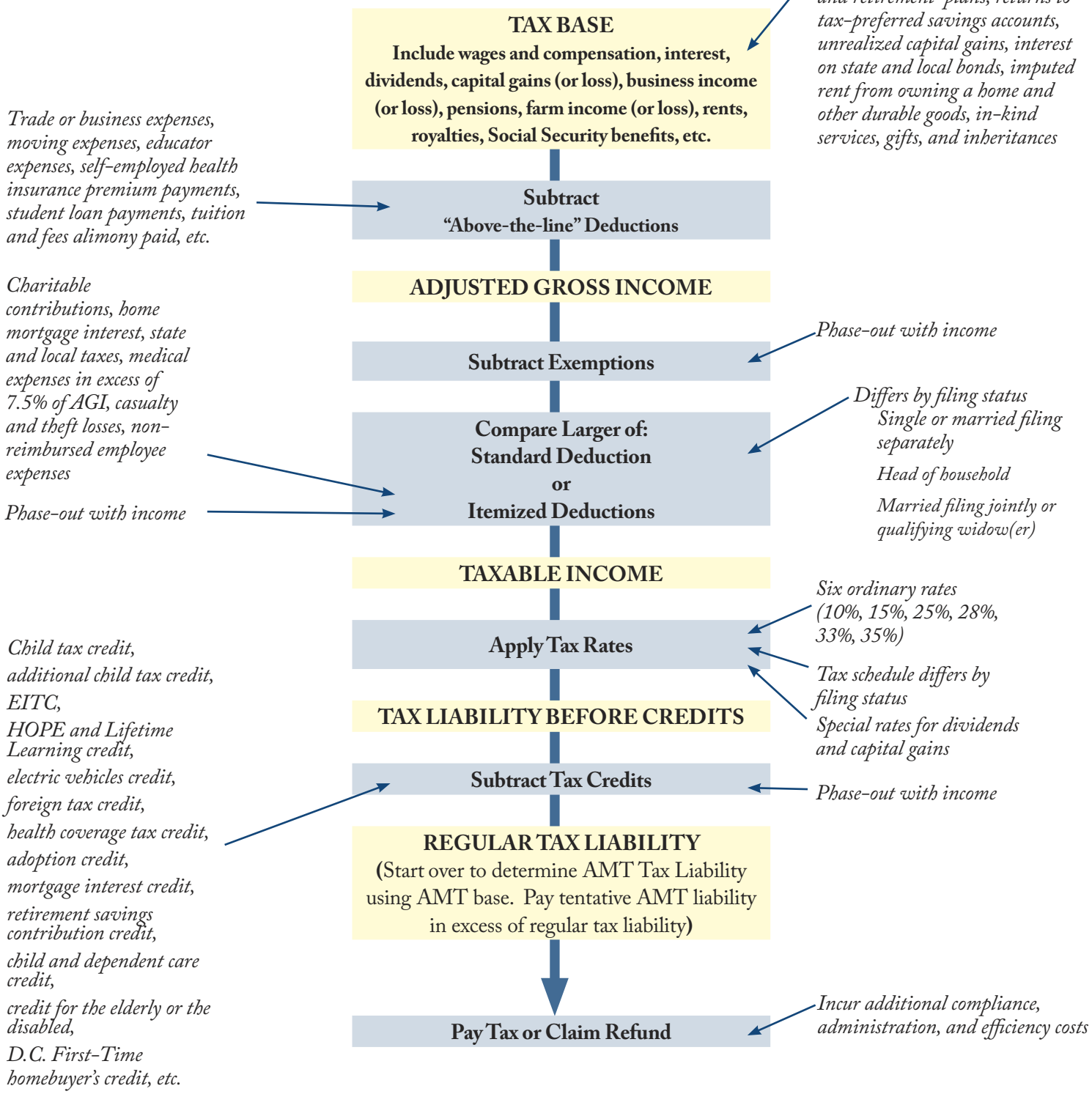


Source: Department of the Treasury, Office of Tax Analysis.

Calculating Tax Liability in Our Current System

As the history of our tax code suggests, calculating tax liability in our current system is not as simple as the four-box diagram shown in Figure 3.1. Figure 3.3 is a more accurate representation of the many steps involved in calculating taxes owed under the current personal income tax system. Taxpayers start by adding up their taxable income from different sources: wages and salaries, taxable dividends, taxable interest, rents, royalties, capital gains, business income (or losses), taxable pensions and annuities, taxable Social Security benefits, etc. This income, called ***gross income***, is the starting point for the tax calculation. Arriving at each of these components often involves its own set of calculations. Under current law, taxpayers are allowed to deduct certain expenses, such as the costs of moving for a new job or their contributions to individual retirement accounts, from gross income. After taking into account these adjustments, sometimes called "above-the-line" deductions, the taxpayer takes the resulting amount, called ***adjusted gross income*** **(AGI)**, and applies further adjustments to calculate taxable income.

Figure 3.3. Individual Tax Computation Under the Current System



How is taxable income determined? ***Taxable income***, in mathematical terms, equals AGI minus applicable exemptions and deductions. Exemptions and deductions remove a further amount of income from the tax base. In certain cases, these tax provisions, or ***tax preferences***, are in place to encourage certain kinds of economic activity, such as the purchase of homes. In other cases, these preferences are in place to generate a certain kind of social good, such as charitable giving. In still other cases, these preferences are in place to provide assistance to low or moderate-income Americans, especially those with children, by lowering their taxes. Finally, some tax preferences, like the personal exemption discussed in the next paragraph, are designed to reflect a taxpayer's ability to pay taxes. Tax preferences have varying effects and success in achieving their goals.

What is an exemption? Most taxpayers in our system are eligible to exclude a certain amount of income from taxes. This ***exemption*** depends on family size. For example, a single taxpayer claims one exemption and married taxpayers with two children (or other dependents) claim four exemptions. Not every taxpayer is allowed to claim an exemption. Personal exemptions are phased out for higher income taxpayers with AGI in excess of certain amounts. The personal exemption is an example of a tax preference designed to adjust tax liabilities for family size that, for revenue reasons, is not available to higher-income taxpayers.

What are deductions? ***Deductions***, like exemptions, are subtracted from AGI to determine taxable income. Taxpayers are allowed to choose whether to subtract a ***standard deduction*** amount determined by filing status – such as single or married – or to subtract the total of their ***itemized deductions***. It is up to taxpayers to calculate their itemized deductions and claim them if the total is greater than their standard deduction.

Only specific expenditures may be claimed as itemized deductions. Many of the most prominent tax preferences, including deductions for charitable contributions, home mortgage interest, and state and local taxes, come in the form of itemized deductions.

The benefits of these deductions are not spread evenly among taxpayers for several reasons. First, most taxpayers do not itemize their deductions, and those who do tend to have higher incomes than those who do not. The Internal Revenue Service reports that only 34 percent of taxpayers claimed itemized deductions in 2003. Among the taxpayers who did so, over 60 percent had AGI of more than $50,000. By comparison, only 12 percent of taxpayers claiming the standard deduction had AGI of more than $50,000 in 2003.

Second, the value of a deduction (or exclusion) is worth more to a taxpayer in a higher tax bracket than to a taxpayer in a lower tax bracket. The reason is simple: A $1,000 deduction reduces taxes owed to the government by $350 for someone in the top 35 percent tax rate bracket; but it reduces taxes by only $150 for a taxpayer in the 15 percent tax bracket.

Although deductions are worth more to taxpayers in higher tax brackets, the tax code has been written to phase out most deductions when a taxpayer reaches a certain income level. These trigger points are typically at different levels of income and vary based on filing status. Phase-outs add a significant amount of complexity to the process of filling out tax returns and lead to the very complicated and unpredictable set of marginal tax rates depicted in Chapter One, Figure 1.2.

Setting the Tax Brackets

Some low-income taxpayers have zero taxable income after subtracting exemptions and deductions from their adjusted gross income. Nevertheless, these taxpayers must complete the tax form to determine if they are eligible for benefits from several refundable tax credits (as explained later in this chapter). For taxpayers with positive taxable income (that is, positive income after subtracting exemptions and deductions), tax is imposed by applying a tax rate schedule with six tax rate brackets that range from 10 percent to 35 percent. The applicable rate depends on the taxpayer's family filing status. Table 3.1 summarizes the 2005 tax rates for single and married taxpayers.

Table 3.1. Tax Rates for Single and Married Taxpayers Filing Jointly in 2005

Tax Rate	Single	Married Filing Jointly
10%	Up to $7,300	Up to $14,600
15%	$7,300 - $29,700	$14,600 - $59,400
25%	$29,700 - $71,950	$59,400 - $119,950
28%	$71,950 - $150,150	$119,950 - $182,800
33%	$150,150- $326,450	$182,800 - $326,450
35%	$326,450 or more	$326,450 or more

Applying the relevant tax rates to taxable income produces the taxpayer's liability. However, certain portions of a taxpayer's income, such as dividends and capital gains, are taxed at special rates that may be lower than the rate that would be paid on an additional dollar of ordinary income – requiring yet another set of calculations.

What is a tax credit? Like deductions, exemptions, and exclusions, ***tax credits*** provide taxpayers with a tax benefit. However, tax credits are applied after the taxpayer's tax liability is calculated; they are subtracted, just like a coupon at the supermarket.

Depending on how a tax preference is designed – as a deduction, exemption, or credit – it can have different impacts on taxpayers at different income levels. For example, we have already seen how tax deductions and exemptions are more valuable to higher-income taxpayers. Since tax credits provide a dollar-for-dollar decrease in tax liability for all taxpayers who pay tax, they provide an equal benefit to taxpayers at all income levels. Tax credits can also be made refundable. A refundable tax credit is like a gift certificate that can be exchanged for cash. Even if a taxpayer has too little income to actually owe income taxes, he or she may be able to claim a refund equal to the amount of the tax credit that exceeds tax liability. The earned income tax credit (EITC) and the child tax credit are two examples of refundable credits.

In recent years, lawmakers have enacted rules that phase out some tax credits for higher-income taxpayers. This limits the cost of tax credits, but also raises the marginal tax rate, or the tax paid on a taxpayer's last dollar of income, above the rate normally paid by the taxpayer. Consider, for example, a taxpayer in the 28 percent bracket who claims credits that begin to phase out at a rate of $5 for every extra $100 earned. By this measure, each additional $100 earned by the taxpayer increases tax liability by $28, but *decreases* the value of tax credits by $5. The tax on the additional $100 of earnings is not $28, but $33, and the taxpayer's marginal tax rate (the rate applied to the last dollar earned by the taxpayer) is not 28 percent ($28/$100), but 33 percent ($33/$100).

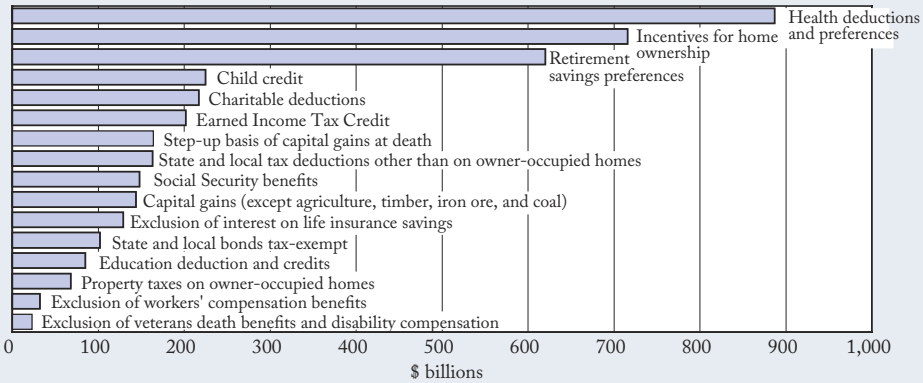
Phase-outs are so pervasive in our system that one recent study found that more than one out of every five taxpayers faced actual marginal tax rates (called "effective marginal tax rates") higher than their statutory rates in 2003. This was even more common among higher-income households: More than half of taxpayers with AGI of $100,000 or above faced effective marginal tax rates greater than the statutory rate.

Box 3.2. The Cost of Tax Preferences

Because of the rising use of special tax provisions, policymakers maintain a "tax expenditure budget" to track tax preferences, whether in the form of credits, deductions, exclusions, or exemptions. The tax expenditure budget lists the subsidy cost of tax preferences – what the government would collect in revenue if any given tax preference did not exist. There does not appear to be any institutional process to evaluate on a regular basis the effectiveness of these tax preferences.

The most recent budget lists 146 tax expenditures, most of which relate to the individual income tax system. The largest tax expenditures, grouped by major category, are the exclusion from income for employer-provided health insurance, incentives for home ownership, tax-preferred retirement savings, the deduction for charitable contributions, the child tax credit, the EITC, the step-up in basis of capital gains upon death, and state and local tax deductions.

Largest Individual Tax Expenditures (FY 2006-2010)



Note: Incentives for home ownership category does not include the exclusion of net imputed rental income on owner-occupied homes of $185.2 billion.
Source: Department of the Treasury, Office of Tax Analysis.

Double-checking: Does the Alternative Minimum Tax apply? After all these calculations, a taxpayer arrives at the moment of truth: the final tax bill. However, many taxpayers still need to consider whether they owe more taxes under the AMT. As explained in Chapter One, the AMT uses a different definition of the tax base, a higher level for exemptions, and fewer tax preferences than the regular income tax. And because the threshold for paying the AMT has never been indexed to inflation, more and more Americans are forced to consider whether they face a higher tax bill under this secondary tax system.

Paying the Tax

Because of exclusions, exemptions, deductions, and credits, a large percentage of income is never taxed, and most low-income families pay little, if any, income taxes. In some cases, refundable credits provide these families with an additional amount of money that helps offset other federal taxes paid, such as payroll taxes. As detailed in Table 3.2, a typical family of four will pay no income tax in 2005 on the first $41,000 of income it earns. The amount of income at which a family starts to pay tax is sometimes called the ***tax threshold*** and has important implications for how the burden of the tax is distributed and how people participate in the tax system and support the federal government.

Table 3.2. Components of Income Tax Thresholds for 2005

	Single, no children	Single, two children	Married, two children
Standard deduction	$5,000	$7,300	$10,000
Personal exemptions	$3,200	$9,600	$12,800
Income not subject to tax before credits	$8,200	$16,900	$22,800
Tax threshold: Income not subject to tax after earned income and child tax credits	$9,737	$34,620	$41,000

Source: Department of the Treasury, Office of Tax Analysis.

In 2002, over 30 percent of taxpayers who filed a tax return – 39 million of 130 million returns filed – either owed no tax or received a refundable credit. An additional 15 million taxpayers earned less income than the total of the standard deduction and personal exemption and, therefore, were not required to file a return. In all, approximately 40 percent of families paid no income tax directly.

It is worth noting that taxpayers do not stay permanently in the status of having a negative, zero, or positive tax liability. As their family and income circumstances change, even from year to year, taxpayers can move in and out of these negative, zero, or positive tax situations. A Department of the Treasury study that followed taxpayers over multiple years suggests that about two-thirds of taxpayers in the bottom (zero rate) bracket in the first year had moved to a higher bracket after 10 years, the vast majority moving to either the 10 or 15 percent tax brackets. This fluidity is important because simply taking people "off the rolls" may not take them out of the system for any significant length of time.

Who really pays the tax? When the calculation is complete and the tax owed (or the refund due) is finally determined, the taxpayer signs the tax form and sends it to the Internal Revenue Service (either electronically or through the mail). In the case of the income tax, the amount of tax owed is paid directly to the federal government. Not all taxes imposed on individuals are remitted directly from individuals to the government, however.

One of the most important concepts in understanding how taxes work is that who remits the tax has no relevance on who bears the ultimate burden of the tax or how the tax affects the economy. For example, the legal burden of the payroll tax (Social Security, Medicare, and unemployment insurance) is shared between employers and employees. Economists have found, however, that the burden of the employer's portion of the payroll tax is largely passed on to employees in the form of lower wages. The ***economic incidence*** is on workers even though the ***legal incidence*** of the payroll tax is shared. Box 3.3 explains how market forces, and not who is legally responsible for remitting the tax, determine who bears the economic burden of any tax.

Box 3.3. Determining Who Bears the Burden of a Tax

Imagine that the government imposed a special tax on ice cream sold from ice cream trucks. If the ice cream truck drivers are able to pass on the tax to their customers in the form of higher prices, the economic incidence of the tax would be on their customers. In this case, the price of ice cream sold from trucks would increase by exactly the amount of the tax. If customers resisted the price increase by buying their ice cream in stores to avoid the tax, and ultimately the only way the truck driver could sell ice cream was by matching the retail price at the store, then the truck driver would bear the economic burden of the tax. In this case, the legal incidence and economic incidence of the tax would be identical.

Understanding the difference between the economic and legal incidence of taxes is important in analyzing both taxes and subsidies. Take the example of tax credits for low-income housing that could be claimed by low-income taxpayers. If the price of low-income housing increases by the amount of the credit, the credit would provide no benefit whatsoever to the low-income household, but enormous value to builders of low-income housing. In this case, market forces would have passed the full benefit of the credit to builders.

Paying a "Fair Share"

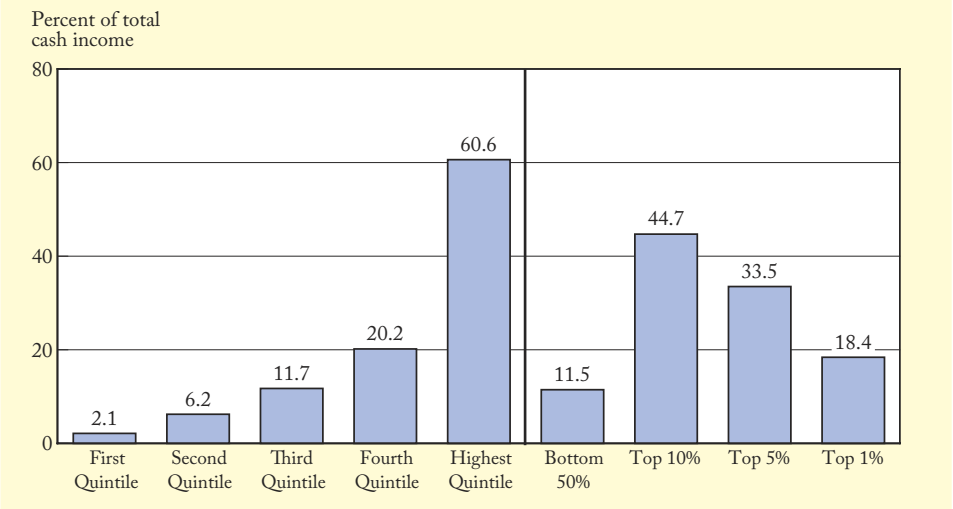
How a tax system is designed determines how the tax burden is distributed. In a progressive tax system, the household's tax burden, measured as tax liability divided by household income, increases as household income rises. Graduated tax rates, exemptions, the standard deduction, and refundable credits all contribute to the progressivity of our tax system.

Another measure of how the burden of our tax system is distributed involves calculating how much of total tax revenue is collected from different income groups. This type of analysis is produced routinely by government organizations, nonprofit organizations, academics, and other groups.

There are many assumptions involved in tax burden analysis and, not surprisingly, different organizations use different methodologies. All analyses start by ranking taxpayers according to a measure of economic well-being intended to approximate "ability to pay." The Treasury Department uses a measure called "cash income," based on the income of each household. Cash income consists of wages and salaries, business or farm net income, taxable and tax-exempt interest, dividends, rental income, realized capital gains, cash transfers from the government, and retirement benefits. Employer contributions for payroll taxes and the federal corporate income tax are also added to cash income calculations.

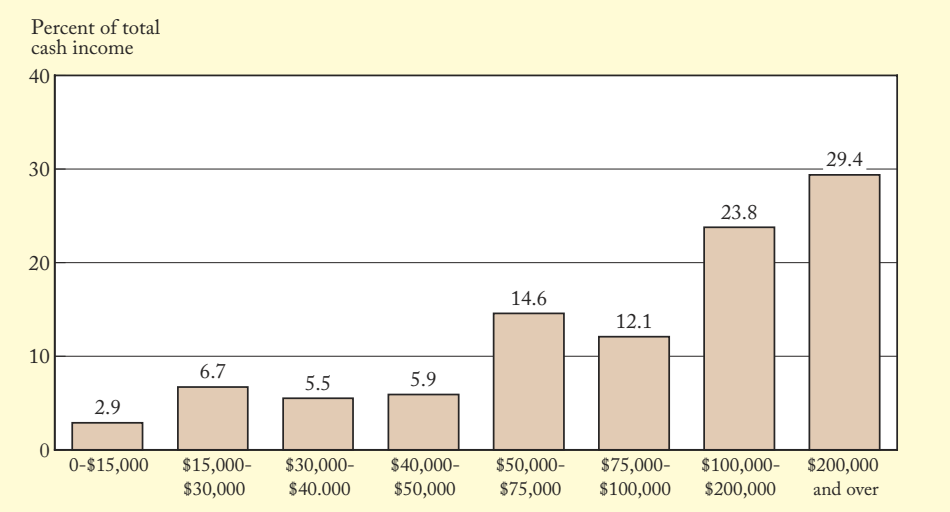
The Treasury Department constructs distribution tables by dividing the entire population of households into income quintiles or cash income levels. Taxes paid are then calculated for each group. The distribution of cash income across quintiles (and the top 10 percent, 5 percent, and 1 percent of taxpayers, as well as the bottom 50 percent of taxpayers) and across cash income levels is shown in Figures 3.4 and 3.5. Figure 3.4 shows that the top 20 percent of households earn about 60 percent of all income and the bottom 20 percent of all households earn about 2 percent of all income.

Figure 3.4. Distribution of Cash Income Under Current Law by Income Percentile



Note: Estimates of 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $48,345; Highest $84,124; Top 10% $123,706; Top 5% $169,521; Top 1% $407,709; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 3.5. Distribution of Cash Income Under Current Law by Income Level



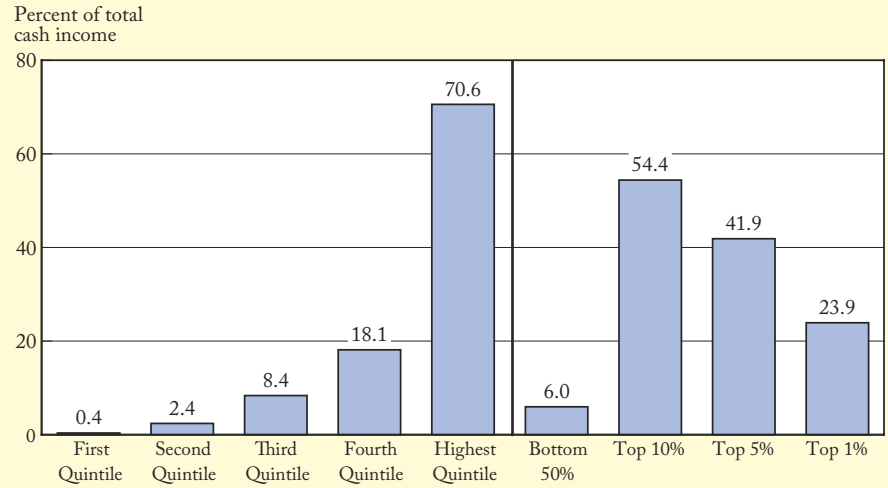
Note: Estimates of 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

The Treasury Department's quintile analysis showing the distribution of all current federal taxes (individual and corporate income taxes, payroll taxes, excise taxes, customs duties, and estate and gift taxes) across cash income quintiles is shown in Figure 3.6. Not surprisingly, given the progressive nature of our tax system, most federal taxes are paid by upper-income taxpayers. Taxpayers in the top 20 percent of the distribution pay 70.6 percent of all federal taxes, while taxpayers in the bottom 20 percent pay 0.4 percent. More than half of federal taxes are paid by taxpayers in the top 10 percent of the distribution. Figure 3.7 provides detail on the distribution of all federal taxes across cash income groups.

The Panel has considered reforms to two important components of the federal tax system: the individual income tax and the corporate income tax. The distribution of these taxes alone is shown in Figures 3.8 and 3.9. Taxpayers in the lowest two quintiles actually receive more in refunds from the federal government than they pay in income taxes and, as a result, have negative tax income burdens. Those taxpayers in the third and fourth quintile pay a relatively small share of the income taxes, 3.8 percent and 13.4 percent, respectively, while those in the top quintile pay over 84 percent of federal income taxes.

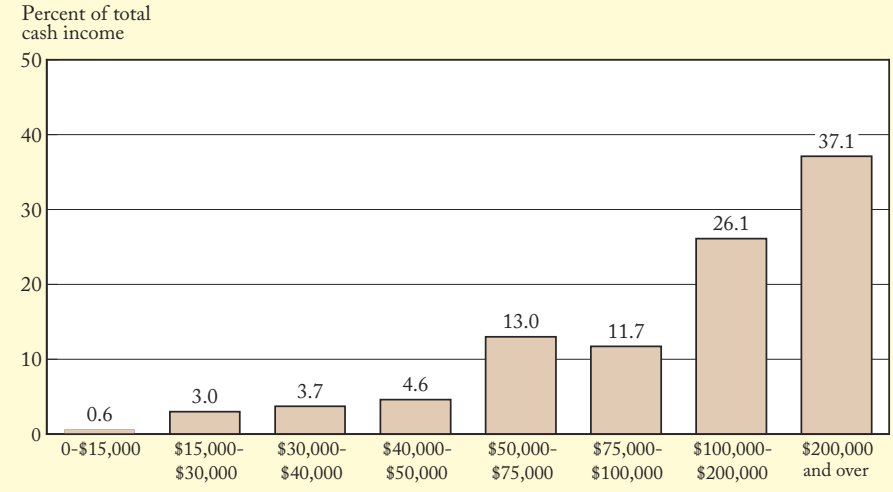
As mentioned previously, a number of assumptions are required to produce these estimates. For example, one must make an assumption about how the employer portion of the payroll tax is distributed and how corporate taxes are distributed. The note under Figure 3.6 describes the incidence assumptions used by the Treasury Department. The following discussion focuses on the assumption for the incidence of the corporate income tax since it may have an important effect on the analysis of the Panel's reform plans.

Figure 3.6. Distribution of Total Federal Tax Burden Under Current Law by Income Percentile



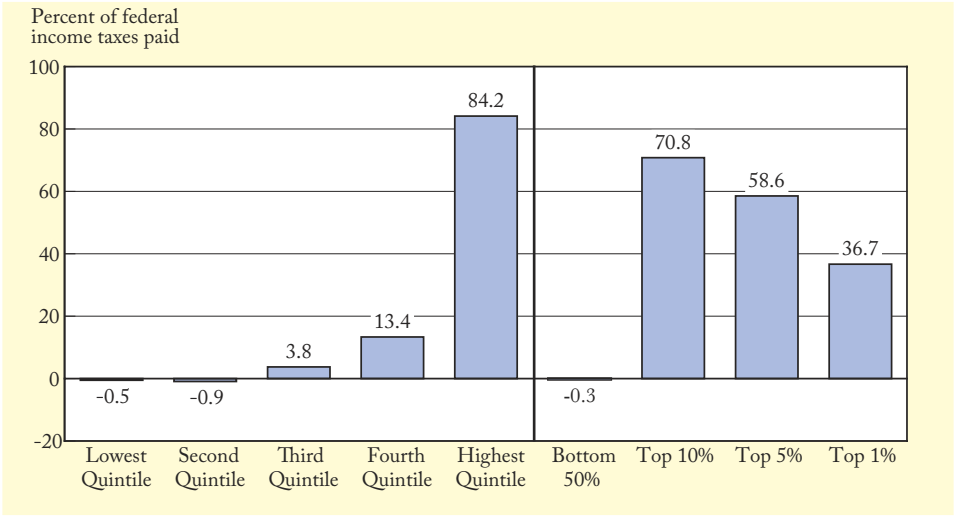
Note: The Treasury Department methodology assumes the individual income tax is borne by payers, the corporate income tax is borne by capital income generally, payroll taxes (employer and employee shares) are borne by labor, excise taxes on purchases by individuals are borne in proportion to relative consumption of the taxed good and proportionately by labor and capital income, and excise taxes on purchases by businesses and customs duties are borne proportionately by labor and capital income. The estate and gift tax is assumed to be borne by decedents. Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $48,345; Highest $84,124; Top 10% $123,706; Top 5% $169,521; Top 1% $407,709; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 3.7. Distribution of Total Federal Tax Burden Under Current Law by Income Level



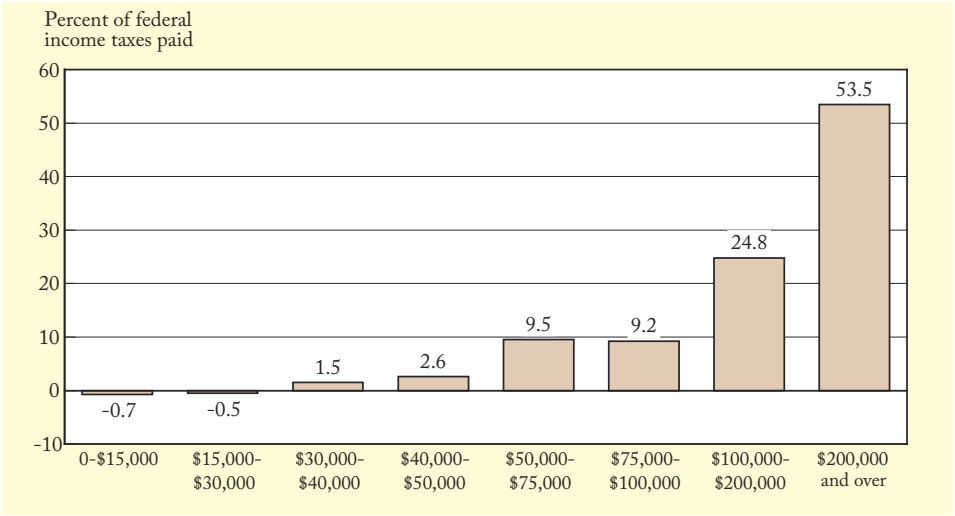
Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 3.8. Distribution of Federal Income Tax Burden Under Current Law by Income Percentile



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $48,345; Highest $84,124; Top 10% $123,706; Top 5% $169,521; Top 1% $407,709; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 3.9. Distribution of Federal Income Tax Burden Under Current Law by Income Level



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Only people can bear the burden of taxation. While corporations do remit tax payments to the federal government, the economic burden of the corporate income tax can fall only on people – specifically, shareholders, employees, or customers. The question for those who are trying to analyze the distribution of the corporate income tax is how this burden is divided. Economists at both the Treasury Department and the Congressional Budget Office assume that the burden of the corporate income tax is borne entirely by owners of capital. This means that all individuals who earn capital income (dividends, interest, rents, and capital gains) from both corporate and noncorporate sources are assumed to pay part of the corporate income tax. While this assumption may be reasonable in the short run, the implication is that most of the corporate income tax burden will be borne by high-income households because they are the ones who earn most capital income.

Over time, however, some of the burden of corporate taxes is likely to be shifted to workers and consumers. Because capital owners can choose to invest in the United States or in other nations, when the U.S. raises tax burdens on capital, some investment is likely to flow elsewhere. As the stock of capital in the United States contracts, the return on that capital rises. The smaller stock of capital leads to reduced productivity, however, and lower real wages and correspondingly higher prices. A 1998 survey asked public finance economists from the leading economics departments in the United States what percent of the burden of the corporate tax falls on capital and what percent falls on labor. Although responses varied considerably, the median response was that only 40 percent of the corporate tax is borne by capital owners and the remaining 60 percent is borne by labor.

Three Burdens of the Tax System

The vast majority of taxpayers either hire a paid tax preparer (about 60 percent in 2003) or buy software (more than 25 percent in 2003) to help them complete their tax return on their computer. These costs are examples of one of three types of burdens beyond the cost of the tax itself that a tax system imposes on taxpayers, the government, and the economy as a whole. Taxes create administrative costs for the government, compliance costs for taxpayers, and efficiency costs for the national economy.

What are administrative costs? ***Administrative costs*** are perhaps the easiest costs to understand because they represent the direct costs incurred by the government to manage and administer the income tax system. These costs include the budget of the Internal Revenue Service and other parts of the Treasury Department that help maintain the income tax system, as well as relevant expenses incurred by other government agencies. These costs total more than $10 billion per year.

Box 3.4. The Tax Gap

Included in the taxes Americans pay is the hidden cost of noncompliance. On average, the "tax gap" – a term used to describe the difference between the total tax that should have been paid and what taxpayers actually paid on time – costs honest and careful taxpayers an extra $2,000 each year. In its most recent study, the IRS estimates that the gross tax gap for individual and self-employment taxes was between $248 and $290 billion in 2001. The IRS expects to eventually recoup less than $55 billion of this amount through late payments and enforcement.

The overall noncompliance rate for the individual income tax is between 17.5 and 20.1 percent. Compliance rates are highest where there is third-party information reporting or withholding. For example, less than 1.5 percent of wages reported by employers to the IRS are misreported on individual tax returns. By contrast, individual compliance is lowest in the "cash economy," where sources of income often are not reported to the IRS. For example, two-thirds of the individual tax gap is attributable to self-employed taxpayers where there is minimal information reporting. The net effect is a subsidy to some individuals and businesses at the expense of others. The subsidy, therefore, distorts the choice about whether to invest or work in the cash or noncash sector.

The IRS has not measured noncompliance among partnerships and corporations for many years, but estimates based on research from older studies suggest that the tax gap for corporations could be as large as $32 billion, with an overall noncompliance rate of approximately 18 percent.

An important aspect of designing a tax system is how it is administered, because this affects the overall level of compliance. Noncompliance is an issue of fundamental fairness because it forces taxpayers who play by the rules to foot the bill for others who fail to pay. It also erodes confidence in the tax system and undermines voluntary compliance. The tax gap is caused by a variety of factors, such as inadvertent mistakes, technical tax shelters, and outright evasion. Although some cheating is inevitable, the complexity of our tax system is a large part of the problem. A less complicated tax code with more information reporting would reduce the tax gap by making it easier for taxpayers to understand and comply with their tax obligations and would improve the administration of the tax system.

What are compliance costs? ***Compliance costs*** represent the time and resources expended by taxpayers to interact with the income tax system. These costs include the value of individuals' time spent learning about the tax law, maintaining records for tax purposes, completing and filing tax forms, and responding to any correspondence from the IRS or to an IRS audit. Compliance costs also include amounts paid to others to conduct any of these tasks on behalf of an individual or a business.

Individuals are estimated to spend a total of 3.5 billion hours each year complying with the income tax system. On average, individuals spend 26 hours annually on their taxes, and $166 per return on out-of-pocket costs for the services of tax professionals, filing fees, and software purchases. Total yearly compliance costs are difficult to estimate, in part because estimating the value of the time people spend on their tax returns is difficult. Nevertheless, the Treasury Department estimates that total costs for complying with the individual income tax amount to

almost $100 billion per year. In addition, businesses are estimated to spend over three billion hours complying with the tax system, at a total yearly cost of $40 billion. This total cost of approximately $140 billion means that one dollar is spent on compliance costs for every nine dollars collected in federal income taxes. Other estimates of total compliance costs are somewhere between $100 billion to $200 billion.

What are efficiency costs? Finally, the income tax imposes ***efficiency costs*** on the economy. These costs arise when high tax rates discourage work, savings, and investment; distort economic decisions of individuals and businesses; and divert resources from productive uses in our economy. Our tax code contains all kinds of incentives for taxpayers to favor activities or goods that are taxed less than others. Provisions for the taxation of wages, of gains on the sale of securities and homes, or of other economic activities influence how much people work and save. As one small business owner explained to the Panel, the tax code affects almost every business decision he makes: where to invest, when to invest, how much to invest, what kinds of machines and equipment to use in production, how to finance investment, etc.

When taxpayers change their behavior to minimize their tax liability, they often make inefficient choices that they would not make in the absence of tax considerations. These tax-motivated behaviors divert resources from their most productive use and reduce the productive capacity of our economy. Economic growth suffers as taxpayers respond to the tax laws rather than to underlying economic fundamentals. These distortions waste economic resources, reduce productivity, and, ultimately lower living standards for all.

These effects are profound. Recall the ice cream truck tax example in Box 3.3. If a higher ice cream tax results in higher ice cream prices at ice cream trucks, some consumers will pay that higher cost, but others will not. They will switch to other ways to get their frozen treats – like getting in their car and driving to an ice cream shop that does not have to charge the tax. That decision, and the loss of time spent driving to an ice cream store instead of having it served up in one's front yard, may seem trivial. But if multiplied millions of times throughout the economy, the effects on economic efficiency are enormous. Economists call this the "***excess burden***" of taxation. Its very name indicates that the true cost of a tax exceeds the tax bill people pay or the revenue that is collected.

Federal Reserve Board Chairman Alan Greenspan explained to the Panel that the excess burden, or cost, of the tax code grows more than proportionately as tax rates increase. In fact, economic theory suggests that if you double the tax rate, you quadruple the excess burden. This means that high tax rates have disproportionately high economic costs associated with them.

A recent study estimated that the excess burden associated with increasing the individual income tax by $1.00 is between $.30 and $.50 cents, so the total cost of collecting $1.00 in additional tax revenue is between $1.30 and $1.50, before taking into account compliance or administrative costs. All else being equal, a tax with a lower excess burden is preferable to one with a higher excess burden. The size of the economic pie will be larger, for example, if it costs only $1.05 to raise a dollar of

revenue instead of $1.30. To put this into perspective, some studies have suggested that a tax system that removes the penalty against savings by switching the current structure to a progressive consumption tax could potentially increase the size of the economic pie by between 3 and 7 percent.

It would be difficult, however, to imagine a tax system that has no excess burden. Excess burden arises from people adopting less efficient behavior. A tax that does not induce people to alter their behavior would be one that does not depend on behavior at all. For example, a tax imposed on anyone with green eyes would be impossible to avoid for someone with green eyes. A real-life example of this was the poll tax, or flat charge on all adults living in a jurisdiction, which was highly efficient in collecting revenue, but perceived as extremely unfair because it applied equally to all people, regardless of wealth. As a result, these types of taxes have been rejected as revenue raising devices.

For this reason, it is clear that that raising revenue through taxation requires some distortions in the economy. One goal of good tax policy is to minimize these distortions within a "fair" tax structure. The trade-off between fairness and efficiency in raising revenue is one of the central challenges of designing a tax system. Economic analysis can describe the efficiency cost of different taxes, but fairness is much more difficult to define and different policymakers may have different views of what constitutes tax fairness.

Is There Another Way?

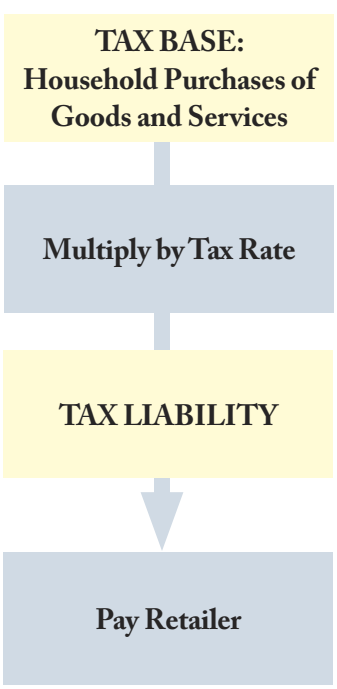
As discussed earlier, the design of a tax system begins with the choice of a tax base. Our current tax system includes a variety of provisions that exempt capital income from taxation and, as a result, move our tax system from a pure income tax base towards more of a hybrid approach. This section briefly explores tax systems that adopt a consumption tax base.

There are several different tax systems built around the taxation of spending or consumption: a retail sales tax, a value-added tax (VAT), a Flat Tax, and a "consumed income" tax. A retail sales tax would tax final sales of goods and services to consumers, with no tax imposed on sales to businesses. Retailers collect this tax and remit tax proceeds to the government. The VAT is a modification of a sales tax in which tax is collected from businesses at each stage of the production process. A Flat Tax is a two-part VAT in which tax is imposed at both the business and individual levels. Wages are deductible at the business level and taxed at the individual level. The consumed income tax is imposed at the household level only, by taxing only the income left after subtracting savings. A discussion of each of these consumption taxes follows.

The four taxes can differ in many respects. They may have different impacts on the share of the tax burden borne by different groups, on the economy, and on compliance and administrative costs. The timing of tax collection differs across the types of taxes. The Flat Tax and consumed income tax operate on a "pre-pay" basis, so that the tax is collected when wages are earned but no further tax is due at the time of consumption. The VAT and retail sales tax, in contrast, operate on a "post-pay" basis so that tax is

paid when money is spent. Although there are some differences, all four consumption taxes share a common feature: As explained in more detail in Chapter Seven, all consumption taxes exempt from taxation what economists refer to as "normal returns" from saving and investment. As a result, consumption taxes do not discourage saving and investment, nor do they distort saving and investment decisions.

Figure 3.10. How a Retail Sales Tax Works



The Retail Sales Tax

A retail sales tax is imposed when households purchase goods or services from businesses. This form of consumption tax is familiar to most Americans since many state and local governments raise revenue through retail sales taxes. In a well-functioning retail sales tax system, purchases by businesses are not taxed because these purchases are "inputs": goods or services used to produce other goods or services for sale to households. In terms of our simple box diagram, the tax base consists of taxable goods and services, the tax rate is the applicable sales tax rate, and the tax collector is the retailer. Although the retailer pays the tax directly to the government, the burden is borne by individuals. And, just as with our current income tax system, there are administrative and compliance costs, as well as distributional consequences to consider when evaluating the desirability of this tax. These issues are discussed further in Chapters Eight and Nine.

The Value-Added Tax

A commonly used variation of a retail sales tax is the value-added tax (VAT). More than 120 countries use VATs to raise a portion of total national government tax revenues. The United States is the only major industrialized country that does not impose a VAT.

The VAT can be thought of as a retail sales tax that is collected in small increments throughout the production process. The tax is calculated at each stage of production: Each business's tax base is calculated from its sales minus its purchases from other businesses. Wages are not deducted. It is easiest to understand the VAT, and its relationship to a retail sales tax, through an example.

A boot maker makes and sells custom-made cowboy boots. He buys leather and other supplies enough for one pair from a leather shop at a cost of $200 before taxes. The boot maker then sells each pair of boots he makes for $500 before taxes.

If a 10 percent retail sales tax were in place, the boot maker would add on the tax to the cost of the $500 pair of boots, and the consumer would pay $550 per pair. In the meantime, the leather shop would not have imposed a retail sales tax on its sale to the boot maker because such a business-to-business transaction would not be treated as a retail sale.

Under a VAT, the tax calculation works differently. Because the VAT is charged on all sales of goods and services, and not just sales to consumers, the leather shop would collect a VAT of 10 percent, or $20 on the $200 of supplies purchased by the boot maker. The boot maker would pay the leather shop $220, and the leather shop would

send the $20 to the government. When the boot maker sells the boots, he computes the VAT as $50, and charges the shoe buyer $550 for the boots. However, instead of sending $50 to the government, the boot maker would subtract the $20 of VAT already paid to the leather shop and remit $30 to the government. The government would receive $50 total: $20 from the leather shop and $30 from the boot maker. The government receives the same revenue under a VAT and a retail sales tax, and from the boot buyer's perspective the taxes look identical.

There is also an alternative method of calculating the VAT. Under the "subtraction method," the boot maker and the leather shop would pay the 10 percent VAT on the difference between their pretax sales and purchases. The boot maker would pay $30 (10 percent of the difference between the $500 of sales and $200 of purchases), and the leather shop owner would pay $20 (10 percent of the difference between sales and purchases). In practice, the subtraction method may be less reliable because it is harder to verify the amount of tax paid on purchases.

Administrative and compliance costs, as well as the progressivity of VATs are discussed in Chapter Seven.

The Flat Tax

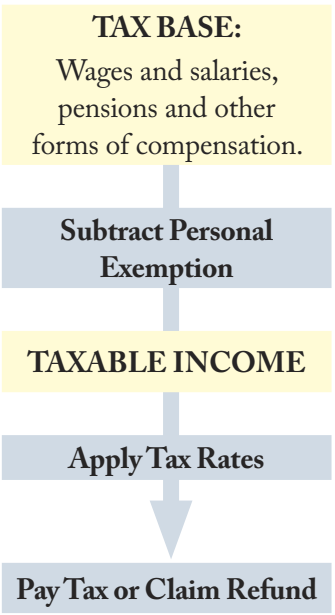
The Flat Tax collects part of the consumption tax directly from workers. As is the case with a VAT, businesses take the total value of their sales and then subtract the total value of purchases from other businesses. However, under a Flat Tax, businesses also subtract the wages and other compensation paid to workers. Thus, the tax base is total revenues from sales minus purchases from businesses and compensation to employees. Employees pay a separate tax on their wages (and other forms of compensation) at the household level.

Consider the boot maker in the VAT example above. Assume that the boot maker pays a worker $200 per pair of boots. Recall that under the VAT, the boot maker's tax liability was $30, since the difference between sales and purchases from other businesses equals $300 and the VAT rate was 10 percent. Under the Flat Tax, the boot maker's tax liability would be only $10, since both purchases from businesses ($200) and compensation to employees ($200) are subtracted from pretax sales ($500). The worker would pay tax at the individual level on his compensation. If there were no personal exemptions, the worker would have a Flat Tax liability of $20.

As the example demonstrates, unlike the VAT, the Flat Tax uses a structure that is similar to the one we have today and, therefore, is familiar to Americans. Workers fill out an annual return as an accounting matter, and the same payroll withholding of our current system is used to collect government revenues throughout the year. Businesses also file annual returns.

As one of the main proponents of the Flat Tax has commented, the Flat Tax "name is brilliant marketing, but it fails to convey the central feature of the idea relative to a VAT – the Flat Tax is progressive." The Flat Tax is progressive because the individual tax applies only above an exemption amount. Low-income workers, therefore, do

Figure 3.11. Individual Tax Computation Under A Flat Tax



not pay tax on their compensation to the extent it falls below the exemption amount. The Flat Tax is most commonly proposed using a single tax rate that applies to both businesses and workers above the exemption level. However, the Flat Tax can be made even more progressive by using multiple graduated rates at the individual level. Economists refer to one proposal that incorporates a progressive rate structure as an X-tax system. The basic X-tax system, developed by the Treasury Department in the late 1970s, works exactly like a Flat Tax at the business level. The only difference occurs at the individual level where there is a progressive tax bracket structure with a top rate equal to the business tax rate.

The Consumed Income Tax

The consumed income tax is collected directly from households. But the tax is collected only from a base of the household's spending. To calculate consumption, a household would add up wages and other forms of labor compensation, investment proceeds that are spent, and net borrowing. To calculate savings, which would not be taxed, a household would add up the net increase in bank accounts, the purchase of financial assets such as stocks and bonds, the purchase of business assets, and the purchase of owner-occupied housing. Generally, a consumed income tax base would exempt a certain level of consumption and use a graduated tax rate schedule to promote progressivity. There is no need for a corporate tax under a consumed income tax – retained corporate earnings would be a form of saving, and dividends would be taxable to shareholders unless saved.

Conclusion

This chapter described the major elements of any given tax system, as found in both our current tax code and some well-known alternatives. Understanding these elements is a critical step in reforming the current tax system. It may be possible to reform some current tax provisions in a way that enhances the objectives of simplicity, efficiency, and fairness. In other cases, changes to a particular provision may promote only one or two of these objectives. The goal of the Panel's work is to identify proposals that taken together will advance all three objectives.

It is simply not enough to use this knowledge to create a tax system that remedies the shortcomings of our current system. Any reform proposal must take into account the expected revenue collected by our current tax system, as well as the way the code has shaped our economy. Chapter Four explores the constraints the Panel faced, both in terms of the President's Executive Order and the realities of our $12 trillion economy.

Chapter Four

Our Starting Point

Courtesy of Marina Sagona

With a firm understanding of the problems in our current tax code, the Panel evaluated numerous proposals to reform the individual and corporate income tax system. The Executive Order directed the Panel to recommend options that would make the tax code simpler, fairer, and more conducive to economic growth, while recognizing the importance of home ownership and charity in American society. Fulfilling all of these objections is challenging. For example, reforms that make the tax system more conducive to economic growth may shift the tax burden toward lower-income households, which some might view as unfair. Improving the fairness of the tax code may require complicated rules and increased data collection, which might work against the goal of simplicity.

In addition to ensuring that the Panel's reform options satisfied these criteria, there were several other constraints that affected the Panel's work. This chapter discusses those constraints, as well as the approaches the Panel took to manage them.

Revenue Neutrality

The most important constraint on the Panel's recommendations is the Executive Order's direction that all of the Panel's reform options be "revenue neutral." In simple terms, this means that the Panel's options should be designed to collect roughly the same amount of money that the federal government projects it will collect under the current tax system. Although this may seem straightforward, it is not. Numerous projections and assumptions about future policy and behavior must be made – and they all have very important ramifications.

Photo by Ken Cedeno

The first building block is setting a baseline; which is the projection of future federal tax revenues. Different branches of government make different assumptions about future policies and economic data and, therefore, have different baseline estimates. The Panel used the Administration's baseline, which projects that $17.4 trillion in federal individual and corporate income tax revenue will be collected over the next ten years. The Panel used this baseline because the Panel anticipated that the Secretary of the Treasury and the Administration would use its own baseline in evaluating the Panel's reform options. It is worth noting that the Congressional Budget Office baseline, which assumes current law, predicts a relatively similar level of revenues (within approximately one percent) during the ten-year budget window.

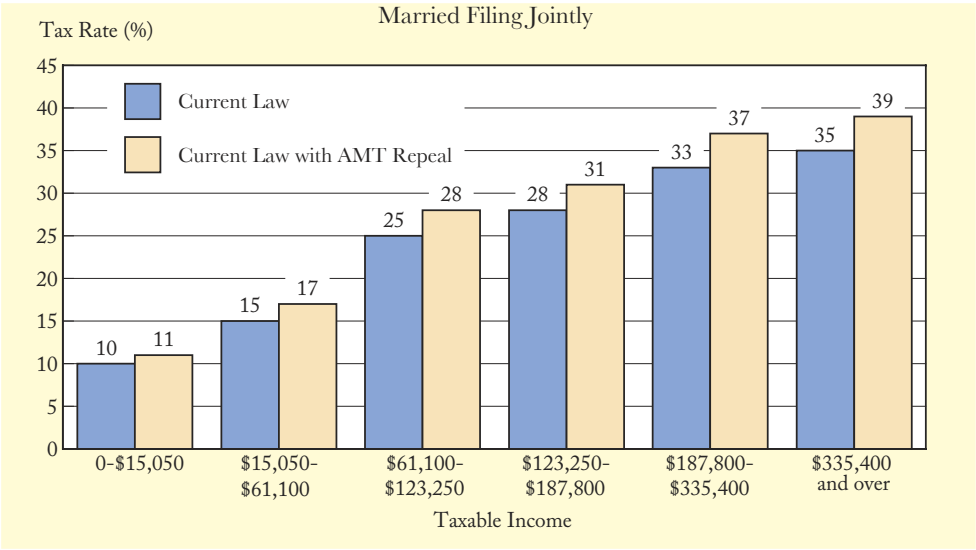
The decision to use the Administration's baseline has a number of important implications. First, the baseline assumes that the 2001 and 2003 tax cuts will be made permanent. Second, it assumes that a current law provision limiting the reach of the Alternative Minimum Tax (AMT) will expire as scheduled after the 2005 tax year. As described in Chapter One, the AMT is a parallel tax system that is steadily affecting more and more taxpayers. The combination of these two assumptions results in a revenue baseline equal to roughly 18 percent of GDP, which is consistent with the historical average for this ratio over the last half century. The Administration has acknowledged the problems caused by the growth of the AMT, and has made it clear that a long-term solution to the AMT problem is an important aspect of the overall tax reform effort.

The Burden of the Alternative Minimum Tax

The AMT is estimated to generate over $1.2 trillion in tax revenue over the next ten years. Including anticipated revenues from the AMT in the baseline of future tax receipts makes the Panel's work particularly challenging. Repealing the AMT in a revenue-neutral way requires the Panel to replace the $1.2 trillion of revenue from the AMT with other changes to the tax code. Recouping AMT revenues inevitably involves other offsetting changes, such as higher tax rates, eliminating tax preferences, or some combination of both. It is important, therefore, that American taxpayers understand that a tax reform proposal that does not repeal the AMT effectively results in a hidden, but real, future tax hike. The AMT currently affects nearly four million American families and is projected to affect more than 50 million taxpayers by 2015.

The Treasury Department estimates that collecting the $1.2 trillion of AMT revenue by simply raising current tax rates would require an 11 percent across-the-board rate increase. This should result in taxpayers in the 15 percent tax bracket paying tax at a rate of about 17 percent, and those in the 35 percent tax bracket paying tax at a rate of about 39 percent. Figure 4.1 shows the rate schedule that would be needed to raise the same revenue as the income tax and the AMT, but with only the income tax.

Figure 4.1. Effect of AMT Repeal on the Tax Rate Schedule



Note: Taxable income brackets are estimates for 2006.
Source: Department of the Treasury, Office of Tax Analysis.

As readers consider the specific rates that are outlined in the Panel's reform options, they should compare those rates to the rates in the above table, which are higher than those in current law. Those higher rates, or some other configuration of higher rates, are the real baseline for the Panel's work, because they are the rates that taxpayers will effectively face if the AMT is left in place. If only changes in the top four brackets were used to raise the same revenue under the income tax alone, each rate would have to be increased by 18 percent. Under this scenario, replicating federal revenues while repealing the AMT would require that the top tax rate be increased from 35 percent to 41 percent.

At the same time, many Panel members recognize that lawmakers are unlikely to allow the full effects of the AMT to hit American families. Congress has extended an AMT "patch" for the past few years, effectively limiting the reach of the AMT. Many observers, therefore, believe that a more realistic starting point for the Panel would assume the continued extension and indexing of the AMT patch. Indeed, there are several proposals currently before Congress that would repeal the AMT without requiring any offset of tax revenues. If these are adopted, the reach of the AMT may be limited, but the federal government would collect far less revenue to pay for necessary government programs in the coming decades.

The Treasury Department estimates that extending and indexing the AMT patch would cost $866 billion during the next ten years. If the Panel did not need to account for that revenue in its recommendations, individual tax rates could be reduced even further. Later in the report, the Panel will present the lower rates for each recommendation.

Limitations of Revenue Estimates

The next question is how to determine the specific dollar cost or savings of a particular proposal. The Treasury Department's Office of Tax Analysis uses what is commonly referred to as "conventional" or "microdynamic analysis" to score tax proposals. In making their revenue estimates, the Treasury Department's economic models account for the fact that taxpayers respond to changes in tax law, for example, by changing the timing of decisions or changing the mix of assets they purchase. However, these estimates do not account for how those behavioral changes will affect the size of the overall economy. Instead, the Treasury Department holds constant the Administration's projections for the future size of the economy. That means, for instance, that even if a reform option caused the total size of the economy to increase due to more favorable investment incentives, conventional estimates would not incorporate the corresponding increase in revenues.

There are many commentators who are troubled by the limitations of conventional scoring, and thus advocate a different method, often referred to as "dynamic" or "macroeconomic" analysis, particularly for proposals that envision broad or fundamental changes in the tax system. This approach provides estimates of the effect of tax reform on the overall economy.

While dynamic analysis conveys useful information, it is important to remember that the estimation of dynamic effects is also subject to much uncertainty. Dynamic scoring relies on numerous assumptions and the estimates may be quite sensitive to changes in these assumptions. A dynamic scoring model needs to predict, among other things, the effects of tax changes on interest rates, equity prices, labor supply responses, saving, investment, and national income. Building such a model requires economists to make a large number of assumptions concerning how individuals and businesses respond to tax policy and how these responses filter into changes in the macroeconomy and in tax revenues.

Given the number of assumptions and modeling decisions necessary to produce dynamic estimates, it is no surprise that different modeling strategies yield alternative estimates. In fact, when the Congressional Budget Office and the Joint Committee on Taxation perform dynamic analysis, they both report estimates from a range of different macroeconomic models and they include sensitivity analyses to show how their predictions are affected by alternative modeling assumptions.

Some Panel members strongly felt that dynamic analysis should be utilized, but the Panel did not want its tax policy recommendations to be overshadowed by a controversy about the validity of its scoring methodology. Other Panel members believed that there are shortcomings to more dynamic estimating techniques that hamper their usefulness. Therefore, the Panel has relied on conventional estimates as supplied by the Treasury Department to meet the mandate of revenue neutrality. At the same time, the Panel requested that the Treasury Department provide a dynamic analysis of the reform options. This analysis, which is based on three different models (described in the Appendix), suggests that the options could have positive effects on the economy.

The "Budget Window"

Another dimension of revenue neutrality concerns the relevant time horizon for revenue estimates. The Panel used a ten-year period, which is the current standard in the federal budget process. The use of any budget window raises a number of issues. Under standard conventions, the revenue effect of a proposal is simply the sum of nominal predicted revenues over the budget window – no attempt is made to discount future revenues for the time value of money. Box 4.1 discusses the effect of nominal versus present value estimates on revenue neutrality.

Box 4.1. The Effect of Nominal versus Present Value Estimates

The Treasury Department's ten-year revenue target is based on the nominal sum of annual revenues. In other words, Treasury first estimates the amount of revenue for each year, and then adds those numbers together to arrive at a total amount of revenue for the period. There is no discount for the time value of money. This approach differs from standard business practice – which does use present value discounting. The reason for discounting future revenues is simple: A dollar received at a future date is worth less than a dollar today because a dollar today can be invested to earn interest and deliver more than a dollar in the future.

The use of the convention of summing annual revenues without discounting future cash flows has implications for the Panel's proposals. Here is why: Under the Treasury baseline, the annual revenue generated by the AMT rises during the ten-year budget window. The Panel's proposals, on the other hand, generally have a much more stable flow of revenue. If one were to picture the revenue flow over the budget window it would be an upward sloping line; the Panel's proposals would flatten out that line. For both the baseline and the Panel's proposals, there will be the same total nominal flow of revenues over the relevant period; however, a tax reform proposal that generates a more stable flow of revenues over the budget window, rather than a more rapidly rising flow, will raise *more* revenue than the baseline if the future revenue flows are discounted. Thus, revenue-neutral tax reforms that repeal the AMT would require lower tax rates if the baseline were calculated using present discounted values instead of nominal values.

Using a ten-year period to gauge revenue neutrality requires assumptions about economic conditions that are subject to considerable uncertainty and likely to change substantially over the course of a decade. It is difficult to predict growth in the economy a year from now, let alone the strength of the economy over a longer time horizon.

At the same time, picking any particular budget horizon may provide an incomplete perspective on the revenue consequences of some tax reforms. This problem can be illustrated with two specific reform provisions included in the Panel's recommendations. One proposal is to expand the use of a particular type of tax-preferred savings and retirement account – commonly referred to as a Roth-style account. Taxpayers make after-tax contributions to these accounts, and then can

withdraw the earnings, subject to certain limitations, without paying any additional tax on the income earned on the deposits. Another proposal would allow businesses to immediately write off, or "expense," capital expenditures rather than taking depreciation deductions for the value of their investments over a defined period of time.

The Treasury Department estimates that introducing or expanding Roth-style accounts results in a slight reduction in tax revenues during the ten-year budget window. This estimate may, however, understate the overall revenue cost of the accounts for a number of reasons. First, the proposal would allow taxpayers to transfer money from traditional IRAs into these new savings vehicles. The revenue estimate assumes that many taxpayers will transfer their savings, producing revenue gains during early years as they pay taxes on money withdrawn from traditional IRAs in return for the benefit of tax-free withdrawals later. Because the taxes on the money in these accounts would have been collected eventually under the current system, but often more than ten years into the future, this transfer of assets has a favorable effect on tax revenues within the next ten years, but it does so at the expense of revenues in future years.

Second, a substantial share of the revenue loss from the reduced taxation of future capital income for each dollar contributed to these accounts occurs outside the ten-year window. When a taxpayer holds assets that would otherwise have been held in a taxable account in a Roth-style account, the Treasury loses revenue from taxes on interest, dividends, and capital gains. This revenue cost accrues for as long as assets are held in these accounts, which may be several decades if the accounts are used for retirement saving. As is summarized in Box 4.2, a rough analysis suggests that for retirement accounts, the revenue cost during the ten-year budget window is roughly one-third of the total revenue cost of this program; two-thirds of the revenue loss is not reflected in the revenue tables provided in this report. For other savings accounts in which the assets are likely to be held for a shorter period of time, the ten-year budget cost is likely to account for a higher fraction of the overall cost. Policymakers should consider the magnitude of these long-term costs.

Box 4.2 also shows that for other provisions, such as expensing of capital expenditures, the revenue estimate for the ten-year budget window may overstate the revenue loss. This is because expensing moves all of the tax deductions associated with a long-lived asset into the ten-year budget window, while traditional depreciation allowances for long-lived assets reduce revenues for a longer time period, in many cases as long as three decades. If one compares the costs of expensing a plant versus taking a hypothetical 30-year straight-line depreciation deduction, using a ten-year budget window may overstate the present value of the tax cost by nearly 25 percent.

Box 4.2. Examples of Long-Term Revenue Costs

The long-term revenue cost of a retirement account contribution depends on several key parameters. The first is the investment horizon of the taxpayer. Assume, conservatively, that each dollar contributed to a retirement account remains in the account for 30 years. For regular savings accounts, the holding period is likely to be shorter.

A second key parameter is the amount of the retirement savings account's investment that would otherwise have been held in a taxable account. This illustration assumes that half of the retirement savings account's balance represents such a transfer.

A third parameter is the investment mix of the retirement savings account's assets. This illustration assumes that 60 percent of the saving in the absence of the retirement savings accounts would have been invested in equities, with 40 percent invested in fixed income assets.

The last key parameter is the tax treatment of saving outside the retirement savings account. Assume that the average tax burden on equity investments is 10 percent, recognizing the 15 percent marginal tax rate on dividends and realized capital gains, as well as the opportunity to defer realization of capital gains, and set the marginal tax rate on interest income at 25 percent.

If equities yield a total return of 8 percent, while bonds yield 5 percent, the taxes that would have been paid on a $1,000 contribution to a retirement savings account in the first year of this contribution equal $4.90. In the absence of the retirement savings account, the assets that would have been saved would have grown through time as the after-tax income was reinvested in stocks and bonds. If the investor's asset mix remained 60 percent stocks and 40 percent bonds at all times, then the after-tax return on the whole portfolio would be 5.82 percent. Thus the nominal tax receipts if the saving assets were held outside a regular savings or retirement savings account would rise by 5.82 percent per year.

To find the present discounted value of this revenue flow over the entire 30-year period when assets are held in a retirement savings account, one discounts the foregone tax revenue stream, which grows at 5.82 percent each year, by the government discount rate. If we use a discount rate of 5 percent, thereby assuming that the government can discount the uncertain stream of future tax receipts using a risk-free interest rate, the present value of the foregone revenue over the 30-year life of the retirement savings account's investment is $164.92. This is 33.7 times the first-year revenue cost of $4.90. The present discounted value of the revenue cost over the first ten years is $50.76, or roughly one-third of the lifetime present value cost. For saving accounts where assets are likely to remain in the accounts for a shorter time period, the ten-year budget cost would account for a larger fraction of the lifetime cost.

While retirement savings accounts have larger long-term than ten-year revenue costs, other tax provisions may have smaller revenue costs from a long-term perspective than from a ten year vantage point. Proposals to expense investment in plant and equipment, for example, have a ten year revenue cost that is larger than their permanent cost. Consider switching from straight-line deprecation over a 30-year lifetime to immediate expensing. The present discounted value of the depreciation allowances over a 30-year horizon, assuming again a 5 percent annual discount rate, is 53.8 percent of the plant's purchase cost. The present value component over the first ten years is 43 percent of the purchase cost. This implies that the revenue cost of expensing over the first ten years, which equals 57 percent of the asset's purchase price (100 minus 43), overstates the long-horizon present discounted value, 46.2 percent of the asset's purchase price, by nearly 25 percent.

Revenue Estimates Are Not Precise

The sources of uncertainty in revenue estimates as discussed earlier, and many others that arise from the difficulty of accurately forecasting the behavioral responses of millions of Americans to tax changes, make projections of the revenue yield of tax

reform plans inherently uncertain. The Panel recognizes that revenue estimates are imprecise. Accordingly, upon the advice of the Treasury Department, the Panel has decided to define "revenue neutrality" as being within one-half of one percent of the projected revenue baseline for the next ten years. Some Panel members, however, believe that two percent or more would be reasonable.

Tax Reform, Progressivity, and the Distribution of the Tax Burden

The Executive Order directed the Panel to recommend options for reform that were "appropriately progressive." As discussed in Chapter Three, the current income tax system is progressive, as it provides exemptions and deductions that shield some income from tax, allows refundable credits, and applies a graduated set of tax rates. All members of the Panel endorsed the goal of a progressive tax structure. Some Panel members felt that the current system has gone too far in removing lower-income taxpayers from the tax rolls and that higher-income taxpayers pay too large a share of federal income taxes. Other Panel members were comfortable with the current distribution or believed that the income tax should be more progressive, with higher-income taxpayers bearing more of the overall income tax burden, because of a concern about substantial inequality of wealth in the country that has grown in the last decades. In the end, the Panel concluded that the appropriate burden of taxation was an issue that elected officials should resolve – and so the Panel decided to design reform options that would remain relatively close to the current distribution of tax burdens.

The Panel relied on "distribution tables" to measure the allocation of tax burdens across households. Such tables are a necessary tool for evaluating tax proposals, but like revenue estimating, creating distribution tables is an imprecise art. Distribution tables are based on an assortment of projections and assumptions about the way various taxes affect the economy and, in particular, how they affect the pretax incomes of various taxpayers.

As explained in Chapter Three, just because someone writes a check to the government, it does not necessarily follow that he or she shoulders the burden of that tax. The Treasury Department prepares distribution tables that generally assume that the corporate income tax is paid by all owners of capital. However, many public finance economists believe that at least some portion of the corporate income tax is shifted from owners of capital (or investors) to labor (or workers) and reflected in lower real wages and living standards. This assumption can make a significant difference in any distributional analysis of corporate income tax reform. Furthermore, the distribution table for 2006 will look different from that for 2015, and a table that assumes no relief from the AMT will differ from a table that assumes either repeal or a patch of the AMT.

This report shows distribution tables for the first year of a proposal, the last year of the budget window, and the ten-year budget window. The Panel also presents tables that distribute half of the corporate tax to owners of capital and half to labor.

Box 4.3. Thinking about Long-Term Distribution

Most of the distribution tables shown in this report allocate the tax burden across households, and group households by their current-year income. This approach offers important information on the distribution of tax burdens, but for some households, current income is an unreliable measure of long-term economic well-being. College students, for example, may report low current income, but their long-term earning prospects would place them much higher in the distribution of lifetime earnings. Elderly people with substantial wealth but limited income from their assets may also appear in a low-income category, even though they have been economically prosperous throughout their careers. A taxpayer who separates from a firm and receives a large one-time severance payment, in contrast, may have a current-year income substantially greater than his long-term average or than his future prospects.

Estimates from the Treasury Department, reported in the 2003 Economic Report of the President, suggest that taxpayers exhibit a considerable amount of fluidity across tax rate brackets. Treasury Department researchers calculated the statutory tax rate bracket taxpayers would have faced in 1987 and in 1996 had the Economic Growth and Tax Relief Reconciliation Act of 2001 been in place in those years. The table below reproduces the results from this study. The shaded cells report the percentage of taxpayers in each tax bracket in 1987 (year one) that remained in the same bracket in 1996 (year ten).

Taxpayers by Rate Bracket Using a Panel of Taxpayers

Year one tax bracket (percent)	Year 10 tax bracket (percent)							Returns in year ten (thousands)
	0	10	15	25	28	33	35	
	Taxpayers by rate bracket (percent distribution)							
0	33.8	24.7	32.1	7.7	0.8	0.5	0.3	10,360
10	20.1	29.3	40.8	8.8	0.6	0.3	0.1	15,370
15	8.6	13.3	53.4	22.9	1.2	0.4	0.2	50,059
25	3.9	5.1	29.9	51.4	6.7	2.2	0.8	31,427
28	3.3	2.8	11.6	35.9	24.0	14.7	7.5	2,682
33	4.7	2.6	9.1	21.0	18.9	23.9	19.8	1,096
35	5.1	1.9	5.7	10.4	8.8	19.0	49.1	633

Note. Tabulations from 1987-1996 panel of taxpayers. Tabulations include only non-dependent taxpayers present in all years of the panel data set. Each cell entry indicates the percent of taxpayers in a rate bracket in the last year of the panel (i.e., column entry) relative to the number of all taxpayers in that rate bracket in the first year of the panel (i.e., row sum).

Source. Council of Economic Advisers, based on tabulations provided by the Treasury Department

The table demonstrates that there is a substantial amount of movement across rate brackets. More than half of taxpayers were in a different tax bracket at the end of the period than they were in at the beginning of the period (the proportion of taxpayers not on the diagonal). The table also shows that the chance that a taxpayer moves from the highest income tax brackets to the lowest, or vice versa, is relatively low. While this evidence suggests that there is value in constructing distribution tables that categorize households based on a longer-term measure of income and economic status, the standard approach to distributional analysis still focuses on annual income, and so that is the approach followed by the Panel for most tables.

Simplicity

The Executive Order also directed the Panel to recommend options that would simplify the tax code to reduce compliance costs and administrative burdens. The objective of simplicity is related to, and at times is at odds with, the objectives of fairness and economic growth. Unfortunately, our tax code has steadily grown more complex as lawmakers in recent years have almost always sacrificed simplicity in choosing among these competing objectives.

Complexity in our current code arises from a number of sources. Some of the complexity is the result of attempts to make our tax system fairer. Many provisions adjust for taxpayers' ability to pay, but the price is greater complexity. Another significant cause of complexity is the numerous tax preferences in the form of deductions, credits, exclusions, and special rates. Each of these tax preferences requires special computations, eligibility rules, and recordkeeping. Mechanisms designed to target tax benefits to specific taxpayers or limit the amount of tax benefits available – such as phase-outs, caps, floors, and the AMT – are yet another source of complexity. Further compounding these sources of complexity in recent years has been the volatility of changes to the code and the increased reliance on temporary and expiring provisions, which are often the consequence of budget rules seeking to restrain loss of revenue through tax expenditures.

Complexity also affects different groups of taxpayers differently. The Panel analyzed the most significant sources of complexity affecting particular types of taxpayers. For example, complex eligibility rules for refundable credits affect low-income taxpayers; recordkeeping burdens and accounting rules are especially onerous for small businesses, and international rules create significant complexity for multinationals. As discussed in the following chapters, each of the Panel's options addresses these areas of complexity.

Recognizing the importance of simplicity, the Panel determined to make simplification a priority. In many cases, the Panel elected to make features of its options simpler, even though a more complicated design could have been used to better target the provision to provide benefits to specific taxpayers or to achieve other goals.

Illustrating the Constraints: A Policy Experiment

The previous discussion describes the many constraints facing the Panel. At the request of the Panel, the Treasury Department ran a number of policy experiments using income and consumption tax bases, to demonstrate the trade-offs between the choice of the tax base, tax rates, and the distribution of the tax within revenue-neutral policy reforms. The experiments are quite useful in understanding the range of choices available to the Panel in reforming the tax code. The analysis discussed below was presented at the Panel's July 20 meeting. The estimates differ slightly from those in other sections of the report because they were created using Treasury Department tax models that had not been updated for the annual mid-session review of the policy baseline.

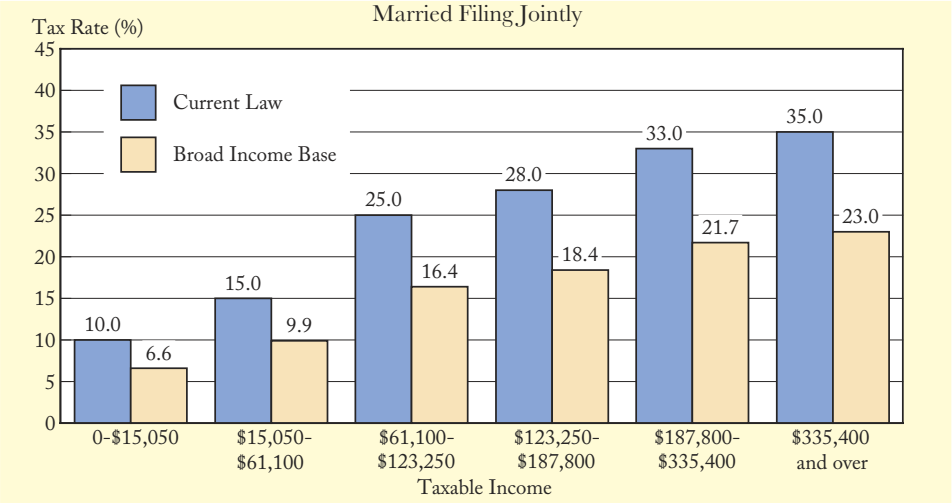
The Panel first asked the Treasury Department to determine the required rate structure to achieve revenue neutrality with a "broad" income tax base. The broad individual income tax base would retain only the standard deduction and personal exemptions. All credits, above-the-line deductions, itemized deductions, and other special preferences in our tax code would be eliminated. The broad base would also eliminate the AMT.

The individual and corporate tax systems would be integrated so that income taxed at the business level would not be taxed again at the individual level; meaning that the double tax on corporate profits would be eliminated. All capital gains would be taxed at ordinary rates, and tax-favored savings or retirement vehicles would be eliminated.

The broad corporate income tax base would eliminate corporate tax preferences. Depreciation deductions would allow taxpayers to deduct the actual decline in the value of a capital asset over the taxable period (which is known as "economic depreciation"). The top rates for the individual income tax and corporate income tax would be equal.

The Treasury Department estimated that adopting this broad base would make it possible to reduce tax rates across the board by about one-third. As Figure 4.2 shows, the lowest individual rate, currently at 10 percent, could be lowered to 6.6 percent, and the highest rate (which also applies to corporate income), 35 percent, could be lowered to 23 percent. Alternatively, the Treasury Department found that the graduated rate structure could be replaced with a single rate of 15 percent and maintain revenue neutrality.

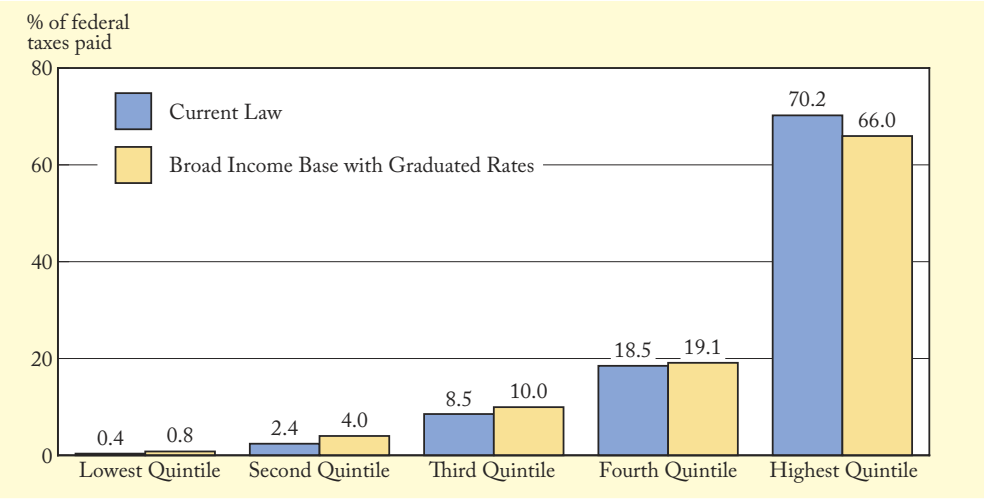
Figure 4.2. Tax Rate Schedule of Broad Income Base with Graduated Rates



Note: Taxable income brackets are estimates for 2006.
Source: Department of the Treasury, Office of Tax Analysis.

The Treasury Department also estimated the impact of the broad base on the distribution of the tax burden. As shown in Figure 4.3, taxpayers in the highest quintile would pay a smaller proportion of total federal taxes, while taxpayers in each of the other four quintiles would pay a greater proportion of the tax burden.

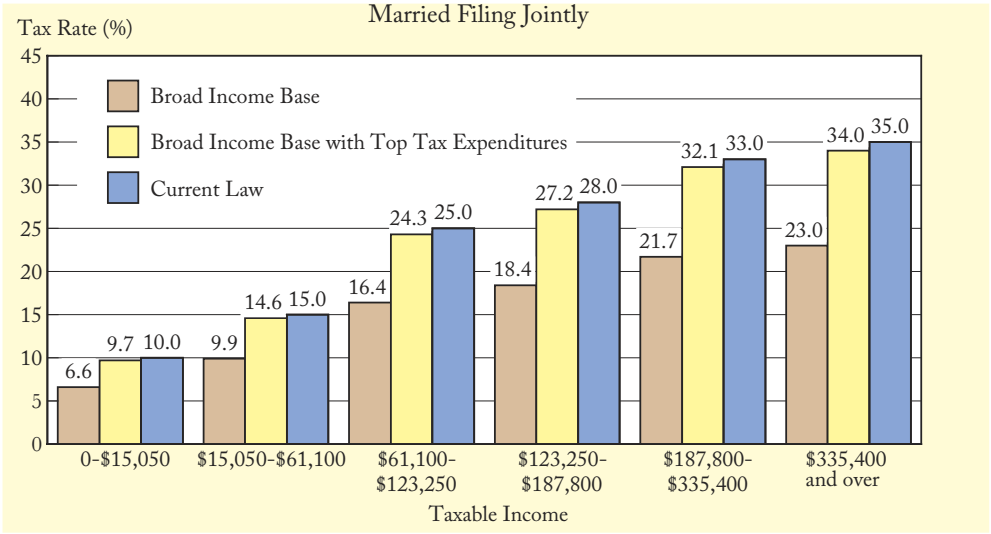
Figure 4.3. Distribution of Tax Burden for Broad Income Base with Graduated Rates by Income Percentile



Note: Estimates of 2006 law at 2004 income levels.
Source: Department of the Treasury, Office of Tax Analysis.

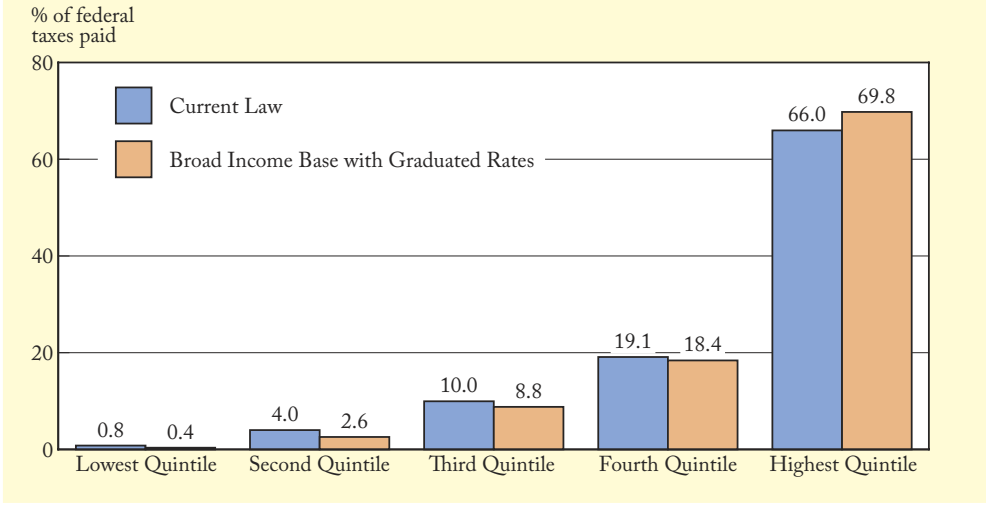
To evaluate the cost of current tax expenditures in terms of both the higher tax rates they necessitate and the distribution of the burden, the Treasury Department ran an experiment that added the top individual and corporate tax expenditures to the broad base. These tax expenditures include the tax exclusion for employer contributions for health insurance and pensions, retirement savings preferences, the mortgage interest deduction, charitable deductions, the EITC, and the child tax credit for individuals; and accelerated depreciation, oil and gas preferences, the manufacturer's deduction, progressive corporate rates, and the research and experimentation credit for corporations. Figure 4.4 shows that adding these tax expenditures to the broad tax base requires tax rates nearly as high as those under current law to collect the same amount of revenue. Figure 4.5 shows that adding the top tax expenditures to the broad base provides a distribution of tax burden that is close to current law.

Figure 4.4. Tax Rate Schedule for Broad Income Base with Top Tax Expenditures Added Back



Note: Taxable income brackets are estimates for 2006.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 4.5. Distribution of Tax Burden for Broad Income Base with Graduated Rates and Top Tax Expenditures by Income Percentile



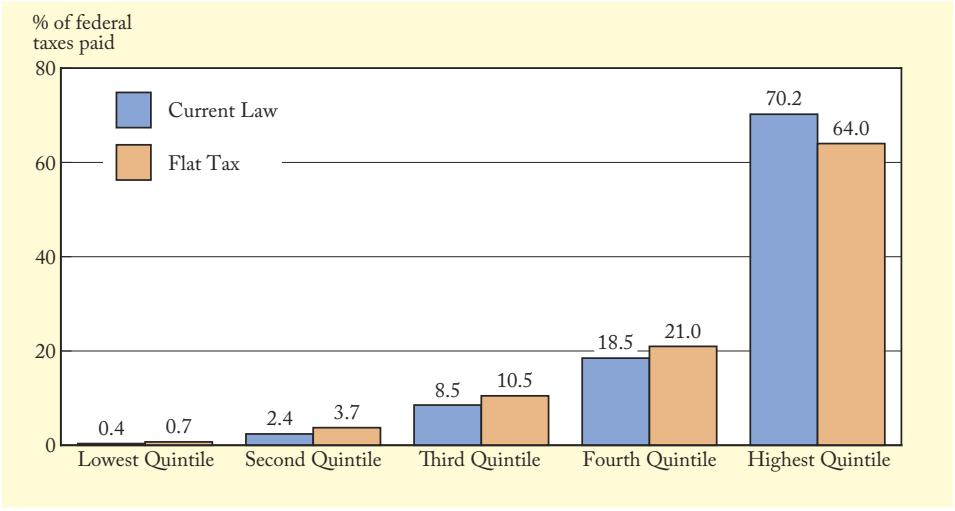
Note: Estimates of 2006 law at 2004 income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Using a Consumption Tax Base

The Panel was also interested in understanding how moving to a consumption tax base would affect tax rates and the distribution of taxes. To answer these questions, the Panel asked the Treasury Department to estimate a revenue-neutral Flat Tax, a prominent consumption tax prototype. The Treasury Department's estimate allowed taxpayers a personal exemption, but eliminated all other tax preferences and the AMT. As described in Chapter Three, the business portion of the Flat Tax is based on cash flow taxation. Businesses do not receive a deduction for interest expense, and can write off all of their capital investments immediately.

The Treasury Department estimated that a Flat Tax imposed on a broad consumption tax base would require a 21 percent tax rate to preserve revenue neutrality. The estimates also showed that the distribution of the tax burden under a standard Flat Tax would be less progressive than the current tax system. Figure 4.6 shows that a standard Flat Tax would significantly increase the portion of the tax burden borne by the first through fourth cash income quintiles relative to the current distribution of the tax burden.

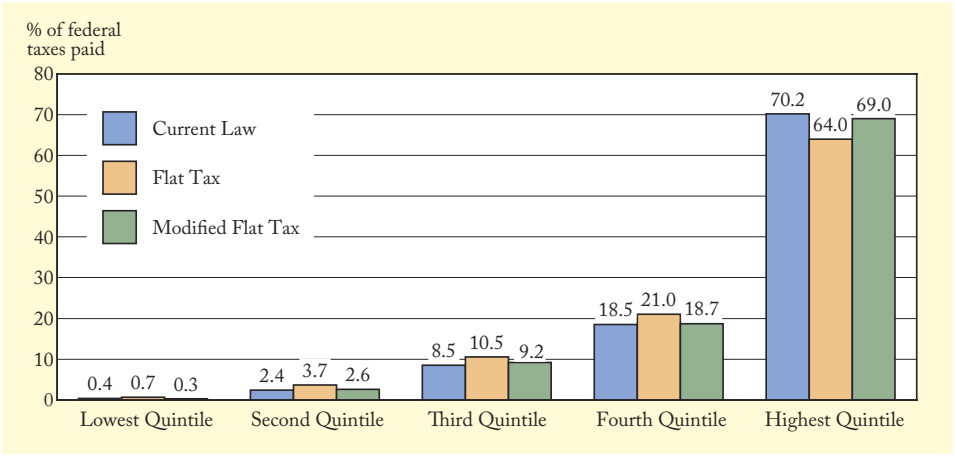
Figure 4.6. Distribution of Tax Burden for Flat Tax by Income Percentile



Note: Estimates of 2006 law at 2004 income levels. Individuals would be allowed an exemption amount that in 2006 would be $13,150 for singles, $26,300 for married taxpayers filing jointly, $17,200 for heads of households, and $6,150 for each dependent.
Source: Department of the Treasury, Office of Tax Analysis.

Consumption taxes can be made more progressive by including graduated rates at the individual level. The Panel asked Treasury to replace the single, flat rate of 21 percent described above with three tax brackets with rates of 15 percent, 25 percent, and 35 percent. The same standard deduction and personal exemption parameters would apply. To even further augment progressivity, the Panel asked the Treasury Department to also include the EITC. As shown in Figure 4.7, with the introduction of progressive rates, the distribution of the tax burden more closely resembles the distribution of the tax burden under current law. Notably, the overall tax burden on families in the first four quintiles increases to a lesser extent than under the standard Flat Tax, and the burden on families in the top quintile is reduced less significantly.

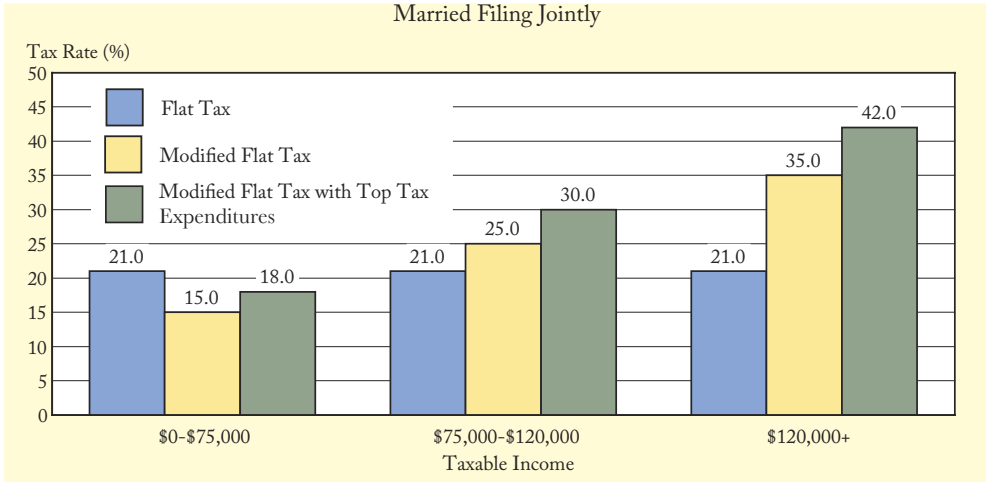
Figure 4.7. Distribution of Tax Burden: Flat Tax, Modified Flat Tax, and Current Law by Income Percentile



Note: Estimates of 2006 law at 2004 income levels.
Source: Department of the Treasury, Office of Tax Analysis.

The Panel then asked the Treasury Department to estimate the tax rates that would be required to implement this revenue-neutral modified Flat Tax with the top individual and corporate tax expenditures. In particular, the Treasury Department added back the exclusion for employer contributions for health insurance, the mortgage interest deduction, charitable deductions, and the child tax credit for individuals; and oil and gas preferences, the manufacturer's deduction, progressive corporate rates, and the research and experimentation credit for corporations. Retirement savings preferences and accelerated depreciation were not included because the tax base is consumption.

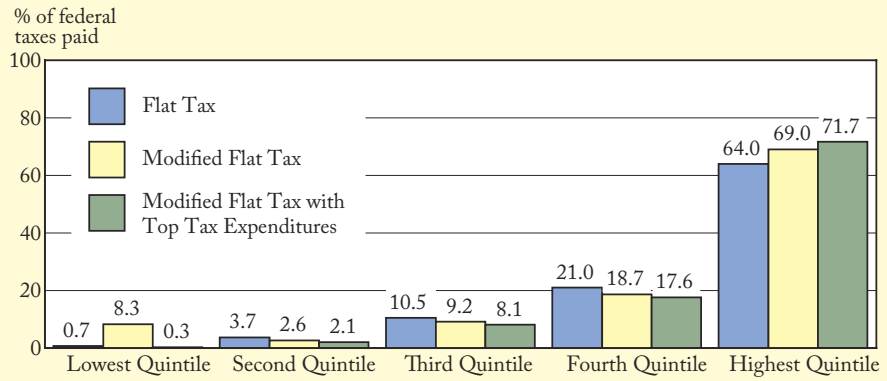
Figure 4.8. Tax Rate Schedule: Comparison of Flat Tax and Modified Flat Taxes



Note: Taxable income brackets are estimates for 2006.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 4.8 shows that tax rates must be substantially higher to support a modified Flat Tax that also includes the top tax expenditures. To keep the same exemption amounts and bracket structure while adding the top tax expenditures, the top tax rate would have to rise from 35 percent to 42 percent, the middle rate would rise from 25 percent to 30 percent, and the lower bracket would rise from 15 percent to 18 percent. These large increases in tax rates highlight the importance of a broad tax base for maintaining low tax rates. Figure 4.9 compares the distribution of tax burden under the Flat Tax, the modified Flat Tax, and the modified Flat Tax with the top tax expenditures. Adding the top tax expenditures to the tax base increases the proportion of taxes paid by the highest quintile, decreases the proportion paid by the second through fourth quintiles, and has little effect on the lowest quintile.

Figure 4.9. Distribution of Tax Burden by Income Percentile: Consumption Taxes with Top Tax Expenditures



Note: Estimates of 2006 law at 2004 income levels.
Source: Department of the Treasury, Office of Tax Analysis.

These policy experiments demonstrate the trade-offs that are inherent in any effort to reform the tax system. Lower rates can be achieved by broadening the tax base – but once the major tax preferences are added back to the tax code, maintaining revenue neutrality means that rates need to rise to their current levels or higher. Similarly, any major changes in the tax base or the inclusion of certain tax expenditures causes significant changes in the current-law distribution of taxes. It is important to recognize these constraints and trade-offs in evaluating the Panel's options for reform.