Grading the President's Tax Reform Panel's Plan

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Congress shows no enthusiasm for pushing the recommendations of the President's Tax Panel. Indeed, the White House shows no enthusiasm for implementing the recommendations.

Nevertheless, we should make it very clear that the panel—guided by two outstanding economists, Edward Lazear and James Poterba, and an equally impressive former IRS commissioner, Charles Rossotti—deserves enormous credit for its work in recommending critical improvements to our tax system. The proposals include: eliminating the Alternative Minimum Tax (AMT), limiting mortgage and health insurance tax breaks for the rich, eliminating the deductibility of state and local taxes, rationalizing deductions, exemptions, tax credits, and retirement account options, and reducing the taxation of saving. If these reforms were to be implemented—and to be implemented with transition rules that did not give away the store—then our tax system would be both more efficient and, in many important ways, more equitable.

That's the good news. The bad news is that even were the Panel's proposals to be adopted, our tax system would remain complex, expensive to administer, highly inimical to working, and still rather inimical to saving. So the best grade I can give it is a B+; it is a vast improvement over the current system, which I give a D, but still short of the ideal.

I'm a tough grader, so a B+ is very good. Let me say why. Having one ridiculously complex tax system is bad enough. Having two, as we do now, borders on the criminal: ridding ourselves of the AMT, as the Panel proposes, is a very good thing. So is limiting the current tax system's highly regressive mortgage and health insurance subsidies, which induce excessive consumption of housing and healthcare by the rich. And, a third key fix—dropping state and local tax deductibility—is long overdue. This provision fosters overspending by states and localities, who know that a good portion of the taxes they levy to finance this spending will effectively be paid for by the federal government.

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The treatment of savings and investment

Our current retirement/medical/educational saving account system is also nuts. We have 401(k)'s, 403(b)'s, IRA's, Roth IRA's, 529 plans, SEP's, HSA's, MSA's, FSA's, HRA's, SIMPLE's, Keogh Accounts, Thrift Savings Plans, Retirement Savings Contribution Credits, and the list goes on. The Panel wipes these all out and substitutes three similar and straightforward plans—Save at Work, Save for Retirement, and Save for Family—all with *very* high contribution limits. By contributing to these plans, low and middle-income households will be able to do *all* of their saving through these vehicles and effectively face a zero tax on saving. Why? Because they are set up like Roth-IRA's. There are absolutely no taxes levied on any income earned on funds saved in these accounts. For low-income households, the Save for Family plans provide refundable tax credits—meaning the government will be directly helping poor people save.

For the rich, the proposed reforms also dramatically reduce the taxation of saving. Thanks to the combined workings of the current federal corporate and personal income taxes, the rich pay the feds roughly 47 cents of every extra dollar earned on savings. Under the Panel's "Growth and Investment Tax Plan" their effective marginal tax rate would fall to 15 percent. This major reduction in the effective taxation of capital income reflects the Panel's endorsement of expensing—the ability of businesses to immediately write off all their new investment. This gives businesses an upfront tax break, fully compensating them for having to pay taxes down the road on the return to that investment. Consequently, they are able to pass on to households the full pre-tax return on the investment—a return on which households will then pay 15 percent, if their holdings are outside retirement accounts, and zero if their holdings are inside retirement accounts.

Personal deductions and exemptions

The Panel's reform also replaces personal exemptions, the itemization of deductions, the standard deduction, the Child Tax credit, the Earned Income Tax Credit, and the marriage penalty with just two credits—a family credit and a work credit. The result is a simpler and much fairer system. Take mortgage interest. Today someone in the 33 percent bracket pays, on net, only 67 cents of every dollar spent on mortgage interest, whereas someone who doesn't itemize pays 100 cents of every dollar so spent. Under the proposed reform, all taxpayers will pay, on net, 85 cents of every dollar spent on mortgage interest up to a relatively low maximum.

The Work Credit will replace the quite complex Earned Income Tax Credit. The Work Credit seems to provide better work incentives. The big problem with the Earned Income Tax Credit is that it claws back the credit at a rate as high as 22 cents on the dollar once a recipient's earnings get sufficiently high. This adds up to 22 percentage points to low-income workers' effective marginal tax brackets. The Work Credit has a much lower and hence better claw back rate—12.5 percent.

So what's not to like?

Here are three big beefs.

First, the Panel's proposed new tax system retains very high marginal rates of taxation of labor earnings. Most American workers will remain in 30 percent or higher total effective marginal federal tax brackets once one takes into account their income tax bracket, the 15.3 percent employer plus employee FICA tax, and the marginal (12.5 percent per dollar) loss of the Work Tax Credit for workers above that Credit's claw back thresholds. Politically, it may also be hard to tell many workers that they are paying higher tax rates on their labor earnings than rich coupon clippers are paying on their asset income.

Second, we now have a very messy mishmash between wage and consumption taxation. The Panel does not fix this. Worse still, it may end up shifting us more toward wage than consumption taxation. Both a wage and a consumption tax levy zero effective tax rates on saving. The difference involves the taxation of current existing wealth. Since consumption is financed by existing wealth and current and future labor earnings, taxing consumption, taxes what's used to purchase consumption—existing wealth and current and future labor earnings. By contrast, taxing just wages exempts any burden on current wealth holders.

To see this distinction, think about a retail sales tax, which is the most straightforward way of taxing consumption. If you have wealth and spend it, you pay the sales tax. If you save your wealth and spend it plus accumulated asset income in the future, you also pay sales taxes. The same holds true if you earn money by working. If you spend your earnings immediately, you pay sales taxes immediately. If you save your labor earnings and spend it plus the accumulated income on that saving, then it turns out that you'll pay the same sales tax, measured in present value as of today, regardless of when you spend it.

What about taxing just wages? Well, this lets current wealth holders completely off the hook. And most current wealth holders are members of older generations. So transiting from our current system to a different wage-consumption tax mishmash, which entails more wage and less consumption taxation, could well shift more of the fiscal burden onto young and future generations at the benefit of the elderly.

A good example of this concern is the generous transition rules for the grandfathering of old depreciation allowances tucked away on page 172 of the Panel's report. A second example is the decision to cut the top corporate tax rate from 38 percent to 30 percent. Given the Panel's proposed move to full expensing of new investment, the effective tax on new investment will be zero if the rate is 38 percent, 30 percent, or, indeed, 80 percent. In dropping the rate, the Panel is providing a windfall, not to new investment, but to old investment. And old investment is existing wealth owned, primarily, by older generations.

My third beef is that in retaining such a complex system, politicians will be as free to add and hide special interest provisions in the future as they have in the past. The Panel's plan is bold and visionary on many fronts. But it's starting with sausage and ending up with sausage, albeit with fewer ingredients.

The true path forward: a national sales tax

What's an A+ plan? An A+ plan is the FairTax: true fundamental reform. It would replace all current federal taxes (income, corporate, payroll (FICA), and estate and gift taxes) with a retail sales tax, assessed at a single rate. The FairTax also provides a monthly rebate to each household based on its demographic composition. The rebate is set to ensure that households living at or below the poverty line pay no taxes on net and makes the plan progressive

Rather than maintain a messy hodgepodge of income and consumption tax elements, the FairTax provides a transparent and direct tax on consumption. As specified in HR25, the legislation that would implement the FairTax, the FairTax tax rate is 23 percent-- spending one dollar of income or wealth would yield 77 cents in consumption after paying the sales tax. (Note that $1.00 is 30 percent higher than 77 cents, so the FairTax's nominal rate—the rate we'd pay at the store -- is 30 percent.) Our current tax system as well as that proposed by the Panel puts almost all American workers in marginal tax brackets far above 23 percent.

The FairTax also provides better saving incentives: it places no tax whatsoever on saving.

If the FairTax is so good, why didn't the Panel recommend it? The Panel wasn't allowed to consider reforming payroll as well as income taxes. Nor could it consider scaling back federal spending, other than Social Security benefits and interest, to pay for the FairTax's rebate. That spending, measured as a share of GDP, has, by the way, risen by one fifth since 2000. Thus, the panel ignored a main advantage of the FairTax—eliminating the regressive payroll tax—and required the sales tax to generate more revenue than the FairTax stipulates. Moreover, the Panel also exaggerated sales tax enforcement problems. In fact, with a relatively low 23 percent effective rate, with the vast majority of retail sales being done in large retail outlets, and with an entire IRS freed up to enforce this single tax, we'd have little problem collecting the FairTax.

Finally, the Panel appears to have viewed sales taxation as too radical. Ironically, the Panel's proposal is not likely to be radical enough to secure its passage. In seeking to kill or maim three sacred cows—the deductibility of mortgage interest, state and local taxes, and employer-paid health insurance—the Panel has taken on powerful vested interests. But the biggest payoff—the elimination of the AMT—is something few voters yet appreciate.

The public may be much more willing to accept dramatic changes in taxes if they can see real gain for their pain. The FairTax offers that payback. It eliminates 17,000 pages of IRS law, the hated FICA tax, and each and every tax shelter of the rich. It provides much better incentives to work and save, and it's highly progressive. It taxes consumption, pure and simple. And in setting a maximum rate of 23 percent, it gives our politicians a maximum spending budget within which they'd have to live. Were the FairTax implemented in 2007, the required cut in real non-Social Security federal expenditures would be 6.3 percent. This is significant, but certainly feasible.

The U.S. tax system needs radical surgery. The FairTax is radical. But it's also transparent, efficient, and progressive. It's adoption would reduce economic distortions, enhance generational equity, and set a global expenditure budget. It would also position the country to best handle its enormous long-term entitlement obligations. The sooner we adopt the FairTax the better.

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References and further reading

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