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Grading the President's Tax Reform Panel's Plan

The President's Tax Panel, guided by two outstanding economists, Edward Lazear and James Poterba, and an equally impressive former IRS commissioner, Charles Rossotti -- deserves great credit for recommending critical improvements to our tax system. The list includes eliminating the Alternative Minimum Tax (AMT), limiting mortgage and health insurance tax 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 are implemented with transition rules that don't give away the store, our tax system will be more efficient and, in many ways, more equitable.

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

I'm a tough grader, so a B+ is very good. Let me say why. Having one ridiculously complex tax system is bad enough. Having two borders on the criminal. Thus, ridding ourselves of the AMT is important. So is limiting the current tax system's implicit and highly regressive mortgage and health insurance subsidies, which induce excessive consumption of housing and healthcare, particularly by the rich. 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.

Our current retirement/medical/educational saving account system is also nuts. We have 401(k)s, 403(b)s, IRAs, Roth IRAs, 529 plans, SEPs, HSAs, MSAs, FSAs, HRAs, SIMPLEs, 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-IRAs. 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 reform also dramatically reduces the taxation of saving. Thanks to the combined workings of the current federal corporate and personal income taxes, the rich now pay the feds roughly 47 cents of every extra dollar earned on their savings. Under the Panel's Growth and Investment Tax Plan their effective marginal tax rate will fall to 15 percent. The reasons are two. First, *all* capital income, including interest, rent, capital gains, and dividends, earned outside of retirement accounts would be taxed at 15 percent at the personal level. Second, the effective tax on capital income levied at the corporate level is reduced from its current roughly 32 percent rate to zero.

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, which fully compensates 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. In designing its new business cash flow tax, the Panel also eliminates the deductibility of business interest payments. This eliminates the bias toward debt finance inherent in the current tax system.

The Panel's reform also eliminates personal exemptions, the itemization of deductions, the standard deduction, the Child Tax credit, the Earned Income Tax Credit, and the marriage penalty. In their place, the Panel offers just two credits – a family credit and a work credit. The result is not just a simpler system. It's also much fairer. 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, on net, 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 isn't much easier to follow, but it seems to provide better work incentives. One of the problems 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 lower claw back rate – 12.5 percent --, although it applies this rate over a longer range of earnings.

Another key provision of the plan is reducing the top marginal rate on labor earnings from 33 percent to 30 percent. This compensates (perhaps overcompensates) the rich for losing a number of goodies. Big business will also be happy to see their top marginal rate fall from 38 percent to 30 percent.

So what's not to like? Well 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 proposes to simplify, but basically retain that mishmash. Worse still, it may end up shifting us more toward wage than consumption taxation. The difference between the two has nothing to do with the taxation of saving. Both a wage and a consumption tax levy zero effective tax rates on saving. The difference involves the taxation, either directly or indirectly, of existing wealth. Since consumption is financed by existing wealth and current and future labor earnings, taxing consumption, either directly or indirectly, taxes what's used to purchase consumption, namely, existing wealth and current and future labor earnings. In contrast, taxing just wages exempts any burden on current wealth holders.

To see this distinction, think about a retail sales tax, which is the most straightforward way of taxing consumption. If you have wealth and spend it, you pay the sales tax. If you save your wealth and spend it plus accumulated asset income in the future, you also pay sales taxes. Indeed, in present value you pay the same sales tax (assuming no change over time in the sales tax rate). 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, you'll pay the same sales tax, measured in present value as of today, whenever you do spend it.

So a retail sales tax hits both existing wealth and current and future labor earnings. 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 represents existing wealth and existing wealth is 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 its starting with sausage and ending up with sausage, albeit with fewer ingredients.

What's an A+ plan? An A+ plan is the FairTax. The FairTax represents 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.

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. This is the effective rate, meaning that 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 tax brackets far above 23 percent.

The FairTax also provides better saving incentives. Indeed, instead of taxing capital income at a 15 percent effective rate, as the Tax Panel would do, the FairTax places no tax whatsoever on saving.

If the FairTax is so good, why didn't the Panel recommend it? Unfortunately, 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 much more revenue than the FairTax stipulates. Moreover, in greatly exaggerating the FairTax rate, 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.