

THE PRESIDENT'S TAX REFORM PANEL

Increased Burdens for Working Families, Less Tax for the Wealthiest Americans

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On November 1, the President's Advisory Panel on Federal Tax Reform is scheduled to deliver its report and recommendations. The Commission has already discussed basic principles and released some ideas informally. This Briefing Paper provides some guidance on basic questions that are expected to be raised in the upcoming report. Although some of the commission's ideas, taken in piecemeal form, have some merit, the overall approach signals further reduction in the tax burdens of the wealthy, and increased taxes on working families.

On the surface, the course of the deliberations has rested on three principal pillars:

- To simplify individual and corporate income taxes by eliminating, reducing, and consolidating numerous deductions and credits;
- To transform the tax base from income to consumption; and
- To collect the same revenue as presently, with the same distribution of the tax burden.

The underlying pattern reflects the commission's consistent focus on limiting the tax base to income received in the form of wages and salary and used to finance consumption.

The haves vs. the have-mores

Many people receive a modest amount of capital income, and others enjoy huge salaries, but in general, capital income is concentrated among high-income recipients, relative to wage income. So a tax shift “from wealth to work,” in John Edwards’ felicitous phrase, is also a shift in tax burden from the better-off to the less well-off.

Less well-off in this case does not mean the poor or the working poor (with an exception to be noted shortly). The vast bulk of the individual income tax is paid by people above median income levels. The most recent data from the IRS has the share of the income tax paid by those below the median level of adjusted gross income (AGI) at less than 4%.¹ As long ago as 1985, this amount was still under 8%. Of course, the chief reason is that those below the median don’t have much AGI to begin with—14% of the total in 2003.

The federal individual income tax is not the tax that low-income people face. That distinction goes to the payroll tax, and to state and local taxes. About 20% of the payroll tax—\$170 billion dollars this year—is surplus to the Social Security and Medicare programs to which it is dedicated, so in that respect lower-income people are contributing general revenue. But this surplus dwindles to zero in a dozen years, and no proposals to increase the payroll tax on the average person have been heard. (It should be noted that the reduction of Social Security benefits is tantamount to a payroll tax hike, and benefit reductions are urged by the Bush Administration and others advocating the privatization of Social Security.)

Figure A shows shares of income tax paid by different groups for 2000 and 2003. (Note that a change in tax liability can be due to changes in pre-tax income, as well as changes in the tax code itself.) The figure shows that only taxpayers below the median and those in the top 1% had reduced tax shares, while those in between took up the slack. In general, the winners and losers under most of these likely tax changes will be those above the median, with the winners further above than the losers.

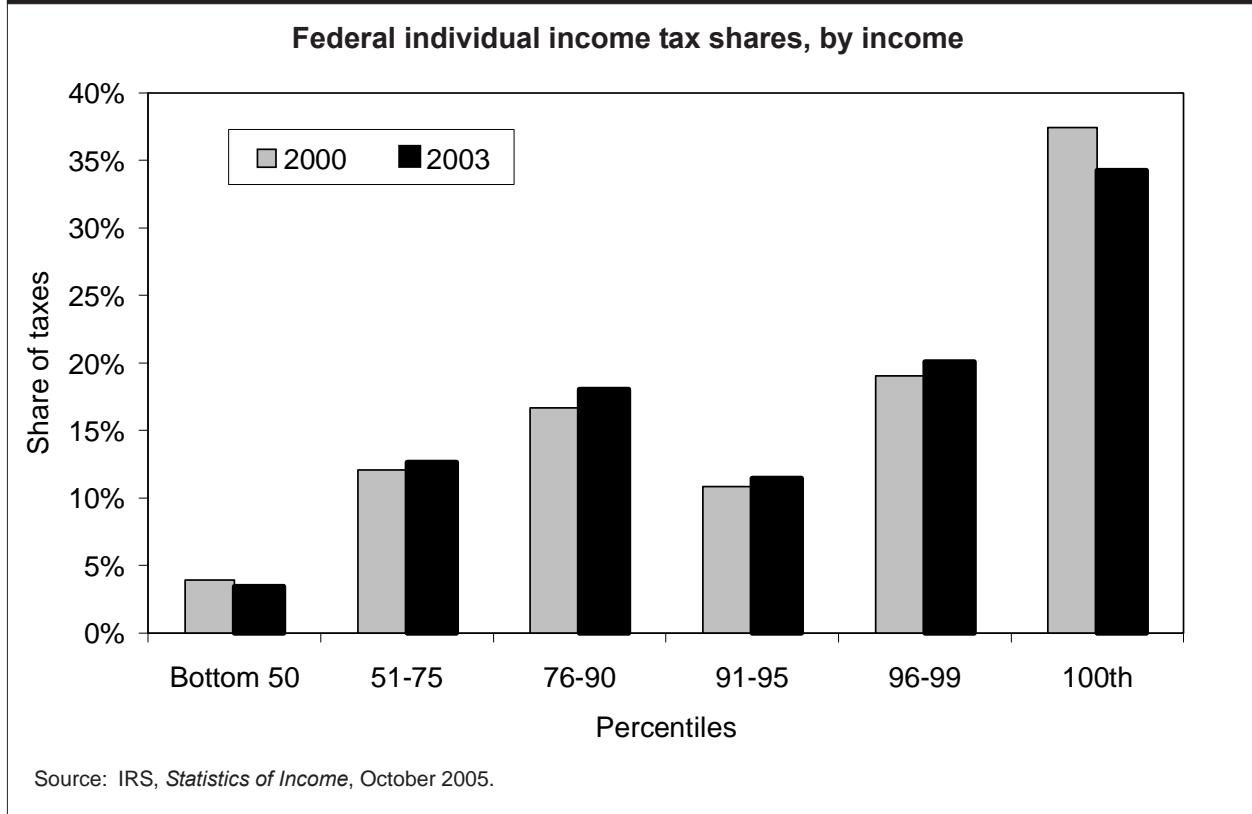
The exception to this pattern, discussed later, lies in potential changes to the prevailing array of refundable credits and other tax benefits to families with children that cause taxpayers below the median to have zero or negative tax liability.

Deductions

The commission will seek to reduce or eliminate the deductions for state and local income taxes and home mortgage interest, and the exclusion for health insurance premiums paid by employers. Any of these changes would significantly alter the tax liabilities of many individuals, even if the impact on average tax burdens or on tax shares by broad income classes were left unchanged. Reported estimates of effective tax rates—the share of one’s income paid in taxes—are averages over large groups of taxpayers. These averages obscure a lot of variation in tax burdens within any income group. For instance, a family with income of \$200,000 in the suburbs might carry a large mortgage; one in the city might rent an apartment and pay no mortgage interest at all. One worker may choose to “max out” his or her contribution to an IRA, another may forego that option altogether.

Itemized deductions tend to reduce the progressive impact of the individual income tax. With marginal tax rates that increase with income, the value of a deduction increases as well. Furthermore, the

FIGURE A



size of a deduction may increase with income. For instance, the higher one's income, the larger a mortgage one can afford and the more deductible mortgage interest one will pay. Limiting the size of deductions makes the income tax more progressive, as would converting a deduction into a credit, since the latter is worth the same to all taxpayers with sufficient positive tax liability to 'soak up' the credit.

Although only about a third of taxpayers itemize deductions, itemizers may be found at all levels of AGI. Changes in deductions will alter relative tax burdens within narrow income classes.

Limiting the particular deductions put into play by the commission will focus costs on specific industries—health care, housing, and real estate—rather than be spread more broadly among all taxpayers. Employer-paid pensions and relatively expensive health insurance plans are enjoyed more by workers in the manufacturing sector and workers in well-paid white collar occupations. That aside, the current provisions directly benefit the health insurance and health care industries.

Capping the deduction for mortgage interest strikes at the housing and real estate sectors, with benefits varying geographically. Mortgage interest deductions are higher where housing is more expensive—especially major cities and wealthy suburbs on the East and West Coast.

The current proliferation of deductions certainly increases the complexity and economic distortions of the income tax. In general, simplification in this realm could be beneficial. Unfortunately, the very uneven pattern of benefits arising from existing deductions is itself an obstacle to reform. One would not

want to duplicate this pattern under a simplified system, and one could not in any case, while flattening these benefits makes for difficult politics.

Any specific deduction can raise additional, thorny issues. For instance, it does not necessarily follow that the more expensive the health insurance benefit, the higher-paid is the worker. Workers in hazardous occupations might carry more expensive policies than higher-paid workers in safer occupations. A cap on the exclusion for health insurance could hurt the fireman more than the stock broker. Efforts to fine-tune this tax provision defeat the purpose of simplifying the system. Another example is the mortgage interest deduction. Limitation could pop some regional housing bubbles, creating “upside-down mortgage”² situations for many families.

As noted above, an additional theme in commission proceedings is the idea of converting deductions into credits. In a progressive tax system with graduated marginal tax rates, a deduction always benefits the higher-income person more. The reason is that the taxpayer’s higher marginal tax rate makes the deduction more valuable. If one is paying 35 cents on the dollar of taxable income, a dollar of deduction is more beneficial than if one only pays 15 cents.

Whatever the rate at which the deduction is converted, it is worth the same to anyone with sufficient positive tax liability to ‘soak up’ the credit. Converting a deduction into a credit eliminates this advantage and makes the system more progressive. The exception is low-income taxpayers with little or no income tax liability. For them neither a credit nor a deduction has any value unless the credit is ‘refundable’—unless the taxpayer gets the cash value of the credit in the event his or her tax liability is too small to use up the credit.

In our example above, conversion of a deduction into a credit does not necessarily help the fireman if the value of the credit is less than the deduction it replaced. For example, let’s say the fireman in the 15% bracket is getting a family health insurance policy that costs \$12,000 a year, tax free. This deduction is worth 15% of \$12,000, or \$1,800 in tax savings. If it is converted into a credit at the 15% rate, he is no worse off. But if the tax-free amount is capped at \$10,000 for a credit of \$1,500, he is out \$300.

A few large deductions do not add much to the complexity of the tax system. Dealing with mortgage interest or state and local income tax is usually very simple. The taxpayer need not keep records. They receive notice of the relevant amounts, and it’s just a matter of adding a number to a form. The information is separately reported to the IRS, facilitating enforcement. The worker-taxpayer does not have to know his employer-paid health care costs, since it is automatically excluded from his gross income on the W-2.

It is more the proliferation of deductions and credits that add to the complexity of the income tax. Some provisions may be small in terms of total revenue cost, but to a given individual taxpayer, a particular benefit could be extremely important.

Alternative Minimum Tax

Limiting deductions and exclusions raises revenue. The intent of the commission is to use this revenue to offset the abolition of the Alternative Minimum Tax (AMT). The AMT is a complex add-on to the individual income tax, originally aimed at preventing wealthy persons from using many deductions to

escape tax liability. Under the AMT, certain deductions are, in effect, taken back, thus increasing taxable income. After using a single standard deduction, AMT rates are applied to the remainder. If AMT taxes are higher than regular income taxes, the higher amount is due in tax.

The standard deduction applicable under the AMT is not indexed to inflation, which causes increasing numbers to fall under the AMT each year, in contravention of its original purpose of taxing the very wealthy. This problem is much exacerbated by tax cuts enacted in 1997, and after that were limited to the ‘regular’ income tax. Lower income tax pushes more taxpayers into AMT territory. The revenue loss from the Bush tax cuts was disguised in great part by the projected increase in AMT coverage, an increase that is not likely to transpire.

Depending on the details of proposed reforms, eliminating the AMT and reducing deductions could affect roughly the same upper-income class of taxpayers, significantly altering tax liabilities for many individuals within that group. The AMT covers approximately the top 3% of taxpayers, while deductions are more broadly distributed. Hence, the higher one’s income, the more advantageous a swap of the AMT for deductions is likely to be, albeit within a relatively high income group to begin with. In particular, in the case of the deduction for state income tax, many middle-income beneficiaries of that deduction will not be made whole by abolition of the AMT.

Paradoxically, AMT repeal would expand the value of some deductions for higher-income taxpayers, flying in the face of the commission’s principle of capping the value of deductions or converting them into credits.

On the one hand, a common theme in the deductions the commission is targeting is an implied tax on the use of *wages* to finance *consumption*. (Health benefits, state and local public services, and housing are types of consumption.) With the other hand, the commission aims to reduce taxes on wealth and investment income, whether or not such income finances consumption.

Consumption taxation: The impossible dream?

Criticism of income taxation has a long history. Use of income as a tax base is compared unfavorably by these critics to a consumption tax base, and the Commission has embraced this criticism. The chief complaints are that income taxation unfairly penalizes and discourages savings, and that it is more complicated than a consumption tax could be.

For individuals, there are two basic ways of taxing consumption—by taxing income when it is used to finance consumption, or by taxing income before it is used. The latter is sometimes described as “prepaying.”

Taxing income when it is used for consumption could be accomplished with a retail sales tax or a value-added tax (VAT). Under this approach, the use of pre-existing savings for consumption, by both wealthy people and the elderly, would be taxed. The commission is steering away from the sales tax, and it is ambivalent about the VAT.

Another approach is to tax income that is not saved, which in principle means income not used to buy financial assets (including deposits to savings accounts), plus any net drawdown of existing saving. Deductible IRAs or employer-paid pensions are mechanisms for sheltering income used for savings. The

commission is likely to propose expansion of these devices. Presently there are contribution limits that constrain relatively high-income persons.

Alternatively, “prepaying” a consumption tax is accomplished by taxing labor compensation, which means wage and salary and all fringe benefits. In this framework, all subsequent returns to saving are untaxed. The flat tax as designed by Robert Hall and Alvin Rabushka, later championed by Rep. Dick Armey (R-Texas) and presidential candidate Steve Forbes, is an example of a prepaid consumption tax.

A deficiency of the flat tax or any wage tax from the standpoint of encouraging savings is the failure to tax pre-existing wealth used to finance consumption. Under a wage tax, there is no obstacle to liquidating one’s wealth to finance consumption. On paper, the business component of the flat tax covers returns to “old capital”—the profits of business firms from pre-existing investments. But that is not the same as taxing the liquidation of assets. Nor does any wage tax affect taxpayers’ uses of income from ownership of assets in other countries.

In principle, the flat tax could be inaugurated with a one-time tax on all wealth. That would effectively prepay the tax due on any subsequent use of wealth for consumption. Of course, some wealth would never be used for consumption, so this sort of capital levy would be excessive. At the same time, no wealth tax at all would be insufficient.

An inevitable consequence of an ideal consumption tax is that it would increase inequality between the very richest of taxpayers and all others. Wealthy family dynasties would accumulate wealth and garner tax-free income without limit through the decades. Most families are not so fortunate as to be able to preserve and pass along wealth in this way. But for the transfer of wealth across generations, an ideal consumption tax has the advantage of taxing without regard to savings decisions. An ideal income tax falls more heavily on those who postpone consumption within their lifetimes and is thought by some to be unfair on that account.

To see this, imagine two persons who each earn \$100 and face a 20 % income tax. Mr. A pays \$20 in tax and spends the rest. Mr. B chooses to save it all and spend it the following year. He pays the same \$20 in tax the first year, plus additional tax on the returns to his savings in the following year. He pays a tax penalty for consuming later rather than sooner. True, his \$80 savings grows, but at a lower, after-tax rate (since the interest is taxed under the income tax). According to the time value of money, the present value of his \$80 plus the after-tax interest is less than the \$80 that Mr. A enjoyed. Whatever one thinks of the fairness of this arrangement, whether it actually affects *savings behavior*, is another question altogether. Some prominent advocates of consumption taxation do not put much stock in a negative savings effect from income taxation.

A consumption-based system would include a business tax. Income from ownership of business firms that is used for consumption would escape taxation under a wage tax. Profits belong in the consumption tax base. To shield savings from tax, a deduction would be allowed for new investment in plant, equipment, and research and development. This is how the business component of the flat tax works.

Including labor compensation in the business-tax base outlined above creates a value-added tax. In other words, the firm’s tax base is the proceeds of all sales, minus purchases of production inputs or

services from other firms. The commission betrays some sentiment for converting the corporate income tax into a VAT.

In either case, the key device that changes the target of a business tax from income to consumption is the allowance for immediate deduction of purchases of plant and equipment, also known as expensing. Under a true income tax, a business firm is not allowed to deduct its capital expenses immediately. It must spread these deductible costs over future tax returns. In other words, if a firm buys a machine that lasts for 10 years for \$100,000, it cannot deduct the entire \$100K the first year. It must spread the cost over 10 years, according to complicated depreciation rules in the tax code.

The reason is that an immediate deduction can generate enough tax savings to completely offset, or perhaps more than offset, future taxes on income generated from the investment. Staggering the deduction over a period of years allows the government to actually tax the income from the investment. That is why in tax planning one strives, to the extent possible, to schedule deductions sooner and tax payments later. Tax savings accumulate interest over time.

As depreciation allowances are made more generous, business taxes become limited to unusually profitable companies (because high profits generate taxes worth more than the initial deduction). If those “abnormal profits” are reinvested, they too would escape tax. Under the flat tax or VAT, most business income would be left untaxed.

Real-world consumption taxes

The ideal consumption tax is vulnerable to criticism, and in the world of actual tax policy, consumption taxes are going to fall well-short of the ideal. Complicated transition rules could facilitate the use of business firms as tax shelters for relatively well-off taxpayers, while wage-earners with little scope for financial legerdemain will bear the brunt of the shift in tax base. The prospects for taxing wealth or pre-existing business investments would be dim.

For the past two decades, the federal income tax has been creeping towards a tax based on wages. Income from ownership of financial assets is increasingly shielded from tax, to the disadvantage of wages and salaries. Lightening the tax burden on capital—chiefly capital gains, dividends, and interest—has been a major theme in conservative tax commentary.

Reducing the exclusion for health insurance premiums paid by employers means increasing the tax burden on labor compensation. In and of itself, it is perfectly in the spirit of wage taxation.

Done in piecemeal, complex fashion by imperfect politicians, the likelihood for tax proposals from the Bush Administration and their allies in Congress is not merely wage taxation, but a profoundly flawed system that subsidizes capital and advantages high-salary earners—the worst of all possible worlds in tax policy. The simple reason is that the tax rules can be crafted so that a deduction is worth more than the subsequent tax it is supposed to match up with.

A simple example is an IRA in which a person’s marginal tax rate at the time of deduction is, say, 25%, but at the time of withdrawal is only 15%. In other words, if the next dollar put into an IRA reduces taxes by 25 cents, and the dollar withdrawn years later is taxed to the amount of 15 cents, savings is not merely tax-free, it is positively subsidized. It is as if the government destroyed \$10,000 worth of

wealth this year in return for \$9,000 next year. The actual effective tax is *negative*. Taxpayers would be paid to save, on top of the market returns to saving. The business-side analog is badly designed depreciation deductions that encourage business firms to make unproductive investments.

A “consumption tax” flawed in this manner is in essence a system for destroying productive capital—a machine for wasting resources. It is the antithesis of a stimulus to economic growth.

The simple, tax-free life

The most important factor in recent tax cuts has been the compression of the rate structure, a trend the commission would extend. As things stand, the top four rates prevailing in 2000—39.6%, 36%, 31%, and 28%—have been reduced to 35%, 33%, 28%, and 25%. The benefits of this change for relatively high-income persons, especially the rich, have been well-documented.

Besides the obvious resort of simply reducing rates for the upper income brackets, there are six mechanisms wherein the wealthy would increasingly wiggle themselves free of federal taxation: discriminatory tax rates, savings preferences, depreciation rules, elimination of the the AMT and the Estate and Gift Tax, and corporate tax integration. All six are likely to be endorsed by the Bush Advisory Commission. All six are consistent with the theme of limiting the tax base to labor compensation used to finance consumption:

Discriminatory tax rates. Presently the tax rates on income vary depending on the type of income. Rates on capital gains and dividends are lower than rates on other income, known as “ordinary income.” In the name of growth incentives, the commission will propose to further reduce these preferential rates, in keeping with “taxing work rather than wealth.”

Savings. Returns to ownership of financial assets are shielded from tax through Individual Retirement Accounts (IRAs) and 401(k)s. The effective tax on investment returns is eliminated, leaving only labor income as a source of tax revenue.

Depreciation. Expensing, including under a VAT, removes income generated in a business firm from the tax base. There is sentiment on the commission for either converting the corporate income tax into a VAT, or liberalizing depreciation rules in the direction of expensing.

The Alternative Minimum Tax. The commission will recommend its abolition. As noted previously, because it is not indexed to inflation, over time it covers increasing numbers of people who are not rich. Without doubt, it will require changes to stay within its original purpose.

The federal Estate and Gift tax is a tax on the transfer of very large amounts of wealth paid by a very small number of people. It too has been marked for elimination. Insofar as the income tax fails to tax capital, this tax becomes the only fall-back. Its repeal helps clear the decks for a wage tax regime.

Corporate tax integration. Presently some corporate profits are taxed twice—once as profits to the business, and second when received as dividends by a taxpayer. It is also true that some profits are not taxed at all, and other profits are taxed, but at lower rates than labor income. “Tax integration” is the name given to reducing taxes on dividends, not necessarily in a way that levels the playing field within the corporate sector, but surely in a way that disadvantages those whose income derives from labor alone.

A point of light

One promising initiative undertaken by the commission is reform of the currently complex and confusing array of tax benefits for low-income families with children. The Earned Income Tax Credit (EITC), Child Tax Credit (CTC), Additional Child Credit (ACC), dependent exemption, and head of household filing status all hinge on the same characteristic—having dependent children. Eligibility rules for these diverse benefits vary, leading to filing errors and administrative headaches for the IRS. Low income families have seen little in the way of tax relief since 2000, an oversight that expanding these benefits would remedy.

To this end, the commission has proposed to consolidate this array of benefits into two credits—one for families with children, the other for workers. This approach has already been written into legislation offered by Reps. Dennis Kucinich (D-Ohio), Bernie Sanders (I-Vt.), and Barbara Lee (D-Calif.) (Sawicky 2004). The bill—H.R. 3655—unifies eligibility criteria for these benefits around two expanded tax benefits. One is a payroll tax credit, the other a child credit. Both would be refundable. Besides simplifying taxes for working families, this approach has the merit of precluding marriage penalties, since the benefit can be the same regardless of the marital status of the taxpayer.

To be sure, the specific benefit levels and other details suggested by the commission could end up reducing existing benefits, as well as raising them. Regardless of the fate of the commission’s recommendations, the issue will endure and the approach will deserve attention.

The political stage

One obstacle to any sort of large-scale reform is anti-tax sentiment that would rule out any change that increased anyone’s taxes. As things stand, deficits are already high and unsustainable (Sawicky 2005), and many politicians show some reluctance to raise them further with major new tax cuts. If proposed tax legislation implies a change that is both large and that collects the same amount of revenue as the system does now, there will be lots of redistribution of the tax burden—winners and losers. Many conservative activists will find it hard to digest proposals for literal tax increases.

A second problem for the commission is the disappointment it will generate among conservative anti-tax advocates. The commission is going to pass on both of the most popular conservative causes—the national retail sales tax and the flat tax. They have apparently absorbed the conventional wisdom that the sales tax is impossible to implement and administer. As for the flat tax, eliminating all deductions is a more sweeping change than they are prepared to embrace.

More fundamentally, the commission has not been organized to jump-start a plausible reform process. To have some prospect of political effectiveness, a commission must embrace a broad section of

the political spectrum. The Bush Advisory Commission is heavily stacked to the right, helping to ensure that its proposals will be “dead on arrival” from the standpoint of most Democrats.

Thirdly, a commission should include those with current political influence. The two chairmen of this commission are retired senators, neither of whom ever had much sway within their respective parties. There is nobody on the commission who can credibly claim to represent opinion in the Congress.

To acquire some momentum, a commission must reflect a broader process of consensus-building in Congress as a whole. It must arrive at a relatively specific proposal that has the weight of the group’s strong support. Otherwise its recommendations amount to little more than off-hand advice, no shortage of which is already available to the Congress. In the context of tax reform, if the commission contents itself with providing a list of disparate options, even though they are separately meritorious, it will have done nothing to facilitate follow-up by legislators.

Finally, for tax reform to be a bipartisan project, some bipartisan political comity is required in the first place. The refusal of the Bush Administration to “govern from the center,” exacerbated by the current atmosphere in Washington, makes it difficult to envision a constructive reform process able to triumph over contentious issues. Instead, we may see yet another effort to ram through a controversial, ideologically driven plan to limit taxation to the consumption of working families, a policy that has no chance of better than a narrow majority of support.

Commission proceedings have provided much of interest to tax analysts, but tax reform requires political spade work as well. None has been done. The sort of reform proposals we may see in the Bush budget for fiscal year 2007, to be presented next February, are more likely to be politics by other means.

—October 2005

Endnotes

1. IRS. *Statistics of Income*. October 2005. <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=129270,00.html>.
2. An upside-down mortgage refers to a situation where the value of a home drops below the amount of outstanding mortgage debt, destroying the owner’s equity and preventing the owner from selling the house.

References

- Sawicky, Max. 2004. “Tax Burdens of the Untaxed.” *Tax Notes*. Vol. 102, No. 12. March 22. Also presented to the Democratic Task Force on Children and Working Families, House and Senate Joint Hearing, February 11, 2004.
- Sawicky, Max. 2005. *Collision Course: The Bush Budget and Social Security*. Briefing Paper #156. Washington, D.C.: Economic Policy Institute.