



## President's Tax Panel Takes on Tough Issues

*Proposals may be at risk of being ignored or substantially revised*

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The president's tax reform panel recently resumed following its post-Katrina delay with the first of its final two public meetings. While the reform panel has not yet put forth any concrete proposals, it has begun to clarify some of its thinking on the tax issues confronting it.

The panel clearly believes that tax reform should be a high priority issue, and in recent days, we have seen some encouraging signs from the panel. We hope that its final report will contribute to a vital debate on our nation's tax policy.

However, given the track record of the Bush administration's decision-making on tax and economic policy, we fear that (1) the panel may ultimately reject the more balanced or progressive proposals, and (2) even if the panel develops such ideas, the administration will likely simply pick the elements that fit its prior agenda, and will throw out the rest.

Since reforming the tax code is largely about setting priorities and making

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choices about trade-offs across different parts of the code, we are not optimistic about what will eventually emerge after a right-wing-led political process is finished modifying the proposal.

We expect to see, when all is said and done, yet more of the same, failed tax policies that give yet more preferences to income from wealth and to high-income individuals, while ignoring work and the middle-class.

## Positive steps

In the process of its deliberations, the tax panel has taken some positive steps, including:

- Opposing replacing the current code with a national retail sales tax. We are encouraged to hear that the panel has rejected the idea of replacing the income tax code with a national retail sales tax. Not only would a national sales tax mean a tax increase for low- and middle-income taxpayers, it would also be subject to high rates of evasion, and would complicate state sales taxes. The panel noted that the tax rate would have to be as high as 87 percent if goods such as medicine, education, and food were exempted. We hope that this puts to rest calls for the so-called “fair tax” by some members of Congress.
- Supporting the elimination of the Alternative Minimum Tax (AMT). This would mean a substantial simplification in the code for many taxpayers, increasingly including middle-income taxpayers. The Center for American

Progress has also proposed eliminating the AMT in the context of an overall reform plan.

However, the cost of repealing the AMT would be an estimated \$1.2 trillion, and the details of how the panel would reform the rest of the system are still unclear.<sup>1</sup> The Center for American Progress's plan would recover the lost revenue from repealing the AMT, and would ensure that high earners pay their fair share, by limiting deductions for high-income individuals. The panel has not yet indicated if or how it would achieve the same results. It appears clear that the panel's current proposals would not raise sufficient revenue to do so.

## Deductions and Sticky Political Issues

The panel is also considering other changes to the various deductions and credits in the code. The panel appears to be altering major deductions to limit the extent to which upper-income taxpayers can receive the credit, and expanding the degree to which low-income taxpayers benefit.

While we agree with this general approach, we have several concerns. First, we believe that any distributional and efficiency benefits could be canceled out by other regressive and inefficient policies the panel is likely to propose, such as further reductions in taxes on income from wealth for the highest-income taxpayers. Second, we are concerned that these changes would be the only changes

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<sup>1</sup>The cost is higher than previous estimates, since the panel was instructed to work from a revenue baseline that includes extending all of the 2001 and 2003 tax changes.

that benefit average taxpayers. And third, we believe that these provisions will eventually be dropped by a conservative-led political process.

1. Possible limitations to home mortgage deduction

The panel is considering changing the deduction for a home mortgage by limiting the total mortgage amount that can be deducted or limiting the deduction to a fixed percentage. They are also considering changing the deduction to a credit so that the benefit does not depend upon the homeowner's tax bracket.

With the current \$1 million limit for mortgage deduction, the vast majority of homeowners do not hit the limit, and high-income taxpayers receive a much larger benefit from the deduction. The median price for an existing home nationwide is an estimated \$220,000, but some markets have much higher prices for a typical home.<sup>2</sup>

Lowering the limit can be good policy. However, we must also be concerned with the potential impact on housing prices and hence on the macro-economy as a whole. Setting the limit too low also raises legitimate concerns about harming middle-class homeowners, especially in high-priced markets. The panel noted that a phase-in period may be necessary to protect those who have already purchased a house thinking there would be a tax benefit.

Extending the deduction (or a credit) to lower-income homeowners would

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<sup>2</sup>National Association of Realtors, August, 2005.

be an improvement over the current system in which high-income taxpayers receive a greater tax incentive and a larger tax reduction from homeownership.

## 2. Possible limitation to deductions for health insurance premiums

The tax panel also considered limiting tax-free premium payments on health insurance by employers to \$11,000 per year. The effect of this policy would surely be to limit the amount of high-premium insurance policies provided to employees.

Since high-premium health insurance policies are likely to be skewed towards upper-income employees, this change would also have the effect of limiting the tax benefits for upper-income taxpayers.

The issue of health care in the U.S. is clearly more than a tax issue, and while the tax reform panel may ultimately tinker with some health provisions, a more comprehensive approach is clearly needed. (See Center for American Progress's Health Plan.)

It also remains to be seen whether the tax panel will propose some form of Health Savings Account, which President Bush has supported in the past. These savings accounts would disproportionately benefit those with the resources to save for health care expenditures, and hence would be skewed towards benefiting higher-income individuals.

## 3. Charitable giving

The tax panel has recognized the importance of the deduction for char-

itable giving, and appears to be willing to consider expanding the tax incentives to include those who do not currently itemize.

In addition to expanding the incentive, the panel should also consider reversing the “upside-down” structure of the code that gives a bigger tax break to those in higher tax brackets. A uniform, 25 percent credit that can be taken by all taxpayers would be an attractive option.

#### 4. Broader elimination of various tax expenditures

In addition to the above deductions, the tax panel has also expressed a desire to “clean the base” by removing a variety of other tax expenditures—perhaps going so far as to call for removal of all deductions except the three mentioned above. A blunt rejection of all deductions and credits, however, would eliminate many valued incentives, such as a federal tax subsidy for hybrid cars or tax benefits for education. There are, of course, many tax expenditures that ought to be removed or curtailed, such as Health Savings Accounts, which primarily benefit upper-income individuals, or the so-called “janitor’s insurance” loophole on the corporate side.

From a political standpoint, it is hard to believe that the full budgetary savings will be achievable given the influence of special interests on tax policy.

In general, extending these tax preferences to low- and moderate-income families can be a good thing, and limiting the extent to which upper-income individuals can claim broad tax deductions would rightfully reverse some of the

massive tax cuts from recent years that this group has enjoyed.

It is unlikely, however, that the savings from limiting these tax deductions (especially if they are simultaneously enhanced for low-income taxpayers) would make up for the loss in revenue from the elimination of the AMT. This would leave the panel to choose other areas in which to increase taxes.

## **What's Ahead**

We are very interested to see if and how the panel chooses to balance the proposed choices above with other changes that are likely to be discussed in the coming weeks.

We expect that the next meeting will take up the issue of taxation of capital gains and dividends, and the overall rate structure. We also expect a version of the Flat Tax will be proposed as one potential reform option. This second meeting will thus contain many more of the “bread-and-butter” conservative proposals that have already been a part of the president’s tax agenda. A discussion of the Earned Income Tax Credit will also likely be part of the agenda.

We also expect that the panel will include in its final recommendations changes that would primarily benefit high-income individuals (such as a reduction or elimination of capital gains and dividend taxes, or an expansion of tax-free savings accounts). But to make the final package look revenue neutral and appropriately fair, it will also include some changes to deductions that benefit low- and moderate-income taxpayers, and limit benefits to high-income individuals. Unfortunately, the latter category also includes the most politically

controversial limits to these incentives, and thus may be the first parts to be removed from the package by the political appointees in the president's Treasury Department, or by the right-wing leadership in Congress.

We believe that in the end, the panel's attempts to improve the tax code by restructuring the benefit structure of the major deductions will ultimately be discarded, and what remains will simply be yet more tax cuts for the rich, more federal borrowing, and very little else left over for middle-class taxpayers.