



Tax Reform Panel's Report Now in Treasury's Hands

First Impressions

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The President's Advisory Panel on Federal Tax Reform today released its final report and recommendations to the Treasury Department and the public. The final report represents months of careful deliberation and policy analysis, and we at the Center for American Progress look forward to reviewing in more detail the panel's report in the coming days and weeks.

The panel has carefully confronted many of the tradeoffs that inevitably arise when considering broad tax reform; however, it is likely that the final report and the panel's recommendations will be cherry-picked by the Bush administration to fit its prior ideological agenda. For example, the administration may highlight the expanded role of tax breaks for savings, lower taxes on capital income, corporate tax breaks for capital investment, and the costly elimination of the Alternative Minimum Tax.

Without other changes in the code, these policies would continue the trend of lower overall revenues, massive budget deficits, and additional tax giveaways

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to high-income individuals. Also, the politically controversial components-such as the proposed caps to the mortgage interest deduction and health insurance premiums-will likely be modified or rejected.

Bush's tax record over past five years shows an administration that has been moving the tax code in the wrong direction by making it more complicated, less fair, and less able to raise adequate revenue. We hope the reform panel's report will provide an impetus to change this direction. But tax reform needs to go beyond the panel's mandate, and to instead increase revenue from current levels in a way that increases fairness and protects the middle class.¹

The final report does contain a number of good ideas that could improve the tax code. In particular, consolidating the myriad savings plans and making the savings available to low-income taxpayers would be a welcome improvement over the current tax code. Integrating business and individual taxation in a rational manner would be a welcome improvement as well.

Below are some first reactions to the report:

- Flawed charge: The panel was limited to making recommendations that lock-in and extend Bush's revenue and distributional changes.
- Open questions: Several open questions remain that must be addressed to practically implement a tax reform.
- Additional analytic issues: The panel's recommendations must be further analyzed by the treasury and independent organizations.

¹See Center for American Progress "A Fair and Simple Tax System for our Future," January, 2005, available at <http://www.americanprogress.org/tax>.

- Rejection of extreme right-wing policies: The panel examines but does not recommend key right-wing suggestions.

Flawed Charge

In the executive order that created the panel, the president requested recommendations that would be “revenue neutral” relative to Bush’s extended tax changes, that would recognize the importance of incentives for charitable giving and home ownership, and that would share the tax burden in an “appropriately progressive manner.” The tax panel later took this to mean that reform proposals should be distributionally neutral as well.

The panel was already put two massive steps behind in crafting a reform recommendation. The president’s so-called “revenue neutral” mandate already assumes the Bush tax changes would be extended beyond their current expiration dates—thus requiring hundreds of billions in revenue losses relative to current law.

This means that the panel’s recommendations effectively lock in low and inadequate revenue levels and the Bush deficits, while also locking in tax changes that benefit high-income individuals.

On a positive note, this guidance prevented the panel from taking steps even further in the wrong direction—the president’s recent tax changes will cost trillions of dollars in lost revenue, and have given disproportionately large tax cuts to those with the highest incomes and the most wealth.

The panel appears to have done some serious work, and what we know of

its final recommendations shows that it may have some positive suggestions. However, the overall direction of recent tax policy—in terms of overall revenue and distribution—must be reversed. These are issues that the president’s commission has not addressed, but that are essential to the overall debate.

Open Questions

The panel’s recommendations leave major areas unaddressed, including:

- Transition costs

The benefits to the economy of a streamlined tax code can depend critically on how the government transitions into the new system. As the panel emphasized, many of the suggested changes might need to be phased in over time to prevent undo burdens on those who made decisions based on an expectation that current law would be continued. However, some of the economic growth benefits (especially in the panel’s consumption tax recommendation) will not be realized if there are transition benefits that shield existing capital investments. While the panel points out these pitfalls, and specifically recommend components of an implementation strategy, there are still many areas left open.

- Other parts of the tax code

The estate tax and the payroll tax are two parts of the tax code that raise significant revenue. Most people pay more in payroll taxes than in income taxes, yet the panel did not address this side of the code. Since the payroll

tax is levied on the first dollar earned and is capped at \$90,000, this is a regressive component of the current code. In addition, the estate tax, whose elimination would cost nearly \$1 trillion in lost revenue and interest costs over the first 10 years of enactment, was not addressed by the panel either.

Additional Analysis Issues

In addition to the panel's recommendations, it has presented a range of analysis to highlight the implications of the reform. While the panel's report is a useful start, there are still areas that need to be developed.

- Revenue implications

The president's tax panel was charged with raising the same amount of revenue as compared to extending the Bush tax changes; however, many of the changes suggested by the tax panel may have different revenue implications inside the 10-year revenue horizon when compared with the out years. For example, some of the retirement savings changes might cause people to reallocate funds from their current savings plans to the new plans, triggering tax liabilities in the near future. The additional current revenue would mask the true cost of the plan's implementation.

- Distributional implications

The panel's report presents a limited picture of the distribution of the tax code across income groups. Fuller analysis of the winners and losers from

the suggested tax changes is necessary to better understand the implications. In particular, the panel's approach of projecting the aggregate tax share paid by each quintile is insufficient. Further detail within quintiles is essential. In addition, the quintile distribution may confound tax changes with changes to the overall distribution of income over time. It is essential to supplement the analysis with a detailed breakdown of the average tax change for taxpayers at various levels of income.

Rejection of Extreme Right-Wing Policies

Importantly, the panel's recommendations shy away from many tax policies that are favored by conservative extremists. The report:

- Recommends against eliminating all taxation on capital income—even the “Growth and Investment Tax” option, which is close to a consumption tax, retains a 15 percent tax rate on capital gains and dividends.
- Recommends against unlimited savings exemptions—while the contribution limits for tax-preferred saving accounts appear to be increased, the panel retains caps on the amount that can be sheltered from tax through protected savings plans.
- Considered but ultimately rejected a flat tax or a national retail sales tax as a replacement for our current income tax.²

²The panel's final report contained a chapter on the national retail sales tax. The flat tax was considered at earlier hearings.

The tax panel rightfully rejected the most extreme of the conservative proposals. While the recommendations do lock in many of Bush's poor tax choices, the panel at least did not adopt even more extreme stances.

Summary

What will eventually come out of the Treasury Department and the Bush administration will not necessarily look much like what the panel is currently recommending. The proposals run the risk of being cherry-picked for those components that fit this administration's narrow, ideological goals; and the hard choices that the commission had to make to achieve revenue and distribution neutrality may simply be ignored.

See also:

- President's Tax Panel Takes on Tough Issues Tax Panel Statement 1(PDF),
by John Irons³
- President's Tax Panel Proposes Broad Reforms Tax Panel Statement 2(PDF),
by John Irons⁴
- The Future of Tax Reform: Overhaul or More of the Same? Expert Panel
on Tax Reform Commission's Recommendations⁵

³Available at
<http://www.americanprogress.org/atf/cf/%7BE9245FE4-9A2B-43C7-A521-5D6FF2E06E03%7D/TAX%20PANEL%20STATEMENT%20I.PDF>

⁴Available at <http://www.americanprogress.org/atf/cf/%7BE9245FE4-9A2B-43C7-A521-5D6FF2E06E03%7D/TAX%20PANEL%20STATEMENT%20II.PDF>

⁵Available at <http://www.americanprogress.org/site/apps/nl/content3.asp?c=biJRJ8OVF&b=593305&ct=1524525>

- Tax Complexity: By the Numbers (PDF), by John Irons and Michael Powers⁶

⁶Available at <http://www.americanprogressaction.org/atf/cf/%7B65464111-BB20-4C7D-B1C9-0B033DD31B63%7D/TAXCOMPLEXITYREPORTTEXT.PDF>