

# Tax Reform Is Dead, Long Live Tax Reform

by William G. Gale

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A year ago, calls for fundamental tax reform were high on the political agenda. The Kemp commission, Steve Forbes, Richard Armev, Bill Archer, and others argued that the existing tax system needed to be uprooted and replaced with one that was simpler, less intrusive, and more conducive to economic growth.

Practical considerations such as transition problems and redistribution of tax burdens silenced, at least temporarily, the effort to uproot the tax system. But now policy has swung too far the other way. Current proposals—for child tax credits, education tax credits, expanded IRAs, and capital gains tax cuts—can only be described as tinkering. They not only give up on the idea of fundamental reform, they largely abandon the widely held goals of reform: a simpler, fairer, more growth-friendly tax system. This is a mistake.

In the broad range of options between throwing out the whole system and tinkering with it ad nauseam, there is a time-honored middle course that preserves the principles of tax reform, but does so by modifying the income tax rather than replacing it.

Converting itemized deductions to 15 percent tax credits is the key toward principled modification of the income tax. The deductions are unfair, expensive, regressive, and complex. The \$50 billion or more raised can be used to eliminate hidden taxes like the phaseouts of personal exemptions and limitations on itemized deductions, the taxes on excess pension accumulations and payouts, and the individual alternative minimum tax (AMT). The extra funds could be used to slash all rates from 28 percent on up. On the business side, slashing corporate subsidies would allow for elimination of the corporate AMT and still leave funds for improving investment incentives or reducing rates.

These proposals would be a down payment toward true reform. With rates that are lower and more uniform across uses and taxpayers, fewer brackets, removal of hidden taxes, increased use of the standard deduction, and reduced special interest subsidies, the income tax would move in a direction that is simpler, more neutral, and more growth-friendly. A better income tax need not be our final destination, but it moves tax policy in the right direction.

## POLICY BRIEF #12

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What a difference a year makes. In early 1996, calls for fundamental tax reform were high on the political agenda. The Kemp commission, candidate Steve Forbes, Representatives Richard Armev and Bill Archer, and others argued that the existing tax system needed to be uprooted and replaced with one that was simpler, less intrusive, and more conducive to economic growth.

For practical reasons, the effort to uproot the tax system has failed, at least temporarily. Because taxes are embedded in numerous ways in the country's economic, social, and institutional structures, tearing out the system all at once would create difficult problems in transition and in the redistribution of tax burdens. In addition to the pain of such dislocations, the potential gains appeared too uncertain in size and distant in time to garner sufficient political support, even

among those—like myself—who believe the existing system is too complex and harms economic growth.

After discussing fundamental reform, Congress passed three relatively minor tax bills in 1996 that added about 655 changes to the tax code—so much for simplicity. In addition, most of the changes currently being proposed can only be described as tinkering. These proposals not only give up on the idea of fundamental reform, they abandon the widely held goals of reform: a simpler, fairer, more growth-friendly tax system.

This is a mistake. In the broad range of options between throwing out the whole system and tinkering with it ad nauseam, there is a time-honored middle course that preserves the principles of tax reform, but does so by modifying the income tax rather than replacing it. The simple formula is to broaden the tax base and lower rates, while also making the system simpler, eliminating loopholes, and removing hidden taxes.

### **The Current Agenda**

As 1997 begins, the Clinton administration and Congress are engaged in a tinkering contest featuring child tax credits, education tax credits, expanded IRAs, and targeted or full-blown capital gains tax cuts. These proposals will make the system more complex and intrusive, and they will do little if anything to spur economic growth.

Child credits erode the tax base without providing any incentive to work or save more. The credits do provide funds to families with children, but there is no guarantee that much of the money will be spent on the children's behalf, and the reduced base will lead to either reduced spending (possibly also on children) or increased deficits, which in turn will become a tax on today's children when they become adults.

Most of the benefits of education tax credits will flow to colleges—via increased tuition prices or reduced financial aid packages—or to households that would have sent their children to college anyway. For such households, the credit may even reduce the amount of money they save for college. Most of the benefits of education tax credits will flow to colleges—via increased tuition prices or reduced financial aid packages—or to households that would have sent their children to college anyway. For such households, the credit may even reduce the amount of money they save for college.

Expanding the conditions under which IRA contributions are tax deductible might be weakly defended on some sort of equity grounds: if some people have access to this tax break, it may seem only fair that others do too. But the effects on private and national saving are likely to be exceedingly small. Households will finance the vast proportion of any new IRA contributions in relatively painless ways: for example, by shifting assets from taxable accounts. At best, only a very small portion of the contributions are likely to be financed via the painful method of saving more, that is, reducing current spending.

Capital gains tax cuts will improve investment incentives, but the effect is smaller than advocates often claim, for two reasons. The *effective* rate on capital gains is already low (estimated at about 7 percent) because capital gains taxes can be deferred, are forgiven on assets held until death, and are capped at 28 percent. In addition, capital gains taxes are only a small part of the overall tax on investments because many capital gains accrue to tax-exempt investors (for whom a tax

cut would be worthless), and about one-third of investment is financed with debt rather than equity. Estimates indicate that cutting the top capital gains rate to 14 percent—as Bob Dole proposed—would reduce the cost of capital by about 0.15 percentage point and would raise investment by about 0.2 percent of GDP.

But there are also unintended effects. Tax shelters will boom if people can borrow, deduct the interest at rates up to 39.6 percent, and invest in assets that generate capital gains and are taxed at 14 percent, if taxed at all. Capital gains tax cuts would also raise the value of existing assets. The increase in wealth would cause people to raise their spending and—assuming their incomes are constant—*reduce* their saving. Finally, the distributional effects of capital gains tax cuts are severe: the vast portion of the gains accrues to households in the top 5 percent of the income distribution.

In short, the current proposals do little to further the goals of tax reform and are better thought of as tax cuts rather than reform. Reducing revenues will make it harder to reduce the deficit in the next few years. Tax cuts are even more troubling when viewed in light of the spending reductions needed to keep the books in balance after the baby boomers start drawing social security and medicare in fifteen years or so. Squandering revenues on tinkering may be a good way to maintain pressure for reducing government spending, but it will hurt chances for real tax reform in the future. Any serious restructuring, like the flat tax, will inevitably create some losers. It will take money to compensate them and to build political support for such changes.

### **An Alternative Course**

The current agenda smacks of a return to the notion of the tax system as a delivery mechanism for political goodies to favored constituencies, and it stands in stark opposition to the principles of simplicity, neutrality, and efficiency sought by true reformers of all political stripes for many years. What is needed is a focus on revenue-neutral efforts to broaden the base, eliminate loopholes, reduce statutory and effective tax rates, and simplify taxes. Here are some first steps in that direction:

#### *Convert Itemized Deductions to 15 Percent Tax Credits*

Itemized deductions are at the heart of any serious tax reform effort. Although they are immensely popular and subsidize activities thought of as "good," they create numerous problems. The deductions largely subsidize activity that would have occurred anyway. They complicate tax filing and enforcement. They erode the tax base and thus require higher tax rates than would otherwise be necessary. They are regressive: only about 28 percent of all taxpayers itemize, but 90 percent of households with income above \$75,000 use the deductions, compared with less than 10 percent with income below \$30,000. And of course high-income households claim larger deductions than low-income households.

The deductions are also unfair: Why should a high-income household save 40 cents on every dollar of mortgage interest while a low-income household saves 15 cents or nothing? Why should homeowners, merely because they have a large mortgage, be able to deduct charitable contributions or use a tax-deductible home equity loan to buy a car, when renters with similar income cannot? Finally, the deductions hide subsidies that would be obvious if they were

spending programs. Imagine that instead of a mortgage interest deduction, we had a program called "homeowner welfare" in which taxpayers earned a "welfare entitlement" equal to their annual mortgage interest payment times their tax rate. Anyone whose entitlement was below a certain threshold, say \$6,000, would receive nothing. Anyone whose entitlement exceeded the threshold would receive the entitlement in cash. This program would be decried as wasteful and a sop to the rich. Yet it is not dissimilar to the way the mortgage interest deduction works.

Supporters of an unrestricted mortgage interest deduction will note that interest payments are a cost of earning income or doing business. Under a well-designed income tax, such costs should be deductible so the system taxes net, rather than gross, income. The problem with the claim is that income from owner-occupied housing (imputed rents and capital gains) is largely untaxed under the income tax. Thus that income does not need to be adjusted for the costs of earning it. Moreover, many other forms of capital income—such as capital gains, funds placed in pensions, IRAs, and 401(k)s—are taxed on a preferred or deferred basis. Financing purchases of these types of assets with tax-deductible interest is at the heart of many tax shelter schemes.

It is sometimes asserted that Congress established the mortgage interest deduction to encourage homeownership, but this seems unlikely. Interest deductions were in the original income tax in 1913, which applied to only the top 1 percent of all households. Homeownership rates in this group were hardly likely to have been a pressing social problem. And there is no overwhelming evidence that the deduction increases homeownership rates. The homeownership rate in Canada, which has no interest deduction, is virtually the same as in the United States.

Finally, changes in the value of the mortgage interest deduction occur all the time. The value of the deduction is determined by tax rates and interest rates. In 1980 mortgage rates averaged 12.7 percent and the highest marginal tax rate was 70 percent, so the deduction was worth up to 8.9 percentage points. In 1997 mortgage rates are about 8 percent and the highest tax rate is about 40 percent, so the deduction is worth up to 3.2 percentage points. Converting the deduction to a 15 percent credit reduces its value to 1.2 percentage points. Given the changes during the last sixteen years, this hardly seems like a catastrophic adjustment. It would also be appropriate to eliminate mortgage interest deductions on principal above \$500,000, since excessive interest deductions are the source of much mischief in the tax code.

Items that represent true reductions in ability-to-pay taxes should be deducted in full, but none of the itemized deductions completely meets that standard. Many people would claim that health expenditures above 7.5 percent of adjusted gross income qualify as legitimate reductions in ability-to-pay taxes and surely some of the expenses qualify. But it is by no means clear that all such expenditures fit that description because there are many elements of choice in health care. For a given illness, taxpayers have some discretion about the quantity and quality (price) of medical care, such as which doctor or which procedures to use. People make decisions every day about their lifestyle and health—what foods they eat, how much exercise they get, whether to take certain risks—that affect their health status and resulting medical expenditures. Most people can also buy health insurance and thus have some choice over how much insurance to buy, which affects the level of out-of-pocket expenditures. In addition, some large health expenditures may be for cosmetic surgery or other items that are not strictly health-related. For all these reasons, taxpayers can affect their level of medical expenditures quite independent of their health status.

Deductions for state and local taxes are often justified on ability-to-pay grounds, since the taxes directly reduce household income. However, state and local taxes largely pay for services that households consume, such as schools, roads, and parks. If the tax payments buy services, they ought to be part of taxable income. A household that paid \$15 a month to a private company for garbage collection would not expect a deduction. Nor should a household that pays the same amount in local taxes for the local government to collect the trash.

Of course, some state and local taxes are not linked directly to specific services, some health expenditures are not discretionary, and completely eliminating the deductions would cause large transition problems. That is why the proposal is not to eliminate the itemized deductions, but rather to allow them at an equal 15 percent rate for each household. This would give each taxpayer the same benefit and would retain full deductability for taxpayers in the 15 percent bracket.

Relative to the existing treatment of deductions, the proposal would reduce revenue loss, dampen regressivity, minimize the other unfair aspects of deductions, and simplify tax filing and compliance by reducing the number of itemizers by about 30 percent, or 9.5 million people. At the same time, it would continue to allow a subsidy for activities that society may deem as "preferred" for one reason or another. The changes would have no effects on the 72 percent of taxpayers who do not itemize or on an additional 6.4 percent of taxpayers who itemize and currently face a 15 percent rate.

Any adverse effects of these proposals could be reduced somewhat by phasing in the changes over time. But reductions in the value of the deductions are not new: similar changes occur every time tax rates are reduced. Finally, if tax reform is to make the economy more efficient, it must do so in large part by moving resources out of currently tax-favored sectors and into other sectors. The proposal would raise well over \$50 billion a year as early as 1998, according to Congressional Budget Office estimates.

#### *Reduce the Number of Exemptions by One and Add the Value to the Standard Deduction*

Unlike itemized deductions, the standard deduction is simple and progressive and does not distort economic choices. Daniel Feenberg of the National Bureau of Economic Research and Jonathan Skinner of Dartmouth College recently proposed to reduce the number of personal exemptions by one and add its value (\$2,550 in 1996) to the standard deduction. This would have no effect on households that take the standard deduction: the sum of the standard deduction and personal exemption would remain the same. The proposal would help those who itemize and have small amounts of itemized deductions (typically middle-income households): it would encourage them to take the standard deduction. By reducing the personal exemptions, it would raise taxes—but not tax rates—on those with large itemized deductions (typically high-income households). Feenberg and Skinner estimate their proposal would have raised \$15 billion a year in 1992, would be progressive, and would simplify taxes by reducing the number of itemizers by 8 million. This policy, in conjunction with converting the deductions to 15 percent credits, would reduce the number of itemizers by about one-third.

#### *Repeal Hidden Taxes and "Take-Back" Provisions*

The personal income tax contains several "take-back" provisions. These taxes are imposed even when a taxpayer is complying perfectly with the law but ends up with what the law has deemed "too many" deductions or "too little" taxable income. These items represent hidden taxes, they distort incentives, they raise little revenue, and, most crucially, they create unnecessary complexity. They should simply be repealed. Four such features in particular stand out.

First, personal exemptions are phased out for high-income taxpayers. Two percent of the exemption is eliminated for each \$2,500 or fraction thereof that adjusted gross income exceeds certain thresholds.

Second, the total amount of itemized deductions a taxpayer may claim is reduced by 3 percent of households' income above certain (different) thresholds. These two items can raise effective tax rates by more than 3 percentage points above statutory tax rates. Limiting itemized deductions to the 15 percent rate obviates the need for either of these provisions. Removing the two provisions would cost about \$8 billion a year, based on updates of earlier estimates by the Joint Committee on Taxation.

Third, alternative minimum taxes (AMTs) work alongside the conventional individual and corporate taxes and are intended to ensure that corporations and high income individuals pay their "fair share." Of course, that is what the rest of the tax system is already supposed to do. One major reason individuals get placed on the AMT is that they have high deductions for state and local taxes, not because they are gaming the system. If these deductions are limited, there is less need for the AMT. The individual AMT generates little revenue—less than \$4 billion—and is horrendously complicated.

Fourth, there is a longstanding tension between pension, tax, and budget policy. Pension contributions reduce current revenues and are restricted by the tax code. But even those restricted contributions can grow to large sums. Current law imposes taxes on excess payouts from pensions as well as a separate tax on excess accumulations at the time of death. Research by John Shoven of Stanford University and David Wise of Harvard University shows that these features can create very heavy effective tax rates on pension accumulations.

### *Cut the Top Personal Rates*

The Tax Reform Act of 1986 strove to broaden the base and reduce tax rates. The top rate was reduced from 50 percent in 1986 to 28 percent by 1988. Shortly thereafter, tax rates rose again, and the highest statutory rate is now 39.6 percent; the phaseouts on personal exemptions and limitations on itemized deductions raise the top effective rate above 42 percent. If tax reform broadens the base as described above, it could and should reduce the top rates. Cutting the top rates raises incentives to work and invest and reduces incentives to shelter or evade taxes.

Cutting the top rate to 31 percent would cost about \$18 billion a year, according to estimates by Treasury economists, and about half that, according to estimates by Martin Feldstein of Harvard and Daniel Feenberg. However, converting itemized deductions to a 15 percent credit would make all groups with rates of 28 percent or higher worse off. Cutting each rate from 28 percent and above by 3 percentage points would cost about \$19 billion a year. Cutting the 28 and 31 percent rates to 25 percent and reducing the top rates to 33 percent would generate a 15-25-33 rate structure and would cost about \$27 billion a year.

### *Cut Corporate Subsidies*

The same principles apply to the corporate tax: slash deductions and use the revenue to simplify and improve incentives. The one bright side of the current set of proposals is the willingness of many parties to focus on targeted business subsidies in the tax code. The president's 1997 budget and proposals by the Progressive Policy Institute, the Cato Institute, and others have identified a number of tax provisions that provide certain industries—frequently energy, agribusiness, and transportation—with unwarranted subsidies. These loopholes complicate the code and redirect corporate energies toward subsidized activities. One could find \$5-10 billion a year in cost savings here, and estimates of corporate welfare range to much higher figures.

### *Eliminate the Corporate Alternative Minimum Tax*

One way to simplify the corporate tax is to eliminate the corporate AMT. It raises very little revenue—about \$3 billion a year—and is the source of tremendous complexity and compliance costs. Moreover, to the extent that the AMT in general is motivated by fairness concerns, having a corporate AMT makes little sense since businesses do not bear the burden of taxes they send to the government, but rather pass it on to consumers, workers, or shareholders. The AMT also has had some unintended effects: corporations can get stuck on the AMT because their income fell during a recession, not because of "excessive" use of deductions. Finally, the corporate AMT is in the nature of a credit: it largely serves to accelerate tax payments over time rather than to raise their present value. The AMT thus seems like a lot of work with very little gain.

### *Simplify Depreciation Deductions*

Calculating depreciation is one of the most complex features of the tax codes, especially for smaller and medium-sized businesses. These calculations could be simplified dramatically if the present value of all depreciation deductions for an asset were given in the year of purchase instead of having to take the deductions over time. This proposal, made years ago by Alan Auerbach of the University of California and Dale Jorgenson of Harvard, would be revenue neutral in the long term but would show up as a revenue loss under current budget procedures. Depending on the amount of revenue remaining, corporate tax rates could be cut or depreciation allowances could be enhanced.

### **A Long Road Ahead**

Income tax reform could go much further, of course, but this might require substantially more preparatory work. Adjusting the taxation of capital income for inflation and integrating the corporate and personal taxes are important but complex steps. Replacing the corporate income tax with a tax on cash flow is worth examining and might be expected to yield benefits on grounds of simplicity, economic efficiency, and quite possibly revenue as well.

Nondiscrimination rules attempt to ensure that different groups of workers receive equitable access to the tax benefits of pensions, but they have become so complex that a thorough working-over is in order.

Fringe benefits currently escape all taxation: they are deducted by businesses and not reported as income by individuals. This creates problems similar to those that arise for itemized deductions. But it is difficult to assign values to fringe benefits at the individual level, so allowing the

benefits to be deducted at a maximum 15 percent rate or imposing a small excise tax on benefits at the business level might provide relatively simple ways to address these problems even if it did not eliminate them altogether. The nontaxation of municipal bonds is another glaring loophole in the personal income tax.

Some integration of payroll taxes and income tax is probably appropriate, given that most families actually pay more in payroll taxes than income taxes. However, income tax deductions for payroll taxes would provide no benefits to households that pay no income taxes and would make social security more regressive. Refundable tax credits would help low-income households more but would prove very expensive. The whole issue should probably be examined jointly with social security reform.

Estate taxes in principle serve to tax income that has escaped taxation under the income tax and to break up "undue" concentrations of wealth. In practice, whether the existing estate tax achieves either of these goals is uncertain, as is—of course—the definition of undue wealth concentrations. Certainly, a full examination of the nature and role of the estate tax is in order.

Versions of the flat tax should also be considered further, but they are not ready for prime time. Besides the drafting details, a particular challenge is to retain a low single rate and a generous personal exemption in a politically plausible, revenue-neutral flat tax. For example, an Armey-style flat tax that provided transition relief for businesses and retained the earned income tax credit and deductions for state and local taxes, charity, and mortgage interest would require a 27 percent tax rate to be revenue neutral. Alternatives with smaller exemptions, a two- or three-rate structure, and deductions set at the lowest rate might be more feasible.

In the meantime, the proposals outlined above would be a down payment toward true reform. With rates that are lower and more uniform across uses and taxpayers, fewer brackets, removal of hidden taxes, increased use of the standard deduction, and reduced special interest subsidies, the income tax would move in a direction that is simpler, more neutral, and more growth-friendly. A better income tax need not be our final destination, but it at least moves tax policy in the right direction.

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