

Lessons from the President's Advisory Panel on Federal Tax Reform

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Executive Order

- Each recommendation for reform required to:
 - **simplify the tax laws**
 - **share the burdens and benefits of the tax system in an appropriately fair and progressive manner while recognizing the importance of homeownership and charity in American society**
 - **promote long-run economic growth**
- Each recommendation required to be revenue neutral



Working with the Revenue Constraint

- Panel used the Administration baseline
 - Assumed 2001 and 2003 tax cuts would be made permanent
 - Assumed AMT “patch” would expire after the 2005 tax year
- **Lesson:** The starting point combined with a revenue constraint can shape the reform
 - creates tradeoffs that affect the ability to garner popular support for tax reform

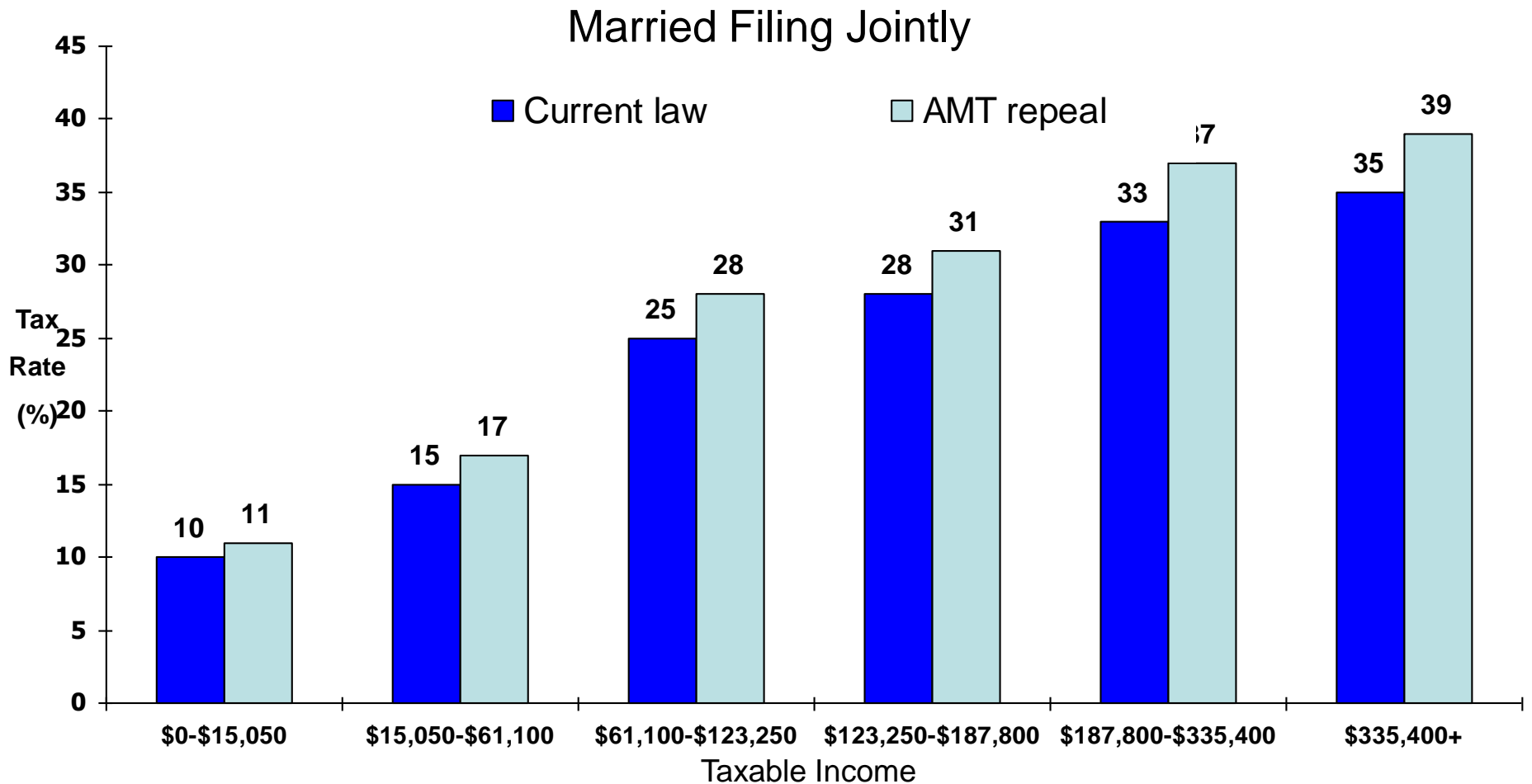


The AMT

- The AMT....
 - was viewed as inconsistent with the Executive Order
- **Lesson:** “Fixing” the AMT is a major problem
 - had a huge impact on reform options
 - doomed the whole endeavor?



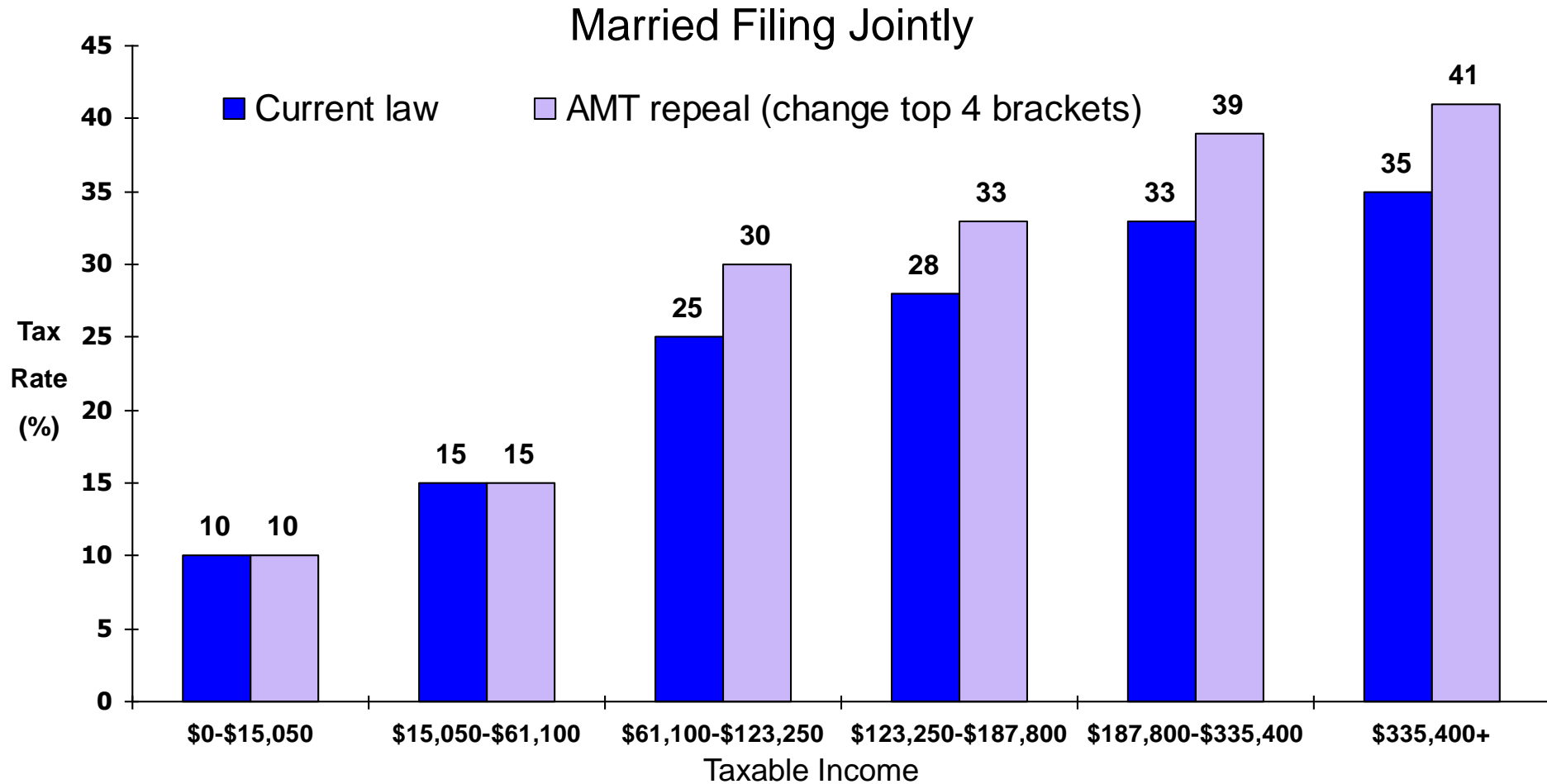
Tax Rate Schedule: Effect of AMT Repeal



Source: Department of the Treasury, Office of Tax Analysis

Note: Taxable income brackets are estimates for 2006.

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Tackling Tax Expenditures

- Top individual
 - employer contributions for health insurance and pensions
 - retirement savings preferences
 - mortgage interest deduction
 - charitable contributions deduction
 - EITC
 - child tax credit
- Top business
 - accelerated depreciation
 - oil and gas preferences
 - deduction for qualified production activities
 - progressive rate structure
 - R&E credit

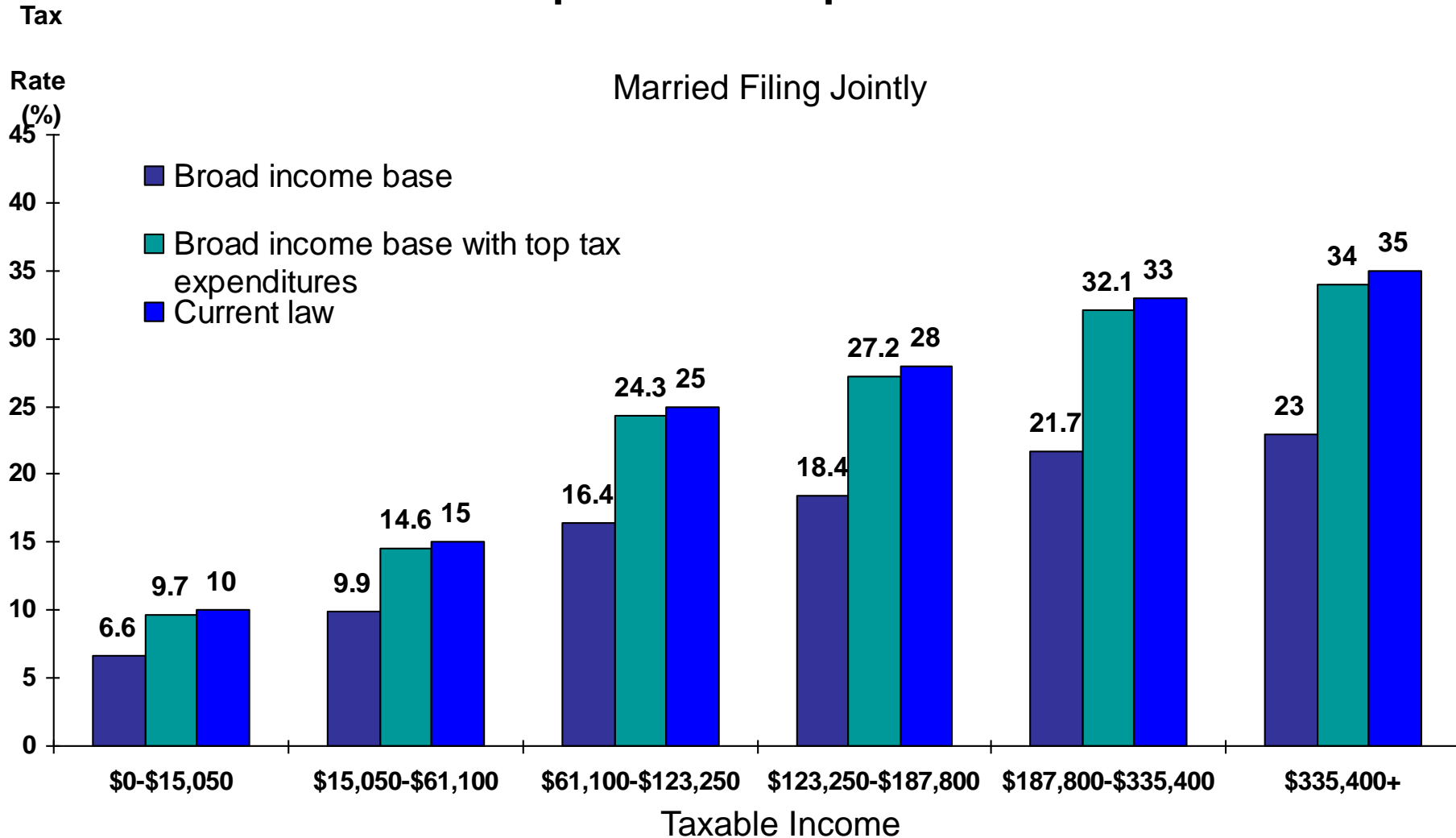


The Top Tax Expenditures

- **Lesson:** The starting point for reform shapes the reform and makes it difficult to present options with broad appeal
- Compare the tax rate schedule under current system and under a broad base that keeps the top tax expenditures
 - **Looks about the same!**
 - **Changes quite a bit once you eliminate the top expenditures**



Tax Rate Schedule: Broad Income Base with Top Tax Expenditures



Source: Department of the Treasury, Office of Tax Analysis.

Note: Taxable income brackets are estimates for 2006.

Tackling Tax Expenditures

- What's left if you decide to keep the top expenditures?
 - **Provisions that don't raise a lot of revenue and are painful to cut**
- Have to go after the top tax expenditures
 - **Panel ended up modifying many of them instead of eliminating them**
- **Lesson:** Hard to sell reform that goes after top expenditures without lowering rates significantly



Applying the “Fairness” Constraint

- Baseline distribution was deemed fair by the Panel
 - **But the baseline used had no AMT patch after 2005!**
 - **Upper middle class ended up with a higher burden of tax than they are paying now since they were subject to the AMT growth in the baseline**



Lessons from Applying the “Fairness” Constraint

- Perceptions of fairness matter
- Notions of fairness are still driven by statutory incidence and not by economic incidence
 - **Case in point: The X-Tax becomes the GIT**
- There is a reluctance among some to remove taxpayers from the tax rolls and this constrains tax reform choices
 - **Case in point: No add-on VAT**
- The public does not understand incidence
 - **Case in point: Support for the FairTax**



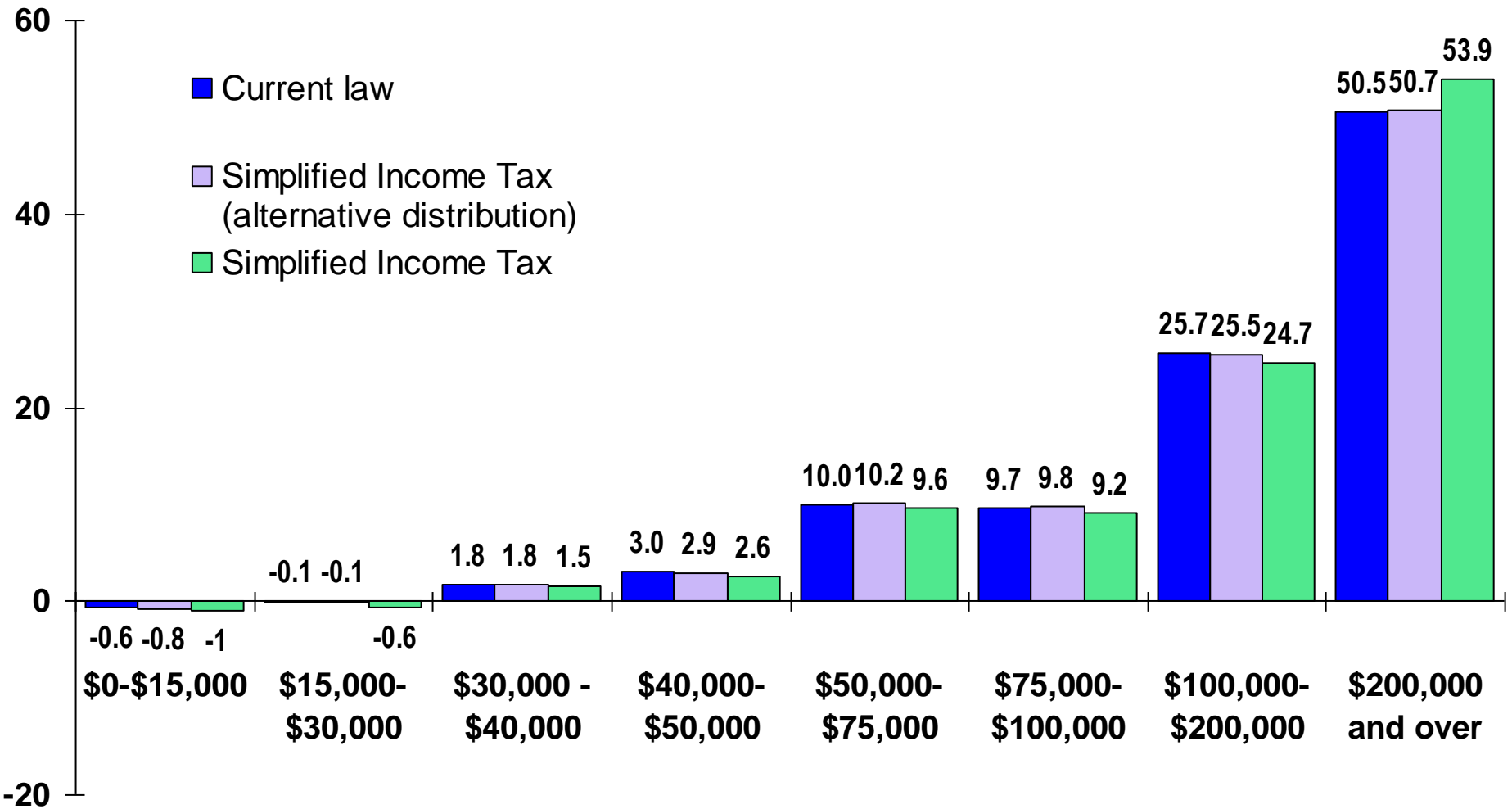
Lessons from Applying the “Fairness” Constraint

- Incidence analysis needs work
 - **Who bears the burden of the corporate tax?**
 - Does it matter in practice? Analysis in appendix of report suggests that it does not
 - **How do we distribute a consumption tax?**
 - Still an open question in the economic literature



Alternative Distribution of the Corporate Income Tax

(50% of corporate tax to labor)



Lessons from Applying the “Fairness” Constraint

- There are many ways to present distribution tables
 - **Presentation involves making subjective choices and can be controversial**



Lessons from the “Pro-Growth” Constraint

- Expensing is attractive to economists but
 - **there is strong resistance to it from business community**
 - **businesses focus on financial reporting and capital budgeting --- rate reductions have larger impact**
- Have to tackle rules for the taxation of international income but
 - **MNCs are heterogenous which creates a “winners/losers” problem in spades**



Working with the “Pro-Growth” Constraint

- Macroeconomic analysis is necessary to estimate growth effects of tax plans
 - There was disagreement about whether the models used to generate estimates were adequate
 - **Lesson:** There were meaningful differences between plans
 - **Lesson:** Simplification can be associated with economic growth



Applying the Simplicity Constraint

- The myriad of phase-outs and phase-ins enacted to hit revenue and distribution requirements since 1986 are overwhelming and expensive to repeal
- **Lesson:** Simplification is possible
 - Elimination of phase-outs and phase-ins (where possible)
 - Unified individual credits
 - Unified savings plans
 - Taxation at the entity level
 - No AMT!
- **Lesson:** Developing reforms with an eye on what the actual tax return will look like is helpful



Many Dimensions to Decisions

- **Lesson:** It's not all about efficiency, equity, and simplicity
 - **Case in point: Ready return**
 - “People should fill out their tax forms”
 - **Case in point: Adopting a VAT**
 - “It's too efficient”
- **Lesson:** Implementation issues are paramount



Implementation Issues are Paramount

- X-tax implementation issues remain unanswered
 - **and affected support for the plan among some panel members**
- Conforming book income and taxable income would dictate fundamental tax policy
 - **especially when dealing with income earned abroad by U.S. taxpayers and tax-free reorganizations consolidation, international, tax free reorganization**



Political Constraints

- **Lesson:** Horse-trading is inevitable
 - Even in the fully insulated panel setting political pressures were felt and impacted the final reforms

