Tax Reform Is Dead . . . Long Live Tax Reform!

By John Irons

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National Procrastination Week was March 6-10, and I've been meaning to get to this commentary for a couple of weeks now. But that's nothing compared with tax reform, which has been waiting for 20 years.

A year ago, March was a busy month for tax reform. The president had just appointed a panel, led by former Sens. John Breaux and Connie Mack, to examine the tax code and propose reforms. The panel was on a sweeping tour of the country listening to dozens of people offering expert testimony on a wide range of tax topics. Think tanks and independent experts were compiling analyses, writing comments, and formulating their own tax reform options.[1]

However, it appears that the tax panel's recommendation is now just gathering dust on some bookshelf in the Treasury Department. Aside from a proposal to expand health savings accounts, the administration is pushing little more than extending the tax changes from 2001 and 2003 that are due to expire in 2010. Congress can't seem to agree on last year's tax reconciliation bill, which may include a one-year alternative minimum tax patch and/or a two-year extension of capital gains and dividend tax cuts. The highlight of the year might be a show vote on estate tax elimination, which no one expects will pass.

Although the Bush administration may have backed off reform, it is essential that the issue remain in the forefront of the policy debate. Policymakers of all stripes need to take up the call for reform and put forth positive ideas for change.

What Happened to Reform?

Many conservatives in Congress have long railed against the tax code and promoted their brand of fundamental reform — flat taxes, national sales taxes, and the like. But now, having been in control for several years, conservatives have either abandoned reform or have silently admitted defeat. It's much easier to be for conservative tax reform in the abstract, but harder when confronted with tax distribution tables.[2] As a result, there is no serious conservative legislative effort under way in Congress or in the administration to significantly reform what has become a broken system.[3]

But the tax code — because it reaches into the lives of every American and because it is in need of repair — can't be allowed to go on in its current form. While it's always easy to take potshots at the tax code, there is also a need to propose positive reforms.[4]

We, as a policy community, already know quite a lot about tax policy. (My dear reader, if you are a *Tax Notes* subscriber you are likely part of this community as well — like it or not!) Tax reform is not a new subject, nor is the economics of taxation; tax reform never really starts from scratch.

But each go-round is different, and there are a couple themes that are emerging this time around.[5] Although it's not an exhaustive list, below are some examples of reforms that might achieve some degree of agreement not only among progressives, but also across the ideological spectrum.

Revenue

First, the tax code needs to raise more revenue than it does now. Simply put, we are failing at the primary goal of tax policy — to raise the revenue needed to adequately fund current national priorities and to prepare for long-term challenges.[6] Not only do we have massive deficits now, but the situation will only get worse as baby boomers retire and as medical costs increase our obligations under Medicare and other programs. A failure to increase revenue means a failure to invest in our nation, our economy, and our kids.

While it would be nice if we could simply grow our way out of the deficit, that is not likely. Some look at the 1990s and conclude that all we need is a prolonged period of growth to get out of deficit trouble. However, the 1990s saw tax increases during the Bush and early Clinton years, and spending restraint for much of the rest of the decade. It is exceptionally hard to find any budget expert — conservative or progressive — who thinks that the deficit will solve itself without major policy overhaul.

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[1]Before the commission's formation, the Center for American Progress proposed a reform package in January 2005. Details can be found at http://www.americanprogess.org/tax.

[2]A flat tax, for example, would entail either large increases in the taxes of middle-income Americans or massive deficits. It's much easier to support a flat tax in the abstract.

[3]I have no doubt that some sponsors and supporters of various conservative efforts will dispute my characterization. But despite the several tax bills submitted — nine of which have flat rates or a consumption base (*see* Congressional Research Service, ''Flat Tax Proposals and Fundamental Tax Reform: An Overview,'' *Doc 2006-4730*, *2006 TNT 48-64*) — there is little momentum for getting to a vote, let alone final passage of a fundamental reform measure.

[4]The Center for American Progress will be hosting a conference on March 24 to highlight several options for reform. *See* http://www.americanprogress.org/taxconference2006. We think it is important to put concrete options on the table. And we are not alone; in the past year there have been many other proposals put forth by academics, policy institutions, the president's tax reform panel, and politicians. Many have appeared in the pages of *Tax Notes*.

[5]The themes below are not necessarily consensus views, but neither are they obviously partisan or limited to one side of the political spectrum.

[6]The need for additional revenue places modern tax reform in a very different starting place than during the 1986 reform, which had revenue neutrality as a primary goal.

Since the ''starve the beast'' strategy is clearly failing as a political tool,[7] that means more revenue will almost certainly be part of any responsible tax reform effort. A debate over the proper size and scope of the government will always be part of the public discourse (as it should be), but calling for tax cuts as a serious means toward a small-government end no longer holds water — if it ever did.

'Simple Fairness'

More generally, we need to define and implement what I call a ''simple fairness'' principle. The tax code is wrought with good intentions and needlessly complicated implementations. For example, as a nation, we believe it is important to provide incentives to build assets for retirement. But there are too many programs with different rules (traditional and Roth IRAs, 401(k)s, simplified employee pensions, and so forth), and the benefits are skewed toward those who need the least help accumulating money in their accounts. And although it is important to provide aid for college students and their families, it seems that navigating the sea of tax incentives for education requires an advanced degree.

The earned income tax credit could also be greatly simplified. Because a purpose of the EITC is to encourage work, the plan needs to be simple enough that those who qualify know the effect of the program on their labor earnings. Yet in 2003 an estimated 71 percent of EITC recipients filed their returns through a paid tax return preparer.[8]

The simple fairness principle is doubly violated by the myriad deductions in the code. Nonrefundable tax deductions violate fairness because they provide a greater incentive to (1) itemizers and (2) those in higher tax brackets. And they are not efficient because the incentives ought to benefit everyone — not just those who happen to be eligible under a deduction-based system.

The same is true for child rearing supports: Changes in family structure — yielding deductions for dependents, per-child tax credits, and so forth — should not be a boon to the rich and a bust for middle- or low-income taxpayers. And preparing for a marriage should not require consultation with a tax planner.

Generally speaking, if an activity deserves to be encouraged with a tax incentive, it also deserves to be implemented as a refundable credit with an equal value to everyone.

That same simple fairness principle should be applied to AMT reform as well. The AMT as now implemented has few supporters, and it will start to affect millions of increasingly middle-class taxpayers unless it is reformed or eliminated. But the AMT is an important part of the code because it raises significant revenue and limits the ability of high-income taxpayers to avoid paying taxes. When reforming or eliminating the AMT, it would be important to limit some deductions (or credits) for very-high-income individuals and to restrict the ability of high-income individuals to shelter unlimited amounts of income. The important goals of the AMT should be achieved in the context of the income tax code and not through what has become a complicated parallel tax code.

On the corporate side, we must strive for a clean base to create a level playing field. The tax code has a limited ability to affect the long-run growth of the economy, and we should resist the appeals that businesses need tax cuts every year to survive. And as corporations become multinational, so too must the corporate tax code.

Stuck in the Middle

If the IRS were to reform the low end of the code — for example, by simplifying the EITC — and then simplify the high end through AMT reform, the middle class will have been left out. Middle-income Americans generally believe the tax code benefits high-income taxpayers — who can take greater advantage of deductions and can hire tax accountants, and who have greatly benefited from Bush's tax changes.

The uneasiness of the middle class is not just about taxes. Stagnant real wages and increased risks are leading those in the middle to feel increasingly uncertain about the future.

One way to make the tax code work for everyone — converting tax deductions into credits and making those available to more taxpayers — has been mentioned above. Only one-third of taxpayers with incomes less than $100,000 in adjusted gross income itemize deductions, and over half of all deductions are taken by filers with adjusted gross incomes over $75,000. So for most, the array of deductions in the code are simply benefits for someone else. Changing deductions into refundable credits would not only benefit many in the middle class, but would also increase the perceived fairness of the tax code.

As more people become eligible for tax incentives, pressure on revenue would increase. However, there are two possible ways to reduce the cost. First, the credit rate could be fixed so there would be no revenue loss. (The revenue lost from the new itemizers would be offset by revenue gains because of higher receipts from high-tax-bracket filers.) The second option would be to create a minimum refundable credit — say 25 percent[9] — but then to drastically limit the range of activities that might qualify for the credit. Either way would lead to a more balanced approach for dealing with deductions and credits.

Although it may be tempting to simply eliminate virtually all tax expenditures — which the tax reform commission recommended — that faces daunting political challenges, as the reaction to the panel's report demonstrated. While ''cleaning'' the tax base would

[7]That strategy claims that deficits will lead, via the political process, to reductions in spending.

[8]Alan Berube, ''The New Safety Net: How the Tax Code Helped Low-Income Working Families During the Early 2000s,'' Brookings Institution (February 2006), *available at* http://www.brookings.edu/metro/pubs/eitc/20060209_newsafety.htm.

[9]Three-quarters of return filers in 2003 fell into the 10 percent, 15 percent, or 25 percent brackets, so for most taxpayers that would be an increase in the marginal tax incentive.

certainly be nice, we also must ensure that those incentives that remain part of the tax code are administered fairly and simply.

Conclusion

Procrastination is costly. Not only are we living with a poor tax code, but the longer we put off raising adequate revenue the more debt we accumulate, and the higher our national interest payments will be in the future. Tax reform may be on the back burner for now, but it's only a matter of time before it boils over.