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TIME FOR US TAX REFORM?
THE TAX REFORM PANEL'S RECOMMENDATIONS

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I. Introduction

On November 1, 2005, the President's Advisory Panel on Federal Tax Reform (hereinafter the panel) appointed by President Bush in January of that year issued its report, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*[1] (hereinafter the report). As this title indicates, the panel attempted to craft proposals that would simplify the US income tax, be fair, and be conducive to economic growth. It also attempted to comply with the additional constraints set by President Bush of progressivity, revenue neutrality and continued encouragement of home ownership and charitable giving.

The centerpiece of the report consists of two proposals, one that would drastically reform the existing income tax and an alternative approach that would combine a consumption-based direct tax, which has the effect of exempting the return on marginal investment, with an individual level tax on financial income.[2] Section 5 describes and appraises these proposals. Section 2 sets the stage by giving an overview of the report. Section 3 discusses the problems the panel faced in defining revenue and distributional neutrality. Section 4 briefly discusses three options the panel did not endorse.

II. The Report in Brief

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1 The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Washington: US Government Printing Office, 2005). The report is available at http://www.taxreformpanel.gov/final-report/.

2 We use the term "consumption-based direct tax" to denote a tax that looks like an income tax (in that it takes account of the personal circumstances of the taxpayer), but has consumption (or an economically equivalent concept) as its base, to distinguish it from both a direct tax whose base is income and indirect consumption taxes such as the value added tax and retail sales tax. The present "income tax" and both of the proposals recommended

The Presidential Directive

The executive order issued by President Bush that created the Tax Reform Panel stated:

> The purpose of the Advisory Panel shall be to submit to the Secretary of the Treasury in accordance with this order a report with *revenue neutral* policy options for reforming the Federal Internal Revenue Code. These options should:
>
> (a) *simplify* Federal tax laws to reduce the costs and administrative burdens of compliance with such laws;
>
> (b) share the burdens and benefits of the Federal tax structure in an *appropriately progressive* manner while recognizing the importance of *home ownership* and *charity* in American society; and
>
> (c) promote long-run *economic growth* and job creation, and better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the United States in the global marketplace. (Emphasis added)

As indicated earlier and explained further below, the panel took these marching orders seriously, paying special attention to the terms that have been italicized for emphasis. In particular, in order to promote economic growth, the panel focused on reducing the taxation of the returns to saving and investment. Unfortunately some of the constraints in the executive order are not self-explanatory; this is true especially of "revenue neutral," but also of "appropriately progressive." See section 3 below.

Panel membership

Although most of the nine members of the panel may not have considered themselves experts on tax policy, they did not lack relevant experience. Both Connie Mack III, the Chairman of the Tax Reform Panel, and John Breaux, the panel's Vice-Chairman, were former US Senators who had served on the Senate Finance Committee, Breaux as a member of the sub-committee on

by the panel are actually hybrids that contains features of both income and consumption taxes. See also Section 5

Taxation and IRS (Internal Revenue Service) Oversight. A former member of the U.S. House of Representatives, William Frenzel had served on the House Ways and Means Committee. Along with the Joint (House-Senate) Committee on Taxation, the House Ways and Means Committee and the Senate Finance Committee are the "tax-writing" committees of the US Congress. Charles Rossotti had been Commissioner of Internal Revenue from 1997 to 2002.

Four of the panel members are professors, two of law and two of economics. Elizabeth Garrett, a professor of law and political science at the University of Southern California, had served as Tax and Budget Counsel to former U.S. Senator David L. Boren. Timothy Muris, a law professor at George Mason University, was Chairman of the Federal Trade Commission from 2001 to 2004. Besides being a professor of economics at the Massachusetts Institute of Technology, James Poterba directs the public economics program of the National Bureau of Economic Research. Edward Lazear, a specialist in labor economics, is a professor at the Stanford University Graduate School of Business and a Senior Fellow at the Hoover Institution. Rounding out the panel was Liz Ann Sonders, Chief Investment Strategist at Charles Schwab.

Besides its small staff, the panel relied on support from the US Department of Treasury (particularly the Office of Tax Analysis) and the Internal Revenue Service and called on a few outside consultants.[3]

Process

The panel held 13 public meetings, at which it heard the views of some 80 witnesses. In addition, it solicited written comments on the US tax system. It issued a unanimous report, with no minority opinions or published dissents – a remarkable feat for so diverse a group dealing with such controversial topics. (It does appear, however, that in a few instances the quest for unanimity may have forced the panel not to endorse proposals that a clear majority favored, most notably the Progressive Consumption Tax discussed in Section 3.3.)

The problem

and references provided there.

As documented at length in the report, the US income tax suffers from many well-known and serious problems.

Complexity

The income tax "system" is incredibly complex. The report contains a useful schematic description (p. 24) of the computation of individual income tax under the current system. It lists "exclusions" (types of income that are not included in the tax base[4]), deductions that are "above the line," being taken into account in the calculation of "adjusted gross income" or AGI (primarily for business expenses, but also for certain personal expenditures[5]), personal exemptions for the taxpayer and dependents, which are phased out as income rises, itemized deductions[6] (which are partially phased out and are claimed only if they exceed the standard deduction, which depends on the "filing status" of the taxpayer[7]), tax rates (six "ordinary" tax rates, which depend on filing status, and special rates for dividends and capital gains), tax credits (for foreign taxes paid, but also for various expenditures thought to deserve public support[8]), and the Alternative Minimum Tax (AMT) – which requires that the taxpayer calculate liability under a parallel system that has its own base and pay the larger amount.

The panel estimates that individual taxpayers spend an enormous 3.5 billion hours doing their taxes – an average of 26 hours each – and about $100 billion on tax preparation and compliance. Businesses spend an additional 3 billion hours and $40 billion (p. 36). Complexity is

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3 In the interest of full disclosure, we note that Zodrow served as a consultant to the US Treasury Department Office of Tax Analysis and assisted in its evaluations of the economic effects of the proposals.

4 These include employer contributions to health and retirement plans, returns to tax-preferred savings accounts, unrealized capital gains, interest on state and local bonds, imputed rent from owning a home and other durable goods, in-kind services, gifts, and inheritances.

5 These include moving expenses, educator expenses, self-employed health insurance premium payments, student loan payments, tuition and fees, alimony paid, etc.

6 These include deductions for charitable contributions, home mortgage interest, state and local taxes, medical expenses in excess of 7.5% of AGI, casualty and theft losses, and non-reimbursed employee expenses.

7 The filing categories are single or married filing separately, head of household, married filing jointly or qualifying widow(er).

8 In addition to the foreign tax credit, these include the child tax credit, additional child tax credit, EITC, HOPE and Lifetime Learning credit, electric vehicles credit, health coverage tax credit, adoption credit, mortgage interest credit, retirement savings contribution credit, child and dependent care credit, credit for the elderly or the disabled, and the D.C. First-Time homebuyer's credit.

particularly burdensome for low-income families, small businesses, and those who must pay the Alternative Minimum Tax. Nearly three-quarters of families claiming the Earned Income Tax Credit (EITC) use a tax preparer. (The EITC is an income support system intended to relieve poverty for working families that is administered through the tax system.) Taxpayers reporting self-employment income spend an average of 60 hours and $363 in out-of-pocket compliance costs – some four to five times the figures for other taxpayers (pp. 2-3). Seventy-five percent of AMT taxpayers hire a professional to do their returns – a figure that is especially daunting, given the projected growth in the number of AMT taxpayers under current law (to 45 percent of taxpayers with income tax liability by 2015) (p. 10).

Besides imposing large compliance costs, the system lacks transparency, creating the perception that the system is unfair and is easily manipulated to reduce tax. The panel notes, "The profound lack of transparency means that individuals and businesses cannot easily understand their own tax obligations or be confident that others are paying their fair share." Part of both the complexity of the system and its lack of transparency for individual taxpayers can be traced to the many thresholds, eligibility requirements (many of which are based on different definitions of seemingly identical terms, such as "child"), and phase-outs in the Tax Code.

Complexity is aggravated by the volatility of the Tax Code. The panel explains (p. 4), "The tax system is a kaleidoscope of shifting credits, rates, and benefits because many of the Tax Code's most prominent features – the tax rate for ordinary income, the child tax credit, the lower tax on dividends and capital gains – may shift wildly from one year to the next, and in some cases simply expire." Since 1986, when the system was reformed by eliminating many tax preferences and lowering rates, there have been more than 100 tax-related acts of Congress that have introduced more than 15,000 changes in the Tax Code (p. 16). The resulting instability creates uncertainty and complexity for both businesses and families.

Inequity

The traditional formulation of horizontal equity, "equal treatment of equals," begs the question of when two taxpayers are equal. Presumably it is thought that a family with four children is not equal to one with the same income but only two children, and that the two families thus should not pay the same tax. Similar arguments can be made for many other provisions that cause taxpayers with the same income to pay different taxes. But there are glaring examples of horizontal inequity that cannot so easily be explained away. The panel noted (p. 5), "taxpayers in states with high state and local income and property taxes receive higher deductions than taxpayers who live in lower-tax states with fewer state-provided services. Taxpayers with substantial employer-provided health insurance benefits receive in-kind compensation that is not taxed, while taxpayers who buy the same health insurance on their own usually pay tax on the income used to purchase the insurance." The panel also took aim at the fact that deductions for home ownership and charitable contributions are available only for those who itemize such deductions and are worth more to individuals in relatively high tax brackets.

Economic Distortions

Noting that the tendency to use the Tax Code to achieve policy goals other than raising government revenue accelerated in the 1960s (p.13), the panel said (p. xi) "Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers ... can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers."

A particularly bizarre aspect of the current system is the pattern of marginal tax rates created by the interplay of statutory tax rates, thresholds, and phase-outs of tax benefits. The panel notes that this problem is especially pronounced for low-income individuals subject to the Earned Income Tax Credit, which provides a wage subsidy at low income levels which is phased out at higher income levels.

Disincentives to Save and Invest

Perhaps the most costly distortion of economic choices is the disincentive to save and invest that is inherent in the taxation of income, rather than consumption. A direct income-based tax is levied on both capital and labor income, regardless of whether the income is saved or consumed. By comparison, a direct consumption-based tax either allows a deduction for saving and investment (taxing all subsequent withdrawals, including both principal and interest) or exempts the return to saving and investment.[9] Thus, whereas a constant rate consumption-based tax is neutral with regard to whether to consume now or later, an income-based tax penalizes future consumption. This is generally interpreted as meaning that a consumption-based tax is more conducive to saving, investment, and economic growth than an income-based tax. There is substantial evidence that shifting to a consumption-based tax could increase saving, investment, productivity, and national output.[10]

The Panel's Two Alternatives

The panel chose the names "Simplified Income Tax" (SIT) and "Growth and Investment Tax" (GIT) to describe the two alternatives it agreed unanimously to propose for consideration. The two plans contain many common elements; most of these deal with issues other than the taxation of income from business and capital and reflect the desire to simplify the US tax system, especially for individuals. Because of the way it would treat income from business and capital, the first plan satisfies Bush's requirement that, "At least one option submitted by the Advisory Panel should use the Federal income tax as the base for its recommended reforms." The second plan adds a 15 percent individual level tax on financial income to what would otherwise be a consumption-based direct tax (because of the way it would treat income from business and capital). Section 5 provides a detailed description and evaluation of these two plans.

What Landed on the Cutting Room Floor

Witnesses before the panel and the public made many recommendations, some of them bordering on the bizarre. The panel commented explicitly on three proposals, in addition to those it endorsed: a retail sales tax (RST) that would replace the entire income tax; a value added tax (VAT) that would leave the income tax (as modified by the SIT plan) in place, but replace part of its revenues; and a conceptually pure consumption-based direct tax.

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9 This article follows the standard practice among economists of calling both of these systems "consumption-based," because, under certain circumstances, they result in the same present value of tax payments and consumption flows. The deduction approach is often referred to as "tax postpaid" since tax is deferred until consumption occurs, while the exemption approach is referred to as "tax prepaid" since the taxpayer foregoes a deduction for saving by paying tax upon receipt of any labor compensation. For further details, see Zodrow, George R. and Charles E. McLure, Jr., "Implementing Direct Consumption Taxes in Developing Countries," 46 *Tax Law Review,* Summer 1991, at 405.

III. Ambiguous Constraints

Whether the panel's recommendations satisfy the constraints contained in the executive order is a highly subjective matter. Whether they would "share the burdens and benefits of the Federal tax structure in an appropriately progressive manner" obviously depends on how much progressivity one thinks is appropriate. It may seem to be relatively easy to side-step this inherently political and thus technically intractable problem by requiring that tax reform be distributionally neutral – that it not significantly change the distribution of tax burdens across income levels. That was the approach the Treasury Department took in its 1984 report that led to the Tax Reform Act of 1986.[11] The resulting focus on horizontal equity – equal treatment of those with equal incomes – avoided the politically explosive issue of class warfare inherent in concerns about vertical equity. Although the panel adopted the same strategy, in the current context the appropriate implementation of the strategy is not free from ambiguity. Similarly, the seemingly straightforward mandate "to submit to the Secretary of the Treasury ... a report with revenue neutral policy options" can be interpreted in numerous ways.

The source of ambiguity is the same in both instances: the benchmark against which one measures distributional and revenue neutrality is unclear. In particular, the choice of the time period for the comparison of a reformed tax structure with current law is largely arbitrary. The panel adopted the current US convention of calculating revenue neutrality with respect to a 10-year budget window. Although preferable to using a shorter time frame, even a 10-year window can easily be misleading, as it is vulnerable to manipulation by using uncertain revenue gains in the years near the end of the budget period to offset more certain short-term revenue losses, or delaying revenue losses to the "out years" beyond the budget window. The panel then assessed distributional neutrality by comparing the distribution of tax burdens across quintiles and across

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[10] For a recent discussion of these results, see Zodrow, George R. "Should Capital Income Be Subject to Consumption-Based Taxation?" in Aaron, Henry J., Len Burman and C. Eugene Steuerle, *Taxing Capital Income* (Washington DC: Urban Institute Press, forthcoming).

[11] U.S. Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth* (Washington: November 1984), hereafter referred to as "Treasury I." For further discussion, see McLure, Charles E., Jr. and George R. Zodrow, "Treasury I and the Tax Reform Act of 1986: The Economics and Politics of Tax Reform," 1 *Journal of Economic Perspectives* (Summer 1987), at 37.

income classes under its proposals with the distributions that would prevail under current law at the beginning and end of the 10-year budget window (in 2006 and 2015).

But what is current law for purposes of establishing this benchmark? First, does one assume that the "temporary" changes in law made in 2001, 2003 and 2004 are made permanent, as President Bush requested, or does one assume that the temporary changes are allowed to expire? The panel took the former approach, and further assumed that other proposals included in the policy baseline of the President's current budget, including tax-preferred lifetime saving accounts and retirement saving accounts, are enacted. These assumptions result in a rather unusual interpretation of "current law" for the purposes of generating a revenue baseline, as has been noted by numerous observers.[12]

Second, what does one assume happens to the alternative minimum tax? The AMT is a parallel tax that was originally enacted to prevent high-income taxpayers from escaping all obligation to pay tax, by subjecting certain statutorily defined "tax preferences" to the AMT. The taxpayer calculates tax under both the regular income tax and the AMT and pays the larger of the two. In 1986, many tax benefits enjoyed by the middle class were added to the base of the AMT. (Particularly important for present purposes is the fact that state and local taxes are not deductible under the AMT; see Section 5.2.1.3.) A relatively high exemption level initially kept the AMT from affecting most non-affluent taxpayers. But, because the exemption is not indexed for inflation, contrary to the situation under the regular income tax, the impact of the AMT increased over time, and in the early 2000s large revenue gains were estimated for the later years of the 10-year budget period over which revenues were calculated. These hypothetical revenue gains were used to offset the real up-front revenue losses resulting from various tax reductions enacted in the early years of the first Bush administration.

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[12] Burman, Len and William G. Gale, "Some Good Ideas, But Show Me the Money," 3 *The Economists' Voice* 13 December 2006, http://www.bepress.com/ev/vol3/iss1/art4/; Shaviro, Daniel, "A Blueprint for Future Tax Reform? Evaluating Reform Panel's Report," 109 *Tax Notes*, 7 November 2005, at 827; Auerbach, Alan J., "The Tax Reform Panel's Report: Mission Accomplished?" 3 *The Economists' Voice,* 13 December 2006, http://www.bepress.com/ev/vol3/iss1/art5/.

While this budgetary sleight of hand worked for a while, the chickens have now come home to roost. The exemption has been increased only minimally – from $40,000 in 1982 to only $45,000 in 2006 – relative to an inflation-adjusted figure of $82,000. As a result, the AMT has morphed into a tax that now hits an increasing number of lower-income taxpayers, many of whom may not even know it exists until they are hit with penalties and interest for failing to pay it.[13] The panel estimates (p. 10) that, if left unchanged, the AMT will affect 21.6 million taxpayers in 2006, compared to four million in 2005, and 52 million (or 45 percent of all taxpayers with income) in 2015. Particularly important is the fact that it will take away much of the benefits of the deductions for state and local taxes and home mortgage interest – implying that the panel's recommendations for curtailing these benefits, to be described below, do not represent as dramatic a change from current law as it might appear (assuming the AMT is neither fixed nor patched).

There is widespread agreement that the AMT should be fixed permanently, by narrowing its base or indexing the exemption, but the political will to make the necessary changes has been lacking. After all, fixing the AMT would substantially reduce estimated AMT revenues in future years; thus, to maintain revenues, other taxes would need to be raised. Instead, the AMT has repeatedly been "patched" by temporarily raising the exemption level, in order to reduce its short-term impact on middle-class taxpayers, without admitting that revenue gains in future years, when the exemption reverts to its lower pre-fix level, are illusory. (It is because of the patch that only four million taxpayers will pay AMT in 2005.) So, in making comparisons of the distribution of tax burdens and revenues under current law and the panel's proposals, does one assume that the AMT continues to be "temporarily" patched or that it is fixed permanently – or does one assume neither? In this case, the panel calculated its benchmark under the assumption that the AMT is not fixed (and does not continue to be patched). Since it proposed to eliminate the AMT under both of its proposals as part of its focus on tax simplification, the resulting revenue losses had to be recovered by other elements of the two plans – a point to which we shall return later.

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[13] Burman, Leonard, William G. Gale and Jeff Rohaly, "The Expanding Reach of the Individual Alternative Minimum Tax,"17 *Journal of Economic Perspectives*, Spring 2003, at 173.

The resulting "revenue neutral" baseline implies large deficits in the absence of correspondingly large reductions in projected future expenditures. The significance of the resulting revenue problem is a contentious issue, with some observers arguing that the US faces a fiscal problem of unprecedented proportions,[14] while others conclude that much if not all of the problem will be resolved if the US is successful in the admittedly difficult task of maintaining government expenditures at historical levels.[15] In any case, it seems unreasonable to expect the tax reform panel to resolve this issue, and indeed the panel downplays revenue issues – to the point that its report includes no revenue tables.[16]

Nevertheless, the prospect that future tax rates may have to increase has important implications for an evaluation of the panel's recommendations. Beyond the obvious point that any base broadening tax reform package will be more difficult to enact if it is widely perceived that it will result in less rate reduction than projected, the positive effects of reform on saving and investment will be mitigated if firms and individuals expect higher tax rates in the future. In particular, although all firms are allowed to expense purchases of depreciable assets under the GIT, the benefits of such generous treatment will be muted if the resulting future income is subject to tax rates higher than the rate at the time of expensing. The same point applies for individual saving in tax postpaid savings plans. Any deficit-induced increase in future interest rates would also diminish the favorable effects of tax reform on investment.

The choice of the baseline also has important implications for distributional neutrality. The 2001, 2003 and 2004 changes substantially reduced the progressivity of the income tax, a result that is largely inevitable for any tax cuts, given that the bottom half of taxpayers in the US pay only

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14 Auerbach, Alan J., William G. Gale and Peter Orszag, "Sources of the Long-Term Gap," 103 *Tax Notes*, 24 May 2004, at 1049; Rivlin, Alice M. And Isabel Sawhill, *Restoring Fiscal Sanity 2005* (Washington DC: Brookings Institution Press, 2005).

15 Boskin, Michael J., "A Broader Perspective on the Tax Reform Debate," 3 *The Economists' Voice,* 12 December 2006, http://www.bepress.com/ev/vol3/iss1/art1/; Feldstein, Martin S., "Here are the Facts," *Wall Street Journal*, 12 February 2004; Diamond, John W., "Dynamic Effects of Extending the 2001 and 2003 Income Tax Cuts," 12 *International Tax and Public Finance*, March 2005, at 165.

16 In addition, the panel's proposal to inflation index the income threshold for income taxation of social security benefits would be a significant revenue loser, especially in the years outside the 10-year budget window.

3% of total personal income taxes.[17] As a result, the post-reform distribution of tax burdens under a "distributionally neutral" tax reform would be substantially more progressive if the earlier reforms had been assumed to expire than if they are assumed to be made permanent. In addition, the effects of implementing the panel's recommendations are more favorable to upper middle-income taxpayers under the assumed benchmark than they would be if the AMT were assumed to be fixed as part of the baseline.

IV. Roads Not Taken

The panel considered three tax reform options, in addition to the two proposals examined in the next section -- a national retail sales tax (RST) that would replace the entire income tax, a value added tax (VAT) that would replace part of income tax revenues, and a pure consumption-based direct tax that would replace the income tax. It explicitly rejected the RST, but considered the other two options worthy of further consideration.

National Retail Sales Tax

A Houston-based conservative group has recently advocated replacing all federal income taxes (as well as the payroll tax) with a retail sales tax, which it characterizes as the Fair Tax.[18] Recognizing that, by itself, a RST would impose an unacceptable burden on low-income families, advocates of the Fair Tax have proposed packaging the RST with a "prebate," a lump-sum payment to all families intended to offset the burden of the RST on low-income families. Proponents of the plan have not stressed its distributional effects at the opposite end of the income distribution – substantial reductions in tax burdens, broadly similar to those that would occur under a Flat Tax. The panel notes that under the RST the share of total taxes paid by the five percent of families with the highest incomes would fall from 58.6 percent to 37.4 percent.[19] It would seem difficult to characterize the resulting system as "appropriately progressive."

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17 A separate and important issue, which we do not address in this paper, is whether it is desirable in a democracy to have half of the population paying very little in federal taxes, other than payroll taxes used to finance Social Security and Medicare benefits. For a discussion of this issue, see Boskin, Michael J., "A Broader Perspective on the Tax Reform Debate," supra note 15.

18 See www.fairtax.org.

19 Note, however, that the panel's calculation does not include replacing the payroll tax with the RST plus prebate, as recommended by advocates of the Fair Tax.

In rejecting the RST as a viable reform option, the panel noted these problems:

1. In the absence of the prebate, the replacement RST would violate the requirement that tax reform options be "appropriately progressive."
2. A prebate program designed to offset the burden on low-income families would cost an estimated $600-780 billion annually, making it by far the largest entitlement program in history.
3. The required sales tax rate would be at least 34 percent – far higher than state sales tax rates and VAT rates found in Europe – and probably much higher, once statutory base erosion and evasion are considered.
4. The federal administrative burden would be similar to that of the income tax.
5. If states continued to levy income taxes, taxpayers would experience little simplification, and complexity might actually increase as states could no longer rely on the administrative efforts of the federal Internal Revenue Service.
6. A targeted cash grant program, in which payments were phased out as income rose, would require calculations of income similar to those under the income tax.

Value Added Tax

The panel examined the possibility of introducing a 15 percent credit-method VAT, using the revenues to reduce the top income tax rate, levied on the SIT base, to 15 percent. It could not, however, reach agreement on whether to recommend this option. Some panel members were concerned with the increased administrative and compliance costs of adding a VAT to the fiscal arsenal, and some feared that the VAT would be a "money machine," fueling the growth of government (p. 192).

There are, of course, many ways to combine a VAT and income tax reduction in a revenue-neutral proposal. Perhaps the most visible plan is that offered by Michael Graetz.[20] In it, the personal exemption for income tax purposes would be raised to $100,000, thereby eliminating the need for 80 percent of taxpayers to file tax returns. The panel examined a variant that would utilize the Family Credit and the Work Credit to eliminate income tax on low-income families. The panel notes that the plan it developed would not actually be distributionally neutral. One can surmise that it decided not to devote additional resources to examining options that it would not propose, for reasons stated above.

The Progressive Consumption Tax (X-Tax)

Many tax experts, especially economists, favor the so-called X-Tax developed by the late David Bradford.[21] In a nutshell, it is a progressive-rate version of the Hall-Rabushka Flat Tax.[22] Both the Flat Tax and the X-Tax would impose distinct taxes on the labor income of individuals and on business income. The Bradford X-Tax employs graduated rates on individual income, in order to avoid the drastic reductions in tax paid by high-income taxpayers under the Flat Tax.

The base of the Flat Tax and the X-Tax differ markedly from the base of a conventional income tax. Lay observers probably pay most attention to the elimination of virtually all non-business deductions, but that is not what is distinct about the base. Rather a) immediate deduction is allowed for all business expenditures, b) all financial income (e.g., dividends, interest, and capital gains) is exempt, and c) interest is non-deductible. As noted earlier, this constellation of provisions is tantamount to exempting all marginal income from business and capital and is economically equivalent to taxing consumption, rather than income.

The panel considered recommending the X-Tax, which it characterized as a Progressive Consumption Tax (hereafter, PCT), noting its considerable advantages, relative to the GIT: greater incentives for saving and investment and greater simplification, both resulting from elimination of tax on financial income at the household level (pp. 182-85). Yet the panel did not endorse this option, apparently because one or more panel members could not stomach the idea

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[20] Graetz, Michael J. *The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go From Here* (New York: Norton, 1999); Graetz, Michael J. "100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System," 112 *Yale Law Journal*, pp. 261-310.

[21] See Bradford, David F., *Untangling the Income Tax* (Cambridge MA: Harvard University Press, 1986) and Bradford, David F., "A Tax System for the Twenty-First Century," in Alan J. Auerbach and Kevin A. Hassett (eds.), *Fundamental Tax Reform* (Washington D.C.: AEI Press, 2005), pp. 11-33.

of exempting capital income – this despite the fact, recognized in the report, that supernormal returns to business investment are taxed under the X-Tax and the returns to risk-taking are treated similarly under an income tax and the X-Tax. (See also the next section.)

It may be worthwhile to comment on one commonly overlooked pattern reported by the panel, since it may bode ill for future consideration of the X-Tax. For most of the options examined by the panel, the numbers of "winners" and "losers" (those with lower or higher tax burdens) in each income group are about the same. This is, however, not the case for the PCT; at the top of the income distribution there are far more losers than winners. Although the panel says, "It is unclear why this occurs," the conclusion it alludes to (p. 187) – that for many high-income individuals the benefits of consumption tax treatment of capital income do not offset the costs of a relatively high tax rate – seems correct. That is, the PCT creates gains that are highly concentrated among the relatively few households with large amounts of income from business and financial assets, at the expense of the larger number of high-income households who have relatively little business and financial income, but would pay higher taxes on their non-capital income.

V. The Two Reform Alternatives

We describe and comment on the specific features of the two plans proposed by the panel in this section, focusing on the main structural changes recommended in the report. Further information on the details of the report, as well as commentary on its provisions, are provided in a series of recent articles in *Tax Notes* and the *Economists' Voice*[23]; we draw on all of these excellent sources in our discussion.

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[22] See Hall, Robert and Alvin Rabushka, *The Flat Tax* (Stanford CA: Hoover Institution Press, 1995) and Hall, Robert, "Guidelines for Tax Reform: The Simple, Progressive Value-Added Consumption Tax," in Auerbach, Alan J. and Kevin A. Hassett (eds.), *Toward Fundamental Tax Reform* (Washington DC: AEI Press, 2005), at 70. .

[23] Burman, Len and William G. Gale, "A Preliminary Evaluation of the Tax Reform Panel's Report," 109 *Tax Notes* 5 December 2005, at 1349; Deloitte Tax LLP, Tax Policy Services Group, "Deloitte Reviews Tax Reform Panel Report," 109 *Tax Notes*, 14 November 2005, at 955; Shaviro, Daniel, "A Blueprint for Future Tax Reform? Evaluating Reform Panel's Report," supra note 12; Sheppard, Lee A., "A Look at the U. S. Tax Reform Plan's International Provisions," 40 *Tax Notes International,* 21 November 2005, at 675; Auerbach, Alan J., "The Tax Reform Panel's Report: Mission Accomplished?" supra note 12; Boskin, Michael J., "A Broader Perspective on the Tax Reform Debate," supra note 15; Burman, Len and William G. Gale, "Some Good Ideas, But Show Me the Money," supra note 12; Edward P. Lazear and James M. Poterba, "Reforming Taxes to Promote Economic Growth," 3 *The Economists' Voice,* 13 December 2006, http://www.bepress.com/ev/vol3/iss1/art3/; Graetz,

Overview

As described above, the panel recommended two alternative tax reform proposals. The structure of both these proposals could be described as reflecting the current status of debate regarding the relative desirability of income-based and consumption-based direct taxes. Specifically, there is widespread agreement that an "ideal" or comprehensive accrual-based tax on real economic income is not administrable, and less but still considerable agreement that the taxation of the normal returns to capital that is inherent under an income tax is relatively undesirable. On the other hand, many observers are unconvinced that a movement to a true consumption tax such as the X-Tax is desirable or could be implemented in practice, citing uncertainty about the magnitudes of efficiency gains and improvements in administrative and compliance simplicity, as well as concerns about the distributional implications of such a reform and transitional problems.[24] Reflecting this lack of consensus, the panel was unwilling to recommend either a true consumption-based tax or even a movement toward a more comprehensive income tax. Instead, the panel recommended replacing the current hybrid income-consumption tax system with one of two alternative hybrid systems. The first, the Simplified Income Tax, is a reformed income tax system that nevertheless includes a wide variety of consumption tax features. The second, the Growth and Investment Tax, is best described as a consumption-based system supplemented with a layer of capital income taxation at the individual level. Thus, adoption of either of the panel's recommendations would move the US tax system closer, but not all the way, to a system of direct taxation based on consumption.

Common Elements of the Two Plans

The two plans have many elements in common, especially in their proposed tax treatments of individuals. We focus on these common elements in this subsection, and then examine the unique aspects of the two plans in the following two subsections.

Michael J., "Tax Reform: Time for a Plan C?" 3 *The Economists' Voice,* 12 December 2006, http://www.bepress.com/ev/vol3/iss1/art2/.

24 For recent collections of articles that reflect the current status of the debate on these issues, see Zodrow, George R. and Peter Mieszkowski, *U. S. Tax Reform in the 21st Century* (Cambridge UK: Cambridge University Press, 2002), and Aaron, Henry J., Len Burman and C. Eugene Steuerle, *Taxing Capital Income* (Washington DC: Urban Institute Press, forthcoming).

Taxation of Individuals

The proposals for individual level taxation are very similar under the two plans, as in both cases the panel recommends a traditional base-broadening, rate-lowering approach. Unfortunately, at least in terms of generating political support for the proposals, much of the tax reduction takes the relatively invisible form of the elimination of the tax increases that would occur if the individual alternative minimum tax is neither fixed permanently nor patched indefinitely. Nevertheless, both plans also provide for some individual tax rate reductions, with the maximum tax rate declining from its current level of 35 percent to 33 percent under the SIT and to 30 percent under the GIT. The revenue losses attributable to these rate reductions and the elimination of the individual AMT are offset by eliminating or curtailing various deductions, exemptions and exclusions under current law. In providing its rationales for these measures, the panel focuses on several themes.

First, it emphasizes the need to simplify the tax system, especially for individuals, even at the expense of reducing somewhat the accuracy of the measurement of real economic income or reducing the efficiency or equity of the tax system. Second, the panel stresses the need to focus the tax system on revenue collection by eliminating various tax provisions designed to implement social policies. Third, for those social policies implemented through the tax system deemed sufficiently important to be retained, the panel focuses on rationalizing and carefully targeting the relevant tax incentives and on ensuring that they are available in some form to all taxpayers; in particular, itemized deductions would be eliminated entirely, and any credits or deductions would be available to all taxpayers (rather than just to those who itemize deductions, as under current law). Fourth, the panel strives to eliminate marriage penalties from the tax system (e.g., by setting all tax rate thresholds for married couples equal to twice those for single taxpayers). Finally, the panel stresses that the tax system should promote economic growth, primarily by reducing the tax burden on the income from saving and investment, and should minimize economic inefficiencies by reducing tax-induced distortions of individual decisions as much as possible.

Deductions for Home Mortgage Interest

The panel's general approach is illustrated clearly with its proposed treatment of the home mortgage interest deduction. Under current law, home mortgage interest on loans of up to $1 million incurred to buy or remodel a home is fully deductible, including interest on loans for second homes; in addition, interest on home equity loans is deductible on loans up to $100,000. By comparison, under an ideal comprehensive income tax, home mortgage interest would be deductible only if the return to an investment in owner-occupied housing – the imputed rent earned by the homeowner – were taxable. In the absence of such taxation, deductibility of home mortgage interest results in a subsidy to debt-financed purchases of owner-occupied housing. The rationale for such generous treatment is typically that home ownership generates significant positive externalities, as owner-occupiers are more likely than renters to maintain their properties and thus enhance neighborhood property values, and that home ownership gives people a greater stake in their communities and promotes better political decision making and long run stability.

Nevertheless, as noted in the panel's report, the extent of home ownership in the US differs little from that in other countries in which home mortgage interest is not deductible. In fact, this result is not surprising, given the nature of the subsidy to home ownership implicit in the deductibility of home mortgage interest, which provides little if any tax incentives for most first-time home purchasers, but significant incentives for the purchase of large homes and second homes. Specifically, home mortgage interest deductibility under the income tax is often characterized as an "upside down subsidy." For most first-time home purchasers, deductibility is of little or no value, either because they do not itemize deductions, or because the excess of the deduction for home mortgage interest over the standard deduction is relatively small and these taxpayers are generally subject to low marginal tax rates. Deductibility is moderately valuable for lower- and middle income home purchasers, who face marginal tax rates of 15 or 25 percent, but is most valuable for high-income individuals, who face the top marginal tax rates of 33 or 35 percent, are most likely to invest in large homes and second homes, and are most likely to engage in tax arbitrage by borrowing against their homes to invest in tax-preferred assets.

The panel's recommendations attack these problems head-on. The home mortgage interest deduction would be converted to a tax credit, available to all taxpayers rather than just itemizers, equal to 15% of interest paid on loans below location-specific caps based on the Federal Housing Administration regional loan limits, which varied from $227,147 to $411,704 in 2004.

In addition, interest on mortgages for second homes and on home-equity loans would no longer be deductible. Thus, as long recommended by many reformers, the tax incentive would be more uniform across taxpayers, as it would vary with neither filing status (itemizer or non-itemizer) nor with the marginal tax rate; the net result would be that the tax incentive for home ownership would be much more targeted toward first-time home purchasers, but would provide little incentive for the purchase of large homes or second homes. Note that these provisions, which primarily hurt high income taxpayers, would help mitigate the distributional implications of tax rate reductions that primarily benefit such taxpayers. Finally, the proposed treatment would likely reduce the large existing tax bias favoring investment, especially if financed with debt, in owner-occupied housing over nonresidential investment, and would thus improve the efficiency of resource allocation in the US. However, this effect would be muted because the new credit would be available to all individuals rather than just to itemizers as under current law; indeed, the report estimates that 88% of mortgagors would be eligible for the new tax credit, in comparison to the 54% of mortgagors who currently benefit from the home mortgage interest deduction.

Thus, although the proposed treatment of home mortgage interest is sure to create a political firestorm, the economic arguments that support such treatment, at least in the long run, are compelling (and the benefits of the current deduction, which are heavily concentrated among high income itemizers, would in any case be significantly reduced under the AMT under current law). The transition from the current system is, however, more troublesome, as the new limits on interest deductibility, especially when coupled with the elimination of deductibility for state and local property taxes (to be discussed below), would in all likelihood cause capital losses on existing homes, especially expensive homes in high income areas.

The magnitude of these losses should not be overstated, as they would be offset by a variety of factors, including increases in demand due to any reform-induced reductions in interest rates, reductions in new construction, the propensity for owners to temporarily remove existing houses from the market in response to temporary price declines, the conversion of owner-occupied houses to rental housing, short run technology and capacity constraints that limit profitable investment in other sectors, and the fact that the panel proposes increasing the amount of capital gain on owner-occupied housing that is exempt from tax (e.g., for married taxpayers, to an inflation-indexed level of $600,000 from the current unindexed level of $500,000).[25] In addition, note that owners of lower income housing might experience capital gains due to reform-induced increases in demand for their properties, and the recent increases in housing prices in many areas of the country suggest that tax reform would cause many homeowners to experience reductions in accrued capital gains rather than capital losses. Nevertheless, some transitional relief seems appropriate, and this need is recognized by the panel, which recommends a five-year phase-in period for the replacement of home mortgage interest deductibility with the new 15% credit. Many would consider this transition regime draconian, even for first homes, as illustrated by the effect on the tax saving from mortgage interest on a one million dollar, 6 percent mortgage by a taxpayer subject to the top marginal tax rate of 35 percent, where the tax saving would drop over five years from $21,000 to a maximum of barely $3,700 (ignoring for purposes of this calculation increases over time in the cap on interest eligible for the 15% credit). If deemed necessary, the transition period could be extended.

Finally, the regional differences in the loan caps are sensible in the context of alleviating the transitional problems associated with reform, since windfall losses would vary significantly with house values and thus across regions. However, it is far less obvious that such differentials should be a permanent feature of the Tax Code. Relatively high house prices presumably reflect greater locational amenities, and it is not clear why the Tax Code should subsidize the purchase of such amenities. In addition, note that many costs (e.g., general living costs, health care costs) differ across regions but are not compensated (e.g., by variable credits or caps) under either current law or the panel's two reform proposals.[26] Consideration should be given to phasing out the loan cap differentials under the home mortgage interest credit.

Deductions for Charitable Contributions

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25 For a recent discussion of the effects of consumption tax reforms on housing values, see Diamond, John W. and George R Zodrow, "Consumption Tax Reform and Corporate Equity and Housing Prices," *Rice University Working Paper*, 2005.

26 For a discussion of this issue, see Kaplow, Louis J., "Regional Cost-of-Living Adjustments in Tax/Transfer Schemes," 51 *Tax Law Review* (Winter 1996), at 175.

The panel also proposes significant changes in the tax treatment of charitable contributions. Under current law, charitable contributions are generally deductible (but only for itemizers), on the grounds that they further important social goals and, in contrast to government expenditure programs, allow taxpayers to choose the beneficiaries of their munificence. By comparison, the panel recommends that the deduction for charitable contributions be made available to all individuals, but only for contributions in excess of 1% of adjusted gross income. Thus, a tax incentive for charitable contributions would be available to all taxpayers who make sufficiently large contributions, relative to their incomes. Allowing deductibility only for charitable contributions in excess of an income-based floor (as was also recommended in *Treasury I*) saves revenue by avoiding a tax preference for relatively small contributions that are not likely to be particularly tax sensitive, while still providing a significant marginal tax incentive for larger contributions which are more likely to be tax sensitive. The recommended approach also extends the benefit of the tax preference to all individuals, including those who do not itemize deductions under current law. Of course, one could argue that the tax preference for charitable contributions should be uniform across income groups, so that the deduction should be converted to a credit, as in the case of the proposed treatment of home mortgage interest. However, since charitable contributions represent a reduction in the ability to pay tax, arguably without a significant offsetting consumption benefit, the panel's recommendation to maintain deductibility is defensible. The panel also made numerous recommendations designed to limit abuses, especially in the area of overvaluation of charitable gifts.

Deductions for State and Local Taxes

Another of the panel's recommendations that is certain to provoke significant protest, especially in states with high average incomes and relatively high levels of state and local public services, is its proposal to eliminate deductibility of all state and local taxes. Again following the reasoning presented in *Treasury I*, the panel argues that state and local taxes primarily represent payment for state and local public services received, and thus should not be deductible since they are comparable to ordinary consumption expenditures, including those for private substitutes for public goods. In addition, state and local tax deductibility results in redistribution from low income states with low service levels to high income states with high service levels, and inefficiently lowers the price of state and local public services relative to private alternatives. On the other hand, a significant fraction of state and local expenditures are redistributive in nature, in which case the "benefit tax" argument made above arguably does not apply. Nevertheless, the rationale for eliminating deductions for state and local taxes at the individual level is reasonably compelling. Moreover, in the absence of reform, the alternative minimum tax would in any case eliminate much of the benefits of this deduction.

Three caveats are, however, in order. First, certain activities of state and local governments, especially poverty programs and expenditures mandated at the federal level, no doubt generate positive national externalities. Accordingly, elimination of state and local tax deductibility should be accompanied with carefully targeted increases in matching grants for such services (with the estimates of the revenue gains from eliminating deductibility adjusted appropriately). Second, as will be discussed further below, the panel would also – inappropriately in our view – eliminate business deductions for state and local income taxes paid. Third, the panel retained the exclusion of interest on state and local bonds, an inefficient subsidy to state and local expenditures that favors high bracket taxpayers; elimination of this provision, with generous transition rules for existing debt, would have been consistent with the elimination of deductibility of state and local taxes.

The Exclusion for Employer-Provided Health Insurance

The appropriate tax treatment of employer-provided health insurance is also a contentious issue. Although it is clear that employer purchases of health insurance for employees should be deductible as a form of compensation, such payments would also be imputed to individuals and taxed as ordinary income under a comprehensive income tax. Such treatment is desirable on horizontal equity grounds, as individuals with generous health care packages clearly have a greater ability to pay tax than uncovered individuals with the same wage and salary income. It is also desirable on vertical equity grounds, as the value of an exclusion increases with the marginal tax rate, so that the current exclusion favors those with high incomes. Finally, it is desirable on efficiency grounds, as it avoids a tax bias favoring generous health insurance packages which in turn leads to over-consumption of health care; indeed, some observers have argued that tax-induced increases in health care demand have been an important contributor to recent rapid inflation in health care costs.[27]

Nevertheless, two competing arguments make a compelling case for providing some preferential tax treatment of employer-provided health insurance. First, because employment and health care needs are typically not closely correlated, purchasing insurance at the workplace provides an effective means of solving the "adverse selection" problem typically associated with private insurance purchases – the tendency for insurance to be purchased disproportionately by individuals in relatively poor health, driving up prices for relatively healthy individuals, who then elect not to purchase insurance, which increases prices further in a vicious cycle. Second, because the cost of providing health care to uninsured individuals is ultimately a public responsibility (in the form of free or low cost service at public clinics or emergency rooms), the government has a clear incentive to encourage individuals to purchase health insurance.

The panel resolves this dilemma by recommending that the current exclusion of employer provided health insurance premiums from individual taxation be continued, but limited to the cost of an "average" policy in the US, calculated by the panel as $5,000 for an individual and $11,500 for a family. The caps would be indexed for inflation (to the general price level rather than to increases in health care costs), and premiums in excess of the caps would be imputed to individuals and taxed as ordinary income. The panel also proposes a deduction for the purchase of non-group health insurance, so that the tax preference would be extended to individuals who purchase insurance outside of the workplace.

Such an approach, similar to that recommended in *Treasury I*, represents a reasonable compromise. It leaves a significant tax preference for both employer-provided health insurance and purchases of non-group insurance, while limiting the tax benefits of extremely generous insurance policies that are most likely to lead to significant over-consumption of health care services. Given the reasonable expectation that health care costs will continue to rise at a significantly greater rate than the general price level, however, the caps will become increasingly

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[27] For example, see Gruber, Jonathan and Ebonya Washington, "Subsidies to Employee Health Insurance Premiums and the Health Insurance Market," National Bureau of Economic Research, Working Paper No. 9567

binding over time, generating more revenue (especially outside the 10-year budget window) but also reducing the fraction of "basic" health insurance that is provided preferentially. It seems likely that at some point in the future, the caps should be indexed to health care costs (or perhaps a weighted average of general price inflation and increases in health care costs) in order to preserve a sufficiently large incentive for employers to provide their employees with health insurance. In addition, if it were deemed desirable to provide a tax preference for employer-provided health insurance that did not increase with income, the exclusion could be converted to an individual-level credit; however, such an approach, which would require that all insurance premiums be imputed to individuals and taxed as ordinary income, would be significantly more complicated than the deduction approach recommended by the panel.

The panel also recommends eliminating most other deductions under the personal income tax, including those for uninsured medical expenses in excess of 7.5% of adjusted gross income (AGI), employee business expenses in excess of 2% of AGI, and other miscellaneous deductions including those for uninsured casualty losses. It also proposes eliminating the exclusion of other fringe benefits, other than in-kind benefits available to all employees such as meals at an on site cafeteria, including life insurance premiums, child care costs, and educational expenditures. Such treatment is essential if the goal of significant simplification is to be achieved, and is also generally desirable on efficiency, equity and revenue grounds. In particular, eliminating the deductions of uninsured medical expenses and casualty losses would encourage the purchase of appropriate levels of insurance, since implicit insurance would no longer be provided through the tax system (although some provisions for uninsured losses due to natural disasters may prove necessary). The denial of deductions for employee expenses is undesirable in theory as long as they represent a legitimate cost of obtaining income, but results in significant simplification and reduces opportunities for abuse; note also that such treatment should encourage individuals to negotiate for reimbursement of reasonable work expenses.

<ins>The Family Credit</ins>

(March 2003).

The panel's proposals include two new credits, designed to simplify the tax system by combining a variety of existing provisions. The standard deduction, personal exemptions and child and dependent tax credits would be replaced with a single "Family Credit." The magnitude of the credit – $3,300 for married couples, $1,650 for singles, $2,800 for heads of households, plus $1,500 for each dependent child and $500 for each other dependent (including children who are full-time students and between the ages of 21-23) – is chosen to roughly replicate for lower income individuals the benefits of the provisions it replaces.

The choice of a tax credit rather than a deduction again implies that tax benefits that are independent of income level. One could argue that a deduction is more appropriate, as family allowances reflect a reduction in ability to pay tax that should be reflected as a reduction in taxable income. However, this argument is not accepted even under current law, as the benefits of the standard deduction, personal exemptions and the childcare credit are phased out at higher income levels, resulting in higher implicit marginal tax rates over the phase-out range. The panel argues that such hidden taxes are undesirable and that the phasing out of many provisions greatly complicates the tax system. Although this argument is plausible, it is not entirely convincing, as much simplicity could be achieved by rationalizing and coordinating the phase-out structures of various provisions, while the complexity of higher implicit tax rates is relatively small, and the report does provide for phasing out of the Work Credit and Savers Credit (discussed below) for low income individuals, where complexity is more likely to be a problem. Nevertheless, the decision to avoid a phase-out of the Family Credit increases the transparency and simplicity of the tax system, and increases the likelihood that individuals will be fully aware of their marginal tax rates.

The Family Credit for married couples is exactly twice that of singles, consistent with the panel's goal of reducing marriage penalties. This approach will no doubt be attractive to married couples, who would generally benefit, either from reduced marriage taxes or increased marriage dowries. However, such treatment also implies that singles will pay even more tax, relative to couples with similar income levels than under current law, even though in principle they receive roughly half of the benefits received by their married counterparts. One can be sure that singles will be outraged by the new provisions, much as they were prior to the enactment of the tax structure changes in 1969 that initially gave rise to the marriage penalties under current law. The panel chose not to recommend the alternative of individual filing, an approach used by many countries outside the US, which has the advantage of eliminating all marriage taxes and dowries, but the disadvantage of creating family tax burdens that vary significantly with the distribution of income among members of the family and encouraging the use of tax planning to equalize the incomes of spouses.

The Work Credit

The panel would replace the current earned income tax credit (EITC) and the refundable portion of the child tax credit with a single new refundable "Work Credit." Like the EITC, this credit equals varying fractions of earned income depending on family size, and has a range over which earned income is supplemented and a phase-out range over which the credit is recaptured.[28] The structure of the new Work Credit closely matches that of the EITC, except that the phase-out range is larger, reducing the additional tax on earnings implicit in the recapture of the credit, and eligibility requirements are simpler, consistent with the general focus of the panel on simplification. Like the existing EITC, the credit is generous to singles, especially those with children, and thus gives rise to significant marriage penalties when two individuals who benefit from the credit decide to marry – another argument for an individual-based rather than a family-based approach to taxation.

Savings Accounts and the Savers Credit

Although the SIT is an income tax in name, the plan – like the existing income tax in the US and other countries that utilize the tax – includes many provisions that provide for consumption tax treatment of individual saving. The panel's recommendations would expand opportunities for tax-preferred saving, while significantly simplifying the treatment of such saving by combining a wide variety of existing programs into three types of saving accounts with much simpler rules than under current law.

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[28] More specifically, the new Work Credit consists of two components, the first of which refunds the difference between the Family Credit and income tax liability for low income families with sufficient earnings and thus a sufficiently large credit, and a second component, which applies only to families with children, which consists of the remainder of the credit.

First, defined contribution pensions and the wide variety of other employer-related tax postpaid savings plans, such as 401(k) and 403(b) plans, would be combined into a single "Save at Work" account, with limits equal to those under current law for 401(k) plans. Under the SIT, these accounts would be tax postpaid, as under current law, but under the GIT, these accounts would be tax prepaid. (The panel notes that tax prepaid treatment of the Save at Work account is not an essential feature of the GIT, and that it increases revenues during the 10-year budget window but loses revenue in later years.) The Save at Work accounts would include "automatic saving" default provisions, as employees would be automatically enrolled, with automatic increases in contributions (perhaps tied to salary increases), automatic selection of balanced portfolios that would include well-diversified mutual funds, and automatic rollover in the event of a job change. Although employees could always select alternative options, considerable empirical evidence suggests that the default choices in pension plans significantly affect participation decisions and portfolio choices.[29] The panel's recommendations thus have the important advantage of increasing the likelihood that reform would increase domestic saving.

Second, saving for retirement not related to employment would occur in tax prepaid "Save for Retirement" accounts, which would replace a variety of tax prepaid plans, including Roth IRAs, non-deductible IRAs, deferred executive compensation plans, and inside buildup in life insurance policies and annuities. Up to $10,000 per year could be contributed to these accounts, which would be available to all taxpayers, regardless of income level, and would not be subject to any minimum distribution rules. In addition, traditional tax postpaid IRAs could be converted to assets in the tax prepaid Save for Retirement account by including their assets in taxable income at the time of conversion[30]; this provision is estimated to raise significant revenues during the 10-year budget window, but would also lose significant revenues in future years. As under current law, early distributions made prior to retirement would be subject to a 10% penalty.

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29 These results are reviewed in Bernheim, B. Douglas, "Taxation and Saving: A Behavioral Perspective," *Proceedings of the Eighty-Ninth Annual Conference on Taxation* (Washington DC: National Tax Association, 1997).

30 Shaviro, supra note 12, at 831 notes that the combination of tax prepaid and tax postpaid savings plans will require careful financial planning to minimize tax liabilities.

Third, all other tax preferences for saving under current law, including various education and health care plans as well as health and dependent care flexible accounts would be replaced with a single "Save for Family" account. These accounts would also be subject to a $10,000 per year contribution limit and would be available to all taxpayers regardless of income level. All withdrawals used to finance expenditures for health care, certain education or training expenses, home purchases (of a primary residence) and retirement would be free of tax, as would up to $1,000 per year for any purpose. However, withdrawals for other purposes would be subject to a tax on accumulated earnings as well as a 10% penalty. When coupled with the retirement savings accounts, the Save for Family account implies that most individual level saving, except at the highest income levels, would occur in tax free accounts, as under any consumption tax. Note, however, that the absence of any additional deductions for higher education is problematical, since expenditures on investments in human capital (but not the consumption component of obtaining additional education) should be deductible even under an ideal consumption tax as long as the associated wage and salary income is subject to tax.[31]

Finally, the existing low income Savers Credit would be maintained, simplified (including eliminating existing notch effects under which small changes in saving behavior give rise to large changes in the credit), and significantly expanded by making it refundable, with a credit equal to 25% of contributions to any of the three tax-preferred accounts. This credit would be capped at $2,000 and would be phased out at higher income levels (e.g., between $30,000 and $40,000 for married couples).

Taxation at the Business Level

Most of the differences between the two plans arise in their proposed treatments of business and capital income. Nevertheless, there are several common elements.

First, the panel would revise the rules that determine the residence of the business, which under current law specify that the place of incorporation determines a company's residence. Under the

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31 For a discussion of the effects of income and consumption taxation on investment in human capital, see Judd, Kenneth L., "The Impact of Tax Reform in Modern Dynamic Economies," in Kevin A. Hassett and R. Glenn Hubbard, *Transition Costs of Fundamental Tax Reform* (Washington DC: American Enterprise Institute Press,

panel's recommendations, a firm would also be classified as a US business if its place of "primary management and control" is in the US. This approach is clearly designed to eliminate the "inversion" problem, which arises when firms whose primary operations are in the US establish their legal residence in an offshore location. Many other countries already utilize this approach, which is long overdue in the US.

Second, as noted above, the panel would also inappropriately eliminate business deductions for state and local taxes paid, for "large" businesses, defined as those with gross receipts in excess of $10 million, under the SIT, and apparently for all businesses under the GIT. The argument that state and local taxes represent payment for government services received is unlikely to be valid in the case of businesses.[32] More importantly, even if business taxes and benefits received were closely related, such taxes nevertheless merely represent purchases of publicly provided inputs and, like all other costs of doing business, should be deductible in the determination of business profits. Finally, because the imposition of state and local business taxes tends to be rather haphazard – for example, due to sales taxation of some business purchases but not others, formula-apportioned corporate income taxes with formulas that differ dramatically across states, and relatively high property taxation of capital-intensive businesses – the efficiency costs associated with eliminating deductibility of such taxes may be relatively high. For all these reasons, state and local business tax deductibility should be maintained. Note also that the panel's reported effective tax rates on business are understated because they consider only federal taxes and thus do not capture the effect of eliminating deductibility of state and local taxes.

Third, the panel provides for simpler accounting rules for small firms. Such treatment is reasonable, given the greater relative importance of compliance costs for small firms. However, it should be noted that differences in the treatments of different size businesses create a variety of opportunities for tax avoidance and evasion. For example, requiring accrual accounting for

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2001), at 5. Judd notes that deductibility is not sufficient to eliminate a tax bias against investment in human capital if the tax system is progressive.

32 For estimates which suggest that taxes paid by businesses significantly exceed benefits received, see Oakland, William H. and William A. Testa, "The Benefit Principle as a Preferred Approach to Taxing Business in the Midwest," 14 *Economic Development Quarterly* at 154.

large firms and cash flow accounting for small firms creates opportunities for end-of-year tax deferral schemes.

Elements Specific to the Simplified Income Tax Plan

Integration of the Individual and Business Level Taxes

An important goal of the SIT is to convert the tax system in the US from a "classical" income tax under which capital income is taxed at both the corporate and individual levels to an integrated system providing for a single level of tax. Such an integrated system would lower the effective tax rate on investment in the corporate sector and reduce distortions regarding the choice between debt and equity finance (a distinction that is becoming much less meaningful with ever increasing financial innovation) and the choice between retaining and distributing earnings.[33] In addition, the relevant business tax regime would be determined by the magnitude of the gross receipts of a firm, rather than by its legal status (e.g., as a C corporation).

The panel rejected, presumably on simplicity grounds, the shareholder credit method of integration used in many European countries, under which double taxation is alleviated by providing individual shareholders with credits for taxes paid at the corporate level. Instead, it opted for a system based on dividend exclusion, under which dividends distributed by "large" firms (those with average gross receipts over the past three years in excess of $10 million) to individual shareholders are untaxed. Unfortunately, the panel rejected an approach, recommended earlier by the Bush administration,[34] under which tax exemption at the individual level would apply only for dividends paid from earnings that were actually subject to US corporate tax. (Under this approach, corporations would be required to calculate an "Excludable Dividend Amount" (EDA) of profits on which corporate tax had been paid, and dividends paid would be excluded from tax at the individual level only up to the EDA.) . In our view, the additional complexity due to such provisions is acceptable, especially since it affects only large

[33] The panel assumes the validity of the "traditional" double taxation view of the effects of dividend taxes, rather than the alternative "new" view which implies that dividend taxes do not affect marginal investment incentives for investment financed with retained earnings; for a discussion of these alternative views, see Zodrow, George R., "On the Traditional and New Views of Dividend Taxation," 44 *National Tax Journal,* December 1991, at 497.

businesses with commensurately large accounting departments, and serves the important function of ensuring that corporate income is subject to at least one level of tax under the SIT. Since the exclusion applies only to dividends paid from US income, dividends from foreign source income would continue to be taxed at the individual level. In addition, capital gains on corporate stock held for over a year would be subject to a 75% exclusion at the individual level. By comparison, interest income would generally be fully taxed at ordinary income tax rates.

This approach to integration is consistent with the cuts in dividend and capital gains taxes enacted in 2001 and 2003. In addition, by implementing the single level of tax in an integrated system at the business level rather than at the shareholder level, the proposal ensures that corporate income will be taxed (at least to the extent that the corporate income tax is enforced effectively) even if the shareholders are tax exempt institutions or foreigners.

Small firms (those with gross receipts less than $1 million) and medium-sized businesses (those with gross receipts between $1-10 million) would not be subject to a business level tax and instead would be taxed on a "pass-through" basis, with income attributed to the owners and taxed at ordinary rates under the individual income tax. Similarly, all sole proprietorships would be taxed on a pass-through basis.

The panel's approach to integration represents a reasonable solution to a long-standing problem. However, an even simpler approach to integration that imposes a single level of tax at the business level is the Comprehensive Business Income Tax (CBIT), recommended by the US Treasury in 1992, under which both interest expense and dividends are not deductible and are thus taxed at the business level, largely eliminating the need for any additional income taxation at the individual level. In addition to significant simplicity gains, due primarily to its identical treatment of debt and equity at the firm level (which eliminates the importance of classifying financial transactions as debt or equity[35]), this approach is attractive in terms of limiting transfer

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34 For a recent discussion, see Carroll, Robert, Kevin A. Hassett and James B. Mackie, III, "The Effects of Dividend Tax Relief on Investment Incentives," 56 *National Tax Journal,* September 2003, at 629.

35 In a recent analysis, Edward Kleinbard stresses that, given recent financial innovations that blur or obliterate the distinctions between debt and equity, the differential treatment of interest and dividends is the "primal flaw" of

pricing problems, as its broad base implies a relatively low statutory tax rate. It is also effective in ensuring that corporate income is taxed once, in contrast to the SIT, under which the interest on corporate bonds is untaxed if the debt is held by a tax-exempt institution or a foreigner. The CBIT thus represents a promising alternative to the approach recommended by the panel. It should be noted, however, that the disallowance of interest deductions would represent a radical departure from existing practice and would necessitate renegotiation of all foreign tax treaties.

Additional Features of the Business Level Tax

Large businesses would be taxed at a flat rate of 31.5% under a simplified version of current law, and all special deductions and credits, including the research and experimentation credit, would be eliminated. Depreciation rules would be simplified, as all assets would be placed into four categories and depreciated at fixed annual rates. Most assets would fall into the first category, which would be depreciated at a 30% annual rate. Most land improvements, utility properties and assets used for energy production would be depreciated at a 7.5% annual rate. Residential structures would be depreciated at a 4% rate and nonresidential structures would be depreciated at a 3% rate. Current rules for calculating costs of goods sold from inventory would be maintained. Interest expense would continue to be fully deductible, with no inflation adjustment, and interest income would be fully taxable.

Similar rules would apply to medium-sized businesses, although such businesses would be taxed on a cash basis rather than an accrual basis. By comparison, small businesses would be taxed on a modified cash flow basis – specifically, they would be allowed to expense all business-related purchases other than land and structures (which would be depreciated as above), provided that the expenditures were registered in a designated business bank account subject to requirements for annual reporting to the IRS. Depreciation accounting for medium-sized and small businesses would be significantly simplified as they would be relieved of the requirement to track individual assets in their depreciation accounts, and instead would pool all assets in a given category and receive a deduction equal to the product of the depreciation rate and the size of the asset pool. Asset sales would be treated as withdrawals from the pool and would be fully taxed.

the income tax; see Kleinbard, Edward D., "Designing a Tax on Capital Income," in Aaron, Henry J., Len Burman and C. Eugene Steuerle, *Taxing Capital Income* (Washington DC: Urban Institute Press, forthcoming).

The simplicity advantages of such a pooled approach have long been recognized; indeed, in our view, this approach should be extended to large firms as well.

Note that allowing expensing for small business coupled with full interest deductibility implies that such firms face significantly negative marginal effective tax rates, and pass-through treatment of such entities implies that business losses can be used to offset labor income. The proposed treatment thus creates the potential for significant tax sheltering, especially if consolidation provisions are not effectively enforced.

The biggest change in business taxation under the SIT is that it would be assessed on a "territorial" basis, with foreign source income from business activities tax exempt (passive income would continue to be taxed, subject to a foreign tax credit) and expenses attributable to the earning of such income nondeductible. Payments that are deductible abroad, such as royalties and interest expense, would continue to be taxed in the US.

Many observers have argued that the current US system, which taxes US multinationals on a worldwide basis but allows credits for foreign taxes paid and deferral of domestic tax until funds are repatriated by foreign subsidiaries to their domestic parents, raises relatively little tax revenue but imposes significant administrative costs, distorts the allocation of investment by multinationals, and reduces the international competitiveness of US firms. These arguments support the panel's decision to recommend taxation on a territorial basis. However, the biggest problem with such an approach is that it creates a huge incentive for US firms to use transfer pricing to allocate costs to domestic production and allocate revenues to foreign production, especially low tax countries. Thus moving to a territorial system is by no means a panacea, and it would remain to be seen whether such a system could be enforced effectively. In particular, the GIT would foster avoidance because, unlike the typical territorial regime, the plan does not require that foreign source income be taxed abroad before becoming exempt in the US.

Elements Specific to the Growth and Investment Tax Plan

Although the panel considered and discusses a proposal based on a pure version of the X-tax described in section 4.3, this approach did not receive unanimous support and was thus not included among the panel's recommendations. The GIT differs from the X-Tax primarily in that it includes a flat rate tax on interest, dividends and capital gains at the individual level, an approach that is similar in spirit to the "dual income tax" utilized in the Nordic countries.[36]

The Individual Level Tax

At the individual level, labor compensation would be taxed at progressive rates of 15, 25, and 30%, subject to the same individual level provisions for credits, deductions and savings plans described above, except that new contributions to the "Save at Work" account would be treated on a tax prepaid basis. Although this treatment is consistent with the tax prepaid approach that generally characterizes the X-Tax and Flat Tax proposals, it clearly generates larger revenues during the 10-year budget window. In addition, the GIT plan allows individuals to convert certain existing tax postpaid retirement plans to tax prepaid plans (requiring payment of tax on the entire value of the accounts), clearly raising short run revenues at the expense of future receipts. Thus, as explicitly recognized by the panel, the long run revenue neutrality of this proposal is open to question. Finally, the GIT plan provides for a flat 15% tax on interest, dividends and capital gains.

The Business Level Tax

For most companies, the business level tax under the GIT would be a cash flow tax on real transactions. Financial transactions, including interest income and expense, would have no tax consequences. (An exception is provided for financial institutions, which would be subject to a cash flow tax on both real and financial transactions to ensure that they are taxed on their interest rate spread. Given the extent to which many firms engage in financial transactions as part of their normal business operations, distinguishing between financial and nonfinancial businesses would be exceedingly difficult under the GIT, and avoidance problems involving mischaracterization of interest income and expense would arise – problems duly noted by the panel.[37])

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36 For a description of the Nordic dual income taxes, see Cnossen, Sijbren, "Taxing Capital Income in the Nordic Countries: A Model for the European Union?" in Cnossen, Sijbren, *Taxing Capital in the European Union* (Oxford UK: Oxford University Press, 2000), at 180.

37 Partly for these reasons, we recommended in our "hybrid" consumption tax proposal that all businesses be taxed under a cash flow tax that includes financial transactions while individuals be taxed at progressive rates on labor compensation (although pensions would continue to be treated on a tax postpaid basis). In our view, such an approach combines the best feature of the X-Tax – simplicity at the individual level – with the best features of a tax

In general, all business-related purchases would be expensed, including purchases of capital assets. Such purchases, however, would have to be made from other businesses (and thus included as receipts in their tax base). Although such treatment is desirable to limit potential tax avoidance and evasion schemes based on capital asset purchases from entities not subject to the business level tax including individuals, tax exempt institutions and foreigners[38], it is quite harsh for some legitimate transactions involving assets not held by businesses. For example, an individual who converts an existing home to rental housing would never receive a deduction for the cost of the home. The proposed treatment thus effectively imposes a windfall transitional tax on such assets.

The panel recommends that the GIT be assessed on a destination basis, with exports excluded from the tax base (production costs would be rebated through a border tax adjustment) and no deduction for purchases of imported inputs. Imports of consumption goods would also be subject to border tax adjustment. Such treatment has the significant advantage of eliminating transfer pricing problems.[39] However, as recognized by the panel, such border adjustments add significant complexity to the tax system and quite probably would not be allowed under the WTO rules, which allow border tax adjustments only for indirect taxes like the VAT and not for direct taxes like the GIT; the allowance of border tax adjustments would have to be negotiated for the GIT to be a viable option if it contained this feature. Note that, given the current US trade deficit, border tax adjustments for the GIT would be another factor giving rise to additional revenues during the 10-year budget window that would be offset at some point in the future with revenue reductions.[40]

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on consumed income – cash flow treatment at the business level that is relatively easy to implement, especially in a world where most US trading partners would continue to tax income. See McLure, Charles E., Jr. and George R. Zodrow, "A Hybrid Approach to the Direct Taxation of Consumption," in Boskin, Michael J. (ed.), *Frontiers of Tax Reform* (Stanford CA: Stanford University Press, 1996), at 70.

38 For a discussion of the avoidance possibilities, see Weisbach, David A., "Ironing Out the Flat Tax," 52 *Stanford Law Review*, at 599.

39 For a discussion of the relative advantages and disadvantages of destination-based and origin-based versions of the X-Tax, see Bradford, David F., "Addressing the Transfer-Pricing Problem in an Origin-Basis X-Tax," 10 *International Tax and Public Finance*, at 591.

40 Note also that the GIT would probably be deemed a non-creditable tax by US trading partners that tax on a residence basis but allow credits for foreign taxes paid, especially given US reluctance to allow credibility for

The enactment of any (approximately) consumption-based tax reforms such as the GIT raises significant transitional issues, especially with respect to the treatment of depreciation deductions on existing assets and interest income and expense on existing loans. In particular, immediate enactment of the GIT with no transition provisions (i.e., denial of all depreciation and interest deductions) would create a one-time windfall tax on existing capital owners (Zodrow, 2002).

On the other hand, the provision of extensive transition rules is complicated, costly from a revenue standpoint, and may be unnecessary to the extent that the windfall losses noted above are offset by other reform-induced factors, including rate reductions, efficiency gains, expanded tax exempt savings accounts that can be used to shelter existing assets from tax, and reduced tax rates on dividends and capital gains on existing assets under the GIT. The panel strikes an arguably reasonable compromise by phasing out depreciation deductions on existing assets and deductions for interest expense (as well as taxation of the associated interest income) on existing loans over a five-year period, and also providing a four-year transition period for border tax adjustments. However, given the other features of the reform which generate windfall gains for the owners of existing capital, it is quite possible that these transition provisions – although perhaps essential from a political standpoint – are overly generous.

The GIT would significantly simplify the tax system and reduce (although not eliminate) tax distortions of savings and investment decisions. Moreover, maintaining some taxation of capital income may be essential for political reasons, helps in achieving distributional neutrality, and may even be desirable from a theoretical perspective.[41] However, the taxation of capital income at the individual level under the GIT will ensure that all the complexity of taxing capital income is retained in the system while relatively little revenue is raised, especially given the proliferation

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similar taxes proposed by other countries; see McLure, Charles E., Jr. and George R. Zodrow, "The Economic Case for Foreign Tax Credits for Cash Flow Taxes," 51 *National Tax Journal*, at 1.

[41] In particular, within the context of an overlapping generations dynamic computable general equilibrium life-cycle model, a relatively low level of taxation of capital income may be desirable because leisure and consumption are not separable as assumed in many analyses which suggest that pure consumption taxation is optimal; see Erosa, Andres and Martin Gervais, "Optimal Taxation in Life-Cycle Economics," 105 *Journal of Economic Theory*, at 338. However, this argument does not apply if individuals are effectively "infinitely-lived" due to intergenerational links in individual welfares. For a discussion of the advantages and disadvantages of consumption-based taxation of capital income, see Zodrow, George R., "Should Capital Income Be Subject to Consumption-Based Taxation?" supra note 10.

of generous tax-exempt savings accounts that exist under the plan. The uniformity of the tax rate applied to capital income is also illusory, as the effective tax rate on capital gains, taking into account the benefit of deferral and exemption at death (depending on what happens to the estate tax), would be significantly lower than the effective tax rate on interest and dividends, leaving some (admittedly much smaller) distortions of investment allocation, financing and retention decisions.

The asymmetric treatment of capital income at the individual and business levels will also give rise to avoidance opportunities as individuals will be able to form businesses solely for the purpose of holding their capital assets and obtaining tax free income; rules designed to limit this avoidance technique would no doubt be enacted but would add to the complexity of the system and be difficult to enforce. Other avoidance techniques would no doubt limit the revenue yield from the proposed individual level capital income taxes. It is thus far from clear that a full-scale consumption-based X-Tax option, perhaps with somewhat higher rates, a reformed AMT targeted to capture tax shelter income[42], or a modest estate tax to achieve distributional neutrality, would not be preferable to the GIT. In any case, in our view, such an approach should have been recommended by the panel as an alternative to the two income-consumption tax hybrids proposed.

VI. Conclusion

The report of the President's Advisory Panel on Federal Tax Reform is a landmark effort that will no doubt take a prominent place among similar volumes that have proposed fundamental reform of the US tax system, including the celebrated *Blueprints for Basic Tax Reform*[43] and *Treasury I* reports. The panel's report is especially to be commended for its single-minded focus on simplification, including its proposed elimination of a wide variety of special interest

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42 For such a proposal, see Burman, Leonard, William G. Gale and Jeff Rohaly, "The Expanding Reach of the Individual Alternative Minimum Tax," supra note 13.

43 U.S. Department of the Treasury, *Blueprints for Basic Tax Reform* (Washington DC: U.S. Government Printing Office, 1977). Also available as Bradford, David F. and the U. S. Treasury tax Policy Staff (Arlington VA: Tax Analysts, 1984).

tax preferences, its proposed elimination of the individual and business level alternative minimum taxes, and its rationalization of those tax incentives it deemed essential. Implementation of either of the proposed plans would significantly reduce the costs of administering and complying with the tax system in the US (although not by as much as the implementation of a true consumption tax). In many cases, especially in its base-broadening rate-reducing proposals at the individual level, the panel reinforced the recommendations made in these earlier reports. In other cases, it developed new ideas, especially in its conversion of various itemized deductions, which are available to only to certain taxpayers and have benefits that increase with income, to flat rate credits that are generally available and provide all taxpayers with the same benefit regardless of income. In addition, both of the panel's recommended plans – the Simplified Income Tax and the Growth and Investment Tax – would reduce the distortions of saving and investment decisions that arise under the current income tax system and would foster economic efficiency and growth – conclusions supported by most empirical and simulation studies of the effects of such reforms.[44] The report thus provides an excellent plan of attack for tax reformers in the United States.

Nevertheless, the short term prospects for enactment of either of the panel's recommendations or some combination thereof do not appear particularly favorable, beyond the customary problem of fierce opposition from the special interests whose tax preferences are being eliminated or curtailed. The enactment of fundamental tax reform would provide the Bush administration with a prominent legacy to leave to future generations, a factor that may be perceived internally as highly significant, given the administration's current political unpopularity. However, the administration has already deferred consideration of tax reform to 2007 or 2008, and it seems unlikely that Congress would be willing to tackle seriously a topic as contentious as fundamental tax reform so close to a general election, especially given the nature of the tax reform problem that the US currently faces.

Fundamental tax reform would have been much easier if the tax cuts of 2001, 2003 and 2004 had not already been enacted. Some of the surplus revenues available could have been used to

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44 For a recent discussion of such studies, see Zodrow, George R., "Should Capital Income Be Subject to Consumption-Based Taxation?" supra note 10.

mitigate transitional problems and cut rates, so that fundamental tax reform could have been packaged as part of an overall tax cut with significant rate reductions. Instead, in the current environment, the proposed reforms to a large extent reflect politically unpopular base broadening with the associated revenues used to offset the revenue losses attributable to elimination of the business and individual alternative minimum taxes – a tax cut that is imperceptible to most individuals who are unaware of the impending AMT crisis – rather than highly visible and politically popular tax rate cuts.

Moreover, the tax cuts of 2001, 2003 and 2004 were primarily concentrated at upper income levels, a result that is largely inevitable for any tax cuts, given the minimal share of federal income taxes paid by the bottom half of taxpayers in the US. As a result, the beneficiaries of those cuts may not be particularly interested in a revenue neutral tax reform, while opponents will argue that the claims of distributional neutrality for the panel's recommendations are disingenuous, given the reductions in tax burdens at the upper end of the income distribution that have already occurred.

Congressional concerns about attacking the problem of projected future deficits may also dominate concerns about fundamental tax reform; moreover, there is no apparent bipartisan coalescence of interest in fundamental tax reform, in contrast to the 1986 experience, when ardent supporters of reform included President Reagan, House Republican Jack Kemp and Senate Democrat Bill Bradley.

Finally, it is difficult to build a consensus for tax reform when so many alternative plans, including those rejected by the panel, are viewed favorably by various members of Congress. Although the Bush administration may wish to leave a reformed tax structure as part of its legacy, its ability to push through what seems likely – for the reasons noted above – to be an unpopular fundamental tax reform will also be limited by its preoccupation with the war in Iraq, higher energy prices, various ongoing Washington scandals, and the failure of its proposed Social Security reforms. Thus, it seems likely that the panel's proposals will be shelved for at least the next few years. Nevertheless, they will provide an excellent set of useful recommendations for tax reform in the US and elsewhere – both fundamental and more incremental – for many years in the future.