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Moving Forward with Tax Reform

by John W. Diamond, Ph.D., and George R. Zodrow, Ph.D.

Overview

The past five years have seen renewed interest in fundamental reform of our nation's corporate and personal income tax system. This interest has been prompted by a variety of factors. There is widespread recognition that the current U.S. income tax system is a complex, highly inefficient, and costly way of raising revenues to finance government expenditures. In addition, the temporary nature of the current tax system is problematic because it interferes with individuals' and businesses' ability to make decisions, and creates the potential for a fiscal contraction at a time when the economy is fragile, thus increasing the probability of an economic recession in the near term. Furthermore, the potential for an automatic increase in taxes is slated to coincide with large reductions in spending aimed at reducing the deficit, which together are widely viewed as a poorly timed, contractionary fiscal policy path. Beyond these concerns, the reports of several bipartisan commissions focusing on deficit and debt reduction—including the report of the National Commission on Fiscal Responsibility and Reform and the alternative proposed by the Bipartisan Policy Center's Debt Reduction Task Force (the Rivlin-Domenici Plan)—have highlighted the need to reform the income tax system. In particular, these reports recognize that additional income tax revenues are almost assuredly going to have to play some role in solving our nation's looming fiscal problems—even if this role is secondary to spending reductions and cost-saving reforms of the Social Security, Medicare, and Medicaid programs. Additionally, President Barack Obama stressed the need for fundamental tax reform in his 2011 State of the Union address; the House and Ways and Means Committee is holding hearings on the topic; and several comprehensive blueprints for income tax reform were described in the 2005 report of the President's Advisory Panel on Federal Tax Reform.

- **Recommendation 1:** Satisfy the following criteria for evaluating fundamental tax reform packages: revenue neutrality, distributional neutrality and horizontal equity, simplicity, economic efficiency and tax neutrality, and a favorable environment for foreign investment.
- **Recommendation 2:** Institute base broadening, rate-reducing tax reforms for individuals and businesses.
- **Recommendation 3:** Give serious consideration to the implementation of an “allowance for corporate equity.”

Recommendation 1: Satisfy the following criteria for evaluating fundamental tax reform packages: revenue neutrality, distributional neutrality and horizontal equity, simplicity, economic efficiency and tax neutrality, and a favorable environment for foreign investment.

Numerous criteria might be utilized to evaluate proposals for fundamental tax reform. However, we would argue that any viable reform proposal must satisfy at least the following five criteria.

Revenue Neutrality

We believe that fundamental reform of the income tax structure is sufficiently difficult that the process of reform should not be encumbered by a requirement to raise additional revenues, which would ensure that many, if not most, taxpayers would end up being “losers” from reform, making the passage of reform virtually impossible from a political perspective. Although we understand that additional revenues will be needed in the future to address our nation’s deficit and debt problems as well as eliminate the Alternative Minimum Tax (AMT), we believe that raising rates within a reformed tax structure to obtain additional revenues, in conjunction with spending cuts as part of a sweeping fiscal reform package, must be treated as a separate issue if fundamental tax reform is to be politically feasible. Moreover, we believe that such treatment should be extended to the AMT and the Bush tax cuts; that is, we propose that the revenue (and distributional) baselines for fundamental tax reform assume that the AMT patches and the Bush tax cuts will be permanently extended. Thus, we propose a two-stage approach to reform—a revenue-neutral fundamental tax reform under the assumptions outlined above, followed by fiscal reform that reduces future budget deficits while reaching a compromise on distributional issues.

We would also like to emphasize that fundamental tax reform should not be held hostage to those who argue that the implementation of a more efficient and simplified broad-based income tax system is undesirable because it might facilitate greater growth in the size of government. Decisions regarding the size and scope of government must be left to the political process, and a host of instruments, including the use of budget rules to limit expansions of the size of government, are available to reduce current deficits. But perpetuating a highly inefficient and complex tax system in the hopes that it might limit the growth of government strikes us as an extremely costly and highly inappropriate way of achieving that goal.

Note also that revenue neutrality must be defined broadly to include long-run neutrality. This ensures that the long-run implications of provisions that accelerate revenues (e.g., conversion of retirement savings from traditional IRAs and similar accounts to Roth IRAs) are fully taken into account. At the same time, we believe that the definition of revenue neutrality, especially in the long run, should be broad enough to take into account conservative estimates of the dynamic revenue effects of reform-induced increases (or decreases) in economic growth.

Equity: Distributional Neutrality and Horizontal Equity

Following the approach that was successful in the passage of the Tax Reform Act of 1986 (TRA86), we believe that tax reform should be approximately distributionally neutral (using the revenue baseline described above). As in the case of revenue neutrality, fundamental tax reform is difficult enough from a political perspective without complicating matters further by attempting to redistribute the tax burden across income classes.

We also stress that another dimension of equity—the equal treatment of households with similar taxpaying capacity or horizontal equity—should guide all proposals for fundamental tax reform, as it did in TRA86 and as recommended by virtually all public finance specialists. Note that the implications of adopting horizontal equity as a prime criterion for evaluating reform proposals are far-reaching. In particular, as discussed further below, it implies that all forms of compensation, including currently untaxed fringe benefits, should be included in the tax base to the extent administratively feasible.

Simplicity

Tax simplicity is often emphasized in early discussions of fundamental tax reform, but is usually largely ignored as the process of tax reform unfolds. We believe that simplification should be advanced as an essential criterion for any current reform of the tax system. While we recognize that some tax complexity is unavoidable in measuring income accurately in today's complex economy, we nevertheless believe that there are many areas in which the tax code could be simplified significantly without seriously compromising accurate income measurement. For example, in the taxation of capital income, we are comfortable with ad hoc adjustments for inflation that assume the Federal Reserve Board is successful in achieving its goal of maintaining inflation at around a 2 percent rate, rather than an elaborate system of comprehensive inflation indexing. More generally, we support the simplification measures recommended in the 2005 Tax Panel report, including simplifying and coordinating various individual income tax credits such as the standard deduction, personal exemptions, and the earned income tax credit; collapsing the current wide array of saving and investment incentives into a very small number of simplified plans; simplifying business accounting rules, especially for small businesses and in the area of depreciation allowances; and eventually eliminating the alternative minimum tax.

Economic Efficiency and Tax Neutrality

An essential element of any successful tax reform proposal is the elimination of tax-induced distortions of economic decision-making (other than in a few very narrowly defined activities with widespread economic effects, such as investment in research and development and the emission of pollutants). As stressed in the debate surrounding TRA86, the government should, in general, not be engaged in an implicit industrial policy by distorting investment decisions through differential tax treatment of various investment activities and business sectors, and similarly should avoid distorting individual consumption decisions. We recognize that, from a theoretical perspective, economic efficiency can require differential tax rates. However, we believe that, in

practice, when one tempers efficiency considerations with equity concerns and takes into account the economic difficulties in determining an optimally differentiated tax structure as well as the political and administrative problems of implementing it successfully, simple economic neutrality—uniform tax rates on similar activities in the context of broad-based, low-rate taxes—is a reasonable approximation to an efficient tax structure. Accordingly, we believe that economic neutrality should be a key guiding principle in the formulation of any fundamental tax reform proposal. This in turn has several implications.

Most fundamentally, the general approach to reform should follow the traditional path used in TRA86 of eliminating as many tax preferences as is politically feasible and using the resulting revenues to drastically lower marginal tax rates. In our view, this implies that the elimination of many preferences that have long been considered sacrosanct, even those not touched in TRA86, should be considered seriously. Note that such reforms are desirable on efficiency, equity, and simplicity grounds, and also to limit government expenditures that occur through the tax system and are thus subject to less scrutiny than direct expenditures. Moreover, many tax preferences are poorly designed in any case. The home mortgage interest deduction, discussed further below, is an excellent example. Although its primary purpose is to encourage home ownership over renting, it is very poorly designed to achieve this goal as it offers little or nothing to low- and middle-income individuals who do not itemize, have total deductions that are less than or roughly equal to the standard deduction, or are subject to relatively low marginal tax rates. Instead, the vast majority of the benefits of the home mortgage interest deduction accrue to high-income taxpayers, encouraging overconsumption of housing at the expense of less investment in the rest of the economy.

In addition, neutral tax treatment should also be applied to saving decisions; that is, current consumption should not be favored over future consumption. In principle, this implies the tax base should be consumption rather than income. Although we believe that replacement of the income tax with a full-fledged, consumption-based tax is not feasible at the current time, current personal income tax provisions that encourage saving should be maintained (although they should be simplified, along the lines described previously), and serious consideration should be given to reducing the burden of the corporate income tax on investment income.

Favorable Environment for Foreign Investment

Finally, we believe that in today's globalized economy, the income tax system in the U.S. should not put our multinational companies at a disadvantage relative to competing firms based in other countries, and at the same time should discourage tax evasion and tax avoidance, especially in the form of income shifting to low-tax countries. In particular, the tax system should not discourage foreign investment by U.S. multinationals, and should not discourage investment in the U.S. by foreign multinationals. Although a full discussion of the intricacies of the tax treatment of foreign investment is far beyond the scope of this article, we note that (1) in order to make investing in the U.S. attractive to foreign multinationals, the taxation of capital income in the U.S. should be concentrated at the individual level; (2) the "territorial" system advocated in the "Simplified Income

Tax” proposed by the 2005 Tax Panel has the advantage of putting U.S. multinationals on an equal footing with most of their competitors, but exacerbates incentives for shifting income abroad and requires complex allocations of U.S. costs across domestic and foreign activities; (3) any approach that instead increases the inclusion of foreign income in the tax base of U.S. firms (e.g., the elimination of deferral) should be accompanied by corporate income tax rate reductions that would leave effective tax rates approximately constant; and (4) another advantage of low statutory rates under the corporate income tax is that they reduce incentives for income shifting to other countries with relatively low tax rates.

Recommendation 2: Institute base broadening, rate-reducing tax reforms for individuals and businesses

Base-Broadening, Rate-Reducing Individual Tax Reforms

We propose an individual tax reform that would substantially reduce or eliminate many tax credits, deductions, and exemptions while consolidating and simplifying other tax preferences—that is, a base-broadening, rate-reducing (BBRR) reform similar to TRA86. TRA86 broadened the tax base by eliminating the exclusion for long-term capital gains, the investment tax credit, the deduction for two-earner families, income averaging, the deduction for state and local sales taxes, and the deduction for interest on consumer loans including credit card interest. It also limited deductions for depreciation, passive activity losses, business meals and entertainment, and medical expenses, and expanded the AMT to include deductions utilized by most households. Much of the resulting revenues were used to reduce rates, although standard deductions and personal exemptions were also increased significantly. However, TRA86 did not limit or eliminate the home mortgage interest deduction, the deduction for employer-provided health insurance, the deductions for state and local income and property taxes, the deduction for charitable contributions, or the exemption of interest on public-purpose state and local bonds.

Under current law, home mortgage interest deductions are allowed for interest payments on up to \$1.1 million in mortgage principal on first and second mortgages on residences, including home equity loans. While completely eliminating the mortgage interest deduction is often deemed politically infeasible, there are several options for reducing its magnitude. We propose a combination of reducing the cap on the amount of mortgage principal on which interest receives a tax preference, coupled with either (1) deductibility of only a fraction of home mortgage interest, or (2) a fixed-rate, non-refundable tax credit for home mortgage interest. If deemed necessary to allow time for further recovery of the housing market, these provisions could be enacted with a delayed effective date.

Ending the deduction for employer-provided health insurance has been widely discussed. In 1986, this idea was rejected at least in part because it would reduce reliance on employer-provided health benefits and thus increase the pressure to implement government-funded health insurance. Although the health care reform bill was recently passed, this issue will likely continue to be a point of contention in the debate about the tax treatment of employer-provided health insurance. We propose to cap the deduction

for employer-provided health insurance, and then to gradually allow it effectively to shrink by indexing the cap only to general inflation (rather than to the inflation in health care costs). This would raise revenues over time and allow for a longer and smoother transition from current policy.

The deduction for state and local taxes reduces the effective price for state and local services for individuals who itemize. Many observers, including the 2005 Tax Panel, have argued that state and local taxes approximate payments for public services received and thus reflect consumption expenditures that should not be deductible; moreover, to the extent such services do not provide significant national spillovers, deductibility encourages overprovision of state and local public services. In addition, the deduction is regressive because it increases in value with the tax rate and is thus positively related to income, and is available only to itemizers. We propose full repeal of the deduction for state and local taxes under the personal income tax on the grounds that most state and local expenditures approximate consumption expenditures and do not have significant national spillovers. Similarly, the tax exemption for interest on public purpose state and local bonds encourages overconsumption of state and local services to the extent that they do not generate national externalities and creates a tax bias favoring debt finance. We propose that this exemption be eliminated for new state and local bonds (existing bonds would be grandfathered). We recognize that direct federal expenditures would have to increase to provide subsidies to those state and local activities that generate significant national externalities.

The deduction for charitable contributions is often justified on the grounds that the organizations that receive charitable donations produce national external benefits that should be subsidized and that the deduction allows individual choice of the activities supported. We propose to transform the deduction into a nonrefundable fixed-rate credit that can be claimed by all taxpayers that give more than two percent of adjusted gross income.

Individual reform should also limit and restructure the number of benefit provisions for low-income taxpayers and families with children. These provisions include the child tax credit, the earned-income tax credit, the child and dependent care credit, head of household filer status for unmarried taxpayers with dependents, and personal exemptions. We propose consolidating and reducing the various provisions and simplifying the structure of the provisions, along the lines recommended by the 2005 Tax Panel.

Reform should also reduce the number of provisions related to retirement savings and expand the programs to encourage low-income families to save. We propose to simplify the current system by reducing the number of options to no more than two or three programs, again following the lead of the 2005 Tax Panel, and to expand the low-income savers credit to allow low-income savers to better plan for retirement.

A BBRR individual tax reform that eliminates most tax expenditures and uses that revenue to reduce tax rates, expands incentives to save, and simplifies the tax code would be a critical first step toward fiscal responsibility, balancing the need for revenue, minimizing the efficiency costs of taxation, and achieving an equitable tax system.

Business Tax Reforms

We also propose a traditional BBRR reform of the corporate income tax that would eliminate as many tax preferences as politically feasible and use the resulting revenues to lower the corporate tax rate, along the lines of the reforms accomplished in TRA86. As stressed above, a BBRR reform of the corporate income tax would, in general, be highly desirable. In particular, such a reform would reduce costly distortions of economic decisions and thus promote economic growth and efficiency in resource allocation; simplify tax administration and compliance; reduce incentives for tax evasion and tax avoidance, including incentives for income shifting abroad by U.S. multinationals; and create a fairer tax system.

The primary objection to such a reform, which was also voiced during the debate surrounding TRA86, is that a BBRR reform is not well-targeted toward new investment, and instead confers much of its benefit to existing capital and to investments that earn above-normal economic profits. Critics of the BBRR approach argue that maintaining a high statutory tax rate on all investments, including existing investments and those that are highly profitable—coupled with the introduction of investment incentives such as an investment tax credit or more accelerated depreciation allowances (including partial expensing) that apply only to new investment—is a less costly, better targeted, and thus preferable approach.

Although this argument has some merit, it must be qualified in several ways. Most importantly, a lower statutory rate under the BBRR approach reduces incentives for income shifting by U.S. multinationals (through the use of transfer pricing, debt reallocation, the relocation of patents and other intangible assets, and similar activities), which is a significant factor, given the accumulating empirical evidence which suggests this is currently a serious problem. In addition, rate reduction will attract investments by both U.S. and foreign multinationals that generate above-normal profits, which in turn will contribute to revenues. In our view, these arguments, when coupled with the traditional case for BBRR reforms, make a compelling case for following this traditional approach to fundamental tax reform.

With respect to identifying potential base-broadeners or tax preferences that should be eliminated and used to finance rate reduction, a comprehensive list is provided in the U.S. Treasury's 2007 report on improving the competitiveness of the business income tax system. The most important items are accelerated depreciation allowances, the special deduction for U.S. manufacturing activities, and the research and experimentation credit (which arguably should be maintained for the reasons discussed above). In addition, the report lists many other tax preferences that are potential base broadeners. Note, however, that these should not include eliminating deductibility of state and local taxes paid by

businesses, even though this was recommended by the 2005 Tax Panel report; such taxes represent a cost of doing business (even if they are direct payments for public services received) and should be deductible.

Recommendation 3: Give serious consideration to the implementation of an “allowance for corporate equity.”

We close by mentioning a more ambitious and economically sound—but politically more difficult—potential additional element of fundamental tax reform. Although the BBRR approach outlined above has many advantages, our proposed reform—like TRA86—would neither eliminate the tax bias favoring debt finance under the current income tax (which arises because interest on debt is deductible but dividends paid to shareholders are not), nor would it reduce the overall level of investment disincentives under the current corporate tax. Accordingly, we believe that as part of the process of fundamental tax reform, serious consideration should be given to the implementation of an “allowance for corporate equity” (ACE) that would result in roughly uniform treatment of debt and equity finance and lower the taxation of investment income at the business level to that associated with a consumption-based tax. This approach, which was recommended recently by the tax reform commission headed by Nobel Prize-winning economist James Mirrlees in the United Kingdom and has been implemented successfully in a small number of countries, allows firms an extra deduction equal to the product of the book value of equity capital and a risk-free nominal interest rate. The economic effect of the ACE is to put debt and equity finance on an equal footing at the business level, as the ACE deduction for equity-financed investment is comparable to the deduction of interest expense for debt-financed investment. Moreover, the ACE approach can be applied to all businesses, perhaps with an exception for small firms, and thus would eliminate the current income tax bias against corporate entities.

Relative to the much more commonly discussed option of expensing, the ACE has many advantages as a means of implementing a consumption-based business tax. Most importantly, firms continue to deduct depreciation and interest expense as under the current income tax system, in comparison to expensing interest deductions being disallowed to avoid negative effective tax rates (the Flat Tax provides for such treatment). The ACE plan thus looks much like the current system, which implies it raises relatively minor transitional issues; moreover, the ACE deduction can be limited to new investment to reduce the revenue losses associated with its implementation. In addition, (1) the short-run revenue loss under the ACE is considerably smaller than with expensing; (2) fewer firms are in a loss position under the ACE than with expensing, avoiding the problematic issues that arise with negative tax bases; (3) financial institutions are taxed like all other firms (they are exempt under the flat tax); (4) because depreciation deductions, interest deductions, and the allowance for corporate equity are taken each year (in contrast to expensing which occurs only in the year of investment), changes in future tax rates do not affect investment decisions as they do with expensing; and (5) the ACE system results in relatively accurate income measurement, as any error in

depreciation accounting or in the implicit inflation adjustment for a capital asset due to accelerated depreciation is offset by an equal and opposite error in the calculation of the allowance for corporate equity.

The ACE would of course cost revenue. Since we believe that taxes at the corporate level should be kept low to make investment in the U.S. attractive for foreign investors, we believe that this revenue should be recovered with higher individual-level taxes on dividends and capital gains. Although politically difficult, this would also facilitate meeting our goal of maintaining distributional neutrality. The goal should be a tax system that provides roughly uniform treatment of all forms of investment, taking into account both the corporate and individual tax burdens.

Finally, if a move to a full-scale ACE is too costly or too difficult from a political perspective, a partial ACE—that is, a partial deduction of the type described above—could be utilized. Indeed, if deemed desirable, the fraction deductible could even be varied depending on macroeconomic conditions, with the fraction of the ACE deduction permitted to increase during cyclical downturns (we resist the temptation to refer to this plan as the “ACE in the hole”). Such an approach would be far preferable to the current practice which uses partial or full expensing as a counter-cyclical instrument to stimulate investment, since expensing applies equally to both debt and equity financed investments, resulting in subsidies to the former while leaving the tax bias favoring debt intact. By comparison, a partial ACE would lower the tax burden only on equity-financed investment, narrowing the differential between the tax treatment of debt and equity-financed investment while providing an overall stimulus to investment.

Conclusion

Several recent reports on fixing our nation’s fiscal tax crisis have focused attention on the need for fundamental reform of the corporate and personal income tax systems. In this paper, we focus on delineating the general principles that should guide any fundamental tax reform effort; however, we also identify the general outlines of what we believe fundamental reform of both the individual and corporate income tax systems should entail.

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