A New Tax Framework:
A Blueprint for Averting a Fiscal Crisis

A Statement by the Research and Policy Committee
of the Committee for Economic Development

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Purpose of This Statement

Responsible projections of federal expenditures and revenues indicate an impending fiscal crisis. This prospective explosion of future budget deficits is driven primarily by rapidly rising health care costs and the aging of our society. As this report shows, even very substantial restraint in the growth of federal expenditures is unlikely, in itself, to restore fiscal stability.

In the longer term, far-reaching structural reforms in our health care system and federal entitlement programs are not only necessary, but inevitable. Tax revenues cannot rise to cover expenditures rising to 30, 40, and 50 percent of GDP without severely damaging the economy. But, even in conjunction with substantial spending restraint, tax revenues will also have to rise to restore a sustainable fiscal policy.

In *The Emerging Budget Crisis: Urgent Fiscal Choices* (May 2005), CED argued that the fiscal problem is structural and, as such, requires a structural solution. Although in that statement we focused primarily on federal spending, any comprehensive approach requires an examination of the revenue side as well. CED believes we must broaden the current tax reform discussion to include the critical issue of revenue sufficiency. This policy statement therefore focuses on reforms of the tax system. We specifically address deficiencies in the current income tax, which is complex, inefficient, inequitable, and inadequate for raising needed revenues.

Our recommendations outline a new tax framework, including a value-added tax (VAT) to supplement an improved and simplified income tax. CED believes that the nation needs both a VAT and an income tax—the former to ensure sufficient revenues to pay for government, the latter to ensure the progressivity of the overall tax system. We recommend modifications to the income tax to reduce its complexity (including repeal of the alternative minimum tax, or AMT) and improve its efficiency and equity, as well as changes in the tax-writing and budget processes. We believe this new tax framework can help avert the impending fiscal crisis and create a sound foundation for future growth and prosperity.

Acknowledgements

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Executive Summary

The U.S. fiscal system faces two major problems. The first is an impending fiscal crisis; large and growing Federal budget deficits will soon threaten our economic growth and living standards. The second problem is that the tax system has become unnecessarily complex and riddled with inequitable special preferences that distort our market economy. These two problems are closely related: an ineffective tax system cannot raise the revenues required to finance Federal expenditures and restrain budget deficits without placing heavy burdens on the economy and society. We need a simpler, more efficient, and fairer tax system as the foundation of a more productive economy and a sound long-term fiscal policy.

The fiscal crisis ahead will be driven largely by the impact of escalating health care costs on Medicare and Medicaid expenditures, but also by the demographics of an aging society. *These cost pressures will be so intense that fundamental changes in our health care system, and correspondingly large reductions in the growth of Medicare and Medicaid spending, are unavoidable*. Taxes cannot rise to cover federal expenditures that rise exponentially to 30, 40, and 50 percent of GDP. Tax increases of this magnitude are politically infeasible and would overwhelm the economy.

However, expenditure reductions alone will not be enough. Congressional Budget Office projections indicate that even aggressive and painful changes to reduce expenditures in Medicare and Medicaid, with other spending restraints, are unlikely to restore fiscal balance if federal revenues remain at historical levels. As CED argued in its 2003 budget statement, the nation must undertake a budgetary "war on all fronts" by reforming entitlement programs, reducing discretionary (annually appropriated) spending, *and* by raising additional revenues. CED has previously made recommendations for changes in Social Security and the health care system and continues to work on these critical expenditure issues.[a] This policy statement, however, focuses on revenues and the tax system.

In theory, additional revenues could be provided simply by raising income tax rates. However, the current income tax system is complex, inefficient, and inequitable. The proliferation of special tax preferences confronts the taxpayer with bewildering complexity and impairs compliance with and enforcement of the law. These preferences are also inequitable and impair economic efficiency and growth. Raising the tax rates of this dysfunctional system would compound existing distortions and disincentives, further damaging the economy.

The income tax therefore should be reformed by eliminating, reducing, and consolidating special tax preferences to the extent feasible. This will make the system simpler, fairer, and more efficient, promoting economic productivity and growth. However, even an improved income tax is unlikely to meet our revenue needs, because there are major political and policy constraints on how far we can go in eliminating such preferences and broadening the income tax base. Such a program, however desirable, is therefore unlikely to raise large amounts of additional revenue. Indeed, a simplification and base-broadening program that repeals the Alternative Minimum Tax (AMT)—the most complex and problematic feature of the current system—is likely to raise *less* revenue than the present system.

[a] See CED, *Fixing Social Security* (Washington, D.C.: CED, 1997) and CED, *A New Vision for Health Care: A Leadership Role for Business* (Washington, D.C.: CED, 2002).

In addition, raising income tax rates will prove a counterproductive long-term strategy for increasing revenues, as globalization makes capital more mobile. Domestic production and jobs will become more likely to move offshore, and foreign capital less likely to be invested here, as income tax rates (and especially corporate rates) rise. Under these circumstances, the burden of capital income taxation will increasingly be shifted to workers.

We therefore need a new revenue source to supplement an improved income tax. CED proposes a national value-added tax (VAT), combined with modifications to the income tax (including a refundable low-income credit) that will shield the poor from the VAT and preserve overall tax progressivity. The United States needs *both* a VAT *and* a simpler, progressive income tax—the former to raise additional revenues on a very broad base in an economically neutral manner, the latter to preserve the fairness of the tax system.

This new hybrid tax framework would greatly improve the U.S. fiscal outlook. Budget projections show that, under current tax policies that produce insufficient revenue, even quite severe spending restraint (as described below) is unlikely to restore fiscal balance or even a sustainable fiscal policy. In comparison, however, the additional revenues raised in the CED tax framework, if combined with similar spending restraint, would produce budget balance or surpluses for a number of years. The new revenues would not only reduce deficits and debt directly, but, by forestalling an explosion in interest costs, allow us to "buy time" to restructure health care and other expenditure programs. The proposed CED tax framework would raise net revenues by about 3.7 percent of GDP; an increase in income tax rates of 35-40 percent would be required to produce equivalent revenues.

CED also makes recommendations to improve the taxation of capital income, reform the legislative process to improve tax and budget policies, and provide the resources and support to the Internal Revenue Service (IRS) required to strengthen compliance and enforcement.

Taken together, CED's recommendations involve major changes in our tax system. However, unlike some "fundamental tax reforms" that involve scrapping the income tax entirely and thereby creating enormous problems for the transition to a new system, this "hybrid" system would be more feasible politically and could be more easily implemented. The fundamental structure of the income tax would not change, and the journey to a VAT, which would admittedly require many difficult choices, would take place on the well-prepared ground that over 100 other nations have covered in recent decades.

Summary of CED's Recommendations

1. **Eliminate and Reduce Tax Preferences, Simplify the Tax System, and Broaden the Tax Base.** We should remove unnecessary complexities and reduce or eliminate tax preferences that do not have a compelling rationale. Remaining preferences should be consolidated and simplified, and in some cases deductions should be converted into credits. Consolidation of low-income and education credits and the reform of saving preferences offer important opportunities for simplification.

2. **Phase In a Broad-Based 10 Percent Value-Added Tax (VAT) To Supplement the Income Tax.** A VAT would provide additional revenues to help meet the impending fiscal crisis and to allow lower income tax rates (and thus smaller economic distortions) than would otherwise be required. The VAT base should be as broad as possible, to enhance both economic neutrality and revenues. The VAT's distributional effects should be addressed by modifications to the income tax, not by exclusions of particular goods and services from the VAT.

3. **Modify the Income Tax To Protect Low-Income Households and Support Progressivity.** A common objection to a VAT is that it is regressive. However, the income tax can be modified to address this problem by restructuring and expanding a refundable low-income tax credit, modifying income tax rates for those with tax liability, and increasing the standard deduction to raise the tax-entry threshold.

4. **Repeal the Individual and Corporate Alternative Minimum Taxes.** With AMT repeal, those targeted provisions of the AMT that discourage aggressive tax shelters should be incorporated into the regular income tax. We do not need two parallel tax systems to reduce tax preferences and promote equity. *However, the introduction of a VAT and repeal of the AMT must be accompanied by changes in the income tax rate structure, standard deductions, and low-income credits to support the progressivity of the overall tax system.*

5. **Rationalize Capital Income Taxation by Integrating the Individual and Corporate Income Taxes, Narrowing the Differential Treatment of Ordinary Income and Capital Gains, and Modifying the Estate and Gift Taxes**. We should tax capital income once, but only once, at rates that approximate those on other forms of income. The differential between the top rate on ordinary income and that on capital gains should be narrowed to reduce incentives for arbitrage and tax shelters. The estate tax should be retained. One option would be to continue in 2010 and thereafter the scheduled 2009 exemption of $3.5 million ($7 million for couples) and top rate of 45 percent, with the exemption indexed for inflation.

6. **Improve the Processes for Making Tax and Budget Policies**. Process changes are essential to help protect a new tax framework against renewed onslaughts of complexity and revenue erosion. In addition, rules for budget control should be restored and new requirements should be established for Congressional consideration of the long-term effects of fiscal policy.

7. **Provide the Internal Revenue Service with Political Support and Resources** required to support the integrity and revenue-raising capacity of the tax system.

This policy statement was completed before Hurricane Katrina struck New Orleans and the Gulf Coast on August 29, 2005. In addition to its immense toll in human life and suffering, the hurricane will have large effects on the Federal budget. In the near term, early estimates indicate an increase in expenditures (and the budget deficit) for fiscal years 2005-2006 of $100-200 billion. There are also likely to be significant longer-term effects, in addition to the inevitable interest costs of the larger near-term expenditures. Costs of programs for relief, relocation, and rebuilding are likely to continue for some years. In addition, it is likely that expenditures to prepare more adequately for natural disasters will be permanently higher. Although it is not possible to incorporate such long-term effects into projections at this time, CED believes that these budgetary effects strongly underline the central message of this policy statement: that a new revenue source will be needed to supplement expenditure controls in averting a future fiscal crisis.

I. Introduction: Why This Policy Statement?

There is widespread agreement that the U.S. tax system needs reform. This becomes evident when our fiscal practices are evaluated against the principles that should govern them. CED believes that our tax system should be:

- Capable of raising sufficient revenue to pay for the government expenditures mandated by the political process;
- Equitable, according similar treatment to those in similar circumstances;
- Economically neutral, allowing market forces to allocate resources;
- Progressive, distributing tax burdens according to ability to pay;
- Simple and transparent, imposing as little cost as possible on taxpayers and government.

These goals, of course, often conflict, requiring compromises. Nevertheless, it is evident that the current tax system fails all of these tests. We believe this failure poses enormous risks for the nation in the years ahead. This policy statement analyzes some of the reasons for this failure and makes recommendations to improve the system.

The U.S. fiscal system faces two major challenges. First, an impending fiscal crisis: federal revenues are recovering only modestly from a 45 year low relative to the size of the economy, in the face of large budget deficits and rising debt burdens. These structural deficits, already large and persistent enough to cause serious fiscal concern, threaten to explode in the future under the pressures of rising health care costs and an aging society. As we note below, *these pressures will ultimately require major structural changes in health care and retirement programs to reduce the growth of expenditures*. But even quite severe expenditure restraints are unlikely to prevent a rapid rise in budget deficits under current and prospective tax policies. We therefore believe that *additional revenues also will be essential to restore fiscal balance*.

The second challenge is a tax system that has become riddled with special preferences that are inequitable, distort our market economy, are often regressive, and make the system complex, burdensome, and expensive. These two problems are closely related; *a dysfunctional tax system cannot raise the revenues required to finance federal expenditures and rein in budget deficits without jeopardizing the economy and fracturing society*. We need a simpler, more efficient, and fairer tax system as a foundation for a more productive economy. We need such a system today. But this need will become critical when the retirement of the baby-boomers begins to drive federal expenditures on health care and retirement much higher toward the end of this decade.

This policy statement first examines the impending fiscal crisis, explaining why we must act to meet it, and why we must act now. We also show why this crisis demands "a war on all fronts," encompassing both comprehensive expenditure reductions *and* an increase in tax revenues, as CED said in *Exploding Deficits and Declining Growth* (2003).[1]

We then describe the most serious problems of our current income tax system and suggest changes in tax policy that will ameliorate them. We make three broad arguments:

(1) We must eliminate, reduce, and consolidate special tax preferences wherever possible. This will make the

system simpler, fairer, and more efficient, promoting economic productivity and growth. The reduction of tax preferences will also broaden the income tax base, thereby raising revenues or permitting lower tax rates. We make some specific recommendations and provide illustrations of other such measures.

(2) We recognize that realistically there are major political and policy constraints on how far Congress is likely to go in eliminating preferences and broadening the tax base. Therefore, however important such efforts are in promoting simplicity, efficiency, and equity, they are unlikely to raise large amounts of additional revenue. Indeed, a simplification and base-broadening program that repeals the Alternative Minimum Tax (AMT)—the most complex and problematic feature of the current system—may raise *less* revenue than the present system. In addition, continually rising income tax rates may endanger domestic production and jobs as capital becomes more mobile internationally.

(3) We therefore argue that a new revenue source must be developed to supplement an improved income tax. Continually raising income tax rates to meet future needs would be economically harmful and politically unacceptable. We propose a national value-added tax (VAT), with modifications to the income tax that will preserve overall tax progressivity. *We believe that the United States needs both a VAT and an income tax—the former to raise revenues in an economically neutral manner that does not penalize saving, the latter to preserve the progressivity of the tax system*. We also make recommendations to rationalize the taxation of capital income, reform the legislative process to improve tax and budget policies, and provide the resources and support to the Internal Revenue Service (IRS) required to have an effective and fair tax system.

These goals and recommendations are very far-reaching. Many will see them as unrealistic, since the political barriers to extensive tax reform are notoriously obdurate. They will be strenuously opposed by those who reject all tax increases, those who would continually raise income taxes, and those especially favored by the preferences in the current system. The acceptance of painful change, however, will increase as the reality of destructive and unsustainable deficits becomes more apparent. When the fiscal crisis overtakes us, major changes in expenditure and tax policy, for better or worse, will become inevitable. If we do not now think clearly about where we wish to go, we won't get there.

II. The Impending Fiscal Crisis

Why We Must Act: The Dimensions of the Fiscal Crisis

In 2003 we concluded that the United States confronted an extremely large structural federal budget deficit. A recent estimate puts the "fiscal gap" between projected expenditures and revenues at about 7.1 percent of gross domestic product (GDP) through 2080, assuming we continue to follow current policies.[a] This long-term fiscal gap has risen by about 6 percentage points of GDP since 2001, an extraordinary deterioration of the fiscal outlook.[2]

In our 2003 policy statement, we explained why such large and growing budget deficits, with the resulting burgeoning debt burden, are a threat to our economy and society. They will slow and possibly even reverse increases in living standards, endanger economic stability, force severe cuts in even those federal expenditures that foster growth and equity, and transfer large fiscal burdens to future generations. While we do not repeat those arguments here, they remain a compelling rationale for this statement on tax policy.

By far the largest source of the fiscal gap is the growth in expenditures on health care in the Medicare and Medicaid programs, which are projected to rise dramatically from 4 percent of GDP today to about 14-17 percent in 2030.[3] These rising federal expenditures reflect the escalation of health care expenditures generally, as advancing medical technology stimulates society's demand for the benefits of that technology and the population ages. Medical progress provides great benefits, and substantial increases in health care demand and expenditures, both public and private, should be expected. But the health care delivery system is also economically dysfunctional and often does not provide patients or medical providers with incentives to reduce costs or restrict consumption of relatively low-value services, thereby pushing expenditure growth even higher.[4]

Public expenditures will also rise as the rapidly expanding retiree population presents its claims for Social Security and other public pensions. Under the current benefit structure, Social Security spending will rise from about 4 percent of GDP today to nearly 6 percent in 2030. Because Medicare, Medicaid, and Social Security comprise 43 percent of federal program expenditures and are growing so rapidly, major changes in their structure and financing ultimately will be not only necessary, but inevitable.

As though these alarming pressures on future resources didn't exist, we have chosen to raise the base for future spending in the last few years by rapidly increasing expenditures. New national security requirements are an undeniable reality. But we have also enacted prescription drug legislation that greatly raises Medicare costs, larger farm subsidies, and sharp increases in non-defense appropriations that accounted for nearly half of a 56 percent increase in discretionary spending during 1999-2004.[5]

Recent tax policy has also increased the long-term fiscal gap. In 2004, federal revenues fell to 16.3 percent of GDP, the lowest level since 1959, and individual income tax revenues of 7.0 percent of GDP were the

[a] A 7.1 percent fiscal gap means that immediate and permanent reductions in spending or increases in revenues totaling 7.1 percent of GDP would be required to maintain the current ratio of federal debt to GDP through 2080, so that debt does not grow beyond the capacity of the economy to service it. For assumptions behind the estimate, see endnote following.

lowest since 1951. In the near term, the 2001-2004 tax cuts have raised the 2001-2011 deficits by about 1½ percent of GDP; in the long term, if extended permanently, they contribute about 2 percent of GDP to the fiscal gap.[6]

The dimensions of the long-term fiscal crisis are shown in Figures 1 and 2, which reflect projections of revenues, spending, deficits, and debt by the Congressional Budget Office (CBO).[7] In both figures, revenues are assumed to rise over the next few years from their unusually low current level to their historical average of 18.4 percent of GDP, as a result of the "bracket creep" associated with real growth in taxable incomes. Revenues are then adjusted to remain at that level, presumably through occasional tax reductions, consistent with historical experience.

Two expenditure projections are used to derive Figures 1 and 2. In the "historical spending" projection, Medicare and Medicaid costs per enrollee grow roughly in line with historical experience and defense spending conforms to the Administration's 2004 Future Years Defense Program (with allowances for cost risk). In the "restrained spending" projection, Medicare and Medicaid costs grow much more slowly, as does defense spending, as explained in the figures. *It is essential to recognize that this second path implies very substantial, indeed unprecedented, restraints on Medicare and Medicaid spending.* Two leading health economists note that achieving these spending reductions would be a "monumental achievement" requiring "aggressive action…including some increase in the age of eligibility for Medicare, increased cost-sharing, selective purchasing, and the application of information technology." Even with such measures, some rationing of care would likely prove necessary.[8]

Under the historical spending projection, the deficit explodes and exceeds 10 percent of GDP by 2027 before rising to even more implausible levels. But even under the restrained spending scenario, the deficit rises very rapidly, beginning in the next decade, to levels unprecedented in peacetime. As Figure 2 shows, with revenues at historical levels, both spending projections imply an ever-increasing ratio of federal debt to GDP, which is unsustainable in the long term. These projections, therefore, do not indicate what is "likely to happen" in the future. Rather, they show that current

Figure 1

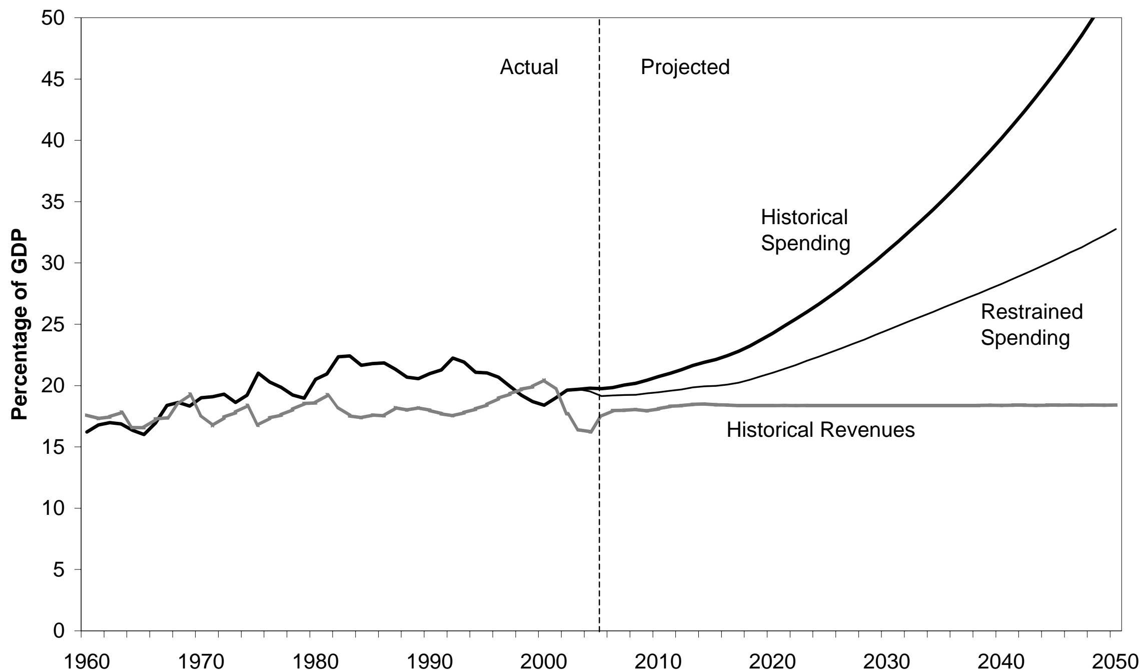
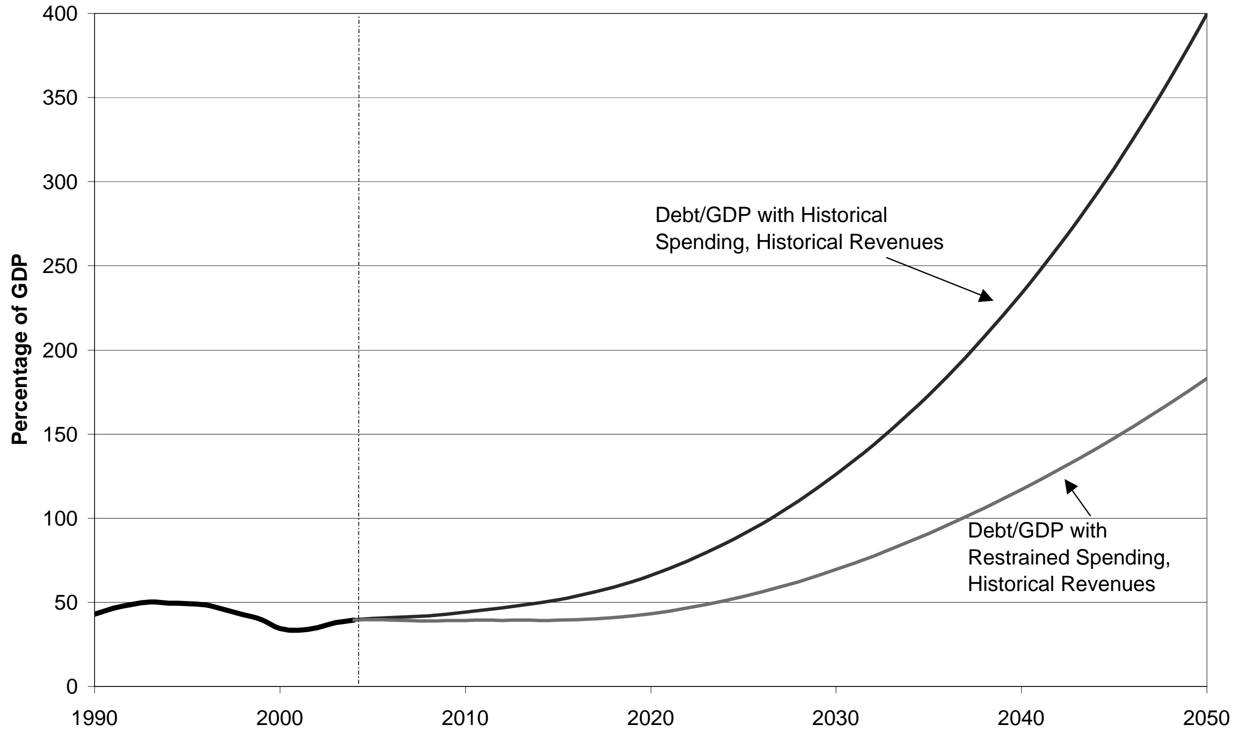


Figure 2



Source: Congressional Budget Office: *The Long-Term Budget Outlook*, December 2003.

Both projections assume that tax policy is adjusted such that revenues increase gradually from their current low level of 17.5 percent of GDP to their 30-year historical average of 18.4 percent of GDP in 2012 and then continue at that level until 2050. The "historical spending" projection assumes that Medicare and Medicaid "excess cost growth" (the difference between the growth of costs per enrollee and that of per capita GDP) continues at the historical rate of 2.5 percent per year, defense spending follows the Administration's 2004 Future Years Defense Program to 2022 and then grows with inflation, all currently scheduled Social Security benefits are paid, and other spending remains at its historical share of GDP. The "restrained spending" projection differs primarily in assuming that Medicare and Medicaid "excess cost growth" is only 1.0 percent per year, and that defense spending phases down until 2022 before growing with inflation. Other categories of spending follow the same trends as those in the historical spending projection.

fiscal policies are *unsustainable* and will have to be radically altered.

How can we predict confidently from such crude projections that radical changes in fiscal policy must be made? While five- and ten-year economic and budget projections have proven to be notoriously fallible, these long-term expenditure projections are likely to be much more robust. First, the fundamental factors driving the projected rise in expenditures—rapid technological change and the rising societal demand for health care and the aging of the society—are firmly established, even if their effects cannot be measured precisely. Second, the long-term budgetary excesses are so large that, even if much more optimistic assumptions are made, the long-term trends all point in the same direction, as Figure 2 indicates. Third, although stronger economic growth can ameliorate this dire outlook, it is extremely unlikely that even a dramatic acceleration of economic growth will allow us to "grow our way out" of the problem. CED has estimated that to do so, even over the next 50 years, would require a 50 percent increase in the rate of productivity growth (of labor and capital combined).[9] This would defy historical experience. It would be irresponsible to proceed in the belief that radical fiscal policy changes can be avoided.

Why We Must Act on All Budgetary Fronts

There are two essential lessons to be drawn from Figures 1 and 2:

1. *In the long term, fundamental changes in our health care system, and correspondingly large reductions in the growth of Medicare and Medicaid spending, are unavoidable. Taxes cannot rise to cover expenditures that rise exponentially to 30, 40, and 50 percent of GDP. Tax increases of this magnitude would overwhelm the economy.*
2. *Expenditure reductions alone will not be enough. At historical revenue levels, even far-reaching changes in Medicare and Medicaid that greatly moderate their growth would not resolve the problem, as the "restrained spending" projection shows. Additional revenues will also be necessary.*

Faced with this alarming long-term fiscal outlook, CED's 2003 report concluded that the nation must undertake a budgetary "war on all fronts" by reforming entitlement programs, reducing discretionary (annually appropriated) spending, and raising new revenues. With regard to entitlement programs, CED previously made a proposal to make Social Security permanently solvent and recommendations for reforms in the pension and health care systems, and is continuing work on these issues.[10] This policy statement, however, focuses on revenues and the tax system.

One important reason that additional revenues will be required is that it will take time to make the public and private sector changes required to slow the growth of health care expenditures, even if we can agree on how to do so.[11] No clear direction for doing so is apparent today. As CBO has noted, "Most of the options to constrain spending that have been proposed in the Congress or by health care experts would not substantially diminish the upward trajectory of the programs' spending."[12] Without additional revenues, deficits would feed on themselves as interest costs and debt balloon. (In the historical spending projection, interest costs rise nearly 10 times as fast as program spending between 2005 and 2030.) This fiscal hemorrhaging would make the budget increasingly unmanageable and greatly restrict options in the future. As shown in Section V below, a timely increase in revenues, by forestalling such an explosion of debt, would "buy time" for a necessary restructuring of health care programs.

In addition to far-reaching changes in health care and other entitlement programs, discretionary spending in defense, international, and domestic programs must also be reined in. The global war on terrorism must not become a rationale for relaxing fiscal discipline; indeed, the demands it places on our resources require more scrutiny, not less. As we said in 2003, the defense budget must be cost-effective and focused sharply on the new national security situation, and homeland security expenditures will require special attention. Non-security discretionary programs must be examined much more carefully than in the past and eliminated or reduced if ineffective. We applaud the administration's attention to ineffective programs in its 2006 budget and urge Congress to establish tight controls over appropriations.

However, even with greater fiscal discipline, cuts in discretionary programs cannot provide long-term budgetary savings of the magnitude required. In recent decades, the defense budget did provide substantial resources, as defense spending fell from about 5½ percent of GDP in the early 1980s to 3 percent in 2000, reflecting both a long-term trend and the end of the Cold War. This decline made room in the budget for growth in other expenditures, especially Medicare and Medicaid. But now that the GDP share of security spending is historically low, it is no longer possible to "squeeze out" of the defense budget another 2-3 percent of GDP. In addition, the global war on terrorism now poses an open-ended threat and therefore the possibility of greatly enlarged security expenditures. Defense and homeland security spending was $333 billion in 2001; it is likely to be $540 billion in 2006, or 4.2 percent of GDP.[13] Although the President's 2006 budget proposes restraint in some military programs, higher security spending for the foreseeable future appears likely.

Similarly, domestic and international discretionary spending fell from about 4½ percent of GDP in the early 1980s to 3.3 percent in 2000. However, like defense spending, these programs no longer will provide a source of large cost reductions. Non-security discretionary programs collectively now account for less than 20 percent of total program expenditures, so

that extremely large cuts would be required to have a significant budget impact. Thus, for instance, even if the President's proposed elimination of more than 150 programs and a five-year aggregate spending freeze (an overall inflation-adjusted reduction of about 16 percent) were enacted, spending in 2010 would fall by less than ½ percent of GDP.[14] Yet signals from both parties in the Congress indicate that even such limited reductions are unlikely.

There are always ineffective domestic programs that can and should be eliminated or reduced. However, this category of spending also contains important and effective programs that provide for law enforcement, environmental protection, public health, investments in human, physical, and knowledge resources, and basic low-income supports, for which both public demand and policy rationale are quite strong. CED has strongly supported many such programs, including those for early childhood education, basic research, worker training, and low-income support. The danger now is that automatic and inexorable increases in entitlement spending, inadequate tax revenues, and rising deficits will crowd out of the budget many programs representing the best of the public sector.

Therefore, after examining the budgetary effects of large reductions in the growth of spending, and the potential for future spending restraint, we believe that additional tax revenue will be an inescapable component of any responsible long-term fiscal policy. Raising additional revenues will be hugely controversial and is certainly not part of current tax reform efforts, but it will be unavoidable if we are to avert a fiscal crisis.

Why We Must Act Now

Why is action so urgent when the explosion of deficits appears some years away? First, the *prospect* of these deficits may begin to produce serious problems long before they occur. For example, some foreign central banks have already indicated an intent to shift the composition of their reserves away from dollars, as our exploding international current account deficit reached $666 billion (5.7 percent of GDP) in 2004. The worsening fiscal outlook could make the rapid growth in U.S. borrowing from abroad unsustainable, provoking sharp exchange and interest rate reactions and recession. Less dramatically, Social Security financing shortly will begin to exert pressure on the federal budget, as the surplus of contributions over outlays shrinks and then disappears, requiring an acceleration in federal borrowing.

Second, today's policy actions sometimes place large burdens on future budgets that are not reflected in today's budget accounting. For example, Roth Individual Retirement Accounts (IRAs) and similar proposed "back-loaded" saving incentives produce large and irreversible future revenue losses. Finally, as noted above, major fiscal policy changes take time to legislate and implement, may take years to produce their full effects, and often must be phased in gradually for reasons of smooth adjustment and fairness. It is therefore essential that we address the issues now rather than wait for a crisis to drive policy decisions. Delayed policy changes will have to be larger and are likely to be less carefully considered, more abrupt, and less equitable.

As a result, we believe policymakers must act *now* to begin to prepare for the fiscal crisis just ahead. As noted above, the long-term fiscal gap has deteriorated by an extraordinary 6 percent of GDP since 2001. Continuing large deficits in the next few years, even if they are not yet exploding, will pile up debt and interest costs that will make future policy choices even more difficult. Yet the required fiscal restraint does not appear likely: national security costs continue to mount, domestic spending reductions encounter deep resistance, and proposals for additional tax cuts proliferate. As we said in our 2003 report, *the first step in climbing out of a hole is to stop digging.* The immediate challenge, therefore, is to stop, and reverse where possible, this fiscal hemorrhaging and restore confidence and credibility to our fiscal policy. Then, for the longer term, we must put in place both major spending restraints and a tax system that can raise the revenue necessary to pay for government in an efficient and equitable manner. Our recommendations in Section IV provide a framework to accomplish this.

III. What's Wrong With the Income Tax?

The current income tax is complex, impairs economic efficiency and growth, and is in certain respects inequitable. It imposes heavy administrative burdens. And it fails to raise sufficient revenue to deal with the impending fiscal crisis. We briefly address each of these problems and conclude that *a new revenue source will be necessary in the future if we are to avoid exploding deficits or unacceptably large increases in income tax rates.*

The Current Income Tax is Complex, Opaque, and Unstable

An effective tax system would be reasonably simple and transparent to limit the costs of tax collection, compliance, and planning. In sharp contrast, our income tax code has become an ever-growing thicket of provisions that benefit particular economic interests or groups of citizens. The income tax code and regulations contain about 7 million words. The instruction booklet for the ubiquitous Form 1040 has increased from four pages in 1940 to 48 pages in 1976 and to 128 pages for the 2004 tax year. The IRS estimates that the time required to complete an average individual tax return has risen from about 17 hours in 1988 to over 28 hours today.[15]

The U.S. Treasury now lists 146 "income tax expenditures," which are special exclusions, exemptions, deductions, credits, preferential tax rates, and deferrals of liability relative to a "normal" tax baseline patterned on a comprehensive income tax.[16] Tax incentives are now major instruments of U.S. economic and social policy and provide a large share of federal support for many policy goals. This is not going to change. However, because of political pressures that favor tax expenditures over direct expenditures, tax preferences now have often become our "first resort" for policies in education, health, housing, and other areas. These 146 tax expenditures reduce revenues for fiscal year 2005 by roughly $726 billion—6 percent of GDP and 65 percent of individual and corporate income tax revenues.[a] A number of tax expenditures were eliminated or reduced by the tax reform of 1986; since then, however, tax expenditures have again risen relative to GDP, and the proportion directed at social goals such as health, retirement security, education, and support for low-income households, has increased relative to those directed at business-related goals. (See Figure 3)

Often there are several preferences for the same activity, such as home ownership, energy production, education, saving, or health care, with the result that the provisions overlap and employ different definitions, criteria for eligibility, and other rules, creating unnecessary complexity that makes planning, compliance, and enforcement difficult. Moreover, these provisions not only accumulate, but many also change frequently, making the tax code a "moving target" for business and financial planning. (The instability of the tax law, of course, provides continuing opportunities for policymakers to reaffirm their concern for the needs of their constituents and supporters.) The American Jobs Creation Act of 2004 (AJCA), originally intended to provide a simple remedy for the violation of

[a] Because the estimated revenue loss associated with each tax expenditure assumes the continuation of all other tax expenditures, and such provisions often interact, adding up the individual tax expenditure revenue costs provides only a very rough approximation of their combined revenue cost. Nevertheless, unless such interaction effects change significantly over time, the aggregates should provide a reasonably good picture of the trends of tax expenditures over time.

international trade rules by an export subsidy, became a monument to complexity, not least in its redefinition of "manufacturing" to encompass extraction of oil, gas, minerals, and timber, movie production, and coffee roasting.[17] Just as a new tax reform commission was appointed to consider tax simplification, the President's 2006 budget proposed 29 new tax incentives for saving, health care, charitable giving, education, housing, telecommuting, energy production, and other activities, as well as the extension of eight other expiring preferences.[18]

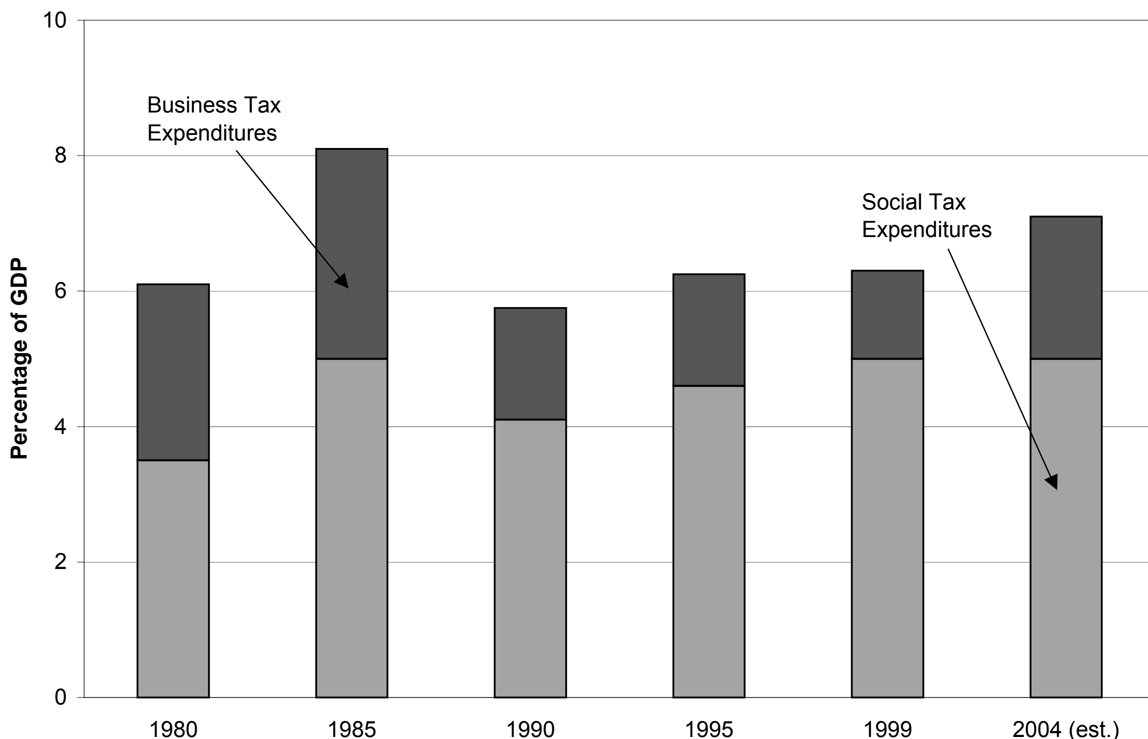
In recent years, the practice of enacting "temporary" tax changes that are scheduled to expire in the near future has become especially troublesome. While temporary tax changes may be justified when used for economic stabilization, most of the recent changes have no such rationale. Although for many years a group of such provisions (the "extenders") was routinely set to expire and then extended, this unfortunate practice has recently been greatly expanded.

Very large expiring provisions have been used to distort budget totals and evade budget rules by producing grossly understated estimates of the revenue losses associated with new tax legislation. The most notable example, of course, is the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), all of whose tax cuts were set to expire after 2010. But the tax legislation of 2002-2004 has added to the problem. At present, all tax provisions scheduled to expire during 2005-2015, if extended, will reduce revenues by about $2.1 trillion during 2006-2015.[19]

A special, and increasingly important, source of complexity is the Alternative Minimum Tax (AMT), levied on both individuals and corporations. The AMT was enacted in 1969, and revised in 1978, to curb tax shelters among a small number of high-income individuals and corporations. (Enactment followed the disclosure by Treasury Secretary Joseph Barr that 155 wealthy families paid no income tax.) It is essentially a "parallel" income tax that disallows certain preferences

Figure 3

TRENDS IN FEDERAL INCOME TAX EXPENDITURES



Source: Eric Toder, private communication; OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2005* (Washington, D.C.: OMB, 2004).

in the regular income tax and has a different set of exemptions and rates. Taxpayers are required to pay the higher of the tax liabilities computed under the two systems.

Historically, relatively few individual taxpayers have been affected by the AMT, and only 1.4 percent of filers paid the AMT in 2001. But the AMT's structure is not indexed to inflation, and this, in combination with recent reductions in the regular income tax, will soon force the AMT upon millions of taxpayers for whom it was never intended and who know nothing of tax shelters. Indeed, less than 10 percent of its revenue now comes from its tax shelter provisions. Rather, the AMT's burden will fall increasingly on the middle class, and especially on married filers with children, as their personal exemptions, standard and most itemized deductions, and personal credits are disallowed under the AMT. It is estimated that 31 percent of individual taxpayers will pay the AMT in 2010 under current law and that those with cash incomes of $50,000 to $100,000 will then pay 11.2 percent of AMT revenues, compared with 0.7 percent in 2004. The AMT would then produce about $105 billion, or 10.6 percent of individual income tax revenues.[20]

The AMT not only forces taxpayers to compute two tax liabilities, but also is intrinsically complex. The National Taxpayer Advocate and the IRS have identified the AMT as one of the most difficult pieces of the tax code to comply with and administer, and the National Taxpayer Advocate and IRS Oversight Board have recommended its repeal.[21] Among other things, capital gains and depreciation rules under the AMT are exceptionally difficult to navigate, and the interactions between the regular tax system and the AMT are highly nuanced—making tax planning particularly costly. This complexity will become especially burdensome for middle-class taxpayers, who will have relatively small AMT liabilities, but will face many of the same complexities as those with higher incomes who already must make heavy use of professional tax planning and preparation. [22]

Tax provisions for the support of low-income families present another area of troublesome complexity. Such families face bewildering and often conflicting rules in applying for assistance through the dependent exemption, head-of-household filing status, child tax credit (and its refundable component), child and dependent care tax credit, and Earned Income Tax Credit (EITC). This complexity has probably also contributed to difficulties in enforcement, fraud, and abuse. Different definitions of "earned income" create undue confusion, although recent legislation has created a uniform definition of a "qualifying child" for such preferences. There are also multiple, unnecessary computations involved.[23] Such complexity places heavy compliance burdens on low-income households and thereby undermines the effectiveness of these provisions. It is estimated that $1.75 billion in Earned Income Tax Credit (EITC) refunds in 1999 were diverted to tax preparation, filing, and high-cost refund loans.[24]

Preferences for higher education present families and students with bewildering choices among 529 plans, education saving bonds, Coverdell education saving accounts, Hope Scholarship Credits, Lifetime Learning Credits, and itemized deductions for higher education expenses. These preferences have different rules for eligibility and often use conflicting definitions of qualifying expenses.

Complexity also abounds in the taxation of capital gains, where there are too many rates and too many rules. Income from realized capital assets is taxed preferentially relative to other income, and this preferential rate system is a mind-numbingly complex hodge-podge, with rates depending on the year in which the gain is realized, the type of asset sold, the owner's other income, when the asset was purchased, and how long it was held. Many calculations therefore are required to compute the tax on long-term gains; in 2004 most taxpayers required a worksheet computation of 19 lines, and those selling collectibles and depreciated real estate needed one of 37 lines. The system will become even more complex in 2009, when different rates will be applied to certain gains on assets held for more than five years.[25]

Tax Preferences Impair Economic Efficiency and Growth

The proliferation of these tax preferences not only produces great complexity, but reduces output, income, and living standards in three important ways.

First, such preferences reduce revenues and increase the budget deficit. Large and sustained budget

deficits reduce national saving and investment, curtail economic growth, shift the costs of consumption to future generations, and increase international economic imbalances, instability and tensions. These effects have been analyzed by CED in previous policy statements.[26]

Second, these preferences reduce taxable income and thereby require higher tax rates. Because the costs that any tax imposes on the economy increase exponentially with the tax rate, these higher rates on a smaller base reduce national output and Americans' incomes.[27]

Finally, tax subsidies distort decisions in the marketplace by changing relative prices of products, services, and economic activities. As a result, individuals and firms produce and consume additional goods and services that are less valuable than their more heavily taxed alternatives. Housing enjoys enormous preferential treatment in our tax system; the 10 major housing tax expenditures provide subsidies of about $158 billion in 2005. The largest single tax expenditure, the open-ended exclusion of employer contributions for medical insurance premiums and care, which encourages the use of unnecessarily expensive health plans, is worth $102 billion.[28] Aid to state and local governments, provided principally through the deductibility of income, property and other taxes and the exclusion of interest on their bonds, amounts to about $89 billion. Sixteen separate preferences for education provide about $18 billion. The 11 energy tax expenditures generate subsidies for this sector of $4 billion, while agriculture, timber, and mineral extraction combined receive about $2.5 billion.[29] (These estimates exclude the effects of the recently-enacted energy and other 2005 legislation.)

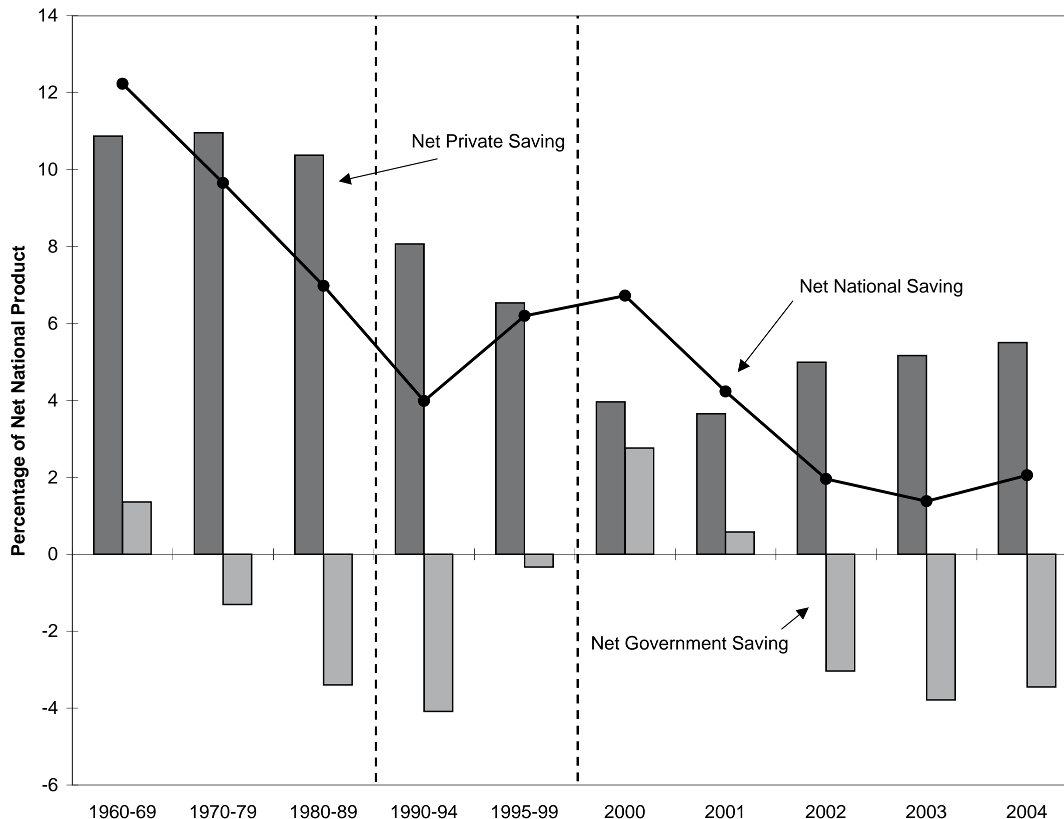
The distortions of prices and economic resources produced by these preferences can have pernicious, if unintended, consequences. It is hardly a coincidence that prices have risen especially rapidly for heavily subsidized activities such as housing, health care, and higher education.[30] The expansion of tax credits and other subsidies for college attendance have made possible rapid increases in tuition and other costs, which ultimately undermine the goal of making college more affordable; recent research suggests that tax credits for higher education have not increased college attendance, although they have expanded choices for some students.[31] The mortgage interest deduction, capital gains exclusion, deduction for property taxes, and other housing preferences have helped drive unprecedented increases in housing prices, making homes unaffordable for the young and less-affluent, while bestowing windfall gains on current owners.[32] The open-ended employer deduction for health insurance and the structure of many insurance plans have made employees and their health service providers insensitive to costs and the consequences of their choices. This has helped fuel rapid increases in the prices and utilization of health care, making health insurance less affordable and increasing the number of uninsured.[33]

Several of the largest income tax preferences are for saving; the exclusion of employer and individual pension contributions and earnings confers tax benefits of about $114 billion. In principle, taxes on saving induce individuals to consume more today (relative to the future) than they would in a tax-free capital market, thereby distorting their consumption choices and reducing their saving.[a] However, saving preferences *as currently designed* probably do not significantly raise national saving and economic growth.[34] These provisions are poorly designed in several respects. First, they do not in fact reward *saving*; they reward deposits in tax-preferred accounts—which may reflect transfers from taxable accounts, gifts, bequests, or other sources, rather than actual new saving. A recent analysis indicates that the tax benefits alone from these deposits—a fraction of the putative new "saving"—now exceed all personal saving.[35] Second, these saving preferences provide very large (and costly) incentives for high-income individuals, most of whom would save in any case, and much smaller incentives for lower-income individuals, who save little and need stronger inducements.[36] If the goal is to increase individual saving, this is a very costly and inefficient approach. Finally, even if such preferences increase *personal* saving, there would be no increase in *national* saving unless the new personal saving exceeded the loss of government revenues from the tax preference.[37]

As Figure 4 shows, personal saving has fallen steadily for many years, in spite of the proliferation and expansion of saving incentives. Recently, with the

[a] However, lower tax rates on saving may *discourage* saving by allowing individuals to reach a future income target with less saving at the lower rates. In addition, saving incentives may indirectly reduce labor market efficiency if the higher income tax rates then required to raise revenue induce individuals to reduce work effort.

Figure 4



reappearance of large federal budget deficits, public saving and national saving have resumed their decline. As CED has long argued, our instruments for raising personal saving are weak; the most effective policy for increasing *national* saving is to raise public saving by reducing the budget deficit.[38]

Whatever their impact on national saving, these saving preferences are more numerous and complex than necessary. In addition to employer plans, we now have 401(k)-type plans and deductible, non-deductible, and Roth IRAs with different rules and complex conversion provisions, as well as Keogh plans, an additional saving credit for lower-income taxpayers, and specialized saving incentives such as Education IRAs and Health Savings Accounts.

The corporate income tax poses especially difficult problems for economic efficiency. The corporate tax is riddled with subsidies including (among others) preferences for energy and other extractive industries, graduated corporate rates, the exemption of private activity bonds, tax credits for non-conventional fuels, the credit union exemption, the exclusion of interest on life insurance savings, timber subsidies, employee stock ownership plans, and accelerated depreciation of machinery and equipment. As noted above, the AJCA of 2004 extends the list even further, especially regarding subsidies for "domestic production activities."

Tax preferences, of course, may be warranted as a matter of public policy when they are the most effective instruments for achieving public goals.[39] Strong arguments can be made that without preferential treatment the resources devoted to some "public goods" such as basic research, education, and retirement saving, will be less than socially optimal. But this is a slippery slope; most activities and groups of potential beneficiaries are eager to claim such status. The most likely outcome, as noted above, is the distortion of prices and misallocation of resources. Since very large amounts of resources are involved and many preferences are ineffectively targeted, there is a strong case for selectively eliminating, reducing, and simplifying tax preferences. This should be done as a matter of sound policy, even though, as noted below, we cannot realistically expect large additional revenues as a result.

Tax Expenditures Are Often Inequitable

There is widespread agreement in the United States on the basic principles of a fair tax system. Horizontal and vertical equity have been widely accepted as the key standards of fairness: Americans generally agree in principle that those in similar economic circumstances should be treated the same (horizontal equity) and that tax liability should increase according to ability to pay (vertical equity). Of course, in application, these principles leave room for large disagreements.

Horizontal equity has been undermined by many of the special preferences littered throughout the tax system. While determining a person's "circumstances" is by no means an exact science, one widely accepted measure is income—the increase in an individual's power to consume.[40] By this definition, the principle of horizontal equity dictates that people with similar incomes should be treated equally. This implies that the tax system should not discriminate among sources of income or the recipients of that income. The many tax preferences for specific sources and recipients of income—whether the preferential treatment of capital gains, the exclusion of certain income earned abroad, or the exclusion of some social security and veteran's benefits—violate this principle.

Many tax expenditures also violate the principle of progressivity. A principal purpose of preferences such as the mortgage interest deduction, the deduction for higher education expenses, and the exclusion of employer contributions for medical insurance is presumably to make housing, education, and medical care more affordable for households of limited means. Yet, tax preferences that reduce taxable income—deductions, exclusions, and deferrals of income—confer much larger benefits on high-income households than on the middle- and lower-income households for whom affordability is most important. This design is not only regressive, but inefficient, because each additional dollar spent on education, housing, health insurance, or other "preferred" activity is subsidized at a higher rate, the higher the taxpayer's tax bracket. Thus, the subsidy for one dollar of education saving for a 35 percent bracket taxpayer is 2.3 times as large as that for someone in the 15 percent bracket. There is little rationale for such "upside-down" subsidies except when the purpose is to adjust taxable income to reflect more accurately the taxpayer's ability to pay, which is not generally the case. For those preferences that must be retained, converting such exclusions or deductions into equal-percentage credits for all taxpayers would improve both progressivity and efficiency.[41]

Another serious problem arises from the income-based phase-outs of benefits that have arisen from attempts to increase the progressivity and reduce the revenue costs of tax expenditures. Phase-outs of exemptions, deductions, and credits increase both complexity and economic inefficiency. To calculate eligibility for (among other preferences) the EITC, the child tax credit, IRAs, and the deduction for student loan interest, taxpayers must negotiate elaborate phase-out rules that vary from provision to provision. Such phase-outs effectively create high (but "invisible") marginal tax rates, because each additional dollar of income reduces the credit, deduction, or exemption; these high marginal rates can significantly distort work effort and other behavior. Although in some cases (such as the EITC) the budgetary costs of removing such phase-outs may be prohibitive, we believe that, in general, it is preferable to pursue progressivity in the income tax by broadly adjusting rates, exemptions, and the standard deduction rather than by "means testing" numerous preferences narrowly targeted on specific groups.

The Tax System is Burdensome to Taxpayers and the Government

To comply with and administer this complex system, Americans and their government spend the equivalent of $75 billion to $130 billion each year in terms of time and money—roughly 10 percent of individual and corporate income tax collections.[42] This estimate does not include the increasing resources devoted to tax planning, creating employment for armies of tax accountants and lawyers, as loopholes and tax shelters have proliferated. Nor does it include the remaining costs of uncertainty, which even expensive planning cannot eliminate. While some complexity is inevitable in a large and diverse economy, such complexity wastes substantial economic resources, yields widespread frustration, and produces a sense of inequity. Eighty percent of Americans apparently believe that tax cuts are generally "aimed at helping …someone else."[43]

Yet, in spite of this expenditure of time and money, the system has not been effectively enforced because the Internal Revenue Service has been starved of resources. The "tax gap" between taxes paid and taxes owed has been estimated by the IRS at about $312 billion to $353 billion (for 2001), or about $2,000 per taxpayer return. The largest component of the gap was the underreporting of income, of which the underreporting of business activities on individual returns accounted for by far the largest revenue shortfall, $150 billion to $187 billion. (Underreporting of income appears to be about 15-19 percent of individual income tax revenues and roughly 20 percent of corporate revenues.)[44] Over the period 1992-2004, the IRS permanent staff fell by 27 percent. Not surprisingly, during this period the overall audit rate on individual returns dropped by 27 percent, and the rate of non-correspondence audits plunged by 77 percent for individuals and 78 percent for corporations.[45] There is now evidence that the declines in IRS enforcement efforts have reduced taxpayers' incentives to comply voluntarily with the tax laws: the IRS Oversight Board found in a recent survey that "one in five taxpayers now believes that it's acceptable to cheat on their taxes," and expresses concern that this trend will "place the entire tax administration system in peril."[46]

In an inadequate enforcement environment, some corporations apparently grew increasingly aggressive in their efforts to reduce or escape tax liability, and the GAO has found that 63 percent of U.S. corporations paid no federal taxes from 1996 to 2000.[47] The 1990s featured an increasing divergence between corporate book and tax income; in 1998 alone, book earnings exceeded taxable income by $287 billion for companies with assets in excess of $250 million.[48] While book and tax income can be expected to differ, recent research suggests that much of the *growth* in this gap was due to increasingly aggressive tax avoidance.[49] In the last several years, after the systematic marketing of tax shelters became prominent, both the IRS and Congress have become increasingly concerned with abusive tax shelters. The enforcement environment therefore may be improving. However, inadequate resources make it difficult for the IRS to provide both effective taxpayer service and adequate enforcement.

Tax avoidance by corporations and individuals is legitimate, but the intensity with which it is pursued and the amount of resources wastefully expended are unquestionably related to the extraordinary complexity of the income tax, produced in great part by the accretion of special preferences, many narrowly targeted.

The Income Tax Alone Cannot Raise Sufficient Revenues

Faced with a large and growing fiscal gap, and the need for more revenues, the United States faces a difficult dilemma. In theory, of course, future income tax rates could be raised to help reduce the fiscal gap. But, as just noted, the current income tax system is complex, inefficient, and inequitable. Raising the tax rates of this dysfunctional system would compound existing distortions and disincentives, damaging the economy's efficiency and capacity for growth. Higher income tax rates are becoming even more problematic as globalization intensifies; highly mobile capital becomes more likely to move offshore, shifting more of the tax burden to labor income, and the income tax becomes more difficult to administer and enforce. Ultimately it will become politically infeasible to continually raise income tax rates to cover ever-rising expenditures.

To avoid rate increases, and to promote simplicity, efficiency, and equity, tax reformers throughout the decades have favored the approach adopted in the Tax Reform Act of 1986—"lower the rates and broaden the base." By reducing preferences in the tax code, more income can be brought into the tax base. As just noted, base-broadening would make the system simpler, fairer, and more efficient. Base-broadening has great merit. CED strongly supports it and makes recommendations below to implement it. Indeed, were we starting from scratch in devising a tax system, we would favor a system with a very broad base of income or consumption that included few tax preferences and achieved progressivity by broad adjustments in individual exemptions, the standard deduction, and the rate structure.

However, we are not starting from scratch. In the real world, there are severe practical limits to eliminating preferences and broadening the tax base—and therefore to raising revenues by this means. Previous tax reform efforts have explicitly been "revenue-neutral"—a luxury we can no longer afford. It is striking that even the

1986 Tax Reform Act (TRA), widely regarded as a dramatic achievement in base broadening, increased income tax revenues by only about one-half percent of GDP by this means.[50]

Many major preferences in the tax code are today so embedded in our economic and social life and so deeply rooted politically that their elimination or great reduction is probably politically infeasible and in some cases unwise. Four sets of these preferences stand out:

- Tax privileged accounts for saving and retirement such as defined benefit pensions, 401(k) plans, and IRAs now form the foundation for private retirement saving.
- The exclusion from taxable income of employer contributions to employee health insurance similarly forms the basis of our private health insurance system.
- The Earned Income Tax Credit (EITC) has become the major pillar of low-income support.
- Removing entirely the deductibility of the interest paid on home mortgages would undermine the value of the homes that are the major asset of many families, who may have received little or no actual benefit from the tax preference.[a] [51]

The "tax expenditures" attributed to these four sets of preferences now total approximately $326 billion annually, about 36 percent of individual income tax revenue and 2.7 percent of GDP.[52] We do not argue that these preferences are sacrosanct and should be held harmless in the process of tax reform. Indeed, we believe that modifications, if appropriately phased-in, would be beneficial, and we make recommendations to this effect below. However, we do not realistically expect base-broadening in these areas to be a source of greatly increased revenues.

The second major obstacle to raising significant revenues by simplifying the tax code is the budgetary effect of AMT repeal or reform. As noted in the discussion of the AMT above, 31 percent of individual taxpayers will pay the AMT in 2010 if no action is taken, so legislative action appears certain. Repeal of the AMT, however, would reduce revenues by over $1 trillion over 2005-2014 if the 2001-2003 tax cuts were extended, and by over $700 billion even if they were not. Substantial modifications of the AMT to reduce its impact on middle-class taxpayers would reduce revenues by about two-thirds of these amounts or more.[53] As a result, any feasible base-broadening and tax simplification program that addresses the AMT may *reduce* rather than raise income tax revenues. For example, the 2014 revenue loss from AMT repeal today would be about $167 billion, or about 0.9 percent of projected GDP—significantly larger than the net revenues of 0.5 percent of GDP produced by base-broadening in 1986. *We conclude from this harsh but realistic arithmetic that a new revenue source will be necessary in the future if we are to avoid exploding deficits or unacceptably large increases in income tax rates.*

[a] Housing preferences generally are capitalized into housing prices so that a new owner in effect "prepays" the value of the tax preferences when purchasing the house.

IV. A New Framework: CED's Recommendations

In the near term, as we move towards a new tax framework, we must halt (and reverse if possible) the deterioration in our current fiscal position to prepare for the more severe challenges that lie ahead. In our March 2003 policy statement we said that

> … after reviewing the size of our long-term fiscal imbalance and the broad possibilities for spending reductions in Social Security, Medicare, national defense, homeland security, and other domestic programs, *CED believes it extremely unlikely that the long-term budget problem can be solved without additional revenues*. We therefore urge the Administration and Congress to forego at this time any additional tax reductions (including the permanent extension of EGTRRA) that would further reduce long-term revenues. Moreover, we should use this opportunity to begin to explore alternative or additional long-term sources of revenue and taxation systems that support our long-term growth objectives.

In spite of a strengthening of revenue collections in early 2005, the long-term fiscal outlook is now significantly worse than it was in 2003, and we strongly reaffirm this recommendation. In practice, this means that **any tax changes in the next several years should be <u>at least</u> revenue-neutral; if the 2001-2004 tax cuts are to be extended, the revenue losses should be financed by equivalent (or larger) revenue increases.** This would be mandated if the PAYGO budget control rules were reinstated, as recommended below.

How might this be done? Our preferred policy would be to enact as soon as feasible, but realistically within the next several years, the new tax framework proposed below. These policies would more than meet these near-term revenue requirements and—more important—put fiscal policy on a sound and sustainable basis for the difficult years ahead.

Some have suggested that we address the fiscal shortfall by allowing some, or all, of the 2001-2004 tax cuts to expire, as scheduled under current law. We do not believe this is a satisfactory policy option, for several reasons. First, the roll-back of the complete set of tax cuts would have virtually no political support, since many of these provisions are so-called "middle-class" tax cuts, such as the child tax credit, marriage penalty relief, the 10 percent tax bracket, and the liberalization of pension plans, such as 401(k)s, and the "529" college saving plans. Second, even if the most politically contentious of the provisions—the high-income marginal rate, capital gains, and dividend income reductions—were allowed to sunset, the additional revenues raised would amount to less than ½ percent of GDP.[54] Whatever one's view of the distributional implications, this would have very little impact on the long-term fiscal gap. Finally, as we argue below, we believe that the new framework we propose would be more conducive to economic efficiency and growth than the alternative of overall higher income tax rates.

Rather than court political deadlock by reviving the 2001-2003 tax battles, it would be preferable to make a quantum shift towards the new framework outlined below. In the process, we must reexamine and adjust the entire structure of tax rates, standard deductions, and low-income credits to produce a fair and progressive system.

A new tax framework should be simpler and more transparent, more efficient, more equitable, less burdensome, and able to raise sufficient revenues. CED makes the following recommendations to promote these goals. These recommendations are far-reaching; their legislation and implementation will have to be phased in over several years, although (for the reasons noted above) we must begin work on them now. We emphasize again that such tax-related policy changes must be part of a "war on all fronts" of the federal budget, since large spending reductions, involving major reforms in major health and pension programs, will be required for long-term fiscal viability.

Summary of Recommendations

1. **Eliminate and Reduce Tax Preferences, Simplify the Tax System, and Broaden the Tax Base.** We should remove unnecessary complexities and reduce or eliminate tax preferences that do not have a compelling rationale. Remaining preferences should be consolidated and simplified, and in some cases deductions should be converted into credits. Consolidation of low-income and education credits and the reform of saving preferences offer important opportunities for simplification.
2. **Phase In a Broad-Based 10 Percent Value-Added Tax (VAT) to Supplement the Income Tax.** A VAT would provide additional revenues to help meet the impending fiscal crisis and to allow lower income tax rates (and associated distortions) than would otherwise be required. The VAT base should be as broad as possible, to enhance both economic neutrality and revenues. The VAT's distributional effects should be addressed by modifications to the income tax, not by exclusions of particular goods and services, or exemptions of particular firms, from the VAT.
3. **Modify the Income Tax to Protect Low-Income Households from the Regressive Effects of the VAT.** A common objection to a VAT is that it is regressive. However, the income tax can be modified to address this problem by restructuring and expanding a consolidated refundable low-income tax credit, modifying rates for those with tax liability, and increasing the standard deduction to raise the tax-entry threshold.
4. **Repeal the Individual and Corporate Alternative Minimum Taxes.** With AMT repeal, those targeted provisions of the AMT that discourage aggressive tax shelters should be incorporated into the regular income tax. We do not need two parallel tax systems to reduce tax preferences and promote equity. *However, the introduction of a VAT and repeal of the AMT must be accompanied by changes in the income tax rate structure, standard deductions, and low-income credits to support the progressivity of the overall tax system.*
5. **Rationalize Capital Income Taxation by Integrating the Individual and Corporate Income Taxes, Narrowing the Differential Treatment of Ordinary Income and Capital Gains, and Modifying the Estate and Gift Taxes**. We should tax capital income once, but only once, at rates that approximate those on other forms of income. The differential between the top rate on ordinary income and that on capital gains should be narrowed to reduce incentives for arbitrage and tax shelters. The estate tax should be retained. One option would be to continue in 2010 and thereafter the scheduled 2009 exemption of $3.5 million ($7 million for couples) and top rate of 45 percent, with the exemption indexed for inflation.
6. **Improve the Processes for Making Tax and Budget Policies**. Process changes are essential to help protect a new tax framework against renewed onslaughts in complexity and revenue erosion. In addition, rules for budget control should be restored and new requirements should be established for Congressional consideration of the long-term effects of fiscal policy.
7. **Provide the Internal Revenue Service with the Political Support and Resources Required to Support the Integrity and Revenue-Raising Capacity of the Tax System.**

Recommendation One: Eliminate And Reduce Tax Preferences, Simplify The Tax System, And Broaden The Tax Base.

We are asking too much of the income tax system. The vast array of tax expenditures in the income tax code produces complexity, economic inefficiency, and inequity. We recognize that some of these preferences —and especially the larger ones directed at saving, health care, low-income support, and housing—are so embedded in our economic life that their elimination is infeasible and (in some cases) unwise. But among the 146 tax expenditures are many that have no compelling economic or social rationale. **We should eliminate or reduce these preferences to the greatest extent possible. This will reduce inefficient price distortions and inequities and permit lower income tax rates than would otherwise be necessary.**

We should also simplify, consolidate, and improve the preferences that remain. Tax provisions intended to promote equity or other social goals through narrow targeting, complex rules, and income-based phase-outs should in many cases be replaced by more broadly targeted provisions or by direct expenditures in situations where administrative and compliance costs are lower. In some cases "upside-down" tax subsidies designed as exclusions or deductions from income, which produce inefficient and inequitable incentives, should be converted into tax credits.

This policy statement does not try to rewrite the tax code, and we have not undertaken a systematic and comprehensive review of all tax expenditures. However, some pertinent examples of the reforms we have in mind are:

- **Production tax subsidies that favor certain economic sectors or activities (such as energy, minerals extraction, timber, agriculture, housing, and, most recently, "domestic production activities") at the expense of others should be eliminated or reduced.** In cases where the subsidies cannot be eliminated, there may be opportunities to at least realign them with their original purposes. For example, the deduction for interest on home equity loans effectively subsidizes personal consumption expenditures rather than homeownership and encourages tax arbitrage through subsidized borrowing; it should be repealed, as recently suggested by the staff of the Joint Committee on Taxation (JCT).[55] The $1 million limit on mortgages qualifying for mortgage interest deductibility should be gradually reduced, and the deductibility of interest on mortgages for second homes should be phased out. **CED reaffirms these three recommendations for changes to mortgage interest deductibility and home equity loans that it made in 1991.**[56]

- **Saving incentives should be consolidated; the current disarray of saving incentives could be replaced with one or two vehicles featuring simpler rules governing eligibility, contributions, and withdrawals.**[57] We believe that saving incentives should be aligned with retirement needs and should not be principally a device for shielding the capital income of the affluent from tax.[58] **We therefore recommend that the exclusion of pension contributions from individual tax be converted to a refundable fixed-rate credit.** This would make saving incentives both more effective and more equitable.[59]

- **The current bewildering and confusing tax benefits for low-income families and children should be simplified by standardizing definitions of income and eligibility and consolidating these benefits.** Currently, the EITC, child credit, child and dependent care tax credit, dependent exemption, and head of household rate schedule provide a complex matrix of choices. This complexity especially burdens low-income households with heavy compliance costs. Some or all of these could be consolidated into a single refundable and indexed credit. This would preserve or expand benefits for children and low-income families in a much simpler and more transparent structure that would reduce error rates and compliance costs.[60]

- **An indexed cap should be placed on the open-ended tax exclusion of employer contributions to purchase health insurance,** as we recommended in 2002. This would promote both cost-conscious decisions in

purchasing insurance and equity, since the open-ended exclusion encourages high-cost insurance and disproportionately benefits higher-income employees. Capping the contribution at the average premium currently paid by employers would raise revenues currently by about $25 billion, or 0.2 percent of GDP.[61]

- **Tax subsidies for higher education should be substantially redirected into an expanded Pell Grant expenditure program that provides larger grants to more low-income students.** Although we strongly believe in public support for education, those resources will be more effective if redirected in this way. If the tax credits are retained, they should be consolidated and simplified. The JCT staff has recently suggested combining the Hope Tax Credit, the Lifetime Learning Credit, and the deduction for higher learning expenses into a single per-student credit that would be simpler and more equitable than the current preferences.[62]
- The National Taxpayer Advocate and the JCT staff have made numerous other proposals for tax simplification. **We urge Congress to consider these proposals expeditiously.**[63]

A major effort to eliminate, reduce, and simplify tax preferences would make the tax code more efficient, more equitable, and more acceptable to many now frustrated by its complexity. However, as explained above, even a successful base broadening program will not raise significant revenue when combined with the repeal of the AMT.

Recommendation Two: Phase In A Broad-Based 10 Percent Value-Added Tax (VAT) To Supplement The Income Tax

As stated in the beginning of this report, the impending fiscal crisis will require either a new revenue source or much higher income tax rates, even in the context of large spending reductions. CED strongly prefers the former and **recommends phasing in a value-added tax to supplement the income tax.**[64]

Over 100 nations, and 29 of 30 OECD members, now have VATs, many adopted within the last several decades as experience and practice have grown. The United States is now the only major industrialized country that does not employ such a tax.[65] Although discussions of tax reform have largely focused on *substituting* a consumption tax for the income tax, we believe that a VAT will best serve to *supplement and complement* an income tax, as it does in most other countries. A VAT is needed to raise revenues in a neutral manner that does not discriminate among economic sectors or penalize saving, while an income tax is required to preserve the progressivity of the tax system.[66]

A VAT is a tax on the value of goods and services that is added at each stage of the production process. There are several ways of designing a VAT. Under the subtraction method, used in Japan, each firm computes its value added (by subtracting purchases from sales) and pays tax on it. The more widely used invoice-credit VAT (See Box: How a VAT Works) requires each business firm to collect tax on its sales at the specified rate and pass to the purchaser an invoice as proof of the tax liability. The purchaser, in turn, is able to credit tax on these purchases against the tax charged on his sales. He pays tax on the difference and receives a refund if there are excess credits. Because investment goods are treated like any other purchased input, the VAT is in effect a tax on consumption. In principle, the economic effect of a VAT is the same as that of a well-designed retail sales tax. However, compliance is better than under a retail sales tax because smaller amounts of tax are distributed more widely among firms, and the invoice-credit procedure allows cross-checking of invoices.[67]

Some countries' VATs have exempted certain products, or sectors of the economy, either because their value added is hard to tax (e.g. financial services and small businesses) or to protect low-income households from the tax. Preferential tax rates for food, health care, education, and other products have often been used for the latter purpose. Exemptions and preferential rates, however, greatly increase administrative costs, increase inefficient distortions, and generally provide relatively small distributional benefits.[68] We recognize that some exemption for small business will be necessary for practical reasons and that policy or political considerations may require other adjustments. But

one of the chief attractions of the VAT is its economic neutrality among different economic goods, services, and sectors, and this neutrality is compromised by exemptions and preferential rates. **Therefore, we strongly urge that a VAT be implemented at a single rate on as broad a base as possible.**

We believe that a tax system combining a VAT with a simpler income tax is the best tax system we can realistically pursue. This combination would be more conducive to economic efficiency and growth than the alternative of higher income tax rates. First, a broad-based VAT would be largely neutral with respect to different economic activities and sectors and, by effectively expensing investment, avoid the large distortions in investment behavior produced by the current income tax. Second, the shift of some taxes from income to consumption should increase domestic saving and investment, in part by discouraging the export of capital that would result from higher income tax rates. Third, as noted above, this "diversified" tax regime should produce a smaller economic burden from tax distortions than would higher income tax rates alone. We are concerned about the economic distortions and burdens that will result as income tax rates rise, and we believe there will be enormous political resistance to continual increases in income tax rates as the fiscal crisis unfolds. A VAT should be phased in as soon as possible to forestall rising deficits and debt burdens, increase the flexibility of our revenue system, and provide us with more fiscal options for the future.

Many features of a VAT would have to be addressed in its design and implementation, as they have been in other countries. Certain sectors, such as financial services and residential housing, are difficult to tax under a VAT, and may require special treatment. The treatment of government activities and non-profits also raises unique issues. In our federal system, a federal VAT raises especially difficult problems with regard to state retail sales taxes (RSTs), since the tax bases of RSTs would differ from one another and from that

HOW A VAT WORKS

10% Invoice-Credit VAT Example

	Stage of Production			
	Manufacturer	Wholesaler	Retailer	Total Tax
1 Sales	400	700	1000	
2 Purchases	0	400	700	
3 Actual Value Added (1-2)	400	300	300	
4 Tax on Sales	40	70	100	
5 Credit on Purchases	0	40	70	
6 VAT Owed (4-5)	40	30	30	100

Under the invoice-credit system of administering a VAT, the "value added" at each stage of production is taxed by allowing producers to offset the tax owed on their sales with credits for taxes paid by their suppliers at earlier stages of production. In this example of a 10% VAT, the manufacturer pays $40 in VAT on $400 of sales. When the wholesaler purchases the goods from the manufacturer, he receives an invoice for the $40 of VAT tax that has been paid and takes this as a credit against the $70 VAT that he owes on his $700 of sales; he then pays $30, the difference between the tax charged on his sales and the taxes already paid on his purchases. Similarly, the retailer receives an invoice for $70 from the wholesaler and uses it as a credit against the $100 of VAT that he will owe on $1000 of sales, thereby paying net VAT of $30. In effect, the manufacturer, wholesaler, and retailer each pay a 10% tax on the actual value added at their stage of production.

In total, the $100 VAT paid by stages is equivalent to a retail sales tax of 10% on final sales at the retail level. However, the invoice-credit system creates strong incentives for compliance because each firm will ensure that it receives the invoices required for its credits and that its intermediate purchases are not undervalued. This creates a record of sales, invoices and credits throughout the stages of production that assists effective enforcement.

of the VAT.[a] This would create substantial pressures for the states to convert their RSTs to VATs, or at least adopt the VAT tax base, which some would regard as an assault upon state fiscal autonomy and others an opportunity to reform RSTs that are often economically inefficient and needlessly complex.[69] This policy statement is not the place to address these detailed issues, which will require careful consideration. But other countries have found ways of dealing with these special problems; these include federalist Canada, where the federal VAT coexists with RSTs in the provinces.[70]

A VAT would require significant additional administration and compliance costs. The administrative costs might run about $1 billion to $2 billion annually, and the compliance costs $5 billion to $8 billion.[71] (Compliance costs for the income tax, however, could be reduced by the simplification measures we propose.) Because of these costs, it would not be worthwhile to levy a VAT at a low rate. We suggest a broad-based VAT of 10 percent, phased in over several years, which would raise roughly 4 percent of GDP annually (about $490 billion at 2005 income levels).[72] In the longer term, the VAT would provide a large degree of fiscal flexibility; simple adjustments of the VAT rate could be used to meet larger revenue requirements or to finance further changes in the income tax or payroll taxes.

Recommendation Three: Modify The Income Tax To Protect Low-Income Households From the Regressive Effects Of The VAT.

A common objection to a VAT is that it is regressive: households with lower incomes consume a larger proportion of their income than more affluent households and therefore pay a larger proportion of annual income in tax. There are several responses to this objection. First, relating consumption tax burdens to annual income overstates regressivity; a VAT is much less regressive in relation to lifetime consumption.[73] Second, considerable protection is provided to the elderly and disabled by the indexation of Social Security, Supplemental Security Income, and other benefits and payments. Finally, and most important, the income tax can be modified to offset the regressive effects of a VAT to the degree desired. Three instruments are available for this purpose: income tax rates can be reduced for those with tax liability; the standard deduction can be increased to raise the tax-entry threshold; and refundable tax credits can be used to assist those with little or no tax liability. We have proposed above that the EITC, child credit, and possibly other provisions supporting children and low-income families be consolidated into a single refundable tax credit. This unified credit could be expanded and structured to redress the impact of the VAT on low-income households. Since there are approximately as many low-income childless households as those with children, the credit should provide relief to households both with and without children.[74] A low-income credit simulated by CBO was shown to fully offset the VAT (on average) for households in the lowest quintile of the income distribution.[75]

There is another critical, but seldom discussed, point regarding the impact of a VAT on low-income households—the importance of the revenue-raising capacity of the VAT for preserving low-income support programs. Under current budget policies, the growth of budget deficits and largely middle-class entitlements will create enormous political pressures to reduce or eliminate such programs. As David Stockman famously noted, the burden of fiscal retrenchment, for well-understood political reasons, falls on weak clients, not weak claims.[76] The effects of a VAT on equity should be considered on both the tax and spending sides of the budget.

Recommendation Four: Repeal the Individual and Corporate Alternative Minimum Taxes

As noted above, the AMT (both individual and corporate) has become one of the most problematic features of the income tax. Originally intended to reduce tax avoidance by a small number of high-

[a] This problem would be mitigated by a subtraction-type VAT, for which the accounting framework and required data would be similar to those of an income tax.

income individuals and corporations, its creeping encroachment on millions of middle-class taxpayers has been deferred only by a series of one-year "fixes" in recent years. It is widely recognized that a more permanent solution will have to be enacted very soon.

Official estimates of future income tax revenues have been grossly overstated because they assume that the AMT "stealth tax" on middle-income taxpayers will remain in place. Clearly, this will not happen. But how should the problem be addressed?

CED believes that the AMT should be repealed. This should be accompanied by income tax changes that preserve progressivity and incorporate into the regular income tax those provisions of the AMT that discourage aggressive tax shelters. In short, we should not continue to use the complex and bewildering AMT to redress the real or perceived deficiencies of the income tax. If, for whatever reason, we decide that certain tax preferences should be retained in the income tax, we should address the consequences of those preferences transparently and directly in the income tax itself, not by the deceptive sleight-of-hand of an AMT. Any undesired distributional consequences of AMT repeal should be addressed through adjustments in income tax rates.

We recognize that repeal of the individual AMT involves a very large future revenue loss—over a trillion dollars during 2005-2014 if the 2001-2003 tax cuts are extended after 2010, and about $700 billion even if they "sunset." This clearly implies that AMT repeal will require either a new revenue source (as proposed in this statement) or significantly higher income tax rates. For the reasons indicated above, we prefer a new revenue source. If AMT repeal nevertheless proves infeasible, the AMT should at least be modified by changes that redirect it towards its original purpose of curbing tax shelter abuse and prevent it from burdening ordinary taxpayers. Although this approach would cost somewhat less in terms of forgone revenues, we regard it as a distinctly inferior alternative to repeal.[77]

Recommendation Five: Rationalize Capital Income Taxation by Integrating the Individual and Corporate Income Taxes, Narrowing the Differential Treatment of Ordinary Income and Capital Gains, and Modifying the Estate and Gift Taxes.

The taxation of capital income may be the most problematic area of tax policy. Under current law, both stock dividends and capital gains are taxed at preferential low rates, and capital gains receive tax deferral and are untaxed at death due to the step-up of basis. Preferential treatment of capital income is presumably intended to increase saving and capital formation, but there is little evidence that it has performed this function.[78] Such preferences are also seen as improving horizontal equity, by compensating in some degree for the taxation of saving. In addition, preferential capital gains tax rates are often defended as a crude offset to the taxation of the inflationary component of capital gains, although other capital gains preferences (i.e. tax deferral and step-up in basis at death) may more than compensate for this. In any case, the web of capital gains preferences has become bewilderingly complex.

The differing tax treatment of dividends and interest influences the form of organization that businesses adopt and the type of financing they employ.[79] In addition, taxing long-term capital gains at rates far below the top rate on ordinary income—the scheduled rates under current law are 15 percent versus 35 percent—invites tax avoidance and evasion. Tax shelters are commonly constructed by characterizing ordinary income as capital gains in order to secure the more advantageous rate, which reduces revenues and wastes resources in both avoidance activities and attempts to enforce compliance.

We believe that capital income should be taxed once, and only once. Capital income is now taxed through the corporate income tax, but dividends distributed to

shareholders are taxed again as personal income. (The 15 percent preferential tax rate provided for dividends in the 2003 legislation provided a simple but crude response to this problem.) Undistributed corporate income may also be double-taxed when it reappears as capital gains. To remedy this, **we believe the individual and corporate income taxes should be integrated.** Integration could produce significant gains in economic efficiency and horizontal equity.[80] There are several possible approaches to integration, and we do not make a specific recommendation here. However, we urge the administration and Congress to consider alternatives for integration as they proceed with tax reform. (See Box: Integrating the Individual and Corporate Income Taxes.)

CED also believes that the taxation of capital gains should be simplified and the prospective 20 percentage point differential between the tax rates on capital gains and ordinary (top-bracket) income should be substantially reduced. While the arguments for and against preferential treatment for capital gains are complex, it is evident that the current system is unnecessarily complicated and that such a large preferential margin simply invites tax shelters and other wasteful tax avoidance activities. One simple way to address both these problems would be to replace the multiple rates on different types of long-term gains with a deduction from taxable income of a fixed percentage of the gains.[81] This would allow a very simple computation similar to the percentage exclusion that was used during 1942-1985. **The percentage deduction should**

INTEGRATING THE INDIVIDUAL AND CORPORATE INCOME TAXES

There are four main approaches to integration:

1. Shareholder Allocation or "Full Integration,"
2. Shareholder Credits for Corporate Taxes Paid,
3. Corporate Deductions for Dividends Paid, and
4. Shareholder Exclusions for Dividends Received.

(1) Under Shareholder Allocation, all corporate earnings, whether distributed or not, are attributed to shareholders and taxed as individual income, as if the corporation were a partnership. Shareholder allocation is somewhat impractical, and not often seriously considered, because it would require that unrealized income be taxed.

(2) The Shareholder Credit provides that shareholders receive a credit for corporate taxes already paid on the dividends that the shareholder receives. The dividend income would then be taxed at the shareholder's income tax rate, and a credit for corporate tax paid would then be subtracted to determine the tax liability.

(3) The Corporate Deduction approach would have the corporation deduct dividends paid to shareholders just as it now deducts interest. The corporation tax would remain as a separate entity, and shareholders would pay tax at the individual rate.

(4) Under Shareholder Exclusion, dividends are taxed only at the corporate level and not to shareholders. A comprehensive example of this approach is the Comprehensive Business Income Tax (CBIT) that was proposed by the Treasury Department under the George H.W. Bush Administration.* Neither dividends nor interest payments would be excluded from taxable corporate income. Instead, both dividends and interest would be paid from post-tax corporate profits and distributed to shareholders on a tax-free basis.

Source: Michael J. Graetz and Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, September 27, 1999.

* US Department of Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, January, 1992

be set at a level that reduces the effective preferential margin and incentives for arbitrage and shelter activities, for instance to 10 percentage points (i.e., an effective tax rate of 25 percent on long-term gains if the top rate remained at 35 percent.) An alternative approach, if the top rate on ordinary income were reduced sufficiently, would be to tax long-term gains as ordinary income, as was done in the Tax Reform Act of 1986.

Estate and gift taxation is closely related to the issue of capital income. EGTRRA provided for gradual increases in the unified credit and thus in the effective exemption level from $600 thousand pre-EGTRRA to $1.5 million in 2005 and $3.5 million in 2009. Similar gradual reductions from 50 percent to 45 percent occur in the top rate of tax. The estate tax (but not the gift tax) is then repealed for 2010 before it reverts to its pre-EGTRRA structure in 2011. We recognize that smaller estates began to feel the burden of the tax as the real value of the (unindexed) unified credit declined prior to 2001, and that modifications were necessary. However, CED is strongly committed to the principle of equality of opportunity and does not believe that principle is compatible with the repeal of the tax on large estates that transfer major accumulations of wealth. **We therefore recommend that the estate tax be retained. One straightforward option would be to retain the scheduled 2009 exemption of $3.5 million ($7 million for couples) and top rate of 45 percent in 2010 and thereafter, while indexing the exemption level for inflation.**

Recommendation Six: Improve the Processes for Making Tax and Budget Policies

Any tax reform will face formidable challenges by vested interests that organize to maintain the preferences found in the current system. The 1986 tax reform was gradually undermined by changes that have again left a Swiss-cheese tax system in disarray today. Both a simplified income tax and a value-added tax would be susceptible to such pressures in the future.

We are not so naïve as to believe that any set of budgetary or legislative procedures will completely and permanently fix this problem; Congress can later rescind any law it passes. But improved procedures could make it politically more difficult to enact counterproductive changes by increasing public attention to tax provisions that benefit narrow interests and increase complexity, and by giving opponents of those provisions a process for actively opposing them. CED favors several such process reforms:

- **Congress should restore the pay-as-you-go (PAYGO) budget control rules that required that legislated tax cuts or increases in entitlement spending be financed by equivalent spending reductions or tax increases.**

The PAYGO rules were enacted in the Budget Enforcement Act of 1990 and later renewed before expiring in 2002. Although the application of budget control rules during the 1990s was far from perfect, we believe that the PAYGO rules (as well as the caps on discretionary appropriations) were an important factor in reducing, and temporarily eliminating, the budget deficit and in focusing government policymakers on fiscal responsibility. It was a mistake to allow these rules to expire and we strongly favor their restoration as soon as possible.

- **Congress should change the rules for "budget reconciliation" to ensure that they are used for deficit reduction, not for spending increases and tax cuts.**

At the beginning of the 1980s, Congress began to use "reconciliation bills" to expedite and protect legislation to reduce the deficit by reducing entitlement spending and raising revenues. The reconciliation process was instrumental in securing deficit-reduction legislation over nearly two decades. In recent years, however, reconciliation bills have been used to expedite and protect tax cuts that increase current and future deficits. In light of the fiscal crisis ahead, the use of reconciliation to increase the deficit should be prohibited.

- **Estimates of the budgetary cost of tax legislation should show the long-term impact on revenues when all provisions are fully phased-in; this would discourage the use of misleading estimates that assume only "temporary" revenue effects.**

As noted above, the use of "sunsets" has now become virtually standard practice in obscuring the true costs of tax legislation and allowing Congress to circumvent

the intent of budgetary rules. In addition, these temporary tax measures frustrate fiscal planning by making official budget projections misleading. The recent history of both tax and prescription drug legislation makes it evident that much more awareness and understanding of the long-term costs of fiscal actions are needed. However many years Congress chooses as the "window" for its budget decisions, it is essential that longer-term cost estimates be available when required for this purpose. In this regard, as we said in 2003, it would be useful to require statistical measures of fiscal balance (such as the "fiscal gap") and an explanation of how proposed policies would affect those measures and future levels of taxes or public debt.[82]

- **The Joint Committee on Taxation should also report the revenue-equivalent change in income tax rates that would be required to finance new tax expenditures.**

We believe that policymakers and the public should be helped to recognize not only the budgetary implications but also the forgone opportunities implied by tax legislation. Thus, if new tax expenditures are proposed, there should be not only an accounting of the revenue loss involved, but also an analysis of how much tax rates might have been reduced (or might have to be raised in the future) to finance them. While the tax rate changes might be quite small for individual provisions of law, they could be significant in the aggregate, and their presentation would, in any case, make an important point.

- **Congressional rules should preclude the consideration of tax legislation unless it is accompanied by a report by the Joint Committee on Taxation that estimates its impact on complexity and on reporting and compliance burdens.**

In 1998, the Congress passed legislation requiring the JCT to prepare for each Congress a report on the overall state of the tax system, including simplification proposals. A comprehensive report was submitted in 2001, but has been largely ignored by policymakers. This legislation also mandated that the JCT provide complexity analysis of tax bills as soon as possible after bills are filed. However, the legislative process has not provided time for such reporting. Our proposal would strengthen this complexity analysis by requiring it before consideration of the legislation. Congress, of course, can waive such a requirement, but such disregard for increasing tax complexity should at least be a matter of public record.[83]

- **The Office of Management and Budget, the Treasury Department, and other federal agencies should conduct more rigorous evaluations of tax expenditures and their relationship to spending programs.**

As described above, tax expenditures, like ordinary spending programs, now are major instruments of government policy. The roughly $725 billion of tax expenditures is equivalent to about 30 percent of non-interest spending for 2005. Many of these tax preferences appear to be unwarranted, for the reasons we have noted—yet little analysis has been done on their effects. And even preferences that might be warranted often overlap with ordinary spending programs. Yet tax and spending policies have historically moved on two separate tracks, with little coordination. In 2004, the Office of Management and Budget began to provide explicit directives to federal agencies to include tax expenditure information and analysis in their budget submissions, as called for by the Senate Governmental Affairs Committee report on the 1993 Government Performance and Results Act (GPRA). We applaud this initiative. Yet, the President's 2006 budget shows little evidence of the incorporation of tax expenditure analysis into its policy decisions. Indeed, the budget states that, with regard to performance objectives, "the Executive Branch is continuing to focus on the availability of data needed to assess the effects of tax expenditures designed to increase savings." We believe that a much more comprehensive effort is required to evaluate the effects of tax expenditures, given their enormous budgetary cost at a time of impending fiscal crisis.[84]

Recommendation Seven: Provide the Internal Revenue Service With Political Support And Resources

The Internal Revenue Service has for many years been starved of resources, and in the late 1990s problems with customer service turned it into a political target. Its problems with the public led to a major effort to improve taxpayer service, but this commitment of resources, in the absence of significant funding

increases, meant that enforcement expenditures, IRS staff, audit rates, and tax prosecutions and penalties all significantly declined. The audit rate on taxpayers with reported incomes greater than $100,000 declined from 5.3 percent in 1992 to 1.39 percent in 2004, at the same time that Congress mandated a disproportionate enforcement focus on low-income EITC recipients, which does not appear to be a cost-effective use of these scarce resources.[85] Meanwhile, the IRS Oversight Board has observed that "the stark budget reality [is that the] IRS does not have the resources to close the $300 billion tax gap", which comes to about $2,000 per taxpayer return.[86] Although the administration's budget requests have been almost fully funded, those requests typically have not been large enough to accommodate stronger enforcement, better taxpayer service, and mandated "unbudgeted expenses" such as government-wide pay increases.[87]

We recognize that there have been some positive developments in enforcement recently, in particular the actions taken by the IRS to shut down abusive tax shelters and renewed Congressional interest in this issue.[88] But this is only a small part of the larger compliance problem. It is apparent to us that the IRS does not have enough resources to produce both high quality taxpayer service and vigorous, effective enforcement, despite the best efforts of several IRS Commissioners to balance these objectives. We recognize that the IRS continues to face problems other than inadequate funding, in particular the modernization of its business systems. But the reports of the GAO and the IRS Oversight Board make it clear that funding is a fundamental barrier to effective enforcement.

We believe there is a serious danger that taxpayers' incentives to comply voluntarily with the tax laws will be compromised by weak enforcement and perceptions that the tax code is unfairly applied and enforced. We also believe that it is very short-sighted, in an era of increasing budget deficits, not to invest more resources in reducing the $300 billion tax gap. The IRS Oversight Board estimates that additional enforcement resources have approximately a 4 to 1 return, and that increasing the Administration's FY2006 request for enforcement activities by $435 million would increase revenues by about $1.74 billion.[89]

For these reasons, CED believes the administration and Congress should reaffirm their support for the IRS and its mission and restore IRS staff and funding to the levels required for effective administration and enforcement.

V. Adding It Up: The Budget Impact of the New Framework

The above recommendations for a new framework are for the most part broad and directional and do not attempt to provide a detailed tax program. Such a detailed set of policy changes could take many different forms, especially with regard to the reduction of tax preferences. Nevertheless, we can illustrate the effects of the new framework by making some simplifying assumptions about such policy changes, as detailed below. Figures 5 and 6 and Table 1 show the long-term budgetary impact of such a simplified CED tax framework in the context of different assumptions about spending policies.

Spending Restraint Under Current Tax Policies

Figure 5 and Table 1-A outline the budget effects of a very substantial reduction in spending growth in the context of a continuation of current tax policies. The "historical spending" and "restrained spending" paths are those described in Section II above (adjusted to reflect the effects of current tax policy on interest costs). It should be recalled that the "restrained spending" path implies severe—perhaps unrealistic—reductions in Medicare and Medicaid spending as well as other spending reductions, compared with historical trends.

Figure 5

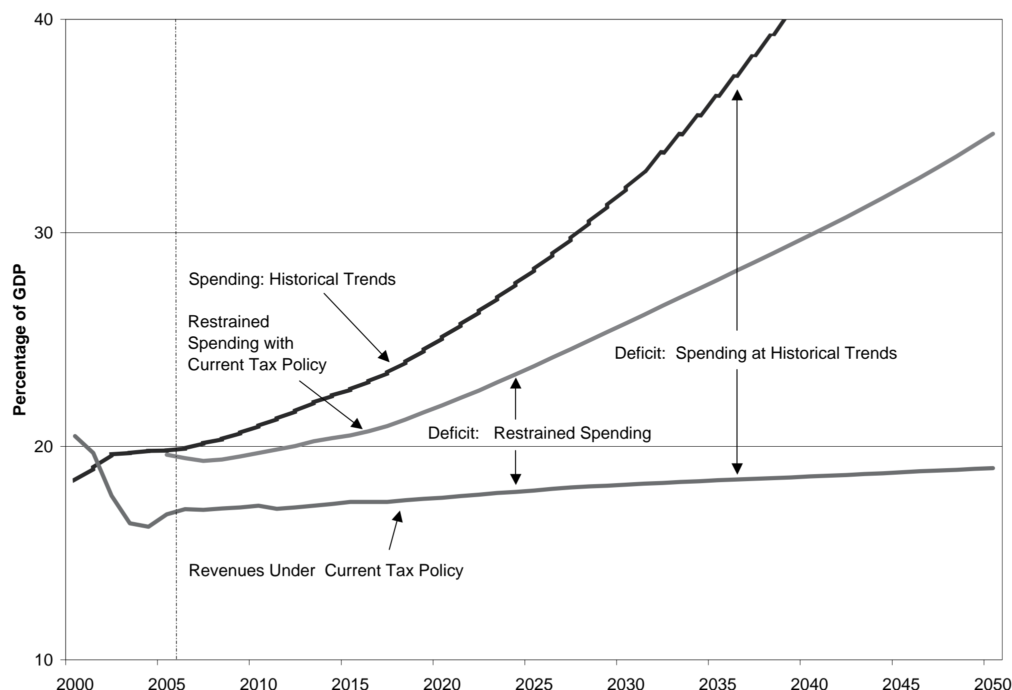
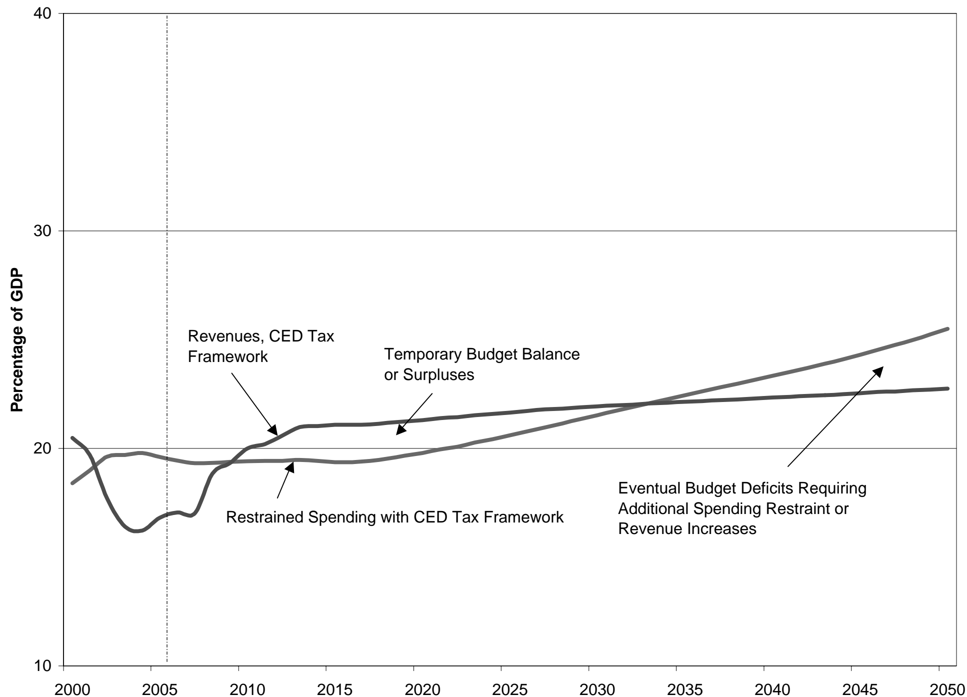


Figure 6



"Current tax policy" assumes that the 2001-2004 tax cuts and other expiring provisions (including estate tax repeal) will be extended and that the individual AMT will be curtailed enough to prevent a significant increase in the proportion of AMT taxpayers.

The notable result shown in Figure 5 and Table 1-A is that, under current tax policies, even this quite severe spending restraint does not come close to restoring fiscal balance or a sustainable fiscal policy, with debt growing no faster than GDP.` While deficits, of course, are smaller than under the "historical spending" scenario, they continue to grow steadily towards 5.8 percent of GDP in 2025 and nearly 10 percent by 2035. The debt/GDP ratio, reflecting the spiraling effect of higher interest costs, rises rapidly and exceeds 100 percent of GDP by 2035.

The CED Tax Framework With Spending Restraint

Figure 6 and Table I-B, in comparison, show the long-term budget effects of substituting the CED tax framework for current tax policy, with the same restrained spending policies assumed above. (The slower growth of "restrained spending" in Figure 6 results entirely from the lower interest costs associated with the higher revenues and lower deficits.)

The simplified CED tax framework used here assumes the "current tax policies" described above, modified by the following changes beginning in 2008:

- A phased-in VAT beginning at a 5 percent rate, rising to 10 percent in 2012;
- A refundable income tax credit providing VAT relief for low-income households (see page 32 and footnote 74);
- Unspecified reductions in tax preferences that raise 0.5 percent of GDP in revenues;
- Repeal of the AMT;
- Integration of the individual and corporate income taxes with an individual dividend exclusion;
- Retention of the estate tax with an indexed $3.5 million exemption and 45 percent top rate, as provided in current law for 2009 (effective in 2010); and

Table 1

BUDGET EFFECTS OF TAX POLICY CHANGES WITH SPENDING RESTRAINT
Percentage of GDP

TABLE 1-A: EFFECTS OF CURRENT TAX POLICY AND SPENDING RESTRAINT

	2000	2005	2015	2025	2035
With Spending at Historical Trends [1]					
Revenues (current tax policy) [2]	20.9	16.8	17.4	17.9	18.4
Spending	18.4	19.8	22.7	28.3	36.4
Surplus or Deficit (-)	2.4	-3.0	-5.3	-10.4	-18.0
Debt	35.1	40.5	58.6	105.8	192.1
With Substantial Spending Restraint [1]					
Revenues (current tax policy) [2]	20.9	16.8	17.4	17.9	18.4
Spending	18.4	19.6	20.5	23.8	27.8
Surplus or Deficit (-)	2.4	-2.8	-3.1	-5.8	-9.4
Debt	35.1	40.3	46.7	69.4	111.6

TABLE 1-B: EFFECTS OF CED TAX FRAMEWORK AND SPENDING RESTRAINT

	2000	2005	2015	2025	2035
Revenues (current tax policy, above)	20.9	16.8	17.4	17.9	18.4
Revenue Changes:					
VAT at 10 percent			4.0	4.0	4.0
Low-income VAT relief			-0.6	-0.6	-0.6
Reduce tax preferences			0.5	0.5	0.5
Repeal AMT [3]			-0.3	-0.3	-0.3
Integrate individual and corporate taxes			-0.2	-0.2	-0.2
Maintain estate tax at 2009 exemption and rate			0.2	0.2	0.2
Reform capital gains taxation			0.2	0.2	0.2
Total Revenue Changes			3.7	3.7	3.7
Revenues, CED Tax Framework			**21.1**	**21.6**	**22.1**
Restrained Spending without CED Tax Framework (above)	18.4	19.6	20.5	23.8	27.8
Reduced Interest from Lower Deficits			-1.1	-3.2	-5.4
Restrained Spending with CED Tax Framework			**19.4**	**20.6**	**22.4**
Surplus or Deficit (-)	2.4	-2.8	**1.7**	**1.0**	**-0.3**
Debt	35.1	40.3	**21.4**	**2.3**	**-0.8**

Notes:

1. For description of the historical trend spending path and spending restraint, see notes to Figure 1 and text.
2. Current tax policy assumes extension of expiring tax provisions, including estate tax repeal, extension of the AMT exemption at its 2005 level, and indexing of the AMT exemption and other AMT parameters.
3. Difference between AMT repeal and the AMT modification in the current tax policy baseline described in footnote 2. AMT repeal loses revenues of 0.9 percent of GDP compared with unmodified AMT and extension of expiring tax cuts.

- Long-term capital gains taxed by deducting 28.6 percent of the gains from taxable income (equivalent to a 25 percent top capital gains rate).

As shown in Figure 6 and Table 1-B, the effects of substituting the CED tax framework for current tax policy in the context of substantial spending restraint are striking. For a period of several decades, the deficit moves into surplus and the debt/GDP ratio falls towards zero, before deficits reappear under continuing pressures from health care costs.

Two caveats are important here. First, the assumed spending restraint is quite large, so that the projected budget surpluses during 2010-2033 may be optimistic.

Whatever the degree of spending restraint, however, the budgetary impact of raising revenues in the near future would be dramatic. Second, the CED tax framework is no budget panacea; eventually deficits reappear and debt burdens begin to rise. As noted in Section II above, fundamental changes in expenditure programs, and in particular the entitlement programs on "automatic pilot," are not only necessary, but inevitable in the long term.

Nevertheless, the vital lesson to be drawn from Figure 6 and Table 1-B is that the additional revenues from the CED tax framework not only reduce deficits and debt directly, but, by forestalling an explosion in interest costs, allow us to "buy time" to restructure health care and other expenditure programs. Table 1-B shows these remarkable fiscal benefits of compound interest; the larger revenues reduce interest costs in 2025 by 3.2 percent of GDP, nearly as large as the direct revenue impact of 3.7 percent, and by 2035 the interest effect is much larger.

In addition, the VAT, levied on a broad base, would allow necessary additions to revenue without the very large increases in income tax rates that would otherwise be necessary. It would require an increase in income tax rates of 35-40 percent to raise the net revenues of about 3.7 percent of GDP produced by the proposed CED tax framework, including the VAT levied on a very broad base.

We therefore believe there would be manifold benefits from CED's new tax framework. A simpler and fairer income tax, maintaining relatively low marginal tax rates, would benefit taxpayers directly and improve economic efficiency and welfare. A supplementary VAT would raise the revenues required to increase national saving and help forestall a fiscal crisis that would curtail growth of the economy and living standards.

VI. Conclusion

The current public discussion of tax reform misses a central point—the inadequacy of the current system for raising the revenues the nation will need in the future. The primary purpose of any tax system must be to raise the revenues required to pay for government. Here the current system, and the current discussion, fail.

Reform is urgently needed. We have outlined broadly the direction that such reform should take—an improved income tax supplemented by a VAT. A simpler income tax with fewer preferences and complex provisions would be fairer to ordinary taxpayers and would enhance economic efficiency and growth. And a VAT would provide the additional revenues required to help address the impending fiscal crisis.

Taken together, CED's recommendations involve far-reaching changes in our tax system. However, unlike some "fundamental tax reforms" that involve scrapping the income tax entirely and thereby creating enormous problems in the transition to a new system, this "hybrid" system could be more easily implemented. The fundamental structure of the income tax would not change, and the journey to a VAT, which would admittedly require many difficult choices, would take place on the well-prepared ground that over 100 other nations have covered in recent decades.

Changes of this magnitude clearly will have to be implemented in stages, and many design details will have to be considered at each stage. Such changes will encounter strong resistance, especially from those who oppose all and any tax increases and from those with strong vested interests in the current system. But the tax system and the long-term federal budget outlook continue to deteriorate, and soon the inadequacy of revenues will be impossible to ignore. We must seize the moment before the crisis arrives.

Endnotes

1. Committee for Economic Development (CED), *Exploding Deficits and Declining Growth: The Federal Budget and the Aging of America* (Washington, D.C.: CED, 2003).
2. William G. Gale and Peter R. Orszag, "Bush Administration Tax Policy: Revenue and Budget Effects," *Tax Notes*, vol. 105, no. 1 (2004), p. 111. This estimate assumes an extension of the 2001-2003 and other expiring tax cuts, indexing of the AMT that prevents significant growth in the number of AMT taxpayers, constant real per capita discretionary spending, and (optimistically) that "excess cost growth"—the difference between the growth of costs per enrollee and that of per capita GDP—in Medicare and Medicaid is only one percent. If the tax cuts are *not* extended, the fiscal gap would be 5.1 percent of GDP. In 2001 the fiscal gap over the 2001-2070 period was estimated at 1.45 percent of GDP.
3. Congressional Budget Office (CBO), *The Long-Term Budget Outlook* (Washington, D.C.: CBO, December 2003) Table 1-1, p. 7. The higher estimate assumes that excess cost growth continues at past rates, about 2.5 percent annually, while the lower estimate assumes that excess cost growth slows to about 1 percent. The lower estimate is consistent with the fiscal gap estimate of 7.1 percent of GDP.
4. See CED, *A New Vision for Health Care: A Leadership Role for Business* (Washington, D.C.: CED, 2002).
5. CBO, *The Budget and Economic Outlook: Fiscal Years 2006-2015* (Washington, D.C.: CBO, January 2005), Table 3-6, p. 69.
6. Alan J. Auerbach, William G. Gale, and Peter R. Orzag, "Sources of the Long-Term Fiscal Gap," *Tax Notes*, vol. 103, no. 8 (2004), p.1057. This estimate, like those of the long-term fiscal gap referenced above, assume extension of a higher exemption and indexing of the AMT that prevent significant growth in the number of AMT taxpayers.
7. CBO, *The Long-Term Budget Outlook*, pp. 6-11. See Table A-1, pp. 50-51, for detailed specifications for the two spending paths, labeled Scenario 1 and Scenario 2 respectively.
8. Henry J. Aaron and Jack Meyer, "Health," in Alice M. Rivlin and Isabel Sawhill, eds, *Restoring Fiscal Sanity 2005* (Washington, D.C.: The Brookings Institution, 2005), pp. 88, 89.
9. CED, *Exploding Deficits and Declining Growth: The Federal Budget and the Aging of America*, p. 26.
10. See CED, *Fixing Social Security* (Washington, D.C.: CED, 1997) and CED, *Fixing Social Security: A CED Policy Update* (Washington, D.C.: CED, 2005); CED, *Who Will Pay For Your Retirement? The Looming Crisis* (Washington, D.C.: CED, 1995); CED, *A New Vision for Health Care: A Leadership Role for Business* (Washington, D.C.: CED, 2002).
11. Henry J. Aaron and Jack Meyer, "Health," pp. 73-86.
12. CBO, *The Long-Term Budget Outlook*, p. 27.
13. Estimated from CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2006* (Washington, D.C.: CBO, March 2005), Table 1-6, p. 12. This estimate includes $40 billion in military spending that CBO estimates would be required to maintain activities in Iraq and Afghanistan at 2005 levels.
14. CED staff estimate.
15. IRS Oversight Board, *Annual Report 2004* (Washington, D.C.: IRS Oversight Board, July 2004), p. 17.
16. Office of Management and Budget (OMB), *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004* (Washington, D.C.: OMB, 2003), pp. 101-140. In principle, the comprehensive income baseline defines income as the sum of consumption and the change in net wealth during the relevant time period. However, due to administrative and other problems involved in taxing some forms of "comprehensive" income, the baseline actually used departs from comprehensive income in some respects.
17. National Tax Department of Ernst & Young LLP, "A Guide to the American Jobs Creation Act of 2004," *Tax Notes*, vol. 105, no. 3 (2004), p. 343.
18. U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals* (Washington, D.C.: Department of the Treasury, February 2005).
19. CBO, *The Budget and Economic Outlook: Fiscal Years 2006-2015*, Table 4-10, pp. 99-101.
20. Leonard E. Burman and others, "The Individual Alternative Minimum Tax: A Data Update," The Tax Policy Center, *A Data Update* (Washington, D.C.: The Brookings Institution, August 2004); The Tax Policy Center, "Table T05-0026: Aggregate AMT Projections, 2005-15," available at <www.taxpolicycenter.org/TaxModel/tmdb/Content/PDF/T05-0026.pdf>
21. Nina Olson, *National Taxpayer Advocate's 2003 Annual Report to Congress* (Washington, D.C.: IRS, December 2003), p. 16; IRS Oversight Board, *FY2005 Budget/Special Report* (Washington, D.C.: IRS Oversight Board, March 2004), p. 22.
22. Leonard E. Burman and others, *The Individual AMT: Problems and Potential Solutions*, Discussion Paper No. 5 (Washington, D.C.: The Urban Institute, September 2002), pp. 33-35.

23. For instance, according to the OMB, "…some taxpayers can offset the cost of child care assistance using either a child and dependent care tax credit or an exclusion from income, but they must make multiple computations to determine which of the two is the most advantageous." OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2003* (Washington, D.C.: OMB, 2002), p. 77.

24. Anne Berube and others, "The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC," *The Brookings Institution and The Progressive Policy Institute Survey Series* (May 2002), p. 1.

25. CBO, *Budget Options* (Washington, D.C.: CBO, 2005), pp. 271-272.

26. The relationship of deficits to saving, investment, productivity growth, and living standards is analyzed in CED, *Exploding Deficits and Declining Growth: The Federal Budget and the Aging of America*, pp. 5-9.

27. Taxes create a "deadweight loss"—an economic loss to society above and beyond the value of taxes collected or the simple costs of administration and compliance. See Harvey S. Rosen, *Public Finance*, 6th edition (New York, NY: McGraw Hill, 2002), p. 531. The "deadweight loss" from a tax increases with the square of the tax rate. Thus, tax rates of zero and ten percent respectively on two activities of equal value produce twice as large an economic loss as equal five percent tax rates.

28. CED, *A New Vision for Health Care: A Leadership Role for Business*, p. 12.

29. OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2005* (Washington, D.C.: OMB, 2004), Table 18-1, pp. 287-289.

30. Steven Pearlstein, "A Culture of Subsidies Inflates Costs," *The Washington Post*, December 1, 2004, p. E1.

31. Bridget Terry Long, *The Impact of Federal Tax Credits for Higher Education Expenses*, Working Paper No. 9553 (Cambridge, MA: National Bureau of Economic Research, March 2003). This paper examines the Hope and Lifetime Learning Tax Credits.

32. See Slemrod and Bakija, *Taxing Ourselves*, pp.185-190.

33. CED, *A New Vision for Health Care: A Leadership Role for Business*, pp. 12-13.

34. See Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform* (Cambridge, MA: The MIT Press, 2000), p. 113 and other sources cited there.

35. C. Eugene Steuerle, "Retirement Saving Incentives and Personal Saving," *Tax Notes*, vol. 105, no. 13 (2004), p. 1689.

36. Eric M. Engen and William G. Gale, *The Effects of 401(k) Plans on Household Wealth: Differences Among Earnings Groups*, Working Paper #8032 (Cambridge, MA: National Bureau of Economic Research, December 2000).

37. A survey of the economics literature estimated that only $0.26 of every dollar contributed to an IRA is new saving. See R. Glenn Hubbard and Jonathan S. Skinner, "Assessing the Effectiveness of Saving Incentives," *Journal of Economic Perspectives*, vol. 10, no. 4 (1996), p. 80. During 1982-2004, while savings preferences expanded rapidly, the U.S. personal saving rate fell from 10.9 percent to 1.2 percent.

38. CED, *Restoring Prosperity: Budget Choices for Economic Growth* (Washington, D.C.: CED, 1992). CED, *Growth With Opportunity* (Washington, D.C.: CED, 1997).

39. Eric Toder, "Evaluating Tax Incentives as a Tool for Social and Economic Policy," in *Bad Breaks All Around: The Report of the Century Foundation Working Group on Tax Expenditures* (New York, NY: The Century Foundation Press, 2002).

40. Harvey S. Rosen, *Public Finance*, p. 339. The appropriate income measure, however, also raises important questions with respect to both the time period considered (e.g. annual versus lifetime income) and the items included (e.g. in-kind, imputed, or non-cash-transactions sources).

41. Eric Toder, "Evaluating Tax Expenditures," p. 73.

42. William G. Gale, "Tax Simplification: Issues and Options" (Testimony submitted to: Congress of the United States House of Representatives, Committee on Ways and Means, Subcommittee on Oversight and Subcommittee on Select Revenue Estimates, Washington, D.C., July 17, 2001), p. 18; Joel Slemrod, "The Simplest Tax System," in Henry J. Aaron and William G. Gale, eds., *Economic Effects of Fundamental Tax Reform* (Washington, D.C.: The Brookings Institution, 1996), p. 367.

43. Associated Press Poll conducted by ICR (March 2002), available at <www/pollingreport.com/budget.htm> Accessed October 21, 2003.

44. $312-353 billion is the gross tax gap. The net tax gap, after enforcement activities and late payments, is estimated at $257-298 billion. Tax gap estimates for individual returns are based on 2001 data, whereas the corporate estimates are based on older and less reliable data and have not yet been updated. See Internal Revenue Service, *The Tax Gap*, available at <www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf> Accessed April 27, 2005.

45. IRS, Budget Office, Performance Budgeting Unit; Syracuse University, Transactional Records Clearing House, 9th Annual Study, 2004.

46. IRS Oversight Board, *Annual Report 2004*, p. 1.

47. U.S. General Accounting Office, *Comparison of the Reported Tax Liabilities of Foreign- and U.S.-Controlled Corporations, 1996-2000*, GAO-04-358 (Washington, D.C.: U.S. General Accounting Office, February 2004), cited in IRS Oversight Board, 2004 Report, p. 12.

48. Howard Gleckman and others, "Tax Dodging: Enron Isn't Alone, Plenty of Companies Pay Little or Nothing," *Business Week Online*, March 4, 2002, available at <www.businessweek.com:/print/magazine/content/02_09/b3772051.htm?mz>

49. Mihir A. Desai, "The Divergence Between Book and Tax Income" in James M. Poterba, ed., *Tax Policy and the Economy, Volume 17* (Cambridge, MA: National Bureau of Economic Research, The MIT Press, 2003).

50. See C. Eugene Steuerle, *The Tax Decade: How Taxes Came to Dominate the Public Agenda*, (Washington, D.C.: The Urban Institute Press, 1992), Tables A-4, A-1. The net reduction in tax expenditures due to base broadening (excluding that which derived from rate reduction) was $32.2 billion, or about 0.66 percent of GDP. These are measured on an "outlay equivalent" basis, however, so that the equivalent revenue gain would be significantly smaller. We take 0.5 percent of GDP as a very rough estimate of the gain. On a gross basis, before the "give-backs," the base broadening was about 1.7 percent of GDP on an outlay equivalent basis, or perhaps 1.25 percent of GDP in increased revenues.

51. Strictly speaking, the exclusion from tax of the implicit income received from owner-occupied housing is the underlying tax preference; were this income taxed, mortgage interest would be a legitimate deduction.

52. OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2005*, Table 18-1, pp. 287-289. This includes the refundable outlay portion of the EITC of $33.6 billion.

53. Leonard E. Burman and others, *The Individual Alternative Minimum Tax: A Data Update* (Washington, D.C.: Tax Policy Center, August 2004), Table 9.

54. Repeal of the reductions in the top two marginal rates, the capital gains and dividend reductions, and the phase-outs of the limitations on personal exemptions and the standard deduction would raise about $76.9 billion in FY 2013, which is 0.43 percent of GDP as projected by CBO. See Tax Policy Center, Table T04-0157, October 13, 2004.

55. U.S. Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-2-05 (Washington, D.C.: Joint Committee on Taxation, January 2005).

56. CED, *Restoring Prosperity: Budget Choices for Economic Growth*.

57. Leonard E. Burman and William G. Gale, "A Golden Opportunity to Simplify the Tax Code," *Brookings Policy Brief*, no. 77 (April 2001), p. 7.

58. John Langbein, "Social Security and the Private Pension System," in Teresa Ghilarducci, Van Doorn Ooms, and others, eds., *In Search of Retirement Security: The Changing Mix of Social Insurance, Employee benefits, and Individual Responsibility* (New York, NY: The Century Foundation Press, 2005), pp. 109-113. "The very term "pension plan" is increasingly a misnomer for defined contribution plans. They are in truth multi-purpose savings, investment, and wealth transmission vehicles for the tax-sensitive classes."

59. See footnote 43. This change could be designed either to raise additional revenue or, if revenue neutral, to raise personal saving. This is both because the incremental propensity for *new* saving is higher at lower income levels and because more incentives can be financed with the revenues saved from ending high-bracket exclusions.

60. See Adam Carasso, Jeffrey Rohaly, and C. Eugene Steuerle, "A Unified Children's Tax Credit" (paper presented at the National Tax Association's 97th Annual Conference, Minneapolis, MN, November 11-13, 2004); also Robert Cherry and Max B. Sawicky, "Giving Tax Credit Where Credit Is Due A 'Universal Unified Child Credit' that Expands the EITC and Cuts Taxes for Working Families," *Economic Policy Institute Briefing Paper*, no. 91 (April 2000). Inclusion of the dependent exemption might depend upon whether relief from the AMT at higher income levels was an objective in addition to low-income and child support.

61. CED, *A New Vision for HealthCare: A Leadership Role for Business*, p. 30. CBO, *Budget Options*, Revenue option 15, p. 284. The cost estimate (adapted from CBO) assumes enactment in 2005 and that the cap is indexed.

62. U.S. Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*.

63. Nina Olson, *National Taxpayer Advocate's 2003 Annual Report to Congress* ; Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986*, JCS-3-01 (Washington, D.C.: U.S. Government Printing Office, April 2001).

64. CED first recommended a VAT, albeit in very different fiscal circumstances, in CED, *A Better Balance In Federal Taxes On Business* (Washington, D.C.: CED, April 1966).

65. An excellent summary of recent developments regarding the VAT can be found in Liam Ebrill, Michael Keen, and others, *The Modern VAT* (Washington, D.C.: International Monetary Fund, 2001); for an excellent earlier analytical treatment see Charles E. McLure, Jr., *The Value-Added Tax: Key to Deficit Reduction?* (Washington, D.C.: American Enterprise Institute, 1987).

66. For a more detailed argument for combining a VAT with the income tax, see Reuven S. Avi-Yonah, "Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT," *Tax Notes*, vol. 105, no. 13 (2004), pp. 1651-1666.

67. Liam Ebrill, *The Modern VAT*, pp. 20-24.

68. CBO, *Effects of Adopting a Value-Added Tax* (Washington, D.C.: CBO, February 1992), chapter 4.

69. For a brief analysis of these issues, see McClure, *The Value-Added Tax: Key to Deficit Reduction?* Chapter 7. The argument for conforming state RSTs to VATs using the federal VAT base is made by Reuven S. Avi-Yonah, "Risk, Rents, and Regressivity: Why the United States Needs Both an Income Tax and a VAT," p. 1665.

70. See James M. Bickley, *Value-added Tax in Canada: Background, Evaluation, and Implications for the United States,* Congressional Research Service Report for Congress (Washington, D.C.: Congressional Research Service, The Library of Congress, April 1993), p. 10.

71. CBO, *Effects of Adopting a Value-Added Tax*, pp. 67-74, which estimated administrative costs of about $1 billion and compliance costs of $4-7 billion for 1988.

72. This is a conservative estimate of VAT revenues which assumes some slippage due to the impact on revenues from other taxes, non-compliance, and administrative costs. McClure estimates that a "limited exclusions" VAT base would comprise 79 percent of consumption, so that a 10% VAT rate translates into 5 to 5.5% of GDP. Graetz assumes a 10% VAT raises 5 percent of GDP. Michael Graetz, "100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System," *Yale Law Journal*, vol. 112, no. 2 (November 2002), Appendix. See also William G. Gale and C. Eugene Steuerle, "Tax Policy Solutions" in Alice M. Rivlin and Isabel Sawhill, eds., *Restoring Fiscal Sanity 2005: Meeting the Long-Run Challenge* (Washington, D.C.: The Brookings Institution, 2005). In this estimate, small businesses and the education, religion, and healthcare sectors are exempt from the VAT.

73. Because consumption and saving patterns vary with age, lifetime measures provide a better index of relative tax burdens. See Gilbert Metcalf, "Value-added Taxation: A Tax Whose Time Has Come," *Journal of Economic Perspectives*, vol. 9, no. 1 (1995).

74. See CBO, *Historical Effective Federal Tax Rates: 1979 to 2002* (Washington, D.C.: CBO, March 2005), Tables 1C, 2C, 3C, 4C. The relief could also be provided by a separate credit; see Laurence Seidman, "A Progressive Value Added Tax: Has Its Time Finally Come?" *Tax Notes*, vol. 103, no. 10 (2004). In the bottom two quintiles of the income distribution in 2002, there were 60 percent childless households and 40 percent households with children.

75. CBO, *Effects of Adopting a Vale-Added Tax*, p. 38. This credit, structured for a 4 percent VAT, provided households with incomes below 125% of poverty with a refundable credit of 5 percent of poverty level income; at 125 percent of poverty the credit began to phase out at a 5 percent rate. The parameters of the credit would be adjusted to fit a 10 percent VAT.

76. David Alan Stockman, *The Triumph of Politics: Why the Reagan Revolution Failed* (New York, NY: Harper and Row Publishers, 1986).

77. A number of proposals for AMT reform are listed in Leonard Burman and others, "The Individual AMT: Problems and Potential Solutions," Discussion Paper no. 5 (Washington, D.C.: The Tax Policy Center, September 2002).

78. See footnote 30.

79. Rosen, *Public Finance*, Chapter 17.

80. Don Fullerton and Diane Lim Rogers, *Who Bears the Lifetime Tax Burden?* (Washington, D.C.: The Brookings Institution, 1993), pp. 223-228.

81. See CBO, *Budget Options*, Revenue Option 06, p. 271.

82. CED, *Exploding Deficits and Declining Growth: The Federal Budget and the Aging of America*, p. 30.

83. C. Eugene Steurele has made a number of suggestions for strengthening procedures for reporting on tax complexity. See, for instance, "Tax Simplification: Testimony Before the United States' House of Representatives Subcommittee on Oversight, Committee on Ways and Means" (Urban Institute, July 17, 2001).

84. See OMB, *Circular A-11*, 2004, Section 33-5 and United States Senate Committee on Government Affairs, *Government Performance and Results Act of 1993*, 103rd Cong., 1st sess., 1993, Report 103-58, and OMB, *Analytical Perspectives, The Budget of the United States Government, Fiscal Year 2006* (Washington, D.C.: OMB, 2005), p. 332. This analysis (pp. 332-334) provides only a general comparison of tax expenditures with spending programs and a listing of tax expenditures in the functional framework of spending programs.

85. U.S. Government Accountability Office, *Internal Revenue Service: Assessment of Fiscal Year 2005 Budget Request and 2004 Filing Season Performance*, GAO-04-560T, 2004, p. 6; Syracuse University, Transactional Records Clearing House, 9th Annual Study, 2004 ; Leonard E. Burman, "Statement of Leonard E. Burman, Senior Fellow, the Urban Institute, Co-director, the Tax Policy Center, Research Professor, Georgetown Public Policy Institute, Before The Committee on the Budget, United States House of Representatives, On Waste, Fraud, and Abuse, In Federal Mandatory Programs" (testimony for The U.S. House of Representatives Committee on the Budget, Washington, D.C., July 9, 2003).

86. IRS Oversight Board, *Annual Report 2004*, p. 12.

87. U.S. Government Accountability Office, *Internal Revenue Service: Assessment of Fiscal Year 2005 Budget Request and 2004 Filing Season Performance*, p. 10.

88. U.S. Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, *The Role of Professional Firms in the U.S. Tax Shelter Industry,* 109th Cong., 1st sess., 2005.

89. IRS Oversight Board, *FY2006 IRS Budget Special Report* (Washington, D.C.; IRS Oversight Board, March 2005), p.20 and Appendix 2.

Memoranda of Comment, Reservation or Dissent

On progressivity and equity (pp. iv, 25) W. BOWMAN CUTTER, with which W.D. EBERLE and LINDA SMITH WILSON have asked to be associated .

I wish to emphasize that, while fully agreeing with the analysis and recommendations of this report, my personal long term and continuing support for this report or any subsequent effort actually to change the tax system in these directions depends upon a real commitment to maintaining a progressive tax structure and to protecting low income households. In my personal view, tax policy during the last 5 years has moved in the wrong direction and has left a tax system that both raises inadequate revenues for the long term and has increased regressivity. I am also fully aware of the genuine skepticism with which any suggestion of a VAT is greeted because a VAT, by itself, can be regressive. However, I also believe strongly that the combination proposed here of the income tax and a supplemental VAT uniquely enables the nation to raise the revenues it requires and simultaneously to return progressivity to the tax system.

On AMT Repeal (pp iv, 32-33) and IRS Enforcement (pp v, 39-40), JOSH WESTON

AMT Repeal

The Alternative Minimum Tax (AMT) should not be entirely repealed. Instead, a much simpler AMT should be retained as part of an improved tax system. This is because any likely income tax system will inevitably be accompanied by preferences and "loopholes" that produce an "avoidance industry" that produces unfair outcomes, cynicism, and resentment. As the CED statement says, the current AMT is too complicated, affects too many taxpayers of modest income, and has too many loopholes of its own, to be efficient, fair and simple.

I recommend a simple AMT with a higher exemption (perhaps $100,000 for joint filers) indexed for inflation that would apply to *all* income (including municipal bond interest and capital gains.) This comprehensive income would be taxed at a low, flat rate of perhaps 10 percent if the resulting tax exceeded regular income tax liability. Such an AMT, with absolutely no deductions, would be very simple. It would affect only a relatively small number of high-income people. The relatively low tax rate could hardly be called burdensome to productive economic behavior or to high income taxpayers who would otherwise pay little or no tax.

Even if such an AMT did not produce large additional revenue, it would increase the perception and reality of fairness and honesty compared with the status quo of loopholes, avoidance, and evasion.

CED's proposal of a hybrid system of VAT and income tax is sound, but does not realistically address the problems of fairness raised by the repeal of the AMT, since in practice the regular income tax is unlikely to be modified sufficiently to do so. I therefore recommend that the CED proposal include such a simplified AMT.

With regard to complexity, the simple AMT could be implemented by adding just a few lines to Form 1040, without additional, complex schedules as at present. In addition, because this proposed AMT is somewhat progressive (because of the $100,000 exemption), it would moderate to a degree the political and social disadvantages of the VAT, which is by its very nature regressive.

IRS Enforcement

I support the recommendation that additional political support and resources should be provided to the IRS, but believe it should be more explicit. I believe the IRS budget and directives from the Congress should provide for a return of the audit rate to at least its historical level of about 1-2 percent (compared with 0.6-0.8 percent recently) and should also permit a much deeper audit of questionable tax shelters and other strategies for tax avoidance.

On several issues, as indicated, JAMES RIORDAN

[Comment #1 — General] (pp. i, 1)

The report is a good contribution to the current debate on tax reform. It makes many important points:

1. The budget deficit needs to be reduced (but with more expense control and less tax increase than is recommended.)
2. The income tax is broken and needs to be reformed. It is too complicated and has too many special provisions. It is biased against savings.
3. We need a VAT (a new revenue source) in addition to an income tax to help us address points 1 and 2. (But the total program should be distributionally neutral and the reform of the income tax should eliminate the bias against savings and make the income tax simpler and more transparent.)
4. The Congressional budget process needs fixing and responsible implementation.
5. The tax legislative process needs fixing and responsible implementation.
6. The IRS should be appropriately funded and supported (and not burdened with the administration of business subsidies and welfare programs that are outside its competence. Those programs—to the extent that they are needed—should be handled through the appropriation process and be administered by other agencies.)

[Comment #2 — Expenditure Control and Taxes] (pp. i, 3)

The report talks a good game about a war on all fronts to reduce the deficit, but fails to make clear the urgent need for prompt expenditure control, especially for medical and other entitlements. There are no specific expense reduction suggestions in the report. The report doubts that even a "restrained" projection of entitlement increases can be achieved. Its primary thrust is for the prompt imposition of more total taxes than we have ever collected in peacetime. A stated purpose is to "buy time" for future expense entitlement reductions that unfortunately are not described. The report calls for these higher taxes with no clearly stated cap.

In my view it is impractical and unwise to suggest the federal government will or should collect more than 20% of GDP in peacetime. The report should have been built on that "inexorable" assumption along with the other "inexorable" assumptions that the report accepts. That would have made it clear that we have no time to "buy time." We need to control entitlement expenditures now.

[Comment #3 — Saving] (pp. iii, 10)

The report's criticism of many of the problems in the current income tax system is on target (if understated). Unfortunately, it is almost silent about a major (perhaps the major) failing of the income tax system—its bias against saving.

The most disappointing aspect of the report is its failure to address the biased treatment of saving under the current income tax. The report accepts as revealed wisdom the Haig Simons "comprehensive accrual" definition of taxable income (even though it recognizes that such a definition is inherently biased against saving). Modern scholarship increasingly supports a "consumed income" approach as a better definition of the income tax base. The issue is clearly developed in the book by David Bradford, *Untangling the Income Tax*, which was published under CED's sponsorship. This report seems to me to ignore earlier research indicating that the income tax should be moved toward a consumed income approach.

The tax on saved income should be deferred until that income is consumed (or gifted or bequeathed). The tax treatment of saving is bound up with the tax treatment of capital income and the achievement of reasonable progressivity. Our objective should be to achieve the desired level of progressivity without penalizing saving, and to do it in a way that makes the special treatment of capital income unnecessary. (The special treatments of capital income now in the law are partial limited responses to the inherent bias against saving in the Haig Simons definition of income.) There is no doubt that these special rules produce unwise and unnecessary complication and distortion, but they

have been made part of the law as a response to the fundamental bias against saving. The bias would be even worse if we eliminated these special ameliorative treatments without fixing the basic problem.

[Comment #4 — Progressivity] (pp. iii, 28)

The major policy recommendation of the report is the introduction of a VAT to provide the resources to help solve the deficit problem and reform the income tax. The report points out that a benefit of the VAT is that it is not biased against saving but is concerned that it will reduce the overall progressivity of the system. The report naturally looks to the income tax to achieve the desired progressivity. That progressivity, however, need not and should not be achieved by penalizing saving. Under a progressive system, high income taxpayers will pay at a higher rate than low earners, but progressivity should not require high income savers to pay more than high income consumers.

Progressivity in the income tax should be achieved as simply as possible—primarily through the rate structure of the income tax and not with drawbacks, hurdles, and take-aways. Each section of the Internal Revenue Code does not need to be progressive. The total system needs to be appropriately progressive. Benefits, as well as taxes, need to be considered.

[Comment #5 — Specificity of Recommendations] (pp. iv, 33)

The report includes a number of specific recommendations for changes in the tax law... On balance, I think that it was a mistake to offer these specifics in this report. We will soon have recommendations from the President's Tax Reform Commission. Hopefully, the Commission's report will offer coherent alternatives developed after hearing comprehensive expert presentations. The Commission's recommendations will have been vetted by many expert and experienced tax specialists and administrators. The specific recommendations in this report did not have the benefit of such a process.

The report's recommendations do not represent a studied coherent package. For example, over the years and especially in recent years, Congress has made a complete mess of the estate and gift taxes. Sensible estate planning is all but impossible. Under current law we will have three different regimes (each of them a mess) in place for the years 2009, 2010, and 2011. We clearly need a considered proposal that integrates the gift and estate taxes and deals with basis step-up of assets in a practical, sensible manner. The report suggests possibly staying with the 2009 mess because it believes it is not as bad as the alternative 2010 or 2011 messes. I don't think that recommendation is a contribution to tax reform.

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