

**Constrained Tax Reform: How Political and Economic Constraints Affect the  
Formation of Tax Policy Proposals**

by

Jonathan Z. Ackerman  
President's Advisory Panel on Federal Tax Reform  
jzackerman@gmail.com

and

Rosanne Altshuler  
Department of Economics  
Rutgers University  
altshule@rci.rutgers.edu

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On November 1, 2005, the President's Advisory Panel on Federal Tax Reform (the Panel) delivered its report to Treasury Secretary John W. Snow. The bipartisan Panel was organized ten months earlier by President George W. Bush to study options to reform the federal income tax system in ways that would make it simpler, fairer, and more growth-oriented.

The Panel unanimously recommended two tax reform plans: the Simplified Income Tax Plan (the "SIT"), which is based on the current income tax system, and the Growth and Investment Tax Plan (the "GIT"), which incorporates a tax on business activity that is similar to some consumption tax prototypes. The individual aspects of both plans are similar and incorporate a simplified filing structure based on newly-designed Family and Work Credits along with tax benefits for homeownership, charitable giving, and health insurance. Both plans would eliminate the Alternative Minimum Tax (AMT) along with numerous individual and business tax preferences. The two plans diverge most significantly in the treatment of saving by individuals and the treatment of business investment. Under the SIT, the six current marginal statutory tax rates of 10, 15, 25, 28, 33, and 35 percent would be replaced with rates of 15, 25, and 33 percent and all large business entities would be taxed at a 31.5 percent rate, which is a ten percent reduction from the current top corporate rate of 35 percent.<sup>1</sup> Under the GIT, the individual statutory rates would be 15, 25, and 30 percent and a flat 30 percent tax rate would apply to all business cash flow.

One theme of the Panel's report is that a rational tax system would favor a broad tax base. The most sweeping prior reform of the tax code, enacted with the Tax Reform Act of 1986

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<sup>1</sup> Under current law, many business taxpayers face a statutory tax rate that is less than 35 percent because of recent legislative changes. Section 199, enacted as part of the American Jobs Creation Act of 2004, provides a deduction that results in a reduced tax rate on a taxpayer's domestic "qualified production activities income." For taxable years beginning in 2005 and 2006, the deduction is three percent of income; for taxable years beginning in 2007, 2008 and 2009, the deduction is six percent of income; and for taxable years beginning after 2009, the deduction is equal to nine percent. When fully phased in, the deduction results in a maximum tax rate of approximately 32 percent [35 percent - (9 percent \* 35 percent)] on production activities income earned in the United States.

(TRA86), was based on a similar theme. The goal of TRA86 was commonly expressed as “broadening the base and lowering the rates.” TRA86 established two individual statutory tax rates of 15 and 28 percent to replace more than a dozen statutory tax rates, which extended up to 50 percent, and lowered the top corporate statutory tax rate from 46 to 34 percent.

Many aspects of the Panel’s recommended plans were greeted with praise. However, a number of commentators criticized the reform options because they did not incorporate reductions in statutory rates on a scale comparable to TRA86. This paper discusses how the economic and political constraints faced by the Panel presented different challenges than the 1986 reform effort and resulted in a substantially different approach to tax reform. The forces that shaped the recommendations and constrained the Panel are keys to understanding the resulting plans. We explore how the policy choices underlying the various provisions of the Panel’s proposals differed from those underlying the initial 1984 Treasury proposal (“Treasury I”) and the subsequent legislation enacted under TRA86.

We draw two conclusions that help explain the Panel proposals and should provide guidance for future reform efforts. First, the tax system as it has evolved over the last 20 years greatly shaped the Panel’s recommendations. Structural features of the current tax system, such as the AMT, phase-outs, and numerous expiring provisions, make it difficult to fashion tax reform plans that are likely to generate popular support based on rate reductions alone. Second, the constraints likely to be imposed on tax reform are different, and in many ways more politically difficult, than those faced by tax reformers during the 1980s. These forces create tradeoffs that make reducing tax rates less politically tenable than past efforts and, ultimately, affect the ability to garner popular support for tax reform.

The paper is organized as follows. In the next section we provide background regarding the tax reform effort that resulted in the passage of TRA86 and compare that effort to the current tax reform debate. That section contrasts the significant features of Treasury I and TRA86 with the Panel’s recommended plans, and includes a discussion of why the starting point for reform –

the underlying structure of the current tax system – is dramatically different than the tax system that existed prior to TRA86.<sup>2</sup> The following section compares the constraints imposed on the Treasury Department as it developed Treasury I with those imposed on the Panel. The next section provides empirical evidence on the importance of the starting point and the constraints on tax reform, and demonstrates how these factors limit the ability of policymakers to lower rates. Finally, we conclude with some thoughts on how the starting point and constraints will affect future tax reform efforts.

### **BACK TO THE FUTURE: A COMPARISON OF TREASURY I, THE TAX REFORM ACT OF 1986, AND THE TAX REFORM PANEL’S REPORT**

In his January 1984 State of the Union address, President Ronald Reagan asked the Treasury Department to prepare “a plan for action to simplify the entire tax code so that all taxpayers, big and small, are treated more fairly.” President Reagan requested that the Treasury Department present recommendations to the White House by December 1984. The President laid out the goals for reform in his address promising to “go forward with an historic reform for fairness, simplicity, and economic growth.”<sup>3</sup>

President Reagan initially imposed no constraints on the Treasury Department in formulating recommendations for reform. However, in May 1984, bowing to pressure from the National Association of Realtors, President Reagan promised not to eliminate the deduction for home mortgage interest.<sup>4</sup> The Treasury Department unveiled its report, subsequently dubbed “Treasury I,” in November 1984. The report laid out the case for tax reform and presented proposals for restructuring the income tax.<sup>5</sup> The recommendations for reform proposed in

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<sup>2</sup> See Auerbach and Slemrod (1997) for a detailed review of the economic effects of TRA86. See Steuerle (2004) for an analysis of both Treasury 1 and TRA86 including historical background relating to the formation of these proposals.

<sup>3</sup> See Reagan (1984).

<sup>4</sup> See Birnbaum and Murray (1987).

<sup>5</sup> The three-volume report also contains a study of the issues involved in adopting a value added tax.

Treasury I, although not adopted in full, were modified and repackaged as the President's recommendations released in 1985, and formed the basis for TRA86.

Just over twenty years after President Reagan's historic call for reform, President George W. Bush announced a similar initiative during his January 2005 State of the Union address. The President declared that he would form a panel of distinguished individuals who would ultimately submit a report on tax reform to the Treasury Secretary.<sup>6</sup> The Executive Order ("EO") creating the President's Advisory Panel on Federal Tax Reform charged it with recommending options to make the tax code simpler, fairer, and more conducive to economic growth.<sup>7</sup> In stark contrast to President Reagan's request, however, President Bush imposed several constraints on the Panel. As discussed in more detail below, these constraints affected the Panel's recommendations by, for example, specifying how much tax revenue should be collected, providing guidelines on how the tax burden should be distributed, and preserving tax benefits for housing and charitable giving. After two postponements from its original due date of July 30, 2005, the Panel presented its report to Secretary of the Treasury John W. Snow on November 1, 2005.

### *The Case for Tax Reform in 1984*

In initiating their tax reform efforts, both Presidents Reagan and Bush were responding to a perception that the tax code was overly complex, unfair, and a barrier to greater economic growth. A driving force for reform in 1984, as it is today, was the perception that the tax code does not treat individuals and corporations in similar situations equally.

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<sup>6</sup> The bipartisan Panel was comprised of nine members from widely varying backgrounds. The Tax Reform Panel was chaired by former Senator Connie Mack III, a Republican from Florida. Former Democratic Senator John Breaux of Louisiana served as the Panel's Vice Chairman. Additional members included former Congressman William Frenzel, former IRS Commissioner Charles Rossotti, Elizabeth Garrett, a law professor at the University of Southern California, Tim Muris, a former Chairman of the Federal Trade Commission, Liz Ann Sonders, the chief investment strategist for Charles Schwab, and two economists, James Poterba of MIT and Edward Lazear of Stanford University.

<sup>7</sup> Executive Order 13369, Relating to the President's Advisory Panel on Federal Tax Reform (January 7, 2005), as amended by Executive Order 13379 (June 16, 2005) and Executive Order 13386, (September 30, 2005).

A particular focus of the case for reform presented in Treasury I was the problem of tax shelters. Prior to President Reagan's announcement heralding the need for reform, newspaper stories and accounts of corporate tax shelter activity fueled the perception that corporations may not be paying their fair share of the tax burden (see Birnbaum and Murray 1987). Especially important in 1984 was the problem of tax shelters entered into by upper-income individuals to shelter unrelated wage and business income.

### *Treasury I*

A primary objective of Treasury I was to make the tax system fairer and more efficient by providing a coherent and stable tax base.<sup>8</sup> To do this, Treasury I advocated a number of far-reaching reforms designed to provide a comprehensive income tax base that would make the measurement of income more consistent with real economic income.

One of the primary goals of Treasury I was to eliminate the differing treatment of many types of income and to repeal a number of tax breaks targeted towards a limited number of taxpayers. For individuals, Treasury I proposed to end the preferential treatment of many fringe benefits and curtail the benefit of others, repeal the deduction for state and local taxes, and tighten the deduction for charitable contributions by subjecting contributions to a two-percent of adjusted gross income floor and eliminating the tax benefits for some gifts of appreciated property.

Another fundamental objective of Treasury I was to treat business income more uniformly. In particular, Treasury I would repeal the accelerated depreciation system enacted in the early 1980s and replace it with depreciation allowances based on best estimates of economic depreciation which would be indexed for inflation. Treasury I also recommended the elimination of a number of business tax breaks, such as the investment tax credit and specialized treatment for taxpayers in particular industries.

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<sup>8</sup> See U.S. Department of the Treasury (1984).

Consistent with the objective of achieving a more even treatment of business income, Treasury I made recommendations to provide a more uniform taxation of capital income. The reform proposed taxing capital gains at the same rates as other income and indexing capital gains for inflation. Treasury I also included recommendations to reduce, but not eliminate, the double tax on corporate earnings by providing a deduction for a portion of dividends paid by corporations.<sup>9</sup>

Treasury I was premised on the argument that a more uniform and comprehensive treatment of income would make the AMT unnecessary. As a result, Treasury I called for the repeal of both the individual and corporate AMT provided that the proposals in the package were fully implemented. Similarly, the proposals to more accurately tax real economic income were designed to reduce opportunities and incentives for tax sheltering.<sup>10</sup>

Treasury I incorporated dramatic changes to the rate structure. The existing rate structure providing for up to 14 tax brackets ranging from 11 to 50 percent would be replaced with three brackets of 15, 25, and 35 percent. The top corporate rate of 46 percent would be lowered to 33 percent. All corporate income, except income of S corporations, would be taxed at the 33 percent rate. In addition to lowering statutory tax rates, Treasury I proposed tax relief targeted to lower-income taxpayers. During the periods of high inflation in the 1970s and early 1980s, the tax brackets were not adjusted for inflation, resulting in automatic tax increases commonly referred to as “bracket creep.” Because of bracket creep, many taxpayers below the poverty line were paying what was viewed as an unacceptably high amount of tax. Treasury I recommended

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<sup>9</sup> Under the proposal, domestic corporations would have been entitled to a deduction for 50 percent of dividends paid to their shareholders. The amount of dividends eligible to be deducted would be limited to dividends paid out of income that was actually taxed at the corporate level. Every corporation would be required to maintain a Qualified Dividend Account that would track the amount of earnings that bore the regular corporate tax.

<sup>10</sup> Eliminating the investment tax credit, relying to a greater extent on economic depreciation, and repealing the capital gains preference, for example, would have reduced the tax benefits that motivated many tax shelters that were premised on acquiring ownership interests in assets that had negative effective tax rates.

reversing this trend through an increase in the amount of income not subject to tax and an expansion of the earned income tax credit (EITC).

### ***The Tax Reform Act of 1986***

In contrast to the sweeping proposals to provide a more theoretically sound tax system under Treasury I, TRA86 focused more narrowly on lowering tax rates. As Congress began to consider reform proposals, eliminating individual and corporate income tax shelters while substantially lowering tax rates became a politically viable approach that could be explained to the American public. Opponents of reform could not advocate high tax rates and a growing tax shelter industry. Thus, for lawmakers, the endgame for the 1986 Act became lowering rates as much as possible by broadening the tax base in politically acceptable ways.

To accomplish lower tax rates, Congress used a combination of complex rules designed to pare back on tax benefits and the elimination of loopholes and special benefits. TRA86 provided complex rules, such as the passive activity loss rules and changes to the AMT, which raised revenue by denying tax benefits to targeted taxpayers. These complicated rules were packaged as reforms to improve perceptions of fairness. On the individual side, TRA86 eliminated deductions for state and local sales tax as well as interest on consumer borrowing, among other proposals. On the business side, TRA86 repealed the investment tax credit, reduced depreciation allowances for structures, and eliminated loopholes that applied primarily to special industries, such as defense contractors, banks, and oil and mining firms.

Substantially reducing tax rates had a spillover benefit for Congress. Cutting tax rates on higher income taxpayers significantly lowered the cost of providing tax benefits. Neubig and Joulfaian (1988) estimated that the steep reductions in marginal tax rates had a dramatic impact on the costs of the tax expenditures that remained after 1986 – even those tax expenditures that were untouched by TRA86. Neubig and Joulfaian found that as much as 60 percent of the

reduction in the cost of tax expenditures after the 1986 Act was due to lower tax rates – and, thus, a lower tax benefit – for higher income taxpayers.

In addition to lowering tax rates, a fundamental goal of TRA86 was to relieve families with the lowest incomes from Federal tax liability. Following the lead of Treasury I, TRA86 increased the amount of the personal exemption and standard deduction, as well as the EITC. This resulted in a substantial increase in the income level at which individuals begin to have tax liability.

Like Treasury I, TRA86 incorporated significant changes to the tax structure. On the individual side, two brackets of 15 and 28 percent combined with a provision phasing out the 15 percent bracket and personal exemption for high-income taxpayers created effective marginal tax rates of 15, 28, 33, and 28 percent. The 33 percent rate, often referred to as the “bubble” rate, was effectively hidden since it was the result of a phase-out. The top corporate rate was reduced from 46 to 34 percent, but unlike the proposal in Treasury I, TRA86 retained the graduated corporate rate structure.

### ***The Tax Reform Panel’s Case for Reform***

As in the mid-1980s, dissatisfaction with the tax code was a major motivating factor in President Bush’s call for comprehensive tax reform in 2005. The sources of the discontent however, differed in several important respects. Specifically, a number of features of the current tax system made the Panel’s task more challenging and significantly shaped the resulting reform options.

The Panel identified unfairness in the tax code as a key motivation for tax reform and concluded that a significant source of unfairness was complexity. Interestingly, much of the complexity in the tax code identified by the Panel had its roots in TRA86. As explained above, during the passage of TRA86, a number of provisions were added to make the Act revenue

neutral and to preserve the appearance of lower statutory rates. These provisions included the phase-out of personal exemptions and itemized deductions, so-called “PEP and Pease,” as well as the phase-out of the 15 percent tax bracket. In addition, other devices (such as the AMT and the passive activity loss rules) were used to reduce, but not repeal, tax benefits for taxpayers who were perceived to be receiving unwarranted tax breaks.

Since 1986, Congress has made over 15,000 changes to the tax code. Many of these changes follow the pattern established in 1986 of pairing tax benefits with complex rules, such as phase-ins and phase-outs, which have contributed to the tax code’s considerable complexity. In its report, the Panel demonstrated that the multitude of complicated tax breaks and rules in the current system produce needless complexity, uneven results for similarly situated taxpayers, and perceptions of unfairness.

The Panel also found that in addition to undermining confidence in the tax system, the tax code’s overwhelming complexity is a significant contributor to taxpayer noncompliance. The Panel report argued that complex rules in the code increase taxpayer error and have been mined by sophisticated tax advisors to create “technical tax shelters.” The \$300 billion tax gap – or measure of noncompliance with the tax laws – was cited as one example of the unfairness created by the complexity of the current code.

One aspect of the tax code in particular, the AMT, was cited repeatedly as an example of the arbitrary nature of the current tax system. The predecessor to the AMT was enacted in 1969 in response to a Treasury Department report that 155 taxpayers with incomes over \$200,000 avoided paying tax in 1966. Today, the AMT is a parallel tax system with its own exemptions, tax rates, tax credits and a definition of income that is broader than the regular income tax. The AMT requires taxpayers to do their taxes a second time by adding back income and deductions to the regular income tax. After completing the AMT tax return, taxpayers subtract the AMT exemption and compute tax at rates of 26 and 28 percent. Taxpayers then compare the amount of tax computed under the AMT with the tax due under the regular tax and pay whichever amount is

higher. The largest contributors to AMT liability are state and local tax deductions and personal exemptions.

The AMT exemptions and tax rate brackets are not indexed for inflation, which causes more taxpayers to be subject to the AMT each year. Rather than indexing the exemption and brackets for inflation, lawmakers have enacted temporary fixes to the AMT to limit its reach. For 2005, a temporary provision provides an AMT exemption of \$58,000 for married couples and \$40,250 for unmarried individuals. After 2005, the exemptions revert back to \$45,000 for married couples and \$33,750 for unmarried individuals. In addition, the exemption amount is phased out for higher income taxpayers, which increases the marginal AMT tax rates and creates four different tax brackets of 26, 32.5, 35 and 28 percent. The Treasury Department estimates that the AMT affected 3.8 million taxpayers in 2005, but if left unchecked will affect 20.5 million taxpayers in 2006 and over 50 million taxpayers in 2015 (see President's Advisory Panel on Federal Tax Reform, 2005).

Although Treasury I recommended repeal of the individual AMT, TRA86 instead expanded the AMT to raise revenue and to improve perceptions of fairness. Over the years, changes to the AMT, as well as a lack of indexing of many of its parameters, has led to a widely-held belief that the AMT is unfairly burdening many middle-income families and creating needless complexity. At the same time, the AMT has failed to achieve its goal of making sure that all upper-income taxpayers pay some income tax. The Treasury Department estimated that in 2006, over 6,600 taxpayers with income greater than \$200,000, and over 1,300 taxpayers with income greater than \$700,000, will pay no tax through legitimate tax avoidance in spite of the AMT (see President's Advisory Panel on Federal Tax Reform, 2005).

The AMT is not the only hidden tax increase in the current system. Almost every tax benefit available to taxpayers phases out with income, creating higher effective marginal tax rates for taxpayers within the phase-out range. Burman and Saleem (2003) find that more than one out of every five taxpayers faced effective marginal tax rates higher than their statutory rates in 2003.

This result was even more common among higher-income households: More than half of taxpayers with AGI of \$100,000 or above faced effective marginal tax rates that were higher than their statutory rates.

The Panel's recommendations represent a concerted effort to rid the tax system of phase-outs. The elimination of phase-outs represents a cut in effective marginal tax rates that is not reflected in a simple comparison of the current schedule of statutory rates with those proposed under the Panel's options. Thus, although taxpayers understand that removing phase-outs makes the tax system less complex, many are unaware that this policy change has the added benefit of lowering their effective marginal tax rates.

In addition to being much more complex, the current system is significantly more volatile than the system that existed prior to the 1986 reform. Although the early 1980s were punctuated by frequent changes to the tax code, many of these changes were made in response to changing priorities and circumstances, such as a desire to reduce the budget deficit. By contrast, Congress increasingly has enacted provisions that are either temporary in nature or are designed to expire with the expectation that they will be extended by subsequent legislation. The current tax code thus has been pre-programmed for a number of changes that require legislative action merely to preserve the status quo. Most notably, the expiration of the tax cuts enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) create complexity in evaluating the revenue and distributional consequences of tax reform proposals. In addition, expiring provisions in the code make it difficult for taxpayers to evaluate the extent to which any tax reform proposal compares with the "current system" because the current system is subject to annual changes that leave it in a perpetual state of flux.

The temporary nature of many recently enacted tax cuts also makes it more politically challenging to demonstrate the benefits of tax reform. Currently, most taxpayers are not aware that they will face substantial increases in statutory tax rates, as well as higher tax rates on

dividends and capital gains, because they do not know the provisions are temporary, or because they expect that these lower rates will be extended. As summarized in Table 1 below, numerous provisions that affect a large cross section of taxpayers are scheduled to expire between now and 2011.

### ***Tax Reform Panel Recommendations***

The starting point for reform and the Panel recommendations differ substantially from both Treasury I and TRA86. Unlike Treasury I, the Panel did not recommend fundamental or comprehensive changes to the tax base or to the basic elements of the measurement of income. Thus, in making its recommendations, the Panel did not rely on a unifying theoretical underpinning. Although the Panel considered proposals to adopt different forms of consumption taxes, the recommended options both retain a tax base, like the current system, that incorporates both income and consumption tax features. While the SIT essentially overhauls the current system's hybrid tax base, the GIT includes a number of proposals designed to shift the tax system in the direction of a tax on consumption.<sup>11</sup>

Although the Panel's recommended plans are less comprehensive in scope than Treasury I, they are more sweeping than the approach taken by TRA86. The Panel's recommendations would dramatically alter tax filing by eliminating itemized deductions and making tax benefits for homeownership, charitable giving, and health insurance coverage more widely available. In addition, an important, but often overlooked, aspect of the Panel's recommendations is its attack on complicated, opaque rules that are designed to curtail certain tax benefits. Both plans eliminate a plethora of complicated tax benefits, repeal the AMT, replace numerous current provisions to adjust for family size and ability to pay with a unified Family Credit, and repeal

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<sup>11</sup> Although the Panel recommended a number of significant changes to the treatment of capital income, the Panel's options essentially adopted a hybrid tax base that is very similar to the base under current law. The GIT incorporates many features of a consumption tax on businesses but provides for a hybrid tax base for individual taxpayers.

almost all income phase-outs.<sup>12</sup> This approach represents a stark departure from TRA86, which relied on the revenue generated by phase-outs and other rules designed to limit available tax benefits to help pay for the reduction in tax rates.

Another theme of the Panel's plans was to provide preferential treatment for capital income and business investment. In both plans, the Panel recommended the expansion and simplification of tax-preferred savings accounts. Known as Save at Work, Save for Family, and Save for Retirement, these new accounts are designed to consolidate the myriad savings vehicles in the current code, while removing the disincentive to save for most Americans. The Panel recommended that the amount of contributions to these accounts, as well as the purposes of the saving, be expanded relative to current law.

In the case of the SIT, the Panel recommended taking steps to reduce the double taxation on the income of corporations earned in the U.S. by providing an exclusion of 100 percent of dividends out of domestic earnings and an exclusion of 75 percent of the gain on the sale of stock of U.S. companies. All other capital income and gains would be taxed at ordinary rates.

Under the GIT, the Panel recommended that there be a single 15 percent tax on all capital income earned outside of Save at Work, Save for Family, and Save for Retirement accounts. In addition, the Panel made a number of recommendations to provide for a more uniform treatment of income from business investment. The GIT allows expensing of all business investment, but denies deductions for interest payments. The GIT also would treat business entities uniformly by imposing a flat 30 percent tax rate on business cash flow.

The Panel's recommendations, which focus on simplifying the tax system and paring back targeted tax breaks while preserving preferential treatment for capital income, differ from both the Treasury I proposals to provide a more comprehensive income tax and the TRA86

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<sup>12</sup> The Panel did retain phase-outs for tax benefits targeted to low-income taxpayers to encourage work effort under the proposed Work Credit and retirement saving under its Saver's Credit proposal. The Panel viewed phase-outs as the most effective method of providing these taxpayers incentives at the lowest revenue cost and with the least administrative burden.

reforms that lowered rates through repealing preferences and limiting certain tax benefits. Both the SIT and the GIT would provide only modest statutory rate reductions. For example, the top rate would be reduced from 35 percent under current law to 32 and 30 percent under the SIT and GIT, respectively. By contrast, at the time Treasury I was issued, the top tax rate on ordinary income was 50 percent and capital gains were taxed at 28 percent. TRA86 presented a tax reform plan that taxed both types of income at ordinary rates of up to 28 percent (not including the “bubble” rate of 33 percent), demonstrating a significant, tangible benefit of tax reform to a broad segment of the population.

The inability of the Panel’s recommendations to lower statutory tax rates on a scale comparable to Treasury I and TRA86 cannot be explained solely by differences in the tax systems being reformed. As discussed in the following sections, the constraints imposed on the Panel limited its ability to substantially lower tax rates by simply following the pattern of Treasury I or TRA86.

## **THE ROLE OF CONSTRAINTS**

The ground rules, or constraints, that are imposed on policymakers as they formulate and evaluate tax reform proposals are a critical aspect in considering proposals for reforming the tax code. This section describes and compares the constraints on the Panel in 2005 and on Treasury Department in 1984. Unlike Treasury I, TRA86 was the result of the legislative process and reflected the multitude of priorities of the legislative majority that enacted it. Although there were a number of objectives imposed by individual lawmakers, there was not a defined set of ground rules applicable to TRA86.

### ***Constraints on Treasury I***

With the exception of preserving the home mortgage interest deduction, the 1984 Treasury Department faced no “external” constraints in formulating options for reform. Early in

the process, however, the Treasury imposed its own “internal” constraints. In an effort to prevent the ensuing tax reform debate from focusing solely on the appropriate cost of reform or how the burden should be distributed, the Treasury Department made the decision to impose two additional constraints on the reform process: revenue neutrality and distributional neutrality.<sup>13</sup> The Panel also was subject to these two constraints. However, as we argue below, the application of these constraints likely had a larger impact on the Panel’s work than it did on the recommendations in Treasury I.

### *Constraints on the Panel*

The EO establishing the Panel provided a number of ground rules that imposed constraints on its work. According to the EO, the Panel was to provide revenue neutral options that would accomplish the following objectives:

- simplify Federal tax laws to reduce the costs and administrative burdens of compliance;
- share the burdens and benefits of the Federal tax structure in an appropriately progressive manner;
- recognize the importance of homeownership and charity in American society; and
- promote long-run economic growth and job creation, and better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the United States in the global marketplace.

At least one option was required to use the Federal income tax as the base.

The Panel was subject to the Federal Advisory Committee Act (FACA), which required all deliberations by, and documents made available to, a quorum of members be made public. This federal “sunshine law” prevented members of the Panel from freely discussing any reform option or any Treasury Department or staff analysis unless in the context of a public meeting, which were subject to extensive media coverage and frequently televised. No such constraint was

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<sup>13</sup> See McLure and Zodrow (1987) for a discussion of the many decisions that were made during the development of Treasury I.

placed on the individuals formulating Treasury I. The Panel formed four “working groups” that were designed to allow for a more efficient division of the Panel’s workload by separately evaluating reform approaches and to allow a subset of the Panel to work through tax reform issues in greater detail.

In addition to the constraints listed in the EO, the Panel also laid down a number of internal constraints and goals.

- **Consensus.** A goal of the Panel was to present reform options that all members agreed were superior to the current system.
- **Repeal the AMT.** Early in the process, the Panel made the decision to repeal the individual AMT. This recommendation was announced at a July 20, 2005 meeting of the Panel.
- **Simplicity.** The Panel’s interim statement and report emphasized the priority placed on simplicity in formulating provisions.
- **Sector neutrality.** Finally, the working group of panelists that crafted the SIT made an internal decision to interpret revenue neutrality more strictly than was required by the EO. The group worked under an internal constraint to maintain “sector neutrality” between the individual and corporate income tax systems. As explained in the Panel’s report, this means that both the corporate tax and the individual tax raise the same amount of revenue as under the current system over the ten-year budget window.
- **Income tax reform.** The Panel limited its consideration to the individual and corporate income tax systems.

In the remainder of this section, we describe how constraints on the Panel impacted the Panel’s options. We also compare how constraints common to Treasury I and the Panel were applied and affected decisions.

### **Consensus**

The bipartisan Panel determined that a report reflecting the full consensus of all nine members would have greater weight with policymakers. Not surprisingly, unanimity forced the Panel to make a number of choices that Treasury I avoided. Although the Panel was intended to be shielded from the pressures of the political process during its policy deliberations, many

members of the Panel were unwilling to propose dramatic reforms that they believed would not have a realistic chance of being adopted by Congress. This constraint prevented the Panel from recommending a sweeping change to our current tax system including, for example, a comprehensive consumption tax proposal.

The unanimity constraint also played a role in the choice of particular options for the plans.<sup>14</sup> For example, options that removed large numbers of taxpayers from the income tax were rejected due to a lack of consensus. As discussed further below, this had a direct impact on the structure of tax rates. Another example involves the savings plans crafted by the Panel. Some members were not comfortable with plans that expanded tax-preferred savings accounts unless provisions were included that (i) limited the use of funds placed in the accounts and (ii) expanded opportunities for tax-preferred savings for low-income taxpayers. As a result, both plans included restrictions on how funds placed in the Save for Family accounts were used and a refundable Savers Credit that required a phase-out and an additional set of rules and restrictions.

### ***Revenue neutrality***

An important constraint imposed on the Panel by the EO and on the decision makers responsible for Treasury I was the requirement that its recommendations be revenue-neutral. The application of revenue neutrality to tax proposals has changed dramatically between the 1980s and 2005. First, the length of the budget window over which the revenue effects of proposals are estimated, or “scored,” doubled. Second, and more importantly, the choice of a revenue baseline

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<sup>14</sup> The constraint also impacted the form of the final report. While there was some discussion about including a chapter presenting potential benefits and costs of adopting a return-free tax system, the unanimity constraint worked against its ultimate inclusion in the report. Treasury I, while not recommending the adoption of a return-free system, recommended further study of the option. Including a section of the report on different tax administrative options, even if not all panelists would ultimately favor a particular option, may have stimulated public debate but was not possible due to the emphasis on consensus.

has become controversial. There are widely varying estimates of federal revenues over the budget window due to assumptions about the expiration of the 2001 and 2003 tax cuts.

Revenue neutrality in 1984 meant that the tax system would raise roughly the same amount of revenue as the system currently in place over five years. The Treasury Department scored the Panel's tax proposals over a ten-year budget window.<sup>15</sup> The use of the five-year budget window during the 1980s likely worked in the direction of allowing lower rates than those required for revenue neutrality using a longer window. As McLure and Zodrow (1987) point out, the tax accounting changes called for in Treasury I would have shifted a significant portion of the increase in corporate tax revenues forward in time. As a result, revenues calculated over a longer horizon are likely to be lower and revenue neutrality would likely require higher tax rates.

Although the Panel used a ten-year window for revenue neutrality calculations, the Panel report acknowledges that some provisions would have effects beyond this budget window. The framers of Treasury I gave themselves an additional degree of freedom to lower individual statutory rates by allowing revenue neutrality to be achieved by shifting some of the burden of taxation from individuals to corporations.

The Panel determined that the baseline used by the Administration to score the proposals in its fiscal year 2006 Budget (referred to as the "Administration baseline" or "baseline") was the most reasonable starting point.<sup>16</sup> This decision had a number of important implications. First,

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<sup>15</sup> The proposals were "scored" by the Treasury Department's Office of Tax Analysis (OTA) using conventional revenue estimating techniques. This revenue estimation technique (also referred to as "microdynamic analysis") allows for taxpayer responses to tax changes while holding the size of the overall economy constant. In addition, the OTA provided the Panel with a macroeconomic (or "dynamic") analysis of the two reform options. Macroeconomic (or "dynamic") analysis provides information on the effect of tax reform on the overall economy.

<sup>16</sup> There were primarily for two reasons for this choice. First, the Panel concluded that the Treasury Department and the White House would analyze any reform option in the context of its own baseline and budget assumptions. The Panel did not wish its recommended options to be rejected solely because it used a revenue baseline that is different than the baseline currently used by the policymakers for which the Panel was charged with providing recommendations. Second, as mentioned above, the Panel relied on OTA for revenue estimates. OTA's revenue estimation models are based on the Administration's baseline, and the use of a different baseline likely would have hindered the Panel's ability to receive timely analysis of specific reform proposals.

the Administration baseline assumes that the legislative proposals contained in the Administration's fiscal year 2006 Budget would be enacted into law. These proposals assume that the 2001 and 2003 tax cuts would be permanently extended and that reform options in the President's 2006 Budget would be enacted. Among other items, the President's 2006 Budget includes the creation of expanded retirement savings accounts (RSAs) and lifetime savings accounts (LSAs). These Roth-style savings accounts have a smaller revenue impact in current years than in years outside the budget window. Second, the Administration baseline assumes that the current law provision limiting the reach of the AMT will expire as scheduled after the 2005 tax year. We examine the implications of this decision in the next section.

Lazear and Poterba (2006) argue that the Panel's use of the Administration baseline is both realistic and appropriate. They consider alternative scenarios for the baseline regarding the extension of the 2001 and 2003 tax cuts and the AMT patch and conclude that the Panel plans reflect neither tax cuts nor tax increases relative to what would likely occur without reform.

It is important to recognize that any future tax reform proposal will encounter a debate over which baseline is appropriate for scoring tax provisions. This makes the starting point for reform much more contentious than it was during the 1986 reform effort. The release of the Panel report generated a firestorm of criticism regarding the Panel's choice of the Administration baseline to score its proposals that likely has detracted focus from the actual Panel proposals.<sup>17</sup> There was no such debate on revenue neutrality that we are aware of following the publication of Treasury I.

### ***Repeal the AMT***

Closely related to the issue of revenue neutrality was the Panel's decision to repeal the AMT. The Panel concluded early on that the AMT violates three fundamental tax reform principles: it is complex, unfair, and inconsistent with policies encouraging economic growth.

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<sup>17</sup> See Auerbach (2006), Burman and Gale (2006), and Shaviro (2005), for example.

Not surprisingly, the Panel determined that an additional, alternative tax computation like the AMT should not be part of any tax reform proposal. This decision had far-reaching implications for the Panel's recommendations. As discussed above, the AMT represents a hidden tax increase for millions of middle-class Americans that is not reflected in the statutory tax rates. In terms of income tax revenue, the AMT was estimated to generate over \$1.2 trillion in tax revenue over the budget window, making its repeal extremely expensive. As described in the Panel's report, replacing the revenue generated by the AMT by simply raising current tax rates would require an 11 percent across-the-board rate increase (i.e., the top tax rate would be increased from 35 to 39 percent). If only changes in the top four brackets were used to raise the same revenue under the income tax alone, each rate would have to be increased by 18 percent. Under this scenario, replicating federal revenues while repealing the AMT would require that the top tax rate be increased from 35 percent to 41 percent.

The baseline also assumes that a current law provision limiting the reach of the AMT will expire as scheduled after the 2005 tax year. The AMT is much more expensive to repeal under the Administration's baseline than it would be if either the tax cuts were not in effect or the AMT "patch" were assumed to be extended. This is so because the AMT generates significantly higher revenues under the Administration baseline because the marginal rates for many taxpayers are much higher than the tax rates under the 2001 and 2003 provisions. The Panel's report explains that some members of the Panel believed that the assumption underlying the Administration baseline that the AMT patch will not be extended is not realistic. They believed it is more likely that lawmakers will extend the patch, maintaining a higher exemption amount, and possibly indexing it for inflation.<sup>18</sup> This approach currently is subject to active debate. For example, Senator Charles Grassley, Chairman of the Senate Finance Committee, has teamed with senior

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<sup>18</sup> Such an approach would have allowed the Panel to provide further rate reductions. According to Treasury Department estimates, if the Panel did not need to account for the cost of the AMT patch in its baseline, estimated to be \$886 billion over the revenue window, tax rates could be reduced across the board under the SIT by 5.0 percent and by 5.6 percent under the GIT.

Democrats to introduce a bill which would repeal the AMT without imposing taxes to offset future AMT revenue. Grassley believes that lawmakers should not be required to make up the revenue from “an unintended tax which balloons federal revenue” (New York Times, May 23, 2005).

### ***Sector Neutrality***

The Panel’s recommended SIT was designed to collect the same amount of revenue as is projected to be collected under both the corporate and individual income tax systems. This focus on avoiding a shift in tax collections between individual and business taxpayers, or “sector neutrality,” was in stark contrast to TRA86, which was estimated to collect an additional \$120 billion over five years through the corporate income tax system to offset an equal amount of lost tax revenue under the individual income tax system.

In formulating the SIT, the Panel used the revenue generated from corporate base broadening to lower the corporate tax rate, rather than lowering individual tax rates.<sup>19</sup> Thus, the decision not to alter the proportion of income tax revenues raised by the corporate and individual income tax limited the ability of the Panel to lower individual statutory rates. However, the Panel considered lowering the effective rate on business investment important to promoting growth.

### ***Distributional Neutrality***

Another significant constraint imposed on the Panel by the EO was that its reform plans be “appropriately progressive.” The Panel debated this constraint and decided that its options should distribute the income tax burden in a way that would be roughly the same as the current distribution. The Panel viewed the current distribution as a product of well-accepted political

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<sup>19</sup> One difficulty facing the Panel in achieving its sector neutrality objective was in drawing the line between individual and business taxpayers. The dramatic increase over the last 20 years in the amount of business income from sole proprietorships and pass-through entities, such as partnerships, limited liability companies (LLCs), and S corporations, that is reported directly on the tax returns of individuals makes drawing lines between corporate and noncorporate tax systems exceedingly difficult.

compromise that had been vetted through the political process. The framers of Treasury I made a similar decision. Treasury I defined distributional neutrality as equal percentage reductions in tax liabilities across income levels.<sup>20</sup> Although the constraints were similar in 1984 and 2005, a number of factors complicated the Panel's application of the distributional neutrality constraint.

As we have stressed, the starting point was different in 2005. Since TRA86, efforts have been made to make the tax system more progressive by reducing the tax burden for families in the bottom half of the income distribution. Expansions of the EITC and child tax credit have increased the tax threshold for a family of four (in 2006 dollars) from \$25,690 (under TRA86 law) to \$41,550 (under current law). In addition, the Treasury Department estimates that the percent of families with no positive income tax liability has increased from 32.9 to 39.6 percent. At the same time, the percent of federal taxes paid by taxpayers in the highest quintile has increased from 66.9 to 70.2 percent (estimates of TRA86 and 2006 law at 2004 income levels, respectively).<sup>21</sup>

The trend of increased progressivity for low-income taxpayers played a role in the Panel's deliberations. As mentioned above, a minority of Panel members were reluctant to recommend options that would take additional taxpayers off the income tax rolls. In their view, an unacceptably high number of Americans currently do not contribute to the cost of government through the income tax system. This belief, combined with the desire to reach consensus, constrained a number of choices, including the use of refundable credits for homeownership and health coverage. This constraint also prevented the Panel from recommending an add-on value added tax (VAT), like that proposed by Yale Law School Professor Michael Graetz, because it would dramatically reduce the number of taxpayers who pay no income tax, even though they

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<sup>20</sup> The distributional tables in Treasury I show that, with the exception of families below the poverty level, individual income tax burdens across income levels under the reform proposals did not differ significantly from those under existing law. As mentioned above, one explicit goal of the reform was to eliminate income tax liability for families with incomes below the poverty level by increasing the tax threshold.

<sup>21</sup> For more information, see the July 20, 2005 presentation on the Panel website (<http://www.taxreformpanel.gov/meetings/meeting-0705.shtml>).

would continue to pay Federal taxes through the VAT (see Graetz 2002). The decision not to increase the number of taxpayers who pay nothing in individual income taxes is significantly different from both Treasury I and TRA86.<sup>22</sup>

The Panel's decision to maintain a distribution that closely tracked the current system, while also attempting to avoid increasing the number of taxpayers who would be below the tax threshold, limited the Panel's reform options. Because the Panel relied on an analysis of distribution that is based on the relative distribution of the tax burden by income class and level, a reduction in tax rates could not be accomplished without either offsetting increases in the tax burden for the same group or further reductions in the tax burden for the bottom half of the distribution and taking more taxpayers off the tax roles.

The concerns about taxpayers contributing to the cost of government also impacted proposals that would provide favorable treatment for capital income. Some members of the Panel were concerned with the perceptions of fairness under some consumption tax proposals because of the possibility that some households that receive only capital income would pay nothing in individual taxes. This concern ultimately led to the rejection of the pure consumption tax plan, dubbed the "Progressive Consumption Tax Plan" in the Panel's report, which was based on the X-tax championed by David Bradford (see Bradford 1996), even though the distributional analysis in the Panel report shows that the income tax burdens for both 2006 and 2015 are close to current law.

The choice of the Administration baseline had consequences for both the revenue and distributional analysis of the Panel's options. For example, one immediate question related to the Panel's interpretation of distributional neutrality concerns the definition of "the current distribution." The "current distribution" of the tax burden for any year in the budget window depends on the baseline. Some commentators have noted that the lower statutory tax rates under

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<sup>22</sup> The Joint Committee on Taxation estimated that TRA86 removed approximately six million taxpayers from the tax rolls (JCT 1987).

the Administration's baseline, in addition to lower rates on dividends and capital gains, make the tax system less progressive than it would be under current law that provides for the expiration of these provisions.

Another consequence of using the Administration baseline in distributional analysis involves the AMT. The Panel recommended repealing the AMT because of its unfairness. However, in structuring tax reform options, it matched the current distribution of tax burdens that includes additional tax receipts from the AMT. This decision has an increasingly important impact on the distribution of the tax burden through the ten-year budget window as the AMT hits more and more taxpayers. The AMT disproportionately impacts upper middle-class taxpayers. Thus, preserving revenue and distributional neutrality suggests that a reform that repeals the AMT include base broadening policies that either eliminate tax benefits or raise rates on this group to preserve the burden of the AMT. For example, the decision to repeal the deduction for state and local taxes and carve back the home mortgage interest deduction helped preserve the distributional neutrality of the Panel options since both deductions disproportionately benefit taxpayers subject to the AMT.

### *Simplicity*

The Panel's focus on simplicity is in stark contrast to TRA86. The framers of TRA86 designed complicated rules to raise revenues, such as income phase outs of tax benefits, under the umbrella of improving fairness.<sup>23</sup> In 2005, however, the Panel concluded that the proliferation of these rules had led to a lack of transparency and widely held perceptions of unfairness. While imposing phase-outs reduces the revenue cost of providing many tax benefits, removing phase-

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<sup>23</sup> The focus of Treasury I was to move the tax system closer to a comprehensive income tax. Many of the proposals would have simplified the tax code, such as the elimination of targeted tax breaks and reductions in the number of taxpayers required to file tax returns. At the same time, some elements of Treasury I that were designed to improve income measurement, such as estimating economic depreciation and indexing depreciation deductions and capital gains, would have added new complexity to the system.

outs generates a revenue hole which must be filled through the imposition of other distributionally neutral tax changes.

The Panel's recommendations to remove phase-outs and focus on simplicity would provide a more stable and transparent tax system. At the same time, transparency makes it much easier for taxpayers to understand the tax rates that they are actually facing. The result is that it is much more difficult to sell a revenue neutral plan the primary benefit of which is the repeal of the AMT, for example, because many taxpayers who will be subject to the AMT in future years are unaware that it will affect them.<sup>24</sup>

To simplify the tax code for individual taxpayers, the Panel proposed removing complicated rules that increase average tax rates for targeted groups of taxpayers. By contrast, the framers of TRA86 benefited greatly from the opposite approach of enacting complex rules, such as the AMT and phase-outs, which were designed to increase average tax rates for some taxpayers to pay for lower statutory rates. For instance, as explained above, the two rate structure of 15 and 28 percent hid the "bubble" tax rate of 33 percent generated by phase-outs.

### ***Recognize the importance of charity and homeownership***

Yet another constraint on the Panel was the requirement in the EO that the Panel's options recognize the importance of charity and homeownership in American society. In addition to impacting both the tax revenue to be collected from any reform option and the distribution of the tax burden by maintaining these benefits, this constraint had two important implications for the Panel. First, the Panel viewed any attempt to eliminate these preferences as a non-starter. Second, the Panel reasoned that if these benefits must be maintained on the basis that they are highly valued in American society, its recommendations should provide a more effective design and a more even distribution of the tax benefits among taxpayers. As a result, the Panel

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<sup>24</sup> A similar observation is made in Graetz (2006).

recommended that they be available in a modified form to more taxpayers than the current system.

In the case of homeownership, the Panel recommended that taxpayers be allowed a Home Credit equal to 15 percent of mortgage interest paid on their principal residence up to a ceiling based on regional housing costs.<sup>25</sup> In the case of charitable giving, all taxpayers would be permitted to deduct charitable gifts that exceed one percent of income. In contrast to TRA86, which reduced the number of taxpayers who could claim benefits from the home mortgage interest deduction and deduction for charitable contributions, the Panel's recommendations would provide every taxpayer the equivalent of the standard deduction through the new Family Credit *and* tax benefits for mortgage interest and charitable giving.

The Panel also made recommendations to reform the treatment of employer-provided health benefits in a manner consistent with the treatment of housing and charitable giving. The Panel recommended that all taxpayers receive a tax benefit up to a ceiling amount based on the average health premium. Taxpayers would be allowed to claim this benefit through either an exclusion for employer-provided coverage or an above-the-line deduction.

The Panel's decision to restructure the tax benefits for homeownership, charitable giving, and health insurance coverage in a way that made them more widely available and less likely to be disproportionately skewed towards upper-income taxpayers would provide lower average tax rates for some taxpayers, but would make it difficult to lower statutory rates across the board. In each case, the Panel's decision to expand the number of taxpayers who could claim a benefit was more costly than merely retaining the current structure of these benefits and imposing a new limit, or repealing some or all of these benefits. In contrast, both Treasury I and TRA86 included provisions designed to reduce the number of taxpayers who could claim these tax benefits by reducing the number of taxpayers who itemize deductions.

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<sup>25</sup> Treasury I would have retained the home mortgage interest deduction for a taxpayer's principal residence. Other interest, including interest on second homes, would have been allowed up to \$5,000 in excess of investment income.

### *Overall impact of constraints*

The constraints imposed on the Panel's work, particularly those relating to revenue and distribution neutrality, are fairly uncontroversial tax reform ground rules. In practice, however, the Panel's interpretation of these constraints in light of the current system yielded some surprising results. By contrast, although the framers of Treasury I worked within the confines of important constraints, they were afforded some degrees of freedom that were not available to the Panel. This additional flexibility worked in the direction of lower revenue-neutral and distributionally-neutral statutory rates.

It simply was not possible for the Panel to hold all of the constraints constant and still reduce statutory rates on a scale comparable to TRA86. For example, lower rates at the top of the income distribution, if a relative tax burden analysis is used, would have required that some offsetting relief be given to low-income taxpayers. As described above, the Panel was not willing to substantially alter the distribution of the taxpayers at the bottom of the distribution because it would have removed additional Americans from the tax rolls. By the same token, many of the tax expenditures that were preserved by the Panel were the largest in terms of revenue cost. Also, the desire to eliminate the AMT, phase-outs, and other rules designed to limit tax benefits that had been increasingly used since 1986 created a substantial revenue hole that the Panel could not fill without painful changes.

Finally, one additional factor, favorable treatment for capital income, influenced the Panel's ability to lower tax rates on labor and business income. The Panel did not adopt a consumption tax, but it also did not wish to impose a heavier burden on capital income than the current system. This policy objective is in stark contrast to both Treasury I and TRA86. The Panel, building on the recent changes to the tax treatment of capital income enacted in 2001 and 2003, concluded that a high tax burden on capital income would discourage both saving and business investment. Many members of the Panel believed that the removal of preferences for

capital income in TRA86 was inconsistent with the goal of promoting economic growth and argued that the tax on capital should be as low as possible.

Like other tax benefits retained by the Panel, providing the tax preferences for capital income impacted both the amount of revenues collected by the Panel's options and the distribution of the tax burden. The tax preferences for capital income, which disproportionately benefit taxpayers in the highest statutory tax brackets, were paid for, in large part, by smaller reductions in statutory tax rates on these same taxpayers.

### **EMPIRICAL EVIDENCE ON THE IMPACT OF THE PANEL CONSTRAINTS ON STATUTORY TAX RATES**

The previous discussion describes the many constraints faced by the Panel in crafting reforms. At the request of the Panel's staff, the Treasury Department ran a number of policy experiments to demonstrate the relationship between the size of tax base, the tax rate structure, and the distribution of the tax burden in the context of revenue-neutral reform proposals. The experiments are helpful in understanding the range of choices that were available to the Panel. The analysis described below was presented at the Panel's July 20, 2005 meeting and is discussed in the Panel's report.

The Panel's staff asked the Treasury Department to determine the rate structure that would achieve revenue neutrality if various income and consumption tax bases that are broader than our current income tax base were adopted. We focus on the results of the experiments involving income tax bases because they are most comparable to the 1986 tax reform effort.

In the experiment, the Treasury Department and the Panel's staff developed a broad individual income tax base that would:

- repeal all credits, above-the-line deductions, itemized deductions, and other special preferences in the current tax code;
- retain the standard deduction and personal exemptions (at current law levels);
- eliminate the AMT;

- integrate the individual and corporate tax systems so that income taxed at the business level would not be taxed again at the individual level;
- tax capital gains at ordinary rates and eliminate tax-favored savings or retirement vehicles;
- eliminate all corporate tax preferences and provide depreciation deductions equal to the actual decline in the value of an asset over the taxable period (which is known as “economic depreciation”); and
- make the top rates for the individual income tax and corporate income tax equal.

As summarized in Figure 1, the Treasury Department estimated that adopting this broad base would make it possible to reduce tax rates across the board by about one-third: the lowest individual rate, currently at 10 percent, could be lowered to 6.6 percent, and the highest rate (which also applies to corporate income), 35 percent, could be lowered to 23 percent. Alternatively, the Treasury Department found that the graduated rate structure could be replaced with a single rate of 15 percent and maintain revenue neutrality.

The Treasury Department also estimated the impact of the broad base on the distribution of the tax burden. As shown in Figure 2, taxpayers in the highest quintile would pay a smaller proportion of total federal taxes, while taxpayers in each of the other four quintiles would pay a greater proportion of the tax burden.

To evaluate the cost of current tax expenditures both in terms of the higher tax rates they necessitate and the distribution of the burden, the Treasury Department ran another experiment in which some of the largest individual and corporate tax expenditures were added back to the broad base described above. These tax expenditures include:

- for individuals, the tax exclusion for employer contributions for health insurance and pensions, retirement savings preferences, the mortgage interest deduction, the deduction for charitable contributions, the EITC, and the child tax credit; and
- for businesses accelerated depreciation, oil and gas preferences, the deduction for qualified production activities under section 199, the progressive rate structure under the corporate income tax, and the research and experimentation credit.

As summarized in Figure 3, adding these tax expenditures to the broad tax base would require tax rates nearly as high as those under current law to collect the same amount of revenue: the lowest individual rate, currently at 10 percent, could be lowered to 9.7 percent, and the highest rate of 35 percent could be lowered to 34 percent, a reduction of only three percent. Figure 4 shows that adding these tax expenditures to the broad base provides a distribution of tax burden that is close to current law.

These policy experiments demonstrate the trade-offs that are inherent in any effort to reform the tax system. Lower rates can be achieved by dramatically broadening the tax base. At the same time, these policy experiments demonstrate that it is difficult to eliminate many of the largest and most popular tax preferences without significantly altering the distribution of the tax burden in a way that would make it less progressive. Thus, it is nearly impossible to fashion a tax reform proposal that lowers tax rates through wholesale base broadening while maintaining both revenue- and distributional-neutrality.

Maintaining popular tax benefits helps provide a distribution that is more in line with the current distribution, but also moves lower statutory tax rates further out of reach. As noted above, once the largest and most popular tax preferences are added back to the broad income tax base, maintaining revenue neutrality means that rates need to rise almost to their current levels. These policy experiments confirm that it will be exceedingly difficult to devise a tax reform proposal that provides significant rate reductions while satisfying all of the constraints imposed on the Panel.

### ***Could statutory tax rates be lower?***

One approach through which lower income tax rates could be achieved is using a value-added tax, or VAT, to substantially decrease the size of the corporate and individual income tax systems. The Panel considered a proposal that would have allowed the top tax rates under both the individual and corporate income tax systems to be cut by more than half – with a top statutory

corporate and individual tax rate of 15 percent. The tax-exclusive VAT rate would be 17.6 percent.<sup>26</sup>

The Panel ultimately rejected this proposal because of concerns about the addition of a new source of federal revenue that could be used in the future to expand the size of the federal government. Although the Panel rejected the VAT on political economy grounds, it did acknowledge that the VAT would have a number of benefits, including the efficiency of the VAT and the ability to rely on the experience of other countries in administering the VAT. In addition to these attributes, the VAT may have a number of additional advantages that would have a positive impact on the income tax system. First, many economists believe that two tax systems with low tax rates may be superior from an efficiency and administration perspective to a single tax with a higher rate. Second, because the VAT is based on consumption, it would represent a move towards a consumption tax. Adopting a VAT may permit lower and uniform rates on both labor and capital income. Lower rates also could reduce pressure on the measurement concepts of our current income tax system and help achieve a number of the objectives of Treasury I in providing a tax system that treats income similarly, is simpler, and reduces a number of distortions. Finally, one often overlooked consequence of adopting a VAT and drastically cutting income tax rates is that the cost of tax expenditures – including tax benefits for homeownership and charitable giving – could be dramatically reduced, as was the case during TRA86.

## **CONCLUDING REMARKS**

Commentators have questioned why the elimination of a number of tax preferences in the Panel's options was not accompanied by tax rate reductions on a scale comparable to those of TRA86. The answer to this question has two parts. First, a close examination of the Panel's report reveals that, although there were some common themes between the Panel's recommendations and the 1986 tax reform effort, the tax system the Panel was charged with

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<sup>26</sup> The tax-inclusive rate for the VAT would be 15 percent.

reforming bears little resemblance to the tax system that existed prior to the 1986 Act. A number of features of our current system that were not significant barriers to reform in the early 1980s had an outsized impact on the Panel's recommendations. Many of these features, including the AMT, could not be modified without substantially altering both overall levels of tax revenues and the distribution of the tax burden.

Differences between today's tax system and the tax system before TRA86 do not fully explain the forces that shaped the Panel's recommendations, however. The second part of the answer is that constraints imposed on the Panel's work by both the President and members of the Panel established ground rules that were significantly different than those in place during the development of Treasury I. These constraints, in addition to the laudable tax reform objectives of simplicity, fairness, and economic growth, had an enormous impact on the Panel's work. Although revenue- and distributional-neutrality constraints were applied to some degree to the proposals leading to TRA86, how they were applied by the Panel differed.

The Panel's experience demonstrates that the starting point for reform and constraints on reform necessarily will play a significant role in dictating future tax policy. As the framers of Treasury I recognized, revenue neutrality and distributional neutrality are important parameters to impose on reform efforts if the aim is to put forward fair and politically feasible reforms of the tax code. These constraints can be beneficial because they focus attention on tax policy and foreclose a larger debate on the appropriate size of the federal government or the appropriate level of progressivity. The tradeoff to imposing these constraints, however, is a greater likelihood that the ultimate reform will be comprised of tax proposals that do not dramatically alter the system. As the Panel experience demonstrates, this tradeoff become even more pronounced once the constraints of simplicity, retaining income as a tax base, preserving tax incentives for homeownership and charitable giving, and obtaining consensus of a bipartisan committee are added. As policymakers consider tax reform, they should be mindful of how constraints imposed at the outset can dictate the outcome of any tax reform effort.

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