University of Southern California
Gould School of Law

Statement on Tax Reform

Senate Finance Committee, U.S. Senate

Elizabeth Garrett[*]

August 3, 2006

The President's Advisory Panel on Tax Reform, a bipartisan advisory committee on which I served, issued a report in November 2005, providing two proposals for fundamental tax reform: the Simplified Income Tax and the Growth and Investment Tax. Both met the President's mandate that our proposals simplify the tax system, promote economic growth and competitiveness, and achieve fairness through progressivity and other features. I am pleased to have been asked to discuss our recommendations with you today, particularly in a hearing with my colleagues Senators Breaux and Mack and Professor Poterba. In my statement, I would like to underscore four characteristics of both of these proposals that I believe relevant as you craft your own tax reform legislation, and then mention briefly two other tax reform proposals that the Panel did not unanimously endorse.

---

[*] Sydney M. Irmas Professor of Public Interest Law, Legal Ethics, Political Science, and Policy, Planning and Development, University of Southern California; Director, USC-Caltech Center for the Study of Law and Politics; Member, President's Advisory Panel on Tax Reform.

A Rigorous Burden of Proof for Tax Expenditures

First, the Advisory Panel was very skeptical about the many tax expenditures in the current tax system and contained in the tax reform proposals put forward by those on both sides of the aisle. As you know, our tax system is not solely devoted to raising the revenue necessary to run government programs, but it also contains hundreds of provisions designed to encourage particular kinds of behavior. Government has a choice when it designs policies to provide incentives to citizens: It can establish a direct subsidy program funded either through annual appropriations or an entitlement program, or it can provide tax subsidies. As the Panel said in its April 13, 2005, statement: "Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers can create complexity and instability, impose large compliance costs and can lead to an inefficient use of resources. A rational [tax] system would favor a broad [tax] base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies the higher taxes paid by all taxpayers."

I urge you to apply a more rigorous burden of proof to proposed and existing tax expenditures – which are often substitutes for discretionary spending programs that would be scrutinized during the annual appropriations process. Tax incentives are justified only when they actually change behavior in the way we intend it to change. It is not worth the revenue loss if a tax expenditure subsidizes behavior that would occur even without the tax benefit. Instead, policymakers create a windfall for a few at the expense of all taxpayers; the tax code becomes more complex; and ordinary taxpayers perceive the system as skewed in favor of those with political clout. Given the long-term fiscal challenges that face this country, Congress can only responsibly maintain lower individual and corporate rates if it also substantially broadens the base, eliminates or scales back many tax expenditures (including those that represent significant revenue loss to the Treasury and are thus valued most by recipients), and imposes a burden of proof on all those advocating new tax subsidies.

Tax Credits are Preferable to Tax Deductions

Second, the Panel did not recommend eliminating all tax expenditures, but we did advocate changing the structure of many of the tax benefits that are retained. We modified most tax benefits aimed at individuals from deductions to credits, and we worked to simplify them. I believe this is one of the Panel's most significant recommendations with respect to individuals, and one that could substantially improve the tax system in ways that would immediately affect the lives of many taxpayers. A deduction can be taken only by taxpayers who have tax liability, and most can be enjoyed only by those who itemize. For example, over 70 percent of tax filers did not receive any benefit from the home mortgage deduction in 2002.

A more effective tax system would restructure most tax expenditures as credits available to all taxpayers and with refundable features in some cases so that even those without tax liability can benefit. As you know, the Panel recommended changing the home mortgage interest deduction to a credit that all taxpayers with tax liability could enjoy, not just those who itemize. We also recommended adopting a simple refundable savers' credit to encourage lower-income Americans, even those who do not pay taxes in a particular year, to save for a better future for their families. Both our reform plans eliminated the duplicative and overlapping system of standard deduction, personal exemption, child tax credit, head of household filing status, earned income tax credit, and refundable child tax credit – all of which have different phase-out ranges and eligibility rules. We proposed instead two credits designed to work together, a Family Credit and a refundable Work Credit.

Using credits is a fairer, more progressive way to provide tax subsidies to Americans. Deductions provide benefits in an "upside-down" manner that offends fairness principles. Deductions are worth more to taxpayers in the higher brackets, but credits are worth the same to all taxpayers and can be made refundable. This was one reason for our recommendation to restructure the subsidy for mortgage interest so that it is taken as a credit, not a deduction, and so that the amount of principal eligible for the deduction is capped below the current limit and applied only to one home. Our recommendation ensures that more Americans can enjoy the tax incentive for home ownership and that the benefit is targeted to lower- and middle-income Americans seeking to buy modest homes – perhaps their first homes – rather than disproportionately aimed at higher-income Americans and encouraging the purchase of larger homes.

I strongly urge this committee to adopt our approach with respect to tax credits in the individual tax system. The combination of eliminating tax expenditures in many cases and restructuring those that are retained as tax credits, some refundable, will enhance both the fairness and simplicity of the system. The structure is also a more effective way to incentivize the behavior of all taxpayers and, in the case of refundable credits, all tax filers.

The Importance of Integrated Packages

Third, although we did not expect that either of our plans would be adopted without change by Congress, some parts of our proposals are "packages" that must be enacted together in our view. If lawmakers cherry-pick some provisions from these packages without also enacting others, they will not be following our recommendations and, more importantly, they will not be improving the tax code. For example, proposals to replace depreciation with expensing to recover the costs of investment in business assets must be accompanied by a repeal of the deduction for interest. As our Report notes: "Allowing both expensing of new investments *and* an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity."

One key package is our proposal to encourage savings. It includes a simplified "Save at Work" plan which combines all the current employer-provided retirement plans into one. Importantly, and crucial to improving the savings rate, the "Save at Work" accounts have different default rules than do most current plans. For example, under the Auto-Save feature of our proposal, employees would be automatically enrolled in diversified retirement plans and would have to act in order to opt-out. When they left their jobs, their savings would be automatically rolled over into a tax-deferred vehicle unless they chose otherwise. This retains freedom of choice while also increasing the number of people who will save for their retirement. The other two accounts – "Save for Retirement" and "Save for Family" – have limitations on withdrawals so that they can be used only for certain life events such as retirement, education, purchase of a home, and health-related expenses. We did not support providing tax benefits to accounts that could be used for any purpose; such a structure does not promote long-term savings and will primarily provide a benefit to savings that would have occurred anyway.

A key component of our savings package is a refundable Saver's Credit that would provide low-income Americans a strong incentive to save by matching contributions to savings accounts. This aspect of the package will encourage new savings by people who desperately need to save but lack the resources to do so; recent studies indicate that a refundable saver's credit could significantly change behavior.

Finally, we would repeal all the other tax subsidies for savings currently in the Code, including benefits targeted toward particular uses like education or health and the substantial tax benefit for the inside build-up in life insurance and deferred executive compensation. Thus, our proposal substantially simplifies the tax system for individuals, which may itself encourage some new saving. The three simple accounts we propose would replace the plethora of current vehicles, all with different rules, requirements and eligibility.

As you consider a savings package, I caution you to keep two concerns in mind. First, as with any tax subsidy, you must aim to encourage new savings and not merely provide a windfall for those who would have saved without the tax benefit. You also need to study seriously the full range of consequences of any reform. For example, perhaps the most successful incentive in the tax code to encourage savings is the tax-preferred employer-provided retirement plan, which we strengthen with Auto-Save features. You must be careful not to make any changes in individual savings plans that might discourage businesses from offering such plans to their workers. Some analysts have cautioned that wider availability of very generous individual savings plans might lead some business owners and managers to abandon their employer-provided plans, thereby reducing pension coverage for middle-income workers. On the other hand, our Panel unanimously believed that phase-outs and other methods to constrain eligibility for savings incentives increased complexity to unacceptable levels.

Second, you must determine, to the extent possible, all the revenue implications of the design of savings vehicles – implications that may occur well outside any five- or ten-year budget window. The Simplified Income Tax used the "Roth IRA" back-loaded format, which masks the ultimate revenue loss, particularly when combined with incentives to encourage taxpayers to convert traditional IRAs. Our report discusses the potential magnitude of these losses in Chapter 4 (page 48). Proposals that reduce the ability of government to raise the revenue that it needs in the future must be considered with great caution, especially if the revenue bite occurs around the same time that the retirement entitlements, such as Social Security and Medicare, will be facing severe fiscal strains. When tax revenues cannot sustain necessary government programs, the resulting deficit financing has significant deleterious effects on the national savings rate; thus, a savings proposal that results in higher deficits is counter-productive.

Progressivity is a Necessary Element of Tax Reform

The final noteworthy characteristic of our reform plans is that both have progressive rates. This reinforces the long-standing tradition in this country of progressivity in the tax code as part of its fundamental fairness, and it responded to the direction of the President to bring forward proposals that were fair and appropriately progressive. Even a pure consumption tax – which was not among the Panel's recommendations – can have progressive rates. Some lawmakers and policy makers have advocated a Flat Tax – which interestingly has two rates, not one – but a single-rate proposal was not supported by the Panel, notwithstanding testimony from its leading advocates. Interestingly, one of the fathers of the Flat Tax, Professor Hall, testified that given growing inequality of wealth in the country, he would now be inclined to include two rates, plus a zero bracket, in the Hall-Rabushka Flat Tax.

For the record, I have included with this testimony my statement upon the release of the Panel's report that discusses the urgent need for a renewed commitment to increased progressivity in today's current economic and social climate. As our country is increasingly characterized by growing and profound inequalities of wealth and opportunity, a progressive tax system – as well as government programs designed to increase economic and educational opportunity for all Americans – can help to redress the inequities. Progressivity means more than just a progressive rate structure; it also means:

- eliminating or scaling back tax expenditures that disproportionately benefit the well-to-do;

- using credits, some refundable, rather than deductions, for those tax expenditures that satisfy the "burden of proof" and remain in the tax code; and
- minimizing the "marriage penalty" that plays a role in discouraging some women from entering the workforce.

The Roads Not Taken in the Panel's Report

I want to conclude by mentioning two proposals that the Panel did not endorse. One, the national retail sales tax, should not continue to have the prominence on the political agenda that it currently enjoys. The other, a credit-invoice Value Added Tax, should remain under consideration, particularly as you begin to grapple with the fiscal challenges facing the entitlement programs and seek a source of revenue more stable than the payroll tax.

In our hearings, former Assistant Secretary of Treasury Mark Weinberger told us that we could play a positive role in the national debate by ruling some things off the table, as well as by putting forward recommendations for reform. Our report, in Chapter 9, should decisively rule out a national retail sales tax as a serious contender for reform. The so-called "FairTax" plan is not a realistic proposal for the country, it would not provide adequate revenue at reasonable rates; it would harm many of the very people who support it; and it meets none of the goals of a healthy tax system.

In contrast, a Value Added Tax, along the lines of the VATs used by the vast majority of our major international competitors, should remain on the table but as part of the reform of Social Security and Medicare. Replacing the payroll tax with a VAT would provide a more stable source of revenue for these important programs. It would appropriately expand the base of those paying for the programs past today's workers to all citizens. Because it would replace the payroll tax, it would not worsen the progressivity of the overall tax system, and the Family and Work credits could be expanded to further reduce regressivity.

Our report, together with other work done by the Treasury Department and scholars, provides a blueprint for a broad-based VAT with very few exemptions, avoiding many of the problems in the European system. It need not be "invisible" but instead could be clearly stated in every purchase of goods and services. Although this issue is not before you now, I encourage you to refer to the Panel's report when you do consider this possible source of revenue, and I urge you to consider it seriously as a replacement for the payroll tax.

Conclusion

In conclusion, I thank you for allowing us to discuss the Panel's report with you today as you embark on your work on tax reform. I hope that your proposal will incorporate the progressive elements of our proposals, and that you will keep in mind the need for our tax system to raise enough revenue to adequately fund necessary government services. Fundamental and structural tax reform is necessary, but at the same time, cries to constantly reduce taxes are problematic because they leave us – and future generations – unable to meet our obligations as a country. Oliver Wendell Holmes called taxes the "price we pay for civilization." The key is to pay for civilization fully, fairly, and simply.

University of Southern California
Gould School of Law

Statement Concerning the Release of the Final Report of the President's Panel on Tax Reform

Elizabeth Garrett[*]

November 1, 2005

I am pleased to join in the recommendations released today in Washington, D.C. by the President's Panel on Tax Reform. I am honored to have had the opportunity to work closely with the other panel members to assess the current tax system, analyze several proposals for sweeping reform, and recommend two comprehensive tax systems. Working as a group of people with different perspectives and from different backgrounds, we were able to reach consensus agreement on plans that we all support. Both proposals that we recommend represent fundamental reform of the income tax system and deserve serious consideration by policy makers in the executive and legislative branches.

I want to emphasize two constraints facing our Panel that will not affect lawmakers when they begin their work on sweeping reform of the tax system. The first constraint – to retain the status quo distribution of tax burdens – was one that the Panel imposed on itself to eliminate one area of potential irresolvable conflict, and the other – revenue neutrality – was part of the President's mandate so that we focused our attention on the best structure for the tax system without determining how much money it

[*] Sydney M. Irmas Professor of Public Interest Law, Legal Ethics, Political Science, and Policy, Planning and Development, University of Southern California; Director, USC-Caltech Center for the Study of Law and Politics.

should raise. Although I believe legislators should use this Panel's report as a roadmap for reform, they should use the structure we have provided to increase the progressivity of the tax system and to raise sufficient revenue to responsibly meet the country's short- and long-term obligations.

First, as described in Chapter Four of the Report, the Panel decided to craft options so that they had the same distribution of tax burdens as the current system. The current system is somewhat progressive, so retaining the status quo is consistent with the President's mandate to retain progressivity as an element of our tax system. Although this decision made sense because it took a contentious issue off our agenda – i.e., how progressive our tax system should be – and allowed us to reach a consensus, responsible tax policy should include significantly greater progressivity than the status quo or the options we now recommend.

The current distribution of tax burden is not acceptable in light of the substantial inequality of income in the United States. Economists have been telling us for several years that income and wage inequality is higher now than it was in the 1970s; yet we have not paid much attention to these dry economic reports. We can no longer afford to ignore inequality of wealth in the United States. The tragedy in New Orleans and the Gulf Coast concretely demonstrated the effects of poverty and limited economic opportunities on the lives of our fellow citizens. Hurricane Katrina provided a dramatic example of the extent and effects of poverty; those who live daily in economic distress know the reality of poverty that does not receive the full attention of the public, the press or elected officials.

For the last several years, tax policy makers have seemed oblivious to growing income inequality; instead, recent tax laws have moved in precisely the opposite direction and made our income tax system less progressive. Thus, to use the current distribution of tax burdens is to accept a distribution that is unacceptably skewed toward upper-income Americans and insufficiently attentive to a fair allocation of the tax burden. However, the options put forward by this Panel provide a good starting point for comprehensive reform that would enhance fairness through a more progressive rate structure than those we propose. Fundamental aspects of our reform proposals are already fairer than the current tax system: we have replaced many deductions with credits; we have eliminated or scaled back a significant number of tax expenditures that disproportionately benefit the well-to-do; we have simplified refundable credits for lower-income Americans; we have worked to minimize the marriage penalty. Our proposals provide a structure that is fairer to all Americans, and they can easily accommodate more progressive tax rates that acknowledge the need to take care of the less fortunate in our country.

Second, the President's Executive Order removed from consideration the question of the amount of revenue the income tax should raise because it required our proposals to be revenue-neutral. This was a reasonable constraint on this Panel as it allowed us to focus only on the structure of the income tax. As policy makers take these proposals and craft legislation, however, they should use the structures we recommend to raise more revenue than the United States is currently collecting. This Panel has noted on several occasions that the main function of a tax system is to raise revenues for necessary government programs. Currently, we are paying for too many government programs through deficit financing, passing the financial burden to our children and grandchildren. Responsible fiscal policy requires the government to raise additional revenue to fund entitlement programs that are increasingly fiscally precarious.

In other cases, the unwillingness to make the politically difficult decision to raise taxes has meant that we have failed to adequately fund initiatives and programs that are most efficiently handled by the federal government. An effective fiscal policy must determine the level of necessary public expenditure on public goods and infrastructure. For too long, policy makers have identified the spending side of the fiscal equation with dispensable "waste, fraud and abuse," rather than acknowledging the arenas where government is the best provider of vital goods and services and working to design and fund those government programs so they operate well. The events surrounding Hurricane Katrina are a dramatic example of the folly of failing to adequately fund expenditures that should be made by government – funding for infrastructure like levees and highways; money to develop and implement adequate disaster management plans; revenues to ensure safety and security for all our citizens. The tax reform proposals contained in this Report provide a foundation to craft a responsible tax system that will provide a stable source of revenue to adequately fund programs now and in the future. Because they are presented as revenue neutral proposals, however, they do not directly deal with the need to raise additional revenues. More money is not the only answer to providing government services to our citizens, but it is a necessary part of well-functioning society.

Katrina and its aftermath are a wake-up call for the United States. The disaster shows the wisdom of what we have been told for several years – that we can no longer ignore the fact that in the midst of the great riches of this country, too many of our citizens live in poverty and find their opportunities limited or nonexistent because of economic conditions into which they were born. For the sake of agreement on innovative and comprehensive structural reform options, this Panel did not address the need for greater progressivity in the tax code, nor did we consider the right level of revenue that our tax system must raise so we can responsibly fund necessary government programs. Those who make the tax laws in the legislative and executive branches cannot ignore the issues we took off the table. They have a responsibility to enact both a more progressive tax system and one that raises sufficient revenues to meet our obligations now and in the future.