The Present and the Future: Thoughts and Guesses

By Donald C. Alexander

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Where We Are

To me a continuing happy surprise is that President Bush’s administration — in many ways the most conservative in at least the last 50 years — has been supporting strong enforcement of the federal tax laws. I had thought that enforcement, much less strong enforcement, was out of step with the base Republican agenda. After all, it is the party of former House Small Business Committee Chair Donald A. Manzullo, R-Ill., who berated IRS Commissioner Mark Everson at an April 5, 2006, hearing and whose invited witnesses demanded that the IRS return to a focus on education rather than on audits, a notion pushed by a former Republican IRS commissioner and his “Compliance 2000” acolytes. One of Manzullo’s chosen witnesses contended that expanding third-party reporting would “squash the entrepreneurial spirit.” But despite urgings of that nature from its base, the administration has stood firm in support of Everson’s strong emphasis on enforcement of the tax laws. Why? I think the reason is simple and clear: The tax laws produce more revenue when they are enforced than when they are not enforced.

To justify its continual push for tax cuts, particularly the reduction in the tax rates on capital gains and dividend income to 15 percent, the administration must find support for its supply-side claim that dropping rates on capital income does not reduce revenue. For example, enhanced enforcement revenue from Everson’s efforts was added to produce an aggregate used to support a September 18, 2006, claim that the IRS return to a focus on education rather than on audits, a notion pushed by a former Republican IRS commissioner and his “Compliance 2000” acolytes. One of Manzullo’s chosen witnesses contended that expanding third-party reporting would “squash the entrepreneurial spirit.” But despite urgings of that nature from its base, the administration has stood firm in support of Everson’s strong emphasis on enforcement of the tax laws. Why? I think the reason is simple and clear: The tax laws produce more revenue when they are enforced than when they are not enforced.

Where We May Be Going

Nevertheless, we have a substantial and growing deficit, largely attributable to the unwise war in Iraq. While the administration and the Republican-controlled Congress largely abandoned the “pay as you go” rule that revenue-losing provisions must be offset by revenue raisers, the new Congress will likely restore it. But in the recent election, Republican candidates claimed that Democrats would raise taxes. New House Ways and Means Committee Chair Charles B. Rangel, D-N.Y., has served on that panel for more than 30 years. He does not want to be a one-term chairman. If the Democrats try to raise tax rates on individuals or to increase the individual tax base, the risk of a one-term chairmanship is probably materially increased. Accordingly, Democrats who campaigned on fiscal responsibility and who would like to curb the alternative minimum tax have the burden of raising revenue without raising taxes. How can they do it?

The answer, or much of it, may be in reducing the tax gap, the annual difference between the amount of federal taxes that should be collected and the amount actually collected. The tax gap is said to amount to a gross $345 billion, with about $50 billion later recovered by IRS enforcement efforts. Some, including myself, think the gap is considerably larger because some revenue sources (excise and estate taxes and the illegal sector) are partially or fully excluded from the base. Also, we skeptics think the estimated rate of noncompliance is probably too low. In any event, there is a large number to work with.

Revenue neutrality is a matter of economists’ scoring rather than actual measuring of the effect of proposals. Over the years, various commissioners have tried to persuade Joint Committee on Taxation or Congressional Budget Office staff to permit scoring (that is, counting as an addition to tax revenue) the effects of IRS enforcement initiatives, such as increased resources and efforts to reduce the tax gap by collecting taxes known to be overdue and unpaid. I hope that with the support of the Office of Management and Budget, Everson will have better luck with that.

Next we turn to withholding and document matching. An effective withholding system produces 99 percent compliance, and an effective system of document matching (information returns) is close behind at about 96 percent. However, compliance can fall below 50 percent when there is neither withholding nor document matching. Various remedial proposals have been made, largely by JCT staff. Among those most frequently mentioned is reporting of tax basis by brokers. If that proposal was adopted, it might seem advisable to distinguish between giant organizations with the needed data and capability and small brokerage houses with neither. Similar recommendations have been made regarding state and local...
property taxes and mortgage interest. Another recommendation would call for reporting of some auction and Internet transactions. Proposals like those have merit but should be carefully designed to prevent unintended consequences and limit unfair competition. On a more substantive side, one proposal would require pass-through entities and subchapter S corporations that conduct service businesses qualifying under section 448(d)(2) to treat their service revenue as self-employment income.

As mentioned above, provisions calling for tightened information reporting and especially withholding should be carefully considered and tested before enactment. Will the anticipated burden and cost imposed on taxpayers justify the anticipated increase in compliance resulting from the proposal? An example of going too far is the recently enacted provision requiring withholding at a 3 percent rate on gross payments to government contractors. (I have an interest in that matter.) While the legislative history of the provision contends that it “balances the goal of greater compliance with concerns regarding administrative burdens of imposing withholding,” the revenue estimate demonstrates no such balance. In 2011, the year in which the provision is scheduled to become effective, the estimate shows a revenue increase of $6.079 billion. In the following year, however, the increase is only $215 million, and subsequent increases above that $215 million base are less than $10 million annually. Little analysis is needed to show that the enormous number of more than $6 billion in increased revenue in the initial year is not attributable to increased compliance. Instead, it simply represents prepayment of tax. Only the comparatively tiny revenue numbers in 2012-2014 (and their 2011 counterpart — the corresponding small portion of the $6.079 billion) constitute revenue from increased compliance, the asserted justification for the provision.

Note that Treasury did not propose the enacted approach, but instead requested further information reporting. Despite claims to the contrary, an effective reporting mechanism was not in place. Substantially all the revenue resulting from increased compliance by governmental contractors would have been produced by information reporting, and that should have been the first choice. Taxwriters should learn from that example.

As to further revenue raisers, perhaps there will be some reconsideration, as JCT staff proposed, of the extension of the check-the-box rates to foreign entities. Also, one can expect an examination of the adequacy of reporting foreign income of U.S. taxpayers and perhaps some substantive legislation dealing with oil companies’ offshore profits, transfer pricing, and sourcing of income from intangibles. Correcting perceived tax leakage from abroad should not be subject to nearly as much political risk as increasing taxes directly on U.S. individuals and domestic businesses, particularly small businesses.

In closing, I must confess that I favor paying for all tax cuts and balancing the budget. I don’t want to turn over a nearly bankrupt federal government to my grandchild.

Americans spend more than 16 percent of gross domestic product on healthcare, and that number is expected to rise to 20 percent in just 10 years. Health insurance premiums have risen more than 75 percent since 2000, more than 50 percent faster than inflation and more than twice as fast as wages. Given the enormous strain that increases in healthcare spending put on both public and private budgets, it is vital that we get the most value for our healthcare dollars — and evidence suggests that right now we do not. We spend roughly twice as much per capita on healthcare as other developed countries, without commensurately better health outcomes. We see the same story across different regions within the United States, with beneficiaries in parts of the country where Medicare spends the most being the least likely to receive highly effective, high-value care. In the long run, improving the value that we get for our healthcare dollars will make healthcare more affordable for everyone and increase access to healthcare and health insurance.

One of the key problems with our private health insurance system is that the tax code penalizes people who choose basic insurance coverage over gold-plated plans. Premiums for employer-provided insurance are paid with tax-free dollars, while most people who don’t get insurance from their employer or who choose basic plans and cover routine care on their own have to pay taxes on their healthcare. Thus people get more tax relief when they buy more expensive health insurance through their employer, and pay less for healthcare services that are covered by their employer-provided insurance plan than they would for care purchased out of pocket. That pushes people into insurance policies that leave patients with little incentive to seek out high-value care and leave healthcare providers with little incentive to compete for their business. Even consumers who would like to shop for the highest-quality, highest-value care often lack access to the price and quality information they need. That inefficiency means that wages have risen more slowly than they otherwise would have and that consumers have less money to spend on other things they value, like food and housing.

An important step toward more effective use of healthcare resources is leveling the playing field between out-of-pocket expenditures and healthcare purchased through an employer’s health plan — freeing people to choose policies that combine the financial protection of catastrophic coverage with potentially higher out-of-pocket costs but correspondingly lower premiums. There
are a number of different ways that the tax code could be changed to accomplish that, each with different distributional and efficiency implications.

One step in that direction, proposed in the president’s fiscal 2007 budget, would be to build on the success of health savings accounts. HSAs were enacted in 2003 as part of the Medicare Modernization Act and allow consumers to pay for many of their out-of-pocket healthcare expenditures tax-free as long as they have a high-deductible health plan with limited financial risk for the enrollee. Those plans can even cover preventive care with no deductible. President Bush has proposed several options for increasing the attractiveness of HSAs, including raising contribution limits and allowing the funds to be put toward health insurance premiums. Some of those policies to improve the flexibility and attractiveness of HSAs were recently enacted, and further improvements would widen HSAs’ appeal. Low-income consumers should be given a credit to help pay for the policy. Employers should be allowed to contribute more to the HSAs of chronically sick employees. An executive order signed by President Bush in August 2005 will help give patients and physicians the price and quality information they need to take advantage of those policies.

HSA-based policies can help achieve greater affordability and higher-value healthcare. First, they can help bring down overall healthcare costs. Roughly half of all healthcare spending by those under age 65 is accounted for by people with medical bills below the typical out-of-pocket maximum of a high-deductible healthcare policy. Only about 20 percent of spending is done in emergency situations, and evidence strongly suggests that, given the information they need, patients and their families choose care that is of higher quality and higher value. Second, high deductibles do not make those policies unaffordable for the poor. Focusing exclusively on the deductible misses half the picture. Lower premiums for those policies make them affordable for people who couldn’t otherwise afford insurance. A recent survey suggests that a third of the individual purchasers of HSAs were previously uninsured, and a third of the small firms newly offering HSAs did not previously offer insurance to their employees. Third, HSA-based policies are not just attractive to the healthy. The policies’ caps on total out-of-pocket spending limit families’ financial exposure in the case of catastrophic illness, and by encouraging high-value health spending, HSAs make healthcare dollars go further. That said, those who are chronically ill need additional assistance in obtaining insurance, such as through state high-risk pools or through innovative programs such as the provision of risk-adjusted health insurance vouchers.

That HSA-based approach is just one way to level the playing field for the purchasers of basic health insurance policies. Even broader approaches could give the same tax benefits to all purchasers of health insurance — regardless of whether they choose basic plans or “Cadillac” plans and whether they get their insurance on their own or from their employer. We need to focus not just on how much we spend on healthcare, but on making our healthcare dollars go further. That would go a long way toward making affordable health insurance available to all Americans. Combined with other policies to improve the effectiveness of public health insurance spending, leveling the playing field for different types of insurance policies and healthcare spending can empower patients to use their healthcare resources in the way that’s best for them, leading to greater provider competition, more cost-effective technology, and higher-value healthcare.
Democratic Tax Opportunities

By Bruce Bartlett

Bruce Bartlett is a syndicated columnist who has worked at the White House and Treasury Department. He is the author of *Impostor: How George W. Bush Bankrupted America and Betrayed the Reagan Legacy*, recently published by Doubleday.

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I think there are some tremendous opportunities in the tax area for Democrats to exploit in the next two years that could help them keep control in 2008 and aid their presidential nominee as well.

First, I think there is an opportunity for Democrats to pick up the mantle of tax reform that the Republicans effectively have abandoned. The growing problems with the alternative minimum tax can be the vehicle for doing that.

Democrats are committed to a permanent AMT fix and also to restoring some semblance of fiscal responsibility by reinstituting “pay as you go” rules for tax bills. Both are popular by themselves. But put them together and it means that taxes will have to be raised on somebody to pay for the high cost of a permanent AMT fix.

There are several ways of approaching that situation. One is that Democrats could raise taxes in ways popular among their own members — raise tax rates on the rich, screw the big corporations, and so on. However, there is no chance that President Bush would sign such a bill and there aren’t enough votes to override his veto.

An alternative approach is to raise taxes in ways Republicans will have a harder time opposing: broaden the tax base, go after the “tax gap” by raising funding for the IRS, clamp down on corporate tax shelters, and maybe raise the gasoline tax.

A third idea would be to throw the bomb and do a grand fix not just for the AMT, but a lot of other glaring tax problems as well. But that would require much more money than can be raised by base broadening and demands a new revenue source. A VAT could raise about $50 billion per percentage point. A modest VAT would raise more than enough revenue to fix the AMT, make the Bush tax cuts permanent, and deal with a lot of other tax problems.

A VAT is controversial, but I think Bush might support it. He supported a VAT for the state of Texas when he was governor. And it would have strong support in the corporate community, which likes its border adjustment. At least it’s something to think about.

Alternatively, Democrats could think about some kind of broad-based carbon tax as a way of both raising revenue to pay for the AMT fix and making a down payment on doing something about global warming. Depending on how it is done, the effect could be similar to a VAT, but it might be more palatable to Democratic constituencies in the environmental community.

Another area in which I would like to see some action by Democrats in the new Congress is the abuse of tax-exempt entities. It is my observation that the political activity by various so-called think tanks has gotten out of hand. It’s no wonder that convicted lobbyist Jack Abramoff even set one up to hide some of his nefarious activities.

Without naming names, there is more than one conservative section 501(c)(3) organization that has been known to fire staff people for no other reason than that they were critical of some policies of the current administration. It didn’t matter that the criticism was consistent with the organization’s stated philosophy. Staying on the right side of the White House or the president’s political party was deemed more important to those groups than staying true to their own principles.

Indeed, in one case I am familiar with, a well-known conservative think tank in Washington barred an outside group from using its facilities simply because it had invited a guest author to speak who was mildly critical of President Bush for straying from conservative principles, even though the group had been meeting there for at least 15 years. (By the way, it wasn’t me.)

If those were profit-making entities, there would be no problem. However, the law confers tax-exempt status on such groups because they are assumed to operate in the public interest and provide benefits to society, and not be fronts for political parties. But if they have effectively become arms of a political party through their actions, they have crossed the line and should be held accountable.

I am also concerned that many think tanks now rival big corporations in the generosity of the pay of their senior executives. A review of the 990 forms at http://www.guidestar.org will confirm that for anyone to see. Those executives also have become adept at using things like rabbi trusts to hide their excessive pay from board members who may not realize just how high it is. Nor are boards always aware that top executives may have a spouse or other close relative on the organization’s payroll, possibly using a different last name or as a consultant of some type, who doesn’t show up on the payroll.

Needless to say, think tank executives have also become adept at using all the usual techniques used by corporations for enriching their managers. Those include compensation consultants hired by the CEO to assure boards their pay is not out of line, loading boards with their personal friends and getting rid of anyone who asks too many questions.

Democrats often complain that the IRS is doing a poor job of auditing corporations and rich people these days. But however bad that may be, its auditing of nonprofits is far worse — virtually nonexistent. In my view, that is an area that badly needs hearings and investigations by the Government Accountability Office.

Lastly, I hope Democrats will restore some transparency to the taxwriting process. The Republicans have been irresponsible in enacting major tax law changes without either hearings or even markups. There is no excuse for that, and I hope it will not continue.
Free Tax Advice for the New Congress: Do Nothing

By Christopher Bergin

It’s a new year and a whole new chess game on Capitol Hill. Democrats will be able to get their hands on the tax code for the first time in years. And Republicans will now have to play second fiddle on the taxwriting committees and serve as the minority in both houses of Congress after years of being unable to keep their hands off the tax code.

With the big changes, I have some free advice for members on both sides of both houses’ rearranged aisles. (I’m sure more than one critic will say I priced my advice about right.)

Democrats
Stay away from the Bush tax cuts. Don’t try to repeal them now. You want to avoid for at least two years the label of tax-and-spend liberal. I’m assuming that as a smart Democrat you agree with this advice because your speaker of the House is doing everything she can to avoid being called a San Francisco liberal. (Isn’t that what she is?) After all, she wants a coming-out party as far from the left coast as possible and has managed to get a street named for her in Baltimore — where she is really from, don’t you know. Lucky for you, President Bush already figured out how to mostly pay for his temporary tax cuts, so it won’t cost you much money to leave them alone (see item directly below).

Don’t talk about the individual alternative minimum tax. It will only get you in trouble because you don’t have the money to truly fix that problem. So pretend it doesn’t exist. H.L. Mencken was apparently right when he observed that most of us average middle-class Americans are dopes. We just don’t care about the AMT. None of us fill out the painful Form 6251 — we let TurboTax or our accountant do that — and we are apparently oblivious to the financial pain the AMT can inflict. Besides, it won’t get too bad for a couple of years, and the money it brings in helps you stay clear of talking about cutting the Bush tax cuts until after the next election.

Be careful in the debate over estate tax repeal. You’re winning. Estate tax repeal is dead for now (no pun intended). The majority of the voters don’t think we can afford outright repeal. So no need to get shrill. You can even afford to be generous to your Republican colleagues here — you know, look like you changed the tone in Washington. Another plus: It’s a great campaign issue for 2008. And when a Republican member tells you that the “death tax” kills family farms, look him or her straight in the eye and say, “Name two.”

The tax gap is not the pot of gold at the end of the rainbow. Please talk to somebody — pick any current or former commissioner of the IRS — before you go on Hardball With Chris Matthews and promise 37 targeted

Republicans
If the Democrats even mention going after the Bush tax cuts during the next two years, you have them in “check” in the political chess game. Bring out the rooks, bring out the bishops, heck, bring out your queen — all screaming, “Tax-and-spend liberals, tax-and-spend liberals. The minute they get in power the first thing the Democrats want to do is raise taxes. Because getting rid of the Bush tax cuts is a tax increase. What do you expect from a party based in San Francisco?” That’s the ticket — keep reminding the speaker where she comes from. (I think she forgot.)

Now, we all know that while you and Bush were running around the country before Election Day telling anyone who would listen that Charlie Rangel, D-N.Y., would raise their taxes, Bush had already proposed raising taxes on many Americans. He did it when he punted the little growing problem with the individual alternative minimum tax to the tax reform panel he formed. You were in the majority long enough to know the AMT is a problem that can’t be fixed. So, if the Democrats even mention the AMT, you start telling everyone that the AMT is part of the Democratic conspiracy of class warfare that has run amok. Pretend the Republicans had nothing to do with it — after all, you’re a politician.

Shut up in the debate about estate tax repeal. You lost. I can’t believe it, either — that “death tax” campaign was great marketing. But times have changed. The voters think there isn’t enough money for repeal because you spent it. (Remember prescription drugs?) Grab what you can behind closed doors for your wealthy constituents; Democrats may be willing to be generous on this one. And if a Democrat asks you to name one family farm that has been hurt by the estate tax, just walk away shaking your head.

You’re a smart Republican. You know you left the Democrats very little room to work with over the next several years — we call it the deficit. They also have to be careful about increasing taxes. And you still have a
If you follow this simple advice, both parties should talk and talk and talk and do absolutely nothing about the tax code for the next two years. In fact, if most of what you talk about is tax reform, that might be a good thing. If you and the president manage to do nothing for the next two years when it comes to the tax laws, the country should be grateful — and whether or not most of us are grateful, we’ll all be better off. Two years of relative peace would be a good place to start seriously thinking about our tax system. Happy New Year.

Now back to those targeted tax credits. Please at least try not to return to the Clinton era, when just about everyone who made less than some arbitrary income threshold apparently deserved a tax credit for everything from snowblowers to car vacuums. I realize that it’s a lot of fun to feed pabulum to the people, but those tax credits are really dumb tax policy and you don’t have the money for them anyway. If you must, pick one — like education. In the end it won’t cost much because you and your fellow Democrats will set the income ceiling so low. And the president will veto it anyway. But you’ll get to tell the folks you really care. (It’s what you do.)

Here’s a hint on corporate taxation you really should consider. Propose broadening the corporate tax base — including dumping the research credit and other favors — and dropping the maximum tax rate for the corporation income tax. Hey, the Europeans are doing it. And don’t be cheap — propose dropping the rate to 25 percent from 35 percent. It will win you new friends and confound old enemies.

If you try to do anything about Social Security and Medicare in the next two years, you should be drummed out of politics. You can talk about how terrible things are because you’re a Democrat. Just don’t try to do anything. Do you want the Republicans to do to you what you did to them?

Take the time to read the report from Bush’s panel on tax reform. The panel did great work — no joke. After you read the report, you can talk intelligently about tax reform and be informed on the major tax issues. What a concept!

Save your breath on talking about global competitiveness. You have a national election coming up in a couple of years, and you’ll need your lungs then. Suggest cutting corporate tax rates to a Democrat, and the answer you will most likely get is “Why do we want to help corporations?” Look at it this way: The Democrats are letting you keep a good piece of your political base.

If you try to do anything about Social Security and Medicare the next two years, you should be drummed out of politics. Be careful even talking about how terrible things are, because you’re not a Democrat. Just ask Bush what it felt like touching that rail.

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Now, back to the deficit. The Democrats are probably going to propose all kinds of targeted tax credits. You know they have no way to pay for them. So go ahead — propose some of your own. In fact, as the Democrats get to work, prepare yourself a little grid and start charting who the Democrats favor. Then start proposing targeted tax credits for people the Democrats skipped. The more ostentatious the credit, the better. Don’t worry about it; nothing will happen anyway. But no proposed targeted tax cuts for the superrich; you Republicans have already done enough for them.

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friend in the White House. So sooner or later the Democrats will have to reach for that brass ring known as the tax gap. They may even hold hearings on IRS tax administration. Hearings on the IRS! That’s been your bread and butter since 1994. You might even enjoy being the minority for a couple of years.

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Will Democrats Raise Taxes?

By Chris Edwards

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The government does not need tax increases of any size to deal with its budget problems. In fiscal 2006 — with the Bush tax cuts and alternative minimum tax relief in place — federal revenues hit 18.4 percent of gross domestic product, which is about the average over recent decades. Long-term budget projections clearly show that the problem is the exploding costs in entitlement programs, not falling revenue.

Another major tax threat is the White House agreeing to tax increases in exchange for repeal or reform of the AMT. Administration officials have said the AMT should be fixed on a “revenue-neutral” basis. But I don’t think many of the public appreciate the meaning of that policy position.

In 2006 the AMT raised about $24 billion — a decent chunk of change, but nothing compared with the more than $1 trillion it will raise over the next decade unless it is repealed or reformed.1 In Washington, revenue neutral means raising all that additional AMT revenue some other way, such as by ending income tax deductions or raising rates. To average families, that would mean a huge tax increase — to them, revenue neutrality means the amount of tax they paid this year, not some theoretical higher amount in government projections.

The Democrats say they favor AMT relief, but they also favor “pay as you go” budget rules. Those rules require that proposed increases in spending or reductions in taxes be offset by other tax and spending changes. How will the Democrats offset the roughly $50 billion needed for AMT relief this year?

Democrats are talking about closing the $345 billion tax gap. But the vast majority of the gap is individual taxes, not corporate, with the largest share stemming from small businesses and the self-employed. It makes no sense — politically or economically — to crush the nation’s entrepreneurial sector with more intrusive tax reporting and enforcement.

And while the Government Accountability Office reports that “billions of dollars” could be raised by taking steps to close the tax gap, it also says the gap has remained relatively stable over the decades, “in spite of many efforts to reduce it.”2 The bottom line is that tax-gap talk makes good press, but there is little real money there for the Democrats.

In sum, I see the Democrats playing temptress to the administration this year, trying to seduce it into a tax increase with the warm embrace of bipartisanship. The administration should keep its distance — no joining hands in budget summits or commissions — and should loudly assert its fidelity to the Republican tax-cutting record and pro-growth agenda.

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1 Estimate from the Urban-Brookings Tax Policy Center. Data are for fiscal years 2007-2016, assuming that the Bush tax cuts are extended.

A Tax Agenda for Manufacturing Competitiveness

By John Engler

John Engler, a former governor of Michigan, is the president and CEO of the National Association of Manufacturers, the largest industrial trade association in the country.

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As the National Association of Manufacturers (NAM) developed its legislative and tax agenda for the 110th Congress, we kept one thing foremost in our minds. I’m not referring to the obvious fact that Democrats now hold majorities in the House and Senate. While the political shift will naturally influence our approach, NAM’s priorities are shaped by its members. Those are companies that represent a manufacturing economy that generated an estimated $1.5 trillion in wealth in 2006 and directly employ more than 14 million Americans.

For manufacturers, competitiveness — not politics — comes first.

The 110th Congress must pursue tax policies that enable manufacturers in the United States to succeed in the hard-fought global marketplace even as our international competitors increase investment, cut costs, and sharpen their tactics. The sad reality is that we are slipping in tax competitiveness.

Released in September 2006, a NAM-backed study, “The Escalating Cost Crisis,” reported that manufacturers in the United States suffer from a 31.7 percent structural cost disadvantage compared with manufacturers in its nine major trading partners (that is, the U.S.’s major competitors). Those are external costs imposed largely by policymakers and regulators — for example, through excessive civil litigation, regulations (specifically, pollution abatement), higher energy prices, soaring healthcare costs, and corporate taxes.

Indeed, corporate taxes emerged as the primary culprit for that 31.7 percent U.S. manufacturing cost disadvantage, a figure that had climbed an astonishing 43 percent since the last study in 2003. Corporate taxation was not only the heaviest burden in absolute terms but also the largest contributor to the deterioration in the structural manufacturing cost comparison — adding 2 percentage points to the U.S. cost disadvantage.

The U.S. statutory corporate tax rate of 40 percent (combined state and federal) was unchanged during that period, while several trading partners lowered their rates. Consequently, the United States now has the second highest corporate tax rate among its major competitors, trailing only Japan by a slight amount. By standing still, the United States is falling behind, and future congressional inaction means manufacturing will fall further.

It’s true that tax relief enacted since 2001 for families and businesses played an important role in stimulating economic growth and job creation. But to build a foundation for continued and durable economic growth — for international competitiveness — that tax relief must be made permanent. Additional pro-growth tax law changes are also needed to ensure that U.S. companies can thrive and compete in the international arena.

NAM’s tax policy agenda will promote U.S. jobs and competitiveness and ensure continued economic growth by:

• providing a permanent, strengthened research tax credit;
• reducing the corporate tax burden;
• reforming and simplifying the U.S. international tax rules;
• promoting a package of permanent tax relief for small and medium-size companies; and
• making permanent preferential tax rates for investment income.

Many, if not all, of those pro-growth, pro-investment proposals are familiar to those involved in the world of tax policy. Still, their familiarity should in no way diminish their critical importance to the U.S. manufacturing economy.

Take, for example, the research credit. As the primary innovators in the United States, manufacturers understand that research and development drives new product development and increased productivity. According to the Commerce Department’s Manufacturing Council, investment in R&D is “the single most important source of technological advancement leading to higher productivity.”

Thankfully, Congress passed a renewed and strengthened research credit in the final days of the 109th Congress, the 12th time the credit had been renewed since its creation in 1981. But that inconsistent approach hampers manufacturers’ ability to make informed investment decisions; in the meantime, other countries provide more generous and permanent R&D incentives. In response, NAM strongly supports a permanent, strengthened research tax credit, one at least as attractive as those offered by other industrialized nations.

The realities of the global economy also shape the other items in NAM’s tax agenda. The 2006 U.S. corporate income tax rate is higher than the average OECD tax rate by more than 10 percentage points, and U.S.-based multinationals suffer the consequences of our system of double taxation.

Accordingly, NAM’s policy agenda calls for reducing the current federal corporate tax rate by 10 percentage points, to 25 percent. As a start, Congress should also simplify and strengthen the rules that allow U.S. companies to pay U.S. tax on the active foreign income of a business based in the United States when the income is paid as a dividend to the U.S. owner.

Small and medium-size companies, including the many that are family-owned, do not stand apart from the tough global economy. A Congress focusing on those companies’ competitive needs could aid those millions of companies by making permanent the temporary rate reductions enacted in 2001 that are set to expire in 2011. Those cuts reduced the lowest individual income tax rate from 15 percent to 10 percent (as well as enacting lower tax rates above the 10 percent bracket).
The Democratic victory may also serve to soften the political battles that always seem to surround the so-called death tax, allowing Congress to reduce that much-hated tax that punishes investment by family-owned businesses. Congress also should increase the expensing allowance to $200,000 and the dollar limit to $800,000 and make enhanced small-business expensing a permanent part of the tax code.

To reinforce that competitive investment environment, Congress should also make permanent the lower, preferential tax rates for capital gains and dividends, which have proven to promote economic growth (and which the 109th Congress extended until 2011). NAM also strongly supports reducing the tax rate on corporate capital gains to 15 percent.

NAM enters the 110th Congress eager to work with members of both parties in a reshaped political environment, one it sees as receptive to change. Manufacturers will make the case for pro-growth and pro-jobs tax policies with fresh vigor and important facts. Above all, manufacturers will stress these facts: We live in a global economy marked by fierce competition; U.S. tax policy must reflect that reality.

Some Tax Wisdom for the 110th Congress

By Stephen J. Entin

The new year brings a new Congress with a new majority and a new leadership. Before setting a new tax agenda for 2007, they would be wise to ask what must be done, what should be done, and what should be swept off the table and into the trash.

There are the perennial must-do “extenders,” such as the research tax credit. Those are never made permanent because, done a year at a time, they fit easier under the budget rules and give the taxwriting committees a nice spruce on which to hang ornaments at Christmas to attract presents.

The new majority is worried about wages, the distribution of income, and the low saving rate. But the new Congress is apt to extend the redistributive elements of the 2001 and 2003 tax cuts, such as the increased child credits, which don’t create jobs, but not the growth elements — the marginal tax rate cuts, the 15 percent tax rate on dividends and capital gains, and the suspension of the estate tax — all due to expire in 2011. Taxes on capital income are largely shifted to labor via lower saving, investment, productivity, and wages. It’s better to boost wages by $2,000 than to give a handout such as a $500 increase in the child credit. A consistency check is needed here.

Federal tax revenues surged 27.5 percent between fiscal 2004 and fiscal 2006. The unusual gain was in nonwithheld personal income taxes on higher dividend payments, huge capital gains realizations, and noncorporate business income. Face facts: Those gains are due to the rate caps and lower tax rates. The December 24 Washington Post editorial “Seize the Chance” notwithstanding, ending those rate cuts would hurt growth and revenues.

Is Congress worried about outsourcing and the trade deficit? Reduce the corporate tax rate, extend the 15 percent dividend cap on U.S. corporate payouts, and scotch the energy tax notions. The United States has the second-highest corporate tax rate among developed nations, and will be first when Japan lowers its rate. The United States also did less than other countries to offset double taxation of corporate income until the 15 percent caps were enacted in 2003. Remember, too, that small businesses are major exporters and major job creators. Don’t raise the top income tax rates on entrepreneurs.

Does Congress think it’s time to force investment home by repealing deferral of tax on foreign-source income? That would make U.S. firms uncompetitive abroad and force them to shrink their foreign operations
or sell them to foreign firms. It would not increase production in the United States, which would lose exports to what were formerly U.S. companies’ foreign affiliates.

What of the deficit? On a recent Kudlow and Company panel, Edward Gramlich of the Urban Institute was asked if reducing the corporate tax rate would raise wages. Instead of saying yes, he suggested that a higher deficit would depress national saving and curb growth. That’s trash talk. When corporate tax rates go down, corporate retained earnings go up; they are part of business saving, so there is no drop in national saving. If reinvested, the company’s value rises, raising capital gains tax revenues. Paid as a dividend, the tax cut money would be retaxed at 15 percent and, if reinvested by the recipient, does not reduce national saving.

Most importantly, a lower corporate rate reduces the rate of return needed to make an investment possible. The price effect of the tax reduction determines how much capital is formed, not the cash flow or fictitious national saving effect. A corporate rate cut (or accelerated depreciation, to reduce the bias against capital-intensive industries in current law) would boost investment and wages. Get the theory right, and good policy will follow.

Another way to boost saving and close a looming budget gap is to fix Social Security the right way. Trim the growth of future retirees’ benefits. They are nothing but transfer payments that displace personal saving, and are funded by payroll taxes that depress work incentives and hiring. Let workers put some of their payroll taxes into personal accounts. Building those accounts would be real saving. They would yield more than Social Security, increase workers’ retirement incomes compared with those under current law, increase jobs and wages along the way, and spread the ownership of wealth.

Don’t raise the payroll tax rate or lift the cap on taxable earnings. Workers over the cap already face marginal state and federal income tax and Medicare taxes of 40 percent to 45 percent. Adding 12.4 percent (or a bit less since half is deductible by employers) would reduce the after-tax incentive to earn by about 20 percent and reduce reported earnings and the taxes on those earnings by about 5 percent or 6 percent. Under current rules, benefits are based on earnings subject to the payroll tax. Ending or raising the cap would increase upper-income benefits. That would trim the work disincentive but would eat up much of the presumed revenue gain. If the link between taxable earnings and benefits were broken to avoid the outlay, it would trigger the full reduction in earnings and associated tax revenues mentioned above. It’s a no-win proposition.

The new majority wants to stabilize the reach of the alternative minimum tax, which increasingly hits middle-income earners instead of the rich, especially in blue states where state and local taxes are highest. The AMT is a travesty. It disallows legitimate deductions needed to correctly define income, and its multiple calculations are a nuisance. But from an economic standpoint, the AMT is only slightly worse than the regular income tax. Its basic rates are 26 percent and 28 percent, but in the phaseout range of the AMT exempt amount, the effective rates are 32.5 percent and 35 percent. The AMT’s chief drawback? It boosts the 15 percent tax rate on dividends and capital gains to 21.5 percent and 22 percent in the phaseout range. And that reduces investment and wages.

For the money, the AMT hurts less than would letting the 15 percent tax caps on dividends and long-term capital gains expire. Those caps provided more than half of the investment incentive in the recent tax cuts. The money to stabilize the AMT would be better spent on extending the growth elements of the 2003 tax cut.
The most contentious issues in tax policy are not going to be settled in the next two years. President Bush and the Democratic Congress are unlikely to come to a sustainable, long-term agreement on the level of revenue — debates on extending the tax cuts or letting some of them expire are likely a matter for the next president and the next Congress. The proper level of progressivity of taxes and the doctrinal debate over consumption and income taxes are unlikely to be settled in the next two years either. But views on one tax issue are rapidly approaching a consensus, at least among tax wonks of various stripes: If you’re going to do social policy through the tax code, do it right. And generally that means using credits rather than deductions. Building bipartisan trust for tax reform may require eschewing a grand vision and instead first focusing on a major change that is ripe for the picking: reforming tax expenditures.

The tax code has a profound effect on housing, health care, charitable giving, saving, and many other aspects of life. In the last budget, Treasury listed a total of $911 billion of tax expenditures in fiscal 2006.¹ That total approaches the total amount of discretionary spending ($1.025 trillion in fiscal 2006) and mandatory spending ($1.418 trillion in fiscal 2006). Unlike discretionary or mandatory spending, most of those tax expenditures are in the form of tax deductions. As is well known, those tax deductions are larger for households in higher tax brackets or with higher deductible expenses — and may be nonexistent for households that take the standard deduction or have no income tax liability.

Many in the tax community have had a long-standing suspicion of tax expenditures, preferring to get the IRS out of the business of administering hundreds of billions of dollars worth of social programs. While many tax expenditures are poorly thought out and serve goals of dubious value, it is unlikely that they will disappear anytime soon. And if we are going to subsidize activities like housing and healthcare, it is far from clear that those goals would be better served by moving the programs out of the tax code. Converting tax expenditures to spending programs would reduce the administrative burden on the IRS and reduce the complexity families face in filling out tax returns. But all of that complexity would simply be shifted to another government agency. Duplicative paperwork would, in fact, likely increase the administrative burden for the government, not to mention families struggling to provide duplicative information on multiple forms to multiple government agencies. Also, centralizing many social expenditures in the tax code makes their phaseout rates more transparent and makes it easier to harmonize the phaseout rates to prevent the marginal rates in excess of 50 percent or even 100 percent that are often observed in the tax and transfer system.

But to accept — or even embrace — tax expenditures is not to defend how they are structured. For years, a wide range of tax analysts from Gene Steuerle to Kevin Hassett to Bill Gale have written about the benefits of shifting from deductions to uniform, refundable tax credits. Recently Lily Batchelder, Fred Goldberg, and Peter Orszag laid out the most comprehensive case for the efficiency benefits of using credits rather than deductions to address externalities or encourage desired behavior.² They point out that the goal of tax expenditures is often to encourage people to consume more of something, for example, health insurance. But deductions reduce the after-tax price more for high-income families than low-income families — generally producing too much added consumption by high-income households and too little by low-income households. In the absence of evidence on elasticities by incomes, Batchelder, Goldberg, and Orszag suggest that credits should be uniform. In reality, it’s likely more economically efficient to provide larger subsidies to lower-income households. For example, a uniform credit might be too little to encourage a lower-income family to purchase health insurance while being more than is needed for a high-income household that would have purchased the insurance in any case.

But that is not just a cause for ivory tower theorists. The President’s Advisory Panel on Federal Tax Reform proposed to convert the personal exemption and the mortgage interest deduction into credits. The panel’s mortgage credit would have expanded tax benefits to more than 20 million middle-income families, a fact that was lost in the uproar over the smaller group of families who would have been affected by the lower cap. Rep. Rahm Emanuel, D-Ill., proposed a similar plan to unify the various child tax benefits, in the process rolling the personal exemption into a tax credit. And the “Fair Flat Tax” proposed by Sen. Ron Wyden, D-Ore., would convert the deduction for state and local taxes to a credit and have Treasury study the possibility of making similar changes to the exclusion for employer contributions to health insurance premiums.

¹Note that those totals are indicative of the extent of tax expenditures but are not an estimate of the revenue that would be raised by repealing those tax expenditures because they ignore behavioral effects and the interaction of tax expenditures with other provisions in the tax code and other tax expenditures.

So what should the president and Congress do? At a minimum, any new tax expenditures with a behavioral motivation should be implemented as credits rather than deductions. House Democrats campaigned on "making college tuition tax deductible," but the details of their plan wisely would implement that rhetoric in the form of a tax credit. But the big gains come only from taking on the existing system of tax expenditures. Ideally that process would contribute toward reducing the nation’s large fiscal gap and toward making the tax system more progressive, helping to offset some of the increase in inequality in recent decades. But even a revenue- and distribution-neutral reform of tax expenditures would have substantial dividends, making the tax code more fair and efficient while helping promote goals policymakers have identified, like increasing the prevalence of health insurance, college, and homeownership.

Converting the dependent exemption, mortgage interest deduction, health exclusion, and savings incentives from deductions to credits would be a major step. Also, in many cases those credits would be more efficient if they were capped, so more of our limited resources go into encouraging people to own a home or have health insurance and less goes into subsidizing more generous homes or health insurance. Finally, those new credits — together with existing credits — should be bundled together and phased out in a uniform fashion.

That process would not be easy — nothing in tax reform is. But it is one of the few areas in tax reform in which the appropriate resolution of the major issues is relatively settled and agreed to by analysts across the political spectrum. That makes it a good place to start our tax reform efforts.

Words of Wisdom for the 110th Congress

By Lawrence B. Gibbs

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As Democrats assume leadership of both the House and Senate, members of the new majority are understandably anxious about advancing their own policy initiatives. After labeling their opponents as the party in control of the "do-nothing" Congress, Democrats will face pressure to deliver meaningful legislation. Taxwriters have expressed interest in several priorities, including alternative minimum tax reform, expanding education and healthcare incentives, and permanently extending provisions such as the research tax credit.

Assuming Democrats also reinstate "pay as you go" budget procedures, legislators will face considerable pressure to identify offsetting revenue raisers to finance their agenda. Early indications suggest Congress will focus on at least four proposals: (1) increasing taxes on the oil and gas industry, (2) revising the U.S. international tax rules, (3) reducing the amount of uncollected taxes (the tax gap), and (4) curbing the use of tax shelters by codifying the judicial economic substance doctrine. Congress would be wise to proceed thoughtfully, giving all interested parties an opportunity to provide input and fully deliberating the consequences of its proposals on business activity and U.S. competitiveness, economic efficiency, and the overall fairness of the tax code.

Oil and Gas Industry

Our government has wrestled with how to tax oil and gas production for almost a century. In 1916 Congress passed tax subsidies for new oil and gas discoveries to aid the war effort, and the Treasury Department ruled that oil companies could immediately expense intangible drilling costs. Congress gradually cut back on the deduction for intangible drilling costs. Today that benefit largely targets domestic production and small producers. In the 2005 energy legislation, Congress gave oil companies the right to amortize their geological and geophysical costs over two years, only to reduce the benefit for the major oil companies in the 2006 tax reconciliation legislation. A historical major tax preference for the oil and gas industry is percentage depletion, a cost recovery concept that permits taxpayers to continue claiming deductions after recovering all acquisition and development costs. Congress eliminated percentage depletion for major oil companies in 1975, but a partial allowance remains for independent producers.
Assuming Congress determines it is appropriate to increase the tax burden on the oil and gas industry, it would be wise to consider carefully the proposals it pursues. In the 109th Congress, the full Senate and several House Democrats proposed limiting the foreign tax credit that large oil companies receive in some circumstances, in particular if the credited tax is tied to a specific economic benefit from the foreign country. The provision seeks to disallow FTCs for amounts that may substitute for royalties. Congress should exercise oversight to ensure that the FTC regime works as intended to reduce the double taxation of U.S. taxpayers without unnecessarily reducing our own revenue base. Targeting the oil and gas industry’s FTCs, however, may create economic distortions while reducing the competitiveness of major U.S. oil firms.

Other proposals aimed at the oil and gas industry would modify inventory accounting rules and deny the recently enacted deduction for domestic production activities. The last-in, first-out accounting method allows oil companies and other taxpayers to match their revenues with the cost of their newest inventory. If inventory costs are rising, LIFO generates lower taxable income by increasing the company’s deduction for its cost of goods sold, but only if the company is willing to use LIFO in computing its financial income as well. Although U.S. accounting standards allow use of LIFO, international accounting standards do not. Integration of U.S. and international standards may eventually require the United States to abandon the LIFO method. In 2005 the Senate endorsed changes to LIFO that would limit its use by large oil and gas producers. Others have proposed repeal of LIFO for all taxpayers. Both changes would impose a tax on firms’ built-in profits from inventories carried on their books from previous years. Use of LIFO raises important policy questions about how income should be measured, and Congress would be wise to consider those implications carefully before adopting fundamental changes to long-established tax accounting rules. Under current baseline assumptions, repeal of LIFO for all taxpayers. Both changes would generate a significant one-time revenue increase.

In 2004 Congress enacted a special deduction in new section 199 for domestic manufacturing activities. Legislation introduced by several Democrats in 2006 would deny the deduction for the domestic production, refining, processing, transportation, or distribution of oil and gas. The proposal to deprive a specific industry of otherwise broadly applicable tax benefits would add further economic distortions to the tax code and violate the general principle that tax policy should not intervene in the allocation of capital.

International Tax Rules

The search for revenue will likely also lead Congress to further examine the U.S. international tax rules. Perceived as lacking political leverage, foreign corporations investing in the United States are, as a group, a popular revenue target. U.S. multinationals also attract scrutiny because of the widely held belief that their overseas activities reduce the number of American jobs. The U.S. international tax system is a complex web of disjointed rules reflecting often-contradictory policy goals. A high corporate tax rate in the United States, relative to that of our major trading partners, increases the incentive to shift income overseas and puts substantial pressure on the U.S. international tax rules. Congress, rather than engaging in a comprehensive review of our international tax system, has adopted a piecemeal approach in recent legislation. Before proposing significant tax increases on international activities, the taxwriting committees would be wise to undertake an honest assessment of how the international tax rules conform with economic objectives and underlying principles of federal tax policy.

Tax Gap

Reducing the tax gap is another popular goal that both parties share. The IRS estimates that more than $345 billion in tax liability goes unpaid annually, or the equivalent of 16 cents for every dollar in tax liability. Contrary to public perception, only a small percentage of the tax gap is attributable to underpayments by corporations. Congress would be wise to view with skepticism proposals to change corporate tax rules as a means to reduce the tax gap. Unfortunately, most of the tax gap is attributable to improper underreporting by small businesses and sole proprietors who often receive income in cash. Administratively, reducing the small-business and sole proprietor tax gap is costly and may necessitate expanding burdensome withholding or information reporting requirements. In the late 1990s a backlash against IRS enforcement techniques drove legislation to create a “customer friendly” approach to tax collection. Today the pendulum has swung and Congress again seeks to improve tax compliance. Congress would be wise to think carefully about the implications of tax gap proposals on the overall effectiveness of the tax administration system and the IRS allocation of scarce budget resources.

Economic Substance Doctrine

Finally, the 110th Congress will consider codifying a judicial doctrine that requires transactions to have independent economic substance to be respected for tax purposes. Many observers question whether codifying the economic substance doctrine will generate the $15 billion suggested by revenue estimators. Relying in part on the economic substance doctrine, the IRS recently has experienced remarkable success combating tax shelters in the courts. The estimators likely assume that codification of the economic substance doctrine, combined with a strict liability penalty for violations of the rule, will deter corporations from participating in transactions they otherwise would pursue. Recent cases, however, have already put a chill on tax shelter transactions, in part because of the imprecision of when and how the courts will apply the doctrine. Many tax specialists worry that codifying the doctrine may reduce judicial discretion and create a bright-line test that creative tax attorneys will learn how to circumvent. Congress would be wise to resist the temptation that the revenue estimate for this codification proposal offers and to consider the competing considerations carefully before acting in that area.

In sum, tax and spending initiatives will generate considerable pressure to find revenue-raising tax provisions. Some of the proposals deserve consideration, but they also deserve careful deliberation because of their
implications for tax policy and the economy. Aggressive oversight of the nation’s complex, and sometimes unwieldy, tax system is appropriate, but should be driven by substantive and thoughtful debate, not simply by the desire to raise tax revenue.

Tax Credits — Just Say No
By Scott A. Hodge

After watching Republicans publicly humiliated over earmarked pork barrel projects such as the infamous Bridge to Nowhere, the leaders of the new Democratic majority have promised to reduce the amount of earmarking and to make the practice more transparent. While they are fixing the spending process, they would do well to also call a truce to using the tax code for social, political, or economic purposes.

Special tax breaks may not have as much of a sexy fleecing-of-America appeal as swine waste research, but they are a major factor in making the tax code the byzantine mess it has become today. Moreover, special tax provisions steer private resources where politicians want, not in the direction that might make the most sense for the overall economy. Finally, carving up the tax code for special interests shrinks the tax base, which not only forces the rest of us to pay higher taxes, but also provides a political roadblock to fundamental tax reform.

While the outgoing Republican majority enacted many good tax provisions since taking control of Congress in 1995 — such as lower capital gains and dividend tax rates and lower personal income tax rates — they also enacted some tax measures that resulted in serious unintended consequences.

One of those — the child tax credit — was the centerpiece of the 1994 Contract With America. Enacted with the best of intentions to lower the tax burden on working families with children, the tax credit (which was initially worth $500 and is now $1,000 per child) has knocked millions of taxpayers off the rolls and deepened the divide between Americans with skin in the game and those without.

Today, there are more than 43 million households that file a tax return but have no tax liability after they have taken advantage of all of the credits and deductions available to them. That is a 50 percent increase in the number of nonpayers since 2000. And many of those households receive generous cash benefits through provisions such as the earned income tax credit. The IRS is now part of the welfare state, doling out nearly $50 billion in "refundable" credits each year.

Republicans also tried to solve other problems through the tax code. For example, the Energy Policy Act of 2005 authorized $1.65 billion in tax credits for clean coal projects. The IRS and Department of Energy recently announced $1 billion in tax credits to just nine companies. While 49 companies applied for the credits, the bureaucrats at the Department of Energy — not the marketplace — determined that only 9 of them were qualified to benefit.
Ronald Reagan once said that the closest thing to immortality was a federal spending program. Special tax breaks are no different, and their beneficiaries will fight to the death to keep them in the code. The Associated Press recently reported that the CEO of a major auto company was in Washington lobbying to keep the tax credit for hybrid cars. Sales are down because the value of the credits have been reduced for the popular vehicles.

The members of the new Democratic majority will take over with their own laundry list of ways to use the tax code to achieve their priorities, including tax breaks for college tuition, biofuels, broadband service, and small-business health insurance.

Each of those tax breaks is certainly very popular with voters and is, no doubt, very well intended. However, you can’t give income tax relief to people who don’t pay income taxes. As a group, taxpayers in the first two quintiles have a negative effective tax rate — because of refundable credits — while those in the middle quintile are almost at zero as a group.

That raises the question whether there is even enough income remaining in those quintiles to give credits against. And even if some low-income taxpayers do benefit from additional tax relief, they too will likely be taken off the tax rolls. As a result, the universe of nonpayers could expand to nearly half of the population.

Not only will more targeted tax cuts for the “middle class” further undermine the possibility of ever overhauling the tax code — why should people who don’t pay income taxes care about reform? — but they further splinter the nation into two groups: those that pay the bills and those who contribute nothing. Dividing America into those two camps cannot be good for democracy.

As it is, the tax burden is far more progressive than the impression given by the popular press. According to IRS data from 2004, the top 20 percent of taxpayers paid about 85 percent of all the income taxes, while the wealthiest 1 percent shoulder nearly 37 percent of the income tax burden. That is a larger share than was paid by the bottom 90 percent of taxpayers (that is, all the income taxes paid by everyone earning under $100,000 per year).

Democrats can hardly claim the moral high ground in criticizing Republican “tax breaks for the rich” if they are only to turn around and use the tax code to benefit their favored groups. They would gain much more credibility by backing the tireless effort of Sen. Ron Wyden, D-Ore., to muster left-right support for his campaign to “cleanse the code” as the catalyst to fundamental reform.

The first step in halting any arms race is to call a general truce. Twenty years ago, it took Democratic Sen. Bill Bradley reaching out to Republican President Reagan to bring about the Tax Reform Act of 1986. The tax code has deteriorated badly since then. But with the right spirit of cooperation, perhaps the conditions are right for a Democratic Congress and a Republican president to put aside their differences and give our 21st-century economy a 21st-century tax code.

Democrats now control both houses of Congress and have the authority to set the congressional agenda. Of course, that does not mean the Democrats will have a free hand to pass whatever tax laws they feel like; there is still the matter of a president wielding a veto pen and a Senate in which it will be difficult to find a 60-vote majority on major tax legislation.

Nonetheless, the Democrats will likely try to work toward some long-term goals while also enacting short-term fixes. Deficit concerns and promised “pay as you go” budgetary rules will make it harder for the Democrats to maintain the current level of services and even harder for them to follow a progressive agenda. They will have to turn quickly to the revenue side of the ledger to bring the budget closer to balance and to restore priority funding. Perhaps the best hope of finding new funding streams will lie in “green revenue”: taxes or other regulations that generate revenue while protecting the environment.

First, don’t expect a wholesale rejection and reversal of the so-called Bush tax cuts. The Democrats, on balance, support plenty of changes that happened over the last several years, such as the increase in the child tax credit and the reduction in the income tax rates for low- and moderate-income taxpayers. In fact, the child tax credit is one item that the Democrats will likely wish to expand by making the credit available to more low-income workers.

To the extent that recent tax changes are reversed, look to targeted corporate benefits and the rates for high-income individuals. There are the easy targets — loophole closures on corporations are a perennial favorite, and further boosting IRS compliance efforts to close the approximately $350 billion annual tax gap could potentially yield tens of billions of dollars, if not more. New pay-go rules will provide lawmakers with additional incentive to scrub the code as new initiatives are proposed.

Over the long term, however, we are looking at a fiscal gap that is beyond quick fixes. Ten-year deficit projections begin to show the strain placed on the system by Medicare and Social Security. Clamping down on annual discretionary spending is neither sufficient nor necessarily desirable to solve the entirety of the problem. Instead, Congress will have to begin looking at significant new revenue streams.

The most common new source of revenue mentioned in tax policy circles is a VAT. VATs are a major revenue source abroad, especially in Europe. In the United States, a VAT has been seriously mentioned as a replacement for a significant portion of current revenue or as an add-on to
the current system. However, implementing a VAT would create significant and well-known challenges, including adverse distributional consequences. Unless it was paired with a significant and popular national initiative, such as a revamping of our nation’s healthcare system, a VAT is unlikely to be added to our nation’s tax code in the foreseeable future.

Other sources of revenue would include a reversal of the Bush tax changes for high-income earners. Sen. John F. Kerry, D-Mass., set the high-income bar at $200,000, and that level seems to be where policy discussions often tip. Revenue increases on high-income earners will likely be needed to fund any fix to the alternative minimum tax, which also affects that group. One could see a 1986-style cleaning of the code in which AMT reform, loophole closures, and rate adjustments on the top end form a revenue-neutral reform package for those earning more than, say, $200,000. But would Congress also raise revenue from those changes? At this point, simply preventing tax changes that give huge cuts to the wealthy would be a success for the new Congress — and given the estate tax changes and capital gains expiration on the horizon, that is not a given.

If the Social Security debate returns (bets, anyone?) we might see a renewed interest in increasing or removing the cap on taxable earnings subject to the payroll tax. But in the absence of that debate (or a broader debate on tax reform), Congress may not want to reopen the Pandora’s box that was forced closed last year.

So what does that leave? Over the next two years (and likely beyond) we should expect — and perhaps demand — a renewed interest in generating revenue from taxes or regulations that protect the environment. A carbon tax or a cap-and-trade program with auctioned permits could generate significant revenue, while reducing greenhouse gases and cleaning the environment.

To get the greatest gains overall, the green revenue would have to be used to offset other taxes (or to prevent rates from increasing in the future) that create efficiency losses. While the amount of revenue that could be raised from a carbon cap-and-trade program is potentially enormous,1 we must also recognize that some of the money will be used to partially compensate businesses that might be disproportionately affected and low-income consumers, who spend a higher share of their income on energy-sensitive products. The green revenue could be part of a larger tax reform, or it could be used to pursue an aggressive, innovation-driven energy strategy through investment in research on renewable, low-carbon technologies. Also, there should be enough revenue to put a dent in the deficit.

Enacting any one of the changes above would be a major achievement for the new Congress, but will any of those changes make it by the president and the 250 or so signers of Americans for Tax Reform’s antitax pledge?2 What Congress has to realize is that we need more “good” taxes and fewer “bad” taxes and that we must work toward reducing long-term deficits rather than hoping that everything will work out OK in the end.

Finally, the enactment of tax policy over the last several years has been a mess. The tax code is now riddled with temporary or phaseout rules for everything from the AMT “fix,” to the estate tax, to the research credit. While not every tax provision has to be fixed now, responsible tax stewardship will mean that whoever is in power will be forced to revisit those issues in the years to come.

1The amount of revenue raised depends on the targeted emissions limit as well as the resulting market price for the permits. Estimates range from tens of billions of dollars annually to $100 billion or more. (See, e.g., Congressional Budget Office, “An Evaluation of Cap-and-Trade Programs for Reducing U.S. Carbon Emissions,” June 2001, or Energy Department, Energy Information Administration, “Analysis of the Impacts of an Early Start for Compliance With the Kyoto Protocol,” July 1999.)

Top 10 Tax Law Changes I’d Like to See

By Stewart Karlinsky

Stewart Karlinsky (karlin_s@cob.sjsu.edu) is the graduate tax director at San Jose State University. Copyright 2007 Stewart Karlinsky. All rights reserved.

To: Honorable Charles Rangel,
Incoming House Ways and Means Committee Chair
Honorable Max Baucus,
Incoming Senate Finance Committee Chair

As a lifelong Democrat and a firm believer in checks and balances as envisioned by the Founding Fathers, I cannot tell you how thrilled I was with the November 2006 election results. Congratulations!

In the spirit of incoming House Speaker Nancy Pelosi’s 100-hour policy window, I would like to suggest some tax law proposals that I think would be fair and doable. Enactment of these proposals would help your constituencies by promoting equitable and favorable tax provisions for small business as well as for low- and middle-income individuals. These changes would also be fiscally responsible. The side benefit would be to help eliminate the stigma of a “tax increase party” with which the Republicans have painted your party.

1. Publicize what ‘middle income’ and ‘low income’ mean. You should widely disseminate the level of income needed to fall within the top 10 percent, 5 percent, and 1 percent of taxpayers so the average voter can see where he stands relative to current or proposed tax benefits for taxpayers at various income levels.

Everyone aspires to become wealthy, and the following suggestions may help them do so.

2. Social Security. Social Security is a ticking time bomb as well as an albatross around the necks of working persons and small businesses. In many ways, Social Security burdens middle-income and lower-income individuals as well as small businesses more than the income tax does. A few suggestions:

A1. Exempt earnings up to the poverty level from Social Security tax. (If this is too expensive or not politically feasible, exempt the minimum wage x 2,000 hours.) This will immediately help small businesses by saving more than $1,000 per employee ($15,000 per employee x 7.65 percent). It will also save each employee more than $1,000. Those saved amounts would then be available for savings, investment, or consumption.

A2. To help fund A1, remove the Social Security wage ceiling ($97,500 in 2007). This might be marketed as a redistribution of wealth or — the way I look at it — as an indirect transfer from me to my parents for all their years of supporting and educating me. This should also apply to deferred compensation.

B. If A1 and A2 in tandem are not politically feasible, reduce the Social Security tax rate to 14 percent from 15.4 percent, a 10 percent tax cut for small businesses and lower- and middle-income employees, and combine with A2 to offset the revenue loss.

3. Estate and gift taxes. The statutory exemption for decedents is scheduled to move to $3.5 million in 2009, be repealed in 2010, with a return to high tax rates and low exclusions in 2011. Crazy! My suggestion is repeal the 2010 and 2011 provisions and substitute a $3 million to $5 million gift/estate tax exclusion per person. Also, make the tax rate on taxable transfers 35 percent (the highest individual tax rate). That would eliminate more than 99 percent of individuals, farmers, small businesses, and so on from concern about estate and gift taxation and would allow those fortunate enough to receive large gifts or inheritances to keep 65 percent. Also, it would continue to encourage charitable giving.

4. Individual and corporate alternative minimum tax. Here’s another ticking time bomb. Basically, the past several Congresses and the sitting president have reduced regular tax rates but left the alternative minimum tax rates (26 percent on the first $175,000 of alternative minimum taxable income and 28 percent above that) at their historically high levels. A few suggestions to defuse the bomb:

A. Lower the individual AMT tax rate to a flat 25 percent. You could take credit for enacting a flat tax. Also, it would relieve most upper-middle-income and moderately wealthy taxpayers from the AMT.

B. Keep the individual AMT exemption at 2006 levels ($62,500 for married taxpayers filing jointly and $42,500 for singles).

C. Raise the point at which the individual AMT statutory exemption gets phased out from $150,000 to $175,000 or $200,000. That would also help upper-middle-income and moderately wealthy taxpayers avoid the AMT.

D. On the corporate AMT side, I would collapse the adjusted current earnings adjustment into the AMT system and have one system instead of a system within a system. That would simplify the AMT and raise taxes because you would be taxing ACE adjustments at 20 percent rather than the current 15 percent (20 percent x 75 percent).

E. I would truly conform AMT depreciation so that both the life and the method (making both double declining balance, rather than the current rules of DDB for regular tax and 150 percent of DB for AMT) are the same. That would simplify the corporate and individual AMT world and be a slight reduction in tax for corporations to make up for the collapse of the ACE adjustment into the AMT system.

5. Promote a program like California’s ReadyReturn at the federal level. This proposal is being lobbied against
by Intuit (the maker of TurboTax tax preparation software) and antitax lobbyist Grover Norquist because it would help taxpayers deal with the complexity of the tax system and make them less likely to demand drastic changes. If Grover Norquist is against it, all good Democrats should certainly be for it.

6. Tax gap. The tax gap is yet another ticking time bomb. It was estimated to be more than $300 billion in 2001. Research by Stanford Law School Prof. Joe Bankman and me shows that if more Form 1099 reporting were required, more compliance would be engendered and the tax system would be viewed as fairer. You could raise additional revenue by requiring 3 percent withholding on all 1099 payments similar to what was just enacted for government contracts.

7. Investments. One of the most complex aspects of our income tax law is distinguishing among capital gains, dividends, and interest income and losses, not to mention the different rates that apply to the various categories of income. A 1981 study shows that the capital gain and loss provision alone affected 65 percent of all code sections and complicated 15 percent of the tax law. I would eliminate the 15 percent, 25 percent, 28 percent, 0 percent, and 5 percent rates and instead simply exempt from taxation some amount — say, $10,000 — of investment income. That would cover 75 percent to 80 percent of the population, greatly simplify the tax law, and encourage savings by a greater segment of the population, while probably being scored as a revenue raiser. It would also match up nicely with the first proposal above in that the first $10,000-$15,000 of earned income would be exempt from Social Security and the first $10,000 of unearned income would be exempt from income tax.

8. Small business provision. I would eliminate the section 1202 small business provision as it is a complicated joke (unless you reinvest the money). The savings from qualifying is 1 percent [15 percent normal capital gain rate vs. 14 percent (28 percent x 50 percent)].

9. Roth IRA. The Roth IRA is still another time bomb that will bleed future revenue sources for the federal and state governments. At a minimum, I would freeze existing Roth IRAs and repeal in 2010 the provision that would remove the income cap for investing in a Roth IRA.

10. One set of rules. Much of the complication in our tax law is simply unnecessary. For example, there are 40 different definitions of small business. Surely two or three uniform definitions would suffice. “Constructive ownership of stock” is defined differently in seven areas of the law. Similarly, phaseouts are all over the board and should be made more uniform.

Thank you for your kind attention to my Top 10 tax law change proposals, all of which are consistent with the Democratic Party’s avowed goals. I look forward to substantial improvement in the U.S. tax law.

Most everyone agrees that our system for taxing business income requires major renovation. Members of the 110th Congress will get lots of free advice on how to draw up plans for that remodeling. Some will counsel Congress that corporate tax rates are too high, while others will argue that business income is taxed too lightly. How to make sense of all the conflicting advice?

There are two keys to the puzzle. The first is to remember that a normal business enterprise requires the application of capital as well as labor to produce revenues. In turn, the unique challenge in designing a sensible business income tax is to measure comprehensively and tax consistently taxpayers’ returns on the capital they invest in businesses of all shapes and sizes. That turns out to be a surprisingly difficult task.

The second key to unraveling all the competing advice is to adopt a holistic perspective on how we go about taxing returns to capital. The corporate income tax, investor taxes imposed on dividends and interest income, and taxes on unincorporated businesses are all just different aspects of a single issue. It doesn’t really matter that much where we impose tax, just as long as the total sums up to a consistent tax rate on returns to capital invested across different business organizations and business investments. By focusing on the aggregate effective tax rates that our tax code imposes on capital — at the investor level as well as the firm level — we can see how well we are doing today, and whether a proposed rehabilitation improves matters.

In two significant recent studies, the Congressional Budget Office has given us the requisite data to develop a holistic perspective on our current tax code’s rules for taxing capital income.1 The CBO data reveal our current system for taxing business income is a mess. Our tax code combines an excessively high statutory corporate tax rate, much lower marginal effective tax rates in practice, and large differences in those effective tax rates across forms of business organization, industries, and asset classes.

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Specifically, I believe the CBO papers lead to three important sets of conclusions. First, despite the preferences and incentives of current law, we impose significant levels of tax on marginal business investments. That fact is important, because it reminds us that consumption tax proposals (which by definition would set the tax rate on marginal capital investment at zero) have a big revenue gap that they need to fill, presumably by raising taxes on labor and through one-time transition taxes on existing capital.2

Second, the marginal effective total tax rate on corporate income — that is, the “all in” tax rate on a prospective marginal investment, including the tax burdens imposed on investors’ interest and dividend income — is around 26.3 percent, compared with our statutory marginal rate of 35 percent. The marginal effective total tax rate on capital invested in noncorporate businesses is much lower — 20.6 percent. That difference alone points to a fundamental weakness of the current system, which is the differing tax burden the code imposes on capital invested in different legal forms of business.3

Also troubling is the large discrepancy between the statutory corporate tax rate and the actual effective marginal total tax rate on corporate investments (that is, the difference between nominal and actual tax rates on a corporate investment’s projected economic income). If we had a perfect corporate income tax that, in turn, was perfectly integrated with investor-level taxation (so that there was no double taxation of corporate profits, for example), we would expect the marginal effective total tax rate and the statutory rate to be identical. Whenever statutory and marginal effective tax rates diverge so sharply, it is a reliable signal that base broadening is required to close the gap.

Many businesspeople complain that U.S. corporate income tax rates are already too high. They’re right in the sense that our statutory corporate tax rate is too high. Our statutory rate is higher, for example, than that of most of our country’s major trading partners. Because financial statements generally reconcile tax expense to the statutory tax, the result is to make the United States — and U.S.-based firms — look relatively unattractive when compared with foreign peers. The CBO statistics imply that we can lower our statutory corporate rate substantially, without losing revenue, if we broaden the base appropriately.

Third, the CBO analysis demonstrates that our current business tax system imposes wildly divergent burdens on marginal investments depending on funding source (debt vs. equity) and asset class. Equity-funded corporate capital investments are taxed at a marginal effective total tax rate of 36.1 percent (higher than the statutory rate of 35 percent because of investor-level taxes), while debt-financed investments face a negative 6.4 percent rate — a 42.5 percentage point swing.4 And there is a 12.3 percentage point difference between the effective total tax rate imposed on a marginal investment in the 25th percentile of asset classes (ranked in order of tax burden) and that imposed on the 75th percentile — that is, between the top and the bottom of the middle half of all assets.

What do those numbers signify? To me, they demonstrate that our current tax system is hopelessly inefficient, in that it distorts economic decisionmaking by encouraging (or, more accurately, positively begging) corporations to fund their new investments with debt rather than equity, and by imposing wildly different actual tax burdens on different types of assets that businesses acquire. The evidence of those tax distortions surrounds us, from the financial terms of many (leveraged) corporate acquisitions to our economy’s relative overinvestment in some classes of tax-favored assets.

The 110th Congress can rehabilitate the business tax system and lower the statutory corporate tax rate without forgoing revenue. Doing so, however, will require genuinely fundamental reform. The first priority in any comprehensive business tax reform should be to address directly the largest tax-induced distortion in economic decisionmaking, as revealed by the CBO data: the debt-equity distinction.

In its 2005 paper, the CBO focused on how one might resolve the debt-equity conundrum through the tax equivalent of cutting the Gordian knot: Abandon the entire income tax enterprise and move instead to a consumption tax base, under which the debt-equity distinction would become meaningless. I counsel against that suggestion, for reasons that include revenue requirements, perceptions of fairness, transition problems, and rate progressivity.5

One response to the debt-equity dilemma within the confines of the income tax — proposed by the Treasury Department some years ago — is to disallow all business interest expense deductions. Another approach, which I believe to be superior on several technical and policy grounds, is the “cost of capital allowance” component of


3One can argue that many small businesses are unincorporated and that the rate difference noted in the text in turn reflects a congressional decision to tax small businesses more lightly. If that is the justification, it is a poorly directed incentive, as the tax benefits of adopting a noncorporate business structure are freely available to very large enterprises as well as small ones.

4The 26.3 percent marginal effective total tax rate on corporate investments is the weighted average of those two rates, weighted by the CBO to reflect the relative amount of debt financing by American corporations (roughly 41.3 percent of the total capital invested in corporations). 2006 Report at 47.

5The negative tax rate on debt-financed investments stems in part from the fact that, while corporate borrowers invariably obtain tax deductions for the interest expense they incur, the correlated interest income often escapes taxation, because it is earned by a tax-exempt entity.

6It is possible to design a progressive consumption tax. See Daniel N. Shaviro, “Replacing the Income Tax With a Progressive Consumption Tax,” Tax Notes, Apr. 5, 2004, p. 91, Doc 2004-6003, 2004 TNT 66-48. A progressive consumption tax requires high nominal tax rates, however. Because capital is not owned in proportion to income, but rather disproportionately by the highest-income households, it is much easier to preserve moderate nominal tax rates and still achieve a progressive rate structure if the rate base includes current returns to capital — the classic income tax.
my “business enterprise income tax” proposal, which would give firms a statutory allowance for all forms of capital deployed in their businesses (without regard to current debt-equity distinctions), and would require holders to include a comparable amount of income currently. Either approach would be a big step forward from current law.

Words of Wisdom for the 110th Congress

By Martin Lobel

Face Reality

Right now most of the public think of Congress as a tool of the special interests that has abrogated its constitutional responsibility. Many believe that those who pay get to play. For the last six years, Congress has not behaved responsibly. It has handed out billions of dollars of tax loopholes or subsidies to the favored few while increasing the federal deficit at a record rate. We are still discovering goodies that the conference committee on the last continuing appropriations resolution secretly handed out as the 109th Congress came to a merciful end. Indeed, Congress is not even honestly dealing with the billions of dollars a month the United States is spending in Iraq because it is funding Iraq military operations with “emergency” appropriations outside the regular budgetary and appropriations process.

Congress Must Regain Public Trust

Congress must become more transparent so that people can see what it is doing. No longer can taxpayers allow conference committees from which one party is excluded to add goodies for special interests in must-pass legislation.

Congress must resume its role as part of the checks and balances in the U.S. political system. It must assume its oversight responsibility to ensure that the administration functions as it should. Putting aside the most blatant failure of oversight — the Iraq War — here’s one example of what happens when there’s no oversight: Agencies such as the Department of the Interior were allowed to hand out billions of dollars to oil, gas, and coal companies, rewarding employees who went along with those handouts with awards for creative accounting and retaliating against employees who tried to follow the law by terminating or transferring them. As the Cobell Indian trust case illustrates, the courts cannot effectively police a runaway agency. Nor can Congress continue to handle difficult problems by passing legislation using unclear language to cover up its inability to make a decision and expect the courts to define what Congress meant.

Congress must deal with the country’s economic problems that have been ignored. The tax system is a disgrace. It is so complicated that, even when someone has the best intentions, he can’t be sure he isn’t violating one provision or another. Part of the reason for that complexity is that special interests have been able to get tax subsidies. And who can blame them? After all, a business owner...
who doesn’t seek tax subsidies is either a fool or unsophisticated because the rate of return from tax subsidies far exceeds what one can get in the market. The result of those pressures on the tax code is that it has become increasingly irrational and counterproductive. Why should the tax code favor multinational corporations over domestic corporations?

Another problem is that Congress has forgotten that the function of the tax system is to raise revenue, not to be part of a social work program. It has been easy for Congress to dump worthwhile social programs into the tax code because it is easier for Congress to let the IRS figure out how to administer those programs than to do it itself.

Congress could dramatically simplify the tax code and ease the pressure from special interests by eliminating the tax provisions that relate to corporations and simply impose a flat tax on the amount of profits corporations report to their shareholders. We could drop the corporate tax rate to around 25 percent, eliminate the complex tax accounting rules, and raise about the same amount of money in a much fairer manner than under the existing code. Even if Congress were not willing to go so far, it must do what it did in 1986: simplify the code, eliminate most of the special interest provisions, and lower the tax rates. But — and this is a big but — whatever it does, it must lower the growing deficit. Congress can no longer behave like a drunk maxing out his credit card by buying rounds for everyone in the bar. We are already seeing the consequences of that behavior. We have essentially given China a veto power over our foreign policy in Asia because of the amount of dollars the Chinese own.

Another example of an economic problem everyone knows exists but no one wants to deal with is the healthcare system. Everyone knows it’s broken. Medicare and Medicaid are running out of money, medicine is becoming too expensive for all but the richest Americans, and doctors are swamped with paperwork, yet our results are below those of many other countries. The only ones who seem to be prospering are the pharmaceutical and insurance companies.

There are, of course, many other examples of problems for Congress to address. It won’t be easy to get Congress to focus honestly and openly on the real problems affecting most Americans, but it must be done if Congress is to fulfill its constitutional role and regain the trust of the American public. Congress must remember that the overwhelming percentage of voters will respect and vote for politicians with whom they agree if they think those politicians are trying to do an honest job. I remember standing beside my old boss, Sen. William Proxmire, while he shook the hands of constituents, many of whom told him in no uncertain terms about how they disagreed with a position of his but also told him they were going to vote for him because he was an honest man. He took many unpopular positions, but he kept getting reelected with more than 70 percent of the votes. There’s a lesson in that for every member of Congress.

Hopes for Tax Reform in 2007

By Maya MacGuineas

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Will 2007 be the year of fundamental tax reform? It should be, but in all likelihood, it will not be. Still, there are plenty of changes that could be made to move the tax code in the right direction.

First, the reasons there should be tax reform. Everybody hates the tax code. There is no better political rallying cry than “I am going to reform the tax code to make it simpler, fairer, and better for the economy.” The same line is used by the most liberal and conservative would-be reformers. Unlike other public policies in need of reform — Social Security, agriculture subsidies, and defense procurement, for instance — there is no single organized and entrenched group defending the current code. However, once one gets into the details and it becomes apparent that tax reform will have losers as well as winners, the vast we-hate-the-tax-code coalition starts to fray.

In addition to general dissatisfaction with the status quo, there are other reasons that large-scale reform is in order. The coming expiration of the recent tax cuts, the desire to permanently reform the alternative minimum tax, and the likelihood that revenues will have to be a significant component of entitlement reform all make tax reform necessary. Making those changes in a compartmentalized manner rather than as part of fundamental reform is likely to lead to an even more complex and patchwork tax code than we already have.

A Grand Bargain on Taxes

Ideally, there would be some type of “grand bargain” on tax reform, as in 1986 when liberals got a cleaned-out tax base in return for conservatives getting lower rates. But conditions are different this time around. Taxes will go up — not too much, hopefully, because higher rates will take their toll on the economy. But Congress has shown itself unwilling to cut spending anywhere near enough to close the fiscal gap, so taxes are going up.

That will make reform more difficult, and it will make it more important to improve the tax structure. On that front, conservatives who tend to support a consumption rather than an income base have it right. A tax code that encourages rather than punishes saving would be far better-suited for our savings-starved economy.

On the fairness front, more liberal supporters of a progressive tax system have the edge. A reasonable response to growing income inequality in this country is to increase the progressivity of the tax code, particularly if it is done in a way that does not harm the economy. Thus, the ideal grand bargain would be a progressive...
consumption tax to replace many existing taxes, thereby creating a more redistributive tax that is also better for the economy.

But a necessary ingredient for reform — the political opening — is still missing. To get from here to there, an honest assessment of what tax reform will involve is necessary. And there will have to be bipartisan cooperation to lend political cover for the distasteful parts of reform. That environment is unlikely to emerge until after the 2008 election.

The Tax Base: Filling in the Holes

In the meantime, there are important improvements that could be made. If there is one overlooked part of the budget that is out of control, it is tax expenditures. The progress of the 1986 reforms in clearing out the tax base has been chipped away as both parties have come to rely on spending through the tax code as their favored approach to budgeting. Want a policy to help working families, encourage alternative energy sources, stimulate depressed areas of the country, or give some industries a boost? Just create a new targeted tax break.

The problem is that these tax breaks tend to make terrible policy. First, they are really spending programs designed to look like tax cuts to make them easier to pass. No matter the label, they drain money from Treasury and expand the scope of government. That they are so easy to pass probably increases government’s size.

Further, they are poorly targeted, unnecessarily expensive, and extremely regressive, and they do not get nearly the level of scrutiny they should. Billions of dollars of targeted tax cuts have been passed in the past few years with little or no discussion about the worthiness of their goals. And unlike spending programs, which are subject to review, tax expenditure programs are on automatic pilot.

As politicians of both parties look for ways to offset the costs of new initiatives on both the tax and spending side of the budget as well as to reduce the deficit, this area of the budget holds tremendous promise. Capping the home mortgage interest deduction — which currently subsidizes mortgages up to $1 million — and the exclusion for employer-provided healthcare, for instance, could provide over $50 billion a year in savings. (Both policies would also be desirable for many other reasons.) Considering that tax expenditures total more than $700 billion annually, that is just the tip of the iceberg.

Don’t Turn to Businesses for the Answer

Many politicians are quick to point out that the corporate tax’s contribution to federal revenues has dropped significantly over past decades. There are sure to be plenty of tax plans that promise middle-class tax relief paid for by increasing taxes on businesses. That is a losing battle and one that should not be fought.

First, as any good economics professor teaches his students, corporations don’t pay taxes — people do. Levying taxes at the business level merely hides the costs from the people who pay them. Further, in an era of multinational corporations, highly mobile capital, and alluring tax environments abroad, collecting corporate taxes is becoming increasingly difficult. It will only become more so over time. We would do better to pursue policies to maximize U.S. businesses’ competitiveness while making the tax code more progressive to reflect current economic conditions.

Beware Tax Gap Mania

One final warning: The tax gap may well prove not to be all that it promises to be. Sure, $350 billion in free money sounds tempting. But really, if that money were easy to come by, wouldn’t politicians searching for new revenues in the past already have claimed it?

The tax gap is likely to become this decade’s “waste, fraud, and abuse” with politicians relying on the theoretical savings to pay for all their new initiatives. The prudent path would be to instead first ensure that the money is collected and then, and only then, dedicate it to other priorities. Otherwise, the tax gap’s promise may never materialize and enlarge the budget deficit rather than close it.

Going Green on Taxes

Also in need of change is the country’s underreliance on energy taxes. The United States is dependent on foreign oil and engages in many policies that harm the environment. Yet, perversely, the tax code subsidizes numerous environmentally harmful activities and does little to encourage conservation or energy independence.

Adopting a new revenue stream in the form of an environmental tax — such as a gas tax or a broad-based carbon tax — would help curb energy consumption and lead to reductions in environmental degradation, all the while providing a new revenue stream. Politicians have been resistant to back such taxes since the failed attempt to create a Btu tax early on in the Clinton administration, but it was a good idea then, and the political climate may be more receptive to the idea now.
There are two kinds of things that the new Congress can do regarding taxes. One approach is to come up with some revenue-enhancing tax changes that President Bush might sign. The other is to pass tax increase bills that the president will veto. Both approaches will probably be part of the agenda over the next two years, in that order.

Because the Democrats have promised to restore the antideficit “pay as you go” rules that tax cuts must be offset by higher taxes or lower spending, the era of debt-financed tax cuts and spending increases is over. That means that, to avoid big cuts in programs Democrats have promised to maintain or enhance, they must come up with some tax increases that Bush would accept.

The president will certainly balk at anything that attacks his signature program — his huge tax cuts. So to pay for government programs, the Democrats will have to look elsewhere. They could start by passing bills that make it easier to enforce the tax laws we already have and could supplement that by closing unintended or destructive loopholes that are hard to defend on any grounds other than their benefit to major campaign contributors.

One area to focus on especially is offshore tax sheltering, by both multinational corporations and wealthy individuals. That is a growing worldwide problem, as was illustrated by last year’s Levin-Coleman Senate report on abusive tax shelters — revelations that the Rolling Stones and U2’s Bono have avoided (or evaded) billions of pounds in British taxes through offshore shenanigans, recent IRS cases involving drug company profit shifting into tax havens, and so forth.

To address the problem, Congress should beef up IRS enforcement resources, which have been dramatically cut over the past decade. It should force disclosure from the tax havens, a process that the Bush administration largely aborted early in its tenure but that needs to be pursued again. It needs to clarify the laws, as was illustrated by last year’s Levin-Coleman Senate report on abusive tax shelters — revelations that the Rolling Stones and U2’s Bono have avoided (or evaded) billions of pounds in British taxes through offshore shenanigans, recent IRS cases involving drug company profit shifting into tax havens, and so forth.

To address the problem, Congress should beef up IRS enforcement resources, which have been dramatically cut over the past decade. It should force disclosure from the tax havens, a process that the Bush administration largely aborted early in its tenure but that needs to be pursued again. It needs to clarify the laws, as the Levin-Coleman report recommended, so that tax-haven activity will be automatically presumed to be illegal tax evasion. It needs to enact a tough economic substance rule, so that any transaction entered into mainly for tax avoidance is illegal.

Going further, Congress should think seriously of repealing so-called tax deferral on overseas profits, as President Kennedy proposed back in the early 1960s and John Kerry, D-Mass., proposed in his 2004 presidential campaign. “Deferral,” which is really closer to exemption of income that is styled as foreign, is at the heart of offshore tax avoidance. People and companies that have overseas activities and pay taxes on them abroad have little to fear from the end of deferral because they get a tax credit for the foreign income taxes they pay. But without deferral, schemes that allow people and companies to artificially shift U.S. profits offshore will largely be stymied. As a bonus, companies would no longer have a tax incentive to move U.S. jobs to low-tax foreign countries.

While they’re at it, the new Congress should also require disclosure of capital gains to the IRS. Right now, small investors in mutual funds get all their capital gains reported, but better-off investors who work through stockbrokers do not. As a result, untold billions of dollars in capital gains go unreported and untaxed.

Anything else that Congress can come up with along those lines, such as scaling back oil company tax breaks that even President Bush opposes, also should be on the table.

Meanwhile, the Democrats have promised to do something about the individual alternative minimum tax. But they face the problem of the enormous cost. Just extending the temporary AMT relief that applied in 2006 (indexed for inflation) for the next four years would cost a staggering $250 billion. There is a way, however, to pay for that extension without breaking the bank: Eliminate the AMT preference for capital gains and dividends. With a few additional tweaks, that approach could be revenue neutral (see, for example, Citizens for Tax Justice, “A Progressive Solution to the AMT Problem,” Dec. 14, 2006, available at http://www.ctj.org/pdf/amsolution.pdf). As an additional bonus, it would restore the AMT’s original purpose of requiring the people that are best off to pay a reasonable amount in income tax no matter how many loopholes they enjoy under the regular income tax.

Because that plan is revenue neutral, it doesn’t lower the total size of the Bush tax cuts. So President Bush shouldn’t be reluctant to sign it — unless he prefers to maintain his promised tax cuts for a few very rich people at the expense of a lot of people who are merely well-off.

That fix for the AMT does, however, have a very serious drawback. Many Democrats want to repeal some or all of the Bush tax cuts for the rich and use the revenues for other purposes, such as deficit reduction or new initiatives. But the AMT plan reduces the Bush tax cuts for the top 1 percent of taxpayers by more than half and uses the revenue to cut taxes for most other people in the top fifth of the income scale. As a result, most of the revenue that could have been raised from repealing the Bush tax cuts for the wealthy would no longer be available for other purposes. Put another way, if you could rescind $193 billion in tax cuts for the top 1 percent over the next four years, would your highest priority be to give that money to people in the top fifth of the income scale?

Finally, many Democrats are champing at the bit to pass bills that attack the Bush tax cuts directly. That’s a good idea, but in my view, Democrats should wait until the election year of 2008 to force the president into veto mode.
Taxes Matter
By Daniel J. Mitchell

Will Rogers once joked, “The difference between death and taxes is death doesn’t get worse every time Congress meets.” But the joke is not very funny for American taxpayers, who must tangle with a tax code that gets more unwieldy every year. Indeed, taxpayers would be wise to take up a collection and offer to triple congressional pay — but only if lawmakers promised to stay home all year. Because that probably won’t happen, the next-best alternative is to somehow get politicians to understand a few elementary lessons of tax policy.

1. Tax Rates Influence Behavior

Although it is sometimes caricatured as meaning that “all tax cuts pay for themselves,” supply-side economics is merely the understanding that people respond to incentives and that changes in tax rates cause taxpayers to alter their behavior. Politicians generally understand that principle, at least when it serves their purposes. Proposals to increase sin taxes, for instance, are justified because they will lead people to change their behavior. Lawmakers urge higher cigarette taxes to reduce tobacco use, and they want higher gas taxes to lower energy consumption. Regardless of whether those are good policies, the economic reasoning is correct.

Unfortunately, many politicians conveniently forget that tax rates influence behavior when the discussion shifts to the taxation of work, saving, investment, risk taking, and entrepreneurship. Politicians who deny that tax rates influence incentives to engage in productive behavior are being inconsistent, but that is hardly a crisis. The real problem is that that mentality leads to bad tax policy. High tax rates discourage the activities that are necessary for economic growth and wealth creation. There is a reason why America grows faster than France. And there is a reason why Hong Kong grows faster than America. Tax rates are not the only factor influencing economic performance, to be sure, but there is a clear relationship between prosperity and the tax burden.

2. Globalization Is Good for Taxpayers

Thirty years ago, a government could impose punitive tax rates without worrying that labor and capital would escape to another jurisdiction. Thanks to globalization, politicians are now constrained by cross-border flows of labor and capital. Simply stated, the geese that lay the golden eggs now can fly away. That process, known as tax competition, became a feature of the global economy after Prime Minister Margaret Thatcher and President Ronald Reagan lowered individual income tax rates. Those rate reductions helped resuscitate the U.K. and U.S. economies, just as one might expect, but also triggered rate reductions by nations seeking to avoid a loss of economic activity to the United Kingdom and the United States. Even socialist welfare states such as France and Sweden had little choice but to reduce tax rates. The average top income tax rate in the industrial world has dropped by about 25 percentage points since 1980.

Corporate tax rates also have been reduced because of tax competition, although in this case Ireland deserves most of the credit. Policymakers dropped the corporate rate from 50 percent to 12.5 percent and Ireland boomed, transforming itself from the “sick man of Europe” to the “Celtic Tiger.” Other nations have been forced to hop on the bandwagon, and the average corporate tax rate has dropped by roughly 19 percentage points since 1980. Tax competition also is a big factor in the flat tax revolution that is sweeping Eastern and Central Europe. A dozen nations have replaced discriminatory tax regimes with simple and fair flat tax systems, largely because governments are competing for jobs and capital.

Tax competition dramatically increases the cost of bad tax policy, which is why America’s 35 percent corporate tax rate (40 percent including the average of state levies) is such a hindrance to competitiveness. Fortunately, the damage caused by a punitive corporate tax regime is somewhat offset by the fact that America’s overall tax burden is lower than the average tax burden in Europe. Nonetheless, policymakers who complain about outsourcing and the loss of manufacturing jobs should consider that the United States has the highest corporate rate in the developed world.

3. Not All Tax Cuts Are Created Equal

Recalling Lesson 1 about incentives, if a taxpayer earns an extra $1 and gets to keep 80 cents rather than 60 cents, he is much more likely to engage in additional productive behavior. That’s why the marginal tax rate (the tax rate imposed on the next dollar of income) is more important than the average tax rate (a taxpayer’s total tax bill divided by his total income). Tax cuts that reduce marginal tax rates are much more likely to improve economic performance.

The 2001 and 2003 tax cuts are a good example. The 2001 tax cut had some supply-side provisions, but most of the growth-enhancing tax cuts — such as lower income tax rates and death tax repeal — were not scheduled to take effect until later years. The provisions that took effect immediately were things like the rebate and the child tax credit, both of which reduced average tax rates. Those Keynesian tax cuts may have been desirable for other reasons, but they had very little effect on incentives to work, save, and invest. As such, the economy did not respond. The 2003 tax cut, by contrast, was more focused on growth. The legislation lowered the double taxation of dividends and capital gains to 15 percent and also accelerated the income tax rate reductions from the 2001 legislation so that they took effect in 2003 (rather than in 2004 and 2006, as originally scheduled). It is no coincidence that the economy immediately began to grow faster once those rate reductions took effect.

To be fair, other policies also play a role, so it would be an exaggeration to argue that tax rates deserve full credit.
or total blame for every boom or slump. But it also would
be naive to act as if marginal tax rates don’t matter. If
policymakers decide to tinker with the tax code, they
should be guided by a desire to keep marginal tax rates
as low as possible on work, saving, investment, risk
taking, and entrepreneurship.

4. Tax Breaks Are Corrupt and Inefficient
Appropriators were justly ridiculed for some of their
pork barrel excesses last year, including the so-called
bridge to nowhere (actually, it was a bridge to minority
status for the GOP, but that’s a separate story). But just as
a rose by any other name would smell as sweet, special-
interest provisions in the tax code are just as odious as
handouts in the budget.

As noted in Lesson 3, not all tax cuts are created equal,
and that surely applies to loopholes that reduce the
amount of money going to government but that simulta-
neously increase government intervention. Special tax
breaks for ethanol, for instance, lower revenue for the
government, but they also distort the price system in
both the energy and agriculture markets. The healthcare
exclusion is an even more dramatic example. Individuals
save huge amounts of money by getting compensation in
the form of nontaxable health insurance rather than
taxable wages, but that provision (along with the fact
that government programs directly finance about 45 percent
of all health expenditures) has created a “third-party
payer” problem that has largely destroyed any sem-
b lance of a market-based healthcare system in America.

That’s why tax reform is a win-win opportunity. It
eliminates the special tax breaks that distort behavior and
undermine markets, and then uses the money to finance
lower tax rates to boost incentives for productive behav-
or. Everybody benefits — except the politicians because
they no longer can auction off tax loopholes for campaign
cash.

5. Spending Matters, Not Deficits
Advocates of higher taxes claim that more revenue is
needed because of the budget deficit. But even if they
genuinely intend to use additional revenue for deficit
reduction (a rather heroic assumption), they are mis-
guided. Deficits are only a symptom. The underlying
problem is government spending. Regardless of how it is
financed, every dollar spent by government displaces at
least one dollar of activity in the productive sector of the
economy. Shifting from debt-financed government
spending to tax-financed government spending is at best
a lateral move, akin to jumping from one frying pan to
another.

If balanced budgets were the Holy Grail of fiscal
policy, Sweden would be an economic role model be-
cause it currently has a budget surplus. Yet Sweden also
has a government that consumes more than 50 percent of
the nation’s economic output. Economic performance has
been mediocre, not surprisingly, a depressing result since
Sweden used to be one of the world’s richest nations. The
official unemployment rate is almost twice as high as the
U.S. rate, and labor union economists admit the actual
unemployment rate is three or four times higher. Perhaps
most shocking, per-capita disposable income in America
is nearly twice as high as it is in Sweden. Government
spending presumably is just one of many factors under-
mining Sweden’s economy, but the lesson nonetheless is
clear that government spending is associated with eco-

nomic weakness.

Some argue that deficits are a particularly bad way of
financing government because they lead to higher inter-
est rates, but there is little evidence for that proposition.
In the last six years, America went from having a big
surplus to a big deficit, yet interest rates declined. That
doesn’t mean higher deficits cause lower interest rates,
but it does show that other factors have a greater effect.
Indeed, in a world in which $2 trillion changes hands in
capital markets every day, it is silly to think that changes
in the U.S. government’s borrowing — even big changes
— are going to have a significant effect. Japan is an even
better example. In the past 15 years, that country’s
deficits and debt have exploded, but interest rates are
even lower than they are in America.

6. Never Acquiesce in Tax Increases
A corollary to Lesson 5 is that tax increases are
misguided. In part, that’s because higher taxes fail to
address the real problem of excessive spending, but it’s
also because it is likely that tax increases will make the
problem worse by facilitating an expansion in the size of
government.

Under current law, thanks to demographic changes
and entitlement expansions, the burden of government
spending will expand. Indeed, if policy is left on auto-
pilot, federal spending will climb from about 21 percent
of gross domestic product today to nearly 40 percent
of GDP in 2050. And that’s the best-case scenario. Other
estimates show the burden of government climbing to
more than 50 percent of economic output. In other words,
America is in grave danger of becoming an uncompeti-
tive, European-style welfare state. Preventing that out-
come should be the top fiscal goal of lawmakers. Win-
n ing that battle will be difficult, and one necessary
condition is to block all tax increases. A tax increase
reduces the pressure to control spending. A tax increase
slows the economy and creates new demand for govern-
ment programs. A tax increase drives productive activity
to other jurisdictions.

Some believe that a deal can be made — a combination
of tax increases and spending restraint. In the real world,
“budget summits” always have been disastrous for sup-
porters of limited government. In every case, taxes are
increased, yet spending also goes up. That happened in
1982, 1987, and 1990. Lawmakers who care about control-
ling spending should not allow it to happen today.

Conclusion
The tax community in Washington tends to get
wrapped up in endless discussions about issues such as
the alternative minimum tax. Those debates are impor-
tant, but without a solid understanding of tax policy,
lawmakers are likely to blunder from one bad tax policy
to another.

Unfortunately, bad tax policy is sometimes good poli-
tics. It also can be an effective way to fill campaign
coffers. Those forces have combined to give us one of
the world’s most complicated tax systems, according to the
World Bank, and the new Congress will be tempted to
make the tax code even worse. Lawmakers should resist the temptation to engage in class warfare and social engineering and instead focus on the tax policies needed to keep America prosperous in a competitive, global economy.

Beware Trojan Horses

By Grover G. Norquist

Taxpayers looking ahead to the 110th Congress have much to fear and little to look forward to.

For the past 12 years, the Republican House and Senate have passed and sent to the president a tax cut each and every year. President Clinton vetoed many of those. He twice vetoed the abolition of the death tax. Clinton did sign the cut in the capital gains tax rate from 28 percent to 20 percent, which created the stock market boom that flooded Washington with so much cash that the budget went into surplus. (And much like welfare reform was first pushed by Republicans, Clinton’s economic legacy was driven by a tax cut he previously vetoed.)

Since the 2000 election of President Bush, the House, Senate, and president have passed and enacted a tax cut each and every year.

In 2006 there were four tax cuts: the executive branch’s slashing of the Spanish-American War tax on phone bills; the permanent tax savings for IRAs and 401(k)s in the pension reform bill; the extension till 2010 of the 15 percent rate on capital gains and dividends; and in the last hours of the session, a grab bag including the liberalization of health savings accounts, the extension of the tax extenders, and various tariff reductions. (Note to Pat Buchanan: Tariffs are taxes.)

The House and Senate now fall into the hands of old bulls that voted against all the tax cuts of the past 12 years. The oldest of the old bulls all voted for Clinton’s tax increases of 1993 and even Bush Sr.’s tax increases of 1990.

The entire hospital is run by students of Dr. Kevorkian.

The Democratic leadership has promised that any tax cuts will be “paid for” by tax increases. They have announced that there cannot be a net tax cut for the next two years. We have gone from annual tax cuts to no tax cuts. As long as the Democrats run both Houses, there will be no net tax reduction.

Facing that grim reality, the taxpayers’ movement has one goal: to stop any and all tax hikes.

Taxpayers have three potential weapons: First, the president’s veto pen (almost brand new, rarely used); second, the ability of Senate Minority Leader Mitch McConnell, R-Ky., to wield the filibuster as competently as Sens. Tom Daschle and Harry Reid, D-Nev., did for the past six years; and third, the possibility that some of the 61 Democratic congressmen in the 110th Congress elected from districts that gave Bush a majority in 2004 believe a vote for a tax increase would be politically costly. (Thirty-four of those districts voted 55 percent or more for Bush...
in 2004, when he limped across the finish line with 51 percent of the national vote.)

The threat of a tax increase will not likely appear as a frontal assault with Democrats flying the bold banner of “tax hike” (they tried that in 1993).

There are three possible Trojan horses that could carry a tax increase past the guards.

First is any sort of “Social Security reform” that denied President Bush his stated goal of moving from the current “pay as you go” defined benefit system — a Ponzi scheme — to a fully funded, independently owned, portable personal savings account that allows each young American to save his FICA taxes in his own account. Take personal accounts off the table and the only “fix” left is the one done many times before: Cut benefits and raise taxes. Those increased taxes are free to be spent as general revenues.

The second Trojan horse we can call “tax reform.” Before President Reagan, tax reform was always recognized as a code for tax increase.

The third Trojan horse is the promise of abolishing the alternative minimum tax. Since the Democratic leadership is determined to require any tax cut to be taken back with a tax increase elsewhere, the call for abolishing the AMT is really a demand to raise an additional $1.1 trillion dollars from Americans to “pay” for it.

The debate on the AMT will be helpful to taxpayers. Where did the AMT come from? It was invented by Democratic President Lyndon Johnson and pushed as a class warfare, envy tax because a handful of Americans were not paying taxes despite high incomes — much of that flowing from laws that make interest payments on government bonds tax-free, which itself is a tax subsidy for big government. And later Clinton increased the AMT from 24 percent to 28 percent with the help of yes votes from such Democrats as . . . Rep. Nancy Pelosi, D-Calif., Rep. Charles Rangel, D-N.Y., and Reid.

As a first step, the taxpayers’ movement should demand that the Clinton AMT be repealed.

The AMT is the one tax paid by every campaign contributor to the Democratic Party. The AMT hits richer taxpayers in states with high incomes, high property taxes, and high state income taxes — in short, blue states.

Democrats hate the AMT — a Frankenstein’s monster of their own creation. But they are willing to “fix” the problem they created only by creating a monster of the same or greater size to ravage America elsewhere. Perhaps, one might guess, in red states.

The terminally optimistic can see a handful of possible tax cuts that could move through even this Congress. First, Congress could reinstate the Invest in the USA Act — the temporary tax cut on repatriated earnings that allowed American companies that earned profits abroad to bring them back to the United States at the cost of just a 5.25 percent tax rather than the higher rates of the regular corporate income tax. When that was done in 2005 under the leadership of Rep. Phil English, R-Pa., some $300 billion was repatriated and the government took a slice worth $17 billion over two years. Or Congress could do the Full Monty and move from our current worldwide taxation to a territorial tax system like that in use in the rest of the world. For technical reasons, that good idea actually raises money. Or Congress could significantly liberalize H-1B visas and allow the existing fees for those visas to swell the treasury while reinstating the “brain drain” that has so benefited America.

And lastly, President Bush can follow the lead of Clinton and use his executive branch authority to unilaterally change the rules. Bush could define “cost” in the cost basis of capital gains to be cost plus inflation. Republican Reps. Eric Cantor of Virginia and Mike Pence of Indiana have roughly 100 cosponsors for legislation to do that (H.R. 6057), but courts have ruled that the executive branch can unilaterally make such redefinitions if they are “reasonable.” That would reduce by half the capital gains subject to tax — a boon for farmers, landowners, and older folks who bought stocks many years ago. President Reagan’s most important tax policy legacy was the indexation of the tax brackets, which has saved taxpayers hundreds of billions of dollars since being implemented in 1984. Indexing the basis for capital gains would be a great legacy — moving America to the ownership society Bush spoke of in 2000.
Tax Evolution Rather Than Revolution

By Burgess J.W. Raby and William L. Raby

You of the 110th Congress are a part of a marvelous system of checks and balances, and, no, we are not trying to make a bad joke about the taxpayers (whom we represent) writing the checks and the government (which at the policy level is you) accumulating the balances. Individually, you represent your constituents. Collectively, you are part of a system designed to prevent the government from interfering in people’s private lives and legitimate activities while providing for the well-being of the country.

But the system is not working. Past Congresses have approached the tax law as though they were building a skyscraper, so that every detail had to be worked out in advance and spelled out to the umpteenth degree. And changes? They become difficult and disruptive, as well as expensive. Tending the tax law should be more like raising trees than constructing a building. In case you haven’t noticed it, the tax law has become unbearably complex because of this engineering approach. It is interfering in people’s private lives. Few taxpayers, even the poor who seek refunds provided by the earned income tax credit, can prepare their own tax returns any longer.

Fortunately, computer software has been almost equal to the challenge, and taxpayers no longer need to understand what they are doing — they merely need to answer questions posed to them by a computer program. But computer programs designed for general use cannot cope with the variety of economic activities and diversity of transactions in which the country’s millions of people and millions of business entities engage. Despite the availability of software, taxpayers still use the services of a million or more tax return preparers and hundreds of thousands of CPAs, attorneys, and others. Those professionals are engaged in helping plan and analyze transactions so taxpayers can avoid having to pay more tax than the minimum that the law requires of them. Sometimes, of course, those swarms of paraprofessionals and professionals are facilitating the payment of less tax than the law requires, at least as the IRS interprets the law. Thus the IRS Appeals offices, courts, judges, expert witnesses, lawyers, and CPAs handle thousands of tax controversies each year. That is not a bad system. It has evolved to its current form over time and will continue to evolve. But sometimes the system seems to bring issues to an ultimate resolution too slowly for the public and Congress. Congress then steps in to make a quick fix, to relieve perceived inequities, to close perceived loopholes, and to shut down tax shelters.

The tax system is like the traffic system in a large metropolitan area. Change the available routes, perhaps because of detours caused by construction of a light rail system as is currently going on in Phoenix, and there is initial confusion. There are accidents. People get upset. Then they adjust. And then the next change comes along. And the next. And the next.

So it is with the tax system, but with an added twist. Tax law and traffic patterns have some basic differences even though they may have a few similarities. In a common-law system, once some basic legislation has been enacted, the administrative practices that grow up and the court cases that arise as the taxpayer and the tax collector differ over whether the basic legislation is being properly interpreted and applied result in increasingly detailed nuances as taxpayers push the interpretation of the law that minimizes the tax they pay and tax collectors push the interpretation that tends to maximize the tax they collect. Amid that push-pull, the courts, when they function at their best, apply basic propositions and general directives to specific situations that could not possibly be anticipated by legislators. They do what the legislators cannot do.

An example may illustrate what we are talking about. How do partnerships get taxed? They could be taxed as though they were corporations — in other words, as taxpaying entities. But the partnership, and arrangements that are treated for tax purposes as partnerships, is such a common form and is used for such a diversity of activities, both large and small, that it was deemed from the beginning that it should be treated as a pass-through entity and that its tax consequences should be reported by, and its income tax paid by, the partners. That was about all that the tax law even said about the tax treatment of partnerships until the 1954 Internal Revenue Code was enacted.

That code, incidentally, was a model of logical legislative architecture, and it still provides the structural framework of today’s income tax law. It set up subchapter K to deal with partners and partnerships. That’s the 700 series of code section numbers. Section 704, for example, deals with a “partner’s distributive share” and provides in section 704(a) that, “except as otherwise provided in this chapter;” a partner’s distributive share of partnership items to be reflected on the partner’s tax return shall be “determined by the partnership agreement.” But what if the partnership agreement, which can be amended for a given year at any time before the due date of the partnership information return for that year, gets gerrymandered to avoid taxes on the partners? Section 704(b)(2) provided in 1954 that the partnership agreement was not to control if “the principal purpose of any provision in the partnership agreement with respect to the partner’s distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.”

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That language was then interpreted in Orrisch v. Commissioner, 55 T.C. 395 (1970), aff’d without opinion, 476 F.2d 502 (10th Cir. 1973). The court seized on language from the Senate Finance Committee report on the 1954 enactment, which had explained that if “a provision in a partnership agreement for a special allocation of certain items has substantial economic effect and is not merely a device for reducing the taxes of certain partners without actually affecting their shares of partnership income, then such a provision will be recognized for tax purposes.” The phrase “substantial economic effect” was then incorporated into section 704(b) to read as it does today. Section 704(b) now provides that the partnership agreement is not to control if “the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.”

Treasury then amplified the three-word phrase “substantial economic effect” to make it easier to administer and more certain in its application. Whereas the Tax Court in Orrisch, based on then-existing Treasury regulations could note that “an allocation has economic effect if it ‘may actually affect the dollar amount of the partners’ share of the total partnership income or loss independently of tax consequences,’” reg. section 1.704-1(b) takes up 35 pages in the CCH print of the regulations. That portion of the regulations tends to be incomprehensible to actual taxpayers, and the source of many disputes among professionals, in its actual application to specific situations. However, we have found that Tax Court Judge Julian I. Jacobs’s explanation of it, in Interhotel Company, Ltd. v. Commissioner, T.C. Memo. 1997-449, Doc 97-27457, 97 TNT 190-13, is of great help in both teaching this aspect of partnership taxation and resolving interpretative disputes between professionals. He pointed out that:

The regulations governing the economic effect of partnership allocations contain three tests that in a sense serve as “safe harbors.” Partnership allocations are deemed to have economic effect if they are made pursuant to a partnership agreement that meets the requirements of any one of these tests.

Taxpayers and professionals love safe harbors, complex though they may sometimes be. The confusion tends to arise when the safe harbor nature of the detailed rules is overlooked. If the partnership can fit within one of the reg. section 1.704-1(b) safe harbors, the partners will be safe from the gales that may be unleashed by the IRS. However, even if the partnership does not fit within a safe harbor, the partnership can still show that, unlike the Orrisch situation, the tax allocations made “will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.” Reg. section 1.704-1(b)(2)(iii)(a).

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1The court found against the taxpayer, concluding that while the partners’ capital accounts did reflect the special allocation of depreciation, “we think the partners contemplated an equal distribution of the partnership assets [on liquidation] which would be adjusted only for disparities in cash contributions or withdrawals.”

Conclusion

We have gone on at some length with this partnership allocation example because it represents something that seems to us to have worked reasonably well over the years. Congress laid down a general approach. Once it became obvious (after Orrisch) that the “avoidance or evasion” language was not as useful as the “substantial economic effect” that Congress had probably intended in the first place, the language was modified. But Congress refrained from trying to enact detailed rules. Treasury stepped in to fill that gap with interpretative regulations, and it did so with a combination of general propositions, detailed safe harbors, and several examples of application. Thus, in 52 years, there has been only one change in the underlying statute, and that merely to clarify the language to conform to the court decision in Orrisch.

Too often, however, your predecessors have followed a different path. They have tried to fix perceived problems by increasingly detailed legislation — exceptions to the general rule, exceptions to the exceptions, exceptions to those exceptions, and on and on ad nauseam. The result is what one would expect during the morning commute in the metropolitan area if every few days the traffic lanes were restriped, the locations of lights changed, and innumerable detours put in place and relocated. The result would be driver road rage — and ultimately, more accidents and even outbursts of violence.

Thus, our advice to you is to make as few changes as possible, despite the importunities from your constituents and lobbying groups. What changes you make should be in the direction of simplification. Have more faith in the interplay of taxpayer, administrator, and courts to produce solutions — and give the system time to work before jumping in to fix the problems. It is trite but true that “time cures many ills.” And it takes a lot more time to grow a tree than to erect an office building.
Some Advice for Speaker Pelosi
By Deborah Schenk

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Shortly after your reelection, you noted, "We have made history; now let us make progress." Of course you personally made history, and there are two aspects of your own personal story that could be brought to bear not only to make history but to make progress. The first is that you are the first female speaker of the House and the second is that you are obviously also the first grandmother to lead the house, with an oft-stated interest in future generations.

If you are really interested in the well-being of your six grandchildren and others in their generation, your number one priority should be doing something about the long-term budgetary crisis facing the country. Ask yourself: "Do I really want my grandchildren paying for my Social Security or for my neighbor’s Medicare? Do I really want my grandchildren to be without Social Security or their neighbors to be without medical care? Do I really want my grandchildren saddled with a huge national debt or prohibitive tax rates?"

Of course you don’t. No grandmother would wish those things on her grandchildren. The link may not be so obvious, but there are several issues that you will need to tackle if you want to provide a safe and stable future for those grandchildren (and they are just as important as worrying about our shoes at the airport). Unfortunately, mostly of its own making, Congress had put those important issues on the table at the same time. You know what they are, but it probably does not hurt to remind you. There is no hope of bringing the budget under control unless you curb the 2001 and 2003 tax cuts, which are due to expire in 2009. Making them permanent just digs a bigger hole for future generations — a $1.2 trillion hole. Let the tax cuts go. They were chiefly a benefit for the wealthy. Put your grandchildren ahead of wealthy campaign contributors who will lobby to keep the cuts in place. Also expected to return to the front burner in 2009 is estate tax repeal. I’d keep that tax, but reasonable people can differ. What they do not differ on is the mockery Congress makes of our laws when they play games with expiration dates. That is childish behavior. You have lots of experience dealing with that and should know how to put a stop to it. Also, in 2009, 30 million taxpayers will pay the alternative minimum tax. That’s not a good idea; but the longer you wait, the harder it is going to be to find the money to fix it.

But even those items pale in comparison to the approaching fiscal crisis brought on by mandatory spending. The growth in entitlements — Social Security and Medicare — are expected to outstrip economic growth. You’re all too familiar with the sibling behavior response to this one: "The Democrats did it with their entitlement spending" versus "The Republicans are responsible because of their tax cuts." Does it really matter who is responsible? Your grandchildren couldn’t care less. But they will care if you leave the mess for them to clean up 30 years from now with a massive tax increase. Let’s give your and my future grandchildren a gift by solving this problem now. In your first 100 hours (or very soon thereafter), put tax reform, entitlement reform, and yes, spending reform on the table.

But how can you accomplish that? Here is where being a woman should help. Popular and academic literature often asserts that women approach problems differently than men do. Women are better listeners, more thoughtful, collaborative decisionmakers, and consensus builders. Whether those gender-associated personality characteristics are merely an example of “truthiness” is beside the point. This is a case where preconceived notions about women may serve you (and us) well. So start listening to what the people are telling you. Sure, in the surge that swept you into your current office, voters probably said something about the war in Iraq, but they also said something about the way our leaders (or lack thereof) have been governing. They also expressed their fear about the economy and where America is headed, fear that is translated into concerns over minimum wages, high taxes, out-of-control spending, and the massive deficit. They elected you to solve those problems, not just to engage in recriminations. Reach out to and listen to those outside the Washington Beltway who may have bold and thoughtful ideas. And by all means, reach out across the aisle. Find the middle and cling to it. Locate those in Congress — of whatever party — who also care about their grandchildren and together stand above the fray. Collaborating with others is a virtue and may lead to good results. By entering Congress in 1987 you just missed our last national experiment in collaborative tax reform — the Tax Reform Act of 1986, the last tax act true to its name. From day one, start building a consensus that the looming fiscal crisis is unacceptable. Work behind closed doors to build that consensus. And in doing that, why not use a version of the pie rule favored by moms everywhere ("You cut the pie, and I’ll choose the first piece")? Give a little to the other side and get a little for you, your Democratic colleagues, and most importantly, the rest of us.
Getting Started in the Taxwriting Committees

By Gene Steuerle

Many are the changes in policy that might come forth from the newly elected Congress. However, right now the most important changes — the ones that will most effect the policies that are adopted long-term — will come from process reform. Because this is Tax Notes, I would like to direct my comments specifically to Rep. Charles B. Rangel, D-N.Y., and Sen. Max Baucus, D-Mont., the two chairs of the taxwriting committees. Although many broader congressional reforms are worthy of attention, here I confine myself to what could be done by you regardless of the directions taken by other congressional leaders.

My suggestions largely follow one simple theme: If you channel your committee’s time and resources toward nonpartisan and bipartisan consideration of what is in the public good, the public will be better served. Although that may sound like a platitude, in point of fact it means giving up some short-term political power to achieve longer-term political objectives. Paraphrasing Zig Ziglar, at times it means trading what you want now to get what you want most.

The first step is to reinstitute the tradition of retreats. Chairman Rangel, you’ve already indicated an interest in restoring that tradition. But let’s consider how to apply that approach to today’s problems — spending and tax systems that are out of control, special interests that dominate (rather than merely influence) the legislative process, and partisan rancor that deals more in the politics of blame than in problem solving. The additional drafting requirement not only makes it more likely that a provision will be better designed to serve the public, it enhances the ability of the staff to fix something together rather than just being set up to get a consensus in the short run over what to do, but your fellow committee members might agree on just how they are going to walk through those various political quagmires in a way that allows them to get something good accomplished.

For instance, you might consider:

Improving the ways that information is pursued in the legislative process. Renewed emphasis could be put on testimony, giving it more time in the legislative schedule. You could announce that members are expected to attend some portion of those testimonies, with some modest political cost — for example, a black mark on a posted attendance record, or a reduction in privileges or seniority claims — for those who do not. I also suggest that more invitations go to people recommended jointly by both staffs, with more emphasis on nonpartisan analysis rather than simple bipartisan balancing. Most issues really don’t involve left versus right.

Meeting immediately and often with the Treasury secretary. Don’t just confine the effort to small meetings over politics, but call in civil servants and outside experts as “faculty.” In other words, try to co-opt each other into working toward mutual goals. Many years ago, when I was at Treasury, we used to claim that there really was no difference between the parties on 90 percent of the issues. Work with the secretary to figure out a way to spend more time on that large group of issues.

Demanding immediately better and more analysis from executive branch agencies. Of course, highest on your list would be Treasury, the IRS, the Social Security Administration, the Centers for Medicare and Medicaid Services, and other executive branch agencies on which the taxwriting committees are dependent for understanding what is working and what is not. Those agencies have been falling down on the job for some time now. They have a lot of information that they essentially hide from the public because it might offend some interest group whose favor someone, somewhere wants to curry. Or that information might reveal some incompetence within those agencies, including simple failure to undertake even the barest form of data gathering to measure the effectiveness of the programs being administered. Give due attention to how you make the requests, since proper framing gives civil servants the ability to argue with their superiors that they must respond to you under the law. But do it in a friendly manner, as you will get a lot more out of people if they feel they are part of a process of fixing something together rather than just being set up for criticism.

Insisting that all provisions must be drafted by the JCT or other nonpartisan staff according to goals stated in writing by the members asking for such provisions. Both parts of this suggestion are necessary; neither alone is sufficient. This type of process reform effectively requires legislators to identify upfront their special interest provisions, “rifle-shots,” and related items. Contrast that with today’s process, in which lobbyists design provisions that are put into bills, with many members — sometimes even those doing the bidding of the firms or lobbyists — having only a limited understanding of the effect of the provisions they are supporting. Some, certainly not all, of this particular suggestion is contained in the House Democratic rules package for the 110th Congress.

The additional drafting requirement not only makes it more likely that a provision will be better designed to serve the public, it enhances the ability of the staff to know exactly for whom provisions are intended, since intent is stated upfront rather than interpreted by staff after the fact. Note also how centering the drafting process on appropriate staff helps deter some of the...
larger mistakes made when even well-intentioned advocates or policy analysts suggest solutions to problems that turn out not to be very efficient. If one goal of Social Security reform is poverty prevention, for instance, then the staff needs to not automatically accept that some benefit increase or protection — say, for all widows, rich or poor — is the best way of achieving that goal.

As a practical matter, given the pace of legislative change, you probably must figure out a way to corral Treasury’s resources to achieve this objective. The Joint Committee on Taxation staff just isn’t large enough to handle all the tasks it could be assigned.

Restoring the power of the first draft to nonpartisan staffs. Closely related to the previous suggestion, options for reform should be designed first by the JCT or, when appropriate, some other agency (the Government Accountability Office, the Congressional Budget Office, or Treasury) that you ask or mandate to perform a study. No single process reform is more important.

Limiting the number of member items that can be added to bills. I’m not naïve about the need for special interests to have ways to air their grievances nor about the need for you, as chairs, to have some power to corral votes by offering something to your fellow committee members. However, you can set up rules to limit the number of such special items. Those rules ought also to contain some ways of tracking special items and limiting their multiplying impact on the complexity of the tax system. For instance, it is one thing to increase the value of some deduction; it is another to add a new deduction. Former Ways and Means Chair Dan Rostenkowski sometimes set those types of limits; his efforts need to be adapted to today’s needs and the complex legal structure we now have in place. * * *

I am not wedded so much to the details as to the spirit of these suggestions. If they are inadequate, try to figure out alternatives. Most importantly, think long and hard right now about the processes you set up. You may be setting precedents now for the rest of your tenures as chairs.

A new Congress, like a new year, presents an opportunity to take a fresh look at the public policy challenges that confront us and to contemplate just how those challenges can be conquered. With new congressional leadership and lots of new players, now is a good time to look past the proverbial “trees” and focus on the terrain ahead. Congress should fight every pressure to get caught up in those trees; beyond the forest, the cliff is not far away.

The Democrats’ slim majorities in Congress will undoubtedly provide new perspectives to not-so-new problems. Their 2006 campaign promises now become the road map for legislating. That means they will pursue repeal of the alternative minimum tax and will have to decide whether to extend the Bush tax cuts or allow them to expire in 2010 — all within the constraints of “pay as you go” budget rules. There are the annual tax credits and deductions that will be expiring. Undoubtedly, social policy incentives (for example, environmental tax breaks and familial or competitive incentives) for some noble purpose will be pondered. The tax gap will continue to be explored. I am sure that many others will have advice on how to address those issues, which won’t be easy to dispense with. They are the “trees.”

On the other side of the ledger, the aging of the baby-boom generation is putting increasing pressure on federal entitlement programs. As the first wave begins to retire in 2008, the pressure will build at a rapid pace and threaten the strands of our public safety nets. The Congressional Budget Office projects that, if no changes are made to current law, the Medicare Trust Fund and the Social Security Trust Fund could be bankrupt by 2018 and 2040, respectively. The cash flow projections are even scarier, with the increasing cash transfers to their programs tilting our fiscal tightrope even earlier.

Given the path that appears before us, if the 110th Congress does not begin the serious work of rethinking the way the federal government raises and spends money, subsequent Congresses will have more draconian choices. Just as the baby boomers begin to retire, the AMT is projected to hit more than 20 million people. And the potential for a sweeping tax increase on New Year’s Day 2011 will consume much of Congress’s time in 2009 and
2010. Moreover, whoever the next president is, he or she will surely appreciate it if the 110th Congress would start setting the stage for the tough choices that lie ahead.

Having spent more years involved in the tax and entitlement policy arena than I care to publicly admit, Tax Analysts asked if I would offer some suggestions to the 110th Congress. So, for what it is worth, here are a few "words of wisdom."

Address the Deficit in the 'Trust' Fund

Most important of all the political wishes I have for the new year is for a refilling of the depleted "trust fund." I don’t mean the Social Security or Medicare trust funds. I am referring to the reservoir of trust that must extend across the political aisle — and across Pennsylvania Avenue — to accomplish any of the difficult legislating that will be required to address our long-term fiscal challenges. I fear the deficit in this trust fund is even more critical than the often-discussed public retirement and healthcare trust funds. Without a bipartisan approach, the best-intended efforts will fail miserably.

If You Don’t Understand It, Don’t Vote to Enact It

Avoid the temptation to "overtax" the tax system. The number one priority of a tax system should be to raise the required level of revenue in as simple and nondistortive a way as possible. Our current tax system certainly raises revenue, but it also functions as a mechanism to redistribute wealth and to encourage or discourage some behaviors. The resulting complexity is mind-numbing. We all struggle with the complexity of the tax system, and it threatens the very nature of our voluntary compliance system. Try to avoid adding new complexities. And if you feel up to the task, the 110th Congress could do a great public service simply by setting limits on the use of tax expenditures and targeted tax breaks and by refusing to look to the tax code for anything more than raising revenue.

Think Big and Start Tackling the Tough Issues Now

If ignored, the fiscal problems we face get bigger and the solutions become a tougher sell. According to the U.S. comptroller general, the federal government has committed itself to more than $43 trillion in current dollar IOU’s — four times the current gross domestic product. If Congress keeps ignoring the situation, our choices are not good ones. Balancing the budget in 2040 would require reducing total federal spending by about 60 percent and raising taxes to about 2.5 times today’s level. Policy changes to address issues of this magnitude require public debate, shared sacrifice, and time for transition.

Tax and entitlement reform will take time and will require a great deal of education, debate, compromise, and political capital. Changing the tax rules that govern a $12 trillion economy will not happen overnight, and no one will be completely happy with the outcome. The Tax Reform Act of 1986 began with the 1984 State of the Union address and endured many deaths and resurrections along the way. President Reagan and the leaders of the taxwriting committees were committed to reform and worked hard — and worked together — to make it happen. Beneficiaries of the current tax system will fight to protect their personal "trees," so Congress will have to maintain its focus on the big-picture benefits of fundamental tax reform for a healthy "forest."

We Don’t Live in a Vacuum; Don’t Legislate in One

Globalization creates significant challenges to our tax system. Increasingly, lower-tax countries are competing for, and winning, larger shares of business markets, job markets, and manufacturing markets. Financial capital knows no boundaries, and our assets are more intangible than tangible. As Congress considers tax reform in the United States, it would be wise to keep an eye on what’s happening around the world. For example, 80 percent of the OECD countries (24) have lowered their corporate income tax rates since 2000 — many have also broadened the corporate income tax base. None have increased their rates.

Finally, get started; you have a lot of work to do. No matter how "blue ribbon" it is, another commission is not the answer. The shelves are full of good ideas that well-meaning commissions have submitted to Congress on tax and entitlement reform. I have been fortunate to serve on several great ones. But it is time for elected officials to engage honestly with the public, pursue bipartisan policy recommendations, address the inevitable conundrum of "transition," and make real progress on reform. That sounds easy enough, doesn’t it? It will take a long time to get there by cutting down one tree at a time.