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Pathways to Tax Reform Revisited

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Abstract

The U.S. income tax badly needs reform. It is complex, unfair, and inefficient. It doesn't come close to raising enough revenue to finance government expenditures, and won't any time in the foreseeable future unless it is revised. Raising tax rates could increase revenues, but it wouldn't lessen the complexity and would magnify the unfairness and efficiency costs.

Not surprisingly, proposals for reform abound. Income tax reform proposals would virtually all trim so-called tax expenditures, the 200 or so exclusions, deductions, and credits that are designed to provide subsidies for particular activities or groups. This would surely make the late Stanley Surrey smile. He invented the term tax expenditure and instructed the Treasury Department to compile a list and tally up their cost. He viewed cuts in tax expenditures as the "pathway to tax reform," and in 1973 made the case in a book of that title.

Surrey and latter-day reformers are surely right that cutting tax expenditures could raise revenue while reducing the economic cost of the tax system and making it simpler and fairer. The only drawback is political: voters like tax expenditures, the biggest of which are the mortgage interest deduction and the tax break on employer-sponsored health insurance. Simply eliminating people's favorite tax breaks is unlikely to win much public support.

This paper revisits Surrey's pathway, examining various proposals to eliminate, reduce, or reformulate tax expenditures as part of tax reform. I start by outlining the need for tax reform. Then I examine various proposed paths to achieve it. I discuss options to cut tax expenditures and the efficacy of a VAT or carbon tax as a supplement to the income tax. The concluding section summarizes the potential pathways and a few dead ends on the way to tax reform.

JEL No. H21, H24, H50, H60

Key Words: Tax Expenditures; Federal Budget; Deficits; Tax Reform

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I. Introduction

The U.S. income tax badly needs reform. It is complex, unfair, and inefficient. It doesn't come close to raising enough revenue to finance government expenditures, and won't any time in the foreseeable future unless it is revised. Raising tax rates could increase revenues, but it wouldn't lessen the complexity and would magnify the unfairness and efficiency costs.

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II. The Need for Tax Reform[1]

The U.S. tax system is unfair, inefficient, mind-bogglingly complex, and doesn't come close to raising enough revenue to pay for the government. It is tempting to say that it couldn't be worse, but sadly that is not true. Some proposals masquerading as reform would increase the deficit, thereby undermining our economy, and are also deeply unfair. Any reform worthy of the name must meet the stated objectives of the successful Tax Reform Act of 1986—fairness, simplicity, and economic growth. (U.S. Treasury 1984) Given the unprecedented budget challenges facing the U.S., reform should also contribute meaningfully to deficit reduction.

Economists often talk about a trade-off between fairness and efficiency, but tax reform offers the possibility to advance both goals. For example, the standard prescription of broad base and lower rates can be a win-win for fairness *and* efficiency. Moreover, there is some evidence that extreme inequality is itself anathema to economic growth. The tax system mitigates inequality and tax reform should not in my view undermine that important role.

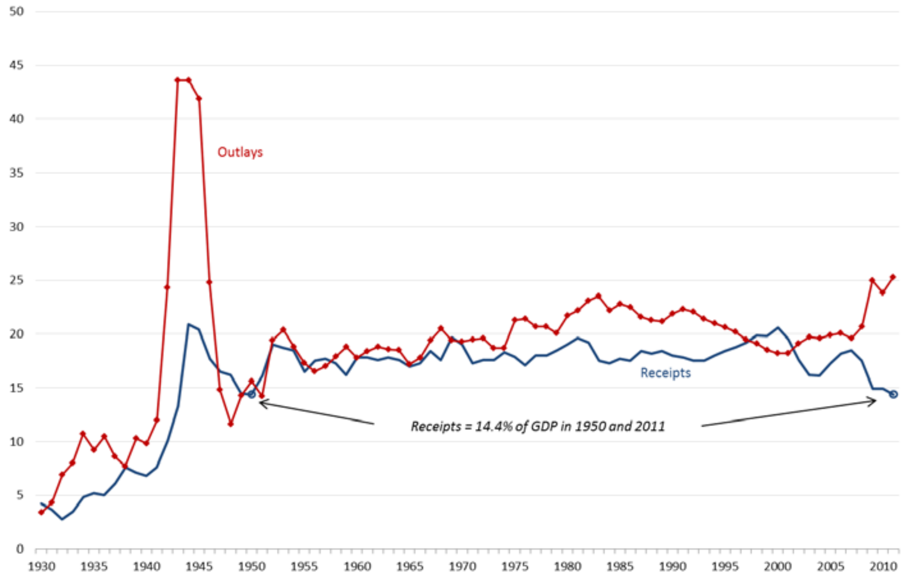
A. Tax Reform and Economic Growth

A better tax system would be good for the economy. Loopholes, complexity, continuing deficits, and high marginal tax rates all entail an economic cost. Loopholes and preferences sap the economy because individuals and businesses are spurred to make bad economic decisions solely because of the tax rewards they bring. Thus, businesses are less productive than they could be. Moreover, the geniuses who invent schemes to exploit loopholes might otherwise turn their talents to socially productive work—like figuring out how to produce products that people around the world would like to buy—if they weren't devoted to engineering tax shelters.

The cost of compliance with the individual and corporate income taxes was roughly $215 billion in FY 2012. (Burman and Slemrod, 2012, p. 172) Not all of that reduces GDP—more than half represents the time individuals spend keeping records, learning about the law, and completing returns—but it all represents an economic cost. If the law were simpler, Americans would have more time to pursue other activities, and companies could invest less in their tax departments and more in innovation.

Perhaps the biggest failure of the tax system is that it hasn't come close to paying for the costs of government for the past dozen years. It is not necessary or even desirable to balance the budget every year. It makes sense to run deficits during recessions to help spur the economy, for example, but the budget should probably be close to balance over the business cycle.[2] Revenues in 2012 were at their lowest level since the Truman Administration. (See figure 1.) Congressional Budget Office (2012) projects improvement as the economy recovers, but then the red ink comes back with a vengeance as population aging and rising health care costs put unprecedented demands on the federal government. [3]

Figure 1. Historical Receipts and Spending, as Percent of GDP, 1930-2011



Source: OMB, Budget of the United States, 2012 (historical tables)

Ballooning public debt could do tremendous harm to the economy. The fact that tiny Greece's debt crisis roiled the world economy is especially disconcerting. If the US were foolish enough to follow in Greece's path, our collapse would be cataclysmic. We are the richest country in history—and intricately connected with all the other major nations. If we failed, we would bring down the rest of the world economy with us. (Burman, Rohaly, and Rosenberg 2010)

Finally there is the issue of marginal tax rates. One of the singular accomplishments of the Tax Reform Act of 1986 was the dramatic reduction in marginal tax rates. The tax rate on the wealthiest individuals fell from 50 percent to 28 percent and the corporate tax rate was cut from 46 percent to 34 percent. This was done without sacrificing revenues or progressivity because a host of tax breaks and loopholes were eliminated. That was also the approach taken by the President's fiscal commission (The National Commission on Fiscal Responsibility and Reform 2010) and the Bipartisan Policy Center (2010).

Lower tax rates are not the economic panacea that supply siders make them out to be—and can be counterproductive if they produce budget deficits—but in a fiscally responsible setting, they produce tangible economic benefits. The tax rate is a good barometer of the incentive to avoid taxes. At a 50 percent tax rate, every dollar of income hidden from the tax authorities saves 50 cents in tax. At a 25 percent tax rate, tax avoidance is half as profitable. Thus tax shelter schemes become more and more attractive as tax rates rise and diminish in value as rates fall. We will never have a perfect tax system, but the cost of our tax system's imperfections diminishes at lower rates.

However, if low tax rates are accompanied by larger deficits, any short-term economic gains may prove illusory. Low tax rates might boost the economy in the short run, but the much higher tax rates required to pay back the resulting debt with interest in the future would entail a far greater economic cost than setting rates at the level required to tame deficits and keeping them there. Studies by the nonpartisan staffs of the JCT, CBO, and Treasury (all directed by Republican appointees) concluded that deficit-financed tax cuts ultimately sap the economy if they lead to higher tax rates in the future.

Policymakers must figure out what government needs to do and, after the economy has recovered from the recession, pay for it. That will probably require higher tax rates or significant tax reform.

B. Tax Reform and Revenues

The question of whether tax reform should raise revenues is highly contentious. Some point to the precedent of the Tax Reform Act of 1986, which was designed to be revenue-neutral, as a rationale for holding the line on tax revenues. I believe that revenue-neutral tax reform now would face considerable hurdles. In 1986, although the whole package did not increase revenues, a large corporate tax increase financed large cuts in individual taxes. This was feasible because the corporate tax code was riddled with costly tax preferences and investment subsidies. Corporate CEOs and shareholders were more than happy to trade corporate tax increases for substantial cuts in their own tax rates. (Birnbaum and Murray 1987) But I think a substantial corporate tax increase would be infeasible and undesirable at a time when our corporate tax rates are the highest in the world.

And revenue-neutral reform of the individual income tax would necessarily mean that some, and probably many, individuals would pay higher taxes. The losers would strongly oppose the reform, probably dooming it to failure.

Moreover, the retirement of the baby boomers and soaring healthcare costs mean that there will be enormous pressures on spending. Unless we are prepared to renege on the promises we have made to seniors, eviscerate the social safety net, and weaken our national defense, we will need more revenues (as well as spending cuts, especially in entitlements).

Some argue that limiting federal revenues is the only way to restrain government spending. That was certainly the operating principle of the Bush Administration. Although this argument—sometimes called “starve the beast”—appears plausible, it is hard to imagine that spending could have been higher as the Bush tax cuts slashed revenues. Government grew much faster from 2001 to 2009 than during the previous Democratic Administration. While some of that spending was war-related, nondefense discretionary spending also sped up and the largest expansion in Medicare since its inception—the prescription drug benefit called Part D—was enacted.

It appears that instead of constraining spending, deficit financing was contagious. If deficits don’t matter when considering tax cuts, why should they be considered when evaluating a new drug benefit or a “bridge to nowhere?”

The late president of the libertarian Cato Institute, William Niskanen (2006), posited a public choice critique of “starve the beast.” If deficits finance 20 percent of government spending, then citizens perceive government services as being available at a discount. Services that are popular at 20 percent off the listed price would garner less support at full price.

Niskanen found strong statistical support for the hypothesis that higher revenues constrain spending in a time series regression of revenues against the change in spending between 1981 and 2005. Another Cato researcher, Michael New (2009), tested Niskanen’s model in different time periods and using a more restrictive definition of spending (non-defense discretionary spending) and found the earlier results to be robust.

Niskanen and New might actually have understated the effect of deficits on spending. The message during the last decade seems to have been not that spending and tax cuts were available at a discount, but that they were free. Spending for two wars, Medicare expansion, and a significant increase in the federal role in primary and secondary education (“No Child Left Behind”) happened at the same time that taxes were falling. Citizens could be forgiven for forgetting that there is *any* connection between spending and taxes.

If President Bush had proposed a new war surtax to pay for Iraq or an increase in the Medicare payroll tax rate to pay for the prescription drug benefit, both initiatives would have been less popular. Given that the prescription drug benefit only passed Congress by one vote after an extraordinary amount of arm-twisting, it seems unlikely that it would have passed at all if accompanied by a tax increase.

Starve the beast doesn't work. Disillusioned conservative Bruce Bartlett (2010) called it "the most pernicious fiscal doctrine in history."

I also think that revenue-increasing tax reform would be more politically feasible than a revenue-neutral package because Americans have embraced the notion of shared sacrifice when they supported the underlying objective. For example, in the past, we have supported tax increases to finance wars. Joint Chiefs of Staff Chairman Admiral Michael Mullen has said that "…the continually increasing debt is the biggest threat we have to our national security." (O'Keefe 2011) A tax reform that raised revenues, reduced the debt, and simplified the tax system in a fair way might win support from the American public, especially if it had bipartisan support among policymakers. The Bowles-Simpson and Bipartisan Policy Center both proposed plans aimed at accomplishing this.

C. Tax Reform and Fairness

Fairness is an essential element of a good tax system. There are two elements of fairness—one is horizontal equity: treating people in similar positions the same way. Broadening the base and eliminating unwarranted subsidies (and penalties) helps to advance that goal.

The other is to require a larger proportional contribution from those who are better off than those with more modest means (vertical equity). This objective, sometimes called progressivity, is more subjective. However, surveys suggest that the public supports more progressivity—at least at the top of the income scale. A Pew survey in December 2011 (table 1) found that 57 percent of respondents felt that the wealthy do not pay their fair share of taxes. By comparison, 28 percent thought complexity was the most vexing defect of the federal tax system and only 11 percent ranked their own tax burden as the top concern. This suggests that the public would favor a more progressive tax system—and might oppose a tax reform that undermined progressivity.

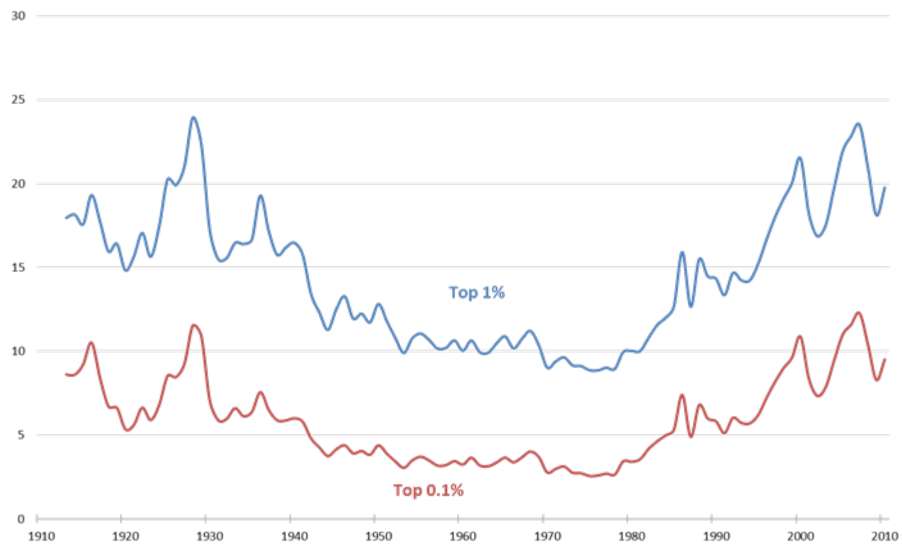
Table 1. Pew Survey of Views about Federal Taxes
Shares in Percent

	Mar 2003	Dec 2011
Federal tax system is …		
Very/Moderately fair	51	43
Not too/at all fair	48	55
What bothers you most …		
Amount you pay	14	11
Complexity of system	32	28
Feel wealthy people don't pay fair share	51	57
Tax system …		
So much is wrong, Congress should completely change	52	59
Works pretty well, Congress should make minor changes	44	34

Source: Pew Research Center, "Tax System Seen as Unfair, in Need of Overhaul," December 20, 2011.

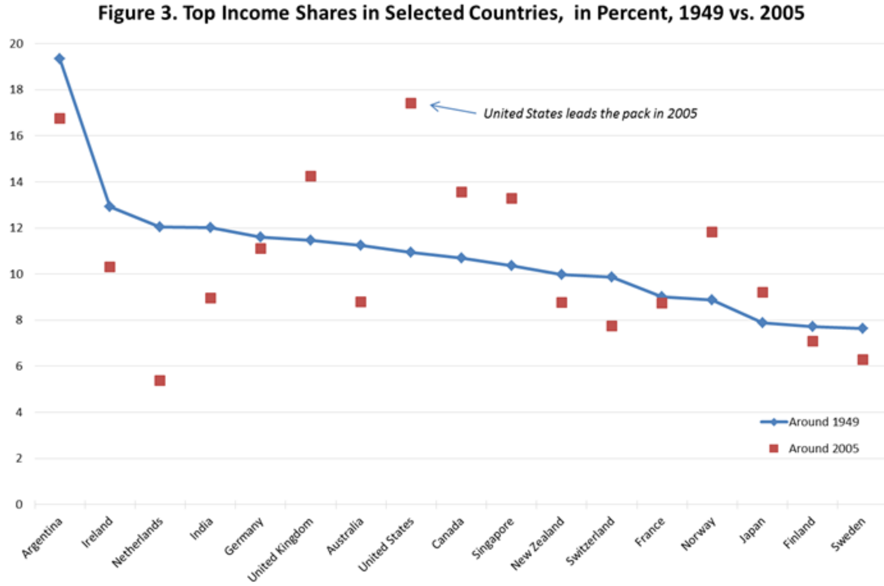
The increasing concern about the tax burdens of the wealthy may be connected to a striking rise in economic inequality. In 2007, before the Great Recession, both income and wealth inequality had reached the highest levels in almost 80 years. For example, data collected by economists Thomas Picketty and Emmanuel Saez[4] show that, in 2007, the top 1 percent of households earned almost 24 percent of all income for the first time since 1928 (see figure 2). The income share of the top earners plummeted during the Great Depression falling to around 10 percent in the 1950s, 1960s, and 1970s before rising steadily starting in the 1980s. A similar pattern applies to the highest-income one in 1,000 households. Their share of income reached an all-time record of 12.3 percent in 2007. Tony Atkinson, Picketty, and Saez (2011) report that income inequality in the United States in 2005 the highest in the developed world—a marked change from 1949 when income inequality in the US was at around the median. (See figure 3.)

Figure 2. Income Share of Top 1% and Top 0.1%, 1913-2010



Source: Picketty and Saez (2003), with updates from http://elsa.berkeley.edu/~saez/TabFig2010.xls.

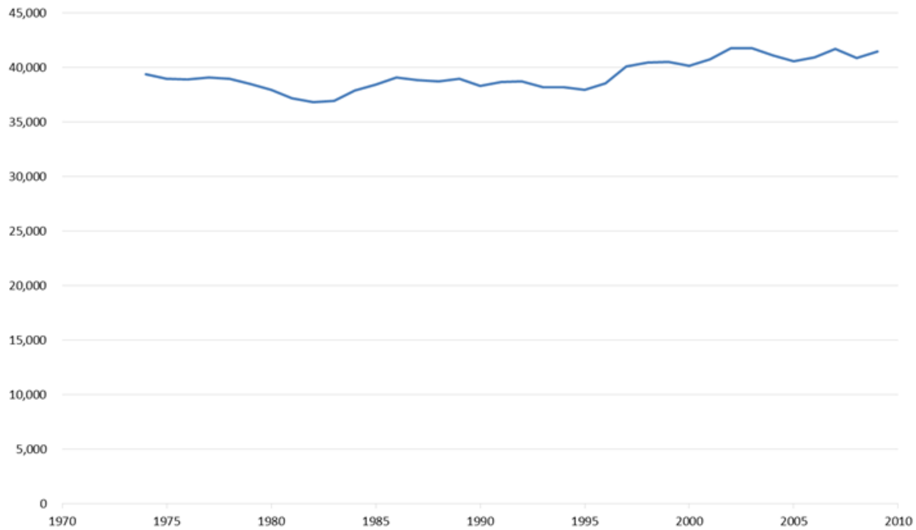
Figure 3. Top Income Shares in Selected Countries, in Percent, 1949 vs. 2005



Source: Atkinson, Piketty, and Saez (2011).

Rising inequality might not be a pressing concern if families at all income levels were gaining ground, but that is not the case. The middle class in the United States has experienced almost no income growth for the past 30 years. Incomes by a variety of measures have grown barely faster than inflation. For example, figure 4 shows that median earnings for full-time, full-year workers grew by only 0.15% per year from 1974 to 2009 after adjusting for inflation. Some point out that total compensation has grown faster because most workers still get health insurance at work and the cost of health insurance has far outstripped inflation. But I doubt that workers perceive more economic gain when it's explained that almost all of their pay increases have gone to pay for increasingly expensive health insurance.

Figure 4. Median Earnings for Full-Time, Full-Year Workers, in 2009$ 1974-2009



Source: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements.

If economic mobility in the U.S. were high, inequality would be less troubling since everyone would have a similar chance at success, but that is also inconsistent with the evidence. Children of rich parents are much more likely to grow up rich than children of lower-income people. (Leonard Lopoo and Thomas DeLeire, 2012) Upper-income children have access to better schools, live in safer communities, and when they grow up, have better connections to help them succeed.

While I view rising economic inequality as undesirable in its own right, I'd argue that even those who do not care about inequality *per se* should be concerned about this trend. If the bottom 80 percent of the population feels like they're not getting their fair share, the result could be a populist revolt. Voters might be tempted to support calls for trade restrictions, more regulation, or throwback policies like a return to the gold standard. Any of those responses could be extremely detrimental to economic growth. For that reason, those who benefit most from the current system have an incentive—completely beyond any notion of altruism—to try to mitigate extreme inequality in ways that entail less economic cost.

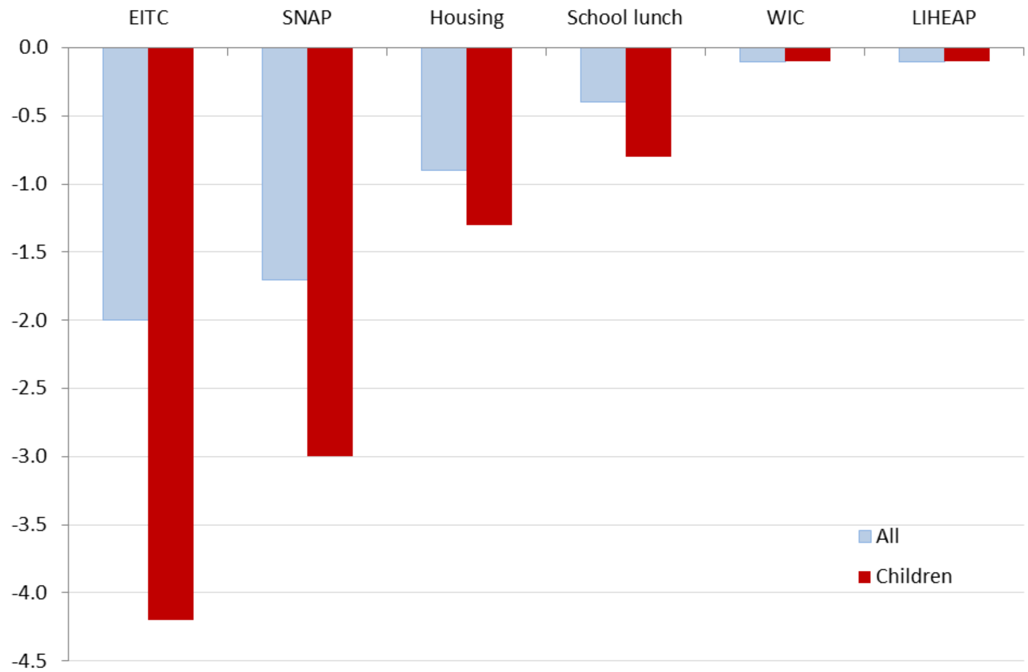
What's more, development economists have long observed that very unequal economies grow slower than economies with less skewed income distributions. There has been debate about whether economic inequality *causes* slower growth. It is possible that the causality goes in the opposite direction because richer countries can afford better public education and other services that boost economic opportunity for those with low incomes. But a study by economist William Easterly (2007) concluded that inequality causes slower growth because poor families cannot afford to invest in their own or their children's human capital, which makes for a less productive workforce.

To be sure, the best approach is to provide more economic opportunities, especially better and more affordable education, but not everyone can or should go to college. The income tax plays an important auxiliary role. It's not the perfect solution because it adjusts outcomes rather than opportunities, but equalizing opportunity is simply impossible. Some people are born smart, rich, good-looking, or with the ability to jump very high or throw a baseball very fast.

There is one more aspect of fairness: the income tax is now a critical component of the safety net. The Census Bureau (Short 2011) developed an alternative measure of poverty that accounts for the effect of tax and transfer programs on poverty levels. (Astonishingly, under the standard measure of poverty, non-cash transfer programs and tax credits can't reduce poverty because they are not counted in families' incomes.) Under the broader measure, the single most effective program at reducing poverty in 2010 was the Earned Income Tax Credit (EITC). It reduced overall poverty rates by 2 percentage points and the child poverty rate by 4.2 percentage points. (See Figure 5.) Overall, this single program cut child poverty by more than 20 percent. It encourages work and helps a significant fraction of working families and children escape poverty.

While the EITC and other tax provisions helping low-income working families such as the child tax credit could certainly be simplified, a fair reform would preserve the tax-based safety net that so many low-income families and children rely upon.

Figure 5. Effect of Selected Government Programs on Poverty Rates in 2010



Source: Kathleen Short, "The Research Supplemental Poverty Measure: 2010," US Census, Current Population Reports, P60-241, November 2011.

III. Proposed Pathways to Tax Reform[5]

There is no shortage of tax reform ideas. President George W. Bush put together a blue ribbon panel to propose fundamental tax reform. The panel (President's Advisory Panel on Federal Tax Reform 2005) proposed two alternative packages that would have each been simpler and more efficient than the existing tax code. One option would have radically simplified the tax code by eliminating many tax expenditures and converting many of the remaining tax deductions to flat credits. One insight of the Bush tax reform panel was that while tax experts view the standard deduction as a simplification—because people who do not itemize don't need to keep records on charitable contributions, mortgage payments, taxes, etc.—most real people think it's unfair that high income people can deduct those items while lower income people can't. The proposal would have dispensed with itemization.

The "simplified income tax" under the Bush panel's scheme would have reduced the number of tax brackets and cut top rates, eliminated the individual and corporate alternative minimum tax (AMT), consolidated savings and education tax breaks to reduce "choice complexity" and confusion, simplified the earned income and child tax credits, simplified taxation of social security benefits, and simplified business accounting. The alternative "growth and investment" tax plan would have lowered the taxation of capital income compared with current law—somewhat similar to Scandinavian dual income tax systems. (Sorensen, 2005)

The Bipartisan Policy Center (2010) Debt Reduction Task Force on which I served designed a tax reform plan aimed at simplifying the tax code enough so that half of households would no longer have to file income tax returns. That plan would create a new value-added tax and use the revenue to cut top individual and corporate income tax rates to 27 percent.

President Obama empaneled another commission, commonly called the Bowles-Simpson Commission (after its two heads) with the mandate to reform the tax code and reduce the deficit.[6] (The Bush panel had been instructed to produce a revenue-neutral plan.) Bowles-Simpson would have eliminated even more tax expenditures than the Bipartisan Policy Center Task Force, allowing it to cut tax rates substantially without the need for a new VAT or other revenue source.

Senators Ron Wyden (D-OR) and Dan Coats (R-IN) produced a more incremental tax reform plan (Wyden and Coats 2011), designed to be revenue-neutral and preserve the most popular tax breaks. It would eliminate the AMT and cut the corporate tax rate to 24 percent while capping individual income tax rates at 35 percent. The cost of these provisions would be offset by closing or scaling back various tax expenditures. The proposal would raise tax rates on high-income taxpayers' long-term capital gains and dividends to 22.75 percent. It would revise the formula the federal government uses to adjust tax parameters for inflation, generally cutting the cost of annual inflation adjustments. The plan would also reduce businesses' interest deductions. It would consolidate and simplify individual tax breaks for saving and education. The most radical change is that the plan would require the IRS to prepare pre-filled tax returns for lower-income filers.

A. Is it Possible to Cut Popular Tax Expenditures?

The common thread in all of these proposals is that they would significantly cut tax expenditures—subsidy programs run through the income tax. This continues a long tradition. In 1973, Stanley Surrey, a Harvard law professor and former Treasury assistant secretary who invented the concept of a tax expenditure budget, published *Pathways to Tax Reform*, which argued that eliminating or reforming tax expenditures is the secret to tax reform. Almost four decades later, would-be reformers still view this as the best path, but it is fraught with difficulties. Yes, there are a lot of tax expenditures and they often represent a dubious use of federal revenues, but the biggest ones are really, really popular.

Reformers point to the 1986 tax reform, which eliminated or reined in numerous tax subsidies, but most of the savings came from cutting large corporate tax breaks such as the investment tax credit and accelerated depreciation. The most popular individual income tax expenditures survived largely unscathed. They include items such as the tax exclusion for employer-sponsored health insurance (almost $300 billion in FY2013, including lost payroll taxes) and the mortgage interest deduction (about $100 billion). (See Table 2.) Ronald Reagan stipulated few parameters to the Treasury Department in 1984 when he commissioned the study that ultimately led to the Tax Reform Act of 1986, but one was to preserve tax incentives for homeownership. (Birnbaum and Murray, 1987) The ultimate law did slightly trim the tax break for homeownership, but only for those with mortgages over $1 million.[7] President Bush gave similar instructions to members of his tax reform commission. And the Affordable Care Act championed by President Obama did not directly limit the health insurance tax exclusion, although the excise tax on "Cadillac health plans" is intended to indirectly cap the tax break, but not until 2018. Former Joint Committee on Taxation Chief of Staff John Buckley (2011) argues forcefully that raising significant revenue from eliminating individual income tax expenditures would be politically difficult, if not impossible.

The appeal of cutting tax expenditures is quite apparent. First, they represent a lot of money – on the order of $1 trillion a year.[8] Second, as noted, eliminating tax expenditures raises revenue without requiring higher tax rates. Indeed, if enough tax expenditures are eliminated, tax rates could be reduced significantly while raising net revenues. Third, paring tax expenditures might garner bipartisan support. Insofar as tax expenditures represent spending hidden in the tax code, curtailing them should appeal to conservatives who would otherwise object to raising taxes. And, since most of the benefits accrue to those with higher incomes, putting tax expenditures on the chopping block should appeal to liberals eager to spare safety net programs from the budget ax. (Burman and Phaup 2012)

Table 2. The Ten Largest Tax Expenditures, FY 2013, in Billions of Dollars

Rank	Provision	Amount
1	Exclusion for employer-sponsored health insurance[a]	294.3
2	Mortgage interest deduction	100.9
3	401(k) plans	72.7
4	Lower rate on capital gains	62.0
5	EITC[b]	55.7
6	Pensions	52.3
7	State and local tax deduction (excluding property tax)	46.3
8	Tax deferral for multi-nationals	41.8
9	Child tax credit[b]	40.8
10	Charity deduction (other than education, health)	39.8

Source: US Budget, Analytical Perspectives, FY2013, and author's calculations

[a] Health insurance estimate includes $113.7 billion payroll tax expenditure.
[b] EITC and child tax credit totals include outlays of $52.6 and $22.4 billion, respectively.

B. Bowles-Simpson

Several approaches have been suggested to make significant tax expenditure cuts feasible. The Bowles-Simpson plan would explicitly trade off lower tax rates against fewer tax expenditures. The co-chair's report (technically, there is no plan since the required super-majority never ratified it) would eliminate most tax expenditures in exchange for a top tax rate of 28%.

The plan has received qualified endorsements from various corners. President Obama said in the 2012 State of the Union address that the plan had many good ideas. Paul Ryan argued at the 2012 Republic convention that the president should have endorsed the plan to move the cause of budget reform forward. And Mitt Romney excoriated the president at the first presidential debate for not supporting the Bowles-Simpson blueprint.

But the president never adopted any of the Bowles-Simpson recommendations, Paul Ryan voted against the plan at a time when his vote might have forced the plan onto the legislative agenda (assuming he could have brought some of the other Republicans on the panel along), and Mitt Romney said that he favored his own unspecified budget plan.

Like Buckley, I'm skeptical that voters will be enthusiastic about a simple trade-off of their favorite tax breaks for lower tax rates. Any revenue-neutral swap would result in some, and perhaps many, households owing more tax after the reform. Despite all the theoretical clamor for simplicity and fairness, it's not clear that voters are willing to pay much for those salutary attributes.

And if the tax reform is intended to increase revenues, as Bowles-Simpson would, a larger percentage of tax filers will owe more income tax after reform. Possibly they can be convinced that this is worthwhile to avoid a debt catastrophe or for the sake of our children, but the idea of shared sacrifice is likely to run into resistance if many people decide that their share is greater than that of their neighbors (who didn't take so much advantage of tax subsidies).

C. Convert most individual income tax subsidies into refundable tax credits

Batchelder, Goldberg, and Orszag (2006) suggest a different approach. Rather than cashiering tax expenditures wholesale, the authors suggest converting most individual income tax expenditures into refundable tax credits. The paper argues that completely aside from distributional concerns, the change would be desirable on efficiency grounds because the justification for most subsidies would imply an equal subsidy rate regardless of the income of the recipient. Providing subsidies by means of deductions or exclusions introduces substantial variation in subsidy rates because the effective subsidy varies with the marginal income tax bracket, which rises with income. Itemized deductions introduce another source of variation. Those deductions are only valuable to the extent that total itemized deductions exceed the standard deduction. For high-income people with large deductions for state and local taxes, mortgage interest, and charity, the marginal subsidy rate is approximately the income tax rate bracket. However, for middle-income households with modest deductions, the value of the itemized deduction can be reduced or even eliminated. Indeed, 70 percent of tax units do not itemize deductions and get no tax benefit from them. Even for those who do itemize, the effective subsidy rate can be substantially reduced because only the amount of itemized deductions in excess of the standard deduction reduces tax liability.[9]

Nonrefundable tax credits are more uniform because their face value does not vary with the income tax rate or itemization status, but those credits are of little or no benefit to households that do not owe income tax. Making those credits refundable would eliminate the variation in value among taxpayers in different tax situations. (When refundable credits exceed tax liability, they are "refunded" to taxpayers.)

Beyond the efficiency argument refundable credits are more progressive than deductions or nonrefundable credits. In addition, the credit rate can be set well below the top income tax rate and still provide as much or more benefit to most taxpayers than a deduction. The Tax Policy Center estimates that more than 80 percent of tax units (including nonfilers) were in the 15-percent tax bracket or lower in 2011.[10] Since the benefits of most individual income tax expenditures accrue mostly to those with high incomes (because they are in the highest tax brackets and tend to make larger charitable contributions, have larger mortgages, and pay more in taxes), a flat refundable tax credit can redirect the subsidy to lower and middle-income households while actually reducing the cost to the Treasury.[11] In addition, to the extent that the subsidies are aimed at encouraging activities such as homeownership or health insurance coverage, most high-income people need *less* subsidy to be induced to participate than those with more modest incomes. Thus a flat refundable tax credit may be able to achieve the objectives of the subsidy at much lower cost.

Refundable tax credits can also be much simpler than current law. Indeed their value could generally be determined without doing any tax calculations since they do not vary with tax status.[12] However, that can also be a drawback since people may have to file a tax return solely for the purpose of the claiming the credit.[13] This creates costs for the IRS and for the new tax filers and may also create new avenues for fraud.

Moreover, there could be many more filers who do not owe income tax if deductions and exclusions are converted to credits. Some observers are concerned about the effects of the substantial share of the population that does not owe income tax. The Tax Policy Center (Johnson, et al, 2011) estimated that 46 percent of tax units did not owe income tax in 2011. Part of that total is senior citizens who primarily rely on Social Security, which only becomes subject to tax at higher income levels, and part attributable to those with very low incomes. But many lower-middle income families with children avoid income tax because of the availability of the child tax credit and the EITC (as well as the standard deduction and personal exemptions). The concern is that the households who do not owe income tax will happily support income tax increases on the taxpaying share of the population to fund expansions in government since they do not bear any of the resulting tax burden.

It is likely that if many individual income tax subsidies are converted into refundable tax credits, the number of households that owe no income tax—and the number that get refunds over and above income tax liability—will increase. It is possible that if the Batchelder, et al, proposal were enacted, the tax credits could be explicitly considered spending programs rather than tax reductions. This would be an advantage for transparency of the tax and spending functions of the US government. And it's possible that making this explicit would lead to more rational budgeting decisions—allowing trade-offs between traditional cash outlays and tax expenditures and making it easier to control the size of government. However, advocates for these programs might not view that as an advantage.

D. Graetz

Michael Graetz (2010) has suggested a kind of divide-and-conquer approach to tax reform. He would return the individual income tax to its original design, as a "class tax" applying only to those with higher incomes rather than the "mass tax" that the income tax became during World War II. A broad-based income tax would apply rates of 16 and 25.5 percent to those with incomes over $100,000 ($50,000 for singles).[14] The individual AMT would be eliminated and capital gains and dividends would be taxed at the same rate as other income. The 15-percent rate would also apply to corporate income, but virtually all corporate tax expenditures would be wiped out. In addition, there would be a 12.3 percent value-added tax (VAT), which would replace the income tax for most taxpayers. Tax compliance would be much simpler for the 100 million households that would no longer owe income tax, although they would need to make a declaration to claim refundable tax credits based on family size aimed at offsetting the regressivity of the VAT and replacing the current law EITC and child tax credit.

The political advantage of this approach is that the VAT could be more palatable than the income tax since voters seem to dislike sales-based taxes less than the income tax. Effectively, the VAT might reproduce the trick of TRA86, by using a politically more acceptable tax to finance net income tax cuts for most households. In addition, with the income tax only applying to a sliver of the population, cuts in tax subsidies might become more politically acceptable. Most Americans presumably would not object because they would not be directly affected.

The drawback of Graetz's approach is also political. The proposal would exempt approximately 80 percent of households from the income tax. And many of those would be eligible for the refundable tax credits. While they would owe VAT and would have "skin in the game" if the VAT is considered the primary means of financing any government expansion, the concern would be that the 80 percent would always favor using the income tax, from which they are exempt, rather than the VAT. It is not clear how to address this concern in the context of Graetz's plan.

Moreover, there is considerable resistance to a VAT in Congress. In response to reports that Paul Volcker, the chair of President Obama's Economic Recovery Advisory Board, was considering a VAT as one tax reform option, former Republican presidential candidate John McCain sponsored a Senate resolution opposing a VAT. It passed with overwhelming bipartisan support by a vote of 85-13. (Fabian, 2010)

More recently, the Republican party platform in 2012 stated: "In any restructuring of federal taxation, to guard against hypertaxation of the American people, any value added tax or national sales tax must be tied to the simultaneous repeal of the Sixteenth Amendment, which established the federal income tax." (Republican Platform, 2012, p. 3) In other words, a VAT or national retail sales tax would only be acceptable if it replaced the income tax. The concern is that a supplemental VAT would fuel an expansion of government.

E. Aggregate limitations on tax expenditures

Rather than repealing or reforming tax expenditures outright, another approach is to apply aggregate limits. For decades, the Congressional Budget Office has included an option to cap the value of itemized deductions at 15 percent in its periodic Deficit Reduction volumes. (See Congressional Budget Office, 2011, for example.) President Obama has proposed a more modest limit—capping the value of certain tax expenditures at 28 percent—but he would apply the limit to a much broader list of items, including employer-sponsored health insurance, interest on municipal bonds, and employee contributions to retirement accounts. (Treasury, 2012) The proposal certainly would not qualify as a simplification as it would require calculating tax liability with and without the specified deductions and exclusions and limiting the tax savings to 28 percent. Taxpayers with relatively modest amounts of deductions and exclusions would also have to compare their tax calculated this way with the tax they'd owe if they claimed the standard deduction, which would become a complex calculation under the proposal.

The intent of the proposal is to limit the disparity in the value of the selected tax expenditures. The maximum value would be 28 percent, compared with 39.6 percent if top tax rates are allowed to return to their pre-2001 levels as proposed by the President (or 35 percent at current tax rates). There would still be a marginal subsidy on the proscribed activities, but it would be capped at 28 percent.[15]

The President has also proposed something he calls the Buffett Rule, which would set a minimum average tax rate for millionaires of 30 percent of gross income.[16] Like the cap on deductions, this proposal would complicate tax compliance as taxpayers would have to calculate the floor on taxes due and pay that amount if it is higher than tax calculated under the normal rules. It would also make it hard for taxpayers close to the threshold to predict their marginal effective tax rate or the value of deductions. The marginal tax rate on some kinds of income would rise and others fall precipitously when the cap is reached. The marginal tax rate on capital gains and dividends would rise from the lower capital gains tax rate (currently 15 percent) to 30 percent whereas the marginal tax rate on ordinary income (such as wages and salaries) would fall from the top individual income tax rate to 30 percent. Meanwhile, the marginal value of tax preferences (with the exception of charitable contributions, which are exempt from the Buffett Rule) would fall to zero as long as ordinary income tax is less than the Buffett Rule threshold.

I don't view these proposals as in the spirit of base-broadening income tax reform. They might, however, reflect strategic first steps insofar as they reduce the value of tax expenditures, which might diminish the intensity of resistance to base-broadening measures. But they are disconcertingly similar to a number of complicated limits that exist under current law. The Buffett Rule is really just a somewhat simpler (and more draconian) AMT. And there already is a limit on itemized deductions, which phase out at higher income levels. That provision, sometimes called Pease after the Congressman who came up with the idea, is currently in abeyance having been phased out by the Bush-era tax cuts, but the President proposes to restore it for higher income taxpayers.[17] While it's clear that these measures have complicated the tax system and also fallen short in terms of efficiency and fairness, it is not at all clear that they have helped build momentum for tax reform, except insofar as they contribute to Americans' view that our tax system is a mind-numbing mess of complexity.[18]

F. The Feldstein/Romney Proposal as a Special Case?

Martin Feldstein, Daniel Feenberg, and Maya MacGuineas (2011) proposed a global cap on tax expenditures of 2 percent of AGI. The authors argue that this approach could raise substantial revenue, improve economic efficiency—by reducing distortions caused by "wasteful tax spending"—and significantly simplify the tax system for most taxpayers, all in a progressive way. They also argue that there are significant political economy benefits:

> Singling out one or a small number of tax expenditures to eliminate strikes many taxpayers as unfair. This paper considers a way of reducing the major individual tax expenditures by capping the total amount that the tax expenditures as a whole can reduce the individual's tax burden. More specifically, we examine the effect of limiting the total value of the tax reduction resulting from tax expenditures to two percent of the individual's adjusted gross income. Each individual can benefit from the full range of tax expenditures but can receive tax reduction only up to 2 percent of his AGI. (p. 10)

In other words, the claimed advantage of this approach is that it is indiscriminate. The proposal would retain the standard deduction, which simulations suggest would be a more advantageous option for most taxpayers—only 9 percent would elect to itemize deductions. For those who do continue to itemize, the calculation of which option is preferable would be very complex, although presumably manageable with the aid of tax preparation software.

Presidential candidate, Mitt Romney, floated a variant of the Feldstein, et al, proposal. Tax expenditures would be capped at a fixed dollar amount (the exact amount suggested has ranged from $17,000 to $50,000). Governor Romney also proposed to eliminate the AMT, which would make his version much simpler than the original proposal.[19] (He would use the revenue raised from the cap to finance tax rate cuts; thus, the proposal would not directly lead to deficit reduction.)

If the cap on tax expenditures could be enacted, it would facilitate broader tax reform because the vast majority of taxpayers would receive little or no benefit from the subsidies subject to the limit. In this sense, it is similar to the Graetz proposal. So it could certainly be a stepping stone to the kind of simplification that Surrey envisioned. However, the political feasibility rests on the assumption that taxpayers don't really understand the proposal. Otherwise, you would expect nearly as much opposition to it as to the sweeping cuts in tax expenditures under Bowles-Simpson.

An alternative is to try to take advantage of myopia to induce taxpayers to allow the tax expenditures to be phased out over time. I have suggested (Burman 2011) that instead of offering a limit on tax expenditures, the proposal be simplified by deeming tax reductions equal to the minimum of a set percentage of AGI or the value of the standard deduction (converted into a credit). The goal would be to end up with a deemed tax expenditure credit of 2 percent of AGI or 15 percent of the current law standard deduction, whichever is greater. (I would still allow the earned income tax credit and the child tax credit, which I think Feldstein et al would do also.) But initially the credit would be much larger—say, the larger of 10 percent of AGI or 30 percent of the standard deduction—and phased down over 5 years. There is substantial evidence that many taxpayers are myopic, so they might take this trade, even though they would pay higher taxes over the long run. This option also has the virtue of providing a net tax cut in the short term, which might speed recovery from the Great Recession.

The fundamental question, though, is whether Congress would succumb to pressure to delay or stop the phase-down of the credit. And there would be pressure over time for Congress to move popular tax breaks outside of the capped category, which would undermine the intent to quarantine tax expenditures.

G. The Virtues of a Return-Free Tax System

The Bipartisan Policy Center tax reform plan (and a predecessor plan that I developed in Burman, 2008) would have radically simplified the individual income tax. Most households would be subject to a 15-percent tax rate. (A 27-percent rate applies at higher income levels.) Capital gains and dividends are taxed at the same rate as other income. Taxes on interest and dividends would be withheld at source at the bottom tax rate (15 percent). Capital gains would have to be reported on income tax returns, but the first $1,000 per year of capital gains would be exempt from tax, which would exempt most households from filing on account of capital gains. Households with income above the 27 percent tax rate threshold and those with self-employment income or other kinds of capital income would have to file a return.

The earned income tax credit, child tax credit, personal exemptions, and standard deduction would be replaced with two refundable tax credits—an earnings credit at a 21.3% rate that would apply to the first $20,300 of earnings that would be advanced directly to workers by employers—and a flat $1,600 per child tax credit available to all taxpayers with qualifying children.

(Workers with multiple jobs would in some cases have to file tax returns to claim the full credit.) Neither credit phases out with income. The child credit would be payable to households that do not file via a smart card, as proposed by Michael Graetz.

The AMT is repealed and most tax subsidies are eliminated. Corporations would also be taxed at the 27-percent rate. There would also be a 6.5 percent value-added tax, which allows for substantial income tax rate cuts while still raising gross tax receipts to help pay down the debt.

Most tax expenditures are repealed, but subsidies for homeownership, retirement savings, and charitable contributions would remain. Those subsidies would be conveyed by means of flat tax credits (equivalent to a 15 percent deduction) paid directly to the entity that provides the subsidized service. For example, every contribution of $85 to charity would be matched with a $15 subsidy paid directly to the organization. This is similar to the Gift Aid program used in the UK (which has a return-free tax system for most citizens). Similarly, subsidies are paid directly to mortgage lenders and financial institutions that hold IRAs.[20]

In my view, there are two key advantages of moving towards a return-free tax system. One is that it is such a radical change that it might actually catch the imagination of voters. To actually have a tax system where April 15 becomes just another day for most households would fundamentally transform the way households interact with the tax authorities. Moreover, it would become much more straightforward for most to understand how the tax system affects them. Most taxpayers would be subject to a 15-percent flat tax with very few tax subsidies.

But perhaps the most important feature is that a tax-free system would create a real cost to add major complications to the income tax. In this way, such a tax reform may turn out to be much more durable than past efforts. Yes, new subsidies in the nature of the flat credit for mortgage interest and charity might be added with little complication, especially if the credits are fully refundable (i.e., not contingent on households' income tax liability). However, running the subsidies as direct payments from the government—rather than a tax credit or deduction claimed on the tax return—would make it quite transparent that these payments are cash outlays and only loosely tied to any notion of calculating tax liability. That would, hopefully, reduce or eliminate the bias in the existing code that favors tax expenditures over direct outlays. (Burman and Phaup 2012)

An alternative to a return-free system would be one where the IRS fills out a preliminary version of tax returns for households. The Wyden-Coates proposal would do that and the Obama Administration has proposed to implement such a system (but has been apparently thwarted in this effort by intense lobbying by the tax software/preparation lobby).

H. A Carbon Tax?

Enacting a carbon tax is a no-brainer for economists (at least the majority that is swayed by science). It is the rare example of a tax that raises economic efficiency. By pricing the harm caused to the environment by burning fossil fuels, a carbon tax unleashes market forces to encourage a more efficient level of consumption of fuel and its derivatives and encourages efficient investment in alternative energy sources and conservation.

So the question is whether this "good tax" could be part of a winning tax reform strategy. Joe Minarik and I were unable to convince the bipartisan group at the BPC because they thought that one new tax—the VAT—was already going to be a big political challenge. A carbon tax would raise the price of carbon-based fuels, transportation, and products whose manufacture is very energy-intensive. It could decimate communities that are heavily reliant on coal and, to a lesser extent, oil. Enormous lobbies exist to protect the interests of the many industries and communities that would be affected.

Probably the most politically palatable option is to recycle all the revenue raised from a carbon tax into cutting other taxes and mitigating the economic dislocation caused by the tax. For example, although it would clearly be second best from a policy perspective, some of the revenue might be used to finance green technology manufacturing in places like West Virginia where many jobs are tied to coal.

It is possible that if most of the revenue from the carbon tax were recycled into an energy tax rebate, the subsidy might make taxpayers more accepting of losing favored deductions or credits since their net tax bill would fall.

I. A VAT Earmarked to Pay for Health Care

The BPC plan had a VAT, relabeled a deficit reduction sales tax (DRST) based on the theory that tying it to the familiar sales tax and emphasizing the connection to deficit reduction would make the levy more acceptable than a tax associated with alien lands like France (I was skeptical). In my original proposal, the VAT was earmarked to pay for federal obligations for healthcare, which the BPC plan did not do. I think the earmarking is a critical feature.

My proposal would set the VAT equal to net federal expenditures on Medicare, Medicaid, and S-CHIP (the program that covers low-income children) over and above payroll tax revenues and premiums already allocated to those programs. (I don't include the Affordable Care Act (ACA) because that law is already self-financing, at least according to the Congressional Budget Office, but if ACA turned out to run a deficit, that could also be covered by the VAT.) As part of tax reform, I would eliminate the tax exclusion for employer-sponsored health insurance, so would subtract the revenues saved from that measure from the VAT requirements. Then I would specify by statute that the VAT is to be set approximately equal to the revenue shortfall from all of those federal programs so that they are self-sustaining. The rate could be revised whenever a rate adjustment of at least 0.5 or 1 percentage point would be warranted by the formula (with the threshold chosen so that rate changes were not expected to be too frequent).

Earmarking a VAT to pay for healthcare is not a new idea. Emanuel and Fuchs (2007) suggested establishing a VAT to pay for a universal healthcare voucher. I think there are both economic and political advantages of this approach. First of all, because a consumption tax does not distort the trade-off between current and future consumption, as an income tax does, it is a more efficient revenue source than the income tax, although the efficiency comes at the cost of a proportionately heavier burden on those with low incomes. That burden may be offset by refundable income tax credits as in Graetz (2010) and Burman (2008).[21] A VAT tied to healthcare costs would allow significant reductions in income tax rates while also raising net revenue that could be used to pay down the debt.

Second, healthcare is the single fastest growing component of federal spending, so dedicating a revenue source to pay for it guarantees a revenue stream tied to the one component of spending that is out of control. This could reassure credit markets and foreign lenders concerned about growing U.S. debt.

Third, other earmarked taxes are better tolerated by the public than general revenues. Even though the OASDI payroll tax is larger than federal income taxes for most working-age Americans (even counting only the employee's share of the tax), the tax enjoys relatively broad support because most voters favor what it pays for (Social Security and Medicare). The tax was partially abated for two years in an effort to boost the economy by raising households' after-tax incomes, but that provision expired at the end of 2012. In sharp contrast to the Bush-era income tax cuts, which also expired at the same time, there was little protest about ending the payroll tax cut. The excise taxes on motor fuels, which are dedicated to pay for highway construction and repairs and mass transit, also seem to be more accepted than income taxes. A dedicated VAT might be far more successful politically than a stand-alone tax

Of course, it is the very acceptability of the VAT that has stimulated the opposition from virtually all Republicans and many Democrats. The concern is that a VAT would be a money machine that would fuel a massive increase in the size of government. I believe, however, that a dedicated VAT would actually serve as an effective brake on spending.

The problem with healthcare is that most people think that someone else pays for it—employers, insurers, or the government. Particularly in the context of federal benefits, there is no direct signal of how runaway spending translates into higher taxes. A VAT dedicated to offset federal healthcare costs would, for the first time, create a very visible metric of how effectively we are controlling spending. If health spending continues to grow at historical rates, the VAT rate will rise quite quickly, which will translate into higher prices for the goods and services that people buy. Voters in this tax-averse country would put pressure on lawmakers to control spending to avoid future tax increases. This might create the conditions necessary to support a bipartisan consensus on controlling Medicare and Medicaid spending that has so far proven elusive.

In addition, the plan might include process reforms designed to limit the growth of mandatory spending (principally Social Security, Medicare, and Medicaid). Penner and Steuerle (2005) have proposed caps and triggers for automatic cuts in mandatory spending that they claim would take those programs off auto-pilot. They also propose a super-majority requirement for the enactment of large new entitlement programs. Enactment of these options might be delayed, however, until policymakers see whether the automatic spending constraint built into the health VAT is effective.

Finally, tying a VAT to healthcare would address the concern that almost half of voters do not have “skin in the game” when it comes to federal spending. The one component that has so far seemed to be out of control is healthcare. A dedicated VAT would mean that everyone would see a connection between their own tax bill and the main driver of federal spending.

IV. Summing Up: Pathways and Dead Ends

For the past 40 years, would-be tax reformers have agreed that controlling tax expenditures is the best approach. Closing loopholes and preferences allows the government to raise more revenue without raising marginal tax rates. This reduces the economic cost of taxation. But closing individual income tax expenditures creates daunting political challenges.

In my view, the most direct approach — offering lower tax rates in exchange for fewer deductions and credits — is also likely to be the least effective. People like the mortgage interest deduction and fringe benefits. That is why I would be surprised if anything like the Bowles-Simpson draft ever becomes law. A potentially more acceptable alternative is to apply aggregate limits to tax expenditures. Several provisions in the law already do that — most notoriously, the alternative minimum tax. Of course, the AMT's complexity and inefficiency suggest that this might not necessarily be the best pathway to tax reform.

President Obama has proposed a limit on the value of itemized deductions and Feldstein, et al (2011) have proposed even tighter limits on a broader class of tax expenditures. Both proposals would introduce new complexity, although Feldstein argues that most taxpayers would opt for the simple standard deduction under his proposal. The political efficacy of this approach rests on taxpayers not understanding that it is a sneaky way to repeal tax expenditures for most households. Burman (2011) offered a variant of this proposal that would try to induce taxpayers to support the proposal by offering a short-term tax cut in exchange for phasing in the tax expenditure limits. It would also be simpler than the Feldstein proposal. But its efficacy depends on taxpayers not revolting when the cuts are fully phased in.

Another option is radical tax reform. Michael Graetz (2010) would eliminate the income tax for most Americans, making up the lost revenue with a VAT. The income tax would apply only to those with higher incomes, which would significantly simplify tax compliance for most people and presumably lessen opposition to trimming income tax expenditures. The drawback is that some might object to exempting even more American from income tax obligations than under current law.

Burman (2008) also proposed a VAT as supplement to the income tax, but the VAT revenue would be earmarked to offset federal spending on healthcare. There are several advantages of this approach: (1) it would allow significant cuts in ordinary income tax rates; (2) it would guarantee a revenue stream to cover the fastest growing aspect of federal spending; (3) voters seem to object less to earmarked taxes (such as the Social Security payroll tax and the gasoline excise tax) than to general revenues; (4) relatively greater reliance on consumption-based taxes like a VAT could boost economic growth; and (5) the earmarked VAT might help build support for sensible measures to slow spending on Medicare and Medicaid as the tax would serve as a price tag for these costly programs. The main drawbacks are: (1) concern that a VAT would fuel growth in government ; (2) the VAT is regressive; and (3) the French have one. I think the first concern would be misplaced in the case of an earmarked VAT and the regressivity could be offset via income tax credits (as it would be in Graetz's proposal). My proposal would also radically simplify the income tax so that most households would no longer have to file income tax returns, which I argue would serve as a limit on future tax complexity.

Readers will note that I have not mentioned the flat tax, the Fair Tax (national retail sales tax), the consumed income tax, or the X-tax. These are all variants of a national consumption tax. They are attractive to economists because they would reduce or eliminate the income tax bias in favor of current consumption—that is, they could boost saving and promote economic growth. However, I think they are all political dead ends.

The flat tax and the Fair Tax are regressive. They are both basically flat sales taxes with some relief for low-income households. The problem is that even if those at the bottom are held harmless, raising the same amount of revenue would require substantial increases in tax burdens on the middle class (since high-income households spend only a fraction of income and thus would get a huge tax cut under either proposal). The consumed income tax is intended to be progressive, but it would be extremely complex, which is why I think it has never garnered much support. Carroll and Viard (2012) make a strong case for the X-tax, which is basically a flat tax with progressive rates, but unless the tax base could be kept pristine, top rates would have to be very high to mimic the progressivity of the income. And I think great political opposition would face a tax system where millionaire investors (not to mention shiftless heirs and heiresses) with no wage income would be exempt from individual-level tax.

While it is obvious to most observers that the income tax sorely needs reform, it is not clear that it will happen any time soon. In the current polarized political environment, it certainly looks impossible. But the Tax Reform Act of 1986 looked like a hopeless cause, almost until it was signed into law. If a charismatic president makes it a priority and finds leaders in Congress he or she can work with, it might happen.

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Notes

[1] Much of this section is taken from my testimony before the Senate Budget Committee (Burman 2012).

[2] Elmendorf and Mankiw (199x) point out that the optimal path for government debt depends on a number of factors and there is no particular reason to think that annual balance or balance over the business cycle is optimal. For example, if the government is investing heavily—which produces benefits for future taxpayers—deficits might be appropriate. If it is taking on large unfunded obligations, then net surpluses might be warranted. However, the exploding public debt that would follow from current policies is certainly not desirable.

[3] The CBO's 2012 projections included two scenarios: the "extended baseline scenario" and the "extended alternative fiscal scenario." The American Taxpayer Relief Act of 2012 locked in most, but not all, of the temporary tax cuts that were assumed to be extended in CBO's alternative scenario. The long-term fiscal scenario is not quite as bleak as the more pessimistic alternative, but still unsustainable.

[4] The date were originally published in Picketty and Saez (2003) and updated online.

[5] Portions of this section are adapted from Burman and Slemrod (2012).

[6] President Obama also commissioned a tax reform study under the direction of former Federal Reserve Board chairman Paul Volcker. (President's Economic Recovery Advisory Board, 2010) The report laid out a laundry list of options the Administration might consider as part of a tax reform plan, but did not actually produce such a plan itself. According to the report, "The Board was not asked to recommend a major overarching tax reform, such as the 1986 tax reform, the tax plans proposed by the 2005 Tax Reform Panel, or proposals for introducing a value-added tax in addition to or in lieu of the current income tax system." (p. v)

[7] The law also limited the use of mortgage debt to finance other, non-housing spending and capped the deduction for home equity lines of credit and second mortgages at $100,000. The IRS has since ruled that the two mortgage limits may be combined, so homeowners may deduct interest on a mortgage up to $1.1 million if they don't deduct other mortgage debt. (Ebeling 2010)

[8] Buckley (2011) argues that the revenue potential of eliminating tax expenditures is vastly overstated because they do not account for behavioral responses. For example, if the mortgage interest deduction were eliminated, some homeowners would take cash out of taxable accounts to reduce mortgage principal amounts. Thus, the Treasury would lose the tax revenue that would otherwise have been collected on the income that would have been earned on those taxable accounts.

[9] For example, suppose the standard deduction for a married couple is $11,000 and that they would have $10,000 of itemized deductions before including charitable contributions. If they make less than $1,000 of charitable contributions, they would get no benefit from itemizing deductions. If they donate $2,000 to charity, the contributions would lower their taxable income by $1,000 (the portion in excess of the $11,000 standard deduction). Thus, the tax subsidy is effectively cut in half. If the household is in a 25 percent tax bracket, the contributions will save them $250 in federal income tax, or 12.5 percent of the $2,000 in contributions.

[10] Tax Policy Center table, T12-0179.

[11] For the distribution of individual income tax expenditures by income, see Burman, Toder, and Geissler (2007).

[12] Note that this is not true for the EITC and the partially refundable child tax credit since they phase out at higher income levels.

[13] This is generally not true for the EITC and the refundable portion of the child tax credit, since they only help families with earnings, and most workers must file to claim refunds of withheld income taxes even if they do not owe any income tax.

[14] These parameters are based on the version of Graetz's proposal estimated by the Tax Policy Center. See Toder, Nunns, and Rosenberg (2012).

[15] This may not strictly be true, depending on how the cap is implemented because the effective marginal tax rate can be significantly higher than the statutory tax rate because of phase-outs. The most notable example is the phase-out of the AMT exemption based on an expanded measure of taxable income (before the AMT deduction), which nets out items such as charitable deductions (although not state and local taxes or miscellaneous itemized deductions, which are not allowed against the AMT). This phase-out raises effective tax rates from the two AMT statutory brackets of 26 and 28 percent to 32.5 and 35 percent, respectively.

[16] The President has called the Buffett Rule a principle for tax reform rather than a specific proposal, but Sen. Sheldon Whitehouse (D-RI) made a specific proposal, which the President endorsed.

[17] Since itemized deductions, especially for state and local taxes, tend to grow with income, Pease actually does not reduce the marginal value of deductions for most taxpayers. It is really just an obfuscated income tax surtax—of up to 1 percentage point, depending of the tax bracket—for most people affected by it. It was clearly enacted as a way to garner revenue, perhaps with the hope that its complexity would reduce resistance to the measure because taxpayers couldn't understand it.

[18] See Burman, Gale, and Rohaly (2003) for a critique of the AMT.

[19] Professor Feldstein is an adviser to the Romney campaign, as reported by various media outlets.

[20] Although the BPC plan did not incorporate this feature, it is not difficult to implement the option of deductibility for higher-income taxpayers who are in the top tax bracket. Taxpayers in the 27-percent bracket must file tax returns. They could claim deductions for charity, mortgage interest, etc., and simply pay back the subsidies that they received directly as additions to tax. The UK does this for charitable contributions.

[21] The standard approach to mitigating regressivity in most countries with a VAT is to exempt necessities from the base, but that is an imperfect offset and creates significant compliance issues. (Toder and Rosenberg, 2010)