Chapter One
The Case for Reform

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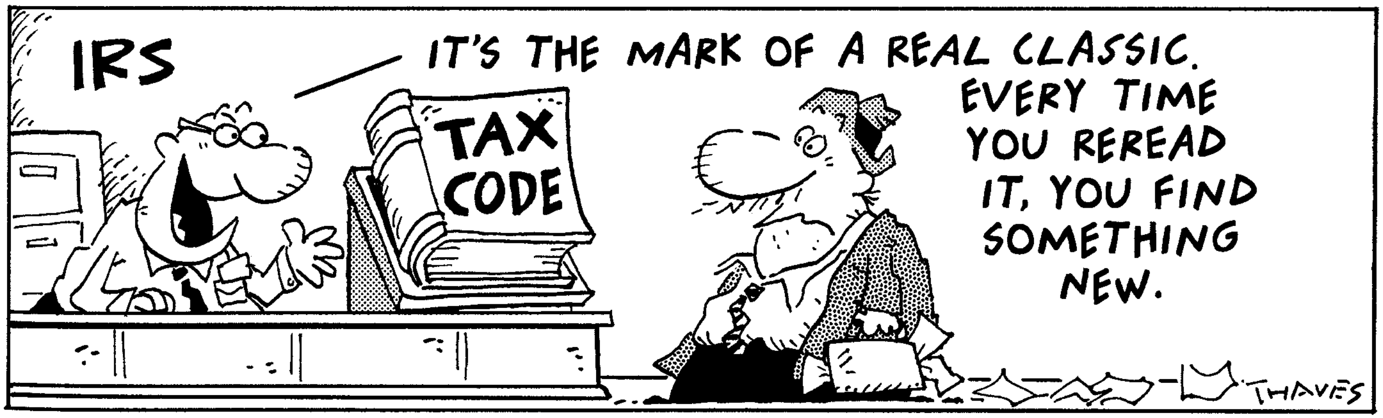


If you were to start from scratch, the current tax code would provide a guide on what to avoid in designing an income tax system. Instead of a sleek and simple system designed to raise revenue for our national defense, social programs, and other vital public services, we have a system so complex that almost $150 billion is spent each year by U.S. households, businesses, and the federal government, just to make sure taxes are tallied and paid correctly. This is more than the sum spent each year on televisions, household electricity, or cereal. Instead of a system that ensures that all pay their fair share, we have a system so confusing that two million taxpayers collectively paid over $1 billion more in taxes by making a wrong decision about the basic choice of itemizing or taking the standard deduction, according to a recent study. Instead of a tax system that draws revenue efficiently from the base of the nation's considerable economy, we have a tax code that distorts basic economic decisions, sets up incentives for unwise or unproductive investments, and induces people to work less, save less, and borrow more. By some estimates, this economic waste may be as much as $1 trillion dollars each year.

The father of modern economics, Adam Smith, said the free market is the "invisible hand" guiding every economic event. In today's U.S. economy, the tax code is the true force. The tax code penalizes savings, contributes to the ever-increasing cost of health insurance, and undermines our global competitiveness. The tax code touches all of life's major events: It tells us the best time to be born, the best time to marry, and the best time to retire.

In short, our current tax code is a complicated mess. Instead of clarity, we have opacity. Instead of simplicity, we have complexity. Instead of fair principles, we have seemingly arbitrary rules. Instead of contributing to economic growth, it detracts from growth. Time and again, witnesses told the Panel about these failings in the tax code.

Complexity

There is no clearer proof of the complexity of the tax code than the collective anxiety felt by Americans every April as the tax filing deadline approaches. For many, filing taxes consists first of procrastination. Then there is the inevitable search for slips of paper containing once-meaningful but now unintelligible financial transactions. Then comes the maze of lengthy instructions complex enough that even highly schooled professionals have to reread the directions several times. Those directions send taxpayers on a search through baffling schedules and detailed worksheets requiring many illogical and counterintuitive computations. And in the end, most taxpayers give up, and visit a tax preparer who promises to make sense of the whole process - for a price.

No matter how much you earn, chances are you do not clearly understand how to figure out your taxes. A recent poll of those with an annual income of $20,000 or less (usually the families with the simplest tax forms) showed that about 80 percent found the tax system either very complex or somewhat complex. That figure rises to nearly 100 percent for taxpayers with incomes exceeding $150,000. The process is so bad that one-third of Americans surveyed believe that completing the annual tax return is more onerous than actually paying large amounts of money in taxes.

To determine something as basic as figuring out the tax implications of having a child, you need to review numerous rules and complete many separate sets of computations. Figuring out whether you can claim the child tax credit, for example, requires the skills of a professional sleuth: You need to complete eight lines on a tax form, perform up to five calculations, and fill out as many as three other forms or schedules. Further research, reading, and computation may be needed to determine whether you can claim head of household filing status, an exemption for a dependent, the child and dependent care credit, the earned income tax credit, or tax credits related to your child's education, to name only some of the possibilities.

Last year, Americans spent more than 3.5 billion hours doing their taxes, the equivalent of hiring almost two million new IRS employees – more than 20 times the agency's current workforce. If the money spent every year on tax preparation and compliance was collected – about $140 billion each year or over $1,000 per family – it could fund a substantial part of the federal government, including the Department of Homeland Security, the Department of State, NASA, the Department of Housing and Urban Development, the Environmental Protection Agency, the Department of Transportation, the United States Congress, our federal courts, and all of the federal government's foreign aid. On average, Americans spend the equivalent of more than half of one work week – 26 hours – on their taxes each year (not to mention the amount of time they work to pay the taxes themselves).

In 2003, about 60 percent of household filers gave up trying to do the work themselves and hired a preparer. About a quarter relied on a computer and purchased software. A small fraction got help from volunteers. And 13 percent of Americans completed their own calculations and filed their taxes the old-fashioned way: with pen and paper.

Complying with the tax code is frequently more burdensome for those with the least ability to pay. For example, the earned income tax credit (EITC) is an important initiative, provided through our tax code to help low-income working families move out of poverty. The EITC differs from other entitlement programs in that it is only available to lower-income workers. Initially, EITC benefits increase as an individual's earnings increase, but then the benefits phase out at higher income levels. These rules are so complex that nearly three-quarters of those families claiming it hire a tax preparer. This makes little sense: These families typically earn less than $35,000. The extra cost of paying a preparer to claim the EITC benefit may offset a significant portion of the benefit itself – and to the family struggling to stay out of poverty, those dollars are scarce. Policy experts regularly praise the EITC's effectiveness, but as a matter of tax administration, it is complicated and inefficient.

The tax code places an undue burden on another critical sector of our society: the small businesses that create a majority of new jobs in our economy. The 31 million taxpayers who reported self-employment income or employee business expenses spent an average of 45 hours and $360 in out-of-pocket compliance costs, compared with 20 hours and $105 in out-of-pocket costs for the 103 million Americans who did not report self-employment income. Studies have found that the smaller the business, the higher the cost of complying with the tax code per dollar of revenue.

Confusion and Unfairness

Did I pay too much? Did I pay too little? Who will notice? These three questions play out in the minds of all taxpayers when they file their forms by April 15 each year. And as journalists and tax analysts have repeatedly shown over the years, rarely will two tax preparers working on the same tax return come up with the same amount of taxes due. There is little confidence that we really know how much we should be paying in taxes in any given year. It is not just a matter of doing arithmetic. According to a recent survey, more than two-thirds of respondents incorrectly answered basic filing questions about the tax implications of selling a home, claiming a dependent, saving for education and retirement, receiving capital gains, and paying the Alternative Minimum Tax. To be sure, some of these issues are complex. But our tax code should aspire to be clear and transparent, not allow confusion to multiply. Taxpayers should be able to understand the tax code's basics.

The result of this fog of ignorance typically isn't overpayment, which occurs occasionally, but underpayment, which happens regularly. This underpayment is measured by what is known as the "tax gap." The tax gap represents the difference between the tax that taxpayers should pay and what they actually pay on a timely basis. The IRS estimates that in 2001, between $281 and $322 billion went unreported on individual and business tax returns. This translates to a tax hike of more than $2,000 each year for honest taxpayers. Research shows non-compliance has been steadily rising over the past two decades, a troubling indicator that our tax code's growing complexity is inviting more cheating.

But taxpayers think that with the myriad of targeted exclusions, deductions, and credits, others may not be paying their fair share – so why should they? Some call this "the cheat or chump syndrome." In addition, clever tax advisors mine the complexity of the tax code to develop and market tax shelters and other schemes clearly designed to manipulate the tax code's hidden loopholes for their clients' exclusive benefit. The perception that the tax code is unfair and easily manipulated undermines voluntary compliance – the foundation of our tax system.

An Arbitrary and Unequal System

A tax code, like any law, should rest squarely on the notion that it will remain largely the same, from year to year, from person to person. In a court of law, there is an expectation by the judge, jury, and all other parties that the law will be equally and fairly applied based on well-established and consistent judicial principles. Yet our tax code shares few, if any, of these features.

Taxpayers cannot plan ahead. The tax system is a kaleidoscope of shifting credits, rates, and benefits because many of the tax code's most prominent features – the tax rate for ordinary income, the child tax credit, the lower tax on dividends and capital gains – may shift wildly from one year to the next, and in some cases simply expire. For example, tax relief passed by Congress in 2001 and 2003 is scheduled to fade away. While some believe Congress will not allow this to happen, no one can say for sure. As Box 1.1 indicates, all individual tax rates are scheduled to rise. The lowest bracket, currently set at 10 percent, will disappear and the top tax rate will climb from 35 to 39.6 percent after 2010. The child tax credit and the deduction for IRA contributions will be cut. Taxpayers have recently seen their taxes on dividends and capital gains reduced but will see them sharply increased in 2008, when those taxes are scheduled to rise again.

Box 1.1. Commonly Applicable Income Tax Provisions Scheduled to Expire

- Reduced Individual Tax Rates on Ordinary Income
- Marriage Penalty Relief
- Increased Child Tax Credit
- Increased IRA Contribution Limit
- Reduced Individual Tax Rate on Dividend Income
- Reduced Individual Tax Rate on Capital Gains
- Investment Incentives for Small Business

This uncertainty has clear effects. If you own a small business and are contemplating an investment in new equipment, the tax provision that quadruples the portion of that investment that can be written-off immediately is an incentive to go forward with the investment. Yet because of the scheduled expiration in 2007 of this provision, your decision to invest may be rushed. Such an investment – timed as it is to a provision in the tax code rather than to economic fundamentals – may turn out to be ill-advised and waste economic resources. In any case, the tax code's constant phase-ins and phase-outs are a nuisance at best, and a negative force at worst, in the daily economic lives of American families and businesses.

The tax code treats similar taxpayers in different ways. Taxpayers with the same income, family situation, and other key characteristics often face different tax burdens. Such differing treatment creates a perception of unfairness in our tax code. For example, taxpayers in states with high state and local income and property taxes receive higher deductions than taxpayers who live in lower-tax states with fewer state-provided services. Taxpayers with substantial employer-provided health insurance benefits receive in-kind compensation that is not taxed, while taxpayers who buy the same health insurance on their own usually pay tax on the income used to purchase the insurance. And Social Security benefits are taxed at a higher rate for married seniors than for those not married. How much or little taxpayers pay in tax is sometimes dependent on where they happen to live, the choices made by their employers, and whether they are married.

The differences in treatment are not always set by design. Rather, the different amounts similarly situated taxpayers often pay is sometimes a reflection of the tax code's complexity. While some taxpayers may take advantage of special provisions that are available to them, others do not. Someone who claims legal credits and deductions has done nothing wrong, yet unequal outcomes suggest that our tax code unfairly benefits those with the time and resources to make sense of it. This situation conflicts with basic principles of equity and erodes public confidence in the system.

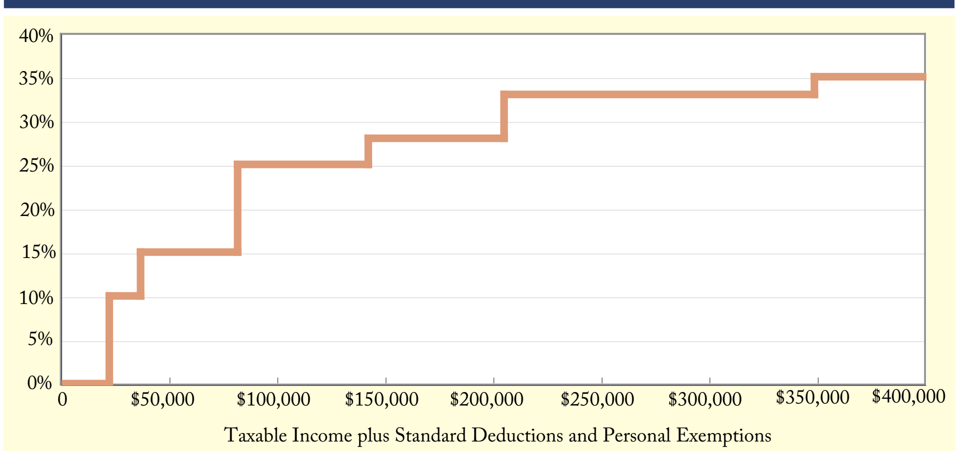
The tax code treats similar income differently. As part of our system of progressive taxation, income is taxed at increasing rates as a taxpayer's annual income increases. This creates a tax rate called the "marginal rate." The marginal tax rate is the rate paid on the last dollar of income earned – it measures how much tax you pay on additional, or marginal, income. The basic tax rate schedule taxes the first $7,300 of taxable income for single individuals at a 10 percent rate. The next $22,400 is taxed at a 15 percent rate. Each block of income is taxed at a higher marginal rate, until a taxpayer reaches the $326,450 level, above which income is taxed at the highest rate of 35 percent.

At first glance, this appears to be a fairly straightforward approach to taxation, but it is not so simple in reality. The effective marginal tax rate can differ substantially from the schedule of basic tax rates described above. This element is complicated by various exclusions, deductions, and credits, and the web of accompanying phase-ins and phase-outs. Some credits and deductions are available to people only when they earn more or less than a certain amount of income. The idea behind setting a limitation on the income one can earn before claiming certain deductions and credits is to target the benefits to those perceived to have the greatest need. But that creates a set of counterintuitive and counterproductive economic consequences that may keep many families from trying to earn more than they currently do.

Let's say you are just offered a great job at $120,000 a year. You are married with one child and your current salary is $80,000. You take the job, right? Not necessarily. The increase in salary might cause you to lose some of the child credit – and subject you to other provisions that increase your total tax bill even more, such as the Alternative Minimum Tax. In all, the pre-tax jump in your new salary may be $40,000, but it could end up costing you an extra $9,203 in tax – meaning that your salary would rise by 50 percent while your tax liability would increase by 140 percent. Not surprisingly, some workers figure this out quickly and avoid taking on work that may pay more, simply because of how the tax code penalizes that extra effort.

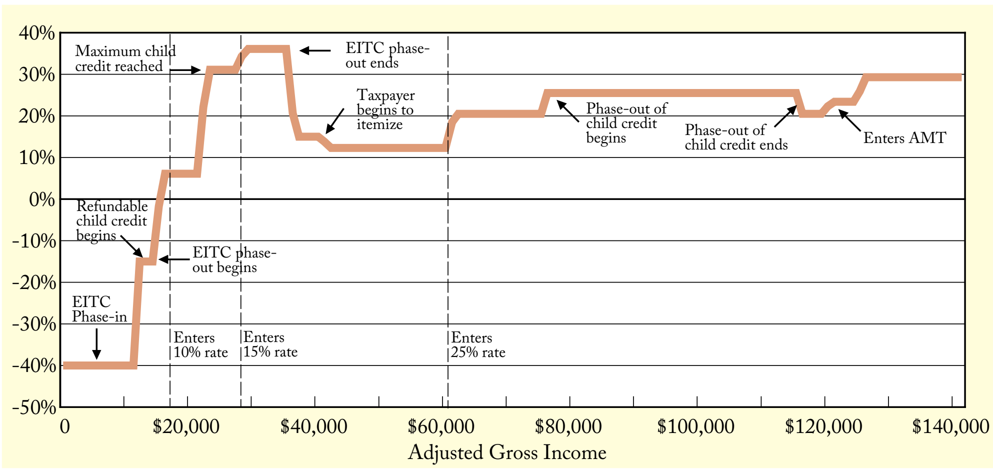
Two charts below illustrate the problem for a hypothetical taxpayer – a single mother with two children. Figure 1.1 shows how she would face a gradually increasing tax rate as she earned additional income if the tax system consisted only of our current schedule of basic tax rates described above, plus the standard deduction and personal exemption.

Figure 1.1. Tax Rate Schedule for a Hypothetical Head of Household with Two Children in 2005



In contrast to this system, Figure 1.2 illustrates the reality of our current system. Low-income taxpayers face very high marginal tax rates, even higher than those with substantially larger incomes. Moreover, even small changes in income can cause large changes in marginal tax rates. For example, our single mother with two children enjoys a *negative* tax rate on each extra dollar of earnings up to $11,000 because she receives a $40 tax credit for every $100 earned through the EITC. As she earns more, however, her tax rate rises sharply. At an income level of $25,000, she pays $31 of tax on each additional $100 earned. So instead of receiving $140 in total wages and tax benefits for each extra $100 earned, she now receives only $69 on every extra $100 of earnings. Figure 1.2 shows how this taxpayer's tax rate shifts as she moves up the economic ladder – and not always in the way you would imagine.

Figure 1.2. Marginal Effective Federal Income Tax Rates for Hypothetical Head of Household with Two Children in 2005



Note: Calculations are for a head of household with two children under 17. Itemized deductions are assumed to be 18 percent of income.
Source: Department of the Treasury, Office of Tax Analysis.

This shifting treatment of one's last dollar of income – far more complex than the basic tax rate schedule – catches many taxpayers by surprise. Yet this shifting treatment does not affect only low-income workers. For example, a married couple with $87,000 of income – somewhat above the national average – and a child in college would be eligible for a tax credit, known as the HOPE credit, to offset education expenses. But if this family has an additional $20,000 in gains from selling stock to pay tuition, they would no longer be eligible for the HOPE credit. Guided by a tax advisor, this family could hold off on selling the stock to maintain HOPE credit eligibility. That is clearly to the family's benefit: The HOPE credit's value, at up to $1,500, is certainly a tidy return for keeping the the stock in their investment account for an extra year. Because the tax code uses income to determine a family's eligibility for federal assistance – and views wealth as immaterial – this family receives a benefit that a less well-advised family does not.

It could be that some well-meaning lawmaker wanted to avoid handing out federal tax credits to high-earning families. But even the best intentions cannot guard against the law of unintended consequences. One such consequence is handing a tax credit to a family that didn't really need it and would have sent their child to college anyway. In this case, the government spent money on a tax benefit that did not change the behavior that it was designed to affect – and thus provided a windfall to the family. Another unintended consequence is that these credits may lead to a higher cost of education for those who do not receive the credits. There is some evidence, for instance, that the credit may encourage colleges and universities to increase tuition, thereby capturing some of the benefit of the credit. A third consequence is that everyone else's taxes are higher.

The Tax Code in Our Lives

Earlier in this chapter, we referred to the "invisible hand," as described by Adam Smith. He observed that the invisible hand of free markets is the force through which individuals and businesses put economic resources to their greatest value. The tax code, however, gets in the way of free commerce and reduces our economic capacity in countless ways. Take health care, for instance. Our tax code treats health care benefits with great deference; they are not treated as income, so those companies that offer health insurance coverage do so as a tax-free benefit to their employees. But that generosity removes many incentives for cost controls, driving up health care costs for everyone, including those whose employers do not offer the same benefits. With virtually no low-cost option for health insurance available, many go without. This situation – a nation divided between those with "Cadillac" insurance coverage and those with none – is exacerbated by our tax code.

The tax code reaches into daily events, and by multiplication of rules and conditions, makes itself into an economic hazard. Yet there are examples of the tax code's failure to account for economic progress when it does occur. In the case of our technology industries, we have a sector of the economy larger in size than health care, and crucial to future job growth and living standards. These technology-based industries depend heavily on how our tax code defines the useful life of all technology. These definitions, laid out in depreciation schedules, permit purchasers of computers and other high-technology equipment to take a deduction against their income for the cost of that equipment over a period of time. The depreciation schedules for technology have always been a source of some controversy; companies routinely discard new computers and other technological equipment after only three years while the depreciation schedules call for a five-year lifespan. Why? Congress based the current depreciation schedule for computers on studies of the useful lives of surplus government typewriters from the late 1970s. Only in our tax code can a late-1970s typewriter be viewed as the same as a high-end, multimedia laptop.

Consider the tax code's impact on savings and consumption: Jack and Jill both earn a dollar and pay 25 cents in taxes on it. Jack spends his 75 remaining cents, while Jill saves it. If Jill's savings gather interest of 20 cents over the next ten years, she will have 95 cents in her savings account. But she will have to pay taxes on the interest income of 20 cents – an extra 5 cents in taxes. In short, Jack pays 25 cents in taxes on his money, while Jill ends up paying 30 cents – simply because she saved while he did not. While the difference may not matter much, spread throughout a $12 trillion economy and tens of trillions of economic decisions (including decisions about how to save for education, health, and retirement), the tax penalty on savings has enormous effects. The nation's personal savings rate, for example, is less than 2 percent. The low savings rate can be explained by many factors, and the tax code is hardly the sole culprit. However, if we want to improve the savings rate, eliminating the tax penalty on savings might be an obvious place to start.

In short, the tax code presents an obvious target for change. Its complexity, lack of clarity, unfairness, and disproportionate influence on behavior lead taxpayers to frustration and many reformers to other lines of work. But we cannot leave this work undone. Without reform, the tax code will consume more energy, more time, more worry, and more economic resources. The effort to reform this complicated mess starts with understanding how we got here. Our tax code has been shaped by goals other than simplicity, by intentions other than helping the taxpayer plan ahead, and by objectives other than expanding our economy. Years of active meddling may have left our tax code in shambles, but it has taught us a valuable lesson: If we are not simplifying our tax code, it is likely to become more complex, more unfair, and less conducive to our economy's future growth. Reform is the only thing that works.

Box 1.2. The Alternative Minimum Tax: A Cautionary Tale

The Alternative Minimum Tax (AMT) is a vivid example of why our tax code is dysfunctional. The minimum income tax, the predecessor to today's AMT, was first enacted in1969 after reports showed a few hundred very wealthy Americans not paying income taxes. Like the minimum income tax of 1969, the AMT is intended to ensure that taxpayers pay at least some income tax and share in the cost of maintaining our government.

But the AMT has a significant flaw: Its definition of high income was never indexed for inflation. Thus, the threshold for AMT liability in 2006 – $45,000 in income for married couples after allowing for AMT deductions – is nearly the same as the $40,000 threshold that was in place in 1982, when the AMT first came into effect. If this figure had been inflation–adjusted, the exemption would be $82,000. Today, many middle-income Americans are above that $45,000 exemption level.

The failure to index AMT income levels for inflation is significant. The AMT, whatever its original strengths and weaknesses, was for many years only a problem for a few thousand high-income families. Now, it is a headache for nearly four million American families and, as shown in the chart below, is projected to affect more than 50 million taxpayers by 2015.

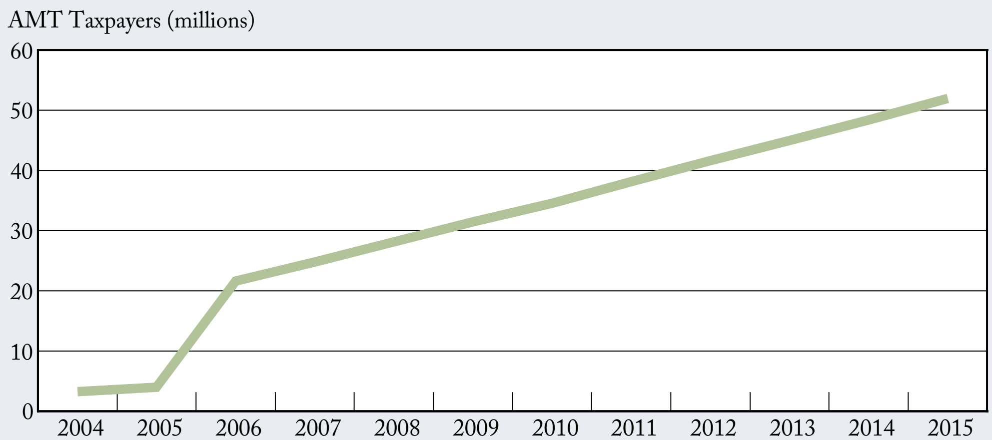
The AMT constitutes a second, parallel tax structure that has its own exemptions, tax rates, and tax credits, and that employs a definition of income broader than that of the regular income tax. Certain deductions available in the "regular" tax code are not available to AMT taxpayers. Taxpayers who have families are especially hurt by the AMT; the marriage penalty is worse under the AMT, and the child-related benefits are lower.

Because of the growing reach of the AMT, millions of taxpayers must now fill out a 12-line worksheet, read 8 pages of instructions, and complete a 55-line form to determine whether they must pay the AMT. Only after making this separate set of calculations to see which tax-owed figure is higher, can a taxpayer file a return – paying the higher amount. Not surprisingly, many taxpayers seek expertise in navigating this maze – 75 percent of AMT taxpayers hire a professional to do their returns for them.

So far, lawmakers have dealt with the problem by passing temporary fixes or "patches" to the AMT to limit its reach on most middle-income families. But after 2005, when the current fix expires, the number of taxpayers projected to be affected by the AMT will rise sharply from 4 million in 2005 to 21.6 million in 2006. Not only will these taxpayers be required to make a second set of calculations to determine their AMT liability, but they will also pay an average of $2,770 more in taxes. By 2015, 52 million taxpayers – 45 percent of all taxpayers with income tax – are projected to be affected by the AMT.

The AMT will increasingly affect upper-middle-income taxpayers – 13 percent of taxpayers with incomes between $100,000 and $200,000 will pay their taxes under the AMT system in 2005, but just one year later, more than 75 percent of taxpayers in this income group will do so.

Taxpayers Subject to the AMT



Note: Assumes 2001 and 2003 tax cuts are made permanent and the temporary AMT provisions are allowed to expire in 2005.
Source: Department of the Treasury, Office of Tax Analysis.

Perhaps not surprisingly, the individual AMT has failed to achieve its goal of making sure all well-to-do Americans pay taxes. The Treasury Department projects that in 2006, in spite of the AMT over 6,600 taxpayers with income greater than $200,000, and over 1,300 taxpayers with income over $700,000, will pay no tax through various combinations of legitimate tax avoidance. What began as a vehicle to focus fairness on a handful of taxpayers has turned into a complex, unfair, and inefficient burden on millions of Americans; few, if any, of those paying the AMT are the intended targets of the tax. The AMT is a salient example of a policy or government program gone astray with unintended consequences carrying malign impacts.

In addition, the corporate AMT subjects many corporations to a second, parallel tax. Like the individual AMT, the corporate AMT has been used to pare back, rather than repeal, tax benefits by partially penalizing businesses that claim tax incentives. Under the corporate AMT, corporations are required to keep an entirely different set of books and records and to calculate their tax liability under two very different complex sets of rules – the regular income tax rules with rates up to 35 percent and the corporate AMT rules with rates up to 20 percent – and then pay the larger of the two amounts.

The corporate AMT is an accounting and administrative nightmare that requires businesses to recompute many deductions using less generous rules. Two witnesses described to the Panel how the existence of these two radically different tax codes with dozens of complex differences between them makes rational tax planning, administration, and compliance exponentially more difficult. In addition, the corporate AMT may exacerbate economic downturns by making corporations that are realizing losses under the regular income tax pay additional taxes when they are losing money.