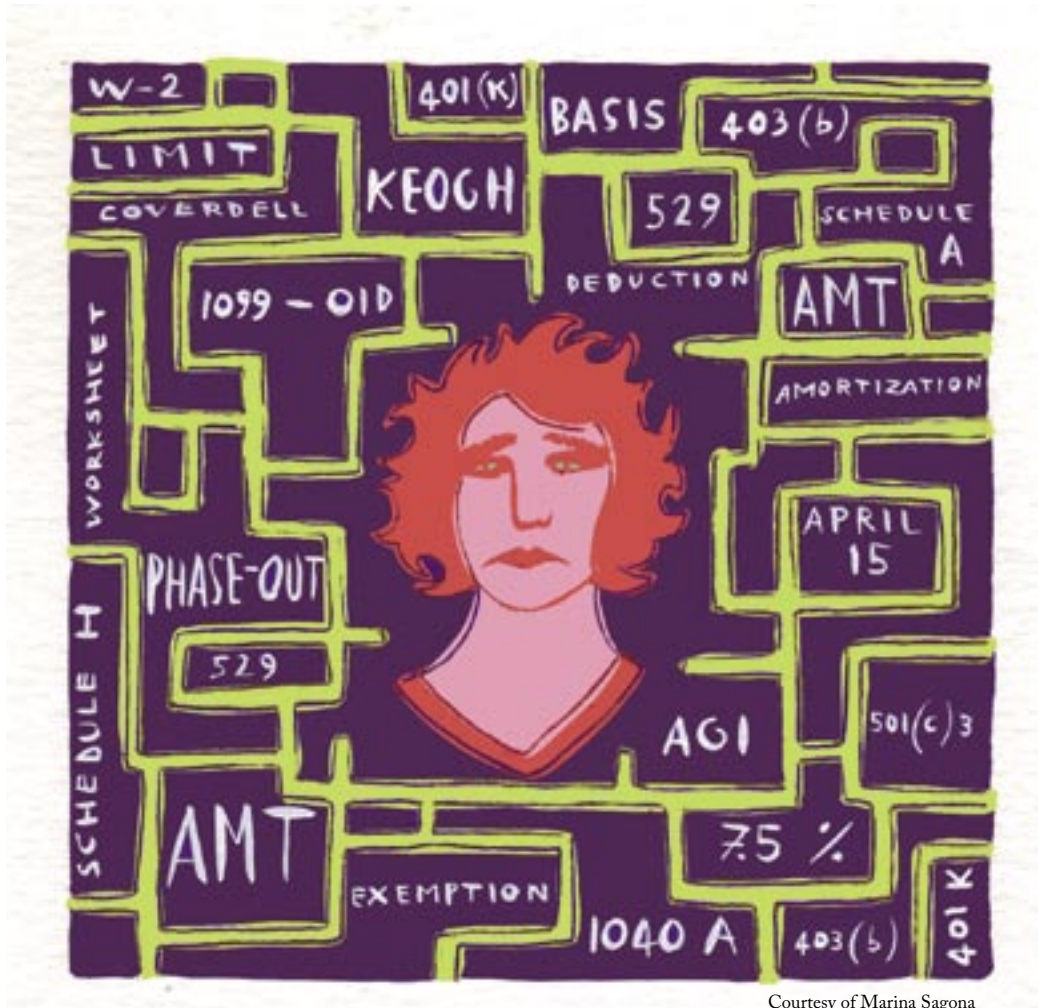


# Chapter Four

## *Our Starting Point*



Courtesy of Marina Sagona

With a firm understanding of the problems in our current tax code, the Panel evaluated numerous proposals to reform the individual and corporate income tax system. The Executive Order directed the Panel to recommend options that would make the tax code simpler, fairer, and more conducive to economic growth, while recognizing the importance of home ownership and charity in American society. Fulfilling all of these objections is challenging. For example, reforms that make the tax system more conducive to economic growth may shift the tax burden toward lower-income households, which some might view as unfair. Improving the fairness of the tax code may require complicated rules and increased data collection, which might work against the goal of simplicity.

In addition to ensuring that the Panel's reform options satisfied these criteria, there were several other constraints that affected the Panel's work. This chapter discusses those constraints, as well as the approaches the Panel took to manage them.

## Revenue Neutrality

The most important constraint on the Panel's recommendations is the Executive Order's direction that all of the Panel's reform options be "revenue neutral." In simple terms, this means that the Panel's options should be designed to collect roughly the same amount of money that the federal government projects it will collect under the current tax system. Although this may seem straightforward, it is not. Numerous projections and assumptions about future policy and behavior must be made – and they all have very important ramifications.



Photo by Ken Cedeno

The first building block is setting a baseline; which is the projection of future federal tax revenues. Different branches of government make different assumptions about future policies and economic data and, therefore, have different baseline estimates. The Panel used the Administration's baseline, which projects that \$17.4 trillion in federal individual and corporate income tax revenue will be collected over the next ten years. The Panel used this baseline because the Panel anticipated that the Secretary of the Treasury and the Administration would use its own baseline in evaluating the Panel's reform options. It is worth noting that the Congressional Budget Office baseline, which assumes current

law, predicts a relatively similar level of revenues (within approximately one percent) during the ten-year budget window.

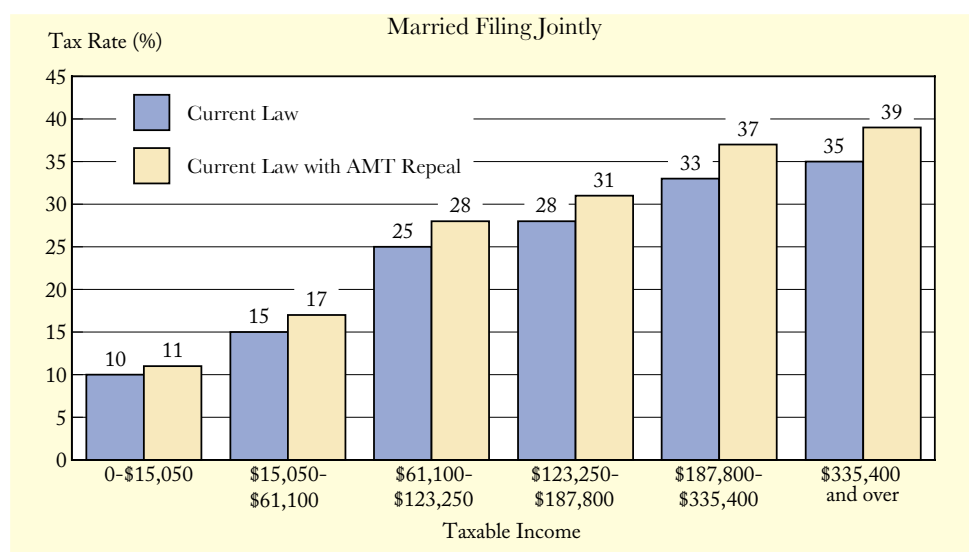
The decision to use the Administration's baseline has a number of important implications. First, the baseline assumes that the 2001 and 2003 tax cuts will be made permanent. Second, it assumes that a current law provision limiting the reach of the Alternative Minimum Tax (AMT) will expire as scheduled after the 2005 tax year. As described in Chapter One, the AMT is a parallel tax system that is steadily affecting more and more taxpayers. The combination of these two assumptions results in a revenue baseline equal to roughly 18 percent of GDP, which is consistent with the historical average for this ratio over the last half century. The Administration has acknowledged the problems caused by the growth of the AMT, and has made it clear that a long-term solution to the AMT problem is an important aspect of the overall tax reform effort.

## The Burden of the Alternative Minimum Tax

The AMT is estimated to generate over \$1.2 trillion in tax revenue over the next ten years. Including anticipated revenues from the AMT in the baseline of future tax receipts makes the Panel's work particularly challenging. Repealing the AMT in a revenue-neutral way requires the Panel to replace the \$1.2 trillion of revenue from the AMT with other changes to the tax code. Recouping AMT revenues inevitably involves other offsetting changes, such as higher tax rates, eliminating tax preferences, or some combination of both. It is important, therefore, that American taxpayers understand that a tax reform proposal that does not repeal the AMT effectively results in a hidden, but real, future tax hike. The AMT currently affects nearly four million American families and is projected to affect more than 50 million taxpayers by 2015.

The Treasury Department estimates that collecting the \$1.2 trillion of AMT revenue by simply raising current tax rates would require an 11 percent across-the-board rate increase. This should result in taxpayers in the 15 percent tax bracket paying tax at a rate of about 17 percent, and those in the 35 percent tax bracket paying tax at a rate of about 39 percent. Figure 4.1 shows the rate schedule that would be needed to raise the same revenue as the income tax and the AMT, but with only the income tax.

**Figure 4.1. Effect of AMT Repeal on the Tax Rate Schedule**



Note: Taxable income brackets are estimates for 2006.

Source: Department of the Treasury, Office of Tax Analysis.

As readers consider the specific rates that are outlined in the Panel's reform options, they should compare those rates to the rates in the above table, which are higher than those in current law. Those higher rates, or some other configuration of higher rates, are the real baseline for the Panel's work, because they are the rates that taxpayers will effectively face if the AMT is left in place. If only changes in the top four brackets were used to raise the same revenue under the income tax alone, each rate would have to be increased by 18 percent. Under this scenario, replicating federal revenues while repealing the AMT would require that the top tax rate be increased from 35 percent to 41 percent.

At the same time, many Panel members recognize that lawmakers are unlikely to allow the full effects of the AMT to hit American families. Congress has extended an AMT "patch" for the past few years, effectively limiting the reach of the AMT. Many observers, therefore, believe that a more realistic starting point for the Panel would assume the continued extension and indexing of the AMT patch. Indeed, there are several proposals currently before Congress that would repeal the AMT without requiring any offset of tax revenues. If these are adopted, the reach of the AMT may be limited, but the federal government would collect far less revenue to pay for necessary government programs in the coming decades.

The Treasury Department estimates that extending and indexing the AMT patch would cost \$866 billion during the next ten years. If the Panel did not need to account for that revenue in its recommendations, individual tax rates could be reduced even further. Later in the report, the Panel will present the lower rates for each recommendation.

### **Limitations of Revenue Estimates**

The next question is how to determine the specific dollar cost or savings of a particular proposal. The Treasury Department's Office of Tax Analysis uses what is commonly referred to as "conventional" or "microdynamic analysis" to score tax proposals. In making their revenue estimates, the Treasury Department's economic models account for the fact that taxpayers respond to changes in tax law, for example, by changing the timing of decisions or changing the mix of assets they purchase. However, these estimates do not account for how those behavioral changes will affect the size of the overall economy. Instead, the Treasury Department holds constant the Administration's projections for the future size of the economy. That means, for instance, that even if a reform option caused the total size of the economy to increase due to more favorable investment incentives, conventional estimates would not incorporate the corresponding increase in revenues.

There are many commentators who are troubled by the limitations of conventional scoring, and thus advocate a different method, often referred to as “dynamic” or “macroeconomic” analysis, particularly for proposals that envision broad or fundamental changes in the tax system. This approach provides estimates of the effect of tax reform on the overall economy.

While dynamic analysis conveys useful information, it is important to remember that the estimation of dynamic effects is also subject to much uncertainty. Dynamic scoring relies on numerous assumptions and the estimates may be quite sensitive to changes in these assumptions. A dynamic scoring model needs to predict, among other things, the effects of tax changes on interest rates, equity prices, labor supply responses, saving, investment, and national income. Building such a model requires economists to make a large number of assumptions concerning how individuals and businesses respond to tax policy and how these responses filter into changes in the macroeconomy and in tax revenues.

Given the number of assumptions and modeling decisions necessary to produce dynamic estimates, it is no surprise that different modeling strategies yield alternative estimates. In fact, when the Congressional Budget Office and the Joint Committee on Taxation perform dynamic analysis, they both report estimates from a range of different macroeconomic models and they include sensitivity analyses to show how their predictions are affected by alternative modeling assumptions.

Some Panel members strongly felt that dynamic analysis should be utilized, but the Panel did not want its tax policy recommendations to be overshadowed by a controversy about the validity of its scoring methodology. Other Panel members believed that there are shortcomings to more dynamic estimating techniques that hamper their usefulness. Therefore, the Panel has relied on conventional estimates as supplied by the Treasury Department to meet the mandate of revenue neutrality. At the same time, the Panel requested that the Treasury Department provide a dynamic analysis of the reform options. This analysis, which is based on three different models (described in the Appendix), suggests that the options could have positive effects on the economy.

## The “Budget Window”

Another dimension of revenue neutrality concerns the relevant time horizon for revenue estimates. The Panel used a ten-year period, which is the current standard in the federal budget process. The use of any budget window raises a number of issues. Under standard conventions, the revenue effect of a proposal is simply the sum of nominal predicted revenues over the budget window – no attempt is made to discount future revenues for the time value of money. Box 4.1 discusses the effect of nominal versus present value estimates on revenue neutrality.

### **Box 4.1. The Effect of Nominal versus Present Value Estimates**

The Treasury Department's ten-year revenue target is based on the nominal sum of annual revenues. In other words, Treasury first estimates the amount of revenue for each year, and then adds those numbers together to arrive at a total amount of revenue for the period. There is no discount for the time value of money. This approach differs from standard business practice – which does use present value discounting. The reason for discounting future revenues is simple: A dollar received at a future date is worth less than a dollar today because a dollar today can be invested to earn interest and deliver more than a dollar in the future.

The use of the convention of summing annual revenues without discounting future cash flows has implications for the Panel's proposals. Here is why: Under the Treasury baseline, the annual revenue generated by the AMT rises during the ten-year budget window. The Panel's proposals, on the other hand, generally have a much more stable flow of revenue. If one were to picture the revenue flow over the budget window it would be an upward sloping line; the Panel's proposals would flatten out that line. For both the baseline and the Panel's proposals, there will be the same total nominal flow of revenues over the relevant period; however, a tax reform proposal that generates a more stable flow of revenues over the budget window, rather than a more rapidly rising flow, will raise *more* revenue than the baseline if the future revenue flows are discounted. Thus, revenue-neutral tax reforms that repeal the AMT would require lower tax rates if the baseline were calculated using present discounted values instead of nominal values.

Using a ten-year period to gauge revenue neutrality requires assumptions about economic conditions that are subject to considerable uncertainty and likely to change substantially over the course of a decade. It is difficult to predict growth in the economy a year from now, let alone the strength of the economy over a longer time horizon.

At the same time, picking any particular budget horizon may provide an incomplete perspective on the revenue consequences of some tax reforms. This problem can be illustrated with two specific reform provisions included in the Panel's recommendations. One proposal is to expand the use of a particular type of tax-preferred savings and retirement account – commonly referred to as a Roth-style account. Taxpayers make after-tax contributions to these accounts, and then can

withdraw the earnings, subject to certain limitations, without paying any additional tax on the income earned on the deposits. Another proposal would allow businesses to immediately write off, or “expense,” capital expenditures rather than taking depreciation deductions for the value of their investments over a defined period of time.

The Treasury Department estimates that introducing or expanding Roth-style accounts results in a slight reduction in tax revenues during the ten-year budget window. This estimate may, however, understate the overall revenue cost of the accounts for a number of reasons. First, the proposal would allow taxpayers to transfer money from traditional IRAs into these new savings vehicles. The revenue estimate assumes that many taxpayers will transfer their savings, producing revenue gains during early years as they pay taxes on money withdrawn from traditional IRAs in return for the benefit of tax-free withdrawals later. Because the taxes on the money in these accounts would have been collected eventually under the current system, but often more than ten years into the future, this transfer of assets has a favorable effect on tax revenues within the next ten years, but it does so at the expense of revenues in future years.

Second, a substantial share of the revenue loss from the reduced taxation of future capital income for each dollar contributed to these accounts occurs outside the ten-year window. When a taxpayer holds assets that would otherwise have been held in a taxable account in a Roth-style account, the Treasury loses revenue from taxes on interest, dividends, and capital gains. This revenue cost accrues for as long as assets are held in these accounts, which may be several decades if the accounts are used for retirement saving. As is summarized in Box 4.2, a rough analysis suggests that for retirement accounts, the revenue cost during the ten-year budget window is roughly one-third of the total revenue cost of this program; two-thirds of the revenue loss is not reflected in the revenue tables provided in this report. For other savings accounts in which the assets are likely to be held for a shorter period of time, the ten-year budget cost is likely to account for a higher fraction of the overall cost. Policymakers should consider the magnitude of these long-term costs.

Box 4.2 also shows that for other provisions, such as expensing of capital expenditures, the revenue estimate for the ten-year budget window may overstate the revenue loss. This is because expensing moves all of the tax deductions associated with a long-lived asset into the ten-year budget window, while traditional depreciation allowances for long-lived assets reduce revenues for a longer time period, in many cases as long as three decades. If one compares the costs of expensing a plant versus taking a hypothetical 30-year straight-line depreciation deduction, using a ten-year budget window may overstate the present value of the tax cost by nearly 25 percent.

### **Box 4.2. Examples of Long-Term Revenue Costs**

The long-term revenue cost of a retirement account contribution depends on several key parameters. The first is the investment horizon of the taxpayer. Assume, conservatively, that each dollar contributed to a retirement account remains in the account for 30 years. For regular savings accounts, the holding period is likely to be shorter.

A second key parameter is the amount of the retirement savings account's investment that would otherwise have been held in a taxable account. This illustration assumes that half of the retirement savings account's balance represents such a transfer.

A third parameter is the investment mix of the retirement savings account's assets. This illustration assumes that 60 percent of the saving in the absence of the retirement savings accounts would have been invested in equities, with 40 percent invested in fixed income assets.

The last key parameter is the tax treatment of saving outside the retirement savings account. Assume that the average tax burden on equity investments is 10 percent, recognizing the 15 percent marginal tax rate on dividends and realized capital gains, as well as the opportunity to defer realization of capital gains, and set the marginal tax rate on interest income at 25 percent.

If equities yield a total return of 8 percent, while bonds yield 5 percent, the taxes that would have been paid on a \$1,000 contribution to a retirement savings account in the first year of this contribution equal \$4.90. In the absence of the retirement savings account, the assets that would have been saved would have grown through time as the after-tax income was reinvested in stocks and bonds. If the investor's asset mix remained 60 percent stocks and 40 percent bonds at all times, then the after-tax return on the whole portfolio would be 5.82 percent. Thus the nominal tax receipts if the saving assets were held outside a regular savings or retirement savings account would rise by 5.82 percent per year.

To find the present discounted value of this revenue flow over the entire 30-year period when assets are held in a retirement savings account, one discounts the foregone tax revenue stream, which grows at 5.82 percent each year, by the government discount rate. If we use a discount rate of 5 percent, thereby assuming that the government can discount the uncertain stream of future tax receipts using a risk-free interest rate, the present value of the foregone revenue over the 30-year life of the retirement savings account's investment is \$164.92. This is 33.7 times the first-year revenue cost of \$4.90. The present discounted value of the revenue cost over the first ten years is \$50.76, or roughly one-third of the lifetime present value cost. For saving accounts where assets are likely to remain in the accounts for a shorter time period, the ten-year budget cost would account for a larger fraction of the lifetime cost.

While retirement savings accounts have larger long-term than ten-year revenue costs, other tax provisions may have smaller revenue costs from a long-term perspective than from a ten year vantage point. Proposals to expense investment in plant and equipment, for example, have a ten year revenue cost that is larger than their permanent cost. Consider switching from straight-line depreciation over a 30-year lifetime to immediate expensing. The present discounted value of the depreciation allowances over a 30-year horizon, assuming again a 5 percent annual discount rate, is 53.8 percent of the plant's purchase cost. The present value component over the first ten years is 43 percent of the purchase cost. This implies that the revenue cost of expensing over the first ten years, which equals 57 percent of the asset's purchase price (100 minus 43), overstates the long-horizon present discounted value, 46.2 percent of the asset's purchase price, by nearly 25 percent.

### **Revenue Estimates Are Not Precise**

The sources of uncertainty in revenue estimates as discussed earlier, and many others that arise from the difficulty of accurately forecasting the behavioral responses of millions of Americans to tax changes, make projections of the revenue yield of tax



reform plans inherently uncertain. The Panel recognizes that revenue estimates are imprecise. Accordingly, upon the advice of the Treasury Department, the Panel has decided to define “revenue neutrality” as being within one-half of one percent of the projected revenue baseline for the next ten years. Some Panel members, however, believe that two percent or more would be reasonable.

### **Tax Reform, Progressivity, and the Distribution of the Tax Burden**

The Executive Order directed the Panel to recommend options for reform that were “appropriately progressive.” As discussed in Chapter Three, the current income tax system is progressive, as it provides exemptions and deductions that shield some income from tax, allows refundable credits, and applies a graduated set of tax rates. All members of the Panel endorsed the goal of a progressive tax structure. Some Panel members felt that the current system has gone too far in removing lower-income taxpayers from the tax rolls and that higher-income taxpayers pay too large a share of federal income taxes. Other Panel members were comfortable with the current distribution or believed that the income tax should be more progressive, with higher-income taxpayers bearing more of the overall income tax burden, because of a concern about substantial inequality of wealth in the country that has grown in the last decades. In the end, the Panel concluded that the appropriate burden of taxation was an issue that elected officials should resolve – and so the Panel decided to design reform options that would remain relatively close to the current distribution of tax burdens.

The Panel relied on “distribution tables” to measure the allocation of tax burdens across households. Such tables are a necessary tool for evaluating tax proposals, but like revenue estimating, creating distribution tables is an imprecise art. Distribution tables are based on an assortment of projections and assumptions about the way various taxes affect the economy and, in particular, how they affect the pretax incomes of various taxpayers.

As explained in Chapter Three, just because someone writes a check to the government, it does not necessarily follow that he or she shoulders the burden of that tax. The Treasury Department prepares distribution tables that generally assume that the corporate income tax is paid by all owners of capital. However, many public finance economists believe that at least some portion of the corporate income tax is shifted from owners of capital (or investors) to labor (or workers) and reflected in lower real wages and living standards. This assumption can make a significant difference in any distributional analysis of corporate income tax reform. Furthermore, the distribution table for 2006 will look different from that for 2015, and a table that assumes no relief from the AMT will differ from a table that assumes either repeal or a patch of the AMT.

This report shows distribution tables for the first year of a proposal, the last year of the budget window, and the ten-year budget window. The Panel also presents tables that distribute half of the corporate tax to owners of capital and half to labor.

**Box 4.3. Thinking about Long-Term Distribution**

Most of the distribution tables shown in this report allocate the tax burden across households, and group households by their current-year income. This approach offers important information on the distribution of tax burdens, but for some households, current income is an unreliable measure of long-term economic well-being. College students, for example, may report low current income, but their long-term earning prospects would place them much higher in the distribution of lifetime earnings. Elderly people with substantial wealth but limited income from their assets may also appear in a low-income category, even though they have been economically prosperous throughout their careers. A taxpayer who separates from a firm and receives a large one-time severance payment, in contrast, may have a current-year income substantially greater than his long-term average or than his future prospects.

Estimates from the Treasury Department, reported in the 2003 Economic Report of the President, suggest that taxpayers exhibit a considerable amount of fluidity across tax rate brackets. Treasury Department researchers calculated the statutory tax rate bracket taxpayers would have faced in 1987 and in 1996 had the Economic Growth and Tax Relief Reconciliation Act of 2001 been in place in those years. The table below reproduces the results from this study. The shaded cells report the percentage of taxpayers in each tax bracket in 1987 (year one) that remained in the same bracket in 1996 (year ten).

**Taxpayers by Rate Bracket Using a Panel of Taxpayers**

Year one tax bracket (percent)	Year 10 tax bracket (percent)							Returns in year ten (thousands)
	0	10	15	25	28	33	35	
	Taxpayers by rate bracket (percent distribution)							
0	33.8	24.7	32.1	7.7	0.8	0.5	0.3	10,360
10	20.1	29.3	40.8	8.8	0.6	0.3	0.1	15,370
15	8.6	13.3	53.4	22.9	1.2	0.4	0.2	50,059
25	3.9	5.1	29.9	51.4	6.7	2.2	0.8	31,427
28	3.3	2.8	11.6	35.9	24.0	14.7	7.5	2,682
33	4.7	2.6	9.1	21.0	18.9	23.9	19.8	1,096
35	5.1	1.9	5.7	10.4	8.8	19.0	49.1	633

Note. Tabulations from 1987-1996 panel of taxpayers. Tabulations include only non-dependent taxpayers present in all years of the panel data set. Each cell entry indicates the percent of taxpayers in a rate bracket in the last year of the panel (i.e., column entry) relative to the number of all taxpayers in that rate bracket in the first year of the panel (i.e., row sum).

Source. Council of Economic Advisers, based on tabulations provided by the Treasury Department

The table demonstrates that there is a substantial amount of movement across rate brackets. More than half of taxpayers were in a different tax bracket at the end of the period than they were in at the beginning of the period (the proportion of taxpayers not on the diagonal). The table also shows that the chance that a taxpayer moves from the highest income tax brackets to the lowest, or vice versa, is relatively low. While this evidence suggests that there is value in constructing distribution tables that categorize households based on a longer-term measure of income and economic status, the standard approach to distributional analysis still focuses on annual income, and so that is the approach followed by the Panel for most tables.

### **Simplicity**

The Executive Order also directed the Panel to recommend options that would simplify the tax code to reduce compliance costs and administrative burdens. The objective of simplicity is related to, and at times is at odds with, the objectives of fairness and economic growth. Unfortunately, our tax code has steadily grown more complex as lawmakers in recent years have almost always sacrificed simplicity in choosing among these competing objectives.

Complexity in our current code arises from a number of sources. Some of the complexity is the result of attempts to make our tax system fairer. Many provisions adjust for taxpayers' ability to pay, but the price is greater complexity. Another significant cause of complexity is the numerous tax preferences in the form of deductions, credits, exclusions, and special rates. Each of these tax preferences requires special computations, eligibility rules, and recordkeeping. Mechanisms designed to target tax benefits to specific taxpayers or limit the amount of tax benefits available – such as phase-outs, caps, floors, and the AMT – are yet another source of complexity. Further compounding these sources of complexity in recent years has been the volatility of changes to the code and the increased reliance on temporary and expiring provisions, which are often the consequence of budget rules seeking to restrain loss of revenue through tax expenditures.

Complexity also affects different groups of taxpayers differently. The Panel analyzed the most significant sources of complexity affecting particular types of taxpayers. For example, complex eligibility rules for refundable credits affect low-income taxpayers; recordkeeping burdens and accounting rules are especially onerous for small businesses, and international rules create significant complexity for multinationals. As discussed in the following chapters, each of the Panel's options addresses these areas of complexity.

Recognizing the importance of simplicity, the Panel determined to make simplification a priority. In many cases, the Panel elected to make features of its options simpler, even though a more complicated design could have been used to better target the provision to provide benefits to specific taxpayers or to achieve other goals.

### **Illustrating the Constraints: A Policy Experiment**

The previous discussion describes the many constraints facing the Panel. At the request of the Panel, the Treasury Department ran a number of policy experiments using income and consumption tax bases, to demonstrate the trade-offs between the choice of the tax base, tax rates, and the distribution of the tax within revenue-neutral policy reforms. The experiments are quite useful in understanding the range of choices available to the Panel in reforming the tax code. The analysis discussed below was presented at the Panel's July 20 meeting. The estimates differ slightly from those in other sections of the report because they were created using Treasury Department tax models that had not been updated for the annual mid-session review of the policy baseline.

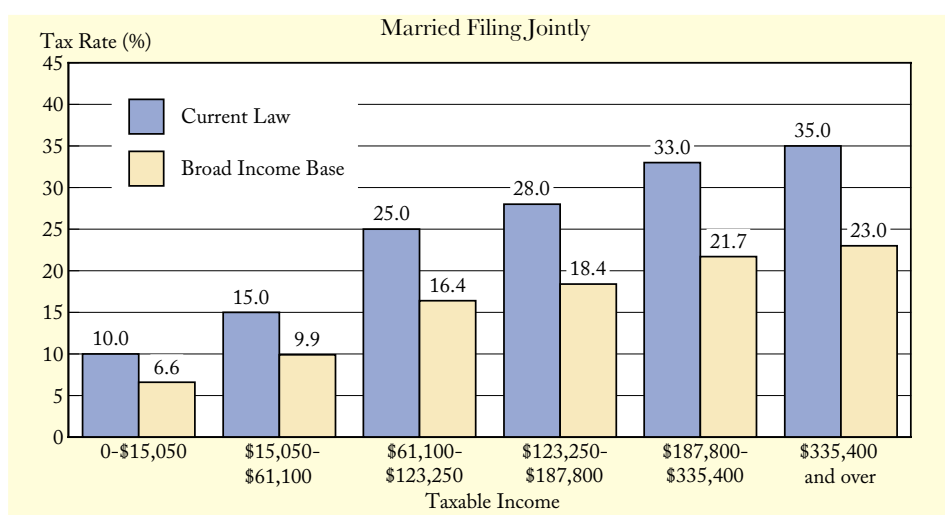
The Panel first asked the Treasury Department to determine the required rate structure to achieve revenue neutrality with a “broad” income tax base. The broad individual income tax base would retain only the standard deduction and personal exemptions. All credits, above-the-line deductions, itemized deductions, and other special preferences in our tax code would be eliminated. The broad base would also eliminate the AMT.

The individual and corporate tax systems would be integrated so that income taxed at the business level would not be taxed again at the individual level; meaning that the double tax on corporate profits would be eliminated. All capital gains would be taxed at ordinary rates, and tax-favored savings or retirement vehicles would be eliminated.

The broad corporate income tax base would eliminate corporate tax preferences. Depreciation deductions would allow taxpayers to deduct the actual decline in the value of a capital asset over the taxable period (which is known as “economic depreciation”). The top rates for the individual income tax and corporate income tax would be equal.

The Treasury Department estimated that adopting this broad base would make it possible to reduce tax rates across the board by about one-third. As Figure 4.2 shows, the lowest individual rate, currently at 10 percent, could be lowered to 6.6 percent, and the highest rate (which also applies to corporate income), 35 percent, could be lowered to 23 percent. Alternatively, the Treasury Department found that the graduated rate structure could be replaced with a single rate of 15 percent and maintain revenue neutrality.

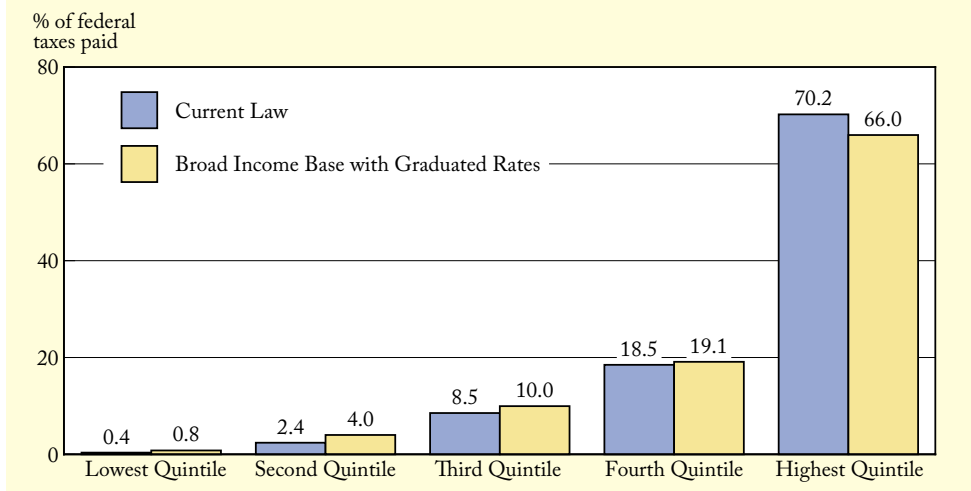
**Figure 4.2. Tax Rate Schedule of Broad Income Base with Graduated Rates**



Note: Taxable income brackets are estimates for 2006.  
 Source: Department of the Treasury, Office of Tax Analysis.

The Treasury Department also estimated the impact of the broad base on the distribution of the tax burden. As shown in Figure 4.3, taxpayers in the highest quintile would pay a smaller proportion of total federal taxes, while taxpayers in each of the other four quintiles would pay a greater proportion of the tax burden.

**Figure 4.3. Distribution of Tax Burden for Broad Income Base with Graduated Rates by Income Percentile**

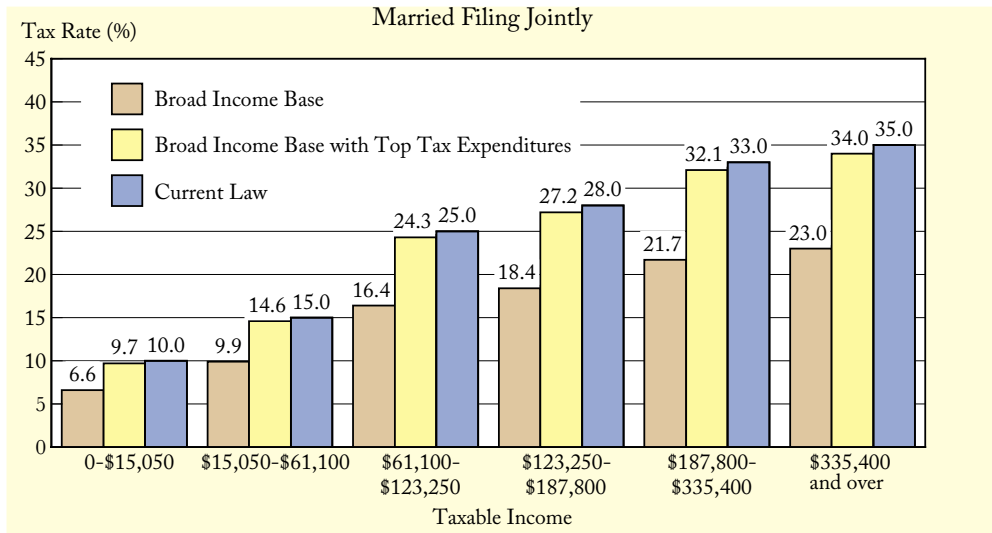


Note: Estimates of 2006 law at 2004 income levels.

Source: Department of the Treasury, Office of Tax Analysis.

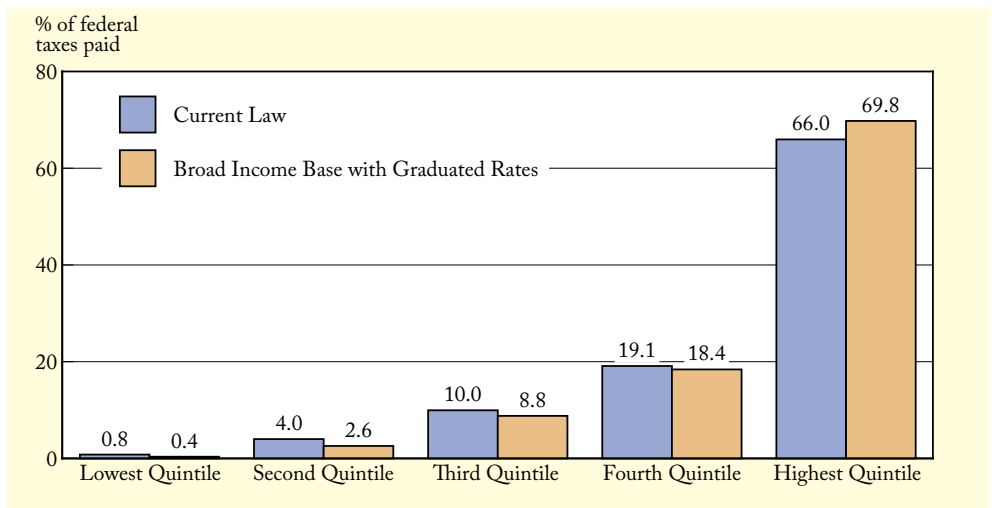
To evaluate the cost of current tax expenditures in terms of both the higher tax rates they necessitate and the distribution of the burden, the Treasury Department ran an experiment that added the top individual and corporate tax expenditures to the broad base. These tax expenditures include the tax exclusion for employer contributions for health insurance and pensions, retirement savings preferences, the mortgage interest deduction, charitable deductions, the EITC, and the child tax credit for individuals; and accelerated depreciation, oil and gas preferences, the manufacturer's deduction, progressive corporate rates, and the research and experimentation credit for corporations. Figure 4.4 shows that adding these tax expenditures to the broad tax base requires tax rates nearly as high as those under current law to collect the same amount of revenue. Figure 4.5 shows that adding the top tax expenditures to the broad base provides a distribution of tax burden that is close to current law.

**Figure 4.4. Tax Rate Schedule for Broad Income Base with Top Tax Expenditures Added Back**



Note: Taxable income brackets are estimates for 2006.  
 Source: Department of the Treasury, Office of Tax Analysis.

**Figure 4.5. Distribution of Tax Burden for Broad Income Base with Graduated Rates and Top Tax Expenditures by Income Percentile**



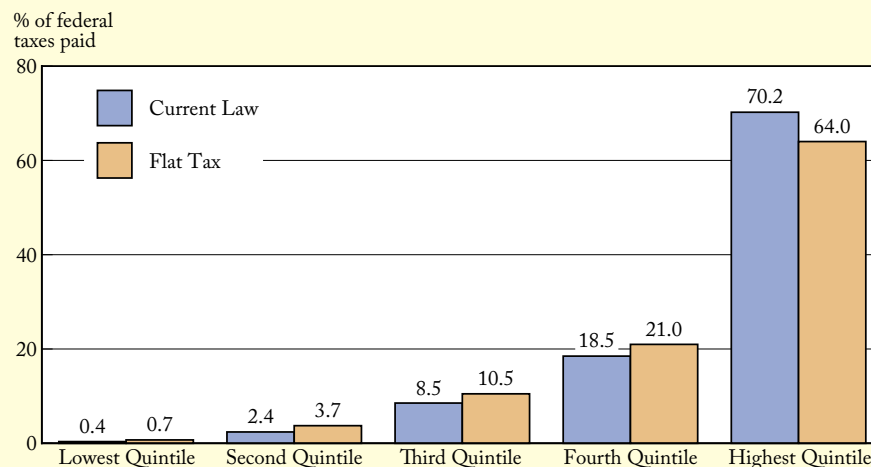
Note: Estimates of 2006 law at 2004 income levels.  
 Source: Department of the Treasury, Office of Tax Analysis.

## Using a Consumption Tax Base

The Panel was also interested in understanding how moving to a consumption tax base would affect tax rates and the distribution of taxes. To answer these questions, the Panel asked the Treasury Department to estimate a revenue-neutral Flat Tax, a prominent consumption tax prototype. The Treasury Department's estimate allowed taxpayers a personal exemption, but eliminated all other tax preferences and the AMT. As described in Chapter Three, the business portion of the Flat Tax is based on cash flow taxation. Businesses do not receive a deduction for interest expense, and can write off all of their capital investments immediately.

The Treasury Department estimated that a Flat Tax imposed on a broad consumption tax base would require a 21 percent tax rate to preserve revenue neutrality. The estimates also showed that the distribution of the tax burden under a standard Flat Tax would be less progressive than the current tax system. Figure 4.6 shows that a standard Flat Tax would significantly increase the portion of the tax burden borne by the first through fourth cash income quintiles relative to the current distribution of the tax burden.

**Figure 4.6. Distribution of Tax Burden for Flat Tax by Income Percentile**

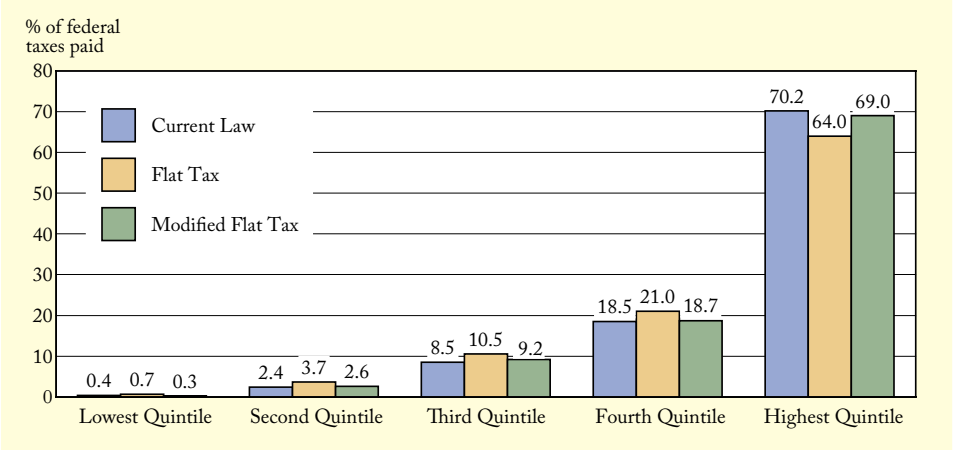


Note: Estimates of 2006 law at 2004 income levels. Individuals would be allowed an exemption amount that in 2006 would be \$13,150 for singles, \$26,300 for married taxpayers filing jointly, \$17,200 for heads of households, and \$6,150 for each dependent.

Source: Department of the Treasury, Office of Tax Analysis.

Consumption taxes can be made more progressive by including graduated rates at the individual level. The Panel asked Treasury to replace the single, flat rate of 21 percent described above with three tax brackets with rates of 15 percent, 25 percent, and 35 percent. The same standard deduction and personal exemption parameters would apply. To even further augment progressivity, the Panel asked the Treasury Department to also include the EITC. As shown in Figure 4.7, with the introduction of progressive rates, the distribution of the tax burden more closely resembles the distribution of the tax burden under current law. Notably, the overall tax burden on families in the first four quintiles increases to a lesser extent than under the standard Flat Tax, and the burden on families in the top quintile is reduced less significantly.

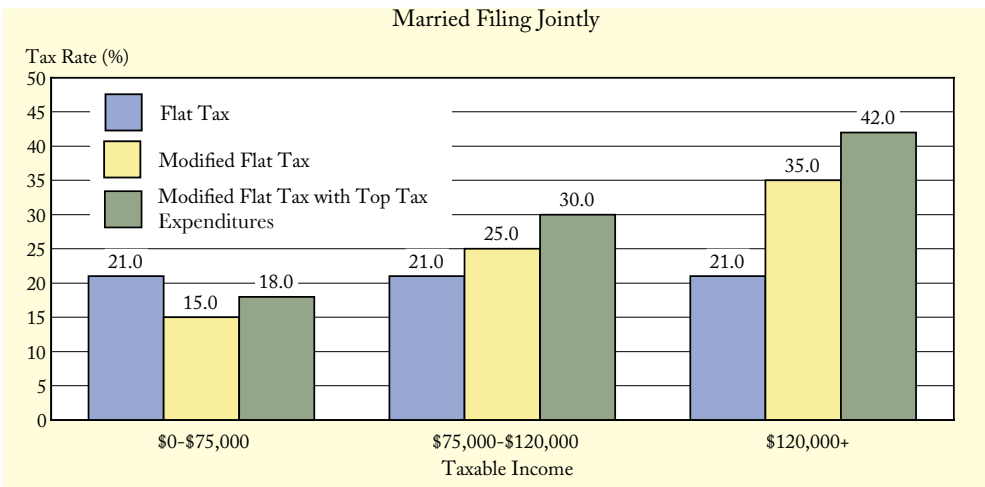
**Figure 4.7. Distribution of Tax Burden: Flat Tax, Modified Flat Tax, and Current Law by Income Percentile**



Note: Estimates of 2006 law at 2004 income levels.  
 Source: Department of the Treasury, Office of Tax Analysis.

The Panel then asked the Treasury Department to estimate the tax rates that would be required to implement this revenue-neutral modified Flat Tax with the top individual and corporate tax expenditures. In particular, the Treasury Department added back the exclusion for employer contributions for health insurance, the mortgage interest deduction, charitable deductions, and the child tax credit for individuals; and oil and gas preferences, the manufacturer's deduction, progressive corporate rates, and the research and experimentation credit for corporations. Retirement savings preferences and accelerated depreciation were not included because the tax base is consumption.

**Figure 4.8. Tax Rate Schedule: Comparison of Flat Tax and Modified Flat Taxes**

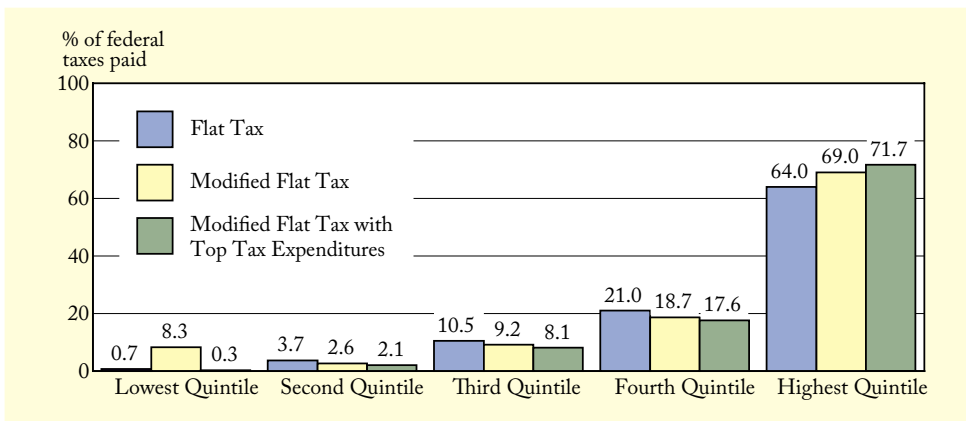


Note: Taxable income brackets are estimates for 2006.  
 Source: Department of the Treasury, Office of Tax Analysis.



Figure 4.8 shows that tax rates must be substantially higher to support a modified Flat Tax that also includes the top tax expenditures. To keep the same exemption amounts and bracket structure while adding the top tax expenditures, the top tax rate would have to rise from 35 percent to 42 percent, the middle rate would rise from 25 percent to 30 percent, and the lower bracket would rise from 15 percent to 18 percent. These large increases in tax rates highlight the importance of a broad tax base for maintaining low tax rates. Figure 4.9 compares the distribution of tax burden under the Flat Tax, the modified Flat Tax, and the modified Flat Tax with the top tax expenditures. Adding the top tax expenditures to the tax base increases the proportion of taxes paid by the highest quintile, decreases the proportion paid by the second through fourth quintiles, and has little effect on the lowest quintile.

**Figure 4.9. Distribution of Tax Burden by Income Percentile: Consumption Taxes with Top Tax Expenditures**



Note: Estimates of 2006 law at 2004 income levels.  
 Source: Department of the Treasury, Office of Tax Analysis.

These policy experiments demonstrate the trade-offs that are inherent in any effort to reform the tax system. Lower rates can be achieved by broadening the tax base – but once the major tax preferences are added back to the tax code, maintaining revenue neutrality means that rates need to rise to their current levels or higher. Similarly, any major changes in the tax base or the inclusion of certain tax expenditures causes significant changes in the current-law distribution of taxes. It is important to recognize these constraints and trade-offs in evaluating the Panel’s options for reform.