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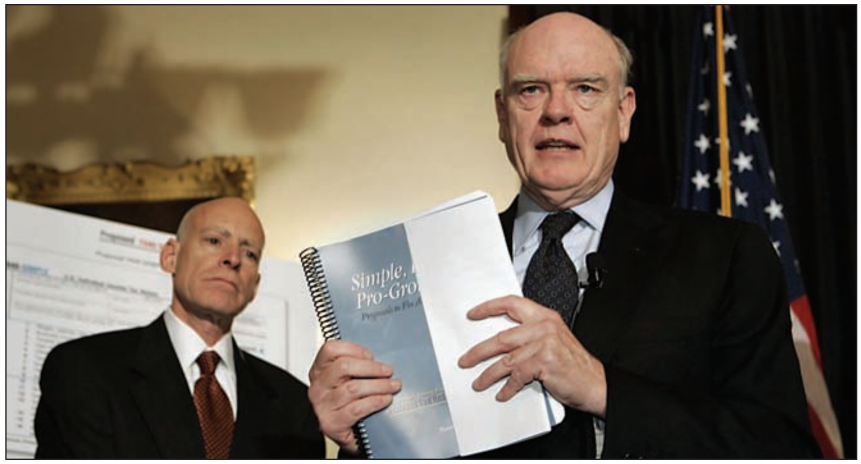
By Edward A. Morse, Professor of Law
and McGrath North Mullin & Kratz
Endowed Chair in Business Law

Semper Reformanda:
A Primer on Tax Reform

Reform is an ongoing human activity. It proceeds from two potentially dissonant conditions: dissatisfaction and hope. Dissatisfaction can lead to despair. Thankfully, not all of us remain in that condition. Optimists among us believe that change is possible, that fault or error can be corrected, and that better days are ahead. The process of change is never complete, as something always needs improving; we are never satisfied that we have gotten it quite right.

Reform processes are fundamentally complex. We must first agree that a problem needs fixing. We must then discover the appropriate means to fix it. Some learning is advisable; after all, we don't want to make the problem worse. We then face the further challenge of coming to agreement without starting a major conflagration. Since human nature is involved, the process is not always predictable.

This article discusses the ongoing process of federal tax reform, which continues to present challenges in the new millennium. It seems that we can only reach agreement at the level of dissatisfaction: Most people believe the tax system is too complex and inefficient. However, the prescription for improvement seems to elude us, as the Tax Code continues to grow more complex and specialized. Congress has tinkered frequently with the Tax Code. According to the President's Advisory Panel on Federal Tax Reform, Congress has enacted nearly 15,000 changes in more than 100 different acts since 1986. However, formidable barriers favor the status quo, causing most changes to be modest and, in recent years, of only limited duration.



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Treasury Secretary John Snow presents the report by the President's Advisory Panel on Federal Tax Reform on Nov. 1, 2005, at the Department of the Treasury in Washington, D.C., as panel member Edward Lazear, left, looks on. The panel presented recommendations for two designs that would rewrite virtually every tax law for individuals and businesses.

Federal Government Finance: The Big Picture

Republican victories in recent elections have given control of the legislative and executive branches of government to people known for a philosophical commitment to lower taxes and smaller government. They have generally delivered on the promise of lower tax rates, but a smaller government has not materialized. (Query whether the fact that some of our leaders are from Texas, where everything is supposed to be big, has contributed to this phenomenon.)

Government spending has been growing. Unfortunately, revenue growth has not kept pace with spending growth, leading to budget shortfalls. Figure 1 (left) gives us a picture of federal government receipts and outlays since 1986, with estimates for 2005-10.

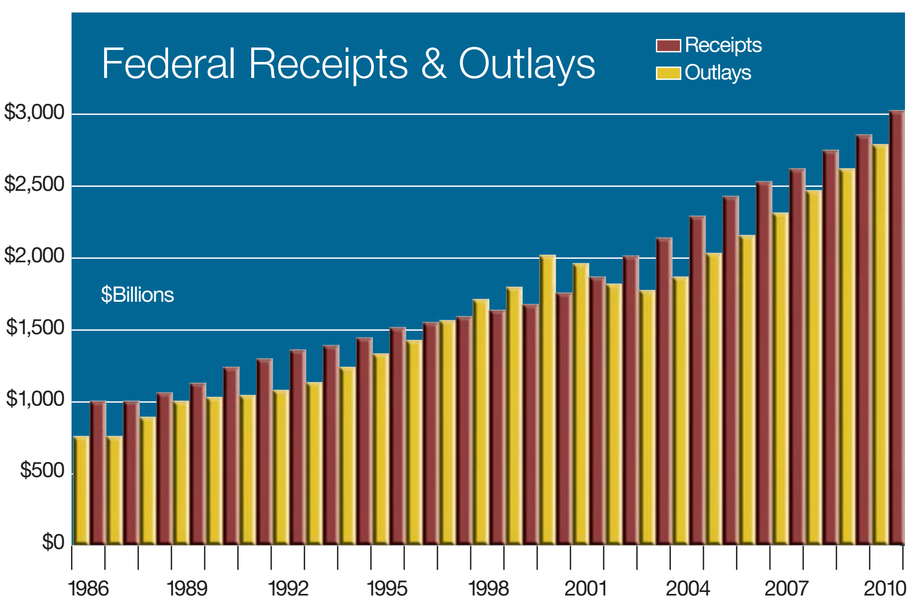

Figure 1: Federal Receipts and Outlays (1986-2004, 2005-10 est.)
(Source: Budget of the United States Government, FY 2006)

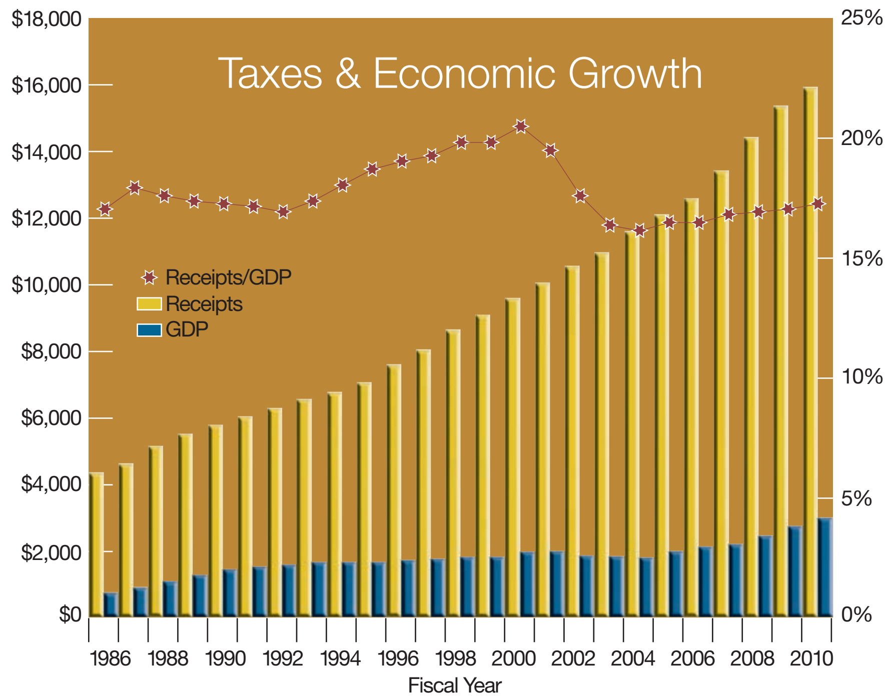

Figure 2: Taxes and Economic Growth (1986-2004, 2005-2010 est.)
(Source: Budget of the United States Government, FY 2006)

Borrowing makes up the shortfall between outlays and receipts. Given the track record shown in Figure 2 (above), slowing spending growth appears difficult to accomplish. However, revenue growth has indeed occurred during this period of general economic expansion. Figure 2 provides another picture of the relationship of tax receipts to economic growth. Both trends are upward, though the percentage of tax receipts to Gross Domestic Product (GDP) has fallen somewhat since 2000. The tax cuts enacted in 2001 and 2003 are partly responsible for this decline. Also responsible, however, is the fact that GDP does not include capital gains, which are included in the tax base. Optimism about future growth reflected in capital appreciation thus affects tax receipts along with actual economic progress.

Of course these figures include all kinds of government receipts, including significant revenues from Social Security taxes. The breakdown of revenue sources can be seen in Figure 3 (below left) that covers federal budget receipts since 1990, with estimated figures for the years 2005-10. As illustrated, taxes on individuals fund most of the government and its programs. For fiscal year 2004, individual income taxes totaled $808 billion, about 43 percent of total receipts of $1.88 trillion. Social insurance and retirement receipts totaled about $733 billion, or about 39 percent of the total. (Although half of these taxes are nominally imposed on an employer, it is fair to say that the real burden of these taxes falls on the employee, who receives less for his or her services because of these taxes.) Corporate income taxes amounted to only $189 billion during this period, or about 10 percent of the total. Other sources round out the remaining 10 percent. As you will also note, these other sources are relatively stable over time; long-term growth occurs primarily from receipts from individuals.

Social insurance taxes fund Medicare and Social Security payments to older Americans, along with disability benefits to eligible beneficiaries. The current system for funding those benefits is

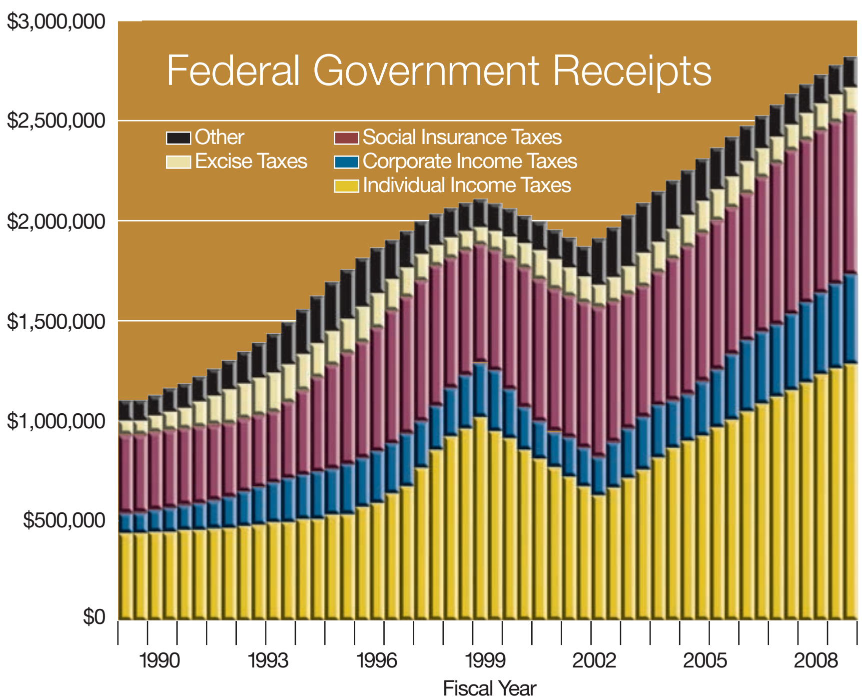

Figure 3: Federal Government Receipts (1990-2004, 2005-10 est.)
(Source: White House Budget Office, FY 2006 Budget Historical Tables)

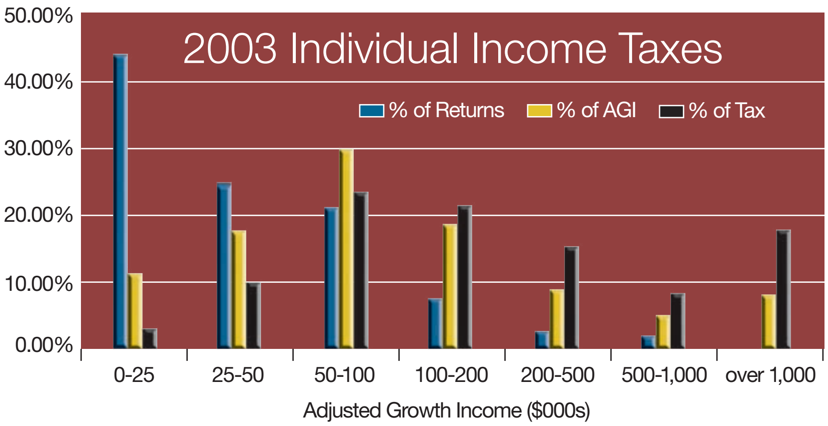

Figure 4: 2003 Individual Income Taxes: % of Returns, % of AGI and % of Tax by Income Strata (Source: IRS Statistics of Income, Fall 2005)

nearing a tipping point in 2017 where the cost of annual benefits will outstrip annual receipts from taxes. This is a matter for concern, as excess revenues currently fund other government spending. When these funds are no longer available, the government will have to seek other financing sources. A detailed analysis of Social Security financing is beyond the scope of this article, but it should be noted that these financing demands may also affect future policymaking regarding other tax sources.

The Income Tax: Who Pays, at What Rates?

Given the significance of the income tax to federal government finances, it is easy to see why so much attention is focused on this topic. One of the principal advantages of a tax focusing on annual income flows is the ability to tax those who, generally speaking, have the greatest ability to pay. However, a disadvantage is that those with the greatest ability to pay may also be the most productive citizens. As a result, an income tax can be viewed as a tax on productivity. There is an old saying that you should tax what you want less of, and this dimension of the income tax is a source of consternation.

Figure 4 (above) shows some key figures for tax returns filed in 2003, the most recent year for which specific data has been compiled by the IRS. As you can see, nearly half of all tax returns are filed by taxpayers with annual income of $25,000 or less. Many of these are not full-time earners, and students or retirees with part-time employment are included in this demographic group. These taxpayers earned about 11 percent of the total adjusted gross income, but they paid only 2.3 percent of the total taxes. Some in this group pay no income taxes at all, but instead receive refundable credits such as the Earned Income Credit. At the other extreme are those earning more than $1 million annually. This is a small group that constitutes only 0.14 percent of all returns, but they report 8.5 percent of the total income and pay 17.7 percent of the total income taxes.

The progressive nature of our income tax system can be seen by comparing the percentage of income (the yellow bar) with the percentage of taxes (the black bar) in each category in Figure 4. Those earning more than $100,000 comprise about 8.8 percent of all returns, and they report about 40 percent of all income. They also pay nearly 64 percent of all taxes. In contrast, those earning below $100,000 reported 60 percent of all income, but paid only 36 percent of all taxes.

Progressivity can also be seen in the tax rates applied to income. Every tax is the product of a rate times a base. For an income tax, the base is taxable income, and rates are graduated based on income amounts. The nominal rate structure for a married couple in 2005 can be seen in Figure 5 (left).

However, this structure is deceptively simple. First, it omits the effects of so-called “phase-out” provisions that raise the marginal tax rate (i.e., the tax rate imposed

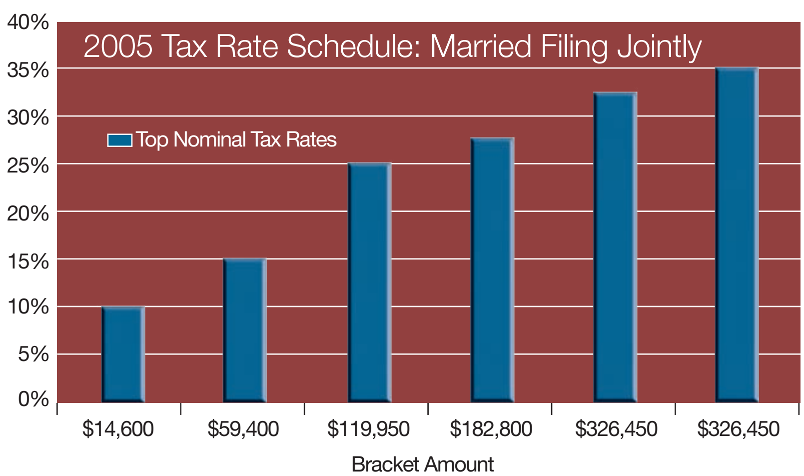

Figure 5: 2005 Tax Rate Schedule: Married Filing Jointly (Source: Rev. Proc. 2004-71)

on the last dollar earned) by removing other tax benefits. To illustrate, suppose that a married couple earning $110,000 is otherwise eligible for a $1,000 credit for their dependent child. Based on the rate schedule in Figure 5, that taxpayer would be in the 25 percent bracket for each dollar earned up to $119,950. However, this taxpayer faces an effective rate of 30 percent on their next thousand dollars of income due to a phase-out of the child credit. (To be precise, the tax would be $50 on the next dollar of income after $110,000, as the Tax Code prescribes a limitation by reducing the allowable credit by $50 for each $1,000 or fraction thereof in excess of the prescribed threshold.)

Second, the rates in Figure 5 also don't reflect preferential treatment given to taxpayers with income from equity investments, such as mutual funds or stocks. Long term capital gains and qualified dividends are now taxed at a maximum rate of only 15 percent. This preferential rate compensates for the fact that capital income is potentially subject to multiple levels of tax by other taxpayers. However, receipt of this income may well push the taxpayer into a higher tax bracket for other income, thus effectively reducing the benefits of the preferred rate. Moreover, this rate structure will expire in 2009, unless Congress works out a compromise to extend it.

And there is one more dimension not included in these rates: the Alternative Minimum Tax (AMT). This tax is a separate system with a completely different tax base at nominal rates ranging from 26 to 28 percent. (Even these rates are deceptively simple, due to phase-out provisions operating like those previously described.) The AMT base is broader than the income tax base because it eliminates certain tax benefits, like state and local tax deductions, that are otherwise available to reduce the regular tax burden. Though originally designed to prevent the very rich from paying too little tax, Congress has failed to index this tax to take into account inflationary effects. As a result, more than 2 million taxpayers owed this tax in 2002, and the Congressional Budget Office estimates that the affected population will grow to 30 million taxpayers by 2010 if changes are not made. An even greater number must compute their income taxes under both regular and AMT methodologies, thereby increasing compliance costs. Fixing this will be costly, however. The President's Advisory Panel estimates that $1.2 trillion will be raised by the AMT over the next 10 years.

What is the Proper Income Tax Base?

As noted previously, rates are only one dimension of an income tax. The other is the base: the amount of taxable income. Congress can expand or contract the base by providing additional deductions in computing taxable income. It can also affect the amount due by allowing for credits that directly reduce tax liability.

The nature and extent of these deductions and credits presents another matter of complexity which goes to a fundamental question: What is the purpose of the income tax system? If your answer to that question is, "Of course, it should be used to raise revenue to fund government programs," then you get only partial credit. Perhaps that should be the answer, but it has gotten much more complex than this.

The Tax Code is used to accomplish many social and economic goals apart from raising revenue. To name just a few, it facilitates a social welfare program that provides payments to eligible citizens through the Earned Income Credit, incentivizes the purchase of hybrid vehicles through deduction and credit provisions, stimulates capital investment through credits and special deductions, and subsidizes health and welfare benefits for employees by exempting them from taxation. All of these functions may be desirable or good, but they add complexity and they significantly reduce the tax base. As a result, rates have to be much higher to accomplish the same revenue stream. Stated differently, we could have much lower rates with an expanded base. The President's Advisory Panel has indicated that a flat rate of 15 percent would generate the same revenue if the base was broadened to eliminate the most significant of the current base reductions. Alternatively, graduated tax rates could range from 6.6 to 23 percent, instead of 10 to 35 percent under the current system.

The concept of "tax expenditures" describes the items that could legitimately be included in the base of an income tax, but which instead are excluded from the tax base to accomplish other policy goals. The term reflects the view that these items are akin to expenditures of federal tax revenues that are not collected. Figure 6 (right) lists several of the largest categories for tax expenditures outlined in the 2006 Federal Budget.

Provisions favoring home ownership top the list, with total lost revenue of more than $760 billion over the next five years. Employer provided health benefits follow closely behind with a comparable cost. But other items also provide large holes in the government's revenue collecting net, which reflect benefits to targeted groups. Such benefits are effectively paid for by less favored groups. For example, deductions for state and local taxes provide an effective

Selected Tax Expenditure Estimates (Ranked By 2006-10 Total in $ Millions)

Home Ownership Provisions:	2006	2006-10
Deduction of mortgage interest	76,030	445,540
Deduction for property taxes on homes	14,830	68,140
Capital gains exclusion on home sales	36,270	247,180
Total Home Ownership Benefits	127,130	760,860
Exclusion of employer contributions for medical benefits	125,690	760,240
Retirement Savings:		
Exclusion for pension contributions and earnings re: 401(k) plans	48,140	283,410
Exclusions re: employer plans	51,050	241,030
Exclusions re: Keogh Plans	9,980	58,670
Exclusions re: IRA	7,310	32,850
Total	116,480	615,960
Deductions for Charitable Contributions:		
Charitable contributions other than education and health	32,550	185,460
Charitable contributions: education	3,680	21,390
Charitable contributions: health	3,670	20,930
Total	39,900	227,780
Excluded capital gains due to step-up in basis at death	28,760	164,420
Child credit	32,810	164,030
Deduction of state and local taxes other than property taxes on homes	34,620	163,240
Capital gains preference	28,370	144,190
Excluded interest on life insurance savings	24,070	143,610
Exclusion of interest on tax exempt bonds	26,610	136,840
Exclusion for Social Security benefits	19,770	106,120
Deduction of medical expenses	9,140	54,770
Deduction for U.S. production activities (§ 199)	5,420	52,930
HOPE scholarship credit	3,220	16,890

Figure 6: Selected Tax Expenditure Estimates
(Source: Budget of the United States, FY 2006, Table 19-3)

subsidy for those living in high-tax states, which are not enjoyed by those living in states with parsimonious legislatures providing low taxes and presumably low public services.

The matter of home ownership is a particularly striking example of a targeted benefit, which nevertheless enjoys broad appeal. A mortgage interest deduction provides an effective federal subsidy that is unavailable to an individual who chooses instead to rent his dwelling. In this sense, the mortgage deduction distorts investment decisions away from other assets and toward home ownership. A citizen who lives in an apartment and chooses to invest in stock is worse off, tax-wise, than if he or she made a comparable investment to become a homeowner.

By structuring this benefit as a deduction (rather than a credit), the value of the subsidy increases depending on one's marginal tax rates. A deduction of $10,000 in mortgage interest receives a subsidy of only $1,500 to a taxpayer in the 15 percent bracket, but up to $3,500 for a taxpayer in the highest income bracket. (As noted previously, phase-outs affect higher income taxpayers, making it difficult to state the precise benefit with precision.) Lower income taxpayers, who are not eligible to itemize their deductions, effectively get no subsidy. The deduction is limited to $1 million of purchase-related indebtedness, which limits the scope of this benefit for higher-income taxpayers, but these income differences remain.

Geographical differences also exist, which affect the equity of deduction limits. A $1 million debt limit in Nebraska allows a taxpayer to own a large and spacious home, whereas a similar amount in Manhattan might purchase only a small space. The current Tax Code ignores these geographical differences, which also impact the related benefit of an exclusion of up to $500,000 in capital gains by a married couple selling their home.

The President's Advisory Panel offered several proposals in the area of home ownership, including limits on deductibility of mortgage interest that varied by geographic region and an alternative credit provision for mortgage interest. Oddly, however, it also argued for increasing the exclusion for capital gains on home sales, thus adding to the tax expenditures in this category.

As for employer-provided health care benefits, their payment with pretax dollars may be contributing to the growth in health care costs. The Panel recommended a cap on the exclusion of benefits per employee, thus making excess expenditures taxable compensation for employees.

Tax Benefits as Entitlements: Barriers to Change

It is easy to recognize that our tax system could be simplified. It is also easy to see how simplifying changes would affect different interest groups, particularly when those changes might expand the tax base by eliminating preferences for particular groups or activities. Complexity is itself an enemy of change, as it requires considerable effort to understand the status quo and the effects of adopting a different approach. This may explain why incremental changes, as opposed to more radical proposals such as consumption-based tax systems, have been enacted. Legislators have a hard time understanding tax changes even with the aid of expert staffs; how much more the citizens they represent, who must occupy themselves with the business of earning a living and paying their taxes.

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The self-interest that we wish to harness through a market-based economy also works in the market for tax benefits. Once a benefit is granted, it is hard to take it away without producing a negative economic impact of some kind. The home mortgage interest deduction is a case in point. Let's assume a taxpayer in the 25 percent bracket is eligible to benefit from a mortgage interest deduction. My own calculations show that this taxpayer may receive tax benefits with a present value of as much as $18,000 per $100,000 borrowed over the life of a 30-year, 6 percent mortgage. Stated differently, this means she can afford to buy a bigger house, or alternatively that she can pay more for the same house. Reducing the tax benefits from mortgage interest would probably reduce real estate values, which are likely to reflect this tax subsidy. Change may thus affect more than future tax bills; laws of unintended consequences also operate in this environment.

Political rhetoric can also obfuscate the benefits from tax reform. It is profitable to serve the interests who have been successful in reaching the status quo. By benchmarking the distributional analysis of tax changes to the current system, changes that result in lower rates or incentives for productivity are subject to criticism on the ground that they favor the "rich." To the extent that a large number of citizens in lower income brackets pay no income taxes at all, or even receive money from the income tax system as a result of refundable credits, it is a foregone conclusion that the dollar value of tax reductions will accrue to those in higher economic strata, as they are paying the bulk of all current taxes. Though equity issues need to be considered, benchmarking to the status quo is a political reality that obfuscates potential merits of tax reform proposals, which can include achieving economic growth or removing distortions in economic choices under the current system.

Growing the economy is perhaps the most politically popular way to raise revenues and to benefit citizens of all income levels. Evidence is mounting that lower taxes are conducive to economic growth, but that growth takes time. Personal income tax receipts have nearly returned to levels achieved in 2000, prior to tax cuts enacted after the devastating blows of the terrorist attacks in September 2001. Growth also requires stability. Uncertainties generated by expiring tax benefits enacted earlier in this decade mean that longer-term incentives for investment prove unrealized. We can do better.

Finally, we face real challenges from international competition, which will continue to influence domestic tax policies, particularly in the area of business taxes. A recent study by the Organization of Economic Cooperation and Development (OECD) found that U.S. effective tax rates on business income was higher than in many of our foreign competitors. Modern capital mobility cannot be ignored.

There is more to be said about tax reform, and you will continue to hear about it in the days and years to come. For those who want to know more, I recommend the President's Advisory Panel report, which is entitled "Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System." It is available at: *www.taxreformpanel.gov/index.shtml*. From time to time, I also comment on tax reform issues on a web log (blog) shared with colleagues from economics and political science, located at: *www.economictrends.blogspot.com*. You are welcome to join the conversation.

Photo by Mark Romesser

About the Author: Edward A. Morse is professor of law at Creighton University. He was recently appointed as the inaugural holder of the McGrath North Mullin & Kratz Endowed Chair in Business Law. Morse's scholarship and teaching focuses on business and taxation issues. His articles have appeared in the *Florida Tax Review*, the *Cornell Journal of Law and Public Policy*, the *De Paul Law Review*, the *Dickinson Law Review*, the *Creighton Law Review* and the *Journal of Taxation of Investments*. Most recently, he has been working with colleague Ernie Goss, Ph.D., holder of the McAllister Chair in Economics in the College of Business Administration at Creighton, in research on the casino gaming industry. Their book, *Governing Fortune*: *Casino Gambling in America*, is to be published this fall by the University of Michigan Press. He can be reached at *morse@creighton.edu*.