# THE 2011 CONGRESSIONAL "SUPER COMMISSION'S" TAX POLICY RECOMMENDATIONS AND THE 2010 NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM'S RECOMMENDATIONS ON REFORMING THE U.S. TAX CODE: A COMPARATIVE POLICY ANALYSIS

**Fitzsimons, Adrian P.**
**St. John's University**

**Silliman, Benjamin Rue**
**St. John's University**

***ABSTRACT***
*In December 2010, the National Commission on Fiscal Responsibility issued its findings on issues involving discretionary spending cuts, saving Social Security, reforming the tax code, along with other proposals aimed at reducing the federal budget deficit and national debt. In its findings on tax reform, the National Commission proposed several recommendations to reduce individual income tax rates by reducing or eliminating a majority of the existing tax expenditures. In addition, it offered recommendations aimed to reforming corporate tax rates and eliminating tax loopholes. In August 2011, as part of the compromise to allow a temporary increase to the federal debt ceiling, Congress created a "super committee" of members who were charged with developing proposals to eliminate the federal budget deficit and national debt. The proposals crafted by this "super committee" will be compared to the National Commissions' proposals to determine the extent the bi-partisan Commission's findings were considered in preparing legislative measures to deal with this major fiscal crisis plaguing the U.S. economy. This paper will allow readers an opportunity to closely examine the specific findings in both sets of proposals as Congress and the White House take the next steps in the policy development process.*

## THE DEBT CEILING CRISIS: PROPOSALS FOR ELIMINATION

The United States recently reached its "moment of truth," by having to cut federal spending significantly in an effort to prevent the U.S. from defaulting on its U.S. Treasury bonds. During the month of July, 2011, members of both political parties met with the President Barack Obama to craft a plan that would reduce spending, raise revenues, and ultimately raise the debt ceiling. The negotiations were complicated and mirrored some of the more unharmonious policy debates that occurred over the last twenty-one years: the 1990 budget debate, the 1995 budget debate that shut down the federal government for several days, the 2009-10 debate to create a federal healthcare program, and other minor dustups. Many of these major debates resulted in positive policy outcomes for the nation over time. However, what was unique about this debate in 2011 is that the composition of the U.S. House of Representatives includes approximately 60 recently elected members of the Republican Party who are members of the Tea Party Caucus. These

members came to Washington, D.C. with an agenda of reducing federal spending and cutting the national debt.

During the negotiations with the White House, House Speaker John Boehner attempted to carve out a deal with the Obama Administration by allowing significant spending cuts with some minor tax increases. The proposed revenue enhancements (tax increases) equaled approximately 25 percent of the package, with the remaining 75 percent coming from cutting revenue expenditures (federal spending programs). There was no apparent discussion of raising rates by the congressional leadership and the White House, but some members of Congress suggested raising the rates on taxpayers earning over $1,000,000. Members of the Tea Party Caucus argued that cutting tax expenditures from the U.S. Tax Code was a tax increase on businesses and balked at the proposal. The Caucus's argument was that raising taxes during a weak economy would only endanger a recovery. The political back-and-forth lasted for several weeks as the nation moved closer to the default deadline of August 2, 2011.

Finally, after tense negotiations, and the passage of a failed bill from the House and one from the Senate, a compromise was eventually reached to cut the federal budget deficit and debt by $2.5 trillion over the next ten years. No revenue enhancements were part of the package. The bill passed Congress overwhelmingly. It was seen as a major victory for the Tea Party Caucus, which refused to allow tax increases in the negotiations and demanded this significant level of spending cuts. On Friday, August 5, 2011, after the U.S. Stock Market had closed, Standard & Poor's downgraded U.S. Treasury Obligations, citing that U.S. Government policymaking and political institutions lacked the effectiveness, stability, and predictability in solving the ongoing fiscal and economic challenges facing the nation. This bond rating adjustment to an AA+ from an AAA rating is a major paradigm shift in the debate centering on how America will handle its ever-rising federal budget deficit and reduce the size of the national debt. Moreover, it now serves as a psychological marker that has disrupted the "business as usual" mindset that has plagued U.S. policymakers. A few days prior to the downgrade, on August 2, 2011, President Barack Obama had signed legislation that enabled the U.S. from defaulting on its debt by lifting the debt ceiling while cutting federal spending.

The President compromised on the debt ceiling legislation in an effort to close the debate and avoid debt default. That legislation created a "super committee," comprised of twelve (12) members of Congress, which was charged with devising proposals that would collectively reduce the $1.2 billion federal budget deficit over the next ten years. As previously mentioned, some of the stronger policy outcomes that have benefited the nation came from divided congresses, where the President (a Democrat) and at least one chamber of Congress is controlled by an opposition party (the U.S. House is controlled by Republicans in the 112th Congress).

In September 2011, the 12- member "super committee," or Joint Select Committee on Deficit Reduction, was formed with six members from the House, six from the U.S. Senate; of the twelve, six were Democrats, six were Republicans. With mounting Congressional voter disapproval, the Super Committee met for two months. On Monday, November 21, 2011, the Committee ended its work in a stalemate, issuing the following statement:

> Despite our inability to bridge the committee's significant differences, we end this process united in our belief that the nation's fiscal crisis must be addressed and that we cannot leave it for the next generation to solve—Senator Patty Murray (D-WA) and Representative Jeb Hensarling (R-TX).

At the time this paper was proposed, the "super committee" had begun its deliberations. Now that the "committee" adjourned with no recommendations, the authors have no recommendations to compare with the results of the 2010 Debt Commission Report. Therefore, the 2010 Debt Commission Report will be

compared to the 2005 Bush Tax Advisory Panel's Report. The Debt Commission's report, issued in December 2010, was cited by both political parties as a model to develop and craft recommendations by this "super commission". Since the Tea Party Caucus so effectively removed any discussion of tax increases and even tax reform from the debt ceiling debate, the focus of this paper will examine only spending cuts recommended by the Commission.

In December 2010, the National Commission on Fiscal Responsibility and Reform ("Fiscal Commission") issued its report, titled "The Moment of Truth" (National, 2010). The Fiscal Commission was charged with examining the short-term and long-term economic effects of the federal budget deficit and level of national debt in the United States. The Fiscal Commission, authorized in 2009 by President Barack Obama, was co-chaired by former Clinton White House Chief of Staff, Erskine Bowles, and former U.S. Senator, Alan Simpson (R-WY). The Fiscal Commission's summative diagnosis of the looming fiscal states:

> Since the last time our budget was balanced in 2001, the federal debt has increased dramatically, rising from 33 percent of GDP to 62 percent of GDP in 2010. The escalation was driven in large part by two wars and a slew of fiscally irresponsible policies, along with a deep economic downturn. We have arrived at the moment of truth, and neither political party is without blame . . . Economic recovery will improve the deficit situation in the short run because revenues will rise as people go back to work, and money spent on the social safety net will decline as fewer people are forced to rely on it. But even after the economy recovers, federal spending is projected to increase faster than revenues, so the government will have to continue borrowing money to spend. The Congressional Budget Office (CBO) projects if we continue on our current course, deficits will remain high throughout the rest of this decade and beyond, and debt will spiral ever higher, reaching 90 percent of GDP in 2020 . . . Over the long run, as the baby boomers retire and health care costs continue to grow, the situation will become far worse. By 2025 revenue will be able to finance only interest payments, Medicare, Medicaid, and Social Security. Every other federal government activity – from national defense and homeland security to transportation and energy – will have to be paid for with borrowed money. Debt held by the public will outstrip the entire American economy, growing to as much as 185 percent of GDP by 2035. Interest on the debt could rise to nearly $1 trillion by 2020. These mandatory payments – which buy absolutely no goods or services – will squeeze out funding for all other priorities . . . Federal debt this high is unsustainable. It will drive up interest rates for all borrowers – businesses and individuals – and curtail economic growth by crowding out private investment. By making it more expensive for entrepreneurs and businesses to raise capital, innovate, and create jobs, rising debt could reduce per-capita GDP, each American's share of the nation's economy, by as much as 15 percent by 2035 (National, 2010, pp. 10-11).

In order to solve these challenges, the Fiscal Commission discussed recommendations sub-divided into six (6) major components for congressional action, including:

1. Enacting tough discretionary spending cuts,
2. Comprehensive tax reform,
3. Health care cost containment,
4. Enacting mandatory savings,
5. Social Security reforms to ensure long-term solvency and reduce poverty, and
6. Ensure debt reduction is on a sustainable path (National, 2010, pp. 15-16).

The second recommendation, comprehensive tax reform, involves both individual and corporate income tax reform. The Fiscal Commission's tax reform recommendations, discussed later in this paper, provide one of the first major attempts at reforming the U.S. Tax Code since the last reform bill nearly 24 years

earlier, known at the *Tax Reform Act of 1986* (P.L. 99-514). The Fiscal Commission's tax reform recommendations are largely structural, stripping the various tax expenditures from the tax code to develop a "zero plan" whereby the tax base is derived using a flat base for assessing income tax rates. The recommendations then "add" limited and targeted tax expenditures back to this flat base in the areas of mortgage interest, support for low-income workers and families, employer-provided health insurance exclusion, charitable donations, and savings for retirement (National, 2010, p. 30).

In addition to the Fiscal Commission's report, nearly five years prior, President George W. Bush commissioned a tax reform panel in 2005 to provide recommendations for reforming the code. Known as the *President's Advisory Panel on Tax Reform* ("Advisory Panel"), the panel issued its findings and recommendations on November 1, 2005. The Advisory Panel's report provided two (2) major proposals for the Bush Administration and Congress to consider. These findings and recommendations will be discussed later in the paper. After its release, the report immediately stalled and was rarely discussed by the Washington media, as it was overshadowed by the events of Hurricane Katrina and the wars in Afghanistan and Iraq.

These two aforementioned documents, the *President's Advisory Panel on Tax Reform*, and the *National Commission on Fiscal Responsibility and Reform* each have distinct policy similarities and differences. The majority of the provisions impacted by the Tax Reform Act of 1986 are still in effect today. However, since the 1986 tax reform bill was signed into law on October 22, 1986 by President Ronald Reagan, four presidents and over twelve congresses (101th Congress to the 112th Congress) have each added their own specific provisions to the U.S. Tax Code, adding layers of complex provisions and laws to the tax system.

## PURPOSE OF THE PAPER

The objective of this paper is to discuss each of the major tax reform proposals issued by the 2010 Fiscal Commission and the Congressional "super committee." Since the "super committee" produced no findings and disbanded, the Fiscal Commission's tax proposals are compared to the proposals contained in the 2005 Advisory Panel's report. The paper will also highlight specific proposals that lawmakers often find the most difficult to modify or repeal, including the deductibility of home mortgage interest, state and local income taxes, as well as the exemption on employer-provided health insurance, and the repeal of the alternative minimum tax.

## TAX REFORM PROPOSALS CONTAINED IN NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM REPORT

The Fiscal Commission's report examines six (6) major components, including discretionary spending cuts, tax reform, health care policies, other mandatory policies, Social Security reform, and process reform. Unlike the 2005 Advisory Panel report on tax reform, which is entirely devoted to reforming the code, the Fiscal Commission's report examines tax reform as a "component" of the overall set of policy prescriptions for reducing the federal budget deficit and reducing the national debt.

Specifically, the Fiscal Commission argues that the tax code allows for $1.1 trillion annually in earmarks (tax expenditures), which are revenue losses due to allowances for income tax deductions and credits for taxpayers (both individual and corporate) to lower their income tax liability. The report suggests that the U.S. Tax Code "drives up health care costs and provides special treatment to special interests" (National, 2010, p. 28). In addition, the Fiscal Commission argues that the tax code is complex and requires high compliance costs in order to file a return, while some taxpayer's under-report their income, evading their tax responsibility. With regard to corporate income taxes, the Fiscal Commission argues that the U.S. corporate income tax rate is much higher than other industrialized nations; areas unique to the U.S. are provisions requiring the taxation of active foreign-source income. The report claims that the tax code

should be reformed to allow for only taxation of territorial income, reducing corporate tax rates, and in the process "leveling the playing field" with other industrialized nations (National, 2010, p. 28).

Prior to discussing the specifics outlined in the Fiscal Commission's report, a brief discussion of the impact of special interests on tax policy is warranted. Nearly twenty-five years ago, much of the challenge in reforming the tax code in 1985-86 and with each incremental tax bill subsequent to the Tax Reform Act is the impact of K Street (located on K Street) lobbying firms (Confessore, 2005). Every special interest in the United States from airlines, mining, oil and gas, homebuilders, to restaurants and hotels has provisions in the U.S. Tax Code that benefit their industry. As documented in the book *Showdown at the Gucci Gulch*, the 1986 reform bill nearly derailed at certain points as lobbyists attempted to influence (or prevent repeal) of popular tax provisions (Birnbaum, 1987). The influence of K Street lobbyists on tax policy has grown over the past twenty years and will likely impact the debate on tax reform with the Obama Administration and the 112th Congress.

The Fiscal Commission's report recommends four (4) basic goals of comprehensive tax reform:

1. ***Lower rates, broaden the base, and cut spending in the tax code.*** The current tax code is riddled with $1.1 trillion of tax expenditures: backdoor spending hidden in the tax code. Tax reform must reduce the size and number of these tax expenditures and lower marginal tax rates for individuals and corporations – thereby simplifying the code, improving fairness, reducing the tax gap, and spurring economic growth. Simplifying the code will dramatically reduce the cost and burden of tax preparation and compliance for individuals and corporations.

2. ***Reduce the deficit.*** To escape our nation's crushing debt and deficit problem, we must have shared sacrifice – and that means a portion of the savings from cutting tax expenditures must be dedicated to deficit reduction. At the same time, revenue cannot constantly increase as a share of the economy. Deficit reduction from tax reform will be companied by deficit reduction from spending cuts—which will come first. Under our plan, revenue reaches 21 percent of GDP by 2022 and is then capped at that level.

3. ***Maintain or increase progressivity of the tax code.*** Though reducing the deficit will require shared sacrifice, those of us who are best off will need to contribute the most. Tax reform must continue to protect those who are most vulnerable, and eliminate tax loopholes favoring those who need help least.

4. ***Make America the best place to start a business and create jobs.*** The current tax code saps the competitiveness of U.S. companies. Tax reform should make the United States the best place for starting and building businesses. Additionally, the tax code should help U.S.-based multinationals compete abroad in active foreign operations and in acquiring foreign businesses (National, 2010, pp. 28-9).

These goals serve as a reference point for overall tax reform. In examining the second goal above, the Fiscal Commission recommended that the House Committee on Ways and Means and the Senate Committee on Finance craft proposals that rely on a "zero-based budgeting" model by "eliminating all tax expenditures" in order to derive three (3) individual rate structure (8%-14%-23%) and one (1) corporate rate (26%). This is known as the "Zero Plan" whereby the basis for tax reform is primarily all-inclusive income with no deduction or credit offsets, or exclusions and is the starting point for tax reform. The Fiscal Commission's report recommends that the increased revenues derived from repealing tax expenditures be used for three purposes: 1. Substantially lowering marginal tax rates; 2. Reducing the reduction (by "adding-back" to the tax base tax expenditures for targeted purposes); and 3. Supporting a

small number of simpler, more targeted provisions that promote work, home ownership, health care, and savings (National, 2010, p. 29). After the zero plan base was derived, the Fiscal Commission recommended adding back targeted provisions, as mentioned in purpose no. 3 above, making it easier for lawmakers to craft bills for passage. This would, in effect, cause the individual rates to increase back up to (12%-22%-28%) and the corporate rate to increase to 28%. In the next section, individual tax reform recommendations will be examined.

## THE FISCAL COMMISSION'S INDIVIDUAL TAX REFORM RECOMMENDATIONS

Figure 1.1 below summarizes the effect of the impact on both individual and corporate rates. Individual tax reform will be examined first.

***Figure 1.1: Tax Rates Under Various Scenarios***

| | ***Bottom Rate*** | | ***Middle Rate*** | | ***Top Rate*** | | ***Corporate Rate*** |
|---|---|---|---|---|---|---|---|
| Current Rates for 2011 | 10% | 15% | 25% | 28% | 33% | 35% | 35% |
| Scheduled Rates for 2013 | | 15% | 28% | 31% | 36% | 39.6% | 35% |
| Eliminate all Tax Expenditures ("Zero Plan") | | 8% | | 14% | | 23% | 26% |
| Keep Child Tax Credit + EITC | | 9% | | 15% | | 24% | 26% |
| Enact Illustrative Tax Plan (Figure 1.2) | | 12% | | 22% | | 28% | 28% |

The add-backs to the zero plan are summarized in Figure 1.2 below. Some of the more prominent highlights of the Fiscal Commission's plan include stripping the Code of a majority of the existing tax expenditures, eliminating the need for itemized deductions. Note that the Fiscal Commission released its report in early December 2010, right before Congress passed and President Obama signed into law a two-year extension of the Bush tax cuts, known as the *Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010* (P.L. 111-312). Many of the provisions in the Fiscal Commission's report were based on prior law, the *Economic Growth and Tax Relief Reconciliation Act of 2001* (P.L. 107-16), or EGTRRA, which was scheduled to "sunset" on December 31, 2010. When the report was filed, there was no agreement moving to the President, so it reflects prior law. Therefore, Figure 1.2 was adjusted by these researchers to reflect these extensions in the "Current Law" column that were not contained in the Fiscal Commission's final report.

| *Figure 1.2: Illustrative Individual Tax Reform Plan* | | |
|---|---|---|
| | ***Current Law*** | ***Illustrative Proposal (Fully Phased In)*** |
| **Tax Rates for Individuals** | In **2011-12**, six brackets: 10%, 15%, 25%, 28%, 33%, 35%. In **2013**, five brackets: 15%, 28%, 31%, 36%, 39.6%. | Three (3) brackets: 12%, 22%, 28% |
| **Alternative Minimum Tax** | Scheduled to impact middle-income individuals, but "patched" annually. | Permanently repealed |
| **PEP and Pease** | Repealed in 2011-12, resumes in 2013 | Permanently repealed |
| **EITC and Child Tax Credit** | Partially refundable child tax credit over $1,000 per child. Refundable EITC of between $457 and $5,666. | Maintain current law or equivalent alternative. |
| **Standard Deduction and Exemptions** | Standard deduction of $5,700 ($11,400 for couples) for non-itemizers; personal and dependent exemptions of $3,650. | Maintain current law; itemized deductions eliminated, so all individuals take standard deductions |
| **Capital Gains and Dividends** | In 2011-12, top rate of 15% for capital gains and dividends. In 2013, top rate of 20% for capital gains, and ordinary dividends. | All capital gains and dividends taxed at ordinary income rates |
| **Mortgage Interest** | Deductible for itemizers; mortgage capped at $1 million for principal and second residences, plus up to $100,000 for home equity loans. | 12% non-refundable tax credit available to all taxpayers; Mortgage capped at $500,000; No credit for interest from second residence and equity loans. |
| **Employer Provided Health Insurance** | Excluded from income. 40% excise tax on high cost plans (generally $27,500 for families) begins in 2018; threshold indexed to inflation. | Exclusion capped at 75th percentile of premium levels in 2014, with cap frozen in nominal terms through 2018 and phased out by 2038; Excise tax reduced to 12% |
| **Charitable Giving** | Deductible for itemizers | 12% non-refundable tax credit available to all taxpayers; available above 2% of Adjusted Gross Income (AGI) floor |
| **State and Municipal Bonds** | Interest exempt from income | Interest taxable as income for newly-issued bonds |
| **Retirement** | Multiple retirement account options with different contribution limits; saver's credit up to $1,000 | Consolidate retirement accounts; cap tax-preferred contributions to lower of $20,000 or 20% of income, expand saver's credit |
| **Other Tax Expenditures** | Over 150 additional tax expenditures | Nearly all other income tax expenditures are eliminated |

Figure 1.2 has several noteworthy recommendations. Before examining each, one theme is consistent: Itemized deductions will be eliminated with the retention of specific tax expenditures that will either be converted into *before AGI* deductions or converted into a tax credit (as is the case with home mortgage interest and charitable contributions). If a deduction or credit is not indicated in Figure 1.2, it is most likely recommended by the Commission for repeal.

***Individual Rates and the AMT***. In examining Figure 1.2, the recommendations by the Fiscal Commission for the zero plan both raise revenues as well as reduce revenues. The Fiscal Commission recommendations to create three (3) individual tax brackets of 12-22-28% are contingent on the implementation of the proposals in the "Illustrative Proposal" column. If this zero plan were enacted, the alternative minimum tax (§55) would be permanently repealed. According to David Cay Johnston, if the alternative minimum tax (AMT) were repealed, it would cost over $70 billion in lost revenues (and most likely cost much more today) (Johnston, 2007). Therefore, a goal of the Fiscal Commission is to repeal this complex provision, even if it causes the federal government to lose revenues. The tax expenditures that would assist in paying down the cost of lost revenues associated with repeal of the AMT and lowering the individual and corporate tax rates.

***Earned Income Tax Credit***. The next Fiscal Commission proposal allowed for the continuance of the Earned Income Tax Credit (EITC) and the Child Tax Credit, or an equivalent alternative. This demonstrates the Commission's desire to continue tax protections for taxpayers with children and lower-income taxpayers. As such, these provisions maintain a relative status quo. The Fiscal Commission also recommended that current law be maintained for the standard deduction and personal exemption (with no phase-outs); the one change would be that all taxpayers would be subject to the standard deduction since the Commission recommended elimination of itemized deductions.

***Preferential Rates on Dividends and Capital Gains***. The Fiscal Commission recommended complete repeal of the preferential dividend and capital gains tax rate at 15% (scheduled to increase to 20% in 2013). The repeal of the preferential rate would require dividend and capital gains to be taxed as ordinary income, raising tax revenues in the process. The preferential rate for dividends was enacted in 2003 and is a very popular tax savings provision for taxpayers subject to the 25, 28, 33, and 35% income tax brackets.

***Mortgage Interest Deduction***. The Commission's recommendation converts the itemized deduction of qualified mortgage interest into a non-refundable tax credit. Since Schedule A would be eliminated, home mortgage interest would be a credit up to 12 percent of some determined base, which the Commission did not define. Often the rule with regard to tax credits, the percentage is multiplied against the specific allowable expenditure; therefore, in this case, the percentage most likely is 12 percent of qualified mortgage interest on the primary residence. The Fiscal Commission specifically disallows the inclusion of mortgage interest on secondary residences as well as interest from home equity lines. In addition, the credit is capped at $500,000 in qualified mortgage interest on the primary residence.

***Employer-provided Health Care***. The Commission recommends continuing to exclude the value of health care premiums paid by the employer from a taxpayer's income, with the exception of those who receive generous health care plans. The exclusion would be capped at the 75$^{th}$ percentile of premium levels determined in 2014; this cap would be frozen through 2018 and ultimately phased out by 2038. At that point, the premiums would be fully taxable to individuals. In addition, the 40 percent excise tax imposed on employers for high-cost plans would drop to 12 percent.

***Charitable Contributions***. Constructed similar to the credit for qualified home mortgage interest discussed earlier, and with the elimination of itemized deductions, the charitable contribution deduction

would be converted into a tax credit. The credit for charitable giving would be a 12 percent, non-refundable tax credit available to all taxpayers, subject to a 2 percent adjusted gross income floor limitation. This floor resembles the same floor imposed currently on miscellaneous itemized deductions and has the effect of limiting small contributions (known as "paperwork reduction").

***Interest on Municipal Obligations***. Interest income earned on tax-exempt municipal bonds is currently exempt from taxable income under current law. Under the Commission's recommendations, such interest would become taxable. This would be a significant departure from current tax treatment in that state and local governments depend on this tax exemption to subsidize part of the return on the bonds. Considering billions in tax-exempt bonds are issued and used as part of sub-government financing, bond issuers would most likely have to increase the cost of issuing the debt by raising the interest rates in order to induce borrowers to acquire municipal bonds.

***Retirement Savings***. Under existing law, several *pre*-tax retirement vehicles exist (401K, traditional IRAs) as well *post*-tax retirement vehicles (Roth IRAs, Roth 401K). The Fiscal Commission recommends consolidating all of these various types of accounts, with contributions limited to the lesser of $20,000 or 20 percent of income. In addition, it recommends expanding the Saver's Credit, but with no specifics on the extent of the expansion.

***Remaining Tax Expenditures***. The Fiscal Commission recommended eliminating nearly 150 different tax deductions and credits. This would significantly simplify the U.S. Tax Code, allowing for the individual income tax rates to drop to the 12-22-28%. The Commission did not specify which remaining tax expenditures would be eliminated, as it only highlighted which ones would be retained (even if modified). If the Commission's proposed "zero-plan" were adopted, all tax expenditures, including the ones discussed above (see Exhibit 1.2) would be repealed; individual rates would be 8-14-23%. This proposal was meant more to establish a threshold for comparison rather than a pure recommendation. If the Commission eliminated all tax expenditures, with the exception of the earned income tax credit and child credit, the rates would rise slightly to 9-15-24%.

Therefore, if the illustrative plan were adopted, the income tax rate brackets would drop to 12-22-28%, and it must be concluded that the following major deductions and credits would be repealed under the Fiscal Commission's recommendations: unreimbursed medical and dental deduction; the deduction for state and local income taxes, state sales taxes, and property taxes; miscellaneous itemized deductions (including unreimbursed employee costs); educator expenses; health savings accounts; moving expenses; one-half of self-employment taxes; self-employed health insurance deduction; tuition and fees deduction; and student loan interest deduction. On the credit side, the Earned income tax credit and child tax credit would be retained; however, other credits would eliminated: the child and dependent care credit; education tax credits (HOPE and Lifetime Learning Tax Credits); the foreign tax credit; residential energy tax credit, and many others. Since all of these aforementioned tax expenditures were a result of the political process, it will be challenging for lawmakers to consider repealing each and every one of these provisions, many which are cherished by specific constituencies.

## THE FISCAL COMMISSION'S CORPORATE TAX REFORM RECOMMENDATIONS

The Fiscal Commission's recommendations on overhauling corporate tax laws stems largely from undesirable economic outcomes that have plagued the United States for several years, including the lack of competitiveness. The Fiscal Commission's summative diagnosis of the problems created by the corporate tax laws are as follows:

> The U.S. corporate tax is a patchwork of overly complex and inefficient provisions that creates perverse incentives for investment. Corporations engage in self-help to decrease their tax liability and improve their bottom line. Moreover, corporations are able to minimize tax through various

> tax expenditures inserted into the tax code as a result of successful lobbying. Without reform, it is likely that U.S. competitiveness will continue to suffer. The results of inaction are undesirable: the loss of American jobs, the movement of business operations overseas, reduced investment by foreign businesses in the U.S., reduced innovation and creation of intellectual property in the U.S., the sale of U.S. companies to foreign multinationals, and a general erosion of the corporate tax base (National, 2010, p. 32).

Figure 1.3 below summarizes the Illustrative Plan recommended by the Commission.

***Figure 1.3: Illustrative Corporate Tax Reform Plan***

| | ***Current Law*** | ***Illustrative Proposal (Fully Phased In)*** |
|---|---|---|
| **Corporate Tax Rates** | Multiple brackets, generally taxed at 35% for large corporations | One rate: 28% |
| **Domestic Production Deduciton** | Up to 9% deduction of Qualified Production Activities Income | Eliminated |
| **Inventory Methods** | Businesses may account for inventories under the LIFO method of acocunting | Eliminated with appropriate transition |
| **General Business Credits** | Over 30 tax credits | Eliminated |
| **Other Tax Expenditures** | Over 75 tax expenditures | Eliminated |
| **Taxation of Active Foreign-source Income** | Taxed when repatriated (deferral) | Territorial system |
| **Taxation of Passive Foreign-source Income** | Taxed currently under Subpart F | Maintain Current Law |

In Figure 1.3, the corporate tax rate brackets would be streamlined into a single bracket of 28%, a drop from the highest rate of 35%. In addition, the following deductions and credits would be eliminated: domestic production deduction, LIFO inventory valuation method, the general business credits, as well as over 75 other tax expenditures. The controversial issue of taxing foreign-source income would move to a territorial system, which has been long advocated by several lawmakers. Unlike the individual tax recommendations, many of the corporate tax recommendations are meant to prevent allowing tax benefits to accrue to corporations that outsource jobs.

In the next section, the 2005 Advisory Panel's similar recommendations will be examined, comparing those proposals to the Fiscal Commission's.

**THE 2005 PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM**

In late 2004, after having been re-elected, President George W. Bush began preparing top agenda priorities for 2005 and the remainder of his upcoming second term in office. One of the top agenda items was reforming the Social Security system, which the Bush Administration had hoped to produce legislation in the first term, but was delayed due to enormous political capital needed for the Iraq War and the Medicare Prescription Drug benefit, among others. Another major item on its agenda was tax reform. After having been sworn in to a second term in January, 2005, President Bush created a bipartisan advisory panel on federal tax reform that same month to provide recommendations to "make the tax code simpler, fairer, and more conducive to economic growth" (President's Advisory Panel xi). The Panel of nine members worked and held hearings for nearly nine months, reporting its findings on November 1, 2005 in a document titled, "Simple, Fair & Pro-Growth: Proposals to Fix America's Tax System" (President's Advisory Panel, 2005).

To contrast with the Fiscal Commission's report, the Advisory Panel's report solely focused on reforming the tax code. The Panel's findings were quite extensive; some of the major ones will be enumerated below, and then compared to the Fiscal Commission's findings.

The nine-member President's Advisory Panel on Tax Reform was chaired by former Senator Connie Mack (R-FL), with Senator John Breaux (D-LA) as the co-chair. The Panel's final report contained an overview of the challenges of the current tax code along with two major overhaul plan recommendations: the *Simplified Income Tax Plan* and *the Growth and Investment Tax Plan*. The final report was approximately 272 pages (including appendices). Unlike the Reagan tax reform process where the U.S. Treasury Department crafted an initial blueprint proposal ("Treasury I"), then offered a revised proposal ("Treasury II"), President Bush sought a bi-partisan commission to study the problem and make recommendations.

The Panel discussed several problems with the current tax system in the United States, but began by stressing the purpose of the federal income tax: "to raise revenue for our national defense, social programs, and other vital public services" (President's, p. 1). The Panel cited that the tax system has become so complicated that U.S. households spent nearly $150 billion annually on tax compliance. In addition, one of the arguments contained in the report sounded similar to the language from the '86 TRA debate: "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 . . . this economic waste may [cost up to] $1 trillion dollars each year" (President's, p. 1). The report stressed that the burdens associated with complexity by indicating that taxpayers spend more than 3.5 billion hours preparing their taxes and each taxpayer spends nearly 26 hours on compliance. In 2003, nearly 60 percent of household filers hired a paid-preparer to calculate their taxes, with nearly 25 percent relying on computer software tax preparation, while only 13 percent hand-prepared their own tax return with paper and pen (President's, p. 3). In developing its proposals, the Panel listed three broad problem areas of the tax code that were used in attempting to produce its recommendations for improvement. The three broad problems included:

1. **Taxpayers cannot plan ahead**. Several provisions, rates, credits, etc., in the tax code are temporary in nature (are subject to a specific "sunset" expiration date). Many of the provisions contained in the 2001 and 2003 tax bills are temporary and Congress has had to pass extensions on several occasions; the majority of these tax cuts are set to expire after December 31, 2010 (and were recently extended late in 2010 to December 31, 2012). The Panel argued that this uncertainty contributes to potentially unwise tax planning and the wasting of economic resources. Johnson (2010) argues that during 2010 private charities have been adversely affected since many

major donors wanted to wait to donate in 2011 when tax rates were scheduled to increase if no legislative action to extend the tax cuts occurred (Johnston, 2010).

2. **The tax code treats similar taxpayers in different ways**. The availability of various provisions in the code is inconsistent for many taxpayers. For example, the Panel cites that taxpayers residing in states with high state income and property taxes receive, on average, greater deductions than taxpayers residing in lower-tax states. Since the deduction for state and local income taxes (I.R.C. §164(a) (3)) survived in the '86 TRA debate, it again became a target by the Advisory Panel. Also, taxpayers who participate in employer-provided health insurance (I.R.C. §125) are allowed the employee's cost of the health insurance to be deducted from their pay on a pre-tax basis while "those who buy the same health insurance on their own usually pay tax on the income used to purchase the insurance" (President's, p. 5).

3. **The tax code treats similar income differently**. The marginal income tax rates operate in that as one's income increases, it is progressively taxed at a higher rate (up to a rate no higher than 35 percent). The Panel argues that this becomes more complicated by various income ceilings on tax deductions and credits. For example, there is an adjusted gross income (AGI) limitation on itemized deductions as well as the standard deduction, the child tax credit, education tax credits, tuition tax deduction, individual retirement accounts, and many others. The higher the AGI, generally, the fewer ability to qualify for certain tax deductions and credits and the Panel cites the reasoning for such treatment: "one can earn before claiming certain deductions and credits is to target the benefits to those perceived to have the greatest need . . . creat[ing] a set of counterintuitive and counterproductive economic consequences that may keep many families from trying to earn more than they currently do" (President's, p. 6).

As a separate but critical issue, the Panel discussed at length the need to eliminate the alternative minimum tax (I.R.C. §55) (President's, p. 43). The Panel did a simulation where if the AMT were eliminated, holding all other variables constant (current law), there would require an 11-percent across the board tax increase, resulting in taxpayers in the 10 percent bracket having to pay up to 11 percent, the 15 percent rate would rise to 17 percent, the 25 percent rate would rise to 28 percent, the 28 percent rate would rise to 31 percent, the 33 percent rate would rise to 37 percent, and the 35 percent top rate would rise to 39 percent (President's, p. 43). The AMT is one of the strongest arguments for reforming the tax code in that it is a complex and burdensome second tax calculation that was meant to prevent upper income tax filers who claim several deductions from paying zero taxes. The two plans recommended by the Advisory Panel shall be briefly summarized in Figure 2.1 below by comparing the Panels' recommendations to the Debt Commission's recommendations.

## COMPARISON OF THE FISCAL COMMISSION REPORT (2010) AND THE ADVISORY PANEL REPORT (2005)

As indicated, the Advisory Panel Report fully concentrated on tax reform, whereas the Fiscal Commission Report contained tax reform proposals as part of a broad set of fiscal recommendations. Therefore, the Fiscal Commission's findings were not as extensive as the Advisory Panel's, but no less important. Figure 2.1 below highlights the comparison of the two reports. Using this comparison, the areas where the Commission and the Advisory Panel seemed to be in agreement will be specifically examined. These may portend to eventual tax policy changes if and when the U.S. Congress takes up reform measures.

***Figure 2.1: Comparison of Fiscal Report (2010) and Advisory Panel Report (2005)***

| | ***Fiscal Commission Report (2010)*** | ***Advisory Panel Report (2005)*** |
|---|---|---|
| **Tax Rates for Individuals** | Three (3) brackets: 12, 22, 28% | ***Simplified Plan*** : Four (4) brackets: 15, 25, 30, 33% ***Growth and Investment Plan*** : Three (3) brackets: 15, 25, 30% |
| **A.M.T.** | Permanently repealed | Permanently repealed |
| **PEP and Pease** | Permanently repealed | Permanently repealed |
| **EITC and Child Tax Credit** | Maintain current law or equivalent alternative. | Replace with ***Work Credit***; maximum credit for family with 1 child is $3,750; two or more children is $5,800 |
| **Standard Deduction and Exemptions** | Maintain current law; itemized deductions eliminated, so all individuals take standard deductions | Replace with ***Family Credit*** available to all taxpayers: $3,300 for married couples, $2,800 for unmarried filers with child; $1,650 for unmarried filers; $1,500 for each dependent child |
| **Dividends** | All dividends taxed at ordinary income rates | ***Simplified Plan*** : Exclude 100% of dividends from domestic firms paid out of domestic earnings; ***Growth and Investment Plan*** : 15% tax rate |
| **Capital Gains** | All capital gains taxed at ordinary income rates | ***Simplified Plan*** : Exclude 75% of capital gains from U.S. firms (tax rate b/t 3.75 and 8.25 %); ***Growth and Investment Plan:*** 15% tax rate |
| **Mortgage Interest** | 12% non-refundable tax credit available to all taxpayers; Mortgage capped at $500,000; No credit for interest from second residence and equity loans. | ***Home Credit*** = to 15% of mortgage interest paid; limited to regional price of housing; repeals deductibility of interest on second residences and repeals equity loan interest |
| **Employer-Provided Health Insurance** | Exclusion capped at 75th percentile of premium levels in 2014, with cap frozen in nominal terms through 2018 and phased out by 2038; Excise tax reduced to 12% | All taxpayers may purchase health insurance with pre-tax dollars, up to the average premium (estimated to be $5,000 for single filer, $11,500 for a family) |
| **Charitable Giving** | 12% non-refundable tax credit available to all taxpayers; available above 2% of Adjusted Gross Income (AGI) floor | Deduction available to all taxpayers (1% of income floor); rules to address valuation abuse |
| **Municipal Bonds** | Interest taxable for newly issued bonds | No Change |
| **Retirement** | Consolidate retirement accounts; cap tax-preferred contributions to lower of $20,000 or 20% of income, expand saver's credit | Consolidate into ***Save at Work*** plans using 401(k) limits. ***Simplified Plan*** : pre-tax plan; ***Growth and Investment Plan*** : post-tax Roth-style plan |

***Tax Rates for Individuals.*** The tax rates were similar for both reports, however, the Advisory Panel's upper rates were higher than the Fiscal Commission's upper rate of 28%. The Simplified Plan upper rate was 33% and 30% for the Growth Plan. This was most likely due to the fact that the Fiscal Commission recommended repeal of over 150 tax expenditures, where the Advisory Panel retained or converted some tax expenditures into either the Work Credit or the Family Credit. This made the Advisory Plan more expensive, requiring slightly higher tax brackets.

***Elimination of Itemized Deductions***. The Commission and the Advisory Panel both structured their recommendations to eliminate the need for a Schedule A. In addition, if the itemized deductions are eliminated, the Pease provision, which limits itemized deductions on higher-earning taxpayers, would be repealed. The two sets of recommendations do retain key provisions for home ownership and charitable contributions. However, other deductions would be repealed, if either plan were enacted—including deductions for state and local income taxes, state sales taxes, property taxes, unreimbursed medical and dental expenses, miscellaneous itemized deductions (especially unreimbursed job expenses). The repeal of the deduction for state and local income taxes, §164(a)(3), would be a very difficult to achieve considering some of the states impacted would include New Jersey, New York, California, Connecticut, and Massachusetts. This was attempted during the '86 TRA deliberations and failed.

***Alternative Minimum Tax***. The Commission and the Advisory Panel both recommended repeal of the alternative minimum tax, §55. The repeal of §55, which is a significant revenue enhancement for the U.S. Treasury, would require significant elimination of several tax expenditures. Many lawmakers on Capitol Hill are predisposed to vote to repeal the AMT, but with the federal budget deficit at its unsustainable level, member's hands are tied until comprehensive reform allows a tax expenditures to be stripped back to offset the AMT repeal.

***Mortgage Interest***. Both reports recommend converting the home mortgage interest deduction into a tax credit. The Fiscal Commission recommended allowing for mortgages capped at $500,000, while the Advisory Panel proposed limiting to the regional cost of housing. Each proposal recommended repeal of mortgage interest on second homes and equity lines. The homebuilders and banking lobbies would fight to retain second home and equity line interest; Congress may not repeal tax benefits for second home or equity lines, but may impose further limitations.

***Charitable Contributions***. The Commission report recommends converting charitable contributions from a deduction to a credit, while the Advisory Panel recommended maintaining as a deduction "for AGI." Both reports would impose a 1 or 2 percent AGI limitation. Congress has long looked at moving this deduction "for AGI," so as to allow non-itemizers the ability to benefit.

***Retirement***. Both reports recommend "consolidation" of all the various retirement devices into one tax device. The Advisory Panel report's Simplified Plan recommends a pre-tax (deferred) arrangement, similar to the existing 401(k) Plan, whereas the Growth and Investment Plan recommends a post-tax (Roth-style) plan, where the vehicle is funded with after-tax dollars.

Lastly, both reports aimed at restructuring the U.S. Tax Code in a manner that would simplify filing, eliminate the need for burdensome recordkeeping, and prevent taxpayers from having to pay such high compliance costs in order to properly file their tax returns annually. In addition, each report emphasized the notion that Congress needs to avoid inserting "sunset" provisions into the Code. The existing tax rates in Figure 1.1, for example, are in effect through December 31, 2012 and if no Congressional action is taken, will revert to pre-2001 levels (Clinton rates). Tied to this are several tax provisions that will also adjust or become inactive after 2012. Sunset provisions greatly complicate the income tax system, particularly the planning aspect since taxpayers are ill informed in making future tax decisions regarding the opening of a business, funding retirement, buying or selling stocks, and other important matters—all

due to the lack of reliable and consistent tax treatments since many provisions are scheduled to adjust or expire on varying dates. Sunset provisions emerged during the budgetary fights post-'86 TRA.

**CONCLUSION**

The objective of this paper was to discuss each of the major tax reform proposals issued by the 2010 Fiscal Commission and compare with similar proposals contained in the 2005 Advisory Panel's report. While the authors intended to compare the proposals to ones crafted by the Congressional "super committee," its failure to issue a report required the paper be compared with the 2005 Advisory Panel report. Through this comparative approach, areas of consensus were investigated to assist in gleaning an understanding of which tax measures may be continued, modified, or repealed. While Congress has not seriously taken any tax reform steps since the '86 TRA, nearly twenty-five years ago, economic realities may force Congressional action. This paper is meant to glean a stronger understanding of the various provisions of the Code that received close scrutiny by the Fiscal Commission and the Advisory Panel. With the failure of the "super committee" to deliver a proposal to handle the debt and deficit, and if no Congressional action is taken prior to January 1, 2013, two major results will occur: Spending cuts totaling $1.2 trillion will be automatically triggered, with half of the spending cuts coming from defense and the other half from non-defense spending (known as sequestration); further, tax rates will adjust back to the Clinton rates (Economist, p. 16). The Fiscal Commission and Advisory Panel reports can serve as models for policy makers to consider when crafting proposals to reform the U.S. Tax Code.

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