

The President's Advisory Panel on
Federal Tax Reform



America Needs a Better Tax System

Statement by the Members of the President's Advisory Panel on Federal Tax Reform

For millions of Americans, the annual rite of filing taxes has become a headache of burdensome record-keeping, lengthy instructions, and complicated schedules, worksheets, and forms – often requiring multiple computations that are neither logical nor intuitive. Not only is our tax system maddeningly complex, it penalizes work, discourages saving and investment, and hinders the competitiveness of American businesses. The tax code is riddled with tax provisions that treat similarly situated taxpayers differently and create perceptions of unfairness.

Since the last major reform effort in 1986, there have been more than 14,000 changes to the tax code, many adding special provisions and targeted tax benefits, some of which expire after only a few years. These myriad changes decrease the stability, consistency, and transparency of our current tax system while making it drastically more complicated, unfair, and economically wasteful. Today, our tax system falls well short of the expectations of Americans that revenues needed for government should be raised in a manner that is simple, efficient, and fair.

As a result, there is widespread agreement that we must reform the tax system. On January 7, 2005, President Bush established the bipartisan Advisory Panel on Federal Tax Reform to recommend options for reform of our tax code. We recognize the importance of our task and the magnitude of the challenges we face. Our muddled tax code reflects years of compromises and quick fixes. History has taught us that although it is relatively easy to achieve consensus on the need for reform, it is much more difficult to devise a solution that satisfies all competing interests. We will undoubtedly be required to make many difficult choices, but we are committed to presenting options to ensure that our tax system will keep pace with America's growing, dynamic, and changing economy.

To develop reform options, we have divided our work into two stages. The first stage, involving a comprehensive examination of the existing tax system to make sure that we understand its complexity, its impact on economic growth, and its unfairness, is nearly complete. In the second stage of our work, which is now beginning, we will build on our understanding of the current system and consider specific reform proposals.

After its formation, the Panel moved quickly to begin a conversation about the current tax system and to discover what Americans think about our tax laws. We established a website – www.taxreformpanel.gov – to provide the public real-time information about the Panel's activities. We also requested comments from the public and have used the website to receive – and post – the submissions. To date, we have been contacted by thousands of concerned Americans who have shared their experiences with the tax code. Their comments confirm the importance of our mission.

Since February 16, the Panel has held six public meetings across the country. Our first two meetings were held in Washington, D.C., followed by meetings in Florida, Illinois, Louisiana, and California. We will be holding a seventh meeting on Monday, April 18, 2005, in Maryland. At each of our meetings, distinguished policymakers shared their views on tax reform. We also heard from tax experts from the fields of economics, accounting, finance, and law. We learned about the problems in our tax system from individuals and from large and small business taxpayers as well as from the people who assist them – both paid and volunteer. We focused on the challenges facing American families, low-income taxpayers, people facing the alternative minimum tax (AMT), and businesses of all sizes.

We have repeatedly heard that our system is needlessly complex. Increasingly, Americans are looking to experts for help navigating this complexity, with over 60 percent using a paid preparer to compute their taxes. This complexity is costing the U.S. economy about \$140 billion per year. To put this amount in perspective, it is roughly the same as giving \$1,000 to every family in America or the amount of money needed to fund all of the following: the Department of Homeland Security, the State Department, NASA, HUD, the EPA, the Department of Transportation, the United States Congress, our Federal courts, and all foreign aid. For low-income taxpayers, the complexity of the Earned Income Tax Credit, child credits, and filing status imposes substantial costs on those who are least able to bear them.

One particular problem that cannot be ignored is the rapidly growing reach of the AMT. The AMT imposes a stealth tax system that is separate from, but parallel to, the regular income tax system. The AMT was enacted in 1969 to target a small group of high-income taxpayers who were avoiding paying all income taxes. Since then, changes to the AMT and the effect of inflation have transformed the AMT into a trap for a growing number of unsuspecting middle-income taxpayers. The AMT will catch almost 4 million taxpayers this year and 20 million taxpayers next year. Some projections suggest that by 2015, as many as 50 million taxpayers, or about 45 percent of all taxpayers who pay income tax, will be paying AMT.

The AMT ensnares taxpayers by denying them exemptions and credits that are available under the regular tax system, while leaving untouched many of the highest earners in the country. Taxpayers subject to the AMT are required to compute their taxes twice even though they have not participated in tax shelters or attempted to avoid taxes. As one of our witnesses commented, good tax policy should be simple, efficient, and fair, and the AMT violates all three of these principles.

The problems of complexity are not limited to individual taxpayers. In the area of business taxation, we heard how our tax code treats business income differently depending on the type of entity that earned it, treats capital invested in businesses differently depending on whether it is debt or equity, and treats mergers and acquisitions differently depending on whether the transaction satisfies certain arcane formalities. Our business tax code is littered with special provisions providing special rates, deductions, or credits. These provisions – designed to encourage particular conduct or business activity – create complexity, volumes of new regulations, opportunities for tax shelters, and unfairness. Moreover, these provisions often do not have their intended effect on taxpayer behavior and motivate businesses to adopt governance structures that may not be consistent with business efficiency.

Representatives from small businesses also explained to us how entrepreneurs bear disproportionately higher compliance costs than larger businesses. In addition, experts described the rules that govern the taxation of income earned abroad as easily avoided by the well advised and a trap for the poorly advised. We were dismayed to hear that very few people actually understand our complex system of international taxation. It is hard to believe that our dysfunctional system does not hinder American businesses from selling their products or otherwise competing in the global marketplace.

Simplifying and reforming the tax code should lighten the burden on taxpayers, eliminating numerous tax headaches. It will allow Americans to spend less time doing their taxes and more time doing what they would rather do, like spending time with their families. For American businesses, a better tax code will allow them to devote more resources to developing new products and services, expanding their operations, and hiring more workers.

Taxes affect almost every aspect of our lives and may hinder America's economic well-being. The United States is a low saving nation, and our savings rate has declined in recent decades. Our tax system may make matters worse by discouraging saving. We heard from experts who described the differing rules and eligibility requirements associated with the multitude of provisions added to our code to encourage saving. The dozen or so tax incentives intended to encourage education represent another example of an area that is needlessly complex. Taxpayers should not need a college degree to figure out if they are entitled to education tax benefits.

It is no surprise that American taxpayers are intimidated by the choices in the code. As a result, taxpayers often make bad decisions about which option is best for them, or they may fail to benefit from these tax incentives. Surely there are better ways to encourage saving and promote education.

At our Chicago meeting, Nobel Laureate James Heckman explained how taxes influence whether we work, how much we work, and which skills we acquire for work. The tax code also impacts a wide range of business decisions, such as how much to invest, how to finance investment, and whether to incorporate or take a company public. For example, business taxes are not well integrated with

personal taxes. Efforts to avoid the double tax on corporate earnings have created a misallocation of investment between the corporate and non-corporate sectors and rapid growth in the use of S corporations, partnerships, and other entities that do not pay corporate income tax.

We have seen how preferences in the tax code cause taxpayers to devote more resources to tax-advantaged investments and activities at the expense of other more productive alternatives. Reform of our tax code should alleviate this wasteful use of our economic resources and boost economic growth.

Some witnesses suggested that distortions created by the tax code may have little or no benefit. Distinguished economists and policymakers, including former Treasury Secretary James Baker and Chairman Alan Greenspan of the Federal Reserve System, told the Panel that a broad-based, low-rate tax system would provide the greatest economic efficiency, simplicity, and ease of administration. One of our witnesses observed that the wave of tax reform in developed countries around the world during the past two decades reflects the view that low-rate, broad-based, progressive systems are fairer and more efficient than tax codes laden with special provisions that must be subsidized by higher rates on all taxpayers.

Our tax code contains numerous provisions that attempt to distribute tax benefits to specific groups of taxpayers. For example, there are 15 common tax benefits available to families – including provisions that relate to children, education, and retirement savings – that provide 14 different phase-out provisions to reduce benefits above specified income levels that, in turn, contain nine different definitions of income. The variety and complexity of targeted tax benefits support the view that some taxpayers are not paying their fair share and reward those who have the means or inclination to find all the angles to reduce their tax. Tax noncompliance is due to a variety of factors, but the complexity of the tax code is a significant contributor because it makes it harder for taxpayers to understand and apply the tax laws and more costly for the IRS to administer them.

Reform of our tax code should result in a simpler and fairer tax system that will be easier to understand and harder to manipulate. This will allow Americans to feel confident that they, their neighbors, and their business competitors are all paying their fair share.

The comments and the testimony of witnesses at the public meetings conveyed the dismal condition of our current tax system. Our tax laws have been compared to an overbuilt and dilapidated house with conflicting architectural styles and a crumbling foundation, a sick patient who is about to expire, and a factory that has been littered with so much garbage that it can no longer operate productively. Nobel Laureate Milton Friedman described our tax system as a blackboard that has been filled up with so much writing that the slate must be wiped clean. Most of the comments reflected the sentiments of one family who expressed their view, “Tax reform is necessary and long overdue!”

During our examination of the existing system, several themes emerged from the public comments and testimony. These themes will guide our efforts as we consider options for reform:

- We have lost sight of the fact that the fundamental purpose of our tax system is to raise revenues to fund government.
- Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers.
- The complex and unpredictable influences of the current tax system on how families and businesses arrange their affairs distorts economic decisions, leads to an inefficient allocation of resources, and hinders economic growth.
- The complexity of our tax code breeds a perception of unfairness and creates opportunities for manipulation of the rules to reduce tax. The profound lack of transparency means that individuals and businesses cannot easily understand their own tax obligations or be confident that their neighbors or competitors are paying their fair share.
- The tax system is both unstable and unpredictable. Frequent changes in the tax code, which often add to or undo previous policies, as well as the enactment of temporary provisions, result in uncertainty for businesses and households. This volatility is harmful to economic development and creates additional compliance costs.
- The objectives of simplicity, fairness, and economic growth are interrelated and, at times, may be at odds with each other. Policymakers routinely make choices among these competing objectives, and, in the end, simplification is almost always sacrificed. Although these objectives at times are in tension, meaningful reform can deliver a system that is simpler, fairer, and more growth oriented than our existing tax code.

With these themes in mind, we are ready to consider specific proposals for reform. These options may include modifying current law, overhauling the existing system, or replacing the current structure and starting over. We will study the major reform proposals that have been offered in the past, as well as new ideas. According to the Executive Order establishing the Panel, each of our recommendations for reform, if implemented, must:

- Simplify the tax laws to reduce the costs of compliance and to make it easier for taxpayers to plan for the future and manage their affairs;

- Share the burdens and benefits of the tax system in an appropriately fair and progressive manner while recognizing the importance of homeownership and charity in American society; and
- Promote long-run economic growth, higher wages and job creation by encouraging work effort and increased saving and investment to strengthen the competitiveness of the United States in the global marketplace.

The President has requested that at least one of our recommendations be based on our existing tax system. Finally, to allow comparisons between the options and the current tax system, the Panel intends to use the baseline in the President's Budget and to recommend options that are revenue neutral.

Americans deserve a fairer tax system that will minimize the burdens of complexity and compliance and promote economic prosperity and growth. The President has presented us with a unique and historic opportunity to take a fresh look at our tax system. Now is the time to take action to reform our broken tax code. We look forward to completing this important and formidable task – and to presenting options that will ensure a better tax system for current and future generations.

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