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Before
The Committee on Finance
United States Senate
August 3, 2006
on
Tax Reform Proposals

Mr. Chairman and Members of the Committee, I am Jane G. Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss tax reform proposals. Although I analyze options and approaches, please note that the Congressional Research Service takes no position on legislative options.

In November 2005, the President's Advisory Panel on Tax Reform presented two potential reform proposals: a simplified income tax (SIT) and a consumption tax proposal (the growth and investment tax, or GIT). Allow me to summarize the main points made about the panel's tax reform proposals in a recent CRS report and in this testimony.

- The plan does not deal with many details that are likely to be important in a legislative proposal, including many minor provisions of current law that may be difficult to eliminate. The resolution of these issues will have important implications for the proposals' effects on revenues, distribution, and simplification.

- The proposals are stated to be both revenue and distributionally neutral. Because the panel uses a baseline assuming the 2001 and 2003 tax cuts are permanent, both would lose revenue compared to the Congressional Budget Office (CBO) official baseline, which has the tax cuts expire as provided by current law. An additional long run revenue loss is expected because of tax-deferred savings plans. These plans also cause the income tax proposal to be slightly less progressive than current law. The consumption tax proposal is likely to be significantly less progressive than current law.

- The plans would simplify tax filing for higher income individuals and the self employed; lower income taxpayers could, in some cases, have more complicated tax returns. Much simplification for ordinary individuals rests on the assumption that many minor provisions, not actually discussed in the panel's report, will be eliminated, which may be unlikely in the case of provisions such as casualty losses and catastrophic medical expenses. Tax compliance by businesses would be simplified, especially with the GIT.

- Both plans would likely increase efficiency in the allocation of capital, by narrowing differentials in tax rates across forms of investment, reducing distortions that favor debt finance over equity finance, and reducing distortions affecting pay-out decisions and realization responses. Most of these effects would be quite small for SIT. The SIT may magnify distortions in the allocation of capital around the world.

- The effects on overall economic growth would be negligible for SIT because of the limited change in marginal tax rates. Although there would be a substantial reduction in effective tax rates on new investment under GIT, the growth effects for this plan are uncertain and may be quite modest. Projections made in a recent Treasury study show substantial variation in results depending on the model used, but the largest results are based on complex economic models whose assumptions are probably not realistic and whose main results are not based on empirical evidence. In addition, the parameters chosen for the models lead to responses that are large relative to the empirical evidence that is available.

- If one accepts the theory behind the complex models, the shift to back-loaded IRAs and other savings accounts, which is particularly significant in the GIT, would reduce saving, a feature not accounted for in the Treasury's study.

- Even where effects on output are greatest, they are small relative to normal growth and are not large enough to materially affect the budget outlook.

- The effects on economic efficiency other than in the allocation of capital are mixed: a floor under charitable deductions along with expansion to non-itemizers would contribute to efficiency, but the effects on health markets are unclear.

- Transition problems present difficulties; the main issue with the SIT would probably be in the loss of deductions for homeowners with large houses and mortgages. These transition problems in the SIT are minor, however, in comparison with the significant problems in the GIT arising from the loss of depreciation deductions, interest deductions, and deductions for the recovery of inventory. The cost of providing full transition relief is prohibitive. Inventories alone amount to close to $2 trillion.

- While the consumption tax proposed would likely increase economic efficiency and provide considerable simplification for business, transition and distributional issues may present significant barriers to adoption. These problems suggest a focus on the income tax proposal. Gains in efficiency and simplicity are smaller for this proposal, however, and problems (albeit more limited) remain with transition. Certain aspects of the plan, however, appear to contribute to efficiency and simplification without creating serious problems, including a charitable deduction floor, encouraging automatic enrollment in savings plans, and capping employer health insurance deductions. Addressing the alternative minimum tax remains an important tax issue if many more families are not to be subject to that tax over time.

The advisory panel's report discussed and found some merit in considering partial replacement of the income tax with a value added tax (VAT), but did not propose such a tax. Finally, the report discussed but rejected a retail sales tax as a replacement for the income tax, and also rejected full replacement of the income tax with a VAT. Note, however, that

there are several congressional proposals that include value added taxes and retail sales taxes as well as flat tax proposals, as well as a proposal for a 1986 style income tax reform.[1]

The remainder of my testimony discusses the panel's tax proposals in more detail. The analysis draws heavily from CRS Report RL33545, *The Advisory Panel's Tax Reform Proposals*, by Jane G. Gravelle, which contains more technical background.

Description of the Proposed Tax Changes

The income tax proposal, or SIT, is an income tax reform proposal that broadens the base and lowers the rates. The consumption tax, or GIT, is imposed as a direct tax which includes a cash flow tax on businesses and a progressive tax on individual wage income. A consumption tax of this type is often referred to by the generic term "flat tax" when rates are flat, and as an "x-tax" when the tax on wages is progressive. The GIT is not a pure consumption tax plan because it also includes a 15% tax on financial income (interest, dividends, and capital gains); rather it is a consumption tax, with a wage credit and an add-on tax on passive capital income at the individual level.

The tax reform plans have not been presented in legislative language, and therefore details of the plans are not always clear. Many tax issues, such as the treatment of casualty losses or alimony, or capital gains on owner-occupied housing, are not directly addressed, but would presumably be addressed once specific legislative changes are contemplated. For example, the proposal appears to disallow casualty loss deductions, even though these deductions were recently expanded for victims in the aftermath of Hurricane Katrina. Current law also allows alimony to be deductible by the payer and taxable by the recipient, and presumably many divorce settlements take into account this tax treatment. Many other small tax provisions are not explicitly addressed in the proposal.

The proposals generally have similar provisions that relate largely to the current individual income tax. Perhaps the most significant individual income tax deductions eliminated are itemized deductions, including the deduction for state and local taxes, although the mortgage interest deduction is replaced by a 15% capped credit and charitable deductions in excess of one percent of income are allowed to all filers. A new deduction for health insurance is added and the deduction for employer health insurance plans is capped.

The current rate structure is flattened, moving from the current rate structure of 10%, 15%, 25%, 28%, 33% and 35% to four rates (15%, 25%, 30%, and 33%) in the SIT and three rates (15%, 25%, and 30%) in the GIT. The alternative minimum tax is also eliminated and personal exemptions and standard deductions are converted to credits, with the maximum earned income credit (EIC) increased.

The proposal simplifies and indexes the exclusion for Social Security benefits, and significantly expands existing preferred savings accounts such as individual retirement

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[1] See CRS Report RL33443, *Flat Tax Proposals and Fundamental Tax Reform,* by James M. Bickley for a discussion of these plans and see CRS Report RL32603, *The Flat Tax, Value-Added Tax and National Retail Sales Tax: An Overview of the Issue*s, by Gregg A. Esenwein and Jane G. Gravelle for a discussion of these different approaches to a consumption tax. Transition problems are actually more severe for these forms of consumption tax.

accounts. This latter provision allows two savings accounts, each with a limit of $10,000. No income restrictions would apply. The "Save for Retirement" account would replace existing individual retirement accounts with a current limit of $5,000. The "Save for Family" account would replace education and health savings accounts; funds could be used for education, health, and first time home purchase. The proposals would also simplify employer savings plans and remove barriers to and encourage automatic enrollment and growth of contributions. All individual savings plans would be converted to Roth- type plans (not deductible up front) and, in the case of the GIT, 401(k) and similar plans would be converted to Roth-type plans as well.

Several provisions listed above would also have consequences for the taxation of investments in assets. For owner-occupied housing the changes in mortgage interest and property taxes would affect the return on that investment. Tax burdens on capital income would also be affected by the preferred savings accounts. In addition, taxes on dividends would be eliminated and taxes on capital gains on corporate stock reduced to much smaller levels under the SIT. A separate financial income tax (on interest, dividends, and capital gains) would be applied under the GIT, although most taxpayers would be able to shield this income in tax preferred savings accounts.

The plans would make major revisions in the taxation of business income, including the elimination of most corporate preferences. Corporate tax rates would be reduced to 31.5% in the SIT and 30% in the GIT and the corporate AMT would be repealed. The SIT (the income tax proposal) would allow a significant amount of expensing of investment in equipment as well as cash accounting for small businesses, and cash accounting for medium sized businesses (small businesses would be required to have a separate business bank account), provide a new, simplified, depreciation system, and eliminate the taxation of income from active business abroad (while taxing foreign source earnings from intangibles on a current basis).

Under the GIT all investments and purchases would be expensed (deducted when paid); old depreciation deductions are phased out, interest would not be deductible by business and interest income would not be taxable; and deductions and payment of taxes on interest on existing debt would be phased out. Taxes paid would be rebated at the border (similar to the treatment of a value added tax).

As in the case of the individual structural provisions the treatment of some items is not entirely clear. For example, while the research and experimentation credit would presumably be repealed, the expensing of intangible investment in R&D would presumably continue in the SIT as well as in the GIT .

Currently, the reform proposals are being considered further by the Treasury Department, which has recently released a dynamic analysis that discussed the two tax reform proposals as well as a third proposal, a progressive consumption tax (PCT) that modifies the GIT by eliminating the 15% financial income tax, and raising the top rate to 35%.[2]

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[2] Robert Carroll, John Diamond, Craig Johnson, and James Makie III, *A Summary of the Dynamic Analysis of the Tax Reform Options Prepared for the President's Advisory Panel on Federal Tax* (continued...)

Revenue Neutrality

One of the objectives of the proposal was revenue neutrality. How revenue neutrality is measured depends on the baseline used, and the panel to used the Administration baseline which included the permanent extension of the 2001-2003 tax cuts. This baseline differs from the baseline used by the Congressional Budget Office (CBO) which simply relies on the current tax law, and thus assumes that temporary provisions, including the 2001-2003 tax cuts, will expire. Thus, revenues raised under the Administration baseline are smaller than those raised under the CBO baseline.

As a result, the revenues raised by the tax reform proposal are associated with a substantial deficit—and one even more substantial given that there is a currently a surplus in the Social Security account that will eventually disappear and become a deficit. Over the period 2007-2016, in addition to the projected deficit of $0.8 billion, the cost of making temporary tax provisions (except the AMT) permanent, including debt service, is about $2.3 trillion. And these projections do not include the possibility that discretionary spending will rise to keep pace with national income, which would increase the deficit by $1.6 trillion.[3]

Because the panel used the Administration baseline, any comparisons made in this testimony are with current law incorporating the 2001-2003 tax reductions. Nevertheless, some additional source of revenue must eventually be identified, which means that tax rates might need to be increased or tax preferences reduced, and how that revenue is made up would affect the analysis. Also there are some smaller provisions that would be difficult to dispense with, as discussed below, and if they were restored, an additional revenue shortfall would occur.

There is an additional reason that the proposals may not be truly revenue neutral even within the context of the baseline used. The adoption of Roth-type savings accounts reduces current losses from deductions in traditional accounts, but loses revenue in the future. Such a loss could be significant. For example, some rough estimates suggest that a similar proposal by the Administration that gained a small amount of revenue in the budget horizon could eventually cost around $50 billion at current income levels, an amount equal to about 4% of current income tax revenues.[4]

Simplification

Both proposals contain many elements that would simplify tax compliance. The elimination of itemized deductions would simplify tax filing. The proposal would, however, add complexity to current non-itemizing returns, which account for 70% of all returns, by allowing the charitable deduction, health insurance deduction, and mortgage credit. Some non-itemizers do not give in amounts that exceed the threshold for charitable deductions (1%

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[2] (...continued)
Reform, U.S. Department of the Treasury, Office of Tax Analysis, May 25, 2006, prepared for the American Enterprise Institute Conference on Tax Reform and Dynamic Analysis, May, 2006.

[3] Based on data in CRS Report RS22045, *Baseline Budget Projections Under Alternative Assumptions*, by Gregg Esenwein and Marc Labonte.

[4] See CRS Report RL32228, *Proposed Savings Accounts: Economic and Budgetary Effects*, by Jane G. Gravelle and Maxim Shvedov.

of income), and either rent their homes (about a third of the population rents) or have paid off their mortgages. But for those who have either a mortgage payment or significant charitable deductions, or who purchase health insurance, tax filing will be more complicated. Charitable deductions, in particular, require record keeping, although floors may eliminate the need of those with small contributions relative to income to do so. All taxpayers should experience simplification from the collapsing of deductions, exemptions, and credits into a single family credit, and, for higher income taxpayers, from eliminating phaseouts and the AMT. Higher income taxpayers who save will also benefit from the simplified savings accounts.

The proposal, on its surface, also eliminates some itemized deductions that are difficult to dispense with, such as the casualty loss deduction, the deduction for extraordinary medical costs, and the deduction for miscellaneous items such as employee and investment costs. Because the panel remained silent on these other itemized deductions, there is no way to know how they would be treated. These exemptions, all over a floor (except for casualty losses for hurricane victims in 2005), are designed to allow offsets for unusually large costs relative to income. It is difficult to imagine not allowing some deduction for these extraordinary costs, but allowing the deductions for all taxpayers would significantly add to the complexity of the tax form. Under current law, two factors limit the claiming of these deductions to truly large costs: the floor, and the fact the deduction is itemized (so that low income individuals must have a significant dollar loss). Since itemized deductions are no longer feasible, as there is no longer a standard deduction, restoring these deductions would be complicated and undo much of the apparent simplification with respect to itemized deductions.

There are also "above the line" deductions, such as those for alimony and for moving expenses, as well as some credits that might be thought desirable (the child care credit) whose retention might prove important. Given the extension of tax benefits to non-itemizers, and the possibility of reintroducing some additional deductions, it is not clear whether simplification for individual tax filers on the whole is increased or decreased.

Allowing cash accounting and expensing for small businesses under the income tax proposal would also significantly simplify their tax compliance, although much of this benefit would be lost if state income taxes do not make similar adjustments. The provision requiring small business bank accounts to be handled separately from personal accounts could complicate the affairs of those with occasional small amounts of self-employment income unless a de-minimus rule were adopted, however. (An example would be a professional who receives a small consulting fee, but whose major source of income is employment, or a skilled workman who occasionally moonlights). Complications would also occur for business owners who use assets for both business and personal use (e.g. homes and cars). Although there is some simplification of the depreciation system for larger businesses, most of the current complexities would remain, as would most of the challenges in allocating international income for multinationals which cannot be eliminated. The elimination of the production activities deduction is an important simplification, however.

On the whole, the income tax proposal appears to simplify the tax system for higher income taxpayers and the self-employed, while possibly complicating it for lower and middle income wage earners. The consumption tax proposal should achieve more simplification for business because all acquisitions would be expensed. In this system, there is no need to keep depreciation accounts or inventories, or deal with the foreign tax credit.

Fairness and Equity

Issues of tax equity may concern vertical equity (how effective tax rates rise as incomes rise) and horizontal equity (how different taxpayers with similar circumstances are treated). The discussion below suggests that the income tax replacement would have relatively small effects on either vertical or horizontal equity, and indeed may increase differentials across family types. It is more difficult to characterize the growth plan, which is essentially a consumption tax, but there is a case to be made that such a tax would be much less progressive than the current income tax system. In any case, the distributional method used in the panel's study for their progressive consumption tax is inconsistent with the one they suggest is appropriate for another, economically equivalent, consumption tax—the VAT.

Vertical Equity

An objective of the panel was to maintain the current progressivity of the tax system and the panel's report shows both the SIT and the GIT to be distributionally neutral, at least across broad income classes. (There is no detail about the extremely high income individuals at the top who constitute only a tiny fraction of taxpayers but a large fraction of income.) Note that this distributional comparison is with respect to the assumption that the 2001and 2003 tax cuts, which favored higher income individuals, are in place. Even so, there are questions about the distributional neutrality of the plans.

The commission's distributionally neutral system is likely, in part, a temporary artifact of the shift into back loaded savings accounts (which can raise revenue from owners of assets in the short run but lower it dramatically in the long run). The magnitude of this effect is difficult to determine, but analysis of the President's budget proposals of this nature, which had less generous contribution limits and negligible revenue effects in the budget window, suggested the long run revenue loss could easily be $50 billion or more at current income levels, an amount equal to 4% of FY2005 corporate and individual income taxes.[5] This saving would accrue to individuals in the higher income levels, as savings of any sort tends to be concentrated there.

Distributional issues are far more problematic in the case of the consumption tax proposal. Although distributional tables are presented that also show distributional neutrality, that conclusion is not clear. As in the case with the income tax proposal, some of the effect reflects the effects of savings accounts and this effect is even more important in the GIT because all defined contribution plans (such as 401(k)s) will be converted into backloaded plans. Moreover, because dividends and capital gains are taxed under this proposal, the long run sheltering of income by high income individuals may be even more important. The effects will likely be larger than the effects in the SIT, which are already significant.

A second, and more important, problem with evaluating vertical equity under the GIT is how to distribute the tax that is collected. One might propose to allocate the tax according to consumption, along with a credit for wage tax reductions due to graduated rates. Indeed, in discussing the VAT, which is also a consumption tax, the study indicates that tax would be allocated according to consumption and would be regressive, not progressive, requiring

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[5] Ibid.

additional fixed rate credits and, even in that case, resulting in lower shares of tax paid by the highest income individuals. However, for the GIT, which is simply a VAT imposed in a different form with a wage credit, a different distributional methodology was used. The business cash flow tax is allocated according to income, and thus the tax is modeled as if it were an income tax.

A consumption tax is a tax on wage income and a lump sum tax on old capital that is effectively collected over time as the assets are consumed. For very high income individuals who indefinitely pass on assets in estates, that consumption may never occur. If one distributed the tax on the basis of consumption, the tax would decline as income rises despite the rate structure. The tax was, however, distributed as if it were an income tax and thus the cash flow tax at the firm level (which is really a lump sum tax on old capital that may or may not be translated into an effective tax on consumption) is treated as if it is a tax on income and falls on high income individuals.

To illustrate the importance of these approaches, consider a recent study that compared the distributional effects of an "x" tax with a 15% and 30% rate and a demogrant (rebate to lower income individuals to offset the tax) under both approaches.[6] This plan is similar in many respects to the panel's proposal. If distributed according to consumption, the middle quintile has an effective tax rate of 23.3%, the top quintile a tax rate of 12.1% and the top 1% a tax rate of 6.1%. If distributed according to income, the tax rate is 11.4% for the middle quintile, 22.5% for the top quintile, and 22.0% for the top 1%.

Distributing a consumption-based tax in the short run is tricky, and there is no perfect answer because the cash flow tax is a tax that causes asset values (or their purchasing power) to fall, but does not burden new investment which can be purchased at a discount. However, in the long run the consumption tax base tends to be similar to a wage tax base, except that it also favors higher income people, even in the long run, because they are less likely to consume all of their lifetime wage income. Thus it is highly unlikely that the GIT is distributionally neutral; it makes the tax system less progressive by largely exempting capital income from tax.

Horizontal Equity

Horizontal equity refers to the equal treatment of equals. There are three basic issues of horizontal equity that could be considered: equal treatment of different family sizes, equity in the treatment of different age cohorts, and equity in the treatment of taxpayers who vary in their preferences for tax favored activities.

A recent study used an equivalency index (similar to the poverty levels that vary across family size) to compare tax burdens on families of different sizes.[7] This analysis suggested that in the lower income levels, families with children tend to be heavily favored compared to singles and childless couples with similar abilities to pay, while the reverse is the case at the higher income levels. The tax reform plans appear largely to preserve these features of

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[6] See Leonard Burman, Jane Gravelle, and Jeff Rohaly, *Towards a More Consistent Distributional Analysis*, forthcoming in the Proceedings of the National Tax Association, 2005 Conference.

[7] See Jane Gravelle and Jennifer Gravelle, "Horizontal Equity and Family Tax Treatment: The Orphan Child of Tax Policy," forthcoming, *National Tax Journal*, Sept., 2006.

the tax system. The benefits for families with children at lower income levels arise from the earned income tax credit and child credits, which are maintained. At higher income levels families with children are penalized because the adjustments for family size are not large enough; this problem may be magnified by the converting of personal exemptions into credits, but reduced by the repeal of the alternative minimum tax and phase-outs of deductions. On the whole there appears to be no major change in this aspect of the tax system.

Consumption taxes, such as the GIT, inevitably shift the burden of the tax towards the current older generation and away from young and future generations. Essentially, those with assets who expect to consume out of these assets are subject to a substantially higher tax. This shifting across the generations is relieved to some extent by the transition rules that allow some recovery of depreciation, but this offset is quite limited. That shift means that older people pay a higher lifetime tax than younger or unborn generations.

The elimination of preferences for investment types, the most frequent type of tax preference in the income tax, is generally not viewed as important to horizontal equity in the long run, since capital and pre-tax returns shift to equate returns after tax. The tax revisions continue to favor home ownership, although, as seen below, to a lesser degree. The proposals eliminate the preferences for taxpayers in states with higher taxes, and appear to reduce the benefits for those covered by employer provided health care while allowing benefits for those not covered by employer plans. Charitable contributions effects are mixed as the benefit is provided to non-itemizers, but also subject to a floor. On the whole, the proposals appear to improve horizontal equity as measured on this basis.

Efficient Allocation of Capital and The Taxation of Capital Income

In the broadest terms, a tax reform can alter economic behavior by changing the tax rates on labor and capital income. One of the most important ways in which the tax reform proposals would affect the nature of the tax system is through changes in the taxes on capital income. Indeed, the indications from a recent dynamic analysis of the tax reform proposals[8] suggest there is little or no change in either average or marginal tax rates on labor income from the proposals. It is largely in the treatment of capital income that the proposals have a potential effect.

Change in the treatment of capital income can improve economic efficiency if they lead to a better allocation of capital to different uses. In general, more even taxation of different types of assets is more efficient. If investors tend to equate returns after tax on different investments, then more neutral taxation will more clearly equate the pre-tax, or social, return, leading to a higher level of output and well-being. A lower aggregate tax rate on capital income can also reduce distortions and lead to a more optimal savings behavior.

CRS Report RL33545, *The Advisory Panel's Tax Reform Proposals,* contains an extensive discussion and estimates of effective tax rates on new investments to indicate the

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[8] Robert Carroll, John Diamond, Craig Johnson, and James Mackie III, *A Summary of the Dynamic Analysis of the Tax Reform Options Prepared for the President's Advisory Panel on Federal Tax Reform*, U.S. Department of the Treasury, Office of Tax Analysis, May 25, 2006, prepared for the American Enterprise Institute Conference on Tax Reform and Dynamic Analysis, May, 2006.

narrowing of differentials of various types, which will be briefly summarized in this section. The discussion below indicates that the SIT is likely to slightly narrow differentials across assets, but the GIT will have a substantial effect.

Distortions Across Assets

Distortions across different types of assets within a firm will be slightly reduced by the SIT, and eliminated by the GIT. Under current law, at the corporate level, tax rates of fixed assets (excluding oil and gas production investment other than equipment, which is taxed at around 6%) vary from 15% for certain long lived equipment eligible for the production activities deduction to 40% for certain structures; the SIT will reduce the range to 13% to 37% inclusive of oil production. The GIT will set all rates to zero. On average, under current law, equipment is taxed at 25%, structures at 30%, and inventories at 37%. SIT would change the rates to 27%, 31%, and 35%, while the GIT would lower them to zero.

Distortions in Financial Decisions

The tax rates discussed in this and the following subsection take into account not only the tax on corporate profits, but also individual level taxes and the benefits of deducting interest by corporations. Under current law, not taking into account tax preferred savings in IRAs and pension plans, corporate debt is taxed at 9% and equity at 37%; under SIT the rates would be 16% and 33%, while under the GIT they would be 15% and 12%. Currently about half of assets are in tax exempt forms, and if those benefits are taken fully into account, the tax rate is -11% for debt and 33% for equity; under SIT the rates are -3% and 31%; under GIT 8% and 6%. It is possible that the SIT could magnify effects, however, if more assets are in tax exempt form. With 100% of assets not subject to individual level tax, the rates would be -23% and 30%. For the GIT they would be zero. The proposals also reduce the distortions between dividends and capital gains and the capital gains lock in effects.

Distortions Across Sectors

The plans also reduce the distortions between corporate business, noncorporate businesses, and owner-occupied housing, especially under the GIT. Under current law, ignoring tax exempt forms, the overall effective tax rate on returns to corporate investment is 32%, for noncorporate business 20% (18% for firms who are eligible for equipment expensing at the margin), and for housing -3%. Under SIT, tax rates are 30% on corporations, 18% on small noncorporate business (who dominate the noncorporate sector), 22% on large noncorporate business, 20% on medium non-corporate business, and 3% on housing. The GIT imposes a tax of 14% on corporations, 6% on noncorporate business, and 0% on housing.

With 50% of assets held in tax exempt forms, the overall effective tax rate for corporations is 25%, for noncorporate business 18% (16% for firms who are eligible for equipment expensing at the margin), and for housing -13%. Under SIT, tax rates are 25% on corporations, 14% on small noncorporate business, 18% on large noncorporate business, 16% on medium non-corporate business, and -1% on housing. The GIT imposes a tax of 7% on corporations, 3% on noncorporate business, and -8% on housing. With 100% tax exempt forms, under SIT, tax rates are 20% on corporations, 10% on small noncorporate business, 14% on large noncorporate business, 12% on medium non-corporate business, and -6% on

housing. The GIT imposes a tax of 0% on corporations and unincorporated businesses and -17% on housing.

In general, therefore, the differentials across assets are narrowed, but that effect is much smaller under the SIT than under the GIT.

Economy Wide Tax Rates

Overall, without tax exempt forms the total tax rate is 18% for current law, 17% for SIT and 7% for GIT. With 50% tax exempt financing, the rates are 11% for current law, 13% for SIT and 1% for GIT. With 100% tax exempt financing the rates are 9% for the SIT and -6% for the GIT. Thus, overall, the SIT has little effect on marginal tax rates on capital income, while the GIT tends to lower the rate.

International Allocation of Capital

The panel proposes a significant change in the tax treatment of foreign source income in its income tax proposal, and proposes to treat taxes in its consumption tax proposal (GIT) in the same manner as a VAT.

Under current income tax law, income of foreign subsidiaries of U.S. parents is not taxed until repatriated as dividends, a treatment referred to as deferral. Income of foreign branches of U.S. companies is taxed currently as is certain passive income (Subpart F income) of subsidiaries that is easily subject to abuse. When income is taxed, firms can take a credit against foreign taxes paid up to the amount of the U.S. tax due and these credits are aggregated across countries, so that unused credits for taxes in high tax countries can be used to offset U.S. tax due in low tax countries. This offsetting of credits across countries is referred to as cross-crediting. Certain passive income is segregated into a separate foreign tax credit "basket."

The international tax regime has several problems relating to economic efficiency and tax compliance. First, because of deferral and cross-crediting, too much of U.S. investment flows to low tax countries (where its pre-tax return is too low) and too little to the United States and high tax countries. Deferral does not produce as large a disincentive as outright exemption, but once income is earned abroad there is an incentive to reinvest abroad to avoid the repatriation tax. Second, the potential to reallocate profits from high to low tax jurisdictions complicates tax administration and compliance. Profits may be reallocated by setting prices for inter-company transactions and by assigning patent rights to operations in low tax countries. In addition, since companies control their tax liability through repatriation decisions, they engage in complex planning to minimize their taxes, and, indeed, very little tax is paid on foreign source income.

One reform approach would be to tax all income currently, which would eliminate the repatriation issue. Also, if it were administratively feasible (although there are claims that it is not), foreign tax credits could be separated into country baskets, a treatment that would eliminate incentives for investment in low tax countries (although it would increase the disincentive to invest in high tax countries). But even with cross-crediting, a case can be made that this change would lead to greater economic efficiency through eliminating much of the incentive to invest in low tax countries. Moreover, there would be less incentive to transfer income across different countries. U.S. individual investors could avoid some of this

current tax by investing in foreign parents and there would also be incentives for U.S. parents to transform into foreign parent corporations (corporate inversion). The evidence suggests that these effects would probably be small, and corporate inversions could be discouraged with legislation. Revenue raised from this approach could be used to reduce the corporate income tax rate and top income tax rates, if the distributional effects are to be held constant.

An argument is sometimes made that this type of change would lead to an unfair disadvantage to companies that must compete in low tax countries with firms from other countries who do not tax their subsidiaries' income. It could lead to a smaller presence abroad of U.S. firms, but, nevertheless, the investment that takes place in the United States would earn a higher return and benefit the U.S. economy. That is, from the point of view of U.S. society as a whole this is not so much an "unfair competition" but rather a system that diverts resources to their best uses.

The panel did not choose current taxation of foreign source income, but rather a complete exemption of active income, and current taxation of passive income including royalties. This latter provision would eliminate the ability of companies to shift income abroad through the use of royalties. This option suggests the panel wanted to focus more on the international abuses and reduction of planning costs, as this treatment eliminates the repatriation decision and reduces the opportunity to shift income through royalties. The panel argues their plan on the basis of conforming to what most other countries do and also invokes the "level-playing-field" argument discussed above. They also suggest that the tax shelter problem is more severe than the real allocation of capital. But the plan can be criticized as not only increasing real asset allocation distortions but also giving up the opportunity to reduce transfer pricing and expense allocation methods of shifting profits to low tax jurisdictions.[9]

For the consumption tax plan, since the tax is no longer a corporate income tax, all of these mechanics would be abandoned. Two approaches that are generally equivalent for a uniform tax (and this tax is relatively uniform) are an origin basis tax (where output is taxed where produced) and a destination basis tax (where output is taxed where consumed). In the destination approach, as used in the VAT, taxes would be rebated on exports and imposed on imports. The panel recommends a destination basis because it eliminates the incentive to shift taxable sales into low tax countries.

Effects on Savings, Labor Supply, Growth, and Output

If tax rates on capital and labor income affect labor and savings and if they are altered, output and, in the near and intermediate term, growth rates in the economy can change.[10]

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[9] For a recent study which compares these systems, with a discussion of these profit shifting issues, see Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross Border Income," presented at the James A. Baker III Institute for Public Policy Conference, "Is It Time for Fundamental Tax Reform?: The Known, Unknown, and Unknowable," Houston, TX, April 27-28, 2006.

[10] In most growth models changes in savings rates and labor supply cannot affect the long run growth rate which is determined by population growth and exogenous technological change. There are models of endogenous growth, but the factors that drive those growth rates are unlikely to be (continued...)

Despite the presumption that lower tax rates will increase supply, such an outcome is neither theoretically nor empirically certain. For both of these effects, there are offsetting income and substitution effects. A rise in after tax wage income can cause work effort to decrease because the individual wishes to consume more of everything, including leisure, offsetting the incentive to shift consumption from leisure to other goods, with the outcome uncertain. Similarly, a rise in the after tax rate of return can allow individuals to achieve a target amount with smaller savings, offsetting the effects of the incentive to save more to achieve a higher target. Simple empirical evidence suggests that effects are small because labor supply and savings responses are relatively small.[11]

Economists at the Treasury Department recently prepared a dynamic analysis of the tax reform plans, and that analysis will be used to discuss the potential growth effects.[12] The Treasury study, in addition to examining the two reform plans, also examined a personal consumption tax (PCT) that was similar to the panel's consumption tax (GIT), but excluded the 15% tax on financial income (interest, dividends, and capital gains) and had a slightly higher top tax rate (35% rather than 30%).

The Treasury used three different models to analyze the effects. One model is a standard neoclassical growth model with fixed labor supply and an elasticity of savings with respect to the rate of return equal to 0.4. The other two models used in the Treasury study were the standard intertemporal models, the Ramsey model which depicts the economy as a single infinitely lived person, and the overlapping generations model (OLG) which traces cohorts of individuals over time. These intertemporal models were developed to bring the microeconomic foundations of decisions regarding savings and labor supply into macroeconomic models. While more satisfying theoretically to many economists, these models have not been tested empirically and are highly stylized in many ways.

Table 1 summarizes the effects on output of the various reform plans using the three models in the first 10 years, in year 20, and in the long run steady state. As the numbers in this table indicate, two results are clear. First, the income tax reform has very small effects on growth in any of the model simulations, because it has little effect on tax rates. None of the proposals had a significant effect on marginal and average wage tax rates, and only the consumption tax proposals had an effect on tax rates on investment.[13] Second, for those

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[10] (...continued)
affected by the tax changes in the reform plan.

[11] For a review of the empirical evidence see CRS Report RL31949, *Issues in Dynamic Revenue Estimating*, by Jane G. Gravelle.

[12] Robert Carroll, John Diamond, Craig Johnson, and James Mackie III, *A Summary of the Dynamic Analysis of the Tax Reform Options Prepared for the President's Advisory Panel on Federal Tax Reform*, op. cit.

[13] The Treasury study reports the marginal and average income tax rates on labor income at 24% and 13% respectively. Under the income tax plan, these rates are estimated at 24% and 12.8%, while in the consumption tax plan they are 23.5% and 13.3% respectively. The marginal and average rates go up slightly in their personal consumption tax plan (PCT), to 26.4% and 14.7%. For capital income, the Treasury study estimates a current marginal tax rate of 13.9%. For the income tax reform, the rate falls slightly to 12.8% but for the consumption plan (GIT), the reduction is much larger, to 1.1%. Their personal consumption tax rate is -3.7%. The tax rates used in their analysis (continued...)

proposals that had a noticeable effect on the capital income tax rate, the results vary significantly depending on the model used. In the first 10 years, on average output increases by 1.9% for the Ramsey model, 1.5% for the OLG model, and 0.1% for the Solow model. In the long run, output is larger respectively by 4.8%, 2.2%, and 1.4%.

Table 1: Percentage Change in National Income, Treasury Study

Plan	Solow Model	OLG Model	Ramsey Model
Simplified Income Tax (SIT)			
Budget Window	0.0%	0.4%	0.0%
Year 20	0.1%	0.8%	0.2%
Long Run	0.2%	0.9%	0.3%
Consumption Tax Plan (GIT)			
Budget Window	0.1%	1.5%	1.9%
Year 20	0.4%	2.1%	3.7%
Long Run	1.4%	2.2%	4.8%
Personal Consumption Tax (PCT)			
Budget Window	0.2%	0.7%	2.3%
Year 20	0.6%	2.6%	4.5%
Long Run	1.9%	2.8%	6.0%

Source: Treasury Department, Office of Tax Analysis.

Explaining the causes of these different results and evaluating the reasonableness of the models is quite complicated, and the technical discussion is contained in an appendix to CRS Report RL33545, *The Advisory Panel's Tax Reform Proposals*. The major conclusions suggested in that appendix are as follows:

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[13] (...continued)
are similar to the ones calculated in this study in Table 5.

- Straightforward empirical evidence indicates that savings could rise or fall and even in the model with the most modest results (the Solow model) it is not clear that the effects would, indeed, be positive, as some time series elasticities are negative.

- The use of Roth-type IRAs and, in some cases, 401(k)s from traditional IRAs would, according to the theory embedded in intertemporal models, be less likely to induce savings as individuals would no longer need to save the up-front tax reduction to pay future taxes. This effect could be particularly pronounced in the GIT where defined contribution pension plans will be converted to Roth style plans, as substituting a Roth for a deductible plan should *reduce* savings. These effects are not accounted for.

- Intertemporal models, while theoretically appealing in many ways, involve some fairly heroic assumptions about the abilities of individuals to make complex decisions and have not been empirically tested. Much of the savings response reflects intertemporal substitution of labor in response to interest rates changes, where virtually no evidence of a response is available. Alternative "rules of thumb" savings behavior may be more consistent with individual savings behavior and tend to imply a zero or negative elasticity. This view of behavior suggests that automatic enrollment in employer retirement plans, facilitated by the proposals, might increase savings, for which there is some direct evidence.

- The Ramsey model also suffers from some serious limitations, as it requires some strict assumptions to achieve an internal solution (i.e. where there is general ownership of capital across many people, as observed in the economy), including homogeneous preferences, asexual reproduction, and a common tax rate, thereby making it impossible to apply the model to a progressive tax rate structure, an open economy, or to incorporate differential state tax rates.

- Even within the context of the intertemporal models, many of the implicit elasticities are inconsistent with the empirical evidence, including the labor supply elasticities and particularly the intertemporal labor substitution elasticity, which empirical work suggests is less than 0.2 but which is set at around 0.75 in the Ramsey model and around 0.5 in the OLG model. Standard labor supply elasticities also tend to be higher than most empirical estimates, especially in the Ramsey model. Part of the reason for these high elasticities is the somewhat arbitrary choice of hours available for additional work.

- Even where the higher growth effects are expected, these effects are quite modest compared to the normal growth of the economy. For example, the largest growth is projected for the GIT by the Ramsey model. In that simulation, over the 20-year period, output rises by 3.7%, for an average annual growth rate of less than 2/10 of a percent. Normal growth is usually 2 to 3% and growth per worker typically 1% or more. Growth induced by even a significant tax change of this nature is not likely to materially affect the fiscal outlook—that is, we cannot grow our way out of the deficit by changing the shape of the tax system.

Other Tax Incentives

The tax reform proposal eliminates a series of tax preferences, some of which are discussed in the document and some of which are simply presumed to be eliminated based on general statements. An analysis of this myriad of tax incentives is beyond the scope of this discussion, although it is possible to argue that many of them tend to distort the allocation of resources and many are simply accidents of history.[14] Some provisions, however, are substitutes for what might be desirable spending programs that are channeled through the tax system, and repealing them without providing an alternative spending program may be questioned.

An example is the low income housing credit, for which a case may be made that use of the tax system is inefficient, but where the goal (helping low income people obtain decent housing) may be laudable. Another example is the education tax credit and deduction which was aimed at making higher education more affordable for the middle class and was phased out at higher incomes. The tuition credits and deductions were criticized because a direct system for delivering aid was already in place, and using the tax system simply made the system more complicated. One can also debate the desirability of expanding aid to middle class, given the extensive subsidies that already exist, but that is a debate about education, not tax, policy. It is the case, however, that the proposal retained the subsidies for saving for higher education through the "Save for Family" accounts, subsidies that are likely to be more concentrated to higher income families who can afford to save for a long period of time.

As noted above, many of the provisions in current law affect the allocation of capital investment and the major ones are incorporated in the analysis of capital income taxes. There are certain consumption items that are favored in a significant way by the current tax law, and these will be discussed briefly in this section. Perhaps the most significant, in terms of lost dollars of revenue, is the current benefits for health care, and specifically for health insurance. Also discussed is the subsidy for charitable giving and the effect on state and local governments (due to the deductibility of state and local taxes and the exclusion of interest on tax exempt bonds). The panel's proposal would make changes in all of these areas. While a full analysis of these issues is beyond the scope of this analysis, some brief discussion is provided.

Health Care

Some of the largest subsidies in the tax code accrue to health care, with forgone revenues of $90.4 billion in FY2006 for the exclusion of health insurance benefits from employees' income. There is also a $3.8 billion loss for exclusion of health insurance for the self-employed. Some part of spending for cafeteria plans, where employees choose benefits, is associated with health care; these plans result in a revenue loss of $27.9 billion. In addition to these benefits for private health insurance, $7.5 billion is lost in itemized deductions for major health costs (those over 7.5% of income). There are also some losses

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[14] For a brief discussion of each of the over 100 tax expenditures see U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compilation of Background materials on Individual Provisions*, Prepared by the Congressional Research Service, S. Prt. 108-54, Dec., 2004.

due to exclusion of employee benefits and Medicare benefits, the latter being relatively costly.

There are reasons for government intervention into the health care market, which is subject to adverse selection (differential premiums for people with poor health histories) and moral hazard (encouraging too much spending on health care due to insurance). In addition, our society does not wish to deny critical medical care to people due to lack of ability to pay.

The revisions in the panel's plan may reduce some of the problems but possibly aggravate others. The exclusion of insurance for employer plans (and the self-employed) can be criticized on the grounds that it adds to moral hazard (by encouraging coverage of ordinary medical expenses) and is unfair because it does not benefit employees of firms without plans. At the same time, employer plans, by pooling individuals in the workplace, can address adverse selection. The proposal to limit employer contribution deductions (it is not practical to tax this implicit income to employees) might reduce moral hazard without interfering with the benefits of offsetting adverse selection, and thus may be considered an efficient reform. Allowing a deduction for health insurance premiums to those not covered by employer plans has both desirable effects—it would be more equitable and would improve coverage—and undesirable effects—it would increase moral hazard and could undermine the employer system with its improvement of adverse selection. In addition to including health-related fringe benefits, the plan would eliminate the extraordinary medical expense deduction, a provision that allowed relief for families with significant medical costs, and which might be difficult to dispense with.

Charitable Contributions

The panel's proposals would restrict the current deduction for charitable contributions to amounts over a floor equal to 1% of income, and would also extend the benefits to all taxpayers, not just itemizers. The proposal would also permit individuals to sell assets and donate the cash to charity without paying a capital gains tax if the cash is donated within a short time frame, a provision that would eliminate the tax benefits of donating property directly.

Charitable contributions are subject to a market failure in that, assuming individuals benefit from the goods financed by charitable contributions, individuals can "free-ride" on others' contribution. Because of this "free-ride," people count on others to fund charities and do not give enough in the aggregate. Thus there is a justification for a subsidy. The tax benefit is potentially subject to abuse as people attempt to gain private benefits, overstate their deductions, and exaggerate values of property donated. Even for taxpayers who are intending to be honest, valuation of property is often difficult. This problem would be reduced to some extent by the provision allowing the property to be sold and then donated.

The 1% floor would contribute to target efficiency, which focuses on how much charitable contributions are increased for each dollar of revenue loss. Target efficiency is often referred to as "bang for the buck." The floor would also achieve administrative simplicity, by disallowing small deductions. Among itemizers, it would reduce the overall incentives for giving (for those with contributions under the threshold). According to calculations using the public use statistics of income file, about 63% of itemizing

contributors gave over 1% of income.[15] These contributors accounted for 95% of giving, with 18% under the floor and 77% above the floor. These numbers suggest for itemizers that the floor will create a more target efficient system without doing much to reduce giving, since 78% of the revenue gain from the floor is associated with the loss deductions by those already over the threshold who will retain an incentive to give at the margin.

The extension of the deduction to non-itemizers may offset the reduction in coverage and also will be more efficient than a deduction without a floor. Thus, overall this change is likely to lead to a more effective incentive for charitable giving.

State and Local Tax Deductions; Tax Exempt Bonds

The proposal eliminates the existing deductions for state and local taxes, which include income, property, and, as a temporary alternative to income tax deductions, sales tax deductions. The property tax deduction can be considered as part of the general beneficial treatment to owner-occupied housing, as well. But, in general, the argument against deducting state and local taxes is that these taxes pay for state and local goods and services that are not taxed to the recipients; hence the deduction encourages more expenditure on these goods. Of course, there is no close relationship between taxes and services as there is for private spending or even fees (such as those for national parks), so this argument is not entirely straightforward. The deduction also encourages the use of deductible taxes (income and property, and, temporarily, general sales taxes); some consider this effect to be an inappropriate interference in choice, but others may support the encouragement to use more progressive taxes, especially the income tax. Another argument for allowing a deduction is that these taxes are not voluntary and reduce ability to pay, although the deduction can also be criticized as favoring taxpayers in high tax states. Whether the deduction for state and local taxes is desirable, or undesirable, therefore, is difficult to determine.

Another major subsidy in the tax system is the exemption of interest on state and local bonds. On theoretical grounds, this benefit is questionable because there seems no particular reason to favor spending on investment goods (which generally are the purposes of these bonds) and some of the subsidies go to investments which are not really public goods either through localities financing (for example) sports stadiums and convention centers, or through the use of private activity bonds which are permitted to benefit private investors with restrictions on the purposes and amounts. Although there is no explicit elimination of the subsidy, the expansion of tax favored savings accounts in both plans will diminish the tax benefit.

Transition Issues

In any major tax revision, transition issues become difficult. In the case of the income tax plan (SIT), these transition issues are likely to be most problematic for moderately high and higher income homeowners who have purchased homes with values high relative to income, and will lose part of the value of their mortgage deductions and their deduction for property taxes.

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[15] These estimates were provided by Maxim Shvedov of CRS based on the Statistics of Income public use file.

The transition problems are much more severe for the consumption tax proposal and, indeed, may be severe enough to make adoption of such a proposal impossible. In shifting from an income to a consumption base, businesses would normally lose all of their recovery of costs of existing assets, including depreciation deductions, basis in the sales of assets, and costs of goods sold when selling items in (or produced from) inventory or intermediate purchases.

A consumption tax is, as noted above, equivalent to a wage tax and a lump sum tax on capital income. Under a consumption tax without transition rules, the value of assets falls because the full value of the asset will be taxed upon sale. Also, because the consumption tax does include financial assets in its base but does not require a price accommodation (as might be the case for a VAT or a retail sales tax), that lump sum tax on old assets falls on the equity share of capital. It should also be reflected in stock market share values, where, absent adjustment costs, the imposition of a 30% consumption tax should be expected, given that about one third of assets is debt financed, resulting in a theoretically predicted fall in asset value of 45% (20%/(2/3)).[16] Taxpayers with heavily debt financed assets not only would not be able to deduct interest costs, as well as depreciation or costs of goods sold, but also can suffer a significant burden if they wish to sell their business or major asset, with the tax due on sale exceeding their cash proceeds.[17] Examples of taxpayers who might be adversely affected are individuals with substantial inventory going out of business (and unable to deduct the cost of their goods sold) or individuals who own and wish to sell a single piece of property, such as a building.

These effects are adjustment costs, and can be reduced by transition rules, but transition rules for recovery of depreciation or inventory costs would be extremely expensive. This lump sum effect would be offset in part if depreciation deductions and recovery of old inventory costs were still allowed, but without adjustment costs, assets would still lose about half of their value because the present value of depreciation deductions is less than the current value of the property.[18]

The panel's transition rules are quite limited. There would be a four-year phaseout of depreciation deductions and interest deductions—80% in the first year, 60% in the second, 40% in the third, and 20% in the fourth. (Interest would be taxed in the same proportions.) No other transitions are allowed, and sale of an asset would terminate depreciation transitional rules and new financial contracts would terminate interest deduction allowances.

Based on this transition rule, a taxpayer with a new nonresidential building purchased before the tax was imposed would lose approximately 95% of scheduled deductions on buildings, about 65% of deductions for equipment (for a typical seven year asset), and all of the deductions for existing inventory (either goods for sale or goods in process). The loss would be smaller in present value for the buildings and, to some extent, for equipment, and smaller for older assets. But inventories would bear virtually the full loss, and the loss is

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[16] These effects are smaller in the short run, if there are adjustment costs.

[17] See CRS Report RL32603, *The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues,* by Gregg A. Esenwein and Jane G. Gravelle for a further discussion.

[18] See Leonard Burman, Jane Gravelle, and Jeff Rohaly, *Towards a More Consistent Distributional Analysis*, forthcoming in the Proceedings of the National Tax Association, 2005 Conference.

substantial. "Current inventories" for the fourth quarter of 2004 were $1.7 trillion, so that providing any sort of partial relief would be extremely costly, as most inventories are turned over very quickly.

Taxpayers with outstanding debt would also lose a significant fraction of interest deductions unless they can refinance. Not all bonds can be called. According to bondmarket.com, out of $207.7 billion of corporate bonds with maturities of over a year, over half, or $121.7 billion, are not callable.[19] The average maturity of bonds is approximately seven years.[20] For a seven-year bond paying a coupon, taxpayers would lose 71% of interest deductions. The loss would be greater for longer maturities: 80% for a 10-year bond, 90% for 20-year bond, and 93% for a 30-year bond.

Presumably all depreciation would be lost when an asset is sold and presumably the basis of the asset would not be recovered (all proceeds taxed). Thus all depreciation would be lost for these assets.

These transition problems impose a very significant barrier to the possibility of adopting a consumption tax.

Conclusion

Of the two proposals presented by the panel, the income tax revision may well be more practical to implement. The consumption tax has gains in efficiency (through the allocation of capital), possibly some gains in growth (although the analysis in this testimony and the CRS report suggests these effects may be modest), and some significant gains in simplicity, especially for business, that exceed those of the income tax proposal. However, the analysis presented in the last section suggests that the progressive consumption tax proposed by the panel would be very difficult to implement. Moreover, the consumption tax is likely, when appropriate distributional analysis is considered, to significantly reduce the progressivity of the federal tax system.

These observations suggest further consideration of the income tax proposal (SIT). There are some important simplifications in the SIT, especially for businesses and high income individuals, although lower income taxpayers may find their affairs more complicated. In translating the income tax plan to a more detailed proposal that deals with small, but important, deductions, however, some of these simplification gains may be lost. The SIT faces revenue sufficiency problems that will require some taxes to be increased in the future, and is probably not entirely distributionally neutral, but shifts some of the burden somewhat away from high income taxpayers. There are efficiency gains in a number of areas, although probably little effect on growth, and the change to the international tax rules may increase inefficiency and even exacerbate tax sheltering. There are also some transition problems, but they are small compared to the consumption proposal.

Whether the gains from the changes under the SIT are worth the costs is unclear. Historically, it has been difficult to make major changes to the tax code because of the

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[19] See[http://www.bondmarkets.com/story.asp?id=2234].

[20] See[http://www.bondmarkets.com/story.asp?id=2235].

disruption in taxpayers' affairs. Nevertheless, there are some limited aspects of the proposals that do seem to have many advantages and few drawbacks. The proposal for a floor on charitable deductions has a salutary effect on both target efficiency and tax administration and simplification. Removing barriers to automatic enrollment in employer retirement plans is, as well, a proposal that is likely to facilitate savings. A ceiling on deductions by employers in health insurance plans appears to preserve the benefits of reduced adverse selection in health insurance markets while reducing both moral hazard effects and differential treatment of taxpayers. It may be that the greatest contribution of the panel study is to identify some possibilities for more limited reforms.