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## EFFECTS OF THE TAX REFORM PANEL'S PROPOSALS ON LOW- AND MODERATE-INCOME HOUSEHOLDS

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### Executive Summary

On November 1, 2005, the President's Advisory Panel on Tax Reform presented its recommendations to Treasury Secretary John Snow. The panel's report offers two alternative comprehensive reform plans, a "simplified income tax plan" and a "growth and investment tax plan." Both plans, the panel argues, would improve on the current system with respect to simplicity, fairness, and effects on economic growth.

A previous CBPP analysis evaluated the impact of the panel's proposals on revenue collections and concluded that adopting either plan would increase deficits by \$1.8 trillion over the next decade, and by significantly more thereafter.<sup>2</sup> Because of these deficit effects, both plans, whatever their other virtues, would likely hinder rather than promote economic growth. Both plans also would lock in the regressive distributional effects of the 2001 and 2003 tax cuts, making the tax system less fair.

In this analysis, we set aside our concerns regarding the overall merits of the reform plans and instead examine the direct effects of certain aspects of the panel's proposals on low- and moderate-income households. Specifically, we consider the effects of the proposed family and work credit structure, the elimination of most itemized deductions, the conversion of the home mortgage interest deduction into a home credit, and the introduction of a refundable saver's credit.

Our overall conclusion is that the structural changes the panel recommends would leave most low- and moderate-income households as well or better off than under current law and would make the tax system fairer and simpler. Aspects of the proposals would have detrimental effects on some low- and moderate-income households, but many of these problems could be addressed through appropriate modification of the relevant provisions.

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<sup>1</sup> The authors would like to thank Jason Furman, Robert Greenstein, Iris Lav, Jason Levitis, Barbara Sard, Arloc Sherman, and John Wanchek for their contributions to this analysis.

<sup>2</sup> Jason Furman, "The Tax Reform Panel's Costly Proposal," Center on Budget and Policy Priorities, November 30, 2005, <http://www.cbpp.org/11-30-05tax.pdf>.

## Background and Overview

### Panel Proposals Increase Long-Term Deficits

The executive order that created the President's Advisory Panel on Tax Reform instructed it to offer proposals that would make the tax code "simpler, fairer, and more conducive to economic growth."

From the outset, however, the panel was hampered in achieving these objectives by its interpretation of another of its mandates. Instructed to offer proposals that were "revenue neutral," the panel developed proposals that would raise far less revenue than current law and appear "revenue neutral" through 2015 only if compared with a baseline that includes the extension of the 2001 and 2003 tax cuts as well as several new tax cuts proposed in the President's 2006 budget. Relative to current law, the panel's proposals would add \$1.8 trillion to deficits over the ten-year period 2006-2015 — \$1.5 trillion due to lower revenues and \$0.3 trillion due to higher interest costs.

In later years, the proposals would not even be revenue neutral relative to the panel's own low baseline; in other words, they would lead to *higher* deficits than would extending the 2001 and 2003 tax cuts. Of particular concern is the panel's proposal to index for inflation the income thresholds used in determining the taxation of Social Security benefits, which would have a very large impact outside the 10-year budget window the panel used. The bipartisan 1983 Social Security reform commission purposefully did not index these thresholds so as to ensure that Social Security would raise more revenue over time as its demographic challenges grew; the panel's proposal to index the thresholds would enlarge the shortfalls in the Social Security and Medicare Hospital Insurance trust funds by about \$1 trillion (in present value) over 75 years. (The revenues gained from the partial taxation of Social Security benefits are dedicated to the Social Security and Medicare Hospital Insurance trust funds.) Ultimately, the higher deficits generated by the panel's proposals would likely reduce economic growth, undermining whatever positive impact the proposals might otherwise have had.

Furthermore, in deciding how to interpret its objective of fairness, the panel adopted a standard of "distributional neutrality" under which a tax reform plan would be considered distributionally neutral if its distributional effects mirrored those that the current tax system will have if the 2001 and 2003 tax cuts are made permanent and additional new tax cuts proposed by the President are enacted. This means the panel's proposals are "distributionally neutral" relative not to current law but to a tax system shaped by a large regressive tax cut. Moreover, the inequitable effects of the proposals likely would be amplified over time, since the higher deficits resulting from the proposals would eventually have to be paid for. Even if the deficit reduction were achieved through a combination of spending cuts and progressive tax increases, most households and, in particular, low- and moderate-income households would tend to lose rather than gain from the combination of the panel's tax proposals and subsequent deficit-reduction measures.<sup>3</sup>

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<sup>3</sup> For a discussion of the distributional consequences of various possibilities for financing tax cuts, see William Gale, Peter Orszag, and Isaac Shapiro, "The Ultimate Burden of the Tax Cuts: Once the Tax Cuts Are Paid For, Low- and Middle-Income Households Likely to Be Net Losers, on Average," Center on Budget and Policy Priorities, June 2, 2004, <http://www.cbpp.org/6-2-04tax.pdf>.

Because of these flaws, adopting either of the panel's proposed systems outright would be highly detrimental to both fairness and economic growth. It would mean locking in the reduced revenue levels and higher deficits resulting from the 2001 and 2003 tax cuts, along with those tax cuts' regressive distributional consequences.

### Components of the Panel's Proposals Have Merit

In this analysis, however, we set aside these concerns and consider only the elements of the panel's proposals that most directly affect low- and moderate-income households.<sup>4</sup> We do not attempt to estimate the short- or long-term distributional consequences of the panel's proposals as a whole.

We consider the panel's "simplified income tax plan" and "growth and investment tax plan" together. Although the differences between the two proposals may have important economic and distributional consequences, the proposed systems are very similar in their treatment of low- and moderate-income taxpayers. A taxpayer with no investment income and work income below \$39,000 (in the case of singles) or \$78,000 (in the case of married filers) in 2006 would have the same tax liability under either proposal.

Our overall conclusion is that many of the components of the panel's plans that affect low- and moderate-income households have strong merit. We find that the structural changes the panel recommends would leave most low- and moderate-income households as well or better off than under current law and would make the tax system simpler, fairer, and more efficient.

- The panel proposes replacing the earned income tax credit, the child tax credit, personal exemptions, and the standard deduction with new family and work credits. Under the proposed system, most low- and moderate-income households would receive refundable credits as large or larger, or face tax liability as low or lower, than under current law.

In addition, the proposed system of family and work credits could be simpler than current law. This would benefit low- and moderate-income, and other, households by making filing taxes less burdensome. To the extent that tax noncompliance results from complexity and innocent error, simplifying the tax system could promote compliance.

- In addition to eliminating the standard deduction, the panel proposes to do away with most deductions currently available to those taxpayers who list or "itemize" their deductions. The panel would retain tax benefits for mortgage interest costs and charitable giving, but would make them available to all taxpayers, eliminating the distinction between itemizers and non-itemizers. Since most low- and moderate-income taxpayers do not itemize deductions, they do not benefit from those itemized deductions available in the current tax code. The panel's changes would therefore benefit many low- and moderate-income households that would be in a position to take advantage of the panel's mortgage interest (discussed below) and charitable giving proposals but that do not benefit from the existing mortgage interest and charitable

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<sup>4</sup> For purposes of this analysis, we use the phrase "low- and moderate-income" to refer to married taxpayers and unmarried taxpayers with children with incomes below \$50,000 a year and to single taxpayers without children with incomes below \$25,000 a year.

giving provisions.

- The panel proposes replacing the home mortgage interest deduction with a home credit. Relative to the existing deduction, this change would benefit low- and moderate-income households, create stronger incentives for homeownership, and distribute the tax benefits of homeownership more equitably. The credit could be further improved by making it refundable.
- The panel proposes replacing the existing non-refundable saver's credit with a refundable saver's credit. This change would benefit low- and moderate-income households and strengthen incentives for saving among these households.

While many of the panel's recommendations are valuable, this analysis also identifies a number of problems with the proposals. For example, the work credit proposal, as described in the panel's report, could have negative effects on moderate-income families that have more than four children or are faced with certain other special circumstances, and it could endanger state earned-income tax credits. The panel's proposed elimination of the Low-Income Housing Tax Credit would negatively impact low- and moderate-income families by reducing the supply of affordable housing.

### Proposals Exemplify Some Key Principles of Reform

The tax reform panel's recommendations demonstrate its support for several key principles that should serve as benchmarks for judging any future tax reform proposal:

- The panel affirms the need for a tax system with a progressive rate structure (tax rates that increase with income) and rejects ideas for replacing the income tax with a national retail sales tax or value-added tax.
- The panel endorses the view that the tax system should provide substantial refundable credits to encourage and reward work by low-income families.
- The panel indicates a preference for tax credits over tax deductions for purposes of adjusting taxes for family situations and promoting social goals like homeownership. The value of a tax credit does not depend on the marginal tax rate that a taxpayer faces. The value of a deduction, in contrast, is greater for those with higher incomes because they face higher marginal tax rates; the incentives and tax benefits provided by deductions thus are greater for households with higher incomes (see box on page 6).
- The panel recognizes, in its proposal for a refundable saver's credit, that tax incentives targeted at low-income families must be made refundable to achieve their goals.

The remainder of this analysis explains and assesses the panel's proposed reforms' effects on low- and moderate-income families in more detail.

## The Proposed Family and Work Credits

Both of the panel's proposals are, in certain respects, quite similar to the current tax system. The panel rejected ideas for replacing the existing income tax with a national retail sales tax or value-added tax, arguing that these would not allow for an adequately progressive distribution of the tax burden and, in the case of a national retail sales tax, would be administratively infeasible. Instead, the panel proposed systems like the current tax system in which both businesses and individuals file tax returns. Moreover, both of the panel's proposals retain a progressive rate structure, with tax rates that increase with income, although the proposals reduce the number of tax brackets.

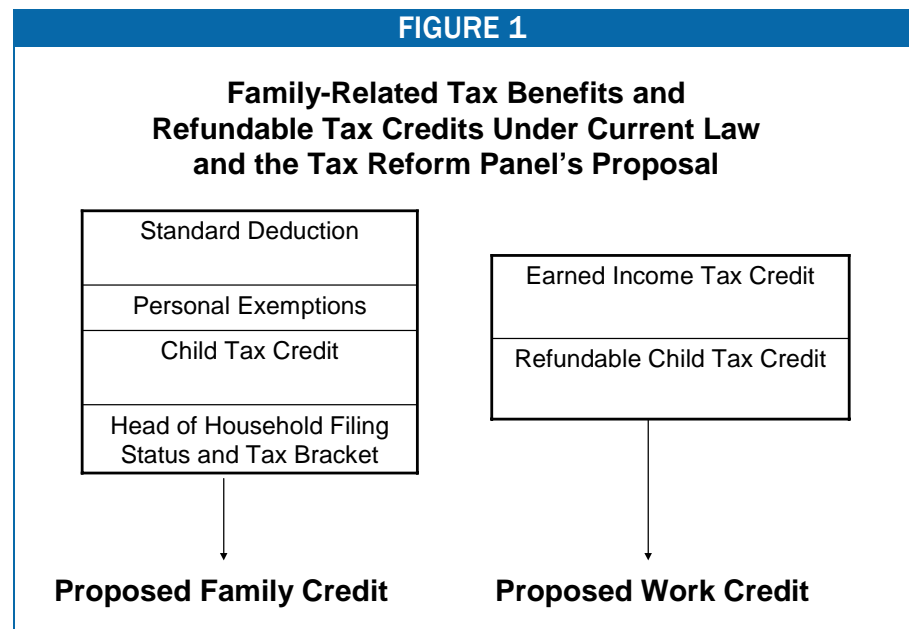
The proposals differ significantly from current law in how they adjust tax liabilities for differences in family size and in how they provide tax assistance to low- and moderate-income families. (The proposed changes are summarized in Figure 1.)<sup>5</sup>

### The Family Credit

Both the current tax system and the panel's proposals contain several provisions that adjust tax liability for family size and prevent the lowest-income households from owing income tax.

Under current law, taxpayers may claim a standard deduction.<sup>6</sup> The size of the standard deduction varies by household type: single, head of household, and married. For instance, married filers receive a standard deduction that is twice as large as the one provided to singles. Taxpayers can also claim a personal exemption for themselves and for each member of their family. In addition, households with children may claim a child tax credit for each child.

The standard deduction and personal exemptions reduce tax liability by reducing taxable income. Taxpayers subtract these adjustments from their income before calculating tax liability, thus reducing the amount of tax they owe. The



<sup>5</sup> Proposals somewhat similar to the panel's for creating more unified systems of personal credits have appeared in other recent tax reform proposals, such as those described in articles by economists Max Sawicky, Robert Cherry, David Ellwood, and Jeffrey Liebman and proposed by Congressman Rahm Emanuel.

<sup>6</sup> If it is more advantageous, taxpayers can list or "itemize" their deductible expenditures rather than use the standard deduction. About one-third of taxpayers itemize their deductions; itemizing is more common at higher income levels. These issues are discussed in more detail later in this analysis, in the section "Other Credits and Deductions."

## Deductions, Exemptions, and Credits

The income tax allows taxpayers to claim a wide variety of deductions, exemptions, and credits. Some of these tax provisions are intended to adjust tax liability based on a taxpayer's "ability to pay." For instance, personal exemptions and the child tax credit are linked to family size, compensating families with children for higher living costs. Other tax provisions, such as the home mortgage interest deduction and the charitable deduction, are intended to create incentives that further certain social policy goals.

Providing tax reductions and incentives in the form of credits is more equitable than providing them in the form of deductions or exemptions, because deductions and exemptions have greater value for higher income taxpayers while credits do not. Even credits, however, fail to benefit the lowest income households, unless the credits are made refundable.

Deductions and exemptions reduce tax liability by reducing taxable income. Taxpayers subtract their deductions and exemptions from income before calculating their tax liability, reducing the amount of tax they owe. The value of an exemption or deduction thus depends on the taxpayer's marginal tax bracket, which determines how much the reduction in taxable income reduces tax liability. For example, the value of a \$10,000 deduction ranges from \$0 to \$3,500, depending on the taxpayer's tax bracket. For a household that has no taxable income (because its earnings are less than its standard deduction and personal exemptions), the deduction has no value. For a household in the 15 percent bracket, a \$10,000 deduction reduces tax liability by \$1,500 ( $\$10,000 \times 15\%$ ). For a household in the 35 percent bracket, it reduces tax liability by \$3,500 ( $\$10,000 \times 35\%$ ).

Credits, by contrast, reduce tax liability directly; taxpayers subtract their credits from the tax they would otherwise owe to determine their final tax liability. Credits are more equitable than deductions, in that they have the same value for all taxpayers — provided the taxpayers have sufficient tax liability. The value of a \$2,000 credit, for instance, is the same for all taxpayers who owe at least \$2,000 in income tax, regardless of their marginal tax bracket. If the household has no taxable income, however, the credit still has no value, and if the household owes only \$1,000 in income tax, the value of a \$2,000 credit is only \$1,000.

Credits can benefit even the lowest income households if they are made refundable. If a credit is fully refundable, the taxpayer receives a check for the amount by which the credit exceeds his or her income tax liability. For example, a household that is entitled to a \$2,000 tax credit but owes no income tax would receive a check for \$2,000. A household that is entitled to a \$2,000 credit and owes only \$1,000 in income tax would receive a check for \$1,000, the amount of the credit that was not used to reduce tax liability. Fully refundable credits are thus worth the same amount to all households, including low-income households with little or no income tax liability.

Deductions Versus Credits			
Marginal Tax Bracket	\$10,000 Deduction – Reduces Tax Liability By:	\$2,000 Non-Refundable Credit – Reduces Tax Liability By:	\$2,000 Refundable Credit – Reduces Tax Liability By:
0%*	\$0	\$0	\$2,000
15%	\$1,500 ( $\$10,000 \times 15\%$ )	\$2,000	\$2,000
25%	\$2,500 ( $\$10,000 \times 25\%$ )	\$2,000	\$2,000
35%	\$3,500 ( $\$10,000 \times 35\%$ )	\$2,000	\$2,000

\* Taxable income is \$0 because total income is less than the standard deduction and personal exemption.

child tax credit, on the other hand, reduces tax liability directly, since taxpayers subtract the credit from the tax they would otherwise owe. Further, the child tax credit is "refundable," (for

households with incomes above \$11,300 in 2006) which means that some or all of the benefits can be provided to taxpayers who have no tax liability. As discussed in the box on page 6, credits tend to be more equitable than deductions and exemptions, because credits can be designed so they are worth the same amount to all taxpayers, while deductions and exemptions are worth more to those with higher incomes.

The panel's proposals would replace almost all of the features of the current tax code related to family structure with a new family credit. The size of the family credit would depend on family structure: a single taxpayer could claim a credit of \$1,650, an unmarried individual with children a credit of \$2,800, and a married couple a credit of \$3,300.<sup>7</sup> A taxpayer would then claim an additional credit of \$1,500 for each child and \$500 for each non-child dependent. All of these amounts would be indexed annually for inflation.

Like the provisions in the current tax code, the family credit would prevent the lowest-income households from owing income tax. Consider the example of a married couple with no children and income of \$16,900. Under current law, the couple could claim a standard deduction of \$10,300 and two personal exemptions of \$3,300 each. The couple would thus subtract a total of \$16,900 ( $2 \times \$3,300 + \$10,300$ ) from its income, reducing its taxable income to zero. Under the panel's proposal, the couple would pay tax at a 15 percent marginal rate and would have tax liability of \$2,535 before the family credit is applied. But the couple would be eligible for a family credit of \$3,300, which would eliminate that income-tax liability.

Unlike the current tax system, which uses a combination of deductions, exemptions, and credits to reduce tax liability, the panel's proposal relies exclusively on credits to achieve this goal. And the family credit, unlike the standard deduction and personal exemptions, would not be more valuable for higher-income households. Another advantage, discussed below, is that the panel's tax credit structure more easily allows for poor families to share in family-related tax benefits.

### **The Work Credit**

Under current law, one of the most important forms of assistance provided to low- and moderate-income working families is the earned income tax credit (EITC). The EITC is a refundable tax credit that supplements earnings for low-wage workers and then phases out for those with incomes above a specified level.

Under the panel's proposals, the EITC and the refundable portion of the child tax credit would together be replaced by a refundable work credit, which would build directly on the panel's proposed family credit. As described, the family credit would first serve to reduce a household's tax liability. But for low-income working taxpayers with tax liability less than the amount of the family credit, some or all of the unused portion of the credit would be refundable. The refundable portion of the unused family credit would be capped, limited to an amount that does not exceed 40 percent of the household's work income and is less than or equal to a maximum value determined by the number of children in the family (see Table 1). In addition, low-income working taxpayers with

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<sup>7</sup> The size of the family credit is intended to compensate not only for the components of current law discussed above, but also for the changes in tax brackets that the panel proposes. For instance, the panel proposes to eliminate the separate tax bracket system for head of household filers and to eliminate the 10 percent bracket for all filers.

children would be eligible for a supplementary credit based on earned income and very similar in structure to the current EITC.

To understand the proposed structure, consider the example of a low-income family with children. Under current law, the family receives the EITC and also is eligible for the child tax credit, some portion of which is refundable. Under the proposal, the family is eligible for a partial refund of its family credit and for the supplementary work credit.

Under both current law and the proposal, the amounts of all refundable credits are determined based on earned income, filing status (married or non-married), and number of children.

Table 1: The Structure of the Panel's Proposed Work Credit			
	Childless Taxpayers	Households with One Child	Households with Two or More Children
Refundable Family Credit:	Up to \$412	Up to \$2,120	Up to \$3,200
Supplementary Credit:	\$0	Up to \$1,450	Up to \$2,600
Total Refundable Work Credit:	Up to \$412	Up to \$3,570	Up to \$5,800

### Effects of the Family and Work Credits on Tax Liabilities and Refundable Benefits

Below, we compare the tax liabilities of hypothetical households under 2006 law with their tax liabilities under the proposal. We consider households with incomes below \$50,000 (in the case of married couples and unmarried individuals with children) or \$25,000 (in the case of single individuals without children). To isolate the effects of the work and family credit structure from the effects of other changes proposed by the panel, we consider households that do not claim other credits or deductions.<sup>8</sup>

Under the panel's proposals, the income levels at which households begin to have positive income tax liability — known as the “tax entry point” — are close to or higher than under current law (see Table 2), and refundable credits are for the most part as large or larger than under current law. For the lowest-income households, the refundable credits provided under the proposal would almost exactly match those provided by the existing tax system. At slightly higher income levels, many households, especially families with children, would gain, for several reasons. First, the maximum refundable credits under the proposal are slightly larger than under current law. Second, the phase-out range for the work credit begins at a higher income level than it does for the EITC under current law, and the phase-out is more gradual.<sup>9</sup> Third, taxpayers are allowed to claim 17 and 18 year old children as dependent children for purposes of the family and work credits, which they

<sup>8</sup> We also make the simplifying assumption that households have only work income. As a result, we do not consider the panel's proposed changes in the treatment of investment income.

<sup>9</sup> To some extent, this change simply compensates for the elimination of the 10 percent tax bracket under the panel's proposal.



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One exception to the general conclusion that the panel's proposals hold low- and moderate-income families harmless is that some large families — those with more than four children that are eligible for the work credit and have income above \$30,000 — would lose significantly. (Large families with incomes below about \$30,000 are held harmless or gain.) The reason for these losses is that the panel fails to allow for any adjustment for family size for households that have more than two children and have incomes too low to benefit from non-refundable tax credits. Under the proposal, the maximum refundable credit does not increase with family size for families with more than two children. In contrast, under the existing child tax credit, the total credit increases by \$1,000 per child and how large a portion of the credit is refundable depends only on earned income. The result is that the current refundable child tax credit can increase with family size even for those with more than two children.

Table 2: Refundable Credits under Current Law and the Panel's Family and Work Credit Proposal				
	Head of Household with Two Children		Married Couple with Two Children	
	Current Law	Proposal	Current Law	Proposal
Tax Entry Point:	\$35,524	\$38,667	\$41,867	\$42,000
Maximum Refundable Credit:	\$5,063	\$5,800	\$5,363	\$5,800
Credit Begins to Phase Out:	\$14,810	\$17,000	\$16,810	\$21,000

<sup>10</sup> To some extent, this change simply compensates for the elimination of the 10 percent tax bracket under the panel's proposal.

### EXAMPLE: Refundable Credits Under Current Law and the Proposal

To see why some low-income families benefit from the panel's proposed changes, consider the example of a married couple with two children and income of \$20,000.

Under current law, the family is eligible for the EITC, but because its income is above \$16,810, its EITC benefits are phasing out at a 21.06 percent rate. Its total EITC is \$3,864, less than the maximum available EITC. The family can also claim the child tax credit, of which \$1,305 is refundable. The family's total refundable credit is thus \$5,169.

Under the panel's proposal, the family is eligible for the maximum refundable family credit, \$3,200, and for the maximum supplementary work credit, \$2,600 (under the proposal, the supplementary work credit begins to phase out for married couples at an income level of \$21,000). The family's total refundable credit is thus \$5,800, some \$631 higher than under current law.

To see why large families lose under the proposal, consider the example of a married couple with six children and income of \$42,000.

Under current law, the family is not eligible for the EITC but is eligible for a refundable child tax credit of \$4,605. Under the proposal, the family would be eligible for the maximum refundable family credit of \$3,200 and no supplementary credit, making its total refundable credit \$3,200, or \$1,405 less.

The above problem with the panel's proposal could be solved entirely by lifting the cap on the refundability of the family credit for all households. Under the panel's proposals, no household can receive more than \$3,200 of its unused family credit as part of its refundable work credit (the maximum is lower for families with one child or no children). Because the cap affects only households with incomes in a fairly narrow range, removing it would not be very costly. In addition to shielding large families from losses, eliminating the cap would simplify the panel's proposal and would benefit some other households, mostly families with incomes between \$10,000 and \$20,000.

### Effects on Simplification

In its report, the panel argues that its family and work credit proposals would greatly simplify the tax system for most taxpayers, and especially for low- and moderate-income households, by providing "a uniform and consistent structure that will replace the existing patchwork of overlapping and duplicative provisions."<sup>11</sup>

The panel's proposal is indeed simpler than the current system in several ways. First, it simplifies the computation of tax liability by replacing a whole array of provisions with the family and work credits. Second, it simplifies the structure of the work credit, relative to the EITC, by linking it closely to the family credit. For example, unlike the current law EITC and child tax credit, the work credit and family credit would use the same definition of a dependent child. While legislation enacted in 2004 took steps toward creating a uniform definition of a child, the panel's proposal goes further.

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<sup>11</sup> President's Advisory Panel on Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," p. 64.

### **The Interdependence of the Panel's Proposals**

Given that various of the panel's proposed structural changes seem positive, one might wonder whether any of them could be enacted independently. For example, could one replace the EITC with the work credit or replace personal exemptions and the child tax credit with the family credit without making other changes?

The answer to this question is no. The work credit could not be implemented without the family credit because it is determined in part by the amount of the taxpayer's unused family credit. Up to a certain maximum level, the portion of a taxpayer's family credit not used to defray his or her tax liability becomes part of his or her refundable work credit.

Similarly, the family credit is meant to replace not only personal exemptions and the child tax credit but also the standard deduction. Eliminating the standard deduction would probably require adopting several of the panel's other proposed reforms (discussed below): eliminating itemized deductions, making all deductions and credits available to all taxpayers, and drastically reducing the number of available credits and deductions.

One could perhaps construct family and work credits that would be somewhat similar to the panel's proposals and would not require all of these other changes. As presented in the panel's report, however, the family credit, work credit, and changes to itemized deductions all go together.

Simplifying the tax code would benefit all taxpayers by making filing taxes easier. It could also improve tax compliance, at least to the extent that tax errors result from complexity and innocent mistakes, and it could encourage more households eligible for refundable credits to file tax returns.

Despite their other contributions to simplicity, the panel's proposals do not much change the system of benefit phase outs affecting low- and moderate-income households. While the panel considered the possibility of designing a work credit that did not phase out with income, it concluded that "the compliance costs and additional burden imposed on all taxpayers" by an alternative design that would not have involved phase outs "outweighed the potential benefits of simplicity and smoother increases in marginal tax rates for eligible work credit recipients."<sup>12</sup>

Phase-out provisions raise effective marginal tax rates because they lead to greater increases in tax liability per dollar increase in income. Consider the example of a married couple with children and income of \$25,000. Under the panel's proposal, this household is in the 15 percent tax bracket, meaning its explicit marginal tax rate is 15 percent. But because its income is above \$21,000, its work credit is phasing out at a rate of 12.5 percent; for every additional dollar of income, it loses 12.5 cents of its work credit. This brings the household's effective marginal tax rate up to 27.5 percent.

Retaining phase-out provisions was a consequence of the panel's decision to structure its supplementary work credit much like the current EITC. A further consequence of retaining an EITC-like structure is that marriage penalties would continue to exist for low- and moderate-income families. Marriage penalties exist for these households under current law in part because the earned

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<sup>12</sup> President's Advisory Panel on Tax Reform, p. 69.

income credit phases out as income rises and in part because of limitations on the maximum credit amounts. As a result, two single parents who each have one child and who are eligible for the maximum earned income credit would receive less than twice that amount if they were to marry. Despite the panel's emphasis on reducing and eliminating marriage penalties for higher income households, marriage penalties for low- and moderate-income households under the proposal are almost identical to those that exist under current law.

### Effects on Low- and Moderate-Income Households with Certain Special Needs

The panel recommends eliminating several current protections for taxpayers faced with certain special circumstances, protections that were purposefully left in place in 2004 when Congress reached agreement on a uniform definition of a dependent child. While the panel may have been motivated by its goal of simplicity, it is important to consider tradeoffs between simplicity and protecting vulnerable groups. Moreover, relatively simple changes could solve several of the problems in this area that the panel's proposals create.

**The Treatment of Children's Social Security Benefits.** Under current law, social security benefits are taken into account in determining whether a child provides more than half of his or her own support. Children who provide more than half their own support cannot be claimed as dependents for purposes of the child tax credit and personal exemptions, but they can be claimed for purposes of the EITC. The tax reform panel proposes to apply this support test to its work credit as well as its family credit, with the result that some low- and moderate-income households in which children receive social security benefits (typically survivor benefits) and which currently are eligible for the EITC could be rendered ineligible for the work credit.<sup>13</sup>

As noted above, the panel's effort to simplify the tax system by creating a single definition of a child is laudable, but in this case the proposed change comes at the expense of some particularly vulnerable households: low- and moderate-income families in which one parent has died. The problem could be solved if children's social security benefits are excluded in determining who is a *child* dependent (for both the family and work credits). This solution would avoid the problem of excluding social security benefits paid to older individuals in determining who could be claimed as a dependent, but it would allow currently EITC-eligible households to retain their refundable credits.

**Social Security Number Requirements.** Otherwise eligible taxpayers with valid SSNs, including some taxpayers with "non-work authorized" SSNs, currently can receive the EITC. Technically, under current law, taxpayers with some types of non-work SSNs are ineligible, while taxpayers with other types of non-work SSNs are eligible, but because the IRS cannot determine what type of non-work SSN a filer may have, it has not been able to implement this partial prohibition. The panel's proposal would make all filers ineligible for the EITC if the filer (or in the case of a married couple, both spouses) does not have a regular — as distinguished from a "non-work authorized" — SSN. Children could have either a regular SSN or a non-work SSN as long as it was a valid SSN.

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<sup>13</sup> Based on data from the March 2004 Current Population Survey, we estimate that about 450,000 children currently receive social security benefits and can be claimed for the EITC. While not all of these children necessarily provide more than half their own support, and while additional provisions of the support test protect some families, this estimate suggests that a significant number of households could be harmed by this aspect of the panel's proposed change.

The panel's recommended requirement in this area for adult filers would have two unintended side-effects. First, it would adversely affect the tens of thousands of working parents who are legally present and authorized to work in the United States but who have not had their initial non-work SSNs converted to regular SSNs. The proposal would create significant hardship for these low- and moderate-income families who have been receiving the EITC but would become ineligible for the work credit. This problem could be partially addressed by requiring the IRS to provide substantial advance notice of the new requirement, supported by hotline and website services, to taxpayers who have previously claimed the EITC using a "non-work authorized" SSN. The notice would explain that taxpayers' work credit claims will be considered invalid unless they adjust their SSN, and would describe the process for doing so for people who are, in fact, authorized to work. Similar information also should be provided in IRS notices issued when work credit claims are denied, in case claimants are new filers or missed the advance notice.

The panel's proposal would have the additional unintended effect of depriving working individuals with work-authorized SSNs of the work credit if they have spouses with non-work authorized SSNs, even if those spouses do not work. This unintended consequence could be avoided by exempting non-working spouses from the requirement to have a work-authorized SSN. For example, a provision in legislation introduced by Senator Jay Rockefeller would authorize an EITC if the tax return clearly indicates that earnings are attributable only to the spouse with a work-authorized SSN.

**The Elimination of the Child Tax Credit for Puerto Rican Families.** The current structure of the child tax credit allows Puerto Rican households with three or more children to claim the credit against payroll taxes; the panel's proposal would eliminate this option. The structure of the current credit for Puerto Rican households is admittedly undesirable since the credit is not available to very poor households with fewer than three children but is available to wealthier households with three or more children. However, some part of the savings obtained from eliminating the child tax credit in Puerto Rico could be devoted to Puerto Rican low-income households, perhaps as federal matching funds for a better-structured Puerto Rican tax credit for low-income working families with children.

### Effects on State Earned Income Tax Credits

Federal tax reform would inevitably have many significant effects, both positive and negative, on state tax bases. The panel's proposed work credit gives rise to particular concerns in this regard because of its likely effect on state earned income tax credits.

Nineteen states currently have state earned income tax credits that link to the federal EITC. The state EITCs are typically a fixed percentage of the federal credit, with the credit percentages ranging from 5 percent to 50 percent. Most if not all of these credits would be threatened by the proposed change to the existing EITC statutory language, since it would leave them linking to a federal credit that no longer existed. It seems likely that most or all of the state credits would have to be reenacted in order to remain in effect.<sup>14</sup>

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<sup>14</sup> Were the panel's work credit to be implemented, careful consideration should be given to whether appropriate legislative drafting could help preserve some state EITCs. It might help, for example, if the work credit were inserted into section 32 of the tax code and were designated as a successor credit to the EITC.

In addition, differences between work credit and EITC benefits could make it difficult for states simply to reenact their credits. Since the work credit replicates the benefits of the current EITC *plus* the refundable child tax credit, linking to the work credit at the same percentage as a state's current EITC links to the federal EITC would increase costs for states. Reducing the state EITC percentages, however, would hurt the lowest income households, for whom the new federal work credit would be no larger than the current EITC.

IRS data indicate that in 2003, more than 6 million households claiming the federal EITC lived in states with state EITCs. The benefits of state EITCs for low-income households can be quite significant; for example, an eligible family with two children living in a state with a credit set at 25 percent of the federal EITC could receive a state credit of up to \$1,134 in 2006. The loss of state EITCs thus could have a significant effect on many low-income families.

## **Other Credits and Deductions**

The tax reform panel adopted as one of its primary goals creating a “cleaner” tax base. What this phrase refers to is a tax base with fewer exemptions, deductions, and credits. All else being equal, a cleaner tax base allows for lower tax rates and arguably enhances economic efficiency. On the other hand, eliminating deductions can raise tax liability for those who previously claimed them.

To further the goal of a cleaner tax base, the panel recommends eliminating most existing deductions, exclusions, and credits, and it recommends major changes in the few it retains.<sup>15</sup> It also recommends eliminating the standard deduction and the choice between claiming the standard deduction and claiming itemized deductions. Under current law, taxpayers choose whether to claim the standard deduction or to list (“itemize”) their allowable deductions. They may do whichever leaves them with lower tax liability; however, if they claim the standard deduction, they may not claim itemized deductions, such as the home mortgage interest deduction and the charitable deduction. Under the panel's proposal, all taxpayers could claim the home credit (its proposed replacement for the mortgage interest deduction) and the charitable deduction.

Because deductions are not refundable and because the panel does not propose making the home credit refundable, these tax preferences would continue not to benefit the lowest-income taxpayers. Nevertheless, those lower- and moderate-income households with incomes high enough to benefit from non-refundable credits and deductions could gain significantly from the panel's proposal. Most such taxpayers currently claim the standard deduction, meaning that they are precluded from claiming other deductions, such as those for charitable giving and home mortgage interest, that are available under current law only to taxpayers who itemize deductions. According to IRS data, only about 17 percent of filers with incomes below \$50,000 itemized deductions in 2003. This suggests that many low- and moderate-income households could benefit from the panel's proposed structural change, while relatively few would be hurt by the loss of the itemized deductions that the panel's

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<sup>15</sup> We focus on the panel's proposed changes to itemized deductions, but the proposals would also eliminate existing credits, such as the child and dependent care credit, and above-the-line deductions, such as the deduction for higher education expenses, that are available to taxpayers who do not itemize their deductions. Because these tax benefits are not refundable, they are unavailable or relatively insignificant for most low-income households.

proposal eliminates.<sup>16</sup> (Low- and moderate-income households would be hurt by the panel's proposed elimination of the Low-Income Housing Credit, discussed in the box on page 16.)

What follows is a more detailed discussion of the panel's specific proposals with regard to credits and deductions.

### The Tax Treatment of Housing

The panel recommends turning the home mortgage interest deduction into a 15 percent home credit. The panel also proposes imposing a cap on the home credit, with the cap equal to 125 percent of the local Federal Housing Administration mortgage limit (between \$227,147 and \$411,704 at 2005 levels). A household with a mortgages above the cap would be able to claim a credit only for the portion of its mortgage interest payments equal to the portion of its total mortgage below the cap.

The avowed objective of providing tax benefits to homeowners is to encourage homeownership. Given this goal, tax provisions assisting homeowners should be assessed based on whether they create an efficient system of incentives, as well as on whether they distribute the tax benefits of homeownership equitably. Based on these criteria, the panel's proposal is a clear improvement over current law.

The panel's proposed home credit would enhance the efficiency of tax incentives for homeownership. Converting the home mortgage interest deduction into a credit, making it available to all households (rather than just itemizers), and capping its value would direct a larger portion of the tax benefits of homeownership to low- and moderate-income households, who are more likely to be deciding whether or not to buy a home, rather than toward high-income households, who are more likely to be deciding how large a home to buy. This would increase the per dollar incentive impact of the provision.

The panel's proposal would also improve the equity of the provision. As discussed above (in the box on page 6) the value of deductions depends on the taxpayer's marginal tax rate, and so the existing home mortgage interest deduction is worth more to higher-income taxpayers. The proposed home credit, in contrast, would be worth the same amount to any two households with the same mortgage. The one exception is that it would have less value for the lowest-income taxpayers (those with little or no tax liability) because the credit would not be refundable.

The proposal would also improve equity because the credit would be available to the predominantly lower-income households that do not itemize their deductions. Under the proposal, the percentage of homeowners benefiting from tax benefits for homeownership would jump from 54 percent to close to 90 percent.<sup>17</sup> The proposed home credit would thus extend the tax benefits of

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<sup>16</sup> One might worry that low- and moderate-income households would lose from the elimination of the standard deduction. As discussed above, however, the panel's proposed family and work credits are, for most households, as or more generous than the combination of the current law personal exemptions, EITC, child tax credit, *and* standard deduction. Therefore, low- and moderate-income households would not be hurt by the loss of the standard deduction and could benefit from being able to claim several of what were formerly itemized deductions.

<sup>17</sup> President's Advisory Panel on Tax Reform, p. 74.

## The Low-Income Housing Tax Credit

As part of its effort to create a “cleaner” tax base, the tax reform panel took as its de facto starting point a tax base that eliminated all tax deductions, exclusions, and credits; it then added back only those few for which it found particular justification. The panel’s proposals do not explicitly address the Low-Income Housing Tax Credit but subsume it in the blanket elimination of tax expenditures.

The reform panel is right to set tough criteria for tax deductions and credits, requiring that they “provide incentives to change behavior in ways that benefit the economy and society, rather than representing a windfall to targeted groups of taxpayers for activity they would be likely to undertake even without a tax subsidy.”<sup>a</sup> The low-income housing tax credit (LIHTC), however, likely meets this strict standard.

The LIHTC is a tax credit that supports the construction and rehabilitation of low-income housing. LIHTCs are allocated to states, which then award them to developers on the basis of criteria intended to ensure that the tax credit funds change behavior in beneficial ways: that the housing built serve low-income households for a long period of time, that developers do not realize “excess profits,” and that the housing serve other state-identified priorities, such as revitalizing urban areas. Housing subsidized by LIHTC funds is subject to rent restrictions and requirements that renters be low-income households (i.e. households with incomes below a specified percentage of median income), and the housing must remain affordable, by those same criteria, for 30 years.

The LIHTC is the only major form of federal support for low-income rental housing construction, and it plays a particularly crucial role in tight housing markets, where there is a significant shortage of affordable housing. LIHTC funds contribute to the construction of about 130,000 affordable housing units per year, and the projects funded are ones that private developers generally would not find worth undertaking without the tax benefit.<sup>b</sup> The LIHTC program involves private investors in affordable housing development, and it allows state agencies to decide what types of projects would be most useful (some states, for instance, target LIHTC funds towards housing units designed for people with disabilities or other households with special needs).

Notably, the LIHTC was created as part of the 1986 Tax Reform Act, when policymakers realized that the reform’s elimination of then-existing tax subsidies for housing construction would shrink the affordable housing supply unless some substitute incentive was provided. Similarly, eliminating the LIHTC now without somehow replacing it (with another source of funding for affordable housing construction) would be harmful to low-income households and would undermine states’ ability to pursue important development objectives.<sup>c</sup>

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<sup>a</sup> President’s Advisory Panel on Tax Reform, “Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System,” p. 70.

<sup>b</sup> National Council of State Housing Agencies, News Release: “NCSHA Expresses Deep Concern about Tax Panel’s Stand on Housing Credits and Bonds,” November 2, 2005,

[http://www.ncsha.org/uploads/NCSHATaxReformPanelStatement\\_110205.pdf](http://www.ncsha.org/uploads/NCSHATaxReformPanelStatement_110205.pdf).

<sup>c</sup> For further discussion and evaluation of the effectiveness of the LIHTC, see the LIHTC bibliography available at <http://www.recapadvisors.com/learn/lihtcbib.html>; see also Jean L. Cummings and Denise DiPasquale, “The Low-Income Housing Tax Credit: An Analysis of the First Ten Years,” *Housing Policy Debate* 10(2), 1999, pp. 251-307.

home ownership to millions of low- and moderate-income households. According to Census Bureau data, about 1 in 3 low- and moderate-income households with incomes high enough to



benefit from a non-refundable home credit had home mortgages in 2004.<sup>18</sup> In contrast, the IRS reports that only about 1 in 5 households in this income range claimed the home mortgage interest deduction in 2003.

The proposal would also improve equity because the credit would be available to the predominantly lower-income households that do not itemize their deductions. Under the proposal, the percentage of homeowners benefiting from tax benefits for homeownership would jump from 54 percent to close to 90 percent.<sup>19</sup> The proposed home credit would thus extend the tax benefits of home ownership to millions of low- and moderate-income households. According to Census Bureau data, about 1 in 3 low- and moderate-income households with incomes high enough to benefit from a non-refundable home credit had home mortgages in 2004.<sup>20</sup> In contrast, the IRS reports that only about 1 in 5 households in this income range claimed the home mortgage interest deduction in 2003.

Many of these low- and moderate-income households have significant mortgage debt. The Census Bureau also provides data on median home mortgage burdens (mortgage payments as a percentage of income) for households that are in different income ranges and have different numbers of children. Based on these data, we calculated the benefits that the home credit would provide to low- and moderate-income households with home mortgages equal to the median mortgage burden for their household structure and income range. These benefits could be very significant: between \$1,000 and \$1,500 for families with children that own their homes and have incomes in the \$25,000 to \$50,000 range. (In contrast, the cap on the home credit is high enough that it is unlikely to affect low- and moderate-income families.)

For low- and moderate-income homeowners who currently take the standard deduction and cannot claim the home mortgage interest deduction, the benefits of the home credit would be new. Even for low- and moderate-income taxpayers who currently itemize, the panel's home credit could provide greater benefits and greater incentives for homeownership. First, the 15 percent credit would have greater value than the existing deduction for households currently in the 10 percent tax bracket. Second, under current law, claiming the home mortgage interest deduction requires giving up the standard deduction, so the true tax benefit from homeownership is the value of the home mortgage interest deduction less the value of the standard deduction. For most low- and moderate-income itemizers, the value of the home mortgage interest deduction is probably small (see example).

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<sup>18</sup> Married couple and other families with children can benefit from the home credit if they have incomes above about \$20,000, and we classify these households as low- and moderate-income if they have incomes below \$50,000. Single filers with no children can benefit if they have incomes above about \$10,000, and we classify these households as low- and moderate-income if they have incomes below \$25,000.

<sup>19</sup> President's Advisory Panel on Tax Reform, p. 74.

<sup>20</sup> Married couple and other families with children can benefit from the home credit if they have incomes above about \$20,000, and we classify these households as low- and moderate-income if they have incomes below \$50,000. Single filers with no children can benefit if they have incomes above about \$10,000, and we classify these households as low- and moderate-income if they have incomes below \$25,000.

### EXAMPLE 3: The Home Credit versus the Home Mortgage Interest Deduction

Consider a married couple with two children, income of \$35,000, and mortgage interest payments of \$12,000.

Under the panel's proposal, the family claims the 15 percent home credit, which reduces its tax liability by \$1,800 ( $15\% \times \$12,000$ ), increasing its refundable credit from \$1,900 to \$3,700. In other words, by decreasing the family's income tax liability, the additional credit would make available as a refund some \$1,800 of the household's family credit that previously was applied against the family's income tax liability.

Under current law, this family benefits from itemizing rather than claiming the standard deduction, since the \$12,000 mortgage payment is larger than the \$10,300 standard deduction. Given its income and deductions, the family is in the 10 percent bracket, and so the \$12,000 deduction reduces pre-credit tax liability by only \$1,200 ( $10\% \times \$12,000$ ). However, the tax benefit the family receives from homeownership is even less than \$1,200. If it had not itemized deductions, the family would have claimed the standard deduction, which would have reduced its tax liability by \$1,030 ( $10\% \times \$10,300$ ). The family's true tax benefit from home ownership under current tax rules is the difference between \$1,200 and \$1,030, or \$170. The \$1,800 benefit the household would receive from the proposed home credit is thus far larger than the benefit it receives from the existing home mortgage interest deduction.

The panel's proposal could be further improved by making the home credit refundable. As discussed above, the lowest-income households cannot benefit from non-refundable credits. Some households with incomes too low to benefit from non-refundable credits do have home mortgages, and for those who do, mortgage payments often consume a very high percentage of income. According to Census Bureau data, about 20 percent of households with children and 15 percent of childless households with incomes too low to benefit from non-refundable credits have home mortgages. Among the households with mortgages, the median mortgage is close to 70 percent of income, a very high debt burden.

With mortgage burdens this high, the danger of losing one's home is real. Households may have been able to obtain a mortgage in a past year when their income was higher but then face losing their homes due to transitory income changes. For a family trying to get through another year and hold on to its home, a credit with a value equal to 15 percent of home mortgage interest could make an important difference.

If the home credit is non-refundable, as the panel proposes, households at the bottom of the income spectrum would receive no tax assistance in shouldering their high mortgage burdens (and no tax incentive for homeownership), while higher-income households with less need for aid would receive help. A refundable credit, on the other hand, would truly extend the tax benefits of homeownership to all taxpayers.

### The Saver's Credit

The panel recommends a variety of changes in the current system of savings incentives. Mostly, these changes involve increasing income and contribution limits for tax-preferred savings accounts. Such changes would primarily benefit high-income households and be very costly, yet do little to increase national saving. Moreover, by making it possible for employers to save substantially more

money in tax-preferred accounts without offering a retirement plan for their employees, the proposals could severely weaken the employer-based saving system, harming low- and moderate-income households.<sup>21</sup>

The panel does, however, also propose replacing the existing non-refundable saver's credit with a refundable saver's credit. Both the existing saver's credit and the panel's proposal are targeted at low- and moderate-income households and phase out at specified income levels. The existing saver's credit matches retirement contributions of up to \$2,000 per person at a 50 percent rate, up to income levels of \$30,000 for married couples, \$22,500 for heads of households, and \$15,000 for singles. It then provides a 20 percent or 10 percent match rate up to income levels of \$50,000 for married couples, \$37,500 for heads of households, and \$25,000 for singles.

The panel's saver's credit would match contributions of up to \$2,000 per person at a 25 percent rate, up to income levels of \$30,000 for married couples and \$15,000 for singles and heads of households. It would phase out at a 5 percent rate and be fully phased out at income levels of \$40,000 for married couples and \$25,000 for singles and heads of households.

While the proposed saver's credit might seem less generous than the current one, it would actually provide significantly greater benefits for most low- and moderate-income households. The existing saver's credit is very generous in theory, but in practice almost no households receive the maximum available benefits because the credit is not refundable. To benefit from the non-refundable saver's credit, a household's income must fall within a narrow band: lower than the saver's credit income limits but high enough to benefit from a non-refundable credit. This band is becoming narrower over time because the income limits for the saver's credit are not indexed for inflation.

According to estimates from the Urban Institute-Brookings Institution Tax Policy Center, only about 17 percent of those with incomes below income limits for the saver's credit in 2003 had incomes that were high enough for them to benefit from a non-refundable credit. Only 0.1 percent of these households could benefit in full from the maximum refundable credit.<sup>22</sup> In contrast, because the tax reform panel's proposed saver's credit is fully refundable, all eligible households who make contributions to qualified savings accounts would benefit. Some households in the current phase-out range would initially lose relative to current law, but by at most a few hundred dollars. And since the panel's income limits are indexed for inflation while the current law limits are not, over time, all eligible households would benefit from the proposed change.

In addition to benefiting low- and moderate-income households, a refundable saver's credit could be an effective form of saving incentive. While savings incentives for upper-income households may largely subsidize saving that would have taken place anyway, savings incentives targeted at low-

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<sup>21</sup> These proposals by the panel are very similar to the Administration's proposed Retirement Savings Accounts and Lifetime Savings Accounts. The effects of these Administration proposals are discussed in more detail in Robert Greenstein and Joel Friedman, "President's Savings Proposals Likely To Swell Long-Term Deficits, Reduce National Saving, And Primarily Benefit Those With Substantial Wealth," Center on Budget and Policy Priorities, revised May 25, 2005.

<sup>22</sup> William Gale, J. Mark Iwry, and Peter Orszag, "The Saver's Credit: Issues and Options," Retirement Security Project, April 2004, <http://taxpolicycenter.org/publications/template.cfm?PubID=8856> These ratios have likely fallen with time, since the income limits for the saver's credit are not indexed for inflation.

and moderate-income households are more likely to promote new saving, since low- and moderate-income households rarely have assets to shift.

The effectiveness of the saver's credit could be further enhanced if it were coupled with two of the panel's other proposals. The panel's "autosave" provisions would create default opt-in rules for employer-provided savings accounts, so that employees would automatically become enrolled in their employers' saving programs unless they actively chose not to participate. Extensive evidence supports the view that default rules are crucial determinants of individuals' saving decisions and that changing default rules can dramatically increase saving.<sup>23</sup>

The panel also recommends that taxpayers should not "by reason of depositing saving that would qualify for the saver's credit, lose eligibility for other means-tested programs, such as food stamps, temporary assistance for needy families, or Pell Grants... the panel recommends that these assets be ignored for purposes of determining whether the taxpayer is eligible for a means-tested federal assistance program."<sup>24</sup> If implemented, this recommendation, as well, could encourage low- and moderate-income households to save.<sup>25</sup>

### Other Tax Expenditures

**Charitable deductions.** The panel recommends retaining the charitable deduction and making it available to all taxpayers but allowing taxpayers to deduct only contributions in excess of 1 percent of adjusted gross income. A household with income of \$40,000, that made \$900 of charitable contributions could thus deduct \$500 from taxable income. The proposal would benefit current non-itemizers while reducing the deduction available to those who currently itemize. These changes would both enhance fairness and likely increase charitable giving.

**Health insurance deduction.** The panel also recommends capping the exclusion for employer-provided health insurance. Currently, the tax code allows employers to provide health insurance to employees as a tax-free "fringe benefit." The employer may deduct insurance premiums, along with wages and other forms of employee compensation, from taxable income. Unlike in the case of wages, however, the employee does not have to include the insurance premiums in his or her taxable income, meaning that this form of employee compensation is never taxed. The panel proposes capping this exclusion at \$11,500 for families and \$5,000 for individuals, and indexing the cap to general rather than health care inflation, so that it will lose value over time as long as health costs continue to increase faster than other prices. In addition, the panel proposes a new deduction for the purchase of non-employer provided health insurance.

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<sup>23</sup> Studies have found that auto-enrollment boosts participation in 401(k) plans from a national average of about 75 percent of eligible employees to between 85 and 95 percent, with even more dramatic increases among subgroups of workers with the lowest participation rates (including low-income, female, and minority employees). For a review of the empirical literature, see William Gale, J. Mark Iwry, and Peter Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Saving," *Tax Notes*, March 7, 2005, available online at <http://taxpolicycenter.org/publications/template.cfm?PubID=9193>.

<sup>24</sup> President's Advisory Panel on Tax Reform, p. 123.

<sup>25</sup> For discussion of the role of asset tests in discouraging low-income saving, see Zoë Neuberger, Robert Greenstein and Eileen P. Sweeney, "Protecting Low-Income Families Retirement Savings: How Retirement Accounts are Treated in Means-Tested Programs and Steps to Remove Barriers to Retirement Saving," Retirement Security Project, June 2005, available online at <http://www.cbpp.org/6-21-05socsec.pdf>.

The effects of all these changes on low- and moderate-income households are uncertain. Most low- and moderate-income households probably would not be directly affected by the cap initially, and capping the health insurance exclusion might help reduce the cost of health insurance, since the tax subsidy drives up prices by encouraging the purchase of costlier coverage. In addition, the health insurance tax benefit — both in the current tax code and in the panel's proposal — functions like a deduction and thus provides smaller tax benefit to low- and moderate-income families than to higher-income families.

On the other hand, as the proposed cap on the exclusion lost value over time, more low- and moderate-income households might be directly affected by it. In addition, both the cap and the new deduction for the purchase of non-employer-provided health insurance would reduce the tax advantage of employer-provided plans. This could lead some employers to stop offering health insurance coverage, which would harm low- and moderate-income households and make the health system less efficient by reducing the pooling of risks.

**Deduction for state and local taxes.** Finally, the panel recommends eliminating other currently available deductions and credits, including the deduction for state and local taxes and various education-related deductions. These changes would have little effect on the tax liabilities of most low- and moderate-income households, since, as discussed above, most such households do not itemize deductions, and, if they do, the benefits they receive are small. Eliminating the state and local deduction could have negative indirect effects on low- and moderate-income households, however, if it led states to reduce funding for programs that benefit these households.<sup>26</sup>

## Conclusion

Considered as a blueprint for future tax reform efforts, the tax reform panel's recommendations have a great deal to offer. While the proposals as they stand would worsen the nation's fiscal problems and make the tax code less progressive, some of the panel's specific structural reforms would simplify the tax system and make existing tax provisions more efficient and fairer. In particular, the panel's work and family credit proposals could provide significant simplification, while the changes to itemized deductions, especially the proposed home credit, would improve equity and incentives. The panel's recommendations warrant further consideration and review, and effort should be made to solve the problems that some of the recommendations would create for certain groups of low- and moderate-income households.

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<sup>26</sup> Studies of the effect of the state and local deduction on state spending decisions have reached no uniform conclusions. Some have found significant effects; others have not. For a brief overview of the literature, see Kim Rueben, "The Impact of Repealing State and Local Tax Deductibility," *State Tax Notes*, August 15, 2005, [http://www.urban.org/UploadedPDF/1000818\\_Tax\\_Analysts\\_081505.pdf](http://www.urban.org/UploadedPDF/1000818_Tax_Analysts_081505.pdf).