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THE TAX REFORM PANEL'S COSTLY PROPOSAL

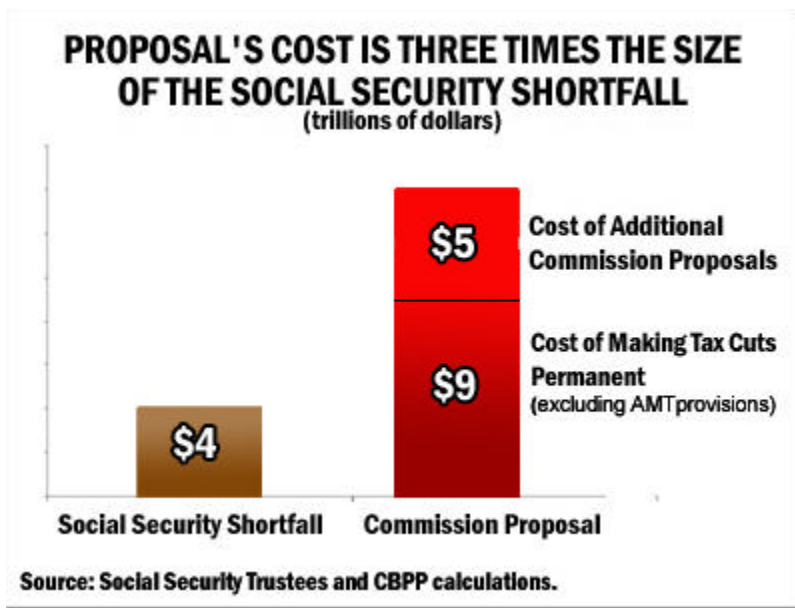
By Jason Furman

Summary

On November 1, the President's Advisory Panel on Federal Tax Reform delivered its Final Report and recommended sweeping changes in the tax system.¹ The Panel's report contained a detailed and thoughtful variety of changes in the tax code, many (but not all) of which represent worthwhile efforts to make the tax system simpler, fairer, and more pro-growth.

Yet any benefit of these changes would be more than outweighed by the very high cost of the Panel's proposals, which would substantially increase long-term deficits. The deficit over the next 75 years would be enlarged by an amount at least three times the size of the Social Security shortfall, thereby draining national savings, reducing investment, and slowing economic growth.

The Panel describes its plans as "revenue neutral." The Panel uses that term, however, in an unprecedented way. The application of that term to the Panel's plans simply means that the plans would bring in the same amount of revenue over the next ten years as the *reduced* level of revenue that would be collected under the President's tax-cut proposals. The Panel's plan is designed to be revenue neutral only in relation to a "baseline" that assumes *both* that the tax cuts scheduled to expire by 2010 are made permanent *and* that other Administration tax-cut proposals — including costly proposals to establish Retirement Savings



¹ The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System*, November 1, 2005.

Accounts (RSAs), Lifetime Savings Accounts (LSAs), and other tax breaks — are enacted as well, even though Congress has declined to enact those tax cuts to date.

Furthermore, the Panel's definition of revenue neutrality applies only *for the first ten years*. Over a longer period of time, the Panel's plans lose revenue even relative to the peculiar baseline the Panel employs that assumes the current tax cuts are made permanent and Administration proposals for new tax cuts are enacted as well.

The Tax Panel has not provided specific revenue estimates for its proposals. This analysis is based on the Panel's descriptions of its proposal, as well as on earlier estimates by the Congressional Budget Office (CBO) and the Joint Congressional Committee on Taxation (JCT). This analysis has several principal findings:

- Compared to current law, the two plans that the Panel proposed each would add \$1.8 trillion to the deficit over the next decade. (Making the 2001 and 2003 tax cuts permanent would add \$1.5 trillion to the deficit over the next ten years, while the President's additional tax cut proposals would add another \$0.3 trillion, for a total of \$1.8 trillion.)
- Over 75 years, the Panel's plans would cause the deficit to increase by about \$14 trillion (measured in "present value"), relative to what the deficit would be if no changes were made in the tax code (i.e., relative to current law).² This increase in the deficit is more than three times as large as the 75-year shortfall in Social Security.
- Moreover, the Panel's proposal is *not* revenue neutral over 75 years even by the Panel's own standard of what constitutes revenue neutrality. The Bush tax proposals that constitute the Panel's baseline would cost \$12 trillion over 75 years (\$9 trillion for making the 2001 and 2003 tax cuts permanent plus \$3 trillion for the President's additional tax-cut proposals). The Panel's reform plans, however, contain additional proposals that would not lose much further revenue in the first ten years but would burgeon in cost in subsequent decades. Over the 75-year period, deficits would be roughly \$2 trillion larger under the Panel's plans than if the 2001 and 2003 tax cuts were made permanent and the President's other tax proposals were enacted.
- Based on economic research and standard economic models, the increased deficits that the Panel's plans would reduce national income by about 8 percent after 50 years. This is substantially larger than most estimates of the potential economic gain that could be produced by reforming the tax code. Thus, despite making a number of thoughtful, innovative reform proposals, the Panel's plans as a whole *would likely reduce economic growth rather than increase it*.
- Also of note, some of the revenue loss that would result from these proposals would come out of revenues collected from a tax that is dedicated to the Social Security and Medicare Hospital Insurance Trust Funds. By reducing this dedicated revenue source, the Panel's proposals would enlarge the Social Security and Medicare shortfalls and thereby accelerate the dates when the two programs would become insolvent. That would necessitate deeper cuts in Social Security

² Consistent with standard budget conventions, the 10-year estimate provided here represents the addition to the deficit over the next decade, while the 75-year estimate presented here is expressed in "present value." The present value, as used here, is the amount of money that would have to be set aside today, with interest, to equal the total addition to deficits over the next 75 years. Economists and budget analysts typically use present-value estimates for periods such as 75 years.

Preliminary and Approximate Estimates of Revenue Collections Under the Simplified Income Tax Plan (All Estimates Are Relative to Current Law)

	2006-15 (incl. interest)	75 Years (present value)	75 Years (% of GDP)
Extending the 2001 and 2003 Tax Cuts	\$1.5 trillion	\$9 trillion	1.5%
Additional Tax Cuts Proposed by President	\$0.3 trillion	\$3 trillion	0.5%
Backloaded Tax Cuts Proposed by Panel	--	\$2 trillion	0.3%
Total Cost	\$1.8 trillion	\$14 trillion	2.3%
<i>Social Security Shortfall (Trustees Estimates)</i>	--	<i>\$4 trillion</i>	<i>0.6%</i>

Source: Estimates by the Center on Budget and Policy Priorities, and Social Security data from the Social Security Trustees' 2005 Annual Report. The sources for the individual estimates are discussed in more detail in the text.

These estimates are conservative in that they likely understate the cost of the Commission plan relative to current law. Under the baseline that the Panel used, tax revenues would continue to grow as a share of the economy after 2015, because the AMT is not indexed for inflation. Since the Panel's proposals would eliminate the AMT, the degree to which the level of revenue that the Panel's proposals would generate would fall short of the Panel's baseline would increase over time. This factor is not included in this analysis, making our estimates conservative.

and Medicare benefits, or greater increases in payroll taxes, to restore solvency.

- Finally, in addition to being portrayed as revenue-neutral, the Panel's plans also have been presented as being neutral with respect to the distribution of tax burdens. This merely means, however, that the distribution of tax burdens would be the same under the Panel's plans as under the Administration's proposals to make the 2001 and 2003 tax cuts permanent and to enact several new tax breaks tilted to high-income households, such as Retirement Savings Accounts and Lifetime Savings Accounts. The Administration's proposals, which the Panel's plans are designed to mirror distributionally, would make the tax code less progressive.

Table 1 summarizes these estimates. The 10-year estimates in the table are based on CBO and JCT scoring of the President's tax proposal. The 75-year estimates are based on a conservative extrapolation of the path for the first decade, as well as on past analyses of the long-term fiscal effects of the President's RSA and LSA proposals and the proposed change in the taxation of Social Security benefits.

Costs Over Ten Years of Assuming the 2001 and 2003 Tax Cuts Are Made Permanent

President Bush established the Tax Reform Panel in January and gave it a mandate to make proposals that would advance three goals: "simplify Federal tax law," "share the burdens and benefits of the Federal tax structure in an appropriately progressive manner," and "promote long-run economic growth." In addition, the Panel was told to provide "revenue neutral policy options," which the White House made clear meant that the proposal was to be "revenue neutral" relative to the President's proposal to extend the 2001 and 2003 tax cuts and make them permanent.³

The Panel's Final Report states that "the most important constraint on the Panel's recommendations is the Executive Order's direction that all of the Panel's reform options be

³ George W. Bush, "Executive Order 13369: President's Advisory Panel on Tax Reform," January 7, 2005.

‘revenue neutral.’” The Final Report goes on to explain that the “Panel used the Administration’s baseline,” which “assumes that the 2001 and 2003 tax cuts will be made permanent.” Although the Final Report does not provide specific revenue estimates, it does state that both of the plans it recommends are “within one-half of one percent of the projected revenue baseline for the next ten years.”

According to the Office of Management and Budget (OMB), the President’s proposal to make the 2001 and 2003 tax cuts permanent would reduce revenue by \$1.1 trillion over the ten years from 2006 through 2015.⁴ According to the Congressional Budget Office (CBO), revenues would be reduced by \$1.3 trillion over this period.⁵ Based on these CBO estimates, making the tax cuts permanent would add a total of \$1.5 trillion to the deficit over the next ten years, when the higher interest costs are taken into account.⁶

Ten-Year Costs of Assuming Additional Tax Cuts Are Enacted

President Bush also has proposed several additional tax cuts, including Retirement Savings Accounts, Lifetime Savings Accounts, tax incentives for health care, and tax incentives for charitable contributions. Many of these have been included in the President’s budget proposal for each of the last several years but have not been enacted by Congress. The Administration’s budget estimates that these proposals would cost \$280 billion over ten years.⁷

The Administration’s budget claims that extending the 2001 and 2003 tax cuts is part of the “baseline” and thus has no cost. The Administration makes no such claim, however, about its *other* tax-cut proposals and depicts them as increasing the baseline deficit. CBO estimates the cost of these other proposals at \$250 billion over ten years (or \$300 billion, including the interest costs).⁸

A presentation by the Tax Panel’s Senior Economist, Roseanne Altshuler, on November 3, 2005 indicated, however, that the Panel’s baseline reflects the cost of new tax cuts proposed by the President. Altshuler specifically cited the cost of Administration proposals to establish Retirement Savings Accounts (RSAs) and Lifetime Savings Accounts (LSAs) as being incorporated into the Panel’s baseline.⁹ The Panel report itself does not mention this additional cost of its proposal or the

⁴ Office of Management and Budget, 2005, *FY 2006 Mid-Session Review*, Table S-7. This includes the effects on federal outlays of extending the child tax credit and Earned Income Tax Credit (EITC) rules enacted in 2001.

⁵ Congressional Budget Office, March 2005, *An Analysis of the President’s Budget Proposals for Fiscal Year 2006*. This includes the effects on outlays of extending the child tax credit and EITC rules enacted in 2001.

⁶ These estimates do not include the cost of extending relief from the Alternative Minimum Tax. Under current law, the AMT will increase taxes for tens of millions of taxpayers. The President and Congress have been extending AMT relief on an annual basis. Multi-year relief is not included in the President’s budget or the baseline used by the Tax Reform Panel.

⁷ Office of Management and Budget, 2005, *FY 2006 Mid-Session Review*, Table S-7. This includes the effects on federal outlays of extending the child tax credit and Earned Income Tax Credit (EITC) rules enacted in 2001.

⁸ Congressional Budget Office, March 2005, *An Analysis of the President’s Budget Proposals for Fiscal Year 2006*. This includes the effects on outlays of extending the child tax credit and EITC rules enacted in 2001.

⁹ See Roseanne Altshuler, “A Summary of the Tax Reform Panel’s Report,” November 3, 2005.

fact that this represents a marked departure from even the Bush Administration's own unusual definition of "revenue neutrality."

Over the Long Term, Panel's Proposals Would Cost *More* than the Administration's Tax Proposals

Looking only at the next ten years understates the budgetary impact of the Panel's proposals. The Panel's first reform plan (the "Simplified Income Tax Plan") includes several provisions that would cause the plan to cost substantially more after the first ten years than making the tax cuts permanent.¹⁰

- **Panel's plan loses more revenues after 2015.** According to the Panel, its plans would raise the same amount of revenue over ten years as the amount of revenue in the Panel's "baseline;" as noted, this baseline assumes the tax cuts will be made permanent and other Administration tax-cut proposals will be enacted. The Panel also noted, however, that its plan would raise more revenue than the baseline in the first part of the 10-year period and less revenue than the baseline toward the end of the period. This implies that the Panel's proposal would raise less revenue beyond the 10-year window than would be raised if the tax cuts were made permanent and other Administration tax-cut proposals were enacted as well.
- **Panel's plan includes backloaded savings proposal.** The Panel proposes a large expansion in savings accounts, under which a couple could place up to \$40,000 a year in tax-advantaged accounts. These accounts are even larger than the accounts that would be established under the President's proposal for Retirement Savings Accounts and Lifetime Savings Accounts. The tax treatment that would be accorded these accounts would be the same as the current tax treatment of Roth IRAs — initial contributions would not be tax deductible, but accounts would accumulate tax free and withdrawals would be tax free. As the Panel acknowledged, "a substantial share of the revenue loss from the reduced taxation of future capital income for each dollar contributed to these accounts occurs *outside the ten-year window*" (emphasis added).¹¹

These future costs would be substantial. Both the Congressional Research Service and economists Leonard Burman, William Gale, and Peter Orszag (three of the co-directors of the Urban Institute-Brookings Institution Tax Policy Center) have estimated that the Administration's proposal for Lifetime Savings Accounts and Retirement Savings Accounts — which is *smaller* than the Panel's proposal — would have very large back-loaded costs.¹²

¹⁰ The Panel's second proposal, the "Growth and Investment Plan," also includes a provision allowing businesses to expense their investment, a proposal that would slightly reduce revenue loss beyond the 10-year budget window relative to the revenue loss in the 10-year window. This would, however, offset only a small portion of the other back-loaded provisions.

¹¹ Page 47.

¹² The Congressional Research Service estimated that the long-term cost of RSAs and LSAs is equivalent to a tax cut costing \$300 billion to \$500 billion over ten years. Burman, Gale and Orszag have estimated that the long-term cost of the RSA and LSA proposals would be more than one-third as large as the 75-year Social Security deficit. See Jane Gravelle and Maxim Shevedov, "Proposed Savings Accounts: Economic and Budgetary Effects," Congressional Research Service, updated March 25, 2005 and Leonard Burman, William G. Gale, and Peter R. Orszag, "The Administration's Savings Proposals: Preliminary Analysis," *Tax Notes*, March 3, 2003.

- **The Panel's plan also includes a backloaded reduction in taxes on Social Security benefits.** The bipartisan 1983 Social Security reform (the reform that the Greenspan Commission designed) included a provision under which Social Security benefits are partially taxed for married couples with incomes over \$32,000 (and individuals with incomes over \$25,000). The Greenspan Commission purposefully did not index this threshold for inflation, in order to ensure that Social Security would raise more revenues as its demographic challenges grew. The Tax Reform Panel proposes to reverse this judgment of the Greenspan Commission and to index these income thresholds, thereby reducing future revenue relative to current law. This provision would have little cost within the ten-year window. But it would cost about \$1 trillion, in present value, over 75 years. Moreover, this provision not only would swell the overall budget deficit but also would make Social Security's and Medicare's solvency problems significantly worse. All of the revenue raised by taxing a portion of Social Security benefits for people above certain income levels is deposited in the Social Security and Medicare Hospital Insurance Trust Funds. Reducing this revenue, as the Panel's proposal would do, would make the holes in Social Security and Medicare deeper, accelerate the dates when the two programs would become insolvent, and necessitate deeper cuts in Social Security and Medicare benefits (or larger payroll tax increases) to keep these programs solvent.

The combined effect of these and other provisions is that the total cost of the Panel's proposals over 75 years would be roughly *\$5 trillion greater* (an amount equal to 0.8 percent of GDP over 75 years) than the already-large cost of making the 2001 and 2003 tax cuts permanent. These added costs, over and above the costs of making the tax cuts permanent, are themselves larger than the entire 75-year Social Security shortfall. (Compared to the cost of *all* of the President's proposals, including his RSA and LSA proposals, the cost of the Panel's proposals is roughly \$2 trillion greater over 75 years.)

As the table on page __ shows, when combined with the costs of making the 2001 and 2003 tax cuts permanent, the total cost of the Panel's proposal — relative to current law — would be about \$14 trillion over the next 75 years (or about 2.3 percent of GDP). This is more than three times the Social Security shortfall over this period. (The Social Security Trustees estimate that the size of the Social Security shortfall equals 0.65 percent of GDP over 75 years. The Congressional Budget Office estimates the Social Security shortfall at 0.4 percent of GDP over this period.¹³)

The Economic Effects of the Panel's Proposals

The Tax Reform Panel was charged with, among other goals, promoting economic growth by encouraging savings and investment. Unfortunately, the large deficits associated with its proposal would undermine this goal.

As explained above, the Panel's proposals would substantially enlarge the deficit. The resulting increases in deficits and debt would reduce national savings and thereby lead to a smaller capital stock and more foreign borrowing, and hence to lower national income.

¹³ The Social Security Trustees estimate is from the Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *The 2005 Annual Report of the Board of Trustees of the Federal Old-age and Survivors Insurance and Disability Insurance Trust Funds*. The CBO estimate is based on calculations from data released with the Congressional Budget Office report, *Updated Long-Term Projections for Social Security*, March 2005.

After 50 years, the proposals would increase the national debt (relative to the effect on the debt of doing nothing and allowing the tax cuts to expire after 2010, or of paying for all tax cuts that are extended) by an amount equal to 130 percent of the Gross Domestic Product. Standard macroeconomic extrapolations used by, among others, President Bush's Council of Economic Advisers, indicate that an increase in the debt of this size would lead to a reduction in the nation's capital stock equal to about 80 percent of GDP.¹⁴ That, together with increased foreign borrowing, would result in a roughly 8 percent reduction in national income in 2055, related to what national income otherwise would be.

Under most estimates, the gains in economic growth that would result from tax reforms that would make the tax code simpler and more "pro-growth" would be much smaller than that. One leading paper often cited by proponents of tax reform found that a tax reform that, like the Panel's proposals, maintained a progressive tax system and did not levy a one-time tax on existing capital would increase national income by 1.9 percent over 150 years.¹⁵ That is the equivalent of an increase in the annual economic growth rate of 0.01 percentage point, or an increase in the economy of significantly less than 1 percent after 50 years. The model used for that simulation would likely show a substantially smaller growth effect from the Tax Panel's proposals, which have fewer pro-growth features than the tax reforms analyzed in the paper.

In other words, the amount by which the U.S. economy would be smaller after 50 years as a result of the enlarged deficits the Panel's proposals would generate — an amount equal to 8 percent of GDP — would be roughly *eight times* the amount by which the economy would grow over this period as a result of the improvements in tax policies themselves. The net effect of these two factors — one of which would increase economic growth as a result of greater tax efficiency, and the other of which would reduce growth as a result of larger deficits — would be a significant *reduction* in growth.

These figures also mean that allowing just one-eighth of the Bush tax cuts to expire as scheduled would likely do as much to boost long-term growth as all of the Panel's tax reform proposals (and that allowing *more than* one-eighth of the tax cuts to expire would do more to promote long-term growth than the Panel's plans).

Even the Panel's own estimates of the potential growth impact of its proposals are insufficient to offset the economic damage that would result under standard estimates of the long-term economic effects of increases in deficits of this magnitude. The Panel estimates that its "Simplified Income Tax Plan" would raise "long run" national income by 1.2 percent and that its "Growth and Investment Tax Plan" would raise "long run" income by 2 to 6 percent. The Panel does not provide sufficient detail to evaluate why these estimates are higher than the standard findings in the published literature of the economic impacts of tax reforms of this nature.

¹⁴ Council of Economic Advisers, *Economic Report of the President*, February 2003. See also Douglas Elmendorf and N. Gregory Mankiw, "Public Debt," in John B. Taylor and Michael Woodford, eds., *Handbook of Macroeconomics*, 1999. Mankiw served as Chairman of President Bush's Council of Economic Advisers from 2003 to 2005.

¹⁵ David Altig *et al.*, "Simulating Fundamental Tax Reform in the United States," *American Economic Review*, June 2001. Specifically, this estimate was for a flat tax with transition relief. In the context of its model, the Panel's proposals are likely to result in even less of an addition to national income because the proposals are more progressive than a flat tax, have a higher tax on capital, and maintain some of the distortions in the current tax system.

Conclusion

The Panel has proposed many specific tax changes that would improve the tax system, as well as some changes that would not. Careful evaluation of the details of the Panel's proposals should be undertaken, and many of the Panel's specific proposals should form the basis of future tax reforms.

But the Panel's proposals as a whole should not be enacted. The proposals would substantially increase long-term deficits and thereby adversely affect the economy. They also would lock in the less progressive distribution of tax burdens that would result from making the 2001 and 2003 tax cuts permanent, and would weaken the long-run viability of basic commitments like Social Security and Medicare.