

Tax Reform and Fairness for Families

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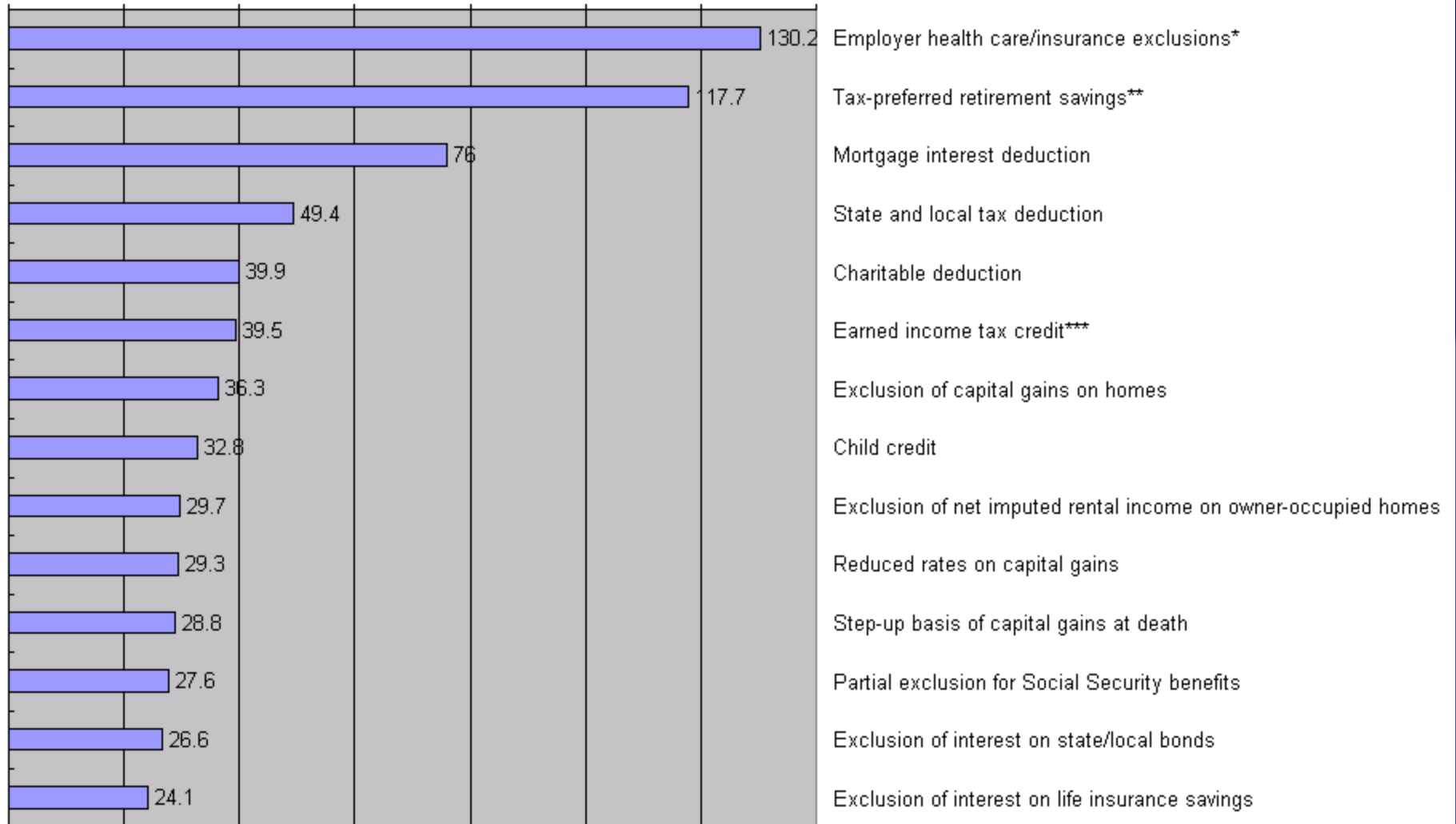
Outline

- ✦ Tax system affects almost every area of family's life
- ✦ Many tax subsidies are complex, unfair, inefficient, non-transparent, and corrupting
- ✦ IRS does *NOT* monitor subsidies' effectiveness
- ✦ Much spending is hidden in taxation
- ✦ Much taxation is hidden in spending
- ✦ Tax reform cannot avoid addressing these "policies"
- ✦ True tax reform identifies who is going to pay

Pervasiveness of Tax Subsidies

- ★ Child-related subsidies (EITC larger than welfare)
- ★ Housing tax subsidies (larger than HUD budget)
- ★ Charitable incentives
- ★ Subsidies for states/localities
- ★ Health tax subsidies (for workers, larger than any direct spending program)
- ★ Retirement/saving incentives (revenue loss greater than total personal saving)
- ★ Higher education incentives
- ★ Business subsidies (that differentiate among families by source of income, not ability to pay)

Major Tax Expenditures FY 2006 (in billions)



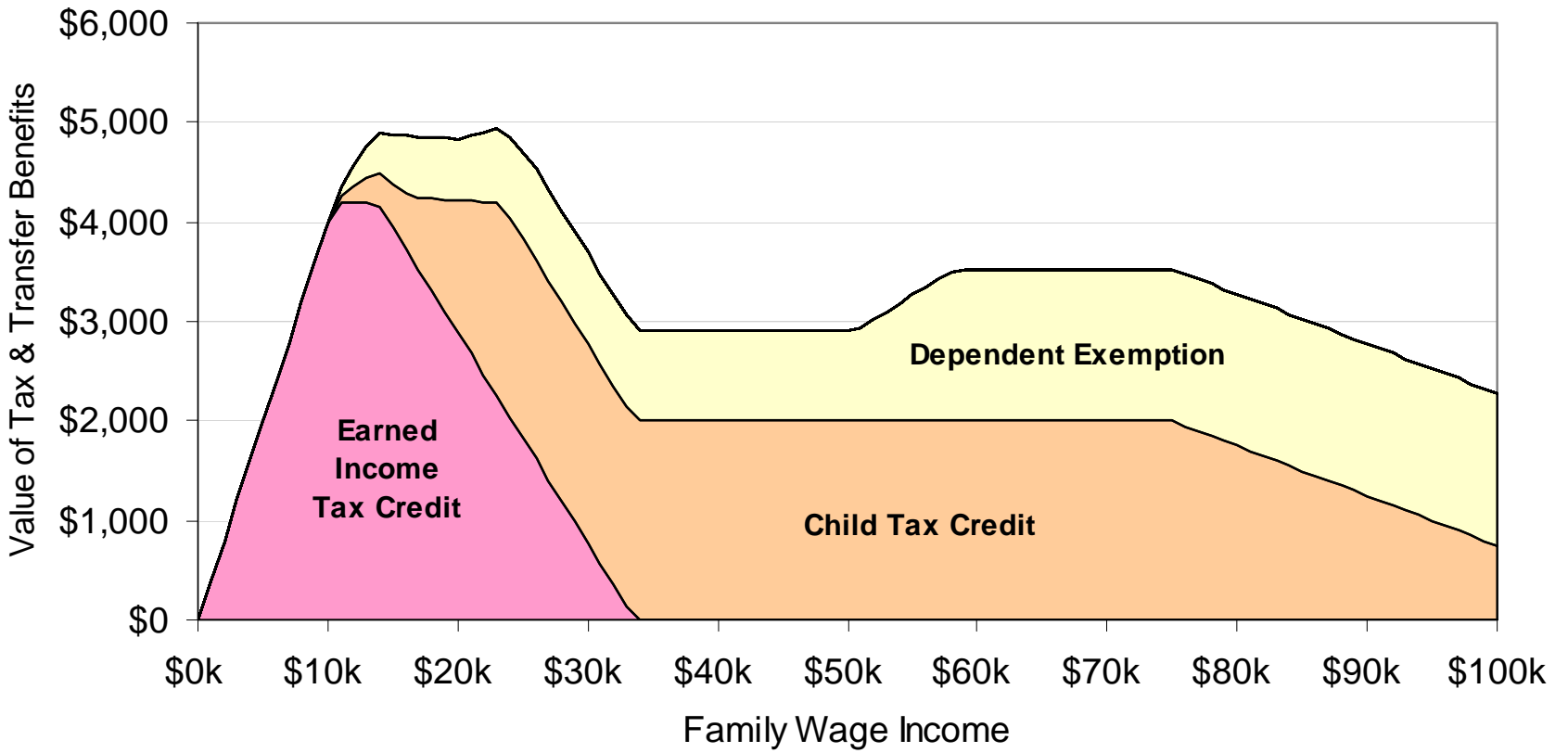
Many Subsidies Poorly Designed As Tax or Spending Programs

- ✦ Complex
- ✦ Provide unequal justice to taxpayers with equal ability to pay (horizontal inequity)
- ✦ Regressive (vertical inequity)
- ✦ Poorly targeted to need
- ✦ Non-transparent
- ✦ Corrupting

Child Provisions & Phase Outs

- ✱ Earned Income Tax Credit
- ✱ Refundable Child Credit
- ✱ Dependent Exemption
- ✱ EITC phase out
- ✱ Child credit phase out
- ✱ Dependent exemption phase out
- ✱ Dependent exemption as AMT tax shelter
- ✱ Head of household status
- ✱ ***Some opportunities:*** one unified credit; integrate phase outs or fold into rate schedule

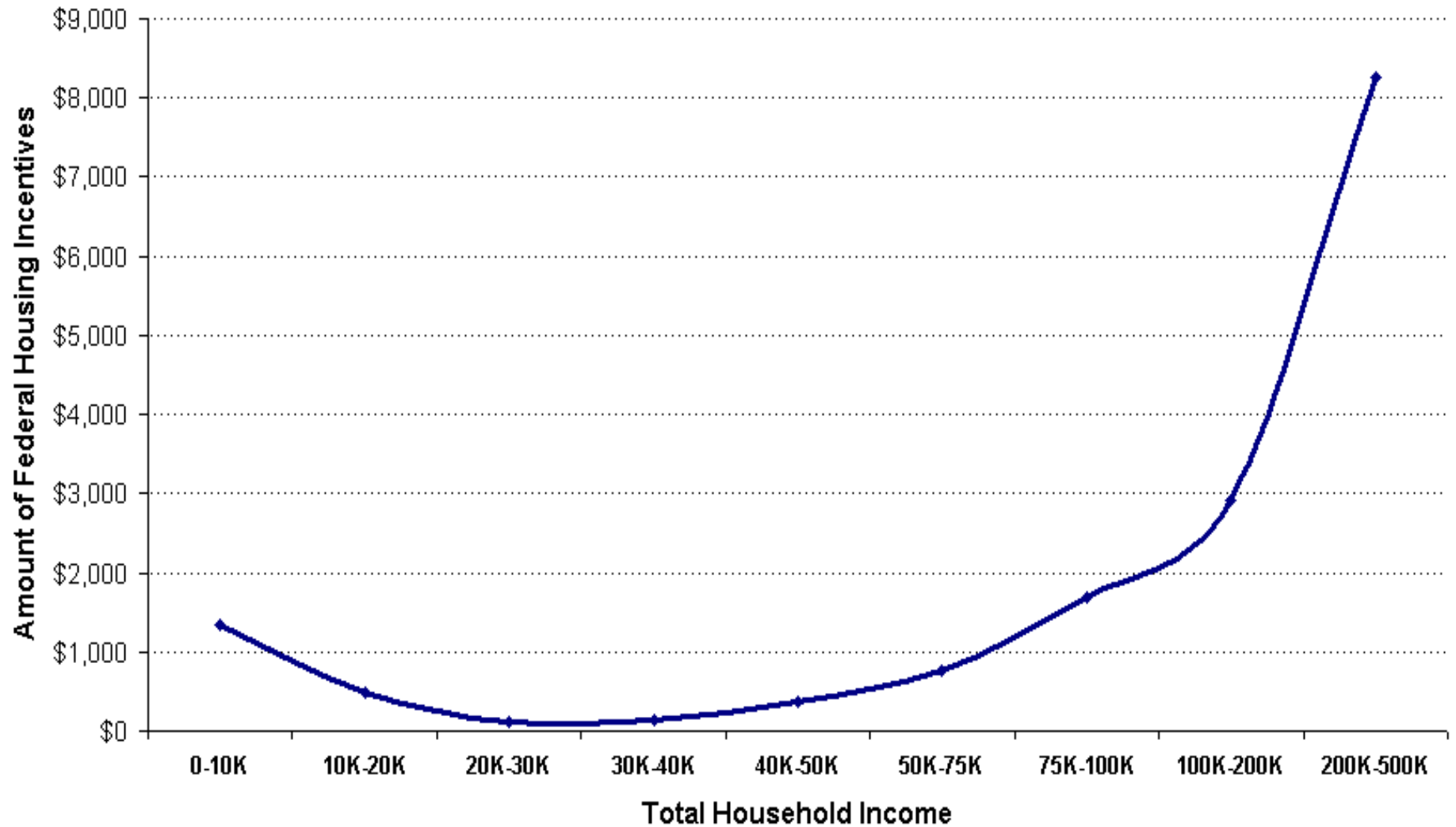
Tax Benefits for a Typical Head of Household with Two Children in Tax Year 2003



Housing Subsidies: Mainly Through Tax Code

- ★ For poor, rental but no ownership subsidies (e.g., low income housing tax credit)
- ★ For moderate income, no rental or tax subsidies, only higher prices
- ★ For middle class, some tax breaks
- ★ For higher-income, the largest subsidies
- ★ Interest deduction rules confusing & prone to error (e.g., secondary versus primary mortgages)
- ★ ***Some opportunities:*** simplify & level out the subsidies

U-Shaped Curve: Average Annual Federal Housing Incentives (Subsidies and Tax Deductions) by Total Household Income



Notes: Chart includes households without subsidies. Housing subsidies include federal public or subsidized housing subsidies. Deductions include mortgage and property tax deductions. Not included are deductions such as exception from passive loss rules for \$25,000 of rental loss or accelerated depreciation on rental housing.
Source: The Urban Institute, 2004. Based on data from the March 2002 CPS. Sample includes individuals less than 65 years of age.

Charitable Incentives

- ★ Subsidies could be better designed to promote giving
- ★ Cash and in-kind contributions sources of cheating & invite corruption
- ★ Little IRS enforcement for charitable organizations
- ★ For some contributions, government subsidy goes mainly to intermediaries, not to charity
- ★ ***Some opportunities:*** fold together bills for improving incentives & removing abuses (Senator Grassley statement & my Senate Finance testimony)

State & Local

- ★ State & local tax deduction
 - ★ Capped already because of AMT
 - ★ Proposed for elimination in 1984 Treasury study
- ★ Public purpose tax-exempt bonds
- ★ Private purpose tax-exempt bonds
 - ★ Often promote arbitrage, not net new investment
 - ★ Favor lobbyists with political connections
- ★ Newer credit based bonds (e.g. for local school construction)
- ★ Empowerment/enterprise zones
 - ★ Favor those on “right” side of the street
- ★ ***Some opportunities:*** AMT forces decision on S&L tax deductibility; limit or better target private bonds/zone subsidies to real needs

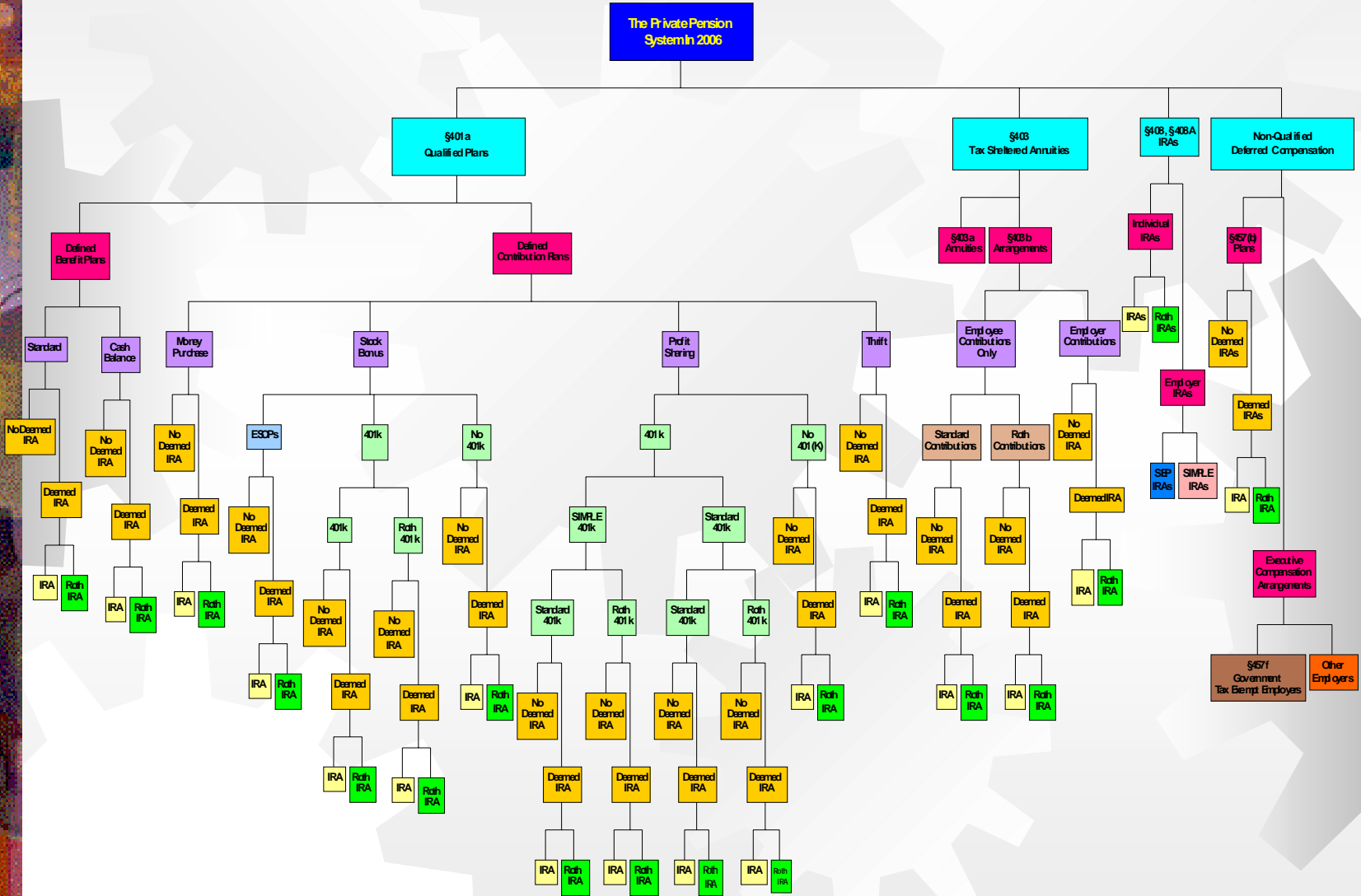
Health Tax Subsidies

- ★ Largest for the richest and those with highest cost plans
- ★ Current subsidies of about \$150 billion will rise by another \$100 billion annually within a few years
- ★ That increase of \$100 billion will likely *INCREASE* number of uninsured
 - ★ By adding to cost pressures
- ★ ***Some opportunities:*** Spend additional subsidies more wisely & distribute to reduce # of uninsured

Retirement Plan Subsidies

- ☀ Dozens of plan options
 - ✿ Substantial complexity
 - ✿ Much of return lost to intermediaries
- ☀ Tax subsidies for retirement now in excess of total personal saving!
 - ✿ Existing subsidies not for saving, but deposits
- ☀ ***Some opportunities:*** Simplify, level out subsidies

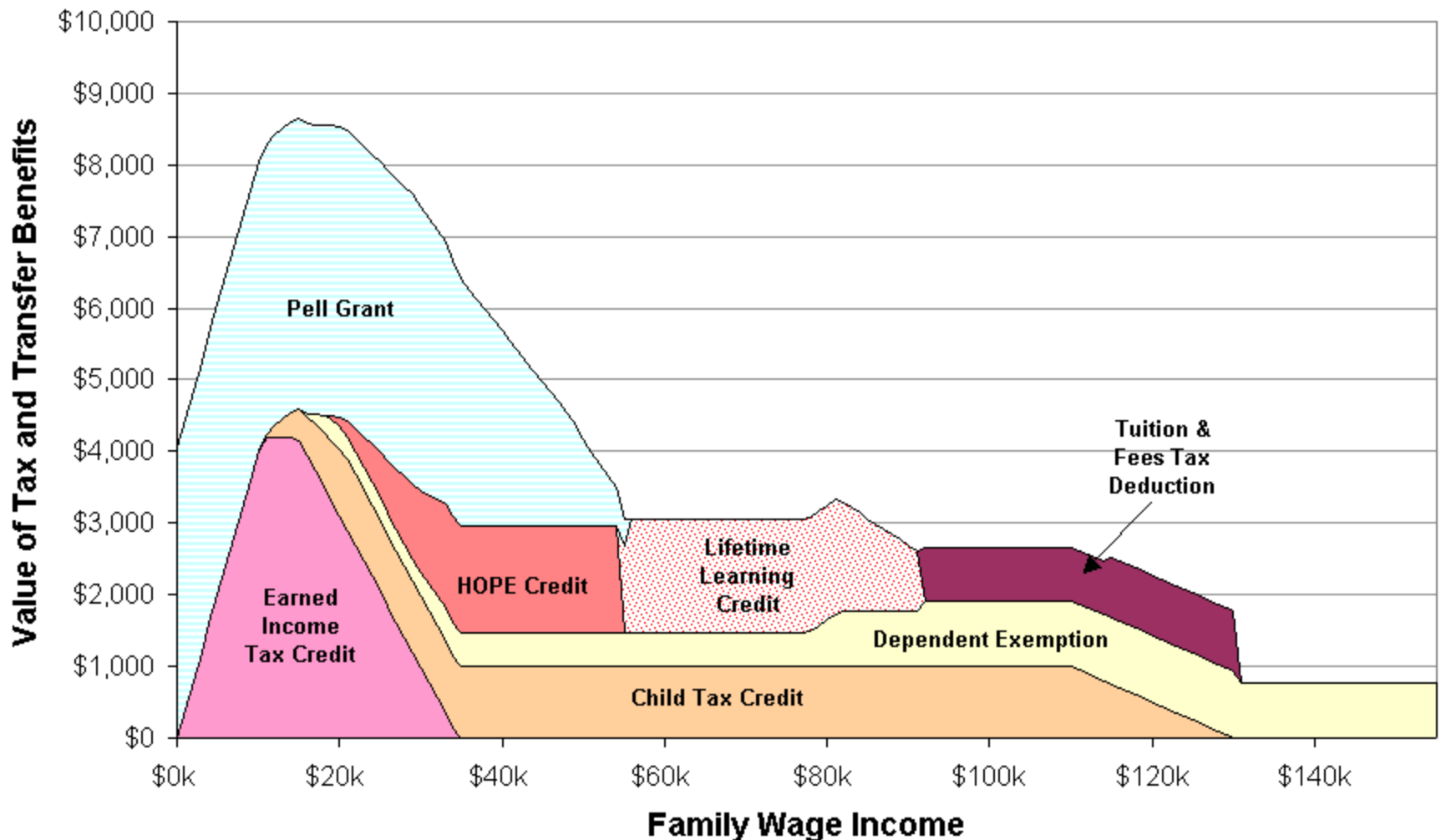
Retirement Plan Options Under Current Law



Higher Education Subsidies

- ✦ Many and contradictory
- ✦ Distributed somewhat randomly
- ✦ Complex and not well integrated with direct aid
- ✦ Often high marginal tax rates
- ✦ ***Some opportunities:*** Unify into one tax program; fold into Pell grants

Child and Higher Education Subsidies in the Tax Code for a Married Couple with Two Children in 2003 (one child in college)



Some Business Tax Incentives

- ★ Special subsidies by type of business (e.g., small business, energy)
 - Affect families very differently
 - Not based on ability to pay
 - Often favor rich owner of subsidized business over poor owner of unsubsidized business
- ★ ***Some opportunities:*** Target benefits better; if consumption tax treatment sought, treat interest deductions consistently

Trade-offs still required

EXAMPLES

- ✱ Simplicity may dictate rough justice
- ✱ Simple subsidies may be very inefficient
- ✱ Progressivity often leads to high tax rates & marriage penalties on moderate income taxpayers

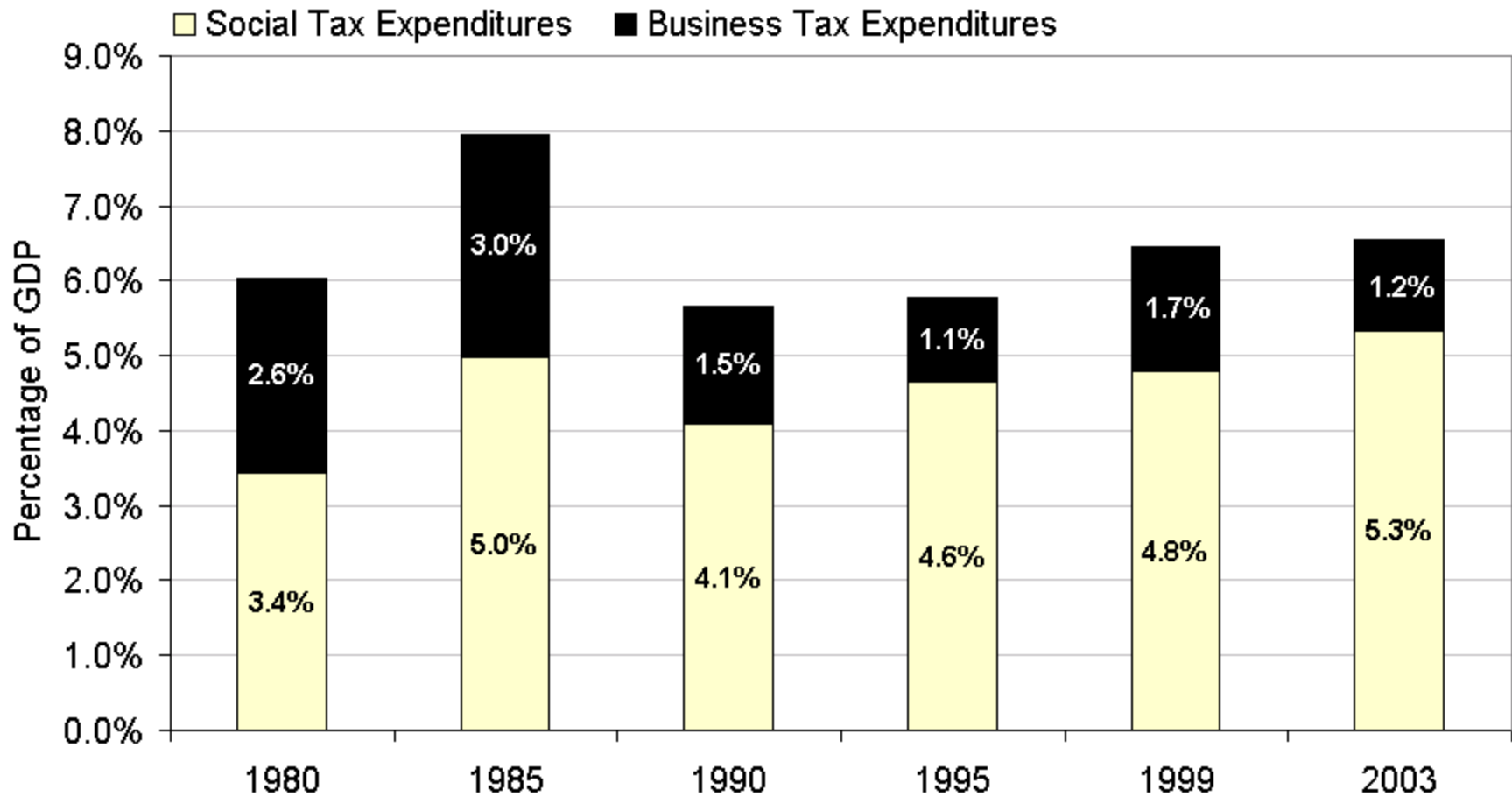
Weak Enforcement & Monitoring

- ★ Great difficulty administering
 - ★ Noncompliance highest when no reports (1099s)
 - ★ Very few taxpayers audited
- ★ Almost no monitoring for effectiveness for almost all subsidies
- ★ Treasury & IRS proclaim inability:
 - ★ Don't have data (“data constraints may limit assessment of effectiveness”—U.S. Treasury)
 - ★ Can't currently fulfill Government Performance & Results Act of 1983 (GPRA) requirement to develop strategic plans for programs

Why Spending is Hidden in Taxation

- ★ Tax subsidies in budget show up as:
 - Reduced taxation
 - No increase in spending
- ★ In reality
 - Same economic effects as spending
 - Cause higher tax rates
- ★ Perhaps 1/4 to 1/3 of all government spending is in tax system
- ★ Social spending now larger fraction of pie

TRENDS IN TAX EXPENDITURES, 1980-2003 (Expressed as a percentage of GDP)



Source: Eric Toder, "The Changing Composition of Tax Incentives, 1980-99," The Urban Institute, March 1999, Chart 1.
Updated to 2003 by author.

Many Taxes Hidden

- ☀ Derives mainly from:

- ☀ (1) Phase outs in tax programs
- ☀ (2) Phase outs in spending programs

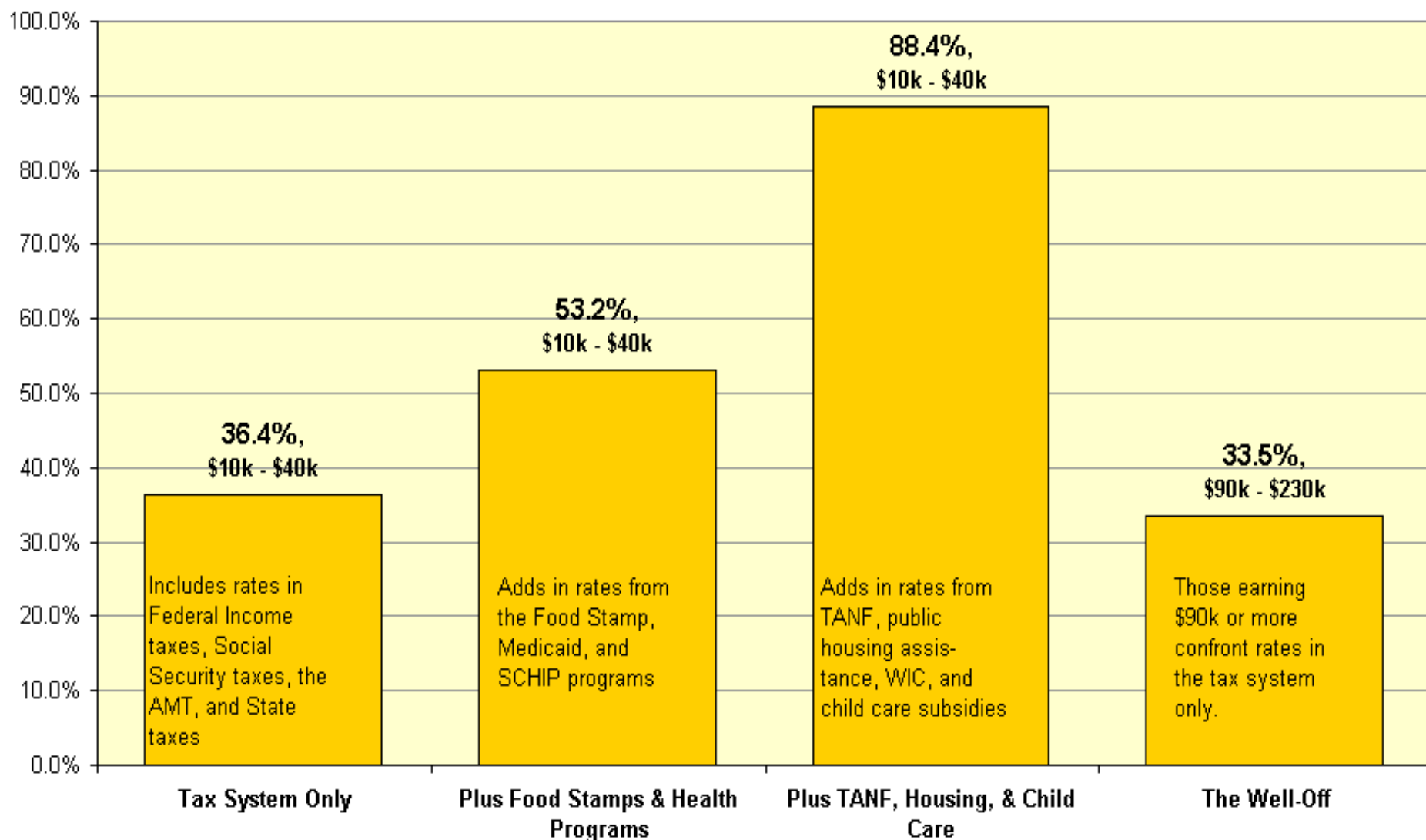
- ☀ Net result for moderate income families:

- ☀ Very high marginal tax rates
- ☀ Huge marriage penalties

- ☀ Implications:

- ☀ Concern over high tax rates must take into account other government programs
- ☀ Removal of income tax still leaves many families subject to income accounting

Comparison of Average Effective Marginal Tax Rates Among Families in Different Tax and Transfer Programs



Source: Adam Carasso and C. Eugene Steuerle, The Urban Institute, 2004. Assumes family had two children and filed as head of household in tax year 2003.

Is There a Magic Bullet?

- ✦ Current system really like three:
 - ✦ Poor – child credits, EITC expenditures
 - ✦ Middle class – incentives, deductions galore
 - ✦ Rich - zero taxes on many accruals
 - double taxes on some income
- ✦ Solving for one group doesn't solve for others
- ✦ Endless search for magic bullet
 - ✦ Flat tax, consumption tax
 - ✦ Still must decide charitable, housing & other policy

Conclusion

- ★ Tax reform is possible
 - ★ We've done it before
- ★ Budget necessity and public outrage over complexity of AMT could force issue
- ★ But it's very hard work
- ★ Tax reform is a test case for systemic reform requirements of a new fiscal era
 - ★ Recognizing who pays
 - ★ Requiring proof of performance to continue programs