

Opportunities in the Tax Bill

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[1] Although the debate over the tax package proposed by President Bush largely centers on size and progressivity, many of the more traditional areas of tax policy are ripe for attention. The problem facing the administration and the taxwriting committees is how to open up the legislative process to accept improvements but not open it up so much that it includes everything but the kitchen sink.

[2] Since the tax code now contains innumerable provisions, a laundry list of potential improvements according to traditional tax reform principles would be quite long. Here I confine myself largely to the topics raised by the president and then suggest various improvements largely on the grounds of efficiency, simplicity, transparency, and equal treatment of equals.

[3] Rates. The president has put prime emphasis on the lowering of marginal tax rates. His stance follows traditional concerns over the distorting aspects of higher rates on behavior and on economic growth. One can easily debate whether he recommends too much or too little lowering of rates, but I seriously doubt that one can argue that hidden rates are OK.

[4] Among the hidden rates that could and should be targeted in the next tax bill are the phaseout of itemized deductions (the so-called Pease provision) and the personal exemption phaseout (known as the PEP provision). Also required, sooner or later will be elimination of most or all of the alternative minimum tax, which mainly raises rates by attacking as tax shelters the following items: personal exemptions, state and local tax deductions, and other miscellaneous tax deductions. The gains from making the tax system more transparent are several. From a conservative viewpoint, it would be harder to raise tax rates in the future if the top tax rate is made explicit at, say, 36 percent rather than having a top direct tax rate of 33 percent and hidden tax rates of 3 percent.

[5] Charity. The idea to try to extend charitable incentives in my view is a good one. There are, however, a variety of ways to achieve this that will get the most bang per buck and achieve some simplification at the same time. An extension of the charitable deduction to nonitemizers, for example, can be achieved without substantially increasing compliance or enforcement costs for the IRS, while still increasing the odds of getting significant charitable contributions per dollar of revenue cost (for more details, see Economic Perspective, Tax Notes, Feb. 28, 2000, p. 1297, and Mar. 13, 2000, p. 1625.) Closely related are other high-payoff efforts such as reduction in the excise tax on private foundations in exchange for the higher grantmaking that a lower excise tax will allow.

[6] Marriage Penalties. Given the voluntary nature of marrying for many couples, and the ability of many other individuals to combine together in dorms, nursing homes, apartments, and other places, it makes little sense any more to impose penalties on people simply for taking marriage vows. With respect to the current tax system, many marriage penalties can be eliminated simply by doubling the standard deduction for married couples relative to single individuals.

[7] Beyond that, about 70 percent of taxpayers face only one rate -- the 15 percent rate -- so that marriage penalties do not arise anew until a higher rate is reached, and that penalty can also be reduced by extending out the next bracket applying to joint returns. (Note, however, that the introduction of a new 10 percent bracket could, depending on design, create new marriage penalties, and the introduction of a second earner deduction adds yet one more layer of complexity to the system as a whole.)

[8] These proposals, however, leave out the very large marriage penalties in the earned income tax credit. Dealing with those requires a much more elaborate effort -- one that cannot be solved simply by expanding

the phase-out range for married people.

[9] Child credits. This brings us to the subject of child credits, which Bush proposes to double as well as to make it available to much higher income levels. The child credit provisions provide a lot of opportunities. Those include (1) simplification of the child credit along with the many other provisions applying to children, such as the dependent exemption and head of household tax rate schedule; (2) expansion of health insurance coverage by requiring that increased child credits be made available at middle- class levels and above only to those who purchase health insurance for their children; (3) an opportunity to combine a larger child credit with the EITC both to level out children's benefits that are highest at low and high income levels, and to reduce the marriage penalties in the EITC.

[10] Estate Tax. If some portion of the estate tax is to remain, it would be far preferable to raise the exemption level (or credit) even further than to accept a lower exemption level in exchange for some of the special tax breaks that favor one form of estate over another. Among the most likely candidates for reform, suggested by Richard Schmalbeck of Duke University Law School, among others, is the provision that allows estates to be priced at below- market value simply because minority interests are held in the estate.

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