Triple Jeopardy
By R. Glenn Hubbard
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In its report released yesterday, the President's Advisory Panel on Federal Tax Reform proposed two answers to the problems of the present federal income tax code: A Simplified Income Tax that streamlines the current income tax; and a fundamental reform prototype that was billed in the panel's last hearing as a progressive consumption tax.

We will learn more when Treasury Secretary John Snow transforms the report into a proposal for President Bush. But at first blush, the panel's answers call to mind the game show "Jeopardy," inviting us to guess the questions. Here are the three most important.

What domestic policy change offers the largest gain in economic well-being?

Arguably, fundamental tax reform. Recent studies, by Alan Auerbach of the University of California at Berkeley and others, suggest that true reform -- changing to a broad-based income or consumption levy that taxes income only once -- could yield once-and-for-all annual household income gains of 9%.

A key lesson from economic research is that the bulk of the gain from tax reform comes from reducing the bias against saving and investment, which slows capital formation and wage growth. Some years ago, Jonathan Skinner of Dartmouth College and I concluded from empirical studies that reducing the tax burden on saving can have significant positive effects on household saving. And, studying firms' investment decisions during previous tax reforms, Kevin Hassett of the American Enterprise Institute and I estimated large effects of tax changes on business investment.

The direction for saving-and-investment reform is clear. Any plan -- whether aiming for a broad tax on income or consumption -- should remove investor-level taxes on dividends, capital gains and interest. That does not imply that capital income escapes taxation. All income would be taxed once -- wages at the household level and business income at the business level.

The panel's "fundamental reform" prototype attempts to make an important point: A clean reform is a big improvement over the current system's convoluted mix of preferences (special provisions or tax shelters) and biases (double taxation or worse). And, by incorporating full expensing of capital investment, the panel would transform a business-income tax to a cash flow tax, by itself consistent with an efficiency-enhancing consumption tax. But it appears to reflect politics as well, reintroducing the double taxation of income from savings, albeit while keeping the lower rates successfully championed in the 2003 tax law change.

Compromise might be the mother's milk of tax legislation, but one might hope for a cleaner start (as in the first Treasury study leading up to the Tax Reform Act of 1986). The Treasury already recommended a clean income tax reform with only one layer of tax on business income in 1992 -- the Comprehensive Business Income Tax. The late Princeton economist David Bradford suggested a progressive consumption tax variant (which he called the X-tax), incorporating expensing of capital investment.

By contrast, the panel's tax reform is not a consumption tax: It marries the X-tax with a surcharge on capital income. To the extent this pairing reflected concern over "fairness," one wonders how the panel squared this choice with the elimination of the tax on dividends in the Simplified Income Tax prototype, or why the panel did not choose less-distorting tax alternatives if a quest for "distributional neutrality" was really the issue

How can we simplify the current income tax in a principled way?

The panel's Simplified Income Tax system makes significant strides here. The panel wisely proposes repeal of the Alternative Minimum Tax on individuals and corporations. If Congress legislates tax policies, it should not reverse them through back-door minimum taxes that, as recent experience suggests, are laden with unintended adverse consequences for taxpayers.

Revenue neutrality requires that such simplification measures be financed. Here the panel correctly avoids raising marginal tax rates; indeed, the proposed top marginal tax rates (33% for individual and 32% for corporations) are lower than under current law (35% for both). It is the marginal tax rate -- the rate on the additional dollar earned from work, saving or entrepreneurship -- that sets incentives and governs the pro-growth gains from tax reform. The elimination of the dividend tax, and a tax cut for capital, going along with expanded and simplified saving incentives, increases after-tax returns to saving. And a shift toward territorial taxation of American multinational companies improves investment incentives and the competitiveness of U.S. firms.

The cuts in marginal tax rates do not reduce average tax rates for upper-income taxpayers. These taxpayers would bear the brunt of the lost state and local tax deductions, and the proposed limitations of the home mortgage interest deduction to a 15% tax credit on a mortgage varying by area and not exceeding $300,000. These offsetting tax changes preserve distributional neutrality.While any such principled simplification exercise will produce individual winners and losers, the panel should be able to document important improvements in incentives and gains for many households. The reform also eliminates the marriage penalty and replaces the earned-income tax credit with a work credit that can be calculated by the Internal Revenue Service.

What public policy change can address leading economic challenges of retirement saving, health-care costs, and global imbalances in saving and investment?

Perhaps the most compelling reason to advocate sweeping tax reform is that it is the linchpin for the reforms necessary to address other numerous economic policy challenges facing the nation.

First, the panel's prototypes confront the challenge of preparing for retirement saving through more straightforward and more generous savings incentives in the Simplified Income Tax option. In addition, a Refundable Savers Credit would credit taxpayers with 25 cents for every dollar they save, up to $2,000 a year. These options would be coordinated easily with Personal Accounts in a reformed Social Security system.

Second, current tax policy allows people to exclude from taxation employer-provided health-insurance expenditures, but requires direct out-of-pocket medical spending to come from after-tax income. This tax preference has given consumers the incentives to purchase health care through low-deductible, low-copayment insurance instead of paying for it out-of-pocket, increasing health care spending.

Eliminating the tax bias altogether in favor of employer-provided insurance is sound tax policy and would increase efficiency in health-care spending. But the panel's proposed cap on the exclusion is a standard Washington Solomonic exercise, with only a small gain for tax policy and a huge missed opportunity in health policy. As John Cogan and Dan Kessler of Stanford University and I argue in a recent book, absent the more radical elimination of the exclusion, market-oriented health-policy objectives would be better advanced by continuing the trend raised in recent Health Savings Accounts -- allowing all out-of-pocket expenditures to be deductible. Resulting changes in behavior toward high-deductible, true insurance would reduce health spending, and the substitution of higher (taxable) wages for (taxed) employer-provided insurance limits the revenue cost of the change.

Third, the U.S. economy must grapple with continued imbalances in global savings and investment. By increasing returns to saving, tax reform will assist the gradual increases in saving required to reduce the nation's current account deficit. In addition, spillovers of global saving from inefficient capital markets in emerging Asia and the Middle East have held down U.S. interest rates, fueling a boom in housing prices and housing investment (where the interest rate is the overwhelming determinant of the user cost of capital). The current tax code, biased in favor of housing and against business investment, further adds to this pressure. The tax reform option suggested by the panel would provide a gradual rotation of investment toward business investment, increasing not only the prospects for growth but the ability of the United States to export capital goods.

The Tax Reform Panel has done the hard, important work of raising public consciousness of the need for tax reform, exploring tradeoffs in various tax changes and outlining prototypes for change. As I have suggested, the panel's "answers" respond to at least three significant policy questions. But the next step is to go to the Final Jeopardy round.

Answer: A convincing explanation of the centrality of tax reform in domestic policy and continued presidential leadership. Question: What will it take to bring into focus the Tax Reform Panel's options and advance legislative action on tax reform?

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