Welcome to Federal Income Taxation! I hope you will find the course to be both engaging and, perhaps just as importantly, useful. It should be: The tax code stands at the center of American political discourse; the issues involved vex policymakers and voters alike; and billions in resources are devoted to administering the tax code and trying to comply with it (or, in some cases, plan around it). In short, it is important to our politics; it is important to our economy and national well-being; and it represents a vast—and ever-changing—body of law.

I will have more to say in introduction to the course on the first day, and I’ll also review my approach to the course and basic course policies, and take your questions. For the record, these are set out below.

**The Basics**

**Class:** Tues., 12:00 to 1:50 and Fri., 10:00 to 11:50 in VH 214

**Office Hours:** Tues., 3:00 to 4:00 and Fri., 12:00 to 1:00 in VH-302(d) (or by appointment)

**Contact info:** (212) 998-6741, kamin@nyu.edu

**Make-Up Classes**

I am tentatively scheduling two make-up classes for Friday, October 20th and Friday, November 3rd. The make-ups will run from 2:00 to 3:50, and they will be recorded.

This is because I might have to cancel one or two classes very early in the semester. I’ll be sure to keep you updated, and apologies for any inconvenience!

**Course Materials**

**Required:**


SELECTED FEDERAL TAXATION: STATUTES AND REGULATIONS (Daniel J. Lathrope ed., 2018 ed.) (“IRC”)

Note: I recommend buying the paper copy of the statutes and regs. You can also access the statutes and regulations online. However, I expect you to be able to reference them in class, and, most importantly, you will need paper copies—whether in the purchased volume or ones you printed out—of relevant code sections and regs for the exam.
**Recommended:**


**Assignments**

You should regularly check the announcements on NYU Classes. After each class, I will post what I expect to cover in the next class, as well as the panel that’ll be on call (see below for more on panels).

The class is broken into assignments, each with its own problem set or questions for discussion. The result is some “lumpiness” in the amount of work you will have to do on a given night. Some nights you might have to read G-S, the IRC, and begin working on problems. Other nights, there might be little work as we could still be going through problems that you’ve already prepared.

**Office Hours**

My office hours are listed above. Please feel free to drop by then or at other times too. I am happy to discuss the class or give advice on careers, law school, etc. I post sign ups for office hours about a week ahead of time on my door.

**NYU Classes Discussion/Forum**

I am of course very happy to take questions in office hours, after class, in class, etc. For written questions, you can either submit them by e-mail or by posting on the NYU Classes discussion/forum. My strong preference is that you use the NYU classes site to post questions so that everyone can benefit from the back and forth, and my default policy is to post any substantive written questions I receive and the answers to them on the Forum site. Of course, I will not post Q+A that is not about the substantive material in the course!

**Exam**

The exam will be 3 ½ hours and open book. It will be a combination of multiple choice and essay questions.

I have a number of sample exams available through the library. Further, most classes will be focused on a set of tax problems related to the materials of the day. That should give you good practice for the exam.

**Class Participation & Panels**

I will use a mix of volunteers and a panel for a given class. This is meant to encourage open class discussion but also make sure that participation is not limited to a handful of students. I will start using panels after our first class.

Class participation can count to the final grade. (For classes like these, we are allowed to raise or
lower grades by one increment based on participation.) If your panel is on call for the day, you should prepare for me to call on you for answers to problems and questions—though on any given day, I may not reach everyone on a panel. Of course, the entire class is also welcome (and encouraged!) to participate in class discussion.

If your panel is on call and you either can’t make the class or are not prepared, please notify me ahead of time. More than one unexcused pass can lower your grade for the course (as would too many excused passes—but I promise that you’ll be given fair warning before you reach that threshold).
Learning Outcomes & Preliminary Syllabus

Learning Outcomes

This class teaches several key skills important to the practice of tax law and policymaking. It will also give students a set of substantive knowledge that will serve them well as lawyers, even if they do not specialize in tax law, and also allow them to better understand and engage some of the country’s most important public debates.

Students will come away with an understanding of:

- Concepts that drive tax policymaking: This includes efficiency, equity, and simplicity.
- Concepts drive tax planning: This includes time value of money and piercing the formality of transactions to see the economics underlying the transactions (and how similarly structured transactions can sometimes lead to very different tax consequences).
- How to engage tax debates as a citizen and understand the substance underlying much of the rhetoric.

The class should cover the topics below in (roughly) the order shown here. I should emphasize that this is subject to change—and topics could be dropped or added as the class goes on. But, this should give you a sense for how the class will proceed.

Introduction

- Intro to class
- Basic policy concepts – efficiency, fairness, and simplicity
- Choice of tax base: income v. consumption v. wages
- Marginal v. average tax rates
- Filling out a tax return (the most exciting class of all!)

Gross Income

- What is income: Haig-Simons
- Treatment of fringe benefits, including employer-provided health insurance
- Treatment of gifts
- Imputed income v. market income
- Treatment of debt (and gambling/discounts)

Business Deductions

- Ordinary and necessary business expenses (deductible) versus personal expenses (not)
- Exceptions: illegal activity & lobbying

Credits, Exemptions, and Treatment of the Family
• Credits and exemptions: EITC, CTC, personal exemptions
• Taxable unit

**Tax Expenditure Concept**
• Tax expenditure concept
• Itemized deductions as tax expenditures: Deductions for mortgage interest, state/local taxes, and charitable giving
• Exclusion for tax exempt bonds as a tax expenditure

**Property Transactions and Returns on Saving**
• Basis and realization
• Debt financing
• Capitalization and depreciation
• Capital gains and character of income
• Annuities v. life insurance v. other deferral mechanisms
• Preferences for retirement savings
• Non-recognition: Like-kind exchanges
• Loss Limitations

**Timing and Accounting** (short)

**Tax Reform**
• Minimum taxes
• Rates, base, and inequality
Assignment 1: Background on the Income Tax and Tax Policy  
(1.5 Classes)

For our first class on Friday, September 1st: Please prepare problems 1 & 2 below.

This assignment is meant to get you thinking about some of the basic issues in tax policy. While much of this course will be very specific (dealing with sections of the code or regs), many of the broad ideas raised in the questions below will come up again and again in this and in other tax classes. In these readings (especially the two reports from the CEA – one under Obama and the other under Bush), you’ll see how progressive and conservative tax policy experts tend to employ the same framework for evaluating tax policy—looking to efficiency, fairness, and simplicity—but arrive at very different conclusions about what that framework means for good policy. The issues raised here are not easy ones; we could spend endless time discussing them; and they are the fodder for many academic papers and policy debates. The goal here is to understand and struggle with the basic concepts, and also to begin to see some of the fundamental disagreements in tax policy debates.

Note that there is no panel for the first day, which will be largely lecture—but also rely on some volunteers. We will begin using panels after the first class.

Listening (yes, listening):  [http://www.npr.org/blogs/money/2012/03/23/149235180/the-friday-podcast-the-surprisingly-entertaining-history-of-the-income-tax](http://www.npr.org/blogs/money/2012/03/23/149235180/the-friday-podcast-the-surprisingly-entertaining-history-of-the-income-tax). Listen to the about 20 minute Podcast on the history of the income tax. I promise—it is (as advertised) “surprisingly entertaining” (on the scale of things). And, sorry for the first few minutes on bank regulation toward the front; you can skip that. The relevant part starts just over 3 minutes into the broadcast.

Reading:

- Graetz-Schenk (hereafter, G-S): pp. 12-22 (stop at Section 3), pp. 27-40 (read the first two paragraphs in the tax expenditure section), p. 769 (time value of money)

- Obama Administration – 2013 Economic Report of the President, p. 92 fig. 3-1, pp. 96-107 (stopping at p. 107 fig.3-10) (posted on NYU Classes)

- Bush Administration – 2003 Economic Report of the President, pp. 175-184 (stopping at the section titled “Analysis of Alternative Reforms” and skip p. 180 on AMT), pp. 207-208 (stopping after “Income Versus Consumption as the Base”) (posted on NYU classes)

- Joint Statement on Tax Reform, July 2017 (posted on NYU classes) (Note that this Joint Statement is short, lacking detail, and, yet, still hard for a non-expert to interpret. For those in the middle of the tax reform debates, there were a few evident, important signals, as I’ll discuss in class.)
• Slides posted on NYU classes (read slides 11-13 on economic efficiency and slide 17 on the tax base especially carefully)

• *Skim in the first few weeks of class from G-S:* pp. 49-55 (up to the notes starting on p. 55), pp. 58-60 (up to the Notes), pp. 71-75 (“the role of the judiciary”—up to the notes section).

  *Note:* You will not be specifically tested on the issues covered in these sections to be skimmed and we will not discuss them extensively in class, but you should be aware of the basic issues laid out in these pages. In some cases, you might find yourself confused in class later on if you haven’t read these sections. (For instance, you might be confused what an IRS Revenue Ruling is or why a matter is being handled by the tax court rather than a district court.)

**Questions to Consider:**

1. **How much taxes should they pay?** Rachel makes $1 million per year working at a Connecticut hedge fund. She works 80 hours per week and is constantly on call, and feels miserable while at work. She is long-time friends with Jim. Rachel and Jim have always had different interests. As kids, Rachel had a great head for numbers. Jim was the artist of the pair and now runs a successful art studio in NYC, which he loves doing. He makes $100,000 per year. He works about 50 hours per week, and is his own boss—and can turn off his cell phone (and often does) when he wants.

There is a $110,000 tax bill to be divided between the two of them (or 10 percent of their aggregate income).

Think about how this tax burden should be divided. Consider this in terms of the three “classic” principles for evaluating tax fairness:

- What would be the most economically “efficient” outcome?

  Consider, what is a perfectly efficient tax:
  A. Tax of $55,000 per person.
  B. Tax of $110,000 applied on only Jim or Rachel—with a lottery to determine which one.
  C. Tax of 10% applied on all of their income ($1.1 mn altogether)
  D. A & B
  E. All of the above

- What would be the “fairest” outcome? Or, if that question feels too big, what would a “progressive” system look like? “Proportional”? “Regressive”? 

- How should “simplicity” (or “complexity”) affect the policy choices?
Now, consider the criteria for evaluating these kinds of tax decisions laid out in the Economic Reports of the President—one under Obama and the other under Bush. How are the criteria they lay out different (or not)?

2. **Which of these taxes/charges improves economic efficiency and which worsens economic efficiency?**

   A. Toll to drive over a bridge.

   B. Tax on luxury boats.

   C. Cigarette taxes.

3. **Spenders v. Thriftys—and choice of tax base.** The Spender and Thrifty families live next door to one another and are constantly comparing each other’s lots in life. Both families make $60,000 in wages in their jobs per year. (Note that $60,000 is about the median income for a household with children in the United States.) Unfortunately, for the Thrifty and Spender families, they are going to live for two years and then their imaginary world will disappear. In this imaginary world, the interest rate—the interest on any money saved—is 3 percent per year.

   **Year 1**

   The Spender family decides that this is the year for a great vacation—a time for a real blow out. The family spends $10,000 on a vacation. They spend the remainder of their wages ($50,000) on normal household expenses.

   By contrast, the Thrifty family wants to save up for Year 2 (in order to throw a big end-of-imaginary-world party). Instead of going on vacation, they save the $10,000 and, like the Spender family, spend the rest of their wages ($50,000) on normal household expenses.

   **Year 2**

   The Spender family makes $60,000 in wages and spends it all in year 2.

   The Thrifty family earns $60,000 in wages and, also, $300 in interest (on the $10,000 saved the year before). The Thrifty family spends all of this income; in addition, the Thrifty family spends the $10,000 it had saved the year before. That brings the Thrifty family’s total spending to $70,300 for the year.

   Consider: For each family, how much should be subject to tax in years 1 and 2 under an income tax, consumption tax, and wage tax, respectively? We will fill out the table on the next page in class. You should try to do Year 1 and Year 2, writing in how much would be subject to tax in each year under each of these respective tax systems. If you feel up to it, fill out the net present value (the total amount subject to
taxation in year 1 and year 2 in net present value). If you’re confused about net present value, don’t worry; we’ll explore/explain in class.

Which of these tax bases do you prefer? Why?
Total Amounts Subject to Tax in Each Year Under the Three Tax Systems (Income Tax, Consumption Tax, Wage Tax)

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Year 1 Spender</th>
<th>Year 1 Thrifty</th>
<th>Year 2 Spender</th>
<th>Year 2 Thrifty</th>
<th>Total (Nominal) Spender</th>
<th>Total (Nominal) Thrifty</th>
<th>Total (Present Value) Spender</th>
<th>Total (Present Value) Thrifty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax</td>
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<tr>
<td>Consumption Tax</td>
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<tr>
<td>Wage Tax</td>
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</tr>
</tbody>
</table>
Class Scheduling

Tentative Make Up Classes (Fridays, 2:00 to 3:50, will be recorded)

• October 20th
• Nov. 3rd

Cancelled Classes

May need to cancel one to two classes very early in the semester. Will keep you updated, and thanks for the flexibility!

Office Hours

Mon., 11:00 to 12:00; Thurs., 1:00 to 2:00 in VH 302-D. (Sign up on door)

Questions

Strongly prefer receiving written questions via the Discussion/Forum on NYU Classes.
Class Units

Part I: Introduction

Part II: Gross Income

Part III: Business Deductions

Part IV: Credits, Exemptions, and Treatment of the Family

Part V: Tax Expenditure Concept

Part VI: Property Transactions and Returns on Saving

Part VII: Timing and Accounting (short)

Part VIII: Tax Reform (short)
Federal Revenues and Spending as a Share of GDP
(Supplement to Figure 1-1 in the Book)

Sources: Historical Data from CBO, June 2017. Projection is CBO’s “current law” baseline as of June 2017.
Federal Publicly Held Debt as a Share of GDP

Sources: Historical Data from CBO, June 2017. Projection is CBO’s “current law” baseline as of June 2017.
Sources of Federal Revenues in 2017 (Supplement to Figure 1-3 in the Book)

- Individual Income Tax: 48%
- Payroll Tax: 33%
- Corporate Income Tax: 10%
- Other: 8%

Source: Congressional Budget Office, June 2017.
Sources of Federal Spending in 2017

- Social Security: 23%
- Medicare: 15%
- Medicaid: 10%
- Other Mandatory: 15%
- Non-Defense Discretionary: 15%
- Defense Discretionary: 15%
- Interest: 7%
- Non-Defense Discretionary: 15%

Source: Congressional Budget Office, June 2017.
# Income and Tax Liabilities by Pre-Tax Income Class in 2013

<table>
<thead>
<tr>
<th>Year</th>
<th>Lowest Quintile</th>
<th>Second Quintile</th>
<th>Middle Quintile</th>
<th>Fourth Quintile</th>
<th>Highest Quintile</th>
<th>All Quintiles</th>
<th>81st to 90th Percentiles</th>
<th>91st to 95th Percentiles</th>
<th>96th to 99th Percentiles</th>
<th>Top 1 Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income Taxes</strong></td>
<td>-4.0%</td>
<td>-1.2%</td>
<td>3.9%</td>
<td>13.3%</td>
<td>88.0%</td>
<td>100.0%</td>
<td>14.6%</td>
<td>12.6%</td>
<td>22.5%</td>
<td>38.3%</td>
</tr>
<tr>
<td><strong>Total Federal Taxes</strong></td>
<td>0.8%</td>
<td>3.9%</td>
<td>8.9%</td>
<td>17.1%</td>
<td>69.0%</td>
<td>100.0%</td>
<td>15.1%</td>
<td>11.5%</td>
<td>17.0%</td>
<td>25.4%</td>
</tr>
</tbody>
</table>

## Share of Tax Liabilities Paid by Each Income Class

### Share of Income Earned by Each Income Class

<table>
<thead>
<tr>
<th>Year</th>
<th>Pre-Tax Income</th>
<th>Post-Tax Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Taxes</td>
<td>5.1%</td>
<td>6.2%</td>
</tr>
<tr>
<td>Total Federal Taxes</td>
<td>9.3%</td>
<td>10.7%</td>
</tr>
</tbody>
</table>

## Average Tax Rate for Each Income Class

<table>
<thead>
<tr>
<th>Year</th>
<th>Income Taxes</th>
<th>Total Federal Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Taxes</td>
<td>-7.2%</td>
<td>3.3%</td>
</tr>
<tr>
<td>Total Federal Taxes</td>
<td>-1.2%</td>
<td>8.4%</td>
</tr>
</tbody>
</table>

### Note: Average Pre-Tax Income for Each Income Class (Households)

- Average Pre-Tax Income
  - Income Taxes: 25,400
  - Total Federal Taxes: 47,400
  - Middle Quintile: 69,700
  - Fourth Quintile: 103,700
  - Highest Quintile: 265,000
  - All Quintiles: 100,200
  - 81st to 90th Percentiles: 147,100
  - 91st to 95th Percentiles: 201,400
  - 96th to 99th Percentiles: 326,800
  - Top 1 Percent: 1,571,600

Source: Congressional Budget Office, 2016
Share of Income Earned by Top 1 Percent (Pre-Tax)

Sources: Congressional Budget Office, 2016.
### 2016 Individual Income Tax Rates, Standard Deductions, and Personal Exemptions

#### If your filing status is Single

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>But not</th>
<th>Over ---</th>
<th>over ---</th>
<th>Marginal Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$9,275</td>
<td>$9,275</td>
<td></td>
<td>10%</td>
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<tr>
<td>$9,275</td>
<td>$37,650</td>
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<td>15%</td>
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<tr>
<td>$37,650</td>
<td>$91,150</td>
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<td>25%</td>
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<tr>
<td>$91,150</td>
<td>$190,150</td>
<td></td>
<td></td>
<td>28%</td>
</tr>
<tr>
<td>$190,150</td>
<td>$413,350</td>
<td></td>
<td></td>
<td>33%</td>
</tr>
<tr>
<td>$413,350</td>
<td>$415,050</td>
<td></td>
<td></td>
<td>35%</td>
</tr>
<tr>
<td>$415,050</td>
<td>and over</td>
<td></td>
<td></td>
<td>39.6%</td>
</tr>
</tbody>
</table>

#### If your filing status is Married filing jointly

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>But not</th>
<th>Over ---</th>
<th>over ---</th>
<th>Marginal Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$18,550</td>
<td>$18,550</td>
<td></td>
<td>10%</td>
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<tr>
<td>$18,550</td>
<td>$75,300</td>
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<td>$75,300</td>
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<td>$466,950</td>
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<td>35%</td>
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<tr>
<td>$466,950</td>
<td>and over</td>
<td></td>
<td></td>
<td>39.6%</td>
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</tbody>
</table>

#### If your filing status is Head of Household

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>But not</th>
<th>Over ---</th>
<th>over ---</th>
<th>Marginal Rate</th>
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<tbody>
<tr>
<td>$0</td>
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<td>$13,250</td>
<td>$50,400</td>
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<td>33%</td>
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<td>$413,350</td>
<td>$441,000</td>
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<td>35%</td>
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<td>$441,000</td>
<td>and over</td>
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<td>39.6%</td>
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#### Standard Deduction

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<tbody>
<tr>
<td>Single</td>
<td>$6,300</td>
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<tr>
<td>jointly</td>
<td>$12,600</td>
</tr>
<tr>
<td>Household</td>
<td>$9,300</td>
</tr>
<tr>
<td>separately</td>
<td>$6,300</td>
</tr>
</tbody>
</table>

#### Personal Exemption

$4,050

#### Threshold for Refundable

$3,000

#### Child Tax Credit

Source: Tax Policy Center
Exploring Problem 1:
What Is a Perfectly Efficient Tax? (can be more than one)

A. Tax of $55,000 per person.

B. Tax of $110,000 applied on only Jim or Rachel—with a lottery to determine which one.

C. Tax of 10% applied on all of their income ($1.1 mn altogether)

D. A & B

E. All of the Above
Addendum on Economic Efficiency (Part I)

Your book defines the efficiency criterion as: “requir[ing] that a tax interfere as little as possible with people’s economic behavior.” (p. 28)

That definition of efficiency is too simplistic. Let me expand on it, give an example of inefficiency, and then give you two examples of how the expanded definition brings you to different conclusions than the book’s short one.

First, the expanded definition:

• Definition of efficiency: An efficient market is one in which no one can be made better off without making someone else worse off. Among other things, in an efficient market, the price of a good will equal its (marginal) social cost and social benefit (i.e. the cost and benefit of the good to society).

• Lump sum taxes are perfectly efficient in an efficient market: A lump sum tax is one that does not change the relative price of goods and so is not dependent on a person’s behavior (i.e. how much you consume of one good or another). A “head tax” is one example (see pp. 34-35 of your book). In an efficient market, lump sum taxes are perfectly efficient—meaning, even after imposition of the tax, it is still the case that no one can be made better off without making someone else worse off.

• How a tax can generate inefficiency: In an efficient market, if a tax changes the relative price of goods (i.e. makes apples more expensive relative to oranges) and thus changes behavior, this will produce inefficiency. This means that someone could be made better off without making another person worse off – as compared to generating that same revenue via a lump sum tax.
Addendum on Economic Efficiency (Part II)

Here’s a (simplistic and extreme) example of a tax reducing efficiency:

A government wants to raise $1,000 of revenue in order to build infrastructure. There are two goods in this society—apples and oranges (and amazingly, people are alive and happy). Before taxes, the price of an apple is $1 and the price of an orange is $1. And, society consumes 1,000 apples and 1,000 oranges before the tax is imposed.

However, the government comes up with a bad idea to raise this revenue. The misguided government believes that it’s better to tax just one product rather than two. So, it places a $1 per apple tax—believing that this should raise $1,000 for infrastructure (since society consumed 1,000 apples).

The tax has changed relative prices—making apples more expensive relative to oranges. Instead of a 1:1 ratio on prices, it’s 2:1. And, it could change behavior, depending on the price sensitivity of the population. Assume that, given this population’s preferences, this results in the population consuming no apples whatsoever and 2,000 oranges. The tax is highly inefficient. The government gets no revenue at all, even as the population is made worse off (they liked apples, even if they’re not willing to purchase them at these high prices relative to oranges).

And, this creates opportunities to make people better off without making anyone worse off. For instance:

(1) They could get rid of the tax and no one would be made worse off, even as people are made better off.
(2) People would even be willing to pay some amount in taxes to the government to get rid of this horribly inefficient tax. In doing so, they could be made better off even as others are also made better off through the purchase of infrastructure.
Addendum on Economic Efficiency (Part III)

Two examples of how the book’s analysis is too simplistic and leads to wrong conclusions:

(1) Externalities. Markets fail. In the case of an externality, private cost and benefit for market participants don’t equal social cost and benefit. So, the price of a good does not equal social cost and benefit and inefficient quantities of the good will be consumed (either too much or too little). In this case, a tax or subsidy could potentially improve efficiency by bringing prices in line with social cost/benefit and changing people’s behavior (an intervention like this is sometimes called a Pigouvian tax).

- Example: A carbon tax. The carbon tax could change people’s behavior and thus improve efficiency—since there is thought to be an over-consumption of carbon relative to the efficient outcome.

(1) Income effects. Taxes and transfers might change people’s behavior by making them either poorer or richer than they were before. Making someone poorer or richer changes their behavior. This “income effect” does not generate inefficiency relative to a lump sum tax or transfer—since a lump sum tax or transfer also makes someone poorer or richer. This does not create an opportunity to make someone better off without making anyone else worse off.

So, why is an income tax thought to generate inefficiency? Because it changes relative prices (labor v. leisure tradeoff, for example) in a (relatively) efficient market.
Exploring Problem 2:
Which of These Taxes/Fees Improves Efficiency and Which Worsens Efficiency?

A. Tolls to drive over a bridge.

B. Tax on luxury boats.

C. Cigarette taxes.
Almost All Americans Get Some Assistance in Tax Preparation

# Distribution of Compliance Burden by Income

## Table 3

<table>
<thead>
<tr>
<th>AGI Strata</th>
<th>Population (Thousands)</th>
<th>Time (Hours)</th>
<th>Average Out Pocket Costs ($)</th>
<th>Average Monetized Burden ($)</th>
<th>Burden/AGI (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entire Population</td>
<td>142,985</td>
<td>12.54</td>
<td>198</td>
<td>373</td>
<td>6.8</td>
</tr>
<tr>
<td>No adjusted gross income</td>
<td>2,577</td>
<td>26.09</td>
<td>243</td>
<td>441</td>
<td>--</td>
</tr>
<tr>
<td>1 to 5,000</td>
<td>9,961</td>
<td>7.30</td>
<td>73</td>
<td>127</td>
<td>83.3</td>
</tr>
<tr>
<td>5,000 to 10,000</td>
<td>12,278</td>
<td>8.95</td>
<td>97</td>
<td>164</td>
<td>2.2</td>
</tr>
<tr>
<td>10,000 to 15,000</td>
<td>12,812</td>
<td>10.34</td>
<td>114</td>
<td>192</td>
<td>1.5</td>
</tr>
<tr>
<td>15,000 to 20,000</td>
<td>11,742</td>
<td>11.24</td>
<td>124</td>
<td>210</td>
<td>1.2</td>
</tr>
<tr>
<td>20,000 to 25,000</td>
<td>10,173</td>
<td>11.30</td>
<td>128</td>
<td>222</td>
<td>1.0</td>
</tr>
<tr>
<td>25,000 to 30,000</td>
<td>8,961</td>
<td>11.46</td>
<td>136</td>
<td>240</td>
<td>0.9</td>
</tr>
<tr>
<td>30,000 to 40,000</td>
<td>14,620</td>
<td>11.74</td>
<td>148</td>
<td>268</td>
<td>0.8</td>
</tr>
<tr>
<td>40,000 to 50,000</td>
<td>10,991</td>
<td>12.69</td>
<td>164</td>
<td>315</td>
<td>0.7</td>
</tr>
<tr>
<td>50,000 to 75,000</td>
<td>18,769</td>
<td>13.44</td>
<td>192</td>
<td>380</td>
<td>0.6</td>
</tr>
<tr>
<td>75,000 to 100,000</td>
<td>11,828</td>
<td>14.09</td>
<td>237</td>
<td>480</td>
<td>0.6</td>
</tr>
<tr>
<td>100,000 to 200,000</td>
<td>13,945</td>
<td>14.51</td>
<td>328</td>
<td>670</td>
<td>0.5</td>
</tr>
<tr>
<td>200,000 and more</td>
<td>4,328</td>
<td>29.79</td>
<td>1,250</td>
<td>2,331</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Choice of Tax Base: Income Versus Wage Tax Versus Consumption Tax

Return to labor: Taxed under all three taxes (income tax, wage tax, and consumption tax). Thus, all three change relative price of labor versus leisure—making labor more expensive relative to leisure.

Return to saving: The normal (risk-free) return to saving is taxed under an income tax but not taxed under a wage tax or consumption tax. Thus, the income tax changes the relative price of consuming now versus consuming in the future—making future consumption more expensive relative to present consumption.

Equivalence of wage and consumption taxes: Under certain conditions, wage and consumption taxes are equivalent.

- Remember this point when we study regular IRAs versus Roth IRAs. The two are considered equivalent in terms of economic effect and logic is the same. (We will return to this.)

- Note: Some of the conditions in which they aren’t equivalent. For instance, may not be equivalent when initially imposed (in transition) as consumption taxes would apply a tax to existing wealth while wage taxes would not. Consumption taxes would apply to extraordinary, above-market returns (e.g., Bill Gates and Microsoft), while wages taxes may not. Will return to this.
The income tax has been the single largest revenue source for the Federal Government ever since World War II. Today it touches nearly every aspect of our lives. The income tax also fosters economic inefficiency, and its complexity leads to staggering compliance costs. Past efforts at partial reform of the income tax have not succeeded in reducing its complexity, removing its distortions of economic incentives, or making it more fair. Some might think that significant obstacles block the way to making great progress toward achieving these goals, but in fact such reform can be accomplished within the basic framework of the existing tax system.

In 2001 the Internal Revenue Service spent $8.9 billion on processing, enforcement, and information systems, but this direct cost of administering the income tax is just a small fraction of its total cost. It has been estimated that individual taxpayers in the aggregate spend up to 3 billion hours each year to comply with the tax system—about 27 hours per taxpayer. The present tax code, with its myriad exclusions, exemptions, adjustments, deductions, and credits has grown into a labyrinth of complexity. In tax year 2000 nearly 72 million taxpayers (56 percent of all taxpayers) used paid tax preparers to complete their tax forms. Many taxpayers purchase tax-help books and computer software. Compliance costs are also onerous for business taxpayers, especially small businesses, and the typical Fortune 500 company spends almost $4 million a year on tax matters.

The current tax system also causes households and businesses to rearrange their affairs in a number of ways that make poor use of economic resources, leading to substantial economic waste and, ultimately, reducing real incomes. The system affects a number of important economic decisions, such as how much to save and invest, how much risk to take, how much home mortgage debt to carry, how much in tax-exempt bonds to hold, when to realize capital gains, whether to hold assets that produce dividends or capital gains or interest, how much labor to supply and how much to hire, whether to organize business operations in corporate or noncorporate form, and to what extent to comply with the tax system. Perhaps one of the more salient distortions in the income tax today is that caused by the “double tax” on corporate income. As discussed extensively later in this chapter, this double taxation occurs when income distributed to shareholders as dividends or realized as capital gains is subject to individual tax after already being taxed at the corporate level. Double taxation causes too little capital to be allocated
to the corporate sector and a disproportionate share of capital to be allocated to other sectors of the economy. For a discussion of the President's recent proposal to eliminate the double tax on corporate income see Chapter 1.

These distortions and others lower saving rates and inhibit investment, capital accumulation, risk taking, and innovation, thereby lowering the growth potential of the economy, real incomes, and consumption. It has been estimated, for example, that elimination of the double tax on corporate income alone could increase economic well-being by as much as $52 billion each year forever. Tax preferences provided through the array of exclusions, exemptions, adjustments, deductions, and credits represent policy decisions to exclude some income from the tax base, but this poses a tradeoff: a higher overall tax rate is then required to raise a given amount of revenue, and this distorts household and business decisions and imposes a corresponding burden on the economy. Reduction or removal of many of these distortions, through broadening the tax base and lowering tax rates, would, by one estimate, increase accumulated capital by 10 to 15 percent and real GDP by 2 to 6 percent. The economic gains from fundamental reform of the tax system could lead to substantial increases in economic well-being for all Americans.

The major objectives of tax reform are to reduce complexity, improve economic incentives, and address fairness. The central theme that brings these objectives together is that household and business decisions should depend on the tax code as little as possible. Taxing all income, but taxing it only once, is a key ingredient of many reform plans. This would involve broadening the tax base while lowering tax rates. Some efforts have also focused on a shift from taxing income to taxing consumption or consumed income.

A possible argument against reform is the suggestion that the current tax system instead needs to be "ripped out by its roots" and completely replaced. Arguments for such wholesale reform certainly have merit. This chapter, however, illustrates ways in which the current system could be modified to improve incentives and boost real incomes.

An important goal of any tax reform proposal is to reduce complexity. In the current tax system, much of the complexity and thus much of the compliance burden result from the numerous tax preferences, differential taxation, and the taxation of capital income. Aspects of the current system often involve complicated phase-ins and phaseouts designed to target tax benefits to certain groups of individuals or businesses. Replacing these targeted tax preferences with broad exclusions or lower tax rates would reduce this complexity. Differential taxation, or the taxation of different types of income at different rates—such as the double tax on corporate income and the exclusion for many employer-provided fringe benefits—creates incentives for taxpayers to rearrange their affairs to realize income in ways that are taxed more lightly. The use of tax shelters and arrangements that allow taxpayers to defer their tax liability is, to a large extent, the result
of these kinds of differentials. Reducing differential taxation would reduce complexity, reduce the incentives for tax shelters, and improve other economic incentives. Finally, research suggests that compliance costs are substantially higher for taxpayers with significant amounts of financial and business income. Defining such income and allocating it to individual taxpayers involves substantial recordkeeping. Many reform proposals would both reduce the tax on certain types of capital income, to promote saving and investment, and simplify the taxation of such income.

Some opponents of reform argue that taxing consumption rather than income would necessarily place a relatively heavier tax burden on lower income taxpayers. Conventional distributional analysis typically considers a snapshot of taxpayers’ economic well-being at a particular point in time. Research has shown that, when a longer view is taken, differences in well-being, whether measured by income or by consumption, tend to be not as great, because of the fluidity of household incomes over time. Also, analyses of the distributional effects of moving to a tax based on consumption rather than income often do not recognize that a substantial portion of capital income, which is earned primarily by higher income taxpayers, is taxed under both income and consumption tax principles. The distributional effect of moving to a consumption tax looks considerably more progressive when the taxation of a substantial portion of capital income under a consumption tax is taken into account. Indeed, both an income tax and a consumption tax levy tax on the extraordinary (or what economists call supernormal or inframarginal) returns to capital.

This chapter revisits these issues, focusing particularly on ways in which the influence of taxes on key economic decisions could be diminished within the framework of the current tax system. First, the key objectives of reducing complexity, improving economic incentives, and achieving fairness are laid out in greater detail. The broad principles that underlie the two main approaches to taxation, that based on income and that based on consumption, are then described. These principles focus on how to raise enough revenue to fund a given level of government services in a way that has the least effect on economic decisions. Next, a framework is outlined against which the current, hybrid tax system can be compared and contrasted. Then two issues important to evaluating the distributional effects of moving to a consumption tax—the fluidity of taxpayer incomes and the taxation of capital income under a consumption tax—are discussed. This is followed by a discussion of how the current tax system taxes neither wholly income nor wholly consumption, highlighting the ways in which the current system departs from these broad principles. Finally, the chapter considers some of the major decisions and tradeoffs involved in proposed changes to the tax system. Modest structural changes are outlined that would move the current tax system toward either an income- or a consumption-based system, improve economic incentives, and reduce complexity.
Objectives of Tax Reform

At the outset, some overriding and fundamental objectives for tax reform can be identified: simplicity, fairness, and the promotion of long-term economic growth through improvements in incentives. These objectives are very much interrelated. Complexity, for example, can undermine one view of fairness if, despite the progressive tax rate schedule and targeted tax preferences, taxpayers perceive that higher income taxpayers pay less tax than they should, through tax avoidance and tax sheltering. Similarly, complexity from the phase-in and phaseout of targeted tax preferences can distort economic decisions, and thus impede long-term growth, by imposing a high effective tax rate on certain taxpayer decisions. But sometimes these objectives come in conflict. For example, addressing fairness through targeted tax preferences may distort economic decisions and undermine long-term growth through differential taxation and a higher overall tax rate.

Simplicity: Freeing up Resources for Productive Use

The current tax system is often viewed as difficult to understand, and the resulting billions of hours and billions of dollars devoted to tax administration and compliance are a drag on the economy. As mentioned above, taxpayers spend as much as 3 billion hours a year on Federal tax matters, and compliance costs associated with the Federal income tax equal about 10 percent of revenue, or about $135 billion in 2001. The numerous tax preferences and the interactions among them, together with differential taxation, give rise to much of the complexity in the current tax system. The taxation of capital income and the complex rules governing depreciation also result in considerable complexity for both households and businesses. The rules used to define business receipts and deductions require recordkeeping and complex calculations, sometimes over many years. Self-employed taxpayers spend an average of 60 hours a year on such tax matters. Studies consistently find that compliance costs are most onerous for smaller businesses. Taxpayers with capital income, such as capital gains, dividends, interest, and rental income, also tend to have high compliance costs.

Compliance costs can be high even for individuals who receive most of their income as wages. The number of tax preferences has risen, often involving multiple definitions, and preferences often give rise to complicated interactions between provisions. For example, the tax code currently defines a “child” in at least five different ways: one way for purposes of qualifying for the child tax credit, another to qualify for the child and dependent care tax credit, another to determine head of household filing status, another for the Earned Income Tax Credit (EITC), and another for the exemption for dependents. Taxpayers with children may need to understand which
definition applies to some or all of these provisions when filling out their tax returns. Multiple definitions also encumber the provisions of the tax code relating to education expenses (such as the Lifetime Learning credit, the Hope credit, the education deduction, Coverdell Savings Accounts, and college savings and prepaid tuition plans), household maintenance tests, and earnings tests. An increasing number of taxpayers are also required to comply with two parallel tax systems: the regular tax and the alternative minimum tax (Box 5-1).

A major source of complexity in the current income tax is its attempt to target tax benefits to meet a variety of social goals. Integration of social goals into the tax system takes the form of altering the definition of ability to pay across a wide set of taxpayer characteristics. In this respect, defining a child five or more different ways is important if it is desirable to vary tax preferences along these dimensions. However, it comes with considerable compliance and economic costs. What is often not appreciated is the extent to which the targeting of these tax preferences subjects taxpayers with the same income to different effective tax rates (Box 5-2). Elimination and consolidation of tax preferences would help simplify the tax system and improve economic incentives.

Fairness: Relating Taxes to Ability to Pay and to Economic Well-Being

The income tax system should relate a taxpayer's tax liability to his or her ability to pay and to his or her economic well-being. This is the rationale behind the current progressive rate structure, whereby tax rates rise with annual income, as well as behind many of the existing tax preferences. However, the link to ability to pay begins to weaken when taxpayers with the same level of income pay different amounts of tax, because of differences in eligibility for some tax preferences, or have different opportunities to avoid paying taxes. Taxpayers fortunate enough to receive good tax advice might, for example, learn of opportunities to shelter income from tax legally; this can erode confidence in the tax system. Faith in the fairness of the tax system can also be undermined when compliant taxpayers see others evading substantial amounts of tax.

How ability to pay is measured is also crucial to perceptions of fairness. The current income tax system uses annual income as a yardstick for ability to pay. Some have argued, however, that what a taxpayer actually consumes better reflects his or her economic well-being than how much income that taxpayer earns. Consumption patterns are determined by incomes over a time horizon that extends well beyond 1 year. A household's past income and, in particular, its expectations about future income are critical in determining how much the household spends in any given year. Researchers have
generally concluded that incomes over longer time horizons are a better indicator of differences in economic well-being than income in any one year. Annual incomes can vary from lifetime incomes for many reasons. One is that income tends to vary in a predictable way over a person's working life. Most individuals' earnings are relatively low when they enter the workforce and then rise as they gain job experience. Earnings typically peak after midlife and fall after one enters retirement. Early in their lives, taxpayers might dissave (that is, dip into their savings or, more likely, borrow) to finance college and job training expenses, and then save during their middle years so as to accumulate wealth on which to support themselves in retirement. How much a taxpayer consumes in a given year depends both on that taxpayer's earnings and on how much he or she decides to save. Aggressive savers can support a higher level of consumption in retirement. Incomes can also vary in response to a variety of other events, such as transitions between jobs, unemployment, marriage and divorce, illness, and volatility in business income and income from the sale of assets.

Two conclusions can be drawn from this distinction between lifetime and annual incomes. First, annual consumption rather than annual income might be a better proxy for economic well-being, because consumption is more closely related to income over a longer time horizon than to income in a given year. Second, the use of annual income in analyzing the distributional effects of the current tax system and proposed changes overstates the extent of inequality among taxpayers. Some of the measured inequality will actually reflect comparisons between taxpayers of different ages—for example, comparing a working professional with a retiree who left the work force long ago. Other measured inequality will reflect temporary shocks to income due to changes in employment status, living arrangements, and the uneven manner in which some people earn their income. Distributional analyses that take these factors into account may provide a better measure of ability to pay and of economic well-being.

**Long-Term Growth: Boosting Economic Performance by Improving Incentives**

A central aspect of tax reform is whether it can improve the economy's overall performance, leading to a rise in real incomes. Reducing the tax system's deleterious impact on incentives to work, save, invest, and innovate would help increase growth and boost real incomes in the long term. The tax system affects these incentives in a number of ways. Differentials in the rate of tax imposed on economic decisions cause households and businesses to shift attention and effort to less taxed activities. These distortions in household and business decisions can result in a misallocation of resources in the economy and reduce real incomes below what could be achieved otherwise.
Box 5-2. What Tax Rate Do Taxpayers Really Face?

Many taxpayers look to their statutory tax rates—their “tax bracket”—to gauge how large a bite the Federal Government takes from their paycheck. Some might be surprised to learn that their effective marginal tax rate—what they actually pay on their last dollar of income—can differ substantially from their statutory tax rate. Moreover, even though statutory tax rates are relatively low at low levels of income, reflecting the progressivity of the current tax rate schedule, the effective marginal tax rates that low-income taxpayers face can in some situations be unexpectedly high.

Chart 5-2 shows the effective marginal tax rate for a hypothetical family of four at various income levels. What is striking about this chart is that effective rates do not consistently rise with income. Rather, there are numerous spikes and steps that reflect the phase-ins and phaseouts of various deductions, credits, and other provisions. Taxpayers may receive a tax benefit from the child tax credit, for example, but find that the tax on their last dollar of income is pushed up as this credit phases out.

The distribution of effective marginal tax rates for taxpayers at given income levels is shown in Chart 5-3, which documents the extent to which effective marginal tax rates vary at given levels of income. The chart shows marginal tax rates for the 10th, 50th, and 90th percentiles, where taxpayers are ranked at each level of income by their marginal tax rate. At any given income level, 50 percent of taxpayers will have marginal tax rates above the line indicated for the median taxpayer, and 10 percent of taxpayers will have marginal tax rates exceeding the line for the 90th percentile. For example, 10 percent of taxpayers with $50,000 in income have marginal tax rates that are below 15 percent (the tax rate at the 10th percentile); 50 percent have marginal tax rates below, and half above, 15.3 percent; and 10 percent have marginal tax rates above 27.8 percent.

As the chart shows, marginal tax rates diverge considerably even among taxpayers at the same income level, especially at lower incomes. The divergence arises because of the various deductions and credits that phase in and then out at various rates, depending on a host of taxpayer characteristics and choices. Indeed, these phase-ins and phaseouts would cause considerable variation in effective marginal rates even under a flat statutory tax rate schedule.
Chart 5-2 Marginal Federal Income Tax Rates for Hypothetical Couple in 2003
The effective marginal tax rate schedule for a hypothetical couple is characterized by numerous steps reflecting targeted provisions under the current tax system.

Note: Calculations are for joint-filer, one-earner family with two children under 14. Itemized deductions are assumed to be 18 percent of income.
Source: Council of Economic Advisers.

Chart 5-3 Distribution of Marginal Federal Income Tax Rates for Joint Filers in 2003
Taxpayers at the same income level often face different marginal tax rates, particularly at lower incomes.

Source: Department of the Treasury.
As described above, reduction of these distortions can have a substantial effect on capital accumulation (and thus wealth), increase long-term growth, and boost real incomes.

Analysis of Alternative Reforms

The two main approaches typically advocated by economists to revamping the current income tax involve moving the current tax base to one that is closer to comprehensive income, or replacing the current income tax with a tax that falls only on consumption. Comprehensive income, which some advocate as the best measure of an individual's overall well-being and ability to pay, is defined as current consumption plus increases to wealth. Taxation based on comprehensive income would include in the tax base all labor income, income from the ownership of capital (such as dividends, interest, rents, and accrued capital gains), and gifts and bequests received. Deductions reflecting the cost of earning income, such as job-related training expenses, would be allowed because they reflect neither purchases for consumption nor any accretion to wealth. One feature of a comprehensive income tax is that it treats individuals with the same accrued purchasing power equally, regardless of the source, thus adhering to the principle of horizontal equity. An individual receiving income primarily from labor, for example, would be treated no differently than a person with the same level of income from capital or a bequest.

This framework, however, has some practical problems related to the taxation of capital gains, inflation, income volatility, and imputed income. Although capital gains reflect additions to wealth, measuring these gains as they accrue is at best problematic: it requires frequent valuation of assets, and accurate market values for some assets cannot easily be established. Another problem is that inflation causes asset appreciation unrelated to changes in purchasing power; a proper accounting would require that the inflationary component of capital gains be removed from the tax base. Dividends and net interest income should likewise be included in taxable income only to the extent they exceed inflationary returns. Yet another problem is that the volatility of taxable income combined with a progressive tax rate schedule could cause two taxpayers who have the same taxable income when cumulated over several years to pay different amounts of tax, thereby violating the principle that taxpayers with equal ability to pay be treated equally.

One of the most vexing problems associated with a comprehensive income tax is the need to include imputed income in the tax base. Imputed income arises from consumption or accretions in wealth that occur outside of normal market mechanisms and therefore are difficult to value. The value
Broadening the Tax Base and Lowering Tax Rates

Broadening the tax base usually means eliminating the various tax preferences under the current tax system. These preferences represent a policy decision to reduce the effective tax rate for some, but they pose a tradeoff in that a higher overall tax rate is needed under both the income and the consumption tax models to raise an equivalent amount of revenue. Eliminating preferences would improve incentives in two ways. First, as illustrated above, many of the preferences carry with them high implicit tax rates as the benefits are phased out. Eliminating these preferences repeals these high implicit rates and the associated kinks in the effective tax rate schedule. Second, once the preferences are eliminated, the same amount of revenue can be raised with lower overall tax rates. Chart 5-4 earlier in the chapter showed that the current tax base is considerably smaller than either the income or the consumption tax base.

Chart 5-4 also indicated that the existing tax preferences are just as important, if not more important, in determining the size of the tax base when saving is included as when it is excluded (that is, the difference between the comprehensive income and comprehensive consumption tax bases). The broader tax base under either reform would allow tax rates to be lowered. Lower rates improve economic incentives, spurring private activity by making more productive use of resources.

There are many avenues by which marginal tax rates can affect individual and business decisions. Individuals can shift compensation toward less taxed sources; they can adjust labor supply, saving, investment, and portfolio allocation decisions; and they can alter their compliance behavior. The economic benefits of lower tax rates were precisely the rationale behind the reduction in tax rates enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001. Some estimates suggest that the reduction in the top statutory tax rate from 39.6 percent to 35 percent will raise the affected taxpayers' taxable incomes by as much as 3 percent when fully effective in 2006. This rise in taxable incomes reflects individuals' decisions to work, save, and invest more, to increase tax compliance, to reduce evasion, and otherwise to shift efforts to activities that become more lightly taxed as a result of the lower tax rates. The extent to which taxes distort these decisions is, to some extent, diminished by lower tax rates. Moreover, the rise in taxable incomes means that individuals' behavioral response to the lower tax rates works to offset the direct cost of rate reduction to the government.

Some estimates indicate that repeal of the double tax on corporate income, combined with the uniform treatment of investment and general base broadening, would increase capital accumulation by over 10 percent and output by
perhaps as much as 4 percent in the long run. A shift to a consumption tax would go even further by excluding income from saving from the tax base. Most estimates suggest that a shift to a consumption tax base would generally increase the size of the capital stock in the long run, with some estimates suggesting an increase of as much as 20 percent. Although estimates of the impact on output vary, some models indicate that real output might rise in the long run by as much as 6 percent.

Income Versus Consumption as the Base

The major difference between the consumption and income models is that a consumption tax does not distort the choice between current and future consumption (that is, saving); in other words, it is intertemporally efficient. In contrast, an income tax distorts the relative prices of current and future consumption by reducing the after-tax return to saving. Under an income tax, current consumption is tax-favored, and saving disfavored, relative to future consumption. Taxing consumption rather than income would eliminate this distortion. Because the tax base under the comprehensive consumption tax model is smaller than under the comprehensive income tax model, however (Chart 5-4), a higher tax rate would be required to raise a given amount of revenue, which may involve some degree of additional distortion. Nevertheless, as discussed above, studies indicate that elimination of the tax on income from saving can have important salutary effects on economic growth and real incomes by encouraging saving.

International Tax Considerations

The U.S. economy is increasingly linked to the world economy through trade and investment. Domestically based multinational businesses and their foreign investment help bring the benefits of global markets back to the United States by providing jobs and income. Like all firms, multinationals face a number of business decisions, including how much to invest and where. Because multinationals by definition operate in a number of countries, they also have to decide in which country to locate their headquarters, and their decisions in turn affect which countries reap the majority of benefits from the multinationals’ operations.

In the context of tax reform, it is important to consider how changes in the international taxation of income would change the incentives for companies to locate production, intangible assets, and research and development in one country rather than another. Reform can have important effects on these business decisions and on the efficient use of the Nation’s economic resources, affecting employment and the competitiveness of workers in the United States.
ECONOMIC REPORT
OF THE
PRESIDENT

TRANSMITTED TO THE CONGRESS
MARCH 2013

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Another recent development in government finance is that the fiscal outlook for State and local governments has improved, although expenditures remain below pre-recession levels and State and local investment spending remains notably low. As shown in Figure 3-2, the continued decline in State and local investment is atypical. In other recoveries, State and local governments’ gross real investment was typically flat for several quarters following a business-cycle trough and then increased, but, in this recovery, gross investment has failed to rebound.

This chapter highlights the declining Federal budget deficit since 2009 and the additional work needed to achieve medium- and long-term fiscal health. It then outlines the principles for Federal income tax reform set forth by President Obama in September 2011 and describes specific plans proposed by the Administration to meet these goals. The enactment of ATRA is a step toward achieving these goals, but substantial work remains to make the tax code more equitable and efficient. The chapter also reviews the State and local budget outlook and the Federal Government’s role in mitigating the recent recession’s effect on government finances at these levels. Finally, the chapter discusses the long-term financial challenge facing State and local governments from the underfunding of pension plans.
reduction would amount to more than $4 trillion over ten years, a goal set by the President to stabilize the debt-to-GDP ratio and to put the country on a sustainable fiscal path over the next decade.

**Federal Income Tax Reform**

A fair, simple, and efficient tax code lays the foundation for job creation, economic growth, and an equitable society. Recognizing the crucial role tax reform can play in deficit reduction and economic growth, President Obama set forth a list of principles in September 2011 for comprehensive tax reform. These principles include lowering tax rates, cutting inefficient and unfair tax breaks, observing the “Buffett Rule” to enhance tax fairness, reducing the deficit, and increasing job creation and growth in the United States (OMB 2011).

Because revenue must be raised to finance essential services provided by the government, sound tax policy attempts to raise revenue fairly and efficiently. A number of notions of fairness can help guide tax policy: “horizontal equity” demands equal treatment of equals; the ability-to-pay principle prescribes that a taxpayer’s burden should be related to her ability to pay; the benefit principle suggests that a taxpayer’s burden should be related to the benefits she receives from government services. Such notions of fairness are often incomplete, and sometimes they are in conflict with each other. Still, these principles can serve as useful guides.

Fairness, however, must be balanced with efficiency. High tax rates, combined with a complex tax system and a narrow tax base (that is, with many deductions, exclusions, or exemptions), provide incentives for taxpayers to shift income between the individual and corporate tax bases, retime income, and alter behavior in other ways to reduce tax liability (Saez, Slemrod, and Giertz 2012). In addition, although tax subsidies could encourage socially beneficial activity or correct market failures, when there are no externalities or other market failures, tax provisions that favor one activity over another can lead to an inefficient allocation of resources.

A key feature of the tax code is the schedule of statutory tax rates on marginal income. To achieve myriad tax, economic, and social policy goals, the tax code also contains a dizzying web of deductions, exemptions, exclusions, credits, and special treatment of certain income. The fact that taxpayers modify their behavior to reap the benefits of special tax provisions is bittersweet. On one hand, it means that well-thought-out tax provisions that are designed to encourage a particular activity are working. On the other hand, a taxpayer determined to avoid liability can engage in tax avoidance
and thereby expend socially unproductive resources navigating the jungle of tax provisions.¹

**Tax Expenditures**

The tax code contains numerous special tax provisions, referred to as “tax expenditures,” which lead the tax system to deviate from taxing economic income (Box 3-1). Economic income generally follows the Haig-Simons definition of comprehensive income as consumption plus changes in net worth. Relative to a tax structure built on a comprehensive income measure, tax expenditures erode the tax base, causing the government to forgo revenue, but they provide important tax benefits to individuals and families. How such benefits are distributed over the income distribution varies widely across tax provisions. To assess the distributional effects of a given tax expenditure, the Treasury Department estimated the tax benefits of each major individual income tax expenditure under 2013 income tax law for taxpayers in different income classes.

As illustrated in Figure 3-6, the Earned Income Tax Credit (EITC) and the Child Tax Credit (including the refundable portion) provide substantial benefits to taxpayers in the lowest income quintile but have little impact on the after-tax income of taxpayers in the top three income quintiles. By contrast, the bottom two income quintiles receive almost no benefits from tax expenditures like the charitable giving deduction and deductions for State and local taxes. Almost all of those tax benefits accrue to taxpayers in the top two income quintiles. Middle and upper-middle income taxpayers benefit the most from the exclusion of employer-provided health insurance, whereas taxpayers in the bottom quintile and those in the top percentile of the income distribution receive relatively little benefit from the exclusion.

Because the tax value of deductions and exclusions increases with taxpayers’ marginal tax rates, these tax expenditures provide larger benefits to high-income taxpayers than to low- and middle-income taxpayers for a given amount of deductions or exclusions. (For various measures of tax rates, see Economics Application Box 3-1.) In particular, an additional dollar of deductions or exclusions reduces taxable income by $1 and consequently reduces the liability of taxpayers in the 39.6-percent bracket and 25-percent bracket, respectively, by 39.6 cents and 25 cents. In an effort to improve tax fairness, improve efficiency, and reduce the deficit, the President has proposed to reduce the tax value of selected tax expenditures to 28 percent for high-income taxpayers, a level comparable to the tax value provided by the tax code for middle-income taxpayers.

¹ Behavior that reduces tax remittances without altering real investment, savings, or labor decisions is called tax avoidance when it is legal and tax evasion when it is illegal.
Box 3-1: Estimates of Tax Expenditures in the President’s Budget

Tax expenditures, commonly viewed as government spending through the tax code, are defined in the Congressional Budget Act of 1974 as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”

Each year the Treasury Department estimates the value of tax expenditures in terms of the Federal income tax loss and reports the estimates in the annual Budget of the United States Government.1 Table 17-1 of the President’s fiscal year 2013 Budget lists 173 corporate and individual income tax expenditures in the tax code. Tax expenditures take many different forms:

- Exclusions and exemptions allow specific types or sources of income—such as compensation received as medical insurance or interest from municipal bonds—to be excluded or exempt from income for tax purposes.
- Deductions permit taxpayers to deduct certain types of expenses from income to calculate the taxable base. Examples include itemized deductions (which include deductions for home mortgage interest, charitable giving, State and local taxes, and medical expenses) and “above-the-line” deductions (which include deductions for student loan interest, self-employed retirement and health insurance contributions, and educators’ out-of-pocket expenses).
- Tax credits reduce tax liability by the amount of the credit. When the amount of a tax credit exceeds tax liability before the credit is applied, the credit will erase the tax liability, and, if the credit is refundable, the government will pay the filer the excess amount. In the Federal Budget, the portion of a refundable credit that reduces tax liability is treated as a revenue loss, and the portion that exceeds tax liability is treated as an outlay.
- Special rates apply a lower tax rate to specific sources of income than the rate applied to ordinary income. For example, long-term capital gains and qualified dividends are taxed at lower rates than ordinary income.
- Deferrals permit taxpayers to delay including certain income in the taxable base. Such tax expenditures include accelerated depreciation

1 The Joint Committee on Taxation also annually publishes a list of tax expenditures. Tax expenditure estimates do not equal the amount of revenue that would be generated if the expenditure were eliminated for two reasons: first, eliminating a tax expenditure would result in behavioral effects that could offset the revenue gain; second, removing multiple tax expenditures simultaneously creates interaction effects that depend on the particular expenditures.
or immediate expensing of business investment as well as tax incentives for retirement saving.

Table 17-3 of the FY 2013 Budget ranks tax expenditures by projected revenue effect. The 10 largest tax expenditures by the projected revenue effect for 2013–2017 are: ²

- Exclusion of employer contributions for medical insurance premiums and medical care ($1,012 billion)
- Deductibility of mortgage interest on owner-occupied homes ($606 billion)
- 401(k)-type plans ($429 billion)
- Accelerated depreciation of machinery and equipment ($375 billion)
- Exclusion of net imputed rental income on owner-occupied housing ($337 billion)
- Special rates for capital gains ($321 billion)
- Defined benefit pension plans ($298 billion)
- Deductibility of State and local taxes other than on owner-occupied homes ($295 billion)
- Deductibility of charitable contributions, other than education and health ($239 billion)
- Exclusion of interest on public purpose State and local bonds ($228 billion).

² The estimates do not include effects on Federal outlays. Refundable tax credits, such as the Earned Income Tax Credit and the Child Tax Credit, can carry significant outlay effects.

The preferential rate on capital gains and dividends gives rise to tax benefits because these sources of income are taxed at a lower rate than ordinary income.² Of the selected tax expenditures in Figure 3-6, the benefits of the preferential tax rate on capital gains and dividends are most skewed to the upper end of the income distribution. The underlying tax data for Figure 3-6 suggest that taxpayers in the top 0.1 percent of the income distribution receive 41 percent of the total positive capital gains realizations and qualified dividends. Because of this unequal distribution of capital gains realizations and qualified dividends, the preferential rate provides substantially more benefit to the top 0.1 percent of taxpayers than to taxpayers in any other income class.

² One argument for the preferential rate is that corporations already pay income taxes so individual income taxes on capital gains and dividends result in double taxation. However, evidence shows that not all of the long-term capital gains are attributable to corporate stocks or mutual funds, and therefore some capital gains are never taxed at the corporate level (Wilson and Liddell 2010; Burman 2012).
Vertical Equity

Vertical equity holds that individuals who have a greater ability to pay should contribute more in taxes than those who are less able to pay (for a discussion of tax fairness, see Economics Application Box 3-1). The President has called one specific formulation of this idea, the Buffett Rule, a basic principle of tax fairness. The Buffett Rule states that no household making over $1 million should pay a smaller share of income in taxes than middle-class families pay. Several studies have shown that the current tax system violates the Buffett Rule; many high-income families pay a smaller share of income in Federal taxes than do middle-income families (Hungerford 2011; CEA 2012; Cronin, DeFilippes, and Lin 2012). Thus, implementing the Buffett Rule, or adopting the rule as a guiding principle for tax reform, would improve tax fairness.

While the current Federal tax system is progressive, its progressivity has significantly declined since the 1960s. Figure 3-1 above shows that average tax rates for middle-income taxpayers rose slightly in the 1960s and the 1970s and then remained relatively stable since the 1980s. By contrast, Federal tax burdens for the wealthiest taxpayers have dropped dramatically since 1960 as a result of changes in tax laws. The share of income the top 0.1 percent paid in Federal individual income and employment taxes fell to 24.1 percent in 2012, about half of what this group paid in 1960.
Figure 3-7 depicts the trends in effective marginal tax rates on wage income. As shown, effective marginal tax rates faced by middle-income taxpayers have been relatively constant during the past five decades, in contrast with the dramatic decline in the effective marginal tax rates faced by the top 1 percent or 0.1 percent of taxpayers. In other words, taxpayers at the top of the income distribution have always faced higher marginal tax rates on wage income than middle-income taxpayers, but the spread between their marginal tax rates has narrowed significantly since 1960. Before ATRA was
enacted, the top effective marginal rate on wage income was close to its lowest level in the past five decades; there was only a short period in the late 1980s and early 1990s when the top effective marginal tax rate was lower than the rate in 2012.

As noted, the preferential rate on long-term capital gains is particularly regressive, and evidence suggests that capital gains realizations have become more concentrated over time. The portion of total capital gains realized by the 0.1 percent of taxpayers who reported the most capital gains income increased from 25 percent in 1987 to over 40 percent in 2010 (Lurie and Pearce 2012). Relative to the increased income concentration, the top effective marginal tax rate on long-term capital gains declined during the period (Figure 3-8). The rate ranged between 20 percent and 30 percent from the 1980s to the early 2000s, fell to 16 percent in 2003, and fell further to 15 percent in 2010 because of the scheduled elimination of the phase-out of itemized deductions under the 2001 tax cut. The rate rose to 25 percent in 2013.

In addition to individual income and employment taxes, the Federal Government collects corporate income taxes and estate taxes. Piketty and Saez (2007) examined the combined effect on vertical equity of Federal individual, employment, corporate, and estate taxes from 1960 to 2004. They argued that corporate and estate taxes substantially contributed to a
The wealthiest taxpayers own a disproportionately large share of the nation’s capital income and wealth, they bear the largest burden of the corporate income and estate taxes. The Federal Government, however, has shifted away from relying on these two Federal taxes as revenue sources, leaving taxpayers at the top of the income distribution with a much lower tax burden in 2004 than in 1960. As shown in Figure 3-9, corporate tax revenues as a percent of total Federal receipts declined from 23.2 percent in 1960 to 10.1 percent in 2004. The share for estate and gift taxes declined modestly from 1.7 percent in 1960 to 1.3 percent in 2004 (OMB 2012b).

**Efficiency and Simplification**

From the current point of a complex tax code with many special provisions, simultaneously eliminating special provisions and lowering tax rates could make the tax code both simpler and more efficient. Cutting unfair and

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3 Piketty and Saez (2007) assume the burden of the corporate income tax falls on owners of capital income. Several tax policy groups, including the Treasury Department’s Office of Tax Analysis, the Congressional Budget Office, and the Tax Policy Center, assume in their current tax models that the majority of the corporate tax burden—about 80 percent—is borne by capital income, whereas the remainder is borne by labor. Cronin et al. (2013) provide details of the different corporate tax incidence assumptions.
inefficient tax breaks and simplifying the tax system with lower tax rates are among the principles the President set forth for tax reform. High tax rates, coupled with a narrow tax base, cause taxpayers to adopt economically inefficient behavior. When examining the efficiency gains from tax reform, it is important to identify the behavioral margins that are in response to changes in tax policy and the resulting economic effects. In theory, lowering tax rates can lead to an increase in labor supply (or a decrease in labor supply if the income effect dominates the substitution effect), but evidence suggests that, when tax rates change, labor supply effects are small compared with tax avoidance effects (Saez, Slemrod, and Giertz 2012). One such effect occurs when investors delay realizing capital gains and hold onto assets only to avoid capital gains tax. Despite this inefficient “lock-in” effect, negative associations between top individual income tax rates on capital gains and private saving, investment, or changes in real GDP are not supported by U.S. experience (Hungerford 2012; Burman 2012).

When taxpayers make decisions in response to special provisions in the tax code, they engage in more of the tax-preferred activity than they would otherwise, thereby steering resources away from other more productive uses. One major unfair and inefficient tax break is the tax treatment of partners’ profits interests, also known as carried interests, in an investment partnership. Carried interests, despite being derived from performance of labor services, receive capital gains treatment. This preferential tax treatment provided for income derived from performing a specific activity induces a behavioral distortion and is economically inefficient. To improve fairness and efficiency of the tax code, the Administration has proposed to tax carried interests as ordinary income and subject that income to self-employment taxes.

In addition, the Administration has proposed to improve the tax code’s efficiency by closing business loopholes and broadening the business tax base. For example, corporations currently use life insurance as a form of tax shelter because of its favorable tax treatment. Investment returns on life insurance products are allowed to accumulate tax free until policies are cashed in. As a result, businesses can take interest deductions for investment-oriented life insurance policies that cover their officers and employees before any gain is realized—and taxed—on the policies. The Administration’s recent Budget would close this loophole and encourage businesses to make more efficient investment decisions by limiting the interest deductions allocable to investment in certain life insurance policies.

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4 If the tax-preferred activity is underconsumed or underproduced because of market failures or externalities, then a favorable treatment could increase quantity and result in more efficient allocations of resources.
The President has also proposed making the Federal subsidy for State and local governments’ borrowing costs more efficient by extending Build America Bonds (BABs), in which the Federal Government makes direct payments to State and local governments. Traditional tax-exempt bonds provide a Federal subsidy through a Federal tax exemption to investors for interest income received from the bonds. One study finds that as much as 20 percent of the tax revenue the Federal Government forgoes from tax-exempt bonds accrues to investors, leaving only 80 percent of the subsidy to benefit State and local governments (CBO/JCT 2009).

Complexity is another source of inefficiency in the tax code because it increases the amount of time and money taxpayers spend to comply with the law and creates opportunities for them to engage in the unproductive activity of tax avoidance. It is estimated that complying with the Federal income tax cost businesses at least $100 billion for tax year 2009 (Contos et al., forthcoming) and individuals over $50 billion for tax year 2010, with the total costs amounting to approximately 1 percent of GDP. Estimating the time and monetary costs incurred by taxpayers for preparing individual income tax returns, an analysis by the Internal Revenue Service (IRS) shows

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Note: Other includes excise taxes, estate taxes, customs duties, and other receipts. Source: OMB (2012b).

The IRS estimates of the business and individual income tax compliance costs include out-of-pocket costs and the monetized burden associated with the time spent on preparing the returns.
sources of individual income tax compliance costs by reporting activity (Figure 3-10). More than half—55 percent—of compliance costs arise from keeping track of and reporting income, and the remaining compliance costs arise mostly from calculations for tax deductions and credits. Thus, tax simplification—such as having fewer deductions and credits or streamlining income reporting—has the potential to reduce compliance burdens. Tax simplification could also enhance taxpayer compliance by reducing the opportunities for tax evasion and decreasing inadvertent taxpayer errors in calculating tax liabilities (Kopczuk 2006).

Reforming the International Corporate Tax

The international provisions of the corporate tax code create opportunities for U.S. companies to reduce their taxes by locating their operations and profits abroad. The tax system is subject to gaming, as corporations manipulate complex tax rules to minimize taxes and, in some cases, shift profit that is attributable to activity performed in the United States or elsewhere to low-tax jurisdictions.

The current U.S. tax system subjects foreign subsidiaries of U.S.-based multinationals to taxes on their overseas income while allowing a tax credit for foreign taxes paid. However, corporations often do not need to pay taxes to the Federal Government on that income until they repatriate it to the United States, a rule called deferral (because it defers taxation of the income). Many companies reinvest, rather than repatriate, a significant portion of their income overseas and, as a result, may never face U.S. taxes on much of that income. The U.S. tax system is often described as “worldwide” because it taxes U.S. companies on profits earned abroad. For many companies, however, opportunities for deferral can make it effectively much closer to a territorial system—a system in which taxes are never paid on foreign income. By contrast, although most other developed countries have taken a territorial approach, some countries, including Japan and the United Kingdom, have implemented tax “triggers” that effectively apply worldwide taxation if a multinational is operating in a low-tax country.

U.S. multinational corporations have a significant opportunity to reduce overall taxes paid by shifting profits to low-tax jurisdictions—either by moving their operations and jobs there or by relying on accounting tools and transfer pricing principles to shift profits. Studies show that U.S. multinational corporations have a significant opportunity to reduce overall taxes paid by shifting profits to low-tax jurisdictions—either by moving their operations and jobs there or by relying on accounting tools and transfer pricing principles to shift profits. Studies show that U.S.

6 Under current law, the IRS is authorized access to Federal tax information for tax administration purposes. Certain Federal agencies have limited access to tax data for governmental statistical use. See Data Watch 3-1.

7 For example, studies have shown that complexity may have affected EITC compliance and kept eligible taxpayers from claiming the tax credit (Holtzblatt and McCubbin 2004; Kopczuk and Pop-Eleches 2007).
multinationals’ decisions about the choice of where to invest are sensitive to effective tax rates in foreign jurisdictions (OECD 2008). Evidence also suggests that U.S. firms’ reported profits in a foreign country increase when the country’s tax rate declines relative to the U.S. rate, after taking into account other factors that would have influenced the level of income earned by U.S. firms in that foreign country (Clausing 2009; Grubert 2012).

The incentive to shift profits to low-tax jurisdictions can lead to inefficient overinvestment abroad and underinvestment in the United States. It can also erode the U.S. tax base, requiring higher tax rates on income that remains taxable in the United States to collect the same amount of revenue. Finally, the international tax system is very complex, which not only burdens companies with complicated accounting and tax requirements but also benefits companies that avoid paying taxes by manipulating intricate rules.

Business tax reform should be a foundation to maximize investment, growth, and jobs in the United States. It should properly balance the need to reduce tax incentives for U.S. companies to locate overseas with the need for them to be able to compete overseas; some overseas investments and operations are necessary to serve and expand into foreign markets in ways that benefit U.S. jobs and economic growth. The President has proposed to protect the U.S. tax base, strengthen the international corporate tax system, and encourage domestic investment by establishing a new minimum tax on

**Figure 3-10**

Individual Income Tax Compliance Costs by Reporting Activity, 2010

- **Other tax-related reporting**
  - Deductions: 25%
  - Credits: 14%
  - AMT: 4%
  - Other taxes: 2%

- **Income reporting**
  - Wages: 18%
  - Self-employment income: 19%
  - Other income: 18%

Note: Tax year 2010. The cost of reporting the self-employment tax deduction is included in Other taxes.
For Immediate Release
July 27, 2017

Joint Statement on Tax Reform

Today, House Speaker Paul Ryan (R-WI), Senate Majority Leader Mitch McConnell (R-KY), Treasury Secretary Steven Mnuchin, National Economic Council Director Gary Cohn, Senate Finance Committee Chairman Orrin Hatch (R-UT), and House Ways and Means Committee Chairman Kevin Brady (R-TX) issued the following joint statement on tax reform:

“For the first time in many years, the American people have elected a President and Congress that are fully committed to ensuring that ordinary Americans keep more of their hard-earned money and that our tax policies encourage employers to invest, hire, and grow. And under the leadership of President Trump, the White House and Treasury have met with over 200 members of the House and Senate and hundreds of grassroots and business groups to talk and listen to ideas about tax reform.

“We are all united in the belief that the single most important action we can take to grow our economy and help the middle class get ahead is to fix our broken tax code for families, small
business, and American job creators competing at home and around the globe. Our shared commitment to fixing America’s broken tax code represents a once-in-a-generation opportunity, and so for three months we have been meeting regularly to develop a shared template for tax reform.

“Over many years, the members of the House Ways and Means Committee and the Senate Finance Committee have examined various options for tax reform. During our meetings, the Chairmen of those committees have brought to the table the views and priorities of their committee members. Building on this work, as well as on the efforts of the Administration and input from other stakeholders, we are confident that a shared vision for tax reform exists, and are prepared for the two committees to take the lead and begin producing legislation for the President to sign.

“Above all, the mission of the committees is to protect American jobs and make taxes simpler, fairer, and lower for hard-working American families. We have always been in agreement that tax relief for American families should be at the heart of our plan. We also believe there should be a lower tax rate for small businesses so they can compete with larger ones, and lower rates for all American businesses so they can compete with foreign ones. The goal is a plan that reduces tax rates as much as possible, allows unprecedented capital expensing, places a priority on permanence, and creates a system that encourages American companies to bring back jobs and profits trapped overseas. And we are now confident that, without transitioning to a new domestic consumption-based tax system, there is a viable approach for ensuring a level playing field between American and foreign companies and workers, while protecting American jobs and the U.S. tax base. While we have debated the pro-growth benefits of border adjustability, we appreciate that there are many unknowns associated with it and have decided to set this policy aside in order to advance tax reform.

“Given our shared sense of purpose, the time has arrived for the two tax-writing committees to develop and draft legislation that will result in the first comprehensive tax reform in a generation. It will be the responsibility of the members of those committees to produce legislation that achieves the goals shared broadly within Congress, the Administration, and by citizens who have been burdened for too long by an outdated tax system. Our expectation is for this legislation to move through the committees this fall, under regular order, followed by consideration on the House and Senate floors. As the committees work toward this end, our hope is that our friends on the other side of the aisle will participate in this effort. The President fully supports these principles and is committed to this approach. American families are counting on us to deliver historic tax reform. And we will.”