

Less is More: The Modified Zero Plan for Tax Reform

BY PAUL WEINSTEIN JR. AND MARC GOLDWEIN

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As the ideological battles between the House Republicans and the President over discretionary spending continue to dominate news headlines, the real progress toward defusing America's debt crisis is occurring more quietly in the Senate. There, a bipartisan group known as the "Gang of Six" has rallied behind the balanced blueprint produced by the National Commission on Fiscal Responsibility and Reform (Fiscal Commission).

Originally derided by some on the left and right when it issued its December 1, 2010 plan, the Fiscal Commission plan has become the only bipartisan game in town when it comes to deficit reduction. In March, 64 Senators (32 Democrats and 32 Republicans) called on the President to support a broad approach for addressing deficit problem and stated that the Fiscal Commission's "work represents an important foundation to

achieve meaningful progress on our debt."¹ Shortly thereafter, ten former heads of the Council of Economic Advisers, both Republicans and Democrats, co-signed a public statement urging that the Fiscal Commission's report "be the starting point of an active legislative process that involves intense negotiations between both parties."²

The Fiscal Commission plan includes something for everyone to dislike, but along with a real plan to cut the deficit, the proposal includes a number of reforms that break through the partisan logjam that has plagued Washington in recent years. One such reform is the Fiscal Commission's tax reform plan, which despite reflexive opposition from conservative anti-tax groups was supported by all three Senate Republicans on the Commission.

About the authors

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This plan, known as the “Modified Zero Plan,” captured the interest of Republicans and Democrats because of its ability to dramatically lower rates, simplify the tax code, enhance fairness and progressivity, increase government revenues for deficit reduction. It achieves this by eliminating or reforming the vast majority of the special preferences and tax expenditures in the tax code. It would also improve America’s competitiveness by lowering the corporate tax rate and moving to a territorial corporate tax system more aligned with the rest of the industrial world.

Addressing GOP skeptics of the Modified Zero Plan, “Gang of Six” member Senator Michael Crapo (R-ID) said that “the plan’s provisions to lower tax rates while creating fairness in the tax code are similar to pro-growth policies supported by President Reagan.”³

This paper will explain the origins and evolution of the Modified Zero Plan, discuss how it works and its numerous strengths, and suggest some possible areas for improvement for Congress to use it as a framework for tax and budget reform legislation.

ORIGIN OF THE “ZERO PLAN”

A common theme of those who testified before the Fiscal Commission was that the tax code needed more than just a touch-up, but rather a clean sweep of the hundreds of tax breaks and loopholes throughout the code, also known as tax expenditures or tax earmarks. During the deliberations of the Fiscal Commission, the number and cost of these tax breaks became the focus of the Commission’s tax reform efforts.

Many experts believe that the array of tax expenditures that favor different groups of taxpayers and special interests undermines compliance, creates unintended economic consequences (such as the housing bubble or exorbitant CEO pay), and provides a compelling argument for reform.

Navigating the labyrinth of tax incentives also makes filing a headache for taxpayers. When income taxes were established in 1913, the tax code could have been published in a single 400-

page book. Today’s tax code is several volumes longer than The Bible and requires 71,684 pages to spell out the rules.⁴ As a result, 80 percent of American households use a tax preparer or tax software to help them prepare and file their taxes.⁵

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The other problem with all these tax incentives is that they are extremely expensive. The total cost of tax earmarks—amounting to \$1.1 trillion a year of spending in the tax code—causes both deficits and marginal tax rates to be higher than is necessary or optimal for the economy. In fact, the total cost of tax expenditures in 2009 was greater than the revenue raised through individual income taxes.

Of course, many of these tax breaks are quite popular, in part because they reduce the net tax liability for households by about \$8,000 a year, according to one analysis.⁶ But this average obscures the fact that the vast majority of what is “spent” on tax expenditures goes to the top 20 percent of taxpayers. This is true for a number of reasons. First, higher earners tend to participate more in the activities subsidized in the tax code, such as health insurance, retirement savings, and homeownership. Second, many deductions (such as mortgage interest and charitable giving) are only available to the one-third of taxpayers who “itemize” their deductions. And finally, the more money you make, the more deductions and exclusions are worth (if your marginal tax rate is 15 percent, you only receive 15 cents in tax benefits for every dollar spent on deductible activity, whereas a taxpayer in the 35 percent tax bracket receives 35 cents on the dollar).

Even though the Commission members and staff shared a desire to reduce tax expenditures, there was little or no agreement on where to start. Months went by without any progress from all of the testimony and discussion on tax reform. The Commission was deadlocked, and the prospects for producing a package of tax recommendations looked very grim.

Out of this deadlock came the great breakthrough of the Commission's tax deliberations. Instead of being trapped in endless piecemeal fights over which breaks to throw out first, the Commission tried a different starting point: first "zero out" all tax expenditures and lower rates as much as possible, then let everyone argue over which breaks to add back in.

The result was the Zero Plan.

The original Zero Plan was proposed late last year as part of the Fiscal Commission's plan to cut \$4 trillion in deficits over the next 10 years and balance the budget by 2035. The plan would lower marginal tax rates to levels not seen since the Reagan Administration while raising revenues in a progressive manner by approximately \$800 billion over ten years.

The Zero Plan, as originally proposed, starts with a few simple but powerful steps:

- Eliminate all \$1.1 trillion of tax expenditures currently in the code.
- Eliminate the Alternative Minimum Tax (AMT), phase-out of itemized deductions (Pease), and the personal exemption phase-out (PEP).
- Consolidate the tax code into three individual rates and one corporate rate.
- Dedicate a portion of savings to deficit reduction and apply the rest to reducing all marginal tax rates.
- Add back in any desired tax expenditures, and pay for them by increasing one or all of the rates from their zero-expenditure low.

The unveiling of the Zero Plan caught many of the Fiscal Commission's members by surprise. Up to that point, very little progress had been achieved on tax reform, especially compared to the Commission's work in other areas such as discretionary spending and entitlements. The Zero Plan appealed to many Republicans on the Commission because it would cut rates and reduce the number of tax brackets, and to Democrats who wanted to raise revenues and close loopholes they felt were unfair and helped wealthier taxpayers game the system.

HOW THE ZERO PLAN WORKS

The Fiscal Commission's Zero Plan is similar in approach to the last major tax reform act, The Tax Reform Act of 1986, but it goes much further. The 1986 law reduced the top rate from 50 percent to 28 percent, treated capital gains as ordinary income, streamlined the number of tax brackets from 15 to 2 (or three if you count the infamous "bubble rate"), and paid for these changes by closing a number (but not all) of tax shelters and preferences, including deductions for interest on credit cards, passive activity losses, and automobile loans.

Studies have suggested that the last major tax reform in 1986 added 1 percent to GDP. The tax code is far more complex today, so sweeping tax reform could have an even greater economic impact.

The Zero Plan creates a very simplified tax system. American taxpayers would no longer need to fuss with deductions, tax credits, and other tax incentives with all their various rules and limitations. Furthermore, the Zero Plan would raise revenue that could be used to lower the deficit and would make tax compliance much simpler, helping to close the tax gap.

The Zero Plan presented in the Bowles-Simpson November 18th “Chairmen’s Mark” adopts most of the core features of the approach described above, with some variations:

- Eliminate all tax expenditures, except for the child credit and the earned income tax credit.
- Eliminate the AMT, Pease, and PEP.
- Replace the current six-bracket individual tax rate schedule of with a three-bracket schedule with incredibly low rates of 9, 15, and 24 percent.
- Treat capital gains and dividends as ordinary income.
- Eliminate corporate tax expenditures and reduce the corporate tax rate to 26 percent or 27 percent.
- Transition the U.S. to a territorial tax system for companies earning income abroad.

It should be noted that the Fiscal Commission proposed some revenue changes outside the Zero Plan, including increasing the gas tax, gradually increasing the amount of income subject to the Social Security payroll tax, and switching to a more accurate measure of inflation for indexing various provisions in the budget and tax code.

Despite its many strength, a number of problems exist with the Zero Plan in its “purest” form.

First, the Zero Plan treats all tax expenditures the same, when in fact there are some that may be of greater economic or social value than others. For example, retirement security has become a major concern for policymakers in recent years, given the nation’s relatively low savings rate (excluding the last two years), the gradual disappearance of defined-benefit plans, and the retirement of the baby boomers and its impact on the solvency of the Social Security Trust Fund. Therefore, a tax code that provides no incentive for retirement security might discourage personal savings and capital formation, undercutting future growth.

As another example, completely eliminating the mortgage interest deduction might undermine the nation’s fragile recovery and devalue many Americans’ most significant financial asset.

Second, the pure Zero Plan does not address the growing inequality that has plagued this country over the last few decades. It’s true that most tax

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expenditures go to higher earners, but those that *do* go to lower earners – for example the child tax credit and Earned Income Tax Credit (EITC) – are quite important and cannot be distributionally offset with lower rates.

Even if the child tax credit and EITC were retained, the pure Zero Plan still ends up being roughly distributionally neutral, which means the bottom quintile will see the same net tax increase (as percent of income) as the top quintile. Given the growing concentration of wealth at the top of the income distribution, and the increasing hardships placed on lower to moderate earners, this is not a sensible way to raise substantial amounts of revenue.

For these reasons as well as others, the Fiscal Commission also offered a Modified Zero Plan which maintained many of the benefits of the original Zero Plan (historically low rates, higher revenues, simpler tax code), while eliminating

a number of its downsides. This paper will detail those differences and describe the strengths of the Modified Zero Plan, while suggesting some other policy options for policymakers to consider.

IMPROVING ON THE ORIGINAL: THE “MODIFIED ZERO PLAN”

In its pure form, the Zero Plan had several drawbacks and would need considerable reworking in order to gain the support of the majority of Fiscal Commission members. As a result, the staff and members of the Fiscal Commission offered an illustrative example of an alternative Zero Plan, one that would still meet the Commission’s goal of very low rates and increased revenues, but would address several of the problems discussed above. This plan, known within the Commission as the Modified Zero Plan, is different in a number of ways from the Zero Plan.

First, as with the pure Zero Plan, the current six-bracket individual tax rate schedule is still replaced by three brackets. However, those rates would be higher (12, 22, and 28 percent) than those included in the original Zero Plan, and the standard deduction would be raised to increase overall progressivity. In addition, as with the original Zero Plan, the Modified Zero Plan taxes capital gains and dividends at ordinary income rates and permanently eliminates the AMT, PEP, and Pease.

Second, a number of tax incentives were re-introduced (as-is or reformulated) that were deemed important to the well-being of the economy and in some cases helped make the final plan more progressive:

- A retained child credit and earned income tax credit (EITC), including the expansions renewed in the 2010 tax cut extension package. These expanded benefits include a “third tier” of the EITC for families with three or more children (about \$1040 more for larger families than under the old EITC), and the child credit at \$1000 per eligible child.

- A new mortgage tax incentive with a 12 percent non-refundable credit for all taxpayers – not just those who itemize. Under current law, the mortgage interest deduction is capped at \$1 million of mortgage debt, and only taxpayers who itemize can claim it. Under the Modified Zero Plan, that cap would be gradually lowered from \$1 million to \$500,000 and would be restricted to primary residences; interest on home equity loans would also cease to be deductible.
- A new, single retirement savings preference that would maintain basic preferences, but consolidate retirement accounts and cap tax-preferred contributions at the lower of \$20,000 or 20 percent of income. In addition, this proposal would expand the savers’ credit from its current level of \$1000. Finally, tax preferences for employer pension plans would remain in effect.
- A charitable giving tax incentive with a 12 percent non-refundable credit for contributions in excess of 2 percent of adjusted gross income (AGI).
- The grandfathering of the exclusion of interest on state and municipal bonds, and gradually making taxable newly issued bonds, in small increments over 5 to 10 years.
- A gradual phase-out the employer health exclusion by capping it at a level consistent with exempting 75 percent of plans from taxation in 2014, freezing the exclusion cap at that level through 2018, and then phasing it out completely by 2038. The plan would retain the excise tax on high-cost plans, but reduce it from 40 percent to 12 percent to account for the phasing out of the exclusion.

Third, the corporate rate was still reduced, but to 28 percent rather than 26 percent as first proposed. To bring the U.S. system more in line with those of our international trading partners, the Fiscal Commission recommended changing the way the U.S. taxes foreign-source income by moving to a “competitive territorial system.”

Under such a system, income earned by foreign subsidiaries and branch operations (e.g., a foreign-owned company with a subsidiary operating in the United States) is exempt from their country's domestic corporate income tax. Therefore, under a territorial system, most or all of the foreign profits are not subject to domestic tax. The taxation of passive foreign-source income would not change (it would continue to be taxed currently).

Why lower the corporate rate and move to a territorial system? The way we tax corporations today is hurting America's competitiveness. U.S. statutory rates are significantly higher than the average for industrialized countries, even though our revenue collection is low. That's because we offer tax breaks that benefit some companies at the expense of others. The U.S. is one of the only industrialized countries with a hybrid system of taxing active foreign-source income. The current system puts U.S. corporations at a competitive disadvantage against their foreign competitors. A territorial tax system would help put the U.S. system in line with other countries, leveling the playing field.

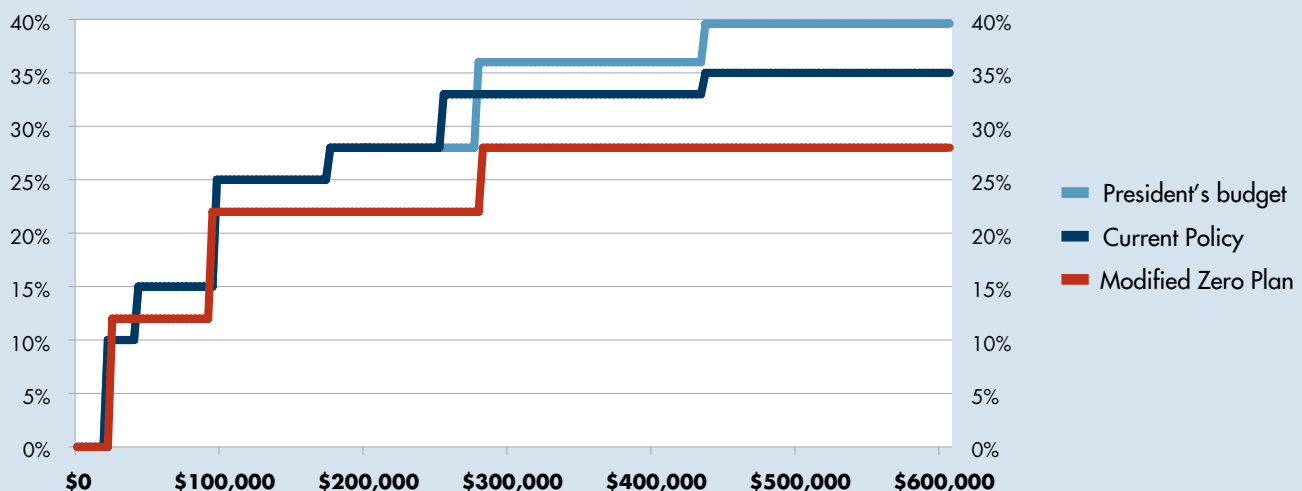
BENEFITS OF MODIFIED ZERO PLAN

Compared to the current tax code as well as the original Zero Plan, the Modified Zero Plan has a number of benefits.

First and foremost, the Modified Zero plan would encourage economic growth by dramatically lowering marginal tax rates. Economic growth is an absolute imperative for getting our fiscal situation under control, particularly in light of the fragile recovery. This plan would bring the top income tax rate down from 35 percent (39.6 percent if the upper-income tax cuts are allowed to expire in 2012) to only 28 percent, a level not seen since the Reagan era. Marginal rates would, in fact, be reduced for nearly all taxpayers, except for a very small segment currently paying at the 10 percent bracket (and those taxpayers would receive a larger standard deduction and therefore not be hurt by the 12 percent bracket on net).

So long as lower rates do not add to the deficit, most economists believe they can substantially improve economic growth. For example, some studies have suggested that the last major tax reform in 1986 added 1 percent to GDP.⁷ The

FIGURE 1. MARGINAL RATE SCHEDULE UNDER THE MODIFIED ZERO PLAN



Rate schedules estimated by authors and assume a two-person family taking standard deduction.

tax code is far more complex today, so sweeping tax reform could have an even greater economic impact.

Second, the corporate reforms in the plan would also contribute to economic growth. By cutting the corporate tax rate from 35 percent to 28 percent, the plan would push U.S. corporate rates from the second highest in the developed world to a level more in line with our partners and competitors. Best of all, this rate drop will be paid for by eliminating 75 business tax expenditures that distort private-market decision making. And by moving to a territorial system, U.S. corporations will be put on equal footing with foreign competitors. Most countries, especially our biggest trading partners (e.g., Canada, Germany, Japan, and the United Kingdom) have a territorial system.

Third, the Modified Zero Plan would dramatically simplify the tax code by moving from six to three income rates, taxing capital gains and dividends as ordinary income, aligning corporate and individual rates, and most importantly eliminating over 150 tax breaks and special preferences in the current code. In addition, the plan would get rid of the AMT, which could hit 28 million taxpayers without enactment of annual patches, and eliminate Pease and PEP. As a result of these changes, most Americans will be able to file their taxes on a one-page form and will save billions in accounting and tax preparation fees.

Fourth, the plan will help reduce the more than \$300 billion annual tax gap (the difference between what the Internal Revenue Service estimates it is owed and what is actually collected). This is true for a number of reasons. Lower corporate and individual rates should reduce the incentive for tax evasion. More important, closing loopholes and shelters should significantly reduce opportunities to avoid paying taxes and the likelihood of taxpayer errors. Uniform individual, corporate, capital gains, and dividends rates will make tax arbitrage and gaming more difficult. And moving to a territorial system will reduce some forms of corporate income shifting.

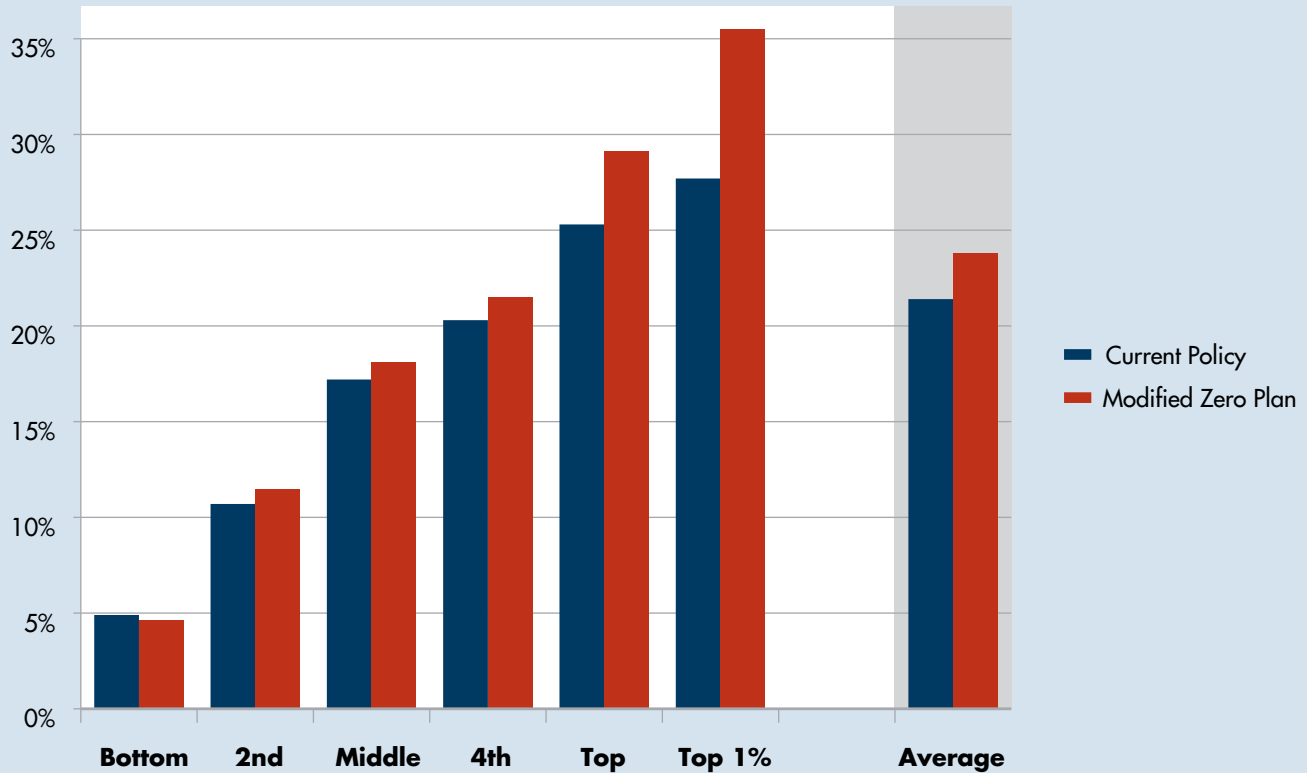
Fifth, the Modified Zero Plan would help make the tax code far more progressive than current policy. According to the Tax Policy Center, nearly 80 percent of the revenue raised would come from the top quintile, and 50 percent would come from the top 1 percent of taxpayers alone. The plan would actually reduce the tax burden for the bottom quintile, while asking for only 1 percent to 1.5 percent of income more from the middle three quintiles. Meanwhile, the plan increases revenue raised from the top quintile by 4 percent—including 8 percent from the top 1 percent and

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12 percent from the top 0.1 percent. As a result, the wealthiest 0.1 percent of taxpayers will pay an extra \$738,149 in taxes per person, while the middle quintile will only pay an extra \$518.

Finally, the Modified Zero Plan will raise \$80 billion in revenues by 2015 and around \$800 billion over ten years (jumping to \$98 billion and over \$1 trillion if you include the Fiscal Commission's other revenue changes), all of which would be dedicated to deficit reduction.⁹ If passed along with the Fiscal Commission's other recommendations, deficit reduction would exceed \$4 trillion over the next ten years. Putting this country on a sustainable fiscal path should be of the highest priority to policy makers, and

FIGURE. 2 AVERAGE TAX BURDEN BY QUINTILE



Source: Tax Policy Center and authors' calculations. Note that numbers include impact of switching to "chained CPI" for indexing the tax code, and a portion (about 1/4) of the increase in the FICA taxable maximum recommended by the Fiscal Commission. The effects of the Fiscal Commission's gas tax increase are not included in these numbers.

generating the revenue through something like the Modified Zero plan is both politically and economically preferable to doing so through rate increases.

GOING FORWARD

While there is much to like about the Modified Zero Plan, a lot of work remains before this plan will be ready to be put into legislative language. First, we need to carefully think through the transition from the existing tax code to the Modified Zero Plan (something which the Fiscal Commission acknowledged and called for in the report). Tax reform that eliminates the vast majority of tax incentives and redistributes tax

burdens among taxpayers, affects asset values, and changes price levels will create winners and losers. Those who stand to lose often seek to prevent the reform or to secure "transition relief," which avoids or delays the full brunt of the new law. Determining how to handle these transition issues creates an interesting dilemma. At one extreme, a pure version of the Modified Zero Plan would allow no adjustments. At the other logical extreme, policymakers could choose to grant extensive "transition relief," by adding back other tax incentives or utilizing an extended phase-out for eliminating almost all tax expenditures. In practice, the transition relief that has accompanied much smaller tax reforms has tended

to turn into a bonanza of hidden tax breaks and subsidies. Policy makers must walk this tightrope carefully.

Second, a number of the incentives added back into the Modified Zero Plan may need further thinking. For example, should the single retirement tax preference be open to taxpayers of all income levels since it is going to replace both IRAs and 401(k)s? And are there incentives or procedures that would increase the take up rate among those who currently don't have either an IRA or 401(k)?

With regards to the fragile state of the housing sector, does the cap on the new mortgage interest credit need to be increased either temporarily or permanently? And should existing homeowners be grandfathered under the current rules to ensure home prices are not significantly depressed? One critical question we should ask is how to prevent enactment of new tax expenditures once tax reform is implemented. One possibility

would be to put into place tough budget rules that lock in current rates and require any future changes to the tax code be paid for by scaling back or eliminating the few tax incentives that would remain under the Modified Zero Plan. Such an approach may also reassure those on the left and the right that the concessions they make in achieving tax reform will not be for naught.

CONCLUSION

Virtually no one disagrees that that the U.S. tax code needs reform; the debate is over how to do it. With the close of another tax season, Americans deserve action on reforming the tax system. If there is one lesson to be learned from the experience of the Fiscal Commission, it's that the best chance for real progress on tax reform lies with an approach based on lower rates, zero-based budgeting for tax expenditures, greater simplicity, higher revenues for deficit reduction, and increasing progressivity.

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