Testimony before the House Committee on Ways and Means on

"The Tax Code's Burdens on Families and Individuals"

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Chairman Camp, Ranking Member Levin, and members of the Committee, it is an honor to appear before you today to discuss the tax code's burdens on families and individuals. The views expressed here are my own and do not necessarily represent the views of the American Enterprise Institute or any other person or organization.

In my testimony, I focus on the complexity affecting individual taxpayers with non-business income. It should be noted that the tax system also imposes significant complexity with respect to the taxation of business income, whether reported on the corporate income tax returns filed by C corporations or on the individual tax returns filed by owners of pass-through firms (sole proprietorships, partnerships, limited liability companies, and S corporations). Although those issues are important, I do not examine them in this testimony.

Due to time and space limitations, I also cannot discuss all of the numerous provisions that contribute to tax complexity for individuals and families. Instead, I focus on three specific areas; the proliferation of complicated and duplicative tax incentives for saving, education, and families, income-based phase-outs, and the alternative minimum tax. As I explain throughout my testimony and in the conclusion, these problems can be addressed separately from such contentious issues as the appropriate level of revenue or degree of tax progressivity. These issues should be addressed as part of comprehensive tax reform if it is adopted, but should be addressed separately if comprehensive reform does not occur.

Because nearly all of this complexity arises from statutory rather than regulatory provisions, corrective action must come from Congress and the president. Because this issue cuts across ideological lines, it offers an opportunity for members of both parties to work together to promote the public interest in a simpler and more workable tax system.

Needless Complexity of Tax Incentives for Saving, Education, and Children

Over the years, Congress has offered tax incentives for a variety of purposes, including saving, education, and children. Unfortunately, the current design of these incentives needlessly burdens taxpayers and detracts from the efficacy of the incentives. Although the decision whether to offer such incentives and the generosity of any such incentives may be contentious, the needless complexity can be addressed separately from those difficult issues.

The primary problem is the proliferation of tax incentives that serve largely similar purposes, but governed by different and complicated rules. Taxpayers must sort through these incentives, keeping in mind that selection of one incentive may preclude the use of others. Because much attention has been devoted to these problems, I provide only a brief discussion here. More complete analysis may be found in the reports of the Joint Tax Committee and the National Taxpayer Advocate and the other articles that I cite below.

These sources also offer detailed proposals to reduce complexity. The general outlines of the proposals are relatively similar across the different sources, reflecting a consensus that spans ideological divides. The proposed solutions generally involve consolidation of the incentives into a much smaller set, along with simpler rules that are more uniform across the remaining incentives.

The current tax system provides more than 20 tax-preferred savings accounts and plans, including employer pension plans, traditional IRAs, nondeductible IRAs, nonworking spousal IRAs, Roth IRAs, rollover IRAs, SIMPLE IRAs, 401(k) plans, profit-sharing plans, employee stock ownership plans, money purchase plans, defined benefit plans, Simplified Employee Pensions, SARSEPs, SIMPLE 401(k) plans for small employers, 403(b) tax-sheltered annuity plans for 501(c)(3) organizations and public schools, 457(b) deferred compensation plans for state and local governments, 529 plans, Coverdell education savings accounts, Archer medical savings accounts, and health savings accounts. Each type of account is subject to different contribution limits, eligibility rules, and restrictions on withdrawals. The National Taxpayer Advocate (2004, pp. 423-432) and the Joint Committee on Taxation (2001, pp. 149-228) documented the complexity of tax-preferred savings accounts and plans and offered suggestions for simplification. The National Taxpayer Advocate cited one study in which 30 percent of workers choosing not to participate in 401(k) plans listed complexity as the principal reason. The President's Advisory Panel on Federal Tax Reform (2005, pp. 115-121) offered a simplification proposal that featured only three types of tax-preferred savings accounts and plans.

Similarly, the current tax system offers multiple tax preferences designed to encourage education. Taxpayers may exclude interest on education Savings Bonds and employer-provided educational assistance from taxable income claim, engage in tax-preferred saving through 529 plans or Coverdell education savings accounts, deduct interest expense on student loans, work-related education costs, and qualified tuition, and claim either the American Opportunity credit or the Lifetime Learning credit for tuition and related costs. These provisions have different rules and limitations; for example, the American Opportunity credit, but not the Lifetime Learning credit, is limited to the first four years of post-secondary education. Joint Committee on Taxation (2001, pp. 122-143) and National Taxpayer Advocate (2004, pp. 403-422) documented the proliferation of educational incentives and offered proposals for simplification.

The current tax system also offers a wide array of incentives for families and children. In many cases, taxpayers may claim both an exemption, currently $3,700, and a credit of $1,000 for each child. Unmarried taxpayers with one or more children are allowed to claim head-of-household status rather than single status, giving them a more favorable tax rate schedule than that available to childless unmarried taxpayers. Low-income workers with children may claim an earned income tax credit far more generous than that available to childless low-income workers. Here, too, different rules apply to different provisions; for example, the child credit is available only for children 16 or younger, while the other tax breaks are also available for older children. The President's Advisory Panel on Federal Tax Reform (2005, pp. 63-69) proposed the replacement of these provisions with two simplified Family and Work credits. Hassett, Lindsey, and Mathur (2009) and Maag (2010) also discussed ways to simplify and consolidate these provisions.

Income-Based Phase-Outs

Income-based phase-outs are another source of complexity. A number of tax preferences are eliminated or restricted for taxpayers with higher incomes. For example, taxpayers are generally allowed a $1,000 credit for each child 16 or younger in the household, but the credit is fully available only to unmarried parents with incomes below $75,000 and married parents with incomes below $110,000. For each extra $1,000 (or portion thereof) of income above those thresholds, $50 of credit per child is phased out. Once income reaches $95,000 for single parents or $130,000 for married couples, the credit is completely eliminated.

The table on page 9 provides information for sixteen income-based phase-outs, updated from Brill and Viard (2008). As can be seen, the phase-outs apply at many different income levels and are constructed in a bewildering variety of ways. Some income ranges are inflation-indexed while others are not. The ratio of the income ranges for married couples to the corresponding ranges for single taxpayers is one, two, or intermediate values for different provisions. Some phase-outs distinguish between single taxpayers and heads of household while others do not. The applicable definition of income (not shown in the table) also varies across some of the provisions.

The current tax system also features a few phase-in provisions, under which tax preferences become larger as income rises. For example, the earned income tax credit increases as labor income rises over a certain interval, as does the refundable portion of the child tax credit.

Phase-outs add to the progressivity of the tax system by raising taxes on those with higher incomes through the reduction or elimination of selected tax preferences. Like other measures that promote progressivity, phase-outs also increase the effective marginal tax rates faced by taxpayers. The marginal tax rate is the fraction of additional income that is paid in tax and controls the incentives to earn additional income.

For example, consider a married couple with two children 16 or younger and with income between $110,000 and $130,000 and suppose that the couple is in the 25 percent tax bracket. Earning an additional $1,000 of income directly and visibly results in an additional tax liability of $250 through the rate schedule. But, because the $1,000 of additional income also triggers the loss of $100 of child tax credits, the couple's tax liability actually rises by $350. The couple's effective marginal tax rate is therefore 35 percent, equal to the official 25 percent marginal tax rate plus 10 additional percentage points from the phase-out of the child tax credit. (Of course, this calculation assumes that the couple is not affected by any other income-based phase-outs. If the couple also claims the District of Columbia homebuyer credit, the exclusion of interest income on Education savings bonds, or the student loan interest deduction, the additional income may also trigger a reduction of those benefits, implying an even higher effective marginal tax rate.)

Striking the appropriate balance between progressivity and incentives is a longstanding and difficult tax policy question. Regardless of what stand is taken on that question, however, income-based phase-outs are generally a flawed way to increase progressivity, because, as discussed below, they reduce the transparency of the tax system and add to its complexity. These problems are avoided if progressivity is instead advanced through direct changes to the tax rate schedule.

Income-based phase-outs reduce the transparency of the tax system because it is difficult for taxpayers to know how much their taxes will rise if they earn additional income. Althsuler and Goldin (2009) documented the significant number of taxpayers who face effective marginal tax rates higher or (due to phase-ins) lower than the official marginal tax rates given by their tax brackets. Phase-outs also cause marginal tax rates to vary capriciously across taxpayers, depending upon which tax breaks they happen to claim. Moreover, income-based phase-outs add to complexity because a separate computation, generally requiring a separate worksheet in the IRS instructions, must be performed for each phase-out that applies to a taxpayer.

There may be good reason for the use of income-based phase-ins and phase-outs in provisions such as the earned income tax credit, which bear a close relationship to the official rate schedule. In principle, phase-outs may also be appropriate if there is a specific reason to provide incentives to promote particular behavior by some, but not all, income groups. In general, though, transparency and simplicity would be advanced by eliminating most income-based phase-outs while altering the tax rate schedule to maintain the desired degree of progressivity. The Joint Committee on Taxation (2001, pp. 79-91) discussed income-based phase-outs and offers proposals to eliminate many of them.

Alternative Minimum Tax

The alternative minimum tax (AMT) is a parallel tax system. Each taxpayer, in each year, must pay either his or her tax liability computed under the regular income tax rules or his or her tax liability computed under the AMT rules, whichever is larger.

Some of the deductions, credits, and exclusions that are allowed under regular tax rules are disallowed under the AMT, causing the AMT to have a broader base than the regular income tax. At the same time, the AMT offers lower tax rates than the regular income tax for many taxpayers, although AMT rates can be higher than regular tax rates for some taxpayers. Current law effectively classifies tax preferences into two categories, those that are available under both the regular tax and the AMT and those that are available only under the regular income tax. The AMT limits the use of the latter preferences, but does so only for taxpayers who claim a sufficiently large amount of those preferences that their liability is higher under the AMT rules than under the regular tax rules.

The AMT disallows the per-person exemptions that taxpayers can claim for themselves and their dependent children under the regular income tax system. It also disallows the regular tax system’s itemized deductions for state and local property taxes and income (or sales) taxes, employee business expenses, and costs of earning investment income and does not allow interest on home equity loans to be deducted. Unlike the regular tax system, the AMT taxes interest income on some private-activity municipal bonds. It also imposes heavier taxes on incentive stock options.

According to the AMT’s permanent rules, it also denies a host of tax credits that are allowed under the regular income tax, including the American Opportunity and Lifetime Learning education credits, the credit for child and dependent care expenses, and the credit for the elderly and disabled. As explained below, however, these credits have actually been allowed under the AMT through 2011 under a series of temporary “patches” adopted by Congress.

On the other hand, the AMT resembles the regular tax system in many respects. It follows the regular tax system by excluding gifts, inheritances, imputed rent on owner-occupied homes, interest income on public-activity municipal bonds, personal-injury damage awards, many government transfer payments, and most fringe benefits from taxable income. Both systems provide preferential tax rates for dividends and long-term capital gains. The AMT also generally conforms, sometimes with minor modifications, to the regular tax system’s deductions for mortgage interest expense (except on home equity loans), moving expenses, charitable contributions, large theft and casualty losses, large out-of-pocket medical and dental expenses, and gambling losses that offset gambling winnings. The AMT also allows the adoption credit, the earned income tax credit, and the $1,000 child credit.

The AMT is an undesirable way to limit the use of tax preferences, because it conditions the availability of particular preferences for a given taxpayer on whether the taxpayer claims a large amount of other AMT-disallowed preferences. There is little justification for allowing a preference under the regular tax system while disallowing it for those taxpayers who fall into a parallel tax system. If Congress decides that a particular preference is undesirable, it should be eliminated under the regular income tax. If Congress decides that a particular preference should be maintained, but at a less generous level, there are many simpler and less capricious ways to cut back on the preference, such as disallowing a fixed percentage of the preference or limiting the allowable dollar amount.

Moreover, the AMT imposes significant complexity on taxpayers who are subject to it by requiring them to engage in two sets of tax computations. The AMT even imposes complexity on some taxpayers who are not subject to it, because they must complete a complicated worksheet to confirm that they are not, in fact, subject to it.

The AMT originally affected only a small set of taxpayers. Lim and Rohaly (2009, p. 12) reported that only 20,000 to 30,000 taxpayers were subject to the AMT in 1970 through 1975 and that the number of affected taxpayers remained below 1 million through 1997. In 2011, however, the AMT affects roughly 4.6 million taxpayers, according to estimates by the Urban-Brookings Tax Policy Center (2010).

The AMT tends to spread to additional taxpayers as time goes on, because the AMT's permanent rules do not provide for inflation indexation of the credit's exemption amounts while the regular income tax's exemption and bracket amounts are indexed for inflation. As inflation marches on, therefore, tax liability under the AMT rules generally increases relative to tax liability under the regular tax rules, causing the number of taxpayers for whom AMT liability exceeds regular-tax liability to grow. Also, the 2001 and 2003 tax cuts reduced regular income tax liability to a greater extent than AMT liability, further contributing to the spread of the AMT.

The spread of the AMT would be far greater without the annual "patches" adopted by Congress over the past decade. Each year's patch allows the tax credits mentioned above to be claimed under the AMT and increases the AMT exemption amount. If the patch expires at the end of 2011, as currently scheduled, the number of taxpayers affected by the AMT will jump to 34.4 million in 2012, according to estimates by the Urban-Brookings Tax Policy Center (2010). It is highly likely, of course, that Congress will enact another annual patch to avert this massive expansion of the AMT. Nevertheless, the annual patches do not truly fix the problem, because they leave several million taxpayers subject to the AMT and fail to provide any permanent assurance that tens of millions of others will not be swept into the AMT.

Simplicity would be promoted by repealing the AMT. Each of the exclusions, deductions, and credits currently disallowed by the AMT could be disallowed, fully allowed, or partially allowed under the regular income tax system, as Congress deems appropriate for each provision. The rate schedules under the regular income tax could also be adjusted to meet any desired distributional goals. If full AMT repeal is not feasible, substantial simplification could still be achieved by permanently narrowing the scope of the AMT.

Conclusion

There is a strong public interest in having a tax system that permits relatively easy taxpayer compliance. Of course, efforts to properly measure ability to pay or to promote social objectives often require some degree of complexity. But, today's tax system features a large amount of avoidable complexity, forcing many taxpayers to choose among an array of complicated provisions that are intended to advance similar objectives, to apply income-based phase-outs, and to confront a parallel tax system.

Although many tax issues give rise to strong ideological and philosophical disagreement, the issues discussed here are less affected by such controversies. The simplification of needlessly complex tax incentives and the elimination of income-based phase-outs and the AMT can be addressed separately from the issue of how much tax revenue the government should collect or how progressive the tax system should be, because the tax rate schedule can be adjusted to meet any desired revenue and distributional targets.

To a large extent, the issues discussed here can even be discussed separately from the question of whether the income tax should be a broad-based tax with few exclusions, deductions, and credits or a narrow-based tax with many such provisions. Individuals with different ideological and philosophical perspectives may sharply disagree about whether the tax system should offer tax incentives for education, saving, and children and the appropriate generosity of any such incentives. Yet, regardless of how those questions are resolved, it is possible to ensure that such incentives are not needlessly complex and that they are not provided under one, but not the other, of two parallel tax systems. In many, though perhaps not all, cases, it may also be possible to agree that such incentives should not be limited to particular income levels.

Although tax complexity is a vexing problem, it also offers an opportunity for bipartisan action to give the American people a better tax system.

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INCOME-BASED PHASE-OUTS

Provision	Filing Status	Beginning Income Level: 2011	Ending Income Level: 2011	Indexed to Inflation?	First Year
Elderly and disabled credit	Unmarried Married	7500 10000	17500 20000 (1 eligible) 25000 (2 eligible)	No	1954
Dependent care credit		15000	43000	No	1982
Performing artists deduction		16000	16000	No	1987
Earned Income Tax Credit	Unmarried Married	7590 16690 16690 12670 21770 21770	13660 (no children) 36052 (1 child) 40964 (2 or more) 18740 (no children) 41132 (1 child) 46044 (2 or more)	Yes	1975
Social Security benefit exclusion	Unmarried Married	25000 32000	Varies Varies	No	1984
Savers credit	Single Hd of Hshold Married	17000 25500 34000	28250 42375 56500	Yes	2002
Conventional IRA deduction	Unmarried Married	56000 90000	66000 110000	Yes	1987
Lifetime Learning credit	Unmarried Married	51000 102000	61000 122000	Yes	1998
Education Bonds interest exclusion	Unmarried Married	71100 106650	86100 136650	Yes	1990
D.C. homebuyer credit	Unmarried Married	70000 110000	90000 130000	No	1997
Child credit	Unmarried Married	75000 110000	95000 130000	No	1998
Student loan interest deduction	Unmarried Married	60000 120000	75000 150000	Yes	1998
AMT exemption	Unmarried Married	112500 150000	247500 330000	No	1987
American Opportunity credit	Unmarried Married	80000 160000	90000 180000	No	2009
Roth IRA eligibility	Unmarried Married	107000 169000	122000 179000	Yes	1998
Adoption credit		185210	225210	Yes	1997
Education IRA eligibility	Unmarried Married	95000 190000	110000 220000	No	1998