Backgrounder

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The Wyden–Gregg Bipartisan Tax Reform Bill: Why Congress Should Listen

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Abstract: *There are few people who can navigate the maze of the U.S. tax code, while an ever-shrinking number of Americans are paying ever-higher taxes to carry more and more of their fellow citizens who pay no income taxes at all. The unmanageability and increasing imbalance of the U.S. tax code is the near-continuous subject of calls for reform. Some reforms have had good effects, as was the case in 1986; other efforts at reform go nowhere. A new bipartisan tax reform bill introduced by Senators Ron Wyden and Judd Gregg has what it takes to go somewhere. Heritage Foundation senior tax policy analyst Curtis Dubay explains why Congress should give Wyden–Gregg a close look.*

Senators Ron Wyden (D–OR) and Judd Gregg (R–NH) recently released a bill for a fundamental reform of the tax code. Their bill, the Bipartisan Tax Fairness and Simplification Act of 2010,[1] is a serious effort to fix a tax code in dire need of repair. Although the Wyden–Gregg tax reform bill does not cure all that ails the tax code, it is a good first step in two important respects. First, the Wyden–Gregg bill demonstrates that congressional interest in tax reform is very much alive. Second, it demonstrates how Congress can work in a bipartisan manner to improve the tax code by simplifying it and minimizing the damage it inflicts on the economy and on taxpayers.

Why Reform Is Needed Now

All taxes imposed today create a drag on the economy. The proper goal of sound tax policy is to mini-

Talking Points

- The U.S. tax code is in dire need of fundamental reform. The new Wyden–Gregg Senate bill is an ambitious bipartisan effort to fix many of the problems caused by the current system.
- Wyden–Gregg is an excellent example of how Congress can work in a bipartisan manner to reduce the complexity of the tax code and limit the damage the tax code inflicts on the economy.
- While it would have been better if Wyden–Gregg reduced the top marginal individual income tax rate below where it stands now, the reduced corporate income tax rate is a major improvement over current law.
- Wyden–Gregg reduces taxes on savings, but does not lower taxes on capital gains and dividends, and still prevents businesses from deducting the purchase of equipment immediately.
- Too often in recent history tax reform plans have gone nowhere legislatively. Congress should buck this trend and use the Wyden–Gregg bill as a positive first step to fundamental reform of the tax code.

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mize the negative impact of taxation on the economy while raising the revenue needed to fund the government. The best way to achieve a sound tax code is to apply low tax rates to broad bases, thereby limiting the impact the tax code has on the economic decisions of individuals and businesses. The United States tax code falls desperately short of this approach and hinders economic growth. The current tax code levies high tax rates on individuals and businesses and, because of a dizzying array of credits, deductions, and exemptions, tax rates apply to narrow bases grounded on no apparent principles at all.

The current tax code also hinders economic growth because it is monstrously complex, both for individuals and businesses. It also discourages saving, investing, and risk-taking, making American businesses uncompetitive in a global economy.

A reformed tax code should also stop the long-term trend of shifting ever more of the national tax burden to a declining number of upper-income earners. Balancing the budget on the backs of a small minority is a recipe for an explosion in the size of government that will be difficult to turn back. Despite protestations that the wealthy benefited the most from the 2001 and 2003 tax cuts, those reductions lowered taxes for *all* taxpayers and *sped up* a decades-long trend of moving the tax burden to a declining proportion of upper-income taxpayers. In 2006, the latest year of available data, the top 1 percent of income earners paid more than 40 percent of all income taxes. The bottom 50 percent paid just 3 percent of all income taxes.[2] (Combined with the long-term trend, new refundable tax credits added by the stimulus bill likely mean that data for more recent years will show that the bottom 50 percent paid no income tax.) This is a precarious position for a democracy. When half the population can vote in the benefits of more government spending while incurring none of the costs, that is a recipe for fiscal implosion: a never-ending government expansion paid for by a smaller and smaller minority of taxpayers.

The last major reform of the tax code took place in 1986 and, though far from perfect, reduced the harm inflicted on the economy in many respects. The guiding principles of the 1986 reform were to be revenue neutral, lower individual and corporate income tax rates, and expand the tax base. Yet over the following 24 years, Congress raised rates considerably and hollowed out the tax base with new credits, deductions, and exemptions. Doing so has resulted in a tax code that highly distorts economic decision making. It is now a serious drag on the economy, and the various measures that eroded the tax base have made complying with the code daunting for the remaining taxpayers. The tax code is so complex that 81 percent of individual taxpayers will choose to use an accountant or a computer-based program to prepare their tax return in 2010.[3] Fundamental reform of the tax code is long overdue to repair the damage done since the last reform. Ideally, current reform would improve the code more than that of the 1986 reform by removing even more deductions and credits and lowering tax rates further.

Wyden–Gregg Offers Sound Reform

The most important goal of tax reform must be to reduce the economic distortions imposed by the tax code. Following are the basic tasks that a tax reform bill must accomplish in order to achieve this goal, and an assessment of how the Wyden–Gregg tax reform bill would meet each objective. A good tax reform bill must:

Reduce Income Tax Rates. Under current law, the top marginal rate on individual income is 35 percent and is scheduled to rise to 39.6 percent in 2011,

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1. The Bipartisan Tax Fairness and Simplification Act of 2010, 111th Congress, 2nd Session, at *http://wyden.senate.gov/issues/Legislation/wyden-gregg/bill_draft.pdf* (March 11, 2010).
2. The Heritage Foundation 2009 Federal Revenue and Spending Book of Charts, "The Top 10 Percent of Income Earners Paid 71 Percent of Federal Income Tax," at *http://www.heritage.org/Research/Features/BudgetChartbook/Top-10-percent-of-Income-Earners-Paid-71-percent-of-Federal-Income-Tax.aspx*.
3. CompleteTax, "Tax Prep Survey 2010," Slide 2 ("Method for Preparing Tax Return"), at *http://www.cch.com/completetax2010/TaxPrepSurvey.pdf* (March 11, 2010).

while the top marginal corporate income tax rate remains at 35 percent. Both rates are too high. High marginal tax rates act as a steep impediment to economic growth because they discourage individuals from working, saving, and investing, and discourage businesses from taking on new economic risks. High tax rates also compound the economic distortions created in the tax base itself. The high corporate tax rate is the second-highest among developed nations and makes the United States uncompetitive in the global race for business investment.[4]

What Wyden–Gregg Offers. The Wyden–Gregg bill retains the top marginal individual income tax rate at 35 percent for taxable income above $140,000. The bill has two lower rates of 25 percent for taxable income above $75,000 and 15 percent for taxable income below $75,000. Preventing the top rate from jumping to nearly 40 percent is a start, but to improve the incentives for income creation requires a top marginal rate lower than the current 35 percent.

On the corporate side, Wyden–Gregg does even better. The bill turns the progressive corporate income tax into a 24 percent flat tax. This lower rate would greatly increase the competitiveness of American businesses and make the United States a more attractive place for new business investment. With a flat rate of 24 percent, the U.S. rate would be below the average 25 percent rate of other developed countries in the Organisation for Economic Co-operation and Development (OECD).[5]

Lower Taxes on Capital. Capital is any resource that individuals or businesses use to generate income. Like anything else, when the income accruing to capital is taxed, its user price rises and less of it is purchased. Less capital means less productivity growth and lower wages. As such, taxes on capital should be minimal or nonexistent. The current tax code taxes capital heavily. It taxes capital through the capital gains tax and taxes on dividends, both at 15 percent, and through taxes on business income and the corporate income tax—especially because businesses cannot deduct the full cost of the capital they buy, but must depreciate it over several years at a lower real value.

What Wyden–Gregg Offers. The Wyden–Gregg plan fundamentally changes the manner in which capital gains and dividends are taxed. Rather than introducing a lower rate, Wyden–Gregg exempts 35 percent of long-term capital gains and dividends from any taxation and then applies the taxpayers' top marginal income tax rate to the remaining 65 percent of the gain. For taxpayers in the top 35 percent bracket, this change will increase the effective tax rate on capital gains and dividends to almost 23 percent.[6] While this higher rate on dividends and capital gains is unfortunate, the effects are ameliorated somewhat by the expansion of tax-exempt savings accounts.

A lower rate on capital gains and dividends for all taxpayers would have been a better promoter of economic growth, but the decreased rate for lower-income taxpayers would help make up for some of this shortcoming and would be a major help to low-income and middle-income seniors who rely heavily on dividend income and capital gains.

As discussed above, the Wyden–Gregg plan wisely lowers the corporate income tax rate, which lowers taxes on some forms of capital. The bill also allows small businesses—defined as those with gross receipts of up to $1 million a year—to write off their purchases of capital as soon as they acquire it. This, too, would help lower taxes on capital. However, for all other businesses, the Wyden–Gregg proposal keeps in place the system of depreciating capital expenses over many years. Allowing all businesses, not just small ones, to expense their capital purchases would lower taxes on capital further and help improve economic growth.

4. Tax Foundation, "Tax Data: National and State Corporate Income Tax Rates, U.S. States and OECD Countries, 2009," December 2, 2009, at *http://www.taxfoundation.org/taxdata/show/23034.html* (March 11, 2010).
5. Organisation for Economic Co-operation and Development, "Taxation of Corporate and Capital Income (2009)," Table II.1., "Corporate Income Tax Rate," at *http://www.oecd.org/dataoecd/26/56/33717459.xls* (March 11, 2010).
6. For taxpayers in the current 25 percent bracket, the effective capital gains and dividends rate would increase slightly from the current 15 percent rate to just above 16 percent, and for taxpayers at the current 15 percent rate, the effective rate would decrease to less than 10 percent. The plan also expands the definition of long-term gains.

Stop Discouraging Saving and Investing. The current tax code, especially the taxation of capital gains and dividends noted above, heavily discourages saving and investing. Such taxes lower the return that families earn from saving and investing, thereby making immediate consumption of income more attractive. This slows the growth of wealth for families, and typically means the U.S. must import more capital from other countries for businesses to expand operations and add new jobs. Taxpayers can limit taxes levied on their savings and investments through retirement, education, and health savings vehicles like employer-sponsored 401(k)-type plans, Individual Retirement Accounts (IRAs), Section 529 higher education accounts, and health savings accounts, but the amounts families can contribute to these plans is restricted, as is the use of the funds.

What Wyden–Gregg Offers. The treatment of retirement savings is one of the strongest points of the Wyden–Gregg bill. The bill expands tax-free savings by consolidating the various forms of IRAs into one Retirement Savings Account and offers a new Lifetime Savings Account. These adjustments will allow families to put away up to $14,000 a year for retirement in addition to what they can save through 401(k) plans. These new opportunities would help families save for retirement and increase the savings rate. Further reducing taxes on all savings, not just for retirement, would encourage even more saving and investing and promote economic growth. Eliminating taxes on all interest income, reducing or eliminating taxes on dividends and capital gains, and increasing or removing all limits on tax-free savings would be ideal.

Reduce Complexity. The current tax code is horrendously complex for both individuals and businesses. The IRS estimates that Americans spend 6.6 billion hours and $194 billion each year to comply with the tax code.[7] There are too many credits, deductions, exemptions, and other provisions in the tax code, each of which requires special paperwork and detailed recordkeeping. The Alternative Minimum Tax (AMT) is another complication. The AMT is a separate and parallel tax system that is supposed to ensure that high-income individuals and businesses pay a minimum amount of tax. It does so by limiting the many credits, exemptions, and deductions they can take. The AMT is a complex labyrinth on its own, and when added to the main tax code multiplies the complications for taxpayers.

What Wyden–Gregg Offers. Wyden–Gregg makes important strides toward reducing complexity. First, it reduces the number of tax brackets and rates for individuals from six to three. It also makes the corporate income tax a 24 percent flat tax. Second, it drastically reduces the number of credits, deductions, and exemptions for families and businesses.[8] Lastly, it completely abolishes the AMT. In addition to reducing complexity, the abolition of the AMT will also remove the threat that the AMT will raise taxes on middle-income families. The AMT is intended to affect only high earners, but the minimum income that designates families for the AMT is not indexed for inflation. So unless Congress passes a patch to increase that minimum threshold each year, the AMT would hit a growing number of middle-income families. Full repeal of the AMT will also stop Congress from raising other taxes to "pay" for the AMT patch each year.[9] Each of these steps will save taxpayers countless hours of filling out tax forms, and it will reduce the cost of compliance.

Maintain Revenue Neutrality. The goals of tax reform are to make the tax code less distortive of economic decision making and less complex. Tax reform is not a tool for increasing taxes. All tax reforms should be revenue neutral, meaning the new system will raise the same amount of revenue as the previous one. Tax reform is difficult enough

7. "The Bipartisan Tax Fairness and Simplification Act of 2010," Wyden.Senate.gov, at *http://wyden.senate.gov/issues/Legislation/wyden-gregg/wyden-gregg_twopager.pdf* (March 11, 2010).
8. "The Wyden–Gregg Bipartisan Tax Fairness and Simplification Act of 2010: Repeals of Tax Credits, Deductions, Exclusions, and Other Preferences," Wyden.Senate.gov, at *http://wyden.senate.gov/issues/Legislation/wyden-gregg/offsets_handout.pdf* (March 11, 2010).
9. J. D. Foster and Stephen Keen, "Senate Tax Extenders: Another Sneaky Tax Hike," Heritage Foundation *WebMemo* No. 2006, July 30, 2008, at *http://www.heritage.org/Research/Taxes/wm2006.cfm*.

without entangling the issue with questions about whether the aggregate tax burden should be higher or lower.

What Wyden–Gregg Offers. The Wyden–Gregg plan is revenue neutral, so it passes this key test. Tax increases are not necessary to get the deficit under control. All tax reforms should follow Wyden–Gregg and reform the tax code without the goal of raising tax revenues.

Stop Trying to Alter Behavior with the Tax Code. Too often, Washington uses the tax code to confer benefits on certain groups of taxpayers for political benefit, such as refundable credits for low-income taxpayers like the Earned Income Tax Credit (EITC), or targeted tax breaks for middle-income families like the Child Tax Credit. Politicians are also guilty of using the tax code to get taxpayers to engage in behaviors Washington deems beneficial, like offering special tax credits for buying hybrid cars, going to college, or buying a new home.

What Wyden–Gregg Offers. By eliminating several exemptions, credits, and deductions, Wyden–Gregg eliminates many provisions designed to alter behaviors to Washington's liking.

Stability Is Vital. The last tenet that tax reform should adhere to is beyond the control of the drafters of the Wyden–Gregg bill. It is essential nonetheless. Businesses and families crave predictability. Businesses need to know how high their taxes will be in future years to make decisions about hiring and expanding. Families need to know how high their taxes will be before they make decisions about large expenditures. A constantly changing tax code makes it difficult for them to make these decisions. The tax code has become sufficiently complex and harmful that a major rewrite is in order—and if Congress passes tax reform, it should make a commitment to keep the reformed code in place for many years.

Going Forward

Too often in recent history tax reform has fallen flat. In 2005, a tax reform panel appointed by President George W. Bush crafted two excellent reform plans only to have Congress fail to even consider them. Unbeknownst to many, President Obama has appointed a tax reform panel himself, headed by Paul Volker, former chairman of the Federal Reserve Board. The President's panel has not held any public hearings, and while it was supposed to report its findings last year, the deadline has been postponed indefinitely. Now with the President's appointment of a deficit reduction commission, questions arise whether the tax reform panel will ever release a report. At the very least, these uninspiring efforts indicate that all sides agree that tax reform is badly overdue, and very difficult to achieve.

While imperfect, the Wyden–Gregg tax reform proposal is a serious bipartisan effort to make the U.S. tax code simpler and less obstructive to economic growth. Congress should seriously consider it, and make improvements as outlined briefly above, while relieving all Americans of a gigantic government-imposed headache.

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