Tax Reform Transition: From Obstacle to Tail Wind

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Introduction

Tax reform transition has long been the ugly duckling of tax reform. It just does not fit within the grand debate, yet it never goes away. When tax reform picks up steam, taxpayers with transition problems become more focused on their problems than on tax reform's promise. For tax reformers, transition threatens to bog reform down in endless detail and political squabbling.

These complaints about the transition between an old tax system and a new one have not been answered systematically, but they can be. Handled piecemeal, transition becomes an obstacle for tax reformers and a nightmare for the economy. Handled comprehensively and guided by sound principles, transition becomes a positive force in the tax reform debate, keeping it settled squarely on the grand issues.

The grand issues in tax reform all revolve around replacing the income tax with a federal tax system more appropriate to a prosperous economy in the 21st century. This means a tax system that is fairer and simpler. It means a tax system much less discriminatory against saving and investment. And it means a tax system that can be readily adapted to new developments in the structure of the national economy.

Grand issues should drive tax reform, but an old saying goes, "The devil's in the details." While considering the overall design of the new tax system, we must also consider how to transition the tax code and the economy from the current income tax to whatever new system is adopted. The federal income tax influences virtually every aspect of our economy, generally to the detriment of economic growth. Tax reform ought to reduce or eliminate those influences. If it does, then the long-term effects of tax reform on the economy will be substantially beneficial. However, without sufficient transition provisions, the short-term effects of tax reform are sure to be harmful to individual taxpayers, to entire industries, and to the economy overall.

At first blush it appears devising such a transitional regime would be so complicated in design and uneven in application that it could be more trouble than it is worth. Indeed, some writers on tax reform argue for going "cold turkey" and ignoring transition altogether. Others argue for taking a minimalist approach and addressing only the most obvious, most imperative matters. This begs the question, of course, because deciding which matters are "obvious and imperative" opens the possibility of the most unseemly political horse-trading.

Another concern often raised regarding tax reform transition is the possibility that it would significantly reduce federal receipts, thereby presenting tax reformers with two possibilities — either allow a temporary reduction in tax receipts or enact tax reform with a temporarily higher tax rate. As developed here, however, comprehensive transition need not reduce federal tax receipts, on balance, and it could in some circumstances actually raise revenues.

This paper discusses why comprehensive transition is imperative from economic, moral, and political perspectives. The paper goes on to consider the concerns raised against tax reform transition and shows that the concerns are grossly exaggerated in some cases, and empty in others. The paper then argues that a proper transition regime adopted early in the debate would actually become a force for change, rather than an obstacle to be overcome. For purposes of discussion, the paper assumes the new tax system under consideration is a flat tax as proposed by Hall and Rabushka and as introduced as legislation by Congressman Dick Armey (R-TX) and Senator Richard Shelby (R-AL). If the tax system were instead some form of consumed income tax or sales tax, the basic points described below would continue to be valid, though the details would vary.
The Necessity of Transition

Fundamental tax reform is by its very nature an issue of grand scale. It will have dramatic consequences for better or for worse for the future of the U.S. economy, affecting the choices of every American. It touches on the most direct contact a citizen has with his or her government on a daily basis — the tax take. It is not surprising, therefore, that most tax reformers focus on the grand design and regard tax reform transition as a side show at best, but more likely as an obstacle threatening their very program. This attitude is counterproductive because proper transition is essential if tax reform is to achieve its goals of fairness and prosperity. Further, omitting transition from most tax reform proposals has greatly hurt their popular acceptance.

The Economic Consequences of Transition

Suppose you were the Chief Executive Officer of a company considering capital purchases in the coming year. You know you will need to borrow to make these purchases, which will include new production-line machinery, a few new delivery vans, and a new computer network. As you consider your company's future needs your chief tax officer reminds you that Congress is expected to enact a new flat tax. As the tax officer explains what tax reform means for the future you appreciate the scope of the matter and you readily grasp that this should be good for your company and the economy.

You then ask what tax reform would mean for your immediate investment decisions and the tax officer tells you the Congress has made no provision for transition. Perplexed, you ask exactly what that means, and he tells you that the interest on the company's existing debt would not be deductible, nor would the company be able to deduct the remaining depreciation on its new machinery. Your responses to this information, once your blood pressure is back under control, are to suspend all equipment purchases and borrowing, and then to call your company's representatives and trade associations in Washington, your Senators and your Representative to ask if the whole city has lost its mind.

While somewhat colorful, the above scenario would be repeated in offices and homes across the country. As tax reform without transition became more likely, economic sector after sector would slow to a crawl. For example, the real estate market would screech to a halt as borrowers figured the true cost of their pre-tax reform mortgages once they lose the mortgage interest deduction. Similarly, all possible business borrowing would be delayed in the expectation that interest rates would decline following tax reform due to the elimination of the tax on interest income. Businesses would face the prospect of being able to deduct only a small fraction of the cost of plant and equipment purchased just before tax reform, but they would be able to deduct the full cost of such purchases immediately after tax reform. Obviously, given these choices, businesses would delay every possible purchase of new capital until after tax reform. This would hardly garner popular support for tax reform.

Now suppose you are the Chief Executive Officer, but this time the chief tax officer tells you the flat tax is coming and the Congress has taken great care to address transitional concerns. Specifically, you will still be allowed to deduct the interest expense on pre-tax reform debt, and you will still be able to deduct depreciation expense on pre-tax reform investments. You may still delay some of your capital purchases to take advantage of the expensing feature of tax reform, but most of your purchases will go forward as planned. As this discussion occurs across the economy, it would be clear that effective transition would allow the economy to proceed without significant disruption pending the effective date of the new tax system.
Tax Fairness

Tax fairness is a universally accepted goal of tax policy. Yet, as has been noted whenever the subject is raised, tax fairness lacks a generally accepted definition.

Progressivity

One area in which there has long been disagreement relates to the appropriate relative tax burdens of different individuals at different income levels, i.e., the tax system's progressivity. In short, if two taxpayers are identical except that one taxpayer has twice the income of the other, should the higher-income taxpayer pay the same amount of tax as the lower-income taxpayer, twice the tax as the lower-income taxpayer, or more than twice the tax?

Average Tax Burdens

Another area of tax fairness under dispute is the minimum and maximum levels of taxation to which a taxpayer should ever be subjected. Even a highly progressive tax system need not generate high levels of average tax burden unless the revenue demands of the government are high.

Consistent Application of Tax Law

Beyond the disagreements regarding progressivity and aggregate tax burdens, there is general consensus regarding most other dimensions of tax fairness. For example, if two taxpayers are similarly situated in terms of their income levels, source of income, and their personal matters, then they should pay the same amount of tax. Also, if a tax system is applied irregularly across situations or jurisdictions, then it is generally agreed that tax fairness is not served.

Retroactive Tax Increases and Tax Cuts

One dimension of tax fairness about which there is almost total agreement is that the tax ought not be applied retroactively. That is, if you make your economic arrangements assuming a specific set of tax rules known to be in effect, then the government should not change those rules and apply the changes to your previous arrangements. This is simply changing the rules after the game has started and every grade-school child understands that is unfair.

For example, suppose you bought a piece of property to farm, to build a home on, or just to hold as an investment. And suppose the government confiscates it under the doctrine of eminent domain, or suppose it prohibits you from using the land as you intended because of a subsequent ruling based on environmental concerns. Even if the government's purpose and reasoning are sound, if it fails to compensate you at fair market value for the loss of your property, then the government has committed a "taking." The term "taking" is a legal expression intended to soften the reality that the government has stolen your property. This is, to say the least, unfair.

As a second example, suppose that you have researched a new process for strengthening metals and the result is a highly valuable and patented technological breakthrough. Suppose the government ignores your patent and uses the new process as part of a government project without compensating you. In this case, the government has stolen the product of your labors and your genius. They are your property every bit as much as your home and your paycheck.

As a third example, suppose you invest money in a project expecting to be able to deduct its costs based on current tax law. Suppose the government changes the tax law after you have made your investment so as to deny you the deduction for your costs. In this case, your tax burden will have been retroactively increased by the economic value of the denied deductions. Changing the rules in the middle of the game in this way to benefit the government at the taxpayer's expense is unfair at the very least and theft at worst.

Tax reform intended to advance the cause of tax fairness in the future cannot succeed if it raises taxes unfairly in the present.

A second dimension of tax fairness that arises with many tax reform proposals, including the flat tax, is avoiding retroactive tax cuts. Like a retroactive tax increase, a retroactive
tax reduction arises whenever a taxpayer makes a decision based on current law and then the law is subsequently changed in such a way as to reduce taxes on the consequences of these prior decisions and actions. A simple example of such a retroactive tax cut arises if an individual buys a bond paying taxable interest only to see the taxes owed forgiven under a new tax system.

Some tax reform advocates protest there is nothing wrong with retroactive tax cuts. They make two arguments. Their first argument is that the interest on the bond should never have been taxed in the first place and, indeed, would not be subject to tax if the bond were bought after tax reform. Granting both propositions, it does not follow that the taxpayer should receive a retroactive tax cut. Even if the tax on the bond's interest is ill-advised, that was the law at the time the asset was purchased, the asset's price was set based on that law, and the purchaser was presumably aware of this fact.

The second argument sometimes raised is that there is nothing wrong with retroactive tax cuts per se. This would be true if they could be enacted without some offsetting consequence. In this case, if tax reform is intended to achieve a specific amount of tax collections, then the offsetting consequence is that tax rates on all other taxpayers must be higher to pay for the retroactive tax relief. Thus, tax rates on new activity must be raised to pay for the windfalls accruing to past activities. If a general reduction in tax receipts is to accompany tax reform, then it makes far more sense to impose a lower tax on prospective activities where the economy can benefit from the potential behavioral effects than to grant a tax cut where consequent changes in behavior are clearly impossible. Again, a lack of transition is unfair and unwise.

The Political Imperative

Many tax reformers have actively advocated enacting a new tax system devoid of transitional provisions. For some, the political calculus is that the difficulties in developing a workable transition regime are so great and the economic benefits of tax reform so obvious, that they are willing to face the prospect of an immediate economic slowdown and the unfairness of retroactive taxation. Others apparently hope to put the problem off for another day. These attitudes have cost tax reform important political support on at least three counts. First, failure to address transition directly has exposed tax reformers to the criticism that they would accept the cold turkey approach as a solution.

Second, as noted above, the early adoption of a comprehensive transition regime is necessary to prevent taxpayers from assuming there would be no transition. In the absence of an explicit transition regime, taxpayers who would suffer such a retroactive tax increase are more likely to believe the tax hike they can calculate than the vague promise of tax relief or higher wages through faster economic growth. This would include such politically powerful groups as mortgage-paying homeowners and manufacturers with remaining depreciable basis on their books.

The third loss of political support for tax reform resulting from a lack of transition arises in the area of tax distribution. The flat tax, for example, shows a significant reduction in the tax system's progressivity when compared to current law. Most tax reform proposals contain only one tax rate, or at most two, and the upper rate is often well below the current top marginal tax rates. It is often presumed that the decline in progressivity under the flat tax is due to the decline in tax rates. While the decline in tax rates is somewhat responsible, the greater cause for the decline in progressivity is the widespread retroactive tax cuts that follow from a lack of transition.

All major tax reform proposals — flat tax, national retail sales tax, consumed-income tax — would shift the tax base from income to consumption. Even if each tax uses multiple tax rates, income taxes tend to be more progressive than general consumption taxes (as distinguished from targeted excises like the telephone excise tax) because an income tax base includes labor and capital income. A consumption tax base, on the other hand, expressly excludes most capital income. Because capital income is earned primarily by
upper-income taxpayers and the wealthy, including capital income in the tax base naturally makes the income tax more progressive.

A proper and comprehensive tax reform transition regime will materially affect the progressivity of the new tax system and must be included as part of the debate. Comprehensive transition would prevent retroactive tax reductions, which means that capital income derived from pre-tax reform saving and that is received primarily by upper-income taxpayers would still be taxed. The recovered taxes on upper-income taxpayers would elevate the progressivity of the new flat tax system relative to a flat tax without transition.

Many tax reform advocates are content if not outright anxious to see a reduction in the tax system’s progressivity. The focus of this intention, however, ought to be with respect to labor income and the fruits of new, post-tax reform saving. There is no political gain to be had, except among those who would reap the windfalls, of providing significant amounts of tax relief retroactively to the wealthy.

**Designing a Transition Regime**

At the date of enactment tax reform draws a bright line in the country's economic history. On one side of that line are all the decisions influenced by the old tax system, and on the other side are all the decisions influenced by the new tax system. In a world of perfect information and perfect knowledge, tax reform transition would subject all the economic consequences of decisions made prior to tax reform to the old tax system. In other words, transition would “grandfather” prior law treatment. This treatment would eliminate all but a few opportunities for tax reform to cause a retroactive tax increase or tax cut.

**The Grandfathering Principle**

Grandfathering prior law treatment is a natural solution for tax reform transition, and it offers the additional benefit of being fairly simple to apply. For example, suppose the home mortgage deduction were eliminated under tax reform. Home mortgage borrowers after tax reform would then not expect to be able to deduct their mortgage interest. However, homeowners who borrowed prior to tax reform expecting to deduct their interest expense would be allowed to continue to take the deduction under the grandfathering principle.

**Grandfathering Individual Taxpayers**

A transition system based on the grandfathering principle would work well for individuals. Individuals' labor income earned after tax reform would be taxed under the new system and so would be unaffected by

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1 Such an ideal regime would not guarantee that no taxpayer would be harmed from tax reform, nor would it guarantee that no taxpayer would reap a windfall from past actions due entirely to tax reform. Tax reform will alter the relative competitiveness of various industries and of businesses within an industry. The current tax system imposes a myriad of distortions that alter these competitive forces. Unwinding these distortions through tax reform would restore the natural competitive structure of the economy, one business relative to another and one industry relative to another. These changes will have economic consequences for taxpayers that may increase or decrease their tax burdens on income arising from prior law decisions. These consequences, however, arise from a change in the economic environment, not from a lack of transition.
transition. Individuals’ capital income is clearly traceable to specific assets. These assets result from saving that occurred either before or after tax reform. All assets acquired using pre-tax reform saving would be subject to pre-tax reform rules. All assets acquired using post-tax reform saving would be subject to the new tax rules. Similarly, their expenses, such as mortgage interest, to which they committed prior to tax reform and which are currently deductible would also be simple to grandfather. Grandfathering prior law treatment, therefore, effectively precludes instances of retroactive taxation and retroactive windfalls without complicating the new tax system.

It is a relative simple matter to apply current law to pre-tax reform savings. If the new tax system is a flat tax, for example, this would necessitate creating some mechanism for segregating pre-tax reform saving and post-tax reform saving out of labor income. This could be easily achieved by creating a separate flat tax account in which all post-tax reform savings out of labor income would be placed for investment. All income earned from investments held in this separate account would then be tax free under the new flat tax.

The creation of this separate account also opens the possibility that taxpayers would be allowed to translate their “old” capital into new capital by shifting it into their flat tax account after first paying some amount of tax on old saving principal. Future income earned on investments made by this shifted saving would then be subject to the new tax rules. The advantages of this solution to the taxpayer are certainty, simplicity, and flexibility. Meanwhile, the government accelerates its tax receipts.

**Grandfathering Business Taxpayers**

Grandfathering current law would work well as a transition system for individuals because items of income and expense can be clearly traced to their source and therefore can be readily distinguished as arising from pre- or post-tax reform activity. Similarly, a business’s expenses, i.e., interest expense and remaining basis, arise out of either pre-tax reform or post-tax reform commitments. Therefore, grandfathering is an effective means of dealing with most transitional issues arising from business expenses. Historically, this has been the greatest concern for the business community.

The Alternative Minimum Tax (AMT) also raises transitional issues for both businesses and individuals. The AMT is a parallel tax system that effectively accelerates a taxpayer's taxable income, either by accelerating the taxable receipt of income or by delaying the time at which a taxpayer may take a deduction, exclusion, or credit. When a taxpayer pays AMT, it is over and above the taxpayer’s regular income tax liability and the taxpayer qualifies for an AMT credit equal to the amount of AMT paid. The taxpayer is then able to apply accrued AMT credits to future regular income tax liability whenever it exceeds the taxpayer’s AMT liability.

Most tax reform proposals repeal the AMT. While an obvious improvement in the tax system, the repeal of the AMT raises a question about the status of accrued AMT credits. This question is easily answered when the transition system is based on the grandfathering principle. The taxpayer would be allowed to apply accrued AMT credits against its future tax liability under whatever new tax system is enacted, assuming the new system includes a tax on businesses as well as a tax on individuals.

Assuming there is a difference in the tax rates between the new and the old tax systems, the one dimension in which comprehensive grandfathering does not offer a satisfactory approach is with respect to net income from active trade or business. Business in-
come is necessarily the product of a multitude of investments, combined with labor. For the period immediately after tax reform it could be argued that virtually all business net income results from pre-tax reform investments and so should be subject to pre-tax reform treatment and tax rates. Then, as new investments are made, the income from these post-tax reform investments would be segregated and taxed under the new tax system. It would quickly become impractical if not impossible to systematically segregate income arising from pre- and post-tax reform investments. Thus, it may not be possible to address this tax transition issue directly.

In practice, the transition problem of business income is addressed indirectly and effectively by the other aspects of the tax transition system, namely the treatment of pre-tax reform-derived business deductions and individual saving. A common concern regarding the grandfathering of expenses arises when the new tax rate differs from the old tax rate, particularly if the new tax rate is lower. For example, if the tax rate is lower, then the value of grandfathered depreciation deductions would be lower as well, in which case the taxpayer would apparently not have been completely protected against retroactive taxation. This concern is readily assuaged because all future income, including income derived from pre-tax reform investments and commitments such as those giving rise to the grandfathered deduction, would also be subject to the lower tax rate. Thus, while the deduction is subject to a lower tax rate, so too is the resulting income.

If there is a residual benefit due to a lower tax rate on business income in the new system, then this benefit is largely recaptured at the individual level. Businesses typically earn returns in excess of the minimum necessary to justify the underlying investment. This excess return is called economic profit. If the new tax system imposes a lower tax rate than the old tax system, then a business' economic profit arising from pre-tax reform investments would be subject to a lower tax rate than was anticipated when the investment was made. This would clearly lead to a retroactive tax cut to the business' owners. If the business is a corporation, then the present value of this windfall as it arises in future years would more or less immediately be manifested in the form of a capital gain to the current shareholders. As noted above, the grandfathering principle applies to individual income earned on assets purchased prior to tax reform. Therefore, the capital gain arising from the application of a lower tax rate to economic profits associated with pre-tax reform investments would be subject to current law capital gains treatment at the shareholder level. The retroactive tax cut that occurs at the business level would be recaptured at the individual level.

**Further Issues in Transition**

The grandfathering principle seems to address the vast majority of tax-related transition problems fairly and simply. There may be specific situations, however, where special care will be needed either to prevent taxpayers from circumventing the intent of the transition regime or to prevent a retroactive tax increase.

An example arises with respect to depreciation. Under current law, most productive assets are depreciated over a number of years. Under most tax reform proposals, these assets would be expensed, i.e., charged against income in the year in which they are purchased.

This is obviously a more valuable treatment to the taxpayer and so taxpayers would be expected to attempt to have pre-tax reform depreciable assets recharacterized somehow as post-tax reform expensable assets. This situation is sometimes referred to as "churning."

For example, if a taxpayer purchased a stamping machine purchased prior to tax reform and sold it to another taxpayer after tax

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1 Mechanical rules apportioning income according to the fraction of a business's capital stock that was purchased before and after tax reform are one possible solution, but such rules would soon fail as reasonable approximations because they are predicated on the assumption that capital purchased before tax reform would be as profitable as capital purchased after tax reform.
reform, the new owner would be able to expense the asset, creating a tax windfall that would likely be split between the buyer and the seller. A natural solution to the churning problem is to require that pre-tax reform depreciable assets resold after tax reform remain subject to the old depreciation system. This could be achieved by having the original depreciation system and remaining depreciation amounts pass-through to the new owner.

Some care might also be needed to prevent a retroactive tax increase arising in cases where an expense is incurred after tax reform and the expense is associated with pre-tax reform income. For example, suppose a business opens a plant and the plant earns income for a number of years prior to and after tax reform. Suppose, as well, that the plant is closed at the end of its useful life and the business incurs expenses as part of an environmental cleanup of the site. Some of these expenses would be associated with income earned prior to tax reform. Presumably, the new tax system would continue to allow these expenses as deductions against income. However, if the new tax rate is below that of the old tax system, then the deductions associated with pre-tax reform income would be worth less to the business, resulting in a retroactive tax increase. While this may seem a fine point, full tax fairness will require that these issues be addressed in full.

Finally, tax reform will create accounting problems that are beyond the scope of tax transition to resolve. One example of such a problem arises for taxpayers that have accrued foreign tax credits. These credits have value because the taxpayer expects to be able to apply them someday to residual U.S. income tax liability on foreign source income. Thus, they are treated as accounting assets on the financial books. Under most tax reform plans, U.S. foreign source income would no longer be subject to U.S. tax. In effect, tax reform would eliminate accrued foreign tax credits as an accounting asset, replacing them with a tax reform benefit of greater value, namely the elimination of residual U.S. tax on foreign source income. Current accounting rules, however, would force the taxpayer to recognize the loss of the foreign tax credits without allowing the recognition for the offsetting tax benefit gain.

Complexity

Tax reform transition has often been characterized as suffering from two major hurdles — complexity and expense. As to complexity, many tax reform advocates have advanced the simplest possible transition system, which is, of course, no transition at all. Facing what appears to be an overly complex problem, they propose the "cold turkey" approach, accepting the likely recession and certain retroactive tax increases and tax cuts.

Without a doubt, depending on the choice of new tax system and the approach taken to transition, tax reform transition can be horribly complicated. Transitional complexity is a major difficulty for proposals like the national sales tax, which boasts that a great many taxpayers would be freed from ever dealing directly with the tax collector. Imagine the difficulty of trying to grandfather deductions for preexisting debt or residual depreciable basis for taxpayers who have been structurally eliminated from the tax system. For example, there is no ready mechanism for allowing homeowners to take a grandfathered mortgage interest deduction against their annual sales tax bills.

Tax reform transition can also be made complex if transition is enacted piecemeal, with no organizing principle. The vast complexity of the current tax system then opens the possibility of an equally vast and complex, virtually line-by-line transition system. Moreover, developing transition rules in this fashion falls to the political process with uncertain and uneven outcomes the only certainty.

Unquestionably, the current tax system is extraordinarily complicated. Its one redeeming grace is that taxpayers have, for the most part, learned how to deal with it. Businesses have spent hundreds of millions of dollars on tax lawyers and accountants, accounting software and computer systems to comply with the law. While this wasteful spending is one of the problems that tax reform is intended to address, the money has already been spent.
It is sunk cost. For most taxpayers the easiest possible transition system is current law for those assets and activities entered into prior to tax reform.\(^5\)

The current tax system would work equally well for individuals with grandfathered expenses such as mortgage interest. However, for individuals the most important transition issues arise with regard to the taxation of capital income. The simplest transition solution in this case would be to repeal the tax on capital income for existing saving, just as it would be repealed for capital income for future saving. This raises the problem of retroactive tax cuts, however, and so it is not an option if tax reform is to maintain its goal of tax fairness. The only way to achieve tax fairness and minimize complexity with respect to this “old” capital income is to continue to apply current law, at least for some period of time. In other words, for some period of time after tax reform’s enactment, income and capital gains from old saving would be subject to current tax treatment.

The Revenue Cost of Transition

A second major stumbling block for transition, and therefore for tax reform, has been the assumption that transition would temporarily and significantly reduce tax revenues. This apparent revenue cost has presented tax reform advocates with two choices. They could either accept a higher tax rate in their new tax system, albeit temporarily, or tax reform would be allowed to reduce tax receipts temporarily. These two unpleasant alternatives have reinforced the tendency of many tax reformers to fall back to the position that transition either can be ignored or dealt with later.

Most previous efforts at transition would dramatically reduce tax revenues because they approached transition piecemeal. In these efforts, transition packages are put together to address the key defined problems, such as remaining depreciable basis, interest expense, AMT credits, etc., the solutions to which all reduce the tax base.

As the list of key defined problems exemplifies, the proposed transition solutions solely address aspects on the expense side of transition. As we have seen, however, comprehensive transition involves both an expense and a revenue side. Comprehensive transition involves maintaining the current tax on capital income and capital gains accruing to the owners of assets purchased prior to tax reform. Thus, there is a significant revenue source to offset some of transition costs. The question is how much of the expense side of transition can be offset by these revenues.

Whether tax reform transition raises or reduces revenues will ultimately depend on how comprehensive the transition regime will be. This matter is explored more deeply in the Appendix. Using assumptions consistent with those of the official revenue scorers at the Joint Tax Committee and Department of Treasury, the worst case scenario is that comprehensive transition would be a very slight revenue raiser. Comprehensive transition could raise revenue on net if the average marginal tax rate on recaptured capital income (the transition tax on “old” capital) would be greater than the corresponding rate in the new tax system. If this is so, then transition could be a clear revenue raiser because capital income is subject to the current law rate, whereas the various expenses that would be grandfathered are subject to the new tax’s rate.

\(^5\) This is even easier for businesses than the cold turkey approach because from an operating business’s perspective, even no legislated transition regime is a change in the rules.

\(^6\) To be perfectly fair, that is, to avoid any potential retroactive tax cuts, this treatment would apply indefinitely. At some point, however, taxpayers would tend to find the separate treatment of old and new capital cumbersome, particularly as the fraction of total capital represented by pre-tax reform saving declined. A reasonable compromise might be to apply current law to old saving for a period of ten years.
Summary

In good times and bad, a more robust economy should be a top goal of policymakers. A stronger economy creates more jobs at higher wages, and it gives us the financial resources we need to address national problems. The existing income tax drains the economy of vitality by misallocating resources. Tax reform offers the promise of restoring that vitality.

Pointing to gains in the future, tax reformers have typically seen transition issues as overly complex, expensive, and distracting from greater issues, despite transition's immediate and compelling interest to taxpayers. In truth, comprehensive transition need be none of these things. The key to the matter is recognizing that a simple and fair treatment for decisions, activities, and investments made prior to the enactment of a new tax system is to subject the resulting income and expenses from these activities to existing tax law. In other words, grandfather all that happened before.

A transition regime built around the concept of grandfathering current law seems not only to resolve the well-known problems of transition but to facilitate the tax reform debate by removing unnecessary stumbling blocks. For example, grandfathering would restore much of the progressivity that is typically lost under the major tax reform proposals. Comprehensive transition also addresses common taxpayer concerns, whether of businesses or individuals, allowing them to refocus on the big picture.

Any tax reform proposal that lacks a plan for transition leaves open many crucial questions in the minds of taxpayers about how the new tax system would affect them and their businesses. Opponents of tax reform have used these doubts to deflect and misdirect the core debate of what sort of tax system the federal government ought to use as its primary revenue source. Until tax reformers commit to comprehensive transition, tax reform will continue to face these obstacles. Using the grandfathering principle for transition would eliminate these obstacles and allow tax reformers to focus on the grand issues of fundamental tax reform.

Appendix

The following two-period model demonstrates the essential revenue consequences of tax reform transition. The model is admittedly oversimplified. Yet its simplicity also allows an exploration of fundamental issues without bogging down in secondary issues. The model assumes the following:

♦ That an income tax is imposed in the first period.
♦ That a flat tax is enacted in the second period.
♦ That tax reform is revenue neutral.
♦ That the tax rate under the income tax would have been constant between periods one and two.
♦ That the tax base under both systems is comprised solely of labor income, capital income, and capital gains.
♦ That tax reform has no net effect on the economy in the second period.
♦ That both the flat tax and the income tax have a single tax rate, though the rates need not be the same.

Let federal income tax receipts in period one be given by

\[ R_1' = t_1' (L_1 + K_1 + K_1' - D_1 - D_1') \]

where

- \( R_1' \) = First period tax receipts under the income tax
- \( t_1' \) = Income tax rate in the first period
- \( L_1 \) = Labor income in the first period
- \( K_1 \) = Capital income that is included in both tax bases such as portion of what is currently included as corporate income
- \( K_1' \) = Capital income that is excluded from the tax base under the flat tax, such as dividends, interest, and capital gains
- \( D_1 = \) Deductions, exclusions, and credits, disallowed under the flat tax such as interest expense
- \( D_1' = \) Deductions, exclusions, and credits allowed under both systems such as

The following two-period model demonstrates the essential revenue consequences of tax reform transition. The model is admittedly oversimplified. Yet its simplicity also allows an exploration of fundamental issues without bogging down in secondary issues. The model assumes the following:

♦ That an income tax is imposed in the first period.
♦ That a flat tax is enacted in the second period.
♦ That tax reform is revenue neutral.
♦ That the tax rate under the income tax would have been constant between periods one and two.
♦ That the tax base under both systems is comprised solely of labor income, capital income, and capital gains.
♦ That tax reform has no net effect on the economy in the second period.
♦ That both the flat tax and the income tax have a single tax rate, though the rates need not be the same.

Let federal income tax receipts in period one be given by

\[ R_1' = t_1' (L_1 + K_1 + K_1' - D_1 - D_1') \]

where

- \( R_1' \) = First period tax receipts under the income tax
- \( t_1' \) = Income tax rate in the first period
- \( L_1 \) = Labor income in the first period
- \( K_1 \) = Capital income that is included in both tax bases such as some portion of what is currently included as corporate income
- \( K_1' \) = Capital income that is excluded from the tax base under the flat tax, such as dividends, interest, and capital gains
- \( D_1 = \) Deductions, exclusions, and credits, disallowed under the flat tax such as interest expense
- \( D_1' = \) Deductions, exclusions, and credits allowed under both systems such as
the current law amount of depreciation
and where the superscript letter I denotes
income tax.

If we let B denote the common elements
of the tax base in the two tax systems, then
(2) \( B_i = L_i + K_i - D_i \) for \( i = 1, 2 \)

Therefore, federal receipts in the first pe-
riod are given by
(3) \( R'_{1} = t' (B_1 + K_1 - D_1) \)

If the federal income tax were to remain
in effect in the second period, then federal re-
ceipts in the second period would be given by
(4) \( R'_{2} = t' (B_2 + K_2 - D_2) \)

**Tax Reform Without Transition**

Three key changes occur in moving to an
alternative tax system like the flat tax — some
capital income \( K_2 \) is excluded from the tax
base, some deductions and credits are elimi-
nated \( D_1 \), and some additional base broad-
eening occurs, such as the inclusion in labor
income of employer-provided health insur-
ance. Let this latter term be denoted by \( H \).

In the second period, suppose a flat tax
replaces the income tax, that it raises the same
amount of revenue as would have been gen-
erated by the income tax, and that there is no
provision for transition. Then revenues in the
second period would be given by
(5) \( R'^{F}_2 = t'^{F} (B_2 + H_2) \)

where the superscript \( F \) denotes flat tax,
and where, by assumption,
(6) \( R'^{F}_2 = R'^{F}_1 \)

Comparing equations (4) and (5) indicates
that the flat tax rate will be less than the in-
come tax rate if there is a net increase in the
tax base. That is,
\( t'^{F}_2 < t'^{F}_1 \) if and only if \( H_2 > K_2 - D_2 \)

**Tax Reform with Partial Transition**

Most transition systems deal only with the
revenue loss side of transition and thus require
a significantly higher tax rate to remain re-
due neutral. Suppose transition is compre-
hensive with respect to those provisions that
lose revenue and suppose there is no transition
with respect to revenue-raising provi-
sions. Then tax revenues in the second pe-
riod under a flat tax with partial transition can
be written as
(7) \( R'^{PF}_2 = t'^{PF} (B_2 + H_2 - D_1) \)

Since tax reform is still constrained to be
revenue neutral, it follows that
\( R'^{PF}_2 = R'^{F}_2 \) which implies
\( \frac{t'^{PF}_2}{t'^{F}_2} = \frac{B_2 + H_2}{B_2 + H_2 - D_1} > 1 \)
if \( D_1 > 0 \)

so that tax reform with partial transition
necessitates a higher tax rate, everything else
held equal.

**The Revenue Consequences of
Comprehensive Transition**

Now consider tax reform with a compre-
hensive transition system. Under such a sys-
tem, all income arising from previous invest-
ments and decisions would be subject to prior
law treatment and subject to the prior law tax
rate. Similarly, all deductions and credits dis-
allowed under the flat tax would be subject
to the prior year tax treatment and rate. To
represent this new treatment, we need to iso-
late the capital income and deductions arising
from decisions made after tax reform from the
capital income and deductions arising from de-
cisions made before tax reform. Thus let
(8) \( K_2 = K'_{2,2} + K'_{2,1} \) where

\( K'_{2,2} = \text{Capital income earned in period two from investments made during period two} \)

\( K'_{2,1} = \text{Capital income earned in period two from investments made during period one} \)

To simplify matters slightly, let \( K'_{2,1} = K'_{1} \),
implying no change in capital income from
period one to period two from investments made in period one. Applying similar treat-
ment to \( K'_{1}, D_{1}, \text{and } D'_{1} \) yields

\( K'_{2} = K'_{2,2} + K'_{1} \)

\( D_{2} = D'_{2,2} + D'_{1} \)

\( D'_{2} = D'_{2,2} + D'_{1} \)

Recall that the apostrophe indicates that
the item of income or expense was allowed
both in the income tax and the flat tax. Thus,
revenues under the flat tax with a comprehensive and ideal transition regime can be written as

$$R^{CF}_{2} = t^{CF}_{2} (L_{2} + H_{2} + K'_{2,2} - D'_{2,2}) + t' (K_{1} + K'_{1,1} - D_{1} - D_{1}')$$

A fundamental question is whether comprehensive transition raises or lowers tax receipts on balance. This question can be answered by taking the following difference

$$R^{CF}_{2} - R^{F}_{2} = t^{CF}_{2} (L_{2} + H_{2} + K'_{2,2} - D'_{2,2}) + t' (K_{1} + K'_{1,1} - D_{1} - D_{1}') - t^{F}_{2} (L_{2} + K_{2}' - D_{2}' + H_{2})$$

Evaluate the expression on the right hand side, setting $t^{CF}_{2} = t^{F}_{2}$. If the resulting expression is greater than zero, then transition raises revenue, on net, so a flat tax with comprehensive transition can actually be revenue neutral at a lower tax rate. Manipulating (10) yields

$$R^{CF}_{2} - R^{F}_{2} = t^{F}_{2} (K_{2}' - D_{2}') - t^{F}_{2} (K_{2}' - D_{2}') - t' (K_{1} + K_{1}' - D_{1} - D_{1}')$$

Recall that

$$K_{2}' = K_{2,2}' + K_{1}'$$

and

$$D_{2}' = D_{2,2}' + D_{1}'$$

so (11) can be reduced to

$$R^{CF}_{2} - R^{F}_{2} = t^{F}_{2} (K_{2}' - D_{2}') - t' (K_{1} + K_{1}' - D_{1} - D_{1}')$$

The first term on the right in (12) essentially represents the current law tax on the economic profit earned in period two from investments made in period one and is clearly positive and large. It is also the bulk of the net retroactive tax cut that would arise without transition.

The second term on the right hand side of (12) is the product of two elements. The second element $(K_{1}' - D_{1}')$ reflects the economic profit from period one investments that is included in both the income and the flat tax bases and is assumed to be positive. Thus the second term overall is positive if the income tax rate is higher than the flat tax rate. If it is positive, then this term represents the remainder of the retroactive tax cut that would arise without transition. If it is negative, then it represents a retroactive tax increase that is prevented by comprehensive transition. Even if the second term in (12) is negative because the flat tax rate is sufficiently higher than the income tax rate, the second term is likely to be much smaller than the first because it is the product of two differences.

On balance, it is nearly certain that the sum of the terms on the right hand side of (12) is positive and large. This implies that comprehensive and ideal transition is revenue raising, on balance. A second implication of this result is that the flat tax with comprehensive and ideal transition can be enacted with a lower tax rate on future economic activity than can a flat tax with no transition.

This two-period model is made possible by a set of simplifying assumptions which were laid out at the beginning of this Appendix. All but one of these assumptions is straightforward and natural and so probably cannot be said to bias the results. The assumption that tax reform does not affect the economy, however, could materially affect whether tax reform transition raises or loses revenue. In practice, this is the assumption made by the official scorers at the Joint Tax Committee and the Department of Treasury, so it is not entirely unreasonable. Moreover, if tax reform benefits the economy as advertised, then revenues would presumably be higher and the new system's tax rate could be lower than if this additional economic growth is assumed not to arise.

The official scorers ignore these additional revenue effects for tax reform generally, so consistency would argue for ignoring changes in the parameters of transition, particularly the amount of income from old capital that is re-captured and brought back into the tax base. This is important because capital gains and losses on assets purchased prior to tax reform will remain subject to prior law tax. If tax reform causes these assets' prices on balance to drop significantly, then tax reform will cause capital losses that would not otherwise occur and thus reduce capital gains tax revenue below what would otherwise occur. Similarly, if tax reform were to cause the prices of these old assets to rise, then there would also arise an extra amount of capital gains tax revenue.