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REPORT OF THE NATIONAL COMMISSION ON ECONOMIC GROWTH AND TAX REFORM

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

JANUARY 31, 1996

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REPORT OF THE NATIONAL COMMISSION ON ECONOMIC GROWTH AND TAX REFORM

WEDNESDAY, JANUARY 31, 1996

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SD-215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Chafee, Simpson, Pressler, Murkowski, Moynihan, Breaux, Conrad, and Moseley-Braun.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Let me begin first by welcoming everybody, particularly our distinguished witnesses, to this, the first in a series of very important hearings.

These hearings are being held for one very specific reason. There is great unhappiness—perhaps unprecedented unhappiness—and frustration with our current tax system. This unhappiness and frustration are borne by a Tax Code that is not only complex and expensive, but counterproductive to economic growth.

The Tax Code is now so out of control that it takes taxpayers six billion hours per year to comply, and costs businesses and individuals an estimated $192 billion annually.

You get an idea of how ridiculously complicated the Code has become just by looking at the size of the tax preparation manual like the ones here on my left. Frankly, it is no wonder that Americans are fed up.

Now, these hearings are being held because the time has come to increase jobs, opportunity, and growth for Americans everywhere, to reward risk-taking, to restore fairness, to create an environment where the economy can grow, bring security to all families.

America's past has proven that the right kind of tax reform, including the Kemp-Roth tax cuts in the 1980s, can be a boon for economic growth. It is, indeed, a pleasure to have my partner in that historic endeavor with us today, Jack Kemp.

Just let me welcome at this time also my good friend and colleague from Delaware, Pete du Pont, former Governor. And, of course, we are delighted to have the Treasurer of California, Hon. Matt Fong.

It is clear, Jack, that neither of us is ready to give up our efforts at tax reform, and there is good reason why we are not. The current Tax Code is rife with problems, problems that not only dampen, but discourage economic growth.

The current system double-taxes savings, thwarts investment, hinders productivity, it increases prices, stifles wages, and hurts exports, and I do not have to tell you sitting at the panel how complex. It has exploded in length to nearly six million words, from 750,000 four decades ago.

I am especially concerned about the burden the tax system places on America's working families. I was especially touched by a story about an Iowa family, the Merten's.

The story was first told in the New Yorker, and later by James Glassman. Kenny Merten, age 51, and his wife Bonita, 49, have two children. Kenny works as a laborer for a barricade company, Bonita works for a nursing home.

Together, the Merten's earned $32,429 in 1994. Of that income, almost 25 percent went to taxes. 25 percent. This leaves them in the kind of situation where they are forced to buy powdered milk instead of real milk, beans instead of meat, just to make ends meet.

And if that wasn't enough, in addition to the money they have to pay the federal, State, and local governments, the complexities of the tax system forced them to pay over $100 to H&R Block to get assistance in preparing their tax return.

It is for the Merten's and for the millions of Americans just like them that we are beginning these efforts to overhaul the Tax Code.

I appreciate very much the Kemp Commission's hard work and the report it produced. It contains important criteria for real reform, criteria developed from hearings the commission held across America.

I cannot overstate how important these hearings were, giving families, small business men and women the opportunity to be heard. The commission's report will help guide us in our tax reform effort, an effort that will be guided by some basic criteria.

These criteria include: (1) real reform must lead to a Tax Code that is simple; (2) it must lead to a Tax Code that is fair, fair to America's working men and women, fair to our families, fair to business; (3) it must promote American competitiveness; and (4) real tax reform must create incentives for savings, investments, and jobs.

These criteria are not intended to be exclusive. I fully expect as we continue our work throughout the year that this list will grow.

In the months ahead, the Finance Committee will examine many reform proposals, from flat to VAT, and I mean many. To follow the media these days, it would appear that there is only one proposal, the flat tax. But that is only one of several that we will carefully explore. There are others. At this stage, I have an open mind concerning each of them.

In the months ahead we will look at the value-added tax advocated by Congressman Gibbons as a replacement for the current income tax. The VAT has the virtue of eliminating the headache of an income tax for everyone, but, as our European trading partners who use the VAT tell us, it's not panacea.

We will look at national sales tax proposals like the one proposed by Senator Luger. This proposal would also life the burden of income tax compliance on our families but it could adversely impact State revenues, which are highly dependent on sales taxes.

We will look at the Domenici-Nunn proposal, aimed at encouraging savings. Their proposal would increase the national savings rate, something that I have long advocated, but it would also retain much of the complexities of the current Tax Code.

And, yes, we will look very closely at the various flat tax proposals being offered by Senators Graham, Shelby, Specter, as well as Congressmen Armey and Gephart. These proposals will appear to simplify the Tax Code, but some might also dramatically affect many tax-favored activities such as the home mortgage interest deduction, a deduction that has enabled millions to realize the American dream.

Let me praise Bill Archer, Chairman of the House Ways and Means Committee. He, too, has pledged to take up meaningful tax reform. I look forward to the opportunity to work with him, as well as with colleagues on both sides of the aisle.

To be successful, tax reform must find a bipartisan consensus, because only in that way, Pat, can we develop a Tax Code that is stable, one which allows Americans to prepare for today and plan for tomorrow.

So, I am grateful to be a part of this important effort, which I believe is essential for America's future. While the road ahead may appear long and difficult, I'm an optimist. I believe it can happen and I believe we can build a bipartisan consensus on this very important issue of tax reform.

Pat?

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Mr. Chairman, let me thank you for this auspicious beginning of a large enterprise. Let me accept your offer that this needs to be a bipartisan effort, and it should be seen as an urgent one.

Just 2 years ago I received what was then an annual letter of sorts from the beloved Erwin Griswold, who was our Solicitor General and sometime Dean at Harvard Law School.

He began working on tax law in 1930 in the Solicitor General's Office under President Hoover. He wrote the great text on it, and was the national authority on it. As a matter of principle, of honor, almost, he made out his own tax returns and he kept track of the time.

He wrote, and I would like to ask that the letter might be placed in the record.

The CHAIRMAN. Without objection.

[The letter appears in the appendix.]

Senator MOYNIHAN. His returns for 1993 required almost 100 hours of Erwin Griswold's personal calculation, computation, and compilation. He, as a matter of principle, I said, would not use a tax accountant. He wrote a nice phrase. He said, "Paying an accountant to do the work seems to me a little like the Civil War practice of hiring a substitute in order to avoid the draft."

But he ended saying, "I venture to suggest that somehow or other a better solution to these problems must be found. A tax law can never be as precise as the drafters have been trying to make it over the past several years.

It is my earnest hope that the Ways and Means Committee and the Finance Committee will take steps to simplify this whole operation, making it possible for the ordinary citizen to comply with his responsibilities and to understand what he is doing in the process, which reduces the issue to one of citizenship in the most elemental and important ways."

So, we are involved in something more than increasing the rate of growth, or whatever, we are dealing with the fundamentals of citizenship in a democracy.

I thank you for this offer, sir, and I accept.

The CHAIRMAN. Thank you very much, Pat.

John?

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM RHODE ISLAND

Senator CHAFEE. Thank you, Mr. Chairman. First, I want to thank this commission for all the hard work they have done, and I greatly look forward to this hearing.

I might say, put me down as a skeptic when we are talking about the so-called flat tax. I know that I am not sure they want this to be termed a flat tax.

But I certainly recall, as do all of us on this committee, the great effort we made in 1986, under the leadership of Bob Packwood, to reduce, and in many cases eliminate, the credits, exemptions, deductions, and, in return, we promised a lower tax rate, which we gave.

Ever since then—and, by the way, that, as you all remember, passed out of this committee unanimously and was close to unanimous on the floor of the Senate—as we all know, those credits, exemptions, and deductions which we reduced or eliminated have been constantly under siege.

For example, we had no difference, as you will recall, between the capital gains and the ordinary income rate, and that was restored. Now the cry is to cut it even more. The cry now currently is to give a $500 tax credit for every child that one has.

I must say, I have always felt that simplicity is the enemy of fairness. You can have a very, very simplistic thing, but then you look at somebody who has had a tragedy, tremendous medical expenses, for example. Are they to be deducted? You have a fire that rages through your house and destroys your house. Is that a deduction? On and on you go.

You have one person that has 10 children, the other has one. Is it a flat tax? Do you give an exemption for the children? I just hope that that philosophy that I enunciated is proven to be completely wrong today. So, I look forward greatly to this hearing. Thank you.

The CHAIRMAN. Thank you, John.

Senator Breaux?

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. Thank you very much, Mr. Chairman, and thank the commission and Matt Fong for being with us. I am delighted to see my two former colleagues from the House who are here with us. We served together in the House many years ago.

I am glad to see they are doing so well in the private sector, and appreciate what you have recommended and the work that you have done in putting this report together. I think it is going to get a lot of attention, it has already received a lot of attention. I think all of that is good in the sense that we are going to have, over the next several months a real discussion about what type of a tax system we want in this country.

I happen to feel that we ought to be making this effort. It is good that tax reform will be the subject of the Presidential debates. Hopefully, after all of that debate is completed we in this Congress can take a serious look at it in the next Congress. I do not think anyone thinks we are going to make radical changes in this Congress.

I happen to think the concept of taxing consumption rather than taxing productivity is probably something we ought to take a look at. I think this country, in concentrating on taxing productivity, has not necessarily produced the best results. Taxing consumption is perhaps something we ought to take a look at.

But I think that we have to be careful. I think that if we had the Steve Forbes proposal before the Congress, I could just see how people would react in this country.

I can see all the real estate interests and all the homebuilders marching on Washington, carrying a float. On top of the float would be the Pope and Mother Theresa objecting to the loss of the mortgage deduction and the loss of the charitable deduction.

I think we would be besieged by citizens in this country when they find out what the proposals really are about. So, it's going to take a lot of thought and careful consideration.

I have looked at the report. You have done a lot of work on this, and I commend you for it. But, with apologies to my good friend, Jack Kemp, the chairman, it is sort of like the punt and pass proposal.

The report punted on a rate and passed on a lot of specifics that would encompass a specific proposal to the committee. We would like to hear more about your thoughts on what type of rate would be fair and what type of tax base to which the rate is applied. These cases are what we are going to have to wrestle with.

So, I think this discussion is good, and I look forward to your testimony. Thank you.

The CHAIRMAN. Thank you, John.

Frank?

OPENING STATEMENT OF HON. FRANK H. MURKOWSKI, A U.S. SENATOR FROM ALASKA

Senator MURKOWSKI. Good morning, Mr. Chairman. I have a few comments that I would like to offer before our witnesses testify, and I want to apologize to the Chairman. I am going to give a few examples of horror stories, and, being on the White Water Commit-

tee, which convenes at 10:00, I have got to get over there for some more. So, please excuse me.

Let me join in welcoming the commission. Jack, it is nice to see you again. The last time we discussed, or I listened, I should say, to your comments——[Laughter.]

Senator MURKOWSKI [continuing]. Was at a Super Bowl breakfast down in Florida where we came to hear about football and heard about the flat tax. So, it is nice to see you again.

Let me just comment briefly, because over the next two and a half months, I think, we are going to see roughly 100 million individuals and families that are going to have to grapple with the forms, the instructions, the worksheets, and the tables that make up the Income Tax Code.

The interest in the flat tax that your commission, Jack, recommended, and the interest it is certainly generating nationally with all the Presidential primaries, I think, is a testament to the fact that an overwhelming majority of Americans are simply fed up with the complexities of the current tax system.

Last year, I noted that this committee found that the IRS instructions for the 1994 returns suggested that the average amount of time for recordkeeping—and that is learning about the law or the form and preparing the 1040 form—was nine hours and 39 minutes. Well, I do not know anyone who ever really believed that.

We have got this form this year, the 1040 form. Guess what? IRS now says the average time for the same task as last year is now 11 hours and 38 minutes. Now, that is two hours longer and we did not even change the tax law. So I do not know where the estimate came from, but, clearly, somebody was guessing.

Last year, the IRS claimed that the average taxpayer would have to spent another 4 hours and 5 minutes to complete Schedule A. This year they have upped that same estimate to 4 hours and 35 minutes. Last year they said another 58 minutes would be needed to complete Schedule B. That is the interest and dividends. This year they have upped that time to one hour and 18 minutes.

Well, Mr. Chairman, that is a total of 17 hours and 31 minutes. If you believe these estimates, I have got a nice bridge in Alaska that I would be happy to sell you and the price is right.

Now, the fact is, the tax forms are becoming more and more confusing and complex, and that is really not the fault of the IRS, it is the fault of Congress and we all know it, because we continually tinker with the process and the Tax Code.

I would also note that the 17 and a half hours IRS claims that it takes for the 1040 is really basically meaningless, because Americans are so intimidated. I looked at that stack of instructions that you had on the table, Mr. Chairman, and that is real intimidation. They are so intimidated by the forms that they simply pay somebody else to go ahead and prepare them. One of the things that I have been doing lately in speaking to various groups is asking, how many people are out there in the audience that actually prepare their own tax return? You get six, seven, eight, nine, out of 100 people. That is a fact.

Now, obviously there is a great appeal for simplicity, easy-to-understand forms, not just for individuals but for businesses. But, as members of the committee, we know only too well, getting from

here to there is not an easy task. As we say, the devil is in the details. In this case, the details are fundamental to our society.

Ten years after our last effort at tax reform we will have to ask the American people, what kind of trade-offs do they really want: deductibility of State and local taxes; do they want to keep a mortgage interest deduction; what about charitable deductions; and how about the base of income, how should that be defined; should the employer provide health benefits, should that be included in income; what about pension contributions; what about the exclusion for employee educational expenses; what about the deduction for health care? These are some of the trade-offs that we are going to have to weigh and consider in a complete revision of the income tax form.

I look forward to working with the commission, and you, Mr. Chairman, and my colleagues in seeing if we cannot find a way to simply make it simpler, and, as Senator Chafee said, fairer as well.

I thank the Chair and look forward to the statements of our distinguished guests.

The CHAIRMAN. Thank you, Frank.

Kent?

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Thank you, Mr. Chairman. I thank the distinguished guests as well.

As a former tax administrator, I am especially interested in this debate. I want to commend you and this commission for helping kick off what I think will be a very healthy debate around the country as to, how we raise the revenue to fulfill the obligations that the government has taken on? I think all of us want to simplify the tax system, make it more fair. I think those are goals that are broadly shared.

I can tell you, when I was Tax Commissioner of the State of North Dakota, when I took over we had two income tax systems, the Federal income tax system and a separate State income tax system.

I said to the State legislature, you know, there would be a way to dramatically simplify things for the people of our State if we just take a percentage of the Federal liability, we would do it on a postcard, and eliminate hundreds of thousands of hours of tax preparation.

The legislature bought that argument and we put in place a very simple tax system that came off of the Federal system. Of course, doing that you take on the difficulties of the Federal system, but, still, you eliminated one entirely additional tax system. It was very popular in the State of North Dakota.

But, as I look at some of the flat tax proposals, especially the one that is getting, perhaps, most of the attention, the Forbes flat tax proposal, it strikes me that it is not flat, it is not fair, and it would dramatically increase the deficit.

I saw a Bob Dole ad running this morning on television that is a Bob Dole ad, saying that Steve Forbes' flat tax idea would increase the deficit $186 billion a year. It was one of these television

programs that tries to assess the truthfulness of political advertising.

So they went through an analysis of whether or not Senator Dole's charge was correct, that the Forbes flat tax would increase the deficit $186 billion a year. They went to the Tax Foundation, and the Tax Foundation said, well, that is very close to being right. Their estimate was that it would increase the deficit $173 billion a year. If that is the outcome from a flat tax, it is counter to our long effort to try to balance the budget by the year 2002.

The notion that we are going to dig the hole deeper before we start filling it in is not very attractive, especially for those of us, I think, who have been part of the Chafee-Breaux group, who, on a bipartisan basis, have agreed on a deficit reduction plan for the next seven years.

Perhaps we are the only group that has been able to reach agreement, but we have reached agreement under the able leadership of Senator Chafee and Senator Breaux, and about 20 Senators, evenly divided between Democrats and Republicans who want to balance the budget. To go in the opposite direction, I think, is totally counterproductive in terms of reaching balance.

The second point is that the tax is not a flat fair tax. I think it is impossible to justify to people that folks who are working at perhaps two jobs, they are going to have their income taxed, but somebody that has inherited money is going to be in a position of not having their investment income subject to tax, at least under the Forbes flat tax proposal.

I thought Morry Taylor, who is one of the Republican Presidential candidates, said it very well. He said, look, I have $15 million of capital gains income and I am not going to pay any taxes on it, but somebody who is working for me who makes $50,000 a year has their labor taxed? That is not fair. I think he is right, that is not fair.

Finally, I noticed with some interest the Newsweek story written by Alan Sloan that talked about the Forbes flat tax and called it appealing, and then went on to say, too bad the numbers do not add up. He said, things start to fall apart when you look at how the Forbes plan would actually work.

I must say, that has been my conclusion as well, that it does not add up, it is not fair, it is really not a flat tax at all, given the fact that investment income and dividend income, does not get taxed, while somebody who is working for a wage is taxed.

One other thing I noted with interest is a little box they had in the Newsweek story on "Who Wins and Who Loses." They pointed out that somebody with $20,000 a year of gross income, even though they have got an exemption for the first $36,000, loses because they lose their Earned Income Tax Credit. So, they would pay $355 more a year than they current pay.

At $75,000, it was about $9,000 under the current tax structure. They would go down to about $7,500 under the Forbes plan, so they would get a slight break. But the dramatic change is at $300,000. They pay $77,000 under the current structure. Under the Forbes flat tax proposal, they would pay $43,000.

So what, in effect, you have here is a shift onto the middle class and lower middle class, at least with respect to those examples. I do not think that really ought to be the outcome here.

I would be very interested to hear how you and your commission proposes avoiding those defects. I know that you have not filled in a lot of the specifics, but I would be very interested to hear how you intend to negotiate the shoals and avoid those outcomes.

The CHAIRMAN. Carol?

OPENING STATEMENT OF HON. CAROL MOSELEY-BRAUN, A U.S. SENATOR FROM ILLINOIS

Senator MOSELEY-BRAUN. Thank you very much. At the outset, I want to congratulate the Chairman for calling this meeting and giving us an opportunity to begin this debate.

Mr. Chairman, I saw you on television this morning and I was delighted that you did not at the time take a position with regard to any of these proposals, but suggested to the American people that this was the beginning of a debate. I think that is precisely where we have to be.

There is no question also, in regards to this debate, that the American people are interested in tax reform of some sort, certainly, simplicity—the Tax Code is entirely too complicated—promoting savings and investment, having fairness in the Tax Code. These are all laudable goals that people want to see happen.

I was tickled, actually, to meet recently with a woman who does taxes for a large multinational corporation, an American company. She has a picture on her desk of herself sitting at a conference table with 30 large, bound volumes of paperwork all spread out on either side of her. She is in the middle, and she is signing something.

She says, I am signing on the bottom of this document that every statement in this tax filing for my company is true and correct, which, of course, is a joke. The fact is, our tax system is complicated.

However, having said that, the question is, how do we get there? How do we get to fairness, how do we get to the kinds of values that a tax system necessarily reflects? Really, in the final analysis, that is what a tax system does, it reflects the values of a community, it reflects that we think is important.

In that regard, I want to associate myself with some of the comments that my colleague, Senator Conrad, made. I am concerned about shifting the tax burden to the middle class.

I am concerned about shifting and exacerbating the disparities of wealth that we are seeing more and more as a phenomenon of American economic life. People who are at the bottom 10 more often tend to be more stuck there; people at the middle class are, more often than not, uncertain about their ability even to maintain, much less to move ahead; people who are wealthy are getting wealthier and wealthier and also able to hold on to their money more. So, the investment in the savings is not happening. We want to, I think, affect changes that will not exacerbate the disparities in wealth.

But there are two specific issues with regard to this current proposal that I have. The first, is to ask a basic kind of fundamental

question, which is, why is it that this proposal would tax money that is made by a person's labor, by the sweat of their brow, if you will, and not tax money made by money?

That is to say, if you work for a living, if you have income from that labor, you will pay tax on it. If you just clip coupons from something you inherited from your grandfather, you do not pay anything on that. That is the first issue.

The second issue has to do with the whole issue of deductions. I noticed that in this specific proposal there are some deductions and exemptions having to do with payroll taxes and the like, so it's not a pure flat rate. But, certainly, with regard to mortgage interest, with regard to charitable deductions, with regard to State and local government tax exemptions, those issues are very, very important. On mortgage interest, remember what happened in 1986 when there were changes in the Tax Code affecting real estate? The real estate market went down and it had a ripple effect on our entire economy.

If this proposal fools around with mortgage interest deductions, which most middle class people particularly rely on, I mean, it is almost an article of faith in America that you can deduct the interest on your mortgage payments, if that gets changed, will that not have an impact on real estate prices? Will that not have an impact on the economies that are associated both in a secondary and tertiary way to real estate?

If you get rid of the charitable deduction, will that not have an impact on charitable giving, which fills in, as you know, an awful lot of activities that the government does not pick up? There are some of us who do not take deductions for our church givings, but most people take deductions for charitable giving. If that is gone, there is no place, given the fact that we are trying to balance the budget, to make that up.

So I would ask those four questions, actually. One, with regard to why tax labor and not tax money, or tax the money that labor makes and not the money that money makes; second, is mortgage interest deduction; charitable deduction; and the State and local bonding authority.

The CHAIRMAN. Thank you, Carol.

Jack, we are finally to you.

STATEMENT OF JACK KEMP, CHAIRMAN, THE NATIONAL COMMISSION ON ECONOMIC GROWTH AND TAX REFORM, AND CO-DIRECTOR, EMPOWER AMERICA, WASHINGTON, DC

Mr. KEMP. First of all, thank you for this opportunity, because it really, in my opinion, is an opportunity to begin a national dialogue and debate over the type of things that have been asked in the comments by the distinguished Senators on both sides of the aisle.

And let me say, Mr. Chairman, never to correct you, but it was not Kemp-Roth, it was Roth-Kemp, for which I am very proud.

The CHAIRMAN. I want to guarantee that anything that comes out of here is going to be Roth-Kemp.

Mr. KEMP. Right, right. [Laughter.]

Third, Mr. Chairman, I do not think this debate could have taken place in 1986 or 1989; it certainly did not take place in 1990

or 1993. In some ways, it began a long time ago at the founding of our Republic, and in other ways it takes place at a propitious time in the history of our country because we can begin to think, in a post-Cold War era, about reorganizing just about everything that is fundamental to the American idea or the American dream.

There is no man or woman on either side of this debate who does not care about the same things that Jack Kemp and his wife and family, or the du Pont, or Fong, or any member does.

We believe with all our heart that the dream of America is not to be caught in a static condition, but, as Lincoln said, to be able to improve our lot in life. I do not personally favor cutting taxes on the middle class. I do not favor cutting taxes on the rich.

I would have trouble if I did not say I do favor cutting taxes on the poor, because I think they face the most burdensome barrier to getting out of poverty, which is linked to what Senator Moynihan has so well articulated for so long, that the system discourages effort, work, marriage, and family and the qualities that we assume that are pretty much a given in our society.

We went at this, thanks to Bob Dole and Newt Gingrich who made their appointment last March or April, with the idea of actually listening to people. I know that would come as a shock to Senator Murkowski that Jack Kemp could actually sit still long enough to listen to people, but we heard thousands of hours of testimony, had hundreds of witnesses.

It would not have been a Kemp or pro-growth tax reform commission without going not only to Silicon Valley, but to South Central Los Angeles; and not just to Omaha, Nebraska and Charlotte, North Carolina, but to East Harlem, thanks to Charlie Rangle, who set up a meeting for us in East Harlem; or to Howard University, upon whose board I proudly sit, to listen to people talking about getting access to that which all too many people take for granted, i.e., upward mobility and fluidity in a society in which there are no boundaries to the individual's ability to reach his or her dreams, aspirations, and hopes. Indeed, we entitled our commission report, "Unleashing America's Potential."

So, I would like to submit it for the record. I would also like to submit, Mr. Chairman, the appendices, which discuss many of the things which have been brought up in the early round of concerns by members of this commission.

Let me make one other point. I think Bob Dole and Newt Gingrich did a good job of appointing men and women who represented different elements of our society: Matt Fong is the Treasurer of the State of California, as was Ken Blackwell; Pete du Pont, former Congressman and former Governor of Delaware, along with Carroll Campbell; Shirley Peterson, former Director of the IRS brought a unique perspective to the problems that had been alluded to in the previous comments. We had some pretty wealthy people, Mr. Chairman, but they did not start wealthy.

In my opinion, one of the biggest mistakes being made in this debate today is that when we talk about the poor, or talk about income from labor, or talk about income from capital, it is a snapshot in time.

America is not static, or should not be static. The very people who work today may be the saviors of tomorrow. The very man or

woman that labors in the vineyards today may someday own the vineyard. The truck driver may buy the truck and start his or her trucking company which, again, to quote Lincoln, is what the system of government was founded upon as a premise.

My daddy was a truck driver and bought the truck and became a small businessman in Los Angeles, California. I think every story in our commission's background reminds us that America is never meant to be a static condition.

I hope we do not, Mr. Chairman, just focus, with all due respect, on the Merten's and their taxes, because I think that, too, is too small a view of what tax reform could be to the American people. It is important to see it today because the Merten's are overtaxed.

When President Kennedy was President or when President Truman was President, the Merten's would have paid—hard to say, but I will bet you there is no way they could have paid 25 percent. It would have been closer to 4 or 5 percent.

Something is happening to the American dream. Every family needs two workers, almost. In fact, income from one breadwinner is not enough in America today, and that says something about the tax system, as well as other problems that exist.

I could not go through, or at least begin my remarks, without my friend, Pete du Pont, who has been such a valuable contributor, and Matt Fong, an equally valuable contributor; without mentioning Jack Faris, President of NFIB, did not start out as the President of NFIB. Dean Kleckner, President of the American Farm Bureau; John Snow, Chairman, President and CEO of CSX; John Wieland, a homebuilder; Herman Cain, President and CEO of Godfather's Pizza. His story is as eloquent a story of the American dream as is any man or woman sitting up there or sitting in our audience. And my friend, Ed Feulner, and myself as the Chair. Grace Marie Arnette, who is here, was our Executive Director. Alan Reynolds, of the Hudson Institute, was our Research Director.

I just wanted, Mr. Chairman, to not read the report, it is there, and I hope it is in the record in its entirety, as I know you would do. But we did make a point that I would feel like I had not done my job if I did not repeat the first paragraph or two of our commission's report.

We just said, to the Congress and to the President, the current Internal Revenue Code should be repealed in its entirety, in toto. We expect skepticism, as there should be as we look at this great issue. But we think the present system, Senator Chafee, is beyond repair. Tinkering will not get it done.

It is time to replace, we said, this failed system with a new, simplified tax rate system for the 21st century, a single low rate, taxing income but once with a general personal exemption for low income, and full deductibility of the payroll tax on the principle, Senator Moynihan, that we should not tax taxes. Do not tax a tax. Social Security is taxed twice, as is labor, as is capital. We suggested that the system, we believe, would reduce the tax burden on middle income people.

And, may I say to my good friend from the State of Illinois, it would not be a Jack Kemp commission with the type of men and women we had on the commission if we did not want to help remove the barriers that keep low-income Americans from reaching

their potential. We think, if it is to be in place, it has to be done with stability. We made that a key principle, I would say to my colleagues.

Dick Gephart has a plan that he wants to take to a national referendum. I would support that publicly. We came to the conclusion that we thought a two-thirds majority should be required to change it once it is in place.

Now, my friend, John Breaux, said that Kemp, using an old football metaphor—very apt a couple of days after the Super Bowl—punted and passed. Actually, I was a pretty good punter in my days. But, John, we did not lay out a street map, we laid out a road map to give a philosophical, hopefully principled, goal for America on the eve of the 21st century.

I do not know what the rate should be. That is the purpose of the deliberation. But I would make a case, I would say to my friend from Louisiana, that both Republican and Democrat, liberal and conservative, black and white, city and suburb, could agree that in peace time the rate ought to be a lot closer to 20 percent than to 40 percent, where it is today.

Reader's Digest did a recent poll. They asked poor people, upper income people, and middle income people, what percentage of someone's income should be taxed and go to the government in peace time, as an abstract question. The answer among all groups of people, according to Reader's Digest, was people did not think that anybody in America should pay higher than 25 percent.

I do not need to remind this famous committee on this auspicious occasion in these hallowed halls that the rates used to be 91 percent in America. I do not want to take the rates to zero; there is no revenue at zero. I agree with what Kent Conrad said: the purpose of taxation should be to raise revenue. It should bear the burden the least on those least able to pay.

I favor progressivity, I just favor it that it should be de facto, not de jure, because every time you get into a lot of rates you end up punishing workers for working harder and longer, you end up punishing savings which is now taxed twice, and you end up punishing capital, which I would say we have among the highest rates of tax on capital in the developed world.

One more comment, to my friend from Louisiana. I know I am running out of time. We tried to write this in such a way as to give both sides of the aisle a chance to reflect on not only the purpose of taxation, but the principles of taxation, and we tried to write it, I would say to John Breaux, with an eye on helping newly-emerging nations think about taxation, that the purpose is not to redistribute wealth, it is to create wealth. Right now, our system discourages the creation of wealth.

A final postscript, Mr. Chairman. This system was not designed by anyone on this committee. It was not designed by Mother Theresa, I can tell you that.

In my opinion, people do not buy homes to only take advantage of the home interest deduction, albeit it is a wash. If the lending institution pays tax on the interest they earn on the mortgage, I personally favor allowing mother and dad, or the purchaser of a mortgage, to deduct the interest.

I do not think, for instance, Mr. Chairman, if people give or go to church because of the charitable contribution—after being at HUD for 4 years, I would say in our society the work that is being done by charitable organizations, from Habitat for Humanity, to Christmas in April, from Boys and Girls Clubs, to Boy and Girl Scouts, from Catholic Charities, to the United Jewish Appeal, do a far better job, including the Salvation Army, of helping the poor find shelter. They did more than HUD, in my opinion, in providing a link between shelter and the human need of rehabilitation.

So, I think we can do a lot better. This is not, as you said, Mr. Chairman, the last word, it is just the first word. We do not expect that this is anything but a tabula rosa upon which to write our social contract with the American people for a new system that would be fair.

I think that requires that it be low. If somebody earns 10 times as much income, they ought to pay 10 times as much tax. I do not debate that. But tax ought to be absolutely zero on those working their way out of poverty.

I would have loved to have taken on Social Security taxes. The best we could do, I would say to my colleague from New York, is to allow for the full deductibility of the payroll tax so that all working men and women would be able to take advantage of that very important principle I alluded to earlier: do not tax taxes.

Finally, the second to last postscript. Thank you. I have been involved with Eleanor Holmes-Norton in a reform of the DC tax system. I saw this morning where the Financial Board is talking about the fact that there is no plan for the recovery of this city. This is the Nation's capital.

As we look around Delaware, New York, Rhode Island, Utah, Illinois, Louisiana, in my opinion, we all have a stake in the Nation's capital. They can't make it without a pro-growth tax reform. They have got to cut spending, I agree, but they have got to grow this economy. They are losing middle class families every single day. She has introduced what she calls a progressive flat tax.

Do not, in my opinion, get hung up on words. Discover that which is fundamental to a code which encourages work, savings, and investment and does not double and triple tax it, then when people pass away the government almost confiscates their lifetime's work, farming, small business, or whatever.

So, I look forward to the questions. I appreciate the extra time, Mr. Chairman. I would remind everybody that it was John F. Kennedy who said, a paradox in America was that if very high tax rates have caused low revenue, the best way to get more revenue is to bring down the rates. I do not think they can go to zero, and I do not want them to go to zero. But I tell you what, they ought to be a lot closer to 20 percent than they are to 40 percent, where they are today.

Thank you very much.

Mr. KEMP. May I turn the chair over to my good friend and comrade-in-arms for many years, Hon. Pete du Pont, former Governor of Delaware.

The CHAIRMAN. Pete, we are looking forward to hearing you.

STATEMENT OF PETE DU PONT, POLICY CHAIRMAN, NATIONAL CENTER OF POLICY ANALYSIS, AND FORMER GOVERNOR OF DELAWARE, WILMINGTON, DE

Mr. DU PONT. Well, Mr. Chairman, thank you. For those of you who may chuckle over the fact that our chairman does tend to sometimes go on a little, I want you to know that, within the deliberations of the committee, he was seriously harassed for that facet of his personality and he has become much shorter in his communications than he was before the commission began. So, we feel we have done good work.

Mr. KEMP. Would you put that in writing?

Mr. DU PONT. I will put that in writing.

The CHAIRMAN. Progress was indeed made, then.

Mr. DU PONT. Progress was made, regardless of what kind of a tax system we end up with.

Mr. Chairman, I would like to submit my testimony for the record and I would like to take a moment to dwell on a couple of aspects of our recommendations.

But before I do that, let me say that the reason I believe I was appointed to this commission is that I am one of the few people around who has actually implemented a substantial change in a tax system.

The Delaware Tax Code in 1977 was very similar to the Federal Code. It had a nice 19.8 top rate on people earning over $200,000, it was graduated down through the income levels, and it was killing opportunity in our State; companies would not come, jobs were being exported.

So we changed it with a massive rate cut. Rates were cut 64 percent. What was 19.8 percent is now 7.1 percent. Where low-income people paid 3, 4, 5 percent in tax, today they pay no tax because they were dropped off the rolls.

Now, with a 64-percent rate I am sure our friends at the Treasury Department would tell us that Delaware's tax system would long ago have collapsed. In fact, income tax revenues are 26 percent higher than they were, and overall revenues because of increased employment in the State are 50 percent higher than they were under that old tax system.

Yes, we cut taxes for the wealthy, we cut taxes for the middle class, we cut taxes for lower income families, and everyone prospered as a result.

So, I give that as an example of the fact that I have been there, I have seen what happens. And the analysis that we get from those who tend to favor the current tax system, that rate cuts produce lower revenue and bigger deficits, I do not believe, is an accurate analysis.

What is wrong with this tax system that we have today is very simple: the American people believe it is too complex, that it is unjust, that it is unfair, that it is riddled with loopholes, that the IRS takes up to 40 percent of what we earn each year, and half of anything that is left over when we die, the family farm, the small business we have built, the savings we have worked to accumulate. Enforcement by the IRS ranges from lax to nasty, depending on their mood and the agent that happens to be working on your case. The American people, frankly, have lost confidence in the system.

I would like to quote author Frank Chodorov, who describes what has happened after 70 years of tinkering with the Tax Code that was put in in 1915. "First, it was the incomes of corporations, then of rich citizens, then of well-provided widows and opulent workers, and, finally, the wealth of housemaids and the tips of waitresses.

If you do not believe it, consider this. By failing to increase the dependent deduction, Congress has reduced its value for median income families by 75 percent. The dependent deduction was introduced in 1944 at $500.

If it had been increased for inflation over time, today it would be worth $9,600. As we all know, it is worth $2,150, so the Congress has simply taken $7,000 per dependent out of the pocketbooks of the middle class.

In 1948, the median income family paid 3 percent of its income to the Federal Government, now the median income family is paying 25 percent of its income to the Federal Government."

We have talked about the Mertens in Iowa. Of course, they represent a class of Americans, the lowest two income quintiles of American families. As Secretary Reich is fond of pointing out, in 20 years, the inflation-adjusted income of families in the lowest 40 percent of American families has remained static. It has not risen. There has been no increase in income, in take-home pay, for those families.

In that same period, the take-home pay of the Federal Government, that is, tax receipts, has gone up 58 percent. For those of you who want a definition of fairness, I would suggest that working family, zero, Federal Government, 58, is a gross unfairness to the families of this country.

We believe that it is time to start over. Senator Conrad gave us a little list of examples, and how would we design a tax system that would be fair in each of those examples? Senator Chafee referred to this, also.

I do not believe you can come at it that way. It is not possible to revise the tax system by tinkering; we have tried that for 70 years and it has not worked. There are 9,400 pages in the Tax Code. You probably could add 1,000 to try to make it fairer, and we would be right where we are today.

We believe we have to start over with, as Chairman Kemp said, a single rate applied to all individuals, with a generous personal exemption. That would be a progressive tax. If your rate, for example, were 19 percent, your exemption for a family of four was $30,000, the $30,000 family, of course, pays no income tax, the $45,000 family pays six percent; $60,000 family pays 10 percent, and the $120,000 family pays 14 percent. So, by a generous personal exemption you are building progressivity into the system.

The commission's proposal is really founded on a very simple concept: a family with 10 times the income of another should pay roughly 10 times the tax, not five times, by good Wall Street accountants who can use the loopholes, and not 20 times by a punitive tax rate on that family. Ten times the income, 10 times the tax is our goal and the reason we have recommended a flat tax system.

Now, the Treasury Department estimated that Mr. Forbes' flat tax required a rate of 20.8 percent to break even, to have zero defi-

cit that Senator Conrad was commenting on. The Treasury Department admitted that that was a static analysis. That is, it assumes that the economy would not grow. If that is true, surely growth would allow something in the range of a 19 percent tax.

The statistics from Delaware I cited earlier indicate that growth would occur and, indeed, if you look at all three tax cuts of this century in America—the Coolidge tax cuts, the Kennedy tax cuts, and the Reagan tax cuts—in every case a substantial reduction in tax rates produced more income for the Federal Government, more tax receipts for the Federal Government, and grew the economy.

The Kennedy tax cut grew the economy from 3.5 percent a year in the 4 years before the tax cut, to 5.2 percent a year in the 4 years after the tax cut.

The Reagan cuts, because of the problem we were in, were even more dramatic. They took growth from 0.4 percent in the 4-year previous average to up over 4 percent, and tax receipts for the Federal Government were 26 percent greater at the end of the Reagan term than at the beginning.

So we suggest, Mr. Chairman, that you all start over and wipe the books clean. Design us a fair and simple system where everyone pays the same rate. You know what I pay and I know what you pay, and that way cab drivers will not say to me, as one did taking me from National Airport to a commission meeting, if you are going to the Tax Commission, you make sure that they adopt a flat tax so that everybody pays.

The American people do not believe everyone is paying, and a uniform rate will reinforce that belief and reestablish a confidence in the U.S. Tax Code that is missing in almost every American household.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Pete.

[The prepared statement of Mr. du Pont appears in the appendix.]

The CHAIRMAN. We look forward now to hearing from you, Mr. Fong, who currently serves as Treasurer of the great State of California.

STATEMENT OF HON. MATT FONG, TREASURER, STATE OF CALIFORNIA, SACRAMENTO, CA

Mr. FONG. Thank you, Chairman Roth and members. As the elected Treasurer of the State of California and the former Vice Chairman of California's taxing authority, the State Board of Equalization, and a member of this Tax Reform Commission, I am honored to be a part of your very first hearing on tax reform this year, with Jack Kemp and Governor du Pont, representing the work of our commission.

I would like to correct, because Chairman Kemp caused me some trouble on national TV and here again when he said that the commission represents a lot of wealthy individuals. I need every dollar I make from the State. I have a big mortgage, my two kids are in public schools, and I am still paying off my law school loan.

You undoubtedly have heard from the critics of the commission's work who claim that the commission's report is full of principles, lacks technical detail, recommends a rate but does not specify a

number, and that it recommends a tax system that will either bust the budget or bust the middle class. In fact, these critics are saying to us that the report was a waste of time, to which I strongly disagree.

I like to analogize the charge of our commission to the approach one takes when setting off to buy a new car. You do not start with a decision in talking about the options you want on the car, like power seats, door locks, and a CD player.

You first decide that you need a new car, and then you start looking at the different models. And, applying this back to the IRS Code, just as the old car is outdated and outmoded and cannot be repaired, the IRS Code is outmoded, outdated, and is beyond repair.

The problem with today's debate on tax reform, as I see it, is that after people agree that a new tax system is needed, everybody is starting to get lost talking about options such as the home mortgage deduction, and all sorts of other various derivatives of those deductions.

So before you decide on bells and whistles, I think we first have to focus on which basic tax structure—whether it is a flat tax, a sales tax, a value-added tax—you think best fits the needs of this country. That is why our report was silent on all of the various options, as far as taking any position.

At the outset, the commissioners found that what we needed to do was to establish a framework to guide us through the different proposals being debated as sort of an analytical screen. We spent a tremendous amount of time determining what principles we were going to measure competing proposals on and then, after we debated, we prioritized these principles. So, Economic Growth, which meant that we were looking at ways to encourage hard work, initiative savings; the Principle of Fairness, treating all citizens alike; a Simplicity Principle, so that everybody can understand the Tax Code; a Neutrality Principle to eliminate bias against savings and investment; a Visibility Principle, an honest accounting of the cost of government and things are not hidden; and a Stability Principle so that businesses, particularly small businesses, can plan for their future without dealing with what we understand is 4,000 Tax Code changes since 1986.

So we did not simply make up this list from a high school government text, these principles came from and were forged from testimony that we heard from taxpayers and from the honest and forthright debate amongst commission members themselves.

We used these six principles to develop a basic tax system that we felt would be best for America. So Chairman Roth and members, we urge that you and your committee debate these principles, add them, subtract them, reprioritize them, but the impact will lead you to your conclusion.

For example, on the Principle of Visibility, using the Principle of Visibility the commissioners, by consensus, not only placed a high value on having citizens know the cost of their government, but we also then were able to review the value-added tax proposal which failed this principle because, as you know, under value-added taxes, the taxes are not visible. How you choose your principles will

lead you to your answer, so instead of focusing on the answer first, focus on principles.

Critics have faulted our report for not recommending a specific tax rate. Senator Breaux was talking about punting. I would like to address his concern, that has been raised by many. I counter that we have a very specific tax rate. We defined it.

It is a single rate that will raise sufficient revenue to continue to operate government at its current size. That is, this is a revenue-neutral rate. But we did not know what the revenue-neutral rate was. I read in the Wall Street Journal, as the Governor just said, Treasury said 20.8 percent for one version of a flat tax.

But the point that we are making and I want to emphasize, is that we should view whatever rate it is as a price tag for government. By establishing a specific number, if we had taken a position and established a specific number, say at 16, 17, or 18 percent, we would have left the back door open for a new debate, and that is that this commission is really an attempt to reduce the size of government. That was not our charge, and I think the tax reform debate would become muddled in the larger context.

The beauty of approaching it from a revenue-neutral standpoint, two, is you remove from the table the debate on what Senator Conrad spoke of, and that was an increased deficit. If you have defined this as a revenue-neutral, then the deficit issue is only in the context of what your current system is today.

The second, Senator Murkowski raised, all these different deductions. If you say it is revenue-neutral, then your options are only going to increase the size of your price tag. So, using Treasury's figure of 20.8, if you want to include a home mortgage deduction or if you decide that we should have the exemption for charitable contributions, all it is going to do is make your price tag higher. The price tag is just what the American people want to pay.

So I, like Chairman Kemp, believe the peace time rate should be less than 20 percent. But if the price tag happened to be as high as, let us say, for example, 23 percent, I would hope that the taxpayers would believe, as I do, that the price of government costs too much, that the rate is too high, and that they would put pressure on their elected officials to reduce this cost. But this would be the result of tax reform, not part of the tax reform debate itself.

Critics have also complained that our report has a single rate rather than a multiple tax rate system. Every commissioner believes strongly that the principle of fairness should be one of the cornerstones of a new tax system. Each taxpayer must be treated equally. That is, proportionately everyone should pay the same tax.

Proponents of a multiple-rate system are clear in their objective, the result of harder work and higher pay as a greater share of your income for taxes. In the commission's eyes, this fails the fairness test.

Throughout our hearings, citizens told us what they want more than anything else in the Tax Code is the knowledge that everyone, from one end of the income scale to the other, is being treated the same. That is the true beauty of the flat tax.

Therefore, Senators, I believe you have two paths. One, is you can design a tax system that only collects revenues for the purpose of funding reasonable government expenditures, or, two, you can

prioritize the redistribution of wealth, as well as creating a tax system that collects a tax revenue. You can take either of those two; we pick the first one.

Finally, we have heard from critics of the flat tax that it will cost the government billions of dollars, create a windfall to the rich, and increase the tax burden on the middle class. Again, I disagree.

Critics fail to account for the economic growth that can be generated from a tax system that rewards savings and investment. In addition, defenders of the status quo ignore the benefits of redirecting the $200 billion—$130 billion corporate, $70 billion individual—that is currently being spent to comply with a very complex system, and to search for loopholes.

That money can be redirected. Even if you only had a 50 percent efficiency savings, you could redirect that money into worker's incentives, growth, training, even retain earnings.

The current complex tax system also wastes America's creative intellect. The president of a high-tech think tank in Palo Alto testified before the commission that his competition for intellectual talent did not come from other firms in the high-tech industry. His competition comes from the Big Six accounting firms and the big law firms that take bright minds into the dark recesses of an outdated Tax Code.

Furthermore, a simpler and fairer system of taxation with a single low tax rate will result in the collection of more revenues. Andrew Mellon once wrote, the history of taxation shows that taxes which are inherently excessive are not paid. Americans are overtaxed, not undertaxed, and many spend a lot of time hiding income from the government and creating fictitious deductions and other loopholes that I have found from my work on the Tax Board.

As a former Vice Chairman of California's Tax Board, I shared with the commissioners when we were deliberating the story of California's experience with a new sales tax on bunker fuel at California's ports. According to the revenue estimates by our legislative staff, the new tax on bunker fuel was to yield almost $100 million for the State.

With a sales tax rate of eight percent, you can readily guess what happened. I told them the ships would stop buying fuel in California; they did not believe me. Well, the ships started loading their fuel in Mexico, Oregon, and Seattle.

Our refueling operations in our State dried up, and I collected the revenue. We did not collect $100 million, we collect $1-2 million. I think we probably spent more on welfare for the out of work families who lost jobs as a direct result of the imposition of this new tax. It was repealed within 1 year by emergency legislation.

The scoring of tax reform plans and the generation of tax distribution tables will employ hundreds of static analyses inside the Beltway alone. Static analyses simply will not work. It is simplistic, it is not fit for use in the 1990s in the world of high-tech modeling. This country will have a very difficult time moving to any new tax system if we listen to the advice of static analysis.

It was static analysis that the Wall Street Journal criticized and saw as a reason for the Federal Government's collection of only 25–30 percent of the original staff estimate of the revenue to be raised from President Clinton's tax increases.

So, I urge you and the members of your committee to study the framework outline in the commission's report, debate it, find out if you agree or disagree with the principles. But I think the first vital step in this tax reform debate is to focus on the principles.

Once the basic system is selected, the rate should be floating to set the price tag so that every citizen knows the cost of government. Finally, we urge you to utilize dynamic modeling when testing the new system for its revenue generating ability. Thank you.

The CHAIRMAN. Thank you, Mr. Fong.

[The prepared statement of Mr. Fong appears in the appendix.]

The CHAIRMAN. We will have a 10-minute limitation in the first round. But, before beginning my questions, I do want to welcome Senator Bennett, who is here, and I understand acted as a valued advisor to the commission. I know he will be able to make great contributions to this debate.

There has been a lot of talk about growth in this country and the need to develop a kind of tax that will help bring about real economic growth. Yet we hear a lot of economics talk about, 2.5 percent is as much growth as one can expect without risking high inflation.

I think, Pete, in your written statement you talked something about 4 percent. I would be interested, how do you answer these economics who state that 2.5 percent is all we can really enjoy, Jack?

Mr. KEMP. Well, our commission, Mr. Chairman, as Pete du Pont pointed out, rejected as unacceptable to America, either economically, fiscally, morally, or socially, a growth rate as low as it is today. With all due respect to the debate, the economy, in revising the estimates from last year, fiscal year 1995, they said it grew at 1.9 percent.

I would suggest that it might be an interesting task for staff on both sides of the aisle to take a 1.9 percent growth rate, calculate revenues and expenditures from social welfare programs to tax revenues, and project it over 7 years and figure out how you can get to a balanced budget with 1.9 percent growth.

You can, but it is unacceptable, as Pete said, because you cannot deliver the jobs. I would say, Mr. Chairman, as Pete du Pont pointed out, and as I have pointed out, and as Matt Fong has pointed out, if we are to double the rate of growth from, say, 1.9 percent or 2.0 percent to 4.0 percent as a goal, that is well within the boundaries of America's economic history, as well as both political parties' commitment to the social consequences of a high-growth, full-employment economy. President Kennedy, in 1960, committed the Democratic Party to 6 percent growth; Ronald Reagan committed the Republican Party in the 1980 platform to full employment without inflation.

My impression is, according to most economists who think that there is a higher potential for this economy to grow without inflation, that if we had sound monetary policy coupled with less regulatory and tax burdens on work and savings and investment, we could easily achieve a 4 percent rate of growth.

That would make it a lot easier to balance the budget, I would say to my colleagues on the left, and I would also say it to my colleagues on the right, who think that that is the sole criterion for

good financing. To me, it is a criterion but not the sole criterion. The highest criterion is high levels of employment, expanding opportunity, and a bigger pie.

Pete, do you want to comment?

Mr. DU PONT. Well, Mr. Chairman, I would answer your question directly by saying that the economists who believe that we cannot exceed 2.5 percent growth were the same economists who told us the core inflation rate in our economy was 6 percent and that we could never go below that. They were wrong there, and I believe they are wrong regarding growth.

A Nation that is scared of economic growth will not prosper. A 1 percent increase in economic growth means six million new jobs over 8 years, it means $700 billion more tax revenue for you all to allocate for expenditures or pay down the deficit, and it means trillions of dollars in additional GNP.

If we are going to have a future and allow people the opportunity of working, we cannot limit ourselves to 2.5 percent growth. After all, finally, Mr. Chairman, we did have 4-percent growth in the Kennedy years without ruinous inflation.

We did have 4-percent growth in the Reagan years after President Reagan's tax cuts without ruinous inflation. It can be done, and I think it is urgently important for the people of the country that we do it.

Mr. FONG. Chairman Roth, economic growth was our number one highest priority principle of all those six that were listed. Hearing testimony, I think we summarized that there are far too many Americans that are still left on the economic sidelines.

Even in this debate that we are having right now on welfare reform, you cannot have a debate on welfare reform without also then having one on economic growth, because if you come off welfare you need a job. At 2.5 percent growth, you cannot have enough jobs available for those hat are coming off of welfare. You need to create growth.

From California, we are very close to the Pacific Rim. We are on the eastern border of the Pacific Rim. In the Pacific Rim countries, for the past 20 years, they have had consistent growth of 8, 10, 12 percent, consistent over 20 years.

It is not unrealistic to think that our country can at least equal what was achieved under President Kennedy's tenure, and maybe even a point better. So I think 2.5 percent is anemic and I think we are selling for too little. I think that unless we have a new system that generates growth, welfare reform is going to be meaningless.

The CHAIRMAN. Jack, your report, which will be included as part of the record——

Mr. KEMP. Thank you.

The CHAIRMAN [continuing]. Recommends a single tax rate. Now, Tuesday, in a Wall Street Journal editorial, it was concluded that a tax reform system of multiple rates would be acceptable as long as the top rate is reasonable. Specifically, it says, "Still, in principle, we would have no objection to some degree of tax progressivity, so long as the highest marginal rate is reasonable.

In this respect, the 1986 Act, with three rates topping at 28 percent, was fine by us. Without going to redistribution extremes, there is something to be said for the ability to pay."

Would you agree with that editorial, or what would be your comment?

Mr. KEMP. Mr. Chairman, as Matt Fong pointed out——

Senator MOYNIHAN. Mr. Chairman, may I suggest, it does not sound so much like an editorial as a judicial decision.

Mr. KEMP. Right. Handed down. I agree with him on a lot of things. I disagree, I think now is the time to get the simplification that would come. I think Matt Fong pointed out that if you have a single rate not only do wealthier people pay a higher percentage, if they earned income 10 times higher than a different income level they will pay 10 times as much.

If you have steeply progressive rates or even graduated rates, you do two things. You punish success, which I personally believe is a big mistake, to punish success, but I also believe that you begin to build in the type of exemptions, deductions and credits that seem on the surface to be fair, but end up causing many of the problems we have today.

In my opinion, having traveled extensively in Asia myself, when Matt Fong pointed this out I raised my eyebrows, because there are many places in Asia that are growing at higher levels than 2.5-3 percent.

My favorite tax code was the Hong Kong tax code, which was a flat 15 on income and a flat 16 on corporate income, with a zero capital gains tax and a large exemption—71 percent of the people of Hong Kong do not pay the income tax, and they grow at 7.9–8 percent. They have had 27 years of budget surpluses.

In my opinion, because of the visibility of that single rate, may I say to the Chair, it is very difficult to raise it and very difficult to build in a lot of exemptions. So, for stability's sake, simplicity's sake, and fairness' sake, we came to the conclusion that all income should be taxed but once at a low rate. Pete says 19, I say 19 or 20.

The CHAIRMAN. Both you and Matt talk about Asia and the rapid rate of growth, which is absolutely correct. But many of those countries also had a high rate of inflation. Are there any of those countries that had 6, 7, 9 percent growth that controlled inflation as well?

Mr. FONG. They are controlling inflation. Although China's inflation was quite high in the past few years, it is coming down.

Mr. KEMP. Hong Kong. Just to answer the question, Hong Kong has a low rate of inflation.

Mr. FONG. I would like to give the three reasons why we approached one rate, although, in effect, The Wall Street Journal said there were two rates, zero and 17, or whatever.

First, from a tax administrator's point of view, if you have one rate it is easier to administer. According to Hall and Rabushka, every additional rate either squares or cubes the complexity of the tax system. You can see that if you have a single rate you can collect tax at the source and withhold; if you have two rates, now it is more complex and you have to start collecting at the individual level. So, administration is one thing that you have to focus on.

Second, Chairman Kemp started talking about. It is a slippery slope. If you have one rate, it is one rate. But if you have two, then why not three, or why not four? Then third, what we are concerned about is people gaming the system. When you have a second rate there is a little play in the system. With one rate, everybody is the same.

The CHAIRMAN. My time is up.

Well, let me ask Jack the next question. One of the criticisms—in fact, it has already been made from the panel here—is that a single tax rate could result in a tax increase for lower and middle income families, and a tax reduction for upper income families. If that is true, how can one justify a single tax rate system?

Mr. KEMP. Well, I do not think there is anyone on this panel, nor was there anyone on our commission, that did not take seriously both Bob Dole and Newt Gingrich's admonition to make sure that not only was the system simple, fair, and pro-growth, as we were constantly reminded by two valuable members of our commission that I did not announce earlier, Loretta Adams, a small business owner in San Diego, California, and Ted Forstmann, of Forstmann Little, one of the most creative financiers in the country.

We, in exploring this issue, were admonished, both by Dole and Gingrich as well as the daily drumbeat of articles, to make sure that everyone did better. It seems to me, Mr. Chairman, you cannot answer the question without recognizing the premise of the criticism, which is, in order to be revenue-neutral and bring down the rates on so-called capital, you must raise income on labor, i.e., salary income.

That is one reason why I told Senator Moynihan earlier that I thought he might positively respond to the fact that we were trying to deal with the payroll tax burden on working men and women by allowing it to be deductible. And, with a large exemption, as Pete du Pont pointed out, you can get to the type of fairness and reduction of the tax burden on middle income families that all of us want.

In my opinion, the most important point in this hearing was Matt Fong's repetition of a statement that was made in the 1920's, that people with excessive tax rates do not necessarily pay it in terms of revenue to the government because they will find ways of obfuscation in the Tax Code and will buy municipal tax-free bonds or find ways of hiding their income.

If you want a fair system, broaden the base, bring the rates down, and tax the rich by bringing the rates to a level at which people are encouraged to invest in widget factories, not tax loopholes, tax deductions, or tax diversions.

So I believe, as in the case that has been constantly reminded by Pete's testimony, that while the rates came down on the rich, revenues went up in the economy and the tax burden actually shifted relatively upward because in 1981 the so-called rich, at levels above a couple hundred thousand dollars, the top 1 percent taxpayers of America, paid about 18.6 percent of the revenues on income taxes. The time that rates came down to 28 percent, they were paying 29 percent of tax revenues.

So, I think fairness goes back to the point of taxing it once, taxing everybody the same, leaving in progressivity de facto, and pro-

viding for more revenue by getting the economy growing and creating more jobs and opportunity for people to move from driving trucks to owning trucking companies.

The CHAIRMAN. Pete, do you have anything you would like to add?

Mr. DU PONT. Well, Senator, I would say the difficulty with your question is, of course it is possible to design a tax with a rate that increases taxes for the middle class and decreases taxes for wealthy people. If, for example, you set your uniform rate at 30 percent, the taxes on 99 percent of the families in the country would go up and they might go down for a small percentage.

It all depends on where you set the rate. I believe the way to set the rate, in fact, is not to try to judge, as Treasury did, the static rate of replacing existing revenues, but to set the rate so that taxes on middle income Americans, in fact, go down.

Taxes on working families are simply too high. Set the rate so taxes go down a little, reap the growth dividend, and I think you all will find that you have much more revenue to use for deficit reduction than you would under the current system.

The CHAIRMAN. Matt?

Mr. FONG. Senator Roth, I would like to add two things. One, is I think the analysis still does not reflect a dynamic analysis. Hall and Rabushka are the only ones I have seen that have come up with an estimate of an increase in revenue, but they say that, over a 7-year period of time, with the implementation of a flat tax, that an individual ought to see an increase of about $2,000 in their paycheck.

If you take a look at any scenario that I have seen, like in USA Today, where they say the burden would be increased on middle class, nothing approaches an increase of $2,000. So, you can argue that, with the dynamic analysis, it would be less.

However, I would flip it the other way. We have taken a lot of testimony. We heard from middle class and lower middle class throughout the country who said they flatly did not mind paying a little more if it meant that they knew that the rich were paying their share, because they were concerned that they did not have the ability to take advantage of the loopholes, they did not have the money to hire the lawyers or accountants.

So they flatly said to us, and that is why I think you see this phenomenon, despite the scary statistics that are being played out by the newspapers, that the popular will of the people is they are expressing an interest in the flat tax, saying, we would pay a little more if we knew that everybody behind the Mercedes were paying the same rate that I am paying behind my Ford Taurus.

The CHAIRMAN. Senator Pressler, I understand you have a brief statement you would like to make but you have another commitment.

Senator PRESSLER. I did want to congratulate the commission and say that one of the things I am most fascinated with is getting the growth rate in this country up. I represent farmers and small business people in middle class America, so we do have concerns about depreciation schedules, home mortgage deductions, and charitable contributions.

But I agree, with our growth rate at only 2 percent or 2.5 percent, we have got to find a way to double that. We should be able to. I commend this commission, and I wish to place my statement in the record. I will have some questions.

Mr. KEMP. May I just add to Senator Pressler's comment, and just answer to it, our plan envisions the expensing of investment in plant, equipment, machinery, and technology, et cetera.

So, there is a transition period to go from the current depreciation schedules to expensing, but clearly it would be in the interest of farming or making widgets to allow an individual entrepreneur or business decision to be made not on the tax consequence of the depreciation schedule set by someone else, but to be able to expense that investment in the year in which the investment is made.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Yes. Mr. Chairman, we are much in the debt of the Chairman and his colleagues. This is not only just a first-class report, but a first-class account of the report.

I would like to express a particular appreciation to Jack Kemp for making clear that there is no hidden agenda here, that you desire to be revenue-neutral, and, as Mr. Fong said, pay for the government at the levels you now have. That is in good time, and thank heavens.

Our problem is how to pay for the government we have. As a proportion of GDP, it has been pretty stable. It was 19.1 percent in President Truman's last year and it is 19.0 percent this year. It has been up a little bit, but it stays about that level.

But the deficit is devastating. It absorbs our energies, it paralyzes our will. At the end of fiscal 1981, on January 20th, the debt of the United States was absorb $1 trillion; 15 years later it is almost $5 trillion. We are talking about default. We are looking at something for which there is no equivalent in our vocabulary. We have never had it.

I said on the floor the other day, if you default it would be on the order of losing a war. As this is not a recession, or whatever, finding the resources to pay for government is our first responsibility.

Here is the point, and I would like to ask you this. You mentioned the Kennedy tax cut in the Kennedy Administration. I was in the Kennedy Administration and remember that our problem, as we saw it then, was that revenue came in faster than Congress would spend it and Walter Heller would speak of fiscal drag. We were throwing money out the windows at one point. We had a GI bill life insurance dividend, we gave one, then we gave another. Then we raised the pay of the Federal employees, just to get money out there. That is not our problem today.

We have, as a matter of fact, in the aftermath of the 1993 tax increases—the biggest tax increase in history, I heard that a couple of times in New York in 1994—for the first time since the Kennedy-Johnson years, spending on government programs—that is outlays excluding interest on the debt—is less than taxes. We have a surplus in 1994–1997 of about $57 billion.

Now, until we get that out of our way we are just paralyzed. I mean, here we are talking about default, the unimaginable. You

both have said we want to be revenue-neutral relative to the current code, but we have to raise more money than we spend for a period to get this debt down. Do you not think this has to be something we try to put a number on, and a date, and say, this is where we want to be? Can you help us on this?

Mr. KEMP. I think all of us would have individually different opinions about answering your question. All of us, I know, would agree that this country must not go into default.

Senator MOYNIHAN. Jack, just think what you just said.

Mr. KEMP. We cannot default on that which this government is obligated to pay.

Senator MOYNIHAN. Yes. Yes.

Mr. KEMP. I say that as a conservative Republican who endorsed the Contract With America; I do not favor default. as Yogi Berra would say, if Alexander Hamilton were here today he would turn over in his grave. Alexander Hamilton founded the Republic on the credit worthiness of the U.S. Government.

Senator MOYNIHAN. Yes. And Thomas Jefferson exacted the move of the capital from the City of New York, where it belongs, to a swamp in the back of the Potomac. That is a price we paid. [Laughter.]

Mr. KEMP. I knew I could not top Moynihan. [Laughter.]

Having said that, Mr. Former Chair, Ranking Member, friend, colleague, I think du Pont gave us an interesting scenario. It is built on that chart that you alluded to that Senator Bennett of Utah put up on the floor of the U.S. Senate, when he showed that no matter where the rates were in America, high or low, the government got roughly 19.2 percent or so revenues. So it seems to me axiomatic that the only way to get more revenue for not only bringing down debt and deficits is to make the pie bigger.

If this economy, as Pete pointed out, were twice as big as it is today, i.e., $12–$13 trillion during the next early years of the millennium, we would have another trillion dollars or so with which to save those programs that should be saved and to pay down debt and deficits.

It would not be a Jack Kemp testimony if I did not suggest that part of the interest rate problem is, since John F. Kennedy, our dollar has been unstable, to say the least, and interest rates on long-term borrowing have been a lot higher than they should have been.

In my opinion, we need to anchor the dollar to get interest rates down and grow the economy to provide the jobs and the fiscal dividend that would come from more revenue, as it did under Kennedy and Reagan.

Senator BENNETT. If I may, Mr. Chairman, before Senator Moynihan jumps in, it is not since John F. Kennedy, it is since Richard Nixon.

Mr. KEMP. What?

Senator BENNETT. It is not since John F. Kennedy, it is since Richard Nixon.

Mr. KEMP. I recognize that. I was going to make the point that Kennedy pledged in the Democratic platform of 1960 to keep the dollar as good as gold. Interest rates were 3.5–4 percent on 30-year mortgages. If you had 4 percent mortgages and 4 percent 30-year

bonds, in my opinion, the deficit opinion would not be debated to the exclusion of how to grow this economy and how to create more jobs for people.

Senator BENNETT. It was just that I could see the Senator from New York pointing out that the break came from Richard Nixon and not from John F. Kennedy.

Mr. KEMP. Nixon, right. 1972. Yes. That was in default, by the way, at least on 20 percent of the debt owned. We have paid off debt in the past, as the Senator from New York knows, by inflation. We did it under Richard Nixon, at a great cost to this country's well-being, until Paul Volker, and now Alan Greenspan, have put us back on a more solid path of monetary policy. That is my own opinion. We were not asked to discuss this by the commission, but it is a very thoughtful question.

Senator MOYNIHAN. Mr. Chairman, I want to hear from others as well, particularly Senator Bennett. Could I just offer the thought, and maybe you would comment. We speak of economic growth. You get to 4 percent in those moments when you are coming out of a recession, and so forth.

We have had a very stable economy since 1946. Only about 10 months did we ever have an unemployment rate above 10 percent, and that was in 1982–1983. You know that, Jack, very well.

In the long run, however, developed economies grow at about 2–2.5 percent. They do not grow any faster than that, Jack, do they? I am open, teach me.

Mr. KEMP. In my opinion, there are too many central bankers around, both in Europe and in the United States, who suggest that if economies grow faster than 2 percent it puts upward pressure on prices and that, ipso facto, is inflationary, as if too many people working cause inflation.

Our commission rejected that element of inflation. Inflation is not caused by too many people working, or too many homebuilders building housing, or too many people going into business, it is a failure of the central banks of a country to maintain the value of its currency. We reject that a priori, that this economy could indeed grow at least 4 percent.

Professor Jorgenson at Harvard suggested that the things that we were talking about would have the effect of——

Senator MOYNIHAN. Dale Jorgenson?

Mr. KEMP. Yes. Yes. Would have the effect of creating 25 percent higher economic growth in our country.

Now, the debate is going to go on ad infinitum, but clearly we can do better than 1.9 percent. I know the Senator would agree with that.

Senator MOYNIHAN. That is the preliminary estimate for the last quarter. Actually, we have had a good run since the mid-Bush years; Growing at 5 percent per year as we recovered from the 1990–91 recession. But I do think that we——

Mr. KEMP. Incidentally, revenues went down when the rates went up. Everybody says, well, lower rates bring more revenue. Let's leave that for speculation. But we do know one thing, do we not? When the rates were raised in the 1990's and raised again in 1993, revenue from income taxes did not go up, it went down, from 9 percent of GNP to 8.2 percent of GNP. So it seems to me axio-

matic that if higher rates cause less revenue, maybe we ought to try the alternative and make the rates fairer.

Senator MOYNIHAN. We know that is your view. [Laughter.]

Martin Feldstein has argued this with respect to the 1993 measures, and we will learn more.

Thank you, Mr. Chairman.

Mr. KEMP. Thank you.

The CHAIRMAN. Thank you, Pat, with the forbearance of the group.

Alan, you had a comment you wanted to make.

Senator SIMPSON. Mr. Chairman, I understood you had opening statements. I will just insert my questions in the record. But I do thank you for holding this hearing. I think it is very important. I have never been enthralled by a flat tax, but I am certainly willing to listen carefully. I admire each and every one of these people. I do not know Mr. Fong, but I certainly know Pete and Jack. I just would add one paraphrase to what Pete has said.

I think, regardless of what we do here with a flat tax, the scenario we are faced with today, regardless of what kind of tax we have, is higher payroll taxes or cuts in the benefits to senior citizens. There is no other place to go. Would you agree with that? I do not get a question, so I will save that.

To paraphrase Pete, a Nation that is afraid to address the Social Security system problem will not grow or flourish, so everything we are doing means nothing until we do something with strengthening to avoid the insolvency of the Social Security system.

It can be saved only in two ways, reduce benefits or increase the payroll tax. Seniors have a great solution for it: raise the payroll tax. As I say, and say again, and again, and again, if the people between 18 and 45 cannot figure out what is going on, I do not have a bit of sympathy for them.

Mr. DU PONT. Senator, if I might comment on that as one who suggested the importance of fixing the Social Security system in the 1988 campaign, and I am here instead of somewhere else. [Laughter.]

But you were right. Until we fix the Social Security system we are going to have a constant generational war between the elders and the youngers. As a footnote and for another hearing, I believe there is a way to fix it without raising taxes or reducing benefits, and that is moving to the IRA-based system. I believe it can be done, but we can talk about that another day.

Mr. KEMP. Incidentally, Senator, your name and that of Bob Kerry have been mentioned in many of our hearings as heroes to suggest the possibility that, as Pete du Pont pointed out, a modest contribution by young working men and women to an IRA or a mutual fund of some sort or other investment in corporate equities and bonds would deliver a higher rate of return.

But, it seems to me if we are ever to get there to where you can even discuss Social Security from some form of a public/private partnership, I believe it has to be preceded by an economy in which you reduce a lot of the tensions that people now feel that they are not getting ahead.

A bigger economy, a growing pie, with more revenue to do the type of things that you and I both know need to be done, I think,

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would ease a little bit of some of the anxieties that people feel and cause, in my opinion, not only the generational gap, but cause people to look with fear at immigrants, and fear of the poor, and create tensions between city and suburb, rich and poor. That is not America. This country was not built on envy, it was built on opportunity. So I think we would need both, maybe simultaneously.

Senator SIMPSON. Thank you, Mr. Chairman. Thank you very much.

The CHAIRMAN. Time is moving on, so we are going to keep regular order now.

John?

Senator CHAFEE. Thank you, Mr. Chairman. First of all, I just do not think we can stress enough here the absolute necessity to get the Federal budget balanced. For that matter, there is nothing in the U.S. constitution that says we cannot start paying off the debt. Therefore, we should not lose sight of this balanced budget effort that is under way here and, in my judgment, absolutely must be carried to fruition.

Second, if I understand your thrust here, particularly under the category of visibility, you believe that if you have one rate and that rate, whatever it is—and I think you are right, you do not have to come up with the rate—that pays the bills of the Federal Government.

Therefore, if the Federal Government embarks on a new spending program, a new expansion, we are going to increase Head Start, or do whatever, then the rate must go up. So everybody in the country is, thus, more conscious of what the Federal Government is spending. Is that one of the points you are making?

Mr. KEMP. Well, none of us would want to associate ourselves with the idea that you automatically have to raise the rate in order to finance a new social program. All of us on the commission believe that a single rate that is set at the level of equilibrium at which people are willing to maximize their output, their work, their savings, and their risk-taking would not only provide more revenue, but would give us the opportunity to reduce debt and deficits.

I do not personally believe it should be raised capriciously. That is why we built into our report stability of the Tax Code by suggesting that it should take a two-thirds majority vote of Congress to change it.

I would be willing to put it on a national referendum, I believe so strongly that the people have a stake in this. It would be visible and the cost of government would be visit, but I do not think it should be tinkered with just to get more funding for Head Start.

Mr. DU PONT. Senator, could I respond to that?

Senator CHAFEE. Yes, please.

Mr. DU PONT. In your first observation that getting this budget deficit under control is vitally important, you did not say it, but the implication that is in that statement is that until the deficit is under control we cannot do anything with the tax system.

Senator CHAFEE. No, I did not mean that.

Mr. DU PONT. That is an important point.

Senator CHAFEE. Yes.

Mr. DU PONT. I do not believe, without growth in the economy, that you can get your balanced budget, ever.

Senator CHAFEE. I am not linking the two things. I am just saying that I do not think we ought to take our eye off of the ball. As Senator Moynihan has pointed out here, the budget is in balance now except for the fact that we must pay interest on past borrowing.

If we can get rid of those interest payments, then that money, in the first place, will be in balance, and hopefully some of that money that we are expending now on interest payments could be used for things we want, better education, better environment, whatever it might be, better health care.

I want to return to the point that Senator Simpson was making. I do not think you have stressed it enough. Everybody has looked at your chart. What throws this off as far as taxes, where their big taxes come from, is they are both working and the bulk of that tax is Social Security, right?

Mr. KEMP. They face a flat 15.3 percent payroll tax, paid half by the employer and half by the employee. So you are right.

Senator CHAFEE. But each of them are paying 7.8 percent, or whatever the Social Security is. So until we get control of this Social Security situation, you are going to continue to have that. Now, I know what you would say under your program is you do not deal with the Social Security tax, except to say that it should be deductible.

Mr. KEMP. Deductible. Right.

Senator CHAFEE. In computing their tax, their Federal income tax, they would be able to deduct what they had paid to the Federal Government.

Mr. KEMP. Right.

Senator CHAFEE. That is no tax on tax, is the way you describe it.

Mr. KEMP. Right. Yes, sir.

Senator CHAFEE. But what has happened here is, we have set up a system whereby the Social Security is taking a very large chunk, not just from the taxpayer but of available revenue in the whole government.

Until we get control of the expenditures under the Social Security system, I do not think we are going to be able to solve the problems of the Merten's, are we, unless we suddenly give them some kind of Earned Income Tax Credit, or whatever it might be.

I mean, what do you do about them? Your Federal tax on them is modest in that illustration, is it not? You can figure out that if their total income is 32 percent and they are having to pay nearly—well, 8 percent of that is, what, $2,400. Well, I guess there is some——

Mr. KEMP. We are drawing a sharp distinction between marginal tax rates and average tax rates, or effective tax rate. The Merten's, as I would understand it, would pay a 15.3 percent payroll tax right now, which is a flat tax. Hits them on the first dollar up to, what, $60,000.

Senator CHAFEE. Jack, it is not quite fair to say that they pay 15 percent. Each of them is paying seven percent, nearly eight.

Mr. KEMP. The employer is paying half and the worker is paying half, which adds up to 15.3.

Senator CHAFEE. Yes, but the Merten's are not paying the employer's half.

Mr. KEMP. Sure they are.

Senator CHAFEE. Well, all right.

Mr. KEMP. Do we think that businesses pay tax? We are making the point that people ultimately pay the tax either in a direct tax or in the cost of the product. No business can survive without passing on the payroll tax to either labor or to the cost of a product.

We are making the point that the Merten's are paying at a higher rate than they have ever paid in this country. They pay a flat 15 percent. Our premise is a 15 percent rate. Plus, they are in the 15 percent marginal tax bracket. If they work harder, they actually pay more payroll tax, plus they move up into a higher bracket. That is why we said, just pay a single rate. As Pete du Pont pointed out, their effective tax would be 4 percent income tax.

So you would increase their after-tax income, under our scenario, (a) to the Merten's; (b) you would lower the cost of labor to their employer; and (c) would be more efficient in terms of growing the economy. We think there are several benefits to moving to this type of a system.

Senator CHAFEE. I do not know how much time I have got, Mr. Chairman. One quick question of you folks of the panel.

What percentage of the American public now files their taxes, in effect, on the back of an envelope, i.e., the 1040A or 1040EZ, and file that way? Is it not 70 percent of the returns? That is my understanding. 70 percent of all filers take the standard deduction.

Mr. KEMP. That may be a little bit high, but it probably is over 50 percent, I would assume. I am looking for help, if anybody knows.

Senator CHAFEE. My statistics say 70 percent. So that I do not think it is quite fair to say that all Americans are having to rush to consult H&R Block, or hire a lawyer or an accountant because of the incredible complexity of the Code.

Mr. KEMP. The complexity, Senator, is in reporting investment income, business income.

Senator CHAFEE. Right.

Mr. KEMP. And I do not care if you are just a small mom and pop operation or a very large corporation, I do not think there is any support for the current system. Also, H&R Block, bless their hearts, fine people—and I know they are honest—is one of the fastest-growing franchises in America.

When young working men and women have to consult a tax accountant or lawyer to get through the system, something is wrong, irrespective of what percentage of the people just file a relatively simple personal tax form.

Senator CHAFEE. An expert told me it was 71 percent file using one of these two forms.

Mr. DU PONT. Senator, if I may.

Senator CHAFEE. Yes.

Mr. DU PONT. 1040–EZ, the form you are referring to, does come with a 36-page instruction book on how to fill it out. The reason you have to go to H&R Block is not that the form is long, it is that the IRS takes 36 pages to explain to you how to fill out one page,

and you cannot read the 36 pages and understand what numbers you are supposed to put in what boxes.

My second comment, regarding the Merten's, the breakdown of those tax numbers are $2,400 in Social Security tax and $2,500 in Federal income tax. I do not believe, until we get to a system similar to the one Senator Simpson has suggested, you are going to be able to do anything with the Social Security tax other than make it deductible, which would help, but there are lots of things you could do with the $2,500 in Federal income tax.

Senator CHAFEE. All right. Did you have a point, Mr. Fong?

Mr. FONG. Governor du Pont made it, thank you.

Senator CHAFEE. All right. Well, just one final statement. Look, the thing that intrigues me about what you all are saying is the possibility of greater growth, and that is something that is attractive. On the other hand, I must say that I personally do not find that the income Tax Code has been such a drag on our economy, as some suggest.

When I see the wealth that seems to be rolling around this country, people battling to buy football franchises at $100 million, $200 million, $300 million, and you look at some of the marinas—not enough of them in my State, regrettably—in Florida with the wealth that is there, somehow I do not feel that this is such a drag on creation of wealth. Maybe it is keeping the fellow from buying that truck, and if so we want to do everything we can to cure that.

Mr. KEMP. We were up in Harlem and a young black entrepreneur by the name of Van Woods owned Sylvia's Soul Food in East Harlem, Senator. He made the point to us that, hey, the rich are getting rich. They get rich under any system. We are preventing him from getting rich, or his children from getting rich, or expanding his employment opportunities.

In my opinion, if we were for redistribution of wealth, the current Code is not doing it. It is not creating wealth or even redistributing wealth. It is allowing a few people to get wealthy because the system works for them, but it absolutely inhibits the guy or gal working for wages to be able to save, then it is taxed again, then if they invest in a small business the government confiscates their earnings over time with an unindexed capital gains tax. So it is not hurting the rich.

I tell people that are already rich, you get rich under any system. It prevents poor people from getting rich, and that is why I took such an interest in this whole issue of how to liberate our inner cities from the poverty that now exists.

Mr. FONG. Senator Chafee, if I may, you stated in your opening remarks that you wanted to be disproven of "simplicity is the enemy of fairness." I started off on the commission also as a skeptic of a flat tax. Actually, I had, in principle, was looking at the value-added tax, coming from my background as a tax administrator.

But I found personally, through hearing the testimony, that the average working person looked upon the simplicity of the flat tax as that delivered fairness, that they did not, especially the small businessmen and women, and I have a small business background, did not have the resources to take advantage of the complex Tax Code.

So, they looked upon us to give them simplicity. They liked the idea that everybody would pay the same rate, there was no gaming, they knew what everybody got, and they thought that was fair.

Senator CHAFEE. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. Mr. Chairman, I think that anytime a tax hearing goes over two hours you should consider giving free Tylenol to all the members. This is mind-numbing. But it is important, and that is why I am still here.

Let me start by saying I think that the great attractiveness of the flat tax is the simplicity that people can point by taxing at a single tax rate. I think some wise man once said that, for every complex problem there is a simple solution and it is generally wrong. I am concerned that a lot of people that support the concept think that all of the deductions and everything else will remain. I am looking at the Time-CNN poll taken last week that said 48 percent of the people in the country favor the flat tax, and 42 percent opposed it. Then when you start talking about the details which we are talking about as a committee, it dramatically changes. Do you favor or oppose a flat tax system if the new system taxed all Americans at a flat rate of 17 percent? Opposed, 48 percent; favor, 41 percent. Suppose it eliminated all the tax deductions for your State and local taxes? 55 percent oppose if it does that, 35 percent favor it. Suppose it taxed wages but not profits from the sale of stocks and real estate? 57 percent of the people in the country oppose it.

Mr. KEMP. We do, too.

Senator BREAUX. Suppose it eliminates the tax deduction for charitable deductions. 64 percent of the people do not favor it. Suppose it eliminated all tax deductions for home mortgages. 60 percent do not favor it. Suppose it increased the size of the Federal budget. 82 percent say, no way.

Now, Jack mentioned, Mr. Chairman, the Reader's Digest poll, which said that most Americans felt that about 25 percent of their income would be a proper contribution to the Federal Government for its operating the Federal Government.

What Treasury tells us is that, in 1992 as the latest example, 72 percent of taxable returns were in the 15 percent bracket, 24 percent more were in the 28 percent bracket, and only 4 percent of all taxable returns faced rates above the 28 percent rate. So, 72 percent of the tax filers are already below 25 percent, and they have a 15 percent marginal rate.

Mr. KEMP. That really was not the point that we were trying to make, I would say to my friend from Louisiana. A good way of explaining it was to take the system prior to the Roth-Kemp bill, with a 70 percent tax rate.

I used to say to people, imagine going to work on Monday and paying 20 percent, on Tuesday paying 30 percent, on Wednesday paying 40 percent, Thursday paying 50 percent, Friday paying 60 percent, and on Saturday you go to work and they tax you 70 percent of everything you produce, how long during the week would you work, trying explain that marginal tax rates going up so steeply leads ultimately to people choosing leisure over work and consumption over savings.

I was not suggesting by the Reader's Digest poll, John, that everybody should pay 25 percent, but I was suggesting that the American people are not interested in soaking the rich, they are interested in getting rich or getting opportunity for their children to maybe move up that ladder. They all, according to the poll, said no one should pay higher than 25 percent. They do not care how many people earn higher than 25 percent, that 20–25 percent in peace time is the top rate.

Senator BREAUX. I understand that. The point I am making is, it seems most——

Mr. KEMP. I think poor people should pay nothing.

Senator BREAUX [continuing]. People, are in the 15 percent bracket already.

Mr. KEMP. Nonsense. The top rate in America on capital gains effectively for any asset held longer than 6 years is 75 percent.

Senator BREAUX. I understand that. But most people in the lower income brackets do not have a lot of capital gains.

Mr. KEMP. Of course not. But do you not think they want to have some capital gains some day? What do you work for if you do not want to build an investment portfolio that someday would lead to a capital gain?

Senator BREAUX. Let me ask this question of the panel members.

Mr. KEMP. If this country had high capital gain taxes——

Senator BREAUX. Let me ask this question. The Tax Code is complicated to a certain degree, not just because it is a means of raising revenue, but also because it is a means of trying to encourage certain types of activities in the country. Now, we have heard from people at the American Academy of Actuaries who say, a flat tax is going to cause problems for private pension plans because of the loss of deductions to contributions to those plans.

Mr. KEMP. No, they are not. That is not true.

Senator BREAUX. The Public Securities Association have come in and said, if you do not give tax incentives for people investing in municipal bonds, people will not have a reason to be attracted to those type of investments.

Charitable groups and organizations and the real estate industry say, the deduction is important. Without it, we are going to lose. The current system is complicated, yes, but it also provides things that I think are important to society that people fear will be lost if we do not make them more attractive types of investment.

Mr. FONG. Senator Breaux, if I may, that is the beauty of the way that we have approached framing our proposal, that it is a streamlined model of a basic car flat tax, and that to the extent the American people decide that they want options on this car, i.e., the charitable deduction or home mortgage deduction which you can design to either be revenue-neutral or add two points, depending on how you set it up, you just increase the rate. So we should not be, I think, getting sidetracked on what these options are, we should be focused, first of all, on the model car and not get sidetracked.

With regard to municipal bonds, for example, and municipal financing of State-level government, I am, as the State Treasurer of California, the largest issuer of municipal bonds in the country. I have argued that we should not maintain the exemption anymore,

and that the reason why is that I am concerned about the infrastructure in my State, my cities, and counties.

The current municipal financing scheme that gives a deduction for municipal financing is not sufficient, the capacity is not there, to build the bridges, schools, and all the things that we need under municipal financing. What we need, therefore, is input investment from the private sector. The private sector is not going to do it under the current tax system.

So what I believe we should do is, by eliminating the difference between the public and the private—in other words, making it taxable—municipalities and States will still enjoy, I believe, a cost advantage. Why? Because the underlying credit of a city or county is going to be greater because they have a revenue-raising ability. They can raise taxes, companies cannot. So, we will have an advantage.

The second thing that would keep down the pressure and price is the pension funds in our States cannot invest now in any infrastructure projects, municipal bonds, because they do not pay Federal taxes. So now you have pension funds coming in to invest in infrastructure, plus to overseas.

My final point is that deductions and exemptions are only valuable to the extent that people are paying higher rates. If you are paying a low rate, the value of your deduction goes way down.

So, in the context of what you were reading from the newspapers about opinion polls, I believe that those individuals were voting or expressing their opinion based upon their current rate. Of course they are going to cherish what they have now. It might be in the 30 or 40 percent bracket, but if they are at 15, 16 or 17 percent, it is less material.

Mr. DU PONT. Senator, if I might interject. First, I would just like to categorically reject that our testimony has been mind-numbing. I think it has been the epitome of clarity and I am distressed that you think you need Tylenol. [Laughter.]

Mr. KEMP. He is speaking for himself.

Senator BREAUX. I am talking from both sides.

Mr. DU PONT. Two observations. First, you on the committee that are going to work on tax changes need to very carefully look at the numbers and the charitable deduction question that you raise is a good one. From 1980 to 1989, charitable giving in the country rose from $49 billion to $107 billion, while rates fell from 70 to 28 percent. So there is no relationship between the value of the tax deduction and giving. That kind of analysis you really ought to look into as you go forward.

Finally, regarding people in the lower tax brackets, someone in the 15 percent marginal tax bracket is still going to pay a 44 percent marginal tax rate on $1 of investment income, 35 cents paid at the company level, another 9.8 cents paid on his return.

So his tax rate may be 15 percent, but on his first dollar of investment income he is paying 44 percent. So to say that 70 percent of the people only pay 15 percent is not totally accurate.

Senator BREAUX. Let me just ask a final generic question. People tell us that what would be done with the flat tax is to lower the rates for poor people and lower the rates for wealthy people. To me,

it seems like there's only one group to make up the loss, and that's the vast middle-income people in this country.

Rabushka and Hall estimate that the Forbes scheme would widen the Federal deficit by $182 billion a year, when most people think the thing we should be doing is reducing the deficit.

Now, if we are going to make up that kind of a loss, it is going to have to come from somewhere. So the flat tax eliminates poor people, which is a great idea, reduces the taxes on the wealthy so they can invest more, which is fine, but there is a big group in the middle. The lost revenue is going to have to come from somewhere.

Mr. DU PONT. Senator, it is not a zero sum game. As I said at the beginning of my testimony, when you reduce rates you do not reduce income. So it is not true that if you reduce rates at both ends that money has to be made up in the middle, because when you reduce rates income grows. Every tax reduction in this century in American has produced more income for the Treasury, not less.

Senator BREAUX. Is that the supply side theory?

Mr. KEMP. Well, no, it is not.

Mr. DU PONT. It is fact.

Mr. KEMP. Thank you for the question. President Kennedy said, our choice is not between reduction of tax rates on one hand and the avoidance of a large Federal deficit on the other, he said it is increasingly clear that in an economy that is hampered by restrictive tax rates cannot produce enough revenue to balance our budget, just as it cannot produce enough jobs or enough profits. It is a false choice to say it is either, balance the budget or reform the Tax Code. We are suggesting you cannot balance the budget absent a pro-growth, pro-family Tax Code.

The CHAIRMAN. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

I would like to ask about the ad I referred to in my opening statement, Senator Dole's ad that I saw this morning says that the Forbes flat tax plan increases the deficit $186 billion a year. Is Senator Dole's ad right, or is he wrong?

Mr. KEMP. No, he is wrong.

Senator CONRAD. He is wrong?

Mr. KEMP. The ad is wrong. I say that as neutral as I possibly can. You asked me an honest question, I give you an honest answer. It assumes, thanks to the Treasury Department's estimate, that a flat tax of either the Forbes plan, or Armey plan, or what Fong, du Pont, and Kemp are talking about, leads to no growth.

Now, if there is no growth in the economy, no one changes their behavior, everybody keeps doing exactly in the future what they are doing today, it might lead to a deficit. But, if you believe that rates of taxation have an impact upon people's decision to work, ask yourself a question.

Did the luxury tax on American luxury boats, automobiles and airplanes raise revenue, did it create jobs? We all know the estimates vastly exceeded the results. So I am sorry to say, I think the ad is wrong. I would not have run that ad. I think it is a mistake. I think they have pulled it; I hope they do.

Senator CONRAD. Well, I tell you, I think the best analysis I have seen suggests that you all are wildly optimistic in terms of what you think a simple change in the tax structure is going to do to eco-

nomic growth. Let me just finish by saying, you know, I myself have sort of heard this song before in the 1980's, that we are going to cut taxes and it was not going to affect the deficit.

Mr. KEMP. No, you did not.

Senator CONRAD. The deficit in this country exploded, and we have now inherited what is a $5 trillion debt. I do not want to go through that. I am all for altering the tax system. My career is dedicated to altering tax systems. That is one reason I am here. But I will tell you, I am dead set against an alteration that leads to exploding the deficit.

Mr. KEMP. So are we.

Senator CONRAD. All right. Well, I think that is an important point to make.

Mr. KEMP. Would you go back to the Tax Code before Reagan cut the rate? Would you go back to 70 percent rates, yes or no?

Senator CONRAD. No, I would not go back to those rates.

Mr. KEMP. Good.

Senator CONRAD. But I will tell you something, I also do not accept the result that we exploded the debt in this country. That is an unacceptable result.

Let me follow up on this question. Jack, you said in 1993 that income tax rates went up but collections went down. Now, I have just put a call in to CBO to find out what you are talking about and it is just not the case.

Mr. KEMP. Revenue from——

Senator CONRAD. Wait a minute. Let me just complete the question.

Mr. KEMP. All right.

Senator CONRAD. Would you say that income tax went up but collections went down?

Mr. KEMP. No.

Senator CONRAD. In 1992, we collected $476 billion in individual income tax. That was 8 percent of GDP. In 1993, we collected $509 billion. That was 8.1 percent of GDP. In 1994, after the increases, we collected $543 billion. That is an increase of 8.2 percent of GDP. That is an increase, it is not a reduction.

Mr. KEMP. I made the point that, in constant dollars, income tax revenues as a percent of GNP went down, not up.

Senator CONRAD. But they did not.

Mr. KEMP. Well, I would debate the point. They were 8.9 percent when Reagan left office in constant dollars, and they were 8.2 percent, according to your own figure.

Senator CONRAD. But that is not a relevant comparison. In 1992, we were collecting 8 percent of GDP in individual income tax. 1992. These are Congressional Budget Office numbers. I just checked with them because I was surprised by the numbers you were using. In 1993, we collected 8.1 percent of GDP in individual income tax, and in 1994, 8.2 percent.

Let me ask you this question. It seems to me——

Mr. KEMP. What were they in 1989 when Reagan left office?

Senator CONRAD. I do not know what they were in 1989. But I am talking about, obviously, you would agree, we had an income tax increase in 1993.

Mr. KEMP. And 1990. I said it did not raise revenue as a percent of the economy, it lowered it.

Senator CONRAD. Well, in 1993 we had an income tax increase and it raised collections and it raised a percentage of GDP from individual income tax. These are from CBO.

Mr. KEMP. But, as long as you are challenging the veracity of my statement, I want to know, what did they say the revenues as a percent of GNP were in 1989?

Senator CONRAD. I did not ask them about 1989.

Mr. KEMP. Well, that was my point. They were higher than they are today.

Senator CONRAD. Well, as I understood it you were making the point that you raised rates and collections went down, not up. We raised rates in 1993 and rates went up and collections went up.

Mr. KEMP. Senator, let me tell you what I said.

Senator CONRAD. Yes.

Mr. KEMP. I would like to see the record. I think I said revenues from income tax, as a percent of our GNP, as a percent based on constant dollars, went down, not up, from the tax increase. I thought I made the point that in 1989 when Ronald Reagan left office income tax revenues as a percent of the economy were over 8.6 percent. I might have said 8.9 percent; I do not know what the record says. They are down to 8.2, even by your figures.

Senator CONRAD. Well, the point I think you were making is, you mentioned that in 1990 and 1993 you said you raised rates, collections went down.

Mr. KEMP. I did not mention the word collections. I said, revenues as a percent of GNP went down, not up.

Senator CONRAD. Well, I do not know what the record will show, and I am not interested in quibbling about that. In either case, I think the facts show in 1993 we had a rate increase, collections went up in dollar terms, collections went up in terms of GDP from income tax. That is just a fact.

Mr. KEMP. From 8.1 percent to 8.2 percent.

Senator CONRAD. That is going up, Jack, it is not going down.

Mr. KEMP. The only point I am making, Kent, is that they were higher under Reagan than they are under President Clinton. I think the higher tax rates have been inefficient for our economy and I think my empirical evidence will hold out. But I am willing to change my testimony——

Senator CONRAD. I am just dealing with the 1993 increase, and I think the facts show something other than you may have communicated.

But let me go to my next question. In terms of economic growth, it seems to me the underlying assumption here of all of your work is that tax reductions are the reasons we get economic growth.

Mr. KEMP. Rate reductions.

Senator CONRAD. Rate reductions. You cited that with respect to Reagan tax cuts, the Kennedy tax cuts. I would just ask you, why then, after the 1993 increase—we would all agree there was an increase in income taxes in 1993, right?

Mr. KEMP. Yes.

Senator CONRAD. Why did economic growth go up substantially?

Mr. KEMP. Is it your premise that raising taxes encourages economic growth?

Senator CONRAD. No, that is not my premise. It is your premise we are talking about here. Your premise is that economic growth is keyed to what happens to tax rates. The fact is, tax rates went up in 1993 and economic growth went up in the fourth quarter of 1993 dramatically, it went up in 1994. So it is your premise that it is tax rates that determine economic growth. It would be my premise that lots of other things contribute.

Mr. KEMP. That is not my sole premise, Kent.

Mr. FONG. Senator, it also went up, according to the Wall Street Journal article. It went up. It only went up 25 percent of what was expected from the administration. They expected 75 percent more. So I think one could argue.

Senator CONRAD. Look, all of these administrations have the rosy scenario. We have been through that over and over.

Mr. KEMP. Yes.

Senator CONRAD. But I am asking you this basic question. Income tax rates went up——

Mr. KEMP. It is my premise that lower rates means more growth.

Senator CONRAD. Yes. But I am asking you the obverse. Income tax rates went up in 1993 and yet economic growth went up in 1993 and 1994.

Mr. KEMP. We came out of a recession. I admit that we were in a recession from 1989 to 1990, I should say, to about 1992. We came out of a recession, the economy began to grow. But I am suggesting, and I think most of us are suggesting, that this economy is not performing up to its potential.

One of the reasons—not the sole reason, Kent—is that the tax rates on labor and capital are too high and we ought to get towards the type of system that we have been arguing for here today. We could do a lot better than 1.9 or 2 percent growth.

Senator CONRAD. Believe me, you and I are on the same page with respect to economic growth potential of this economy.

Mr. KEMP. All right. Good.

Senator CONRAD. I do not accept, and I do not believe that this country is locked in to 2.5 percent economic growth. That is what we have averaged since 1973 in this country, 2.5 percent economic growth. I am absolutely in agreement with you, we have got to find a strategy to do better.

Mr. KEMP. All right.

Senator CONRAD. But I do not want to chase false hopes, I want to find the key to really doing the job.

Mr. KEMP. Good.

Senator CONRAD. And when I try to pierce the veil here, I try to figure out what really is going on with respect to what we could do, I have grave doubts that this flat tax is the absolute thing that is really the key to improving economic growth.

When you make the point, well, the Kennedy tax cuts increased economic growth, the Reagan tax cuts produced economic growth, and then I point out to you, we had a tax increase in 1993 and we got economic growth and you say, well, we were coming out of a recession. Well, in Reagan's term we were coming out of a recession

after the first two years. Remember, we were in deep recession and then we started to get strong economic growth.

Mr. KEMP. We had something worse than recession.

Senator CONRAD. So I really question that the driver here is the income tax rate.

Mr. KEMP. That is an honest question.

Mr. DU PONT. Senator, there are two drivers.

Mr. KEMP. It is an honest, skeptical question. All we are saying is, there is empirical evidence to support our basic premise that there is a link between marginal tax rates on the factors of production and the economic growth rate of a city, a country, or the world.

We can do a lot better. There are a lot of other things that have to be done, I would say to the Senator, but one of the things that we ought to be doing is getting this economy growing by removing the barriers to investment, savings, work, and economic growth.

Senator CONRAD. Let me just say, I am all for that. But I will tell you, I am not for making a structural change in the income tax or placing a big bet that making such a charge is going to dramatically change economic growth, and if it does not happen we once again explode the deficit and the debt of this country. My own belief is, the biggest driver in economic growth is these interest rates that are much too high.

Now, you referred to real interest rates being at historically high levels during this period of the 1980's. My own belief is, what we did in 1993 that reduced the deficit and helped bring interest rates down is what spurred economic growth and that that has a much bigger driver here than what we are talking about.

Mr. KEMP. Fair enough.

Senator CONRAD. The last thing we should do is increase the deficit again.

Mr. KEMP. Fair enough.

Senator CONRAD. If I could get from you guys a commitment that whatever we do we are not going to increase the deficit, because that will again drive up interest rates and I think be a real retarder of economic growth, I would be satisfied.

Mr. KEMP. Senator, with all due respect, we have had high interest rates with low deficits, we have had high interest rates with high deficits. In the 1930's, under Franklin Roosevelt, the interest rate was 1 percent. What happened to growth? Unemployment in 1938 was 28 percent.

Senator CONRAD. And we see the same thing in Japan today. Japan has got zero real interest rates and they are in a recession.

Mr. KEMP. People do not invest because of an interest rate as much as they invest for the after-tax rate of return on additional work effort and additional investment effort. Taiwan the other day put on a capital gain tax on the Taiwan stock market and it dropped 7 percent in one day. They took it off, and it went back up.

All we are saying is, there is a correlation. We are not saying it is a sole correlation, but there is a correlation between the marginal tax on additional effort and the rate of growth of an American economy. It is probably universally true.

Mr. FONG. Senator Conrad, also, there is another driver. As a tax administrator you may recall the complexity of having small busi-

ness comply. That $200 billion figure that comes from the Tax Foundation of what it costs to comply with the IRS Code, that is the preparation dealing with the different appeals through the IRS process. Even if you assume a 50 percent efficiency of savings, say $100 billion, and that $100 billion is redirected—maybe into worker's retraining, or just in inventory—that $100 billion is going to have an impact.

So I would say, one thing to focus on, and I do not think enough has been focused on the attention in the media, and the analysis is the positive impact that we will have in redirecting a lot of the compliance costs.

For example, we are recommending that you have full deductibility of expensing of your capital equipment upon purchase in your first year. That means you can limit all the schedules, do it that very first year. That simplifies the process enormously.

Senator CONRAD. Well, the concern I have remains that you have simplified the process enormously but you have dramatically increased the deficit.

Mr. KEMP. No, we have not.

Senator CONRAD. Well, I think the evidence shows that you do. We have got a difference of opinion. You assert you do not, I think the evidence is quite clear that you do.

Mr. FONG. Why would you say that though, if at the outset we are calling this plan value neutral.

Senator CONRAD. I agree with Senator Dole.

Mr. FONG. We make this value neutral. Senator Dole based his analysis also on a particular rate. We are saying that this is, as Senator Moynihan pointed out, a value-neutral rate.

Senator CONRAD. I understand that. I think you are led though to a rate that gets to be about 25 percent in order to have the mortgage interest deduction, the charitable deduction, to deduct payroll taxes, and to be revenue-neutral. Brookings has done a study that says you would be at a 25.2 percent rate. All of a sudden, the appeal of this whole thing with respect to the middle class evaporates because then very clearly what happens is the wealthiest among us get a big tax reduction, the middle class folks get an increase. I am not interested in participating in a change that does that.

Mr. KEMP. We are not, either.

Mr. DU PONT. Senator, that is specious. Of course, if nothing changes. If you are going to keep all the deductions and go to a single rate, of course it is going to have to be high.

Senator CONRAD. Are you against, then, Mr. du Pont, the mortgage interest deduction; do you oppose that?

Mr. DU PONT. I think that the preferable—and I do not speak for the commission—course is to have a single-rate tax with only a personal exemption because, for the family making less than $40,000, the lack of tax is worth more than the mortgage deduction and only about 20 percent, the wealthiest 20 percent of the people in the country, take advantage of the mortgage deduction. As Senator Chafee pointed out, 71 percent of the people use the standard deduction and do not even take advantage of it.

Senator CONRAD. But then you are saying you do not want the deduction for payroll taxes either?

Mr. KEMP. You do favor the deduction for payroll.

Mr. DU PONT. I do favor the deduction for payroll tax.

Mr. KEMP. Senator, may I make a point?

Senator CONRAD. You are not only for the personal exemption, but you are for the payroll deduction as well.

Mr. KEMP. Wait, wait, wait.

Senator CONRAD. I mean, you have amended it.

Mr. KEMP. No.

Senator CONRAD. Would you amend it further for the deduction for charitable contributions?

Mr. KEMP. Kent, please, to be fair to both sides of the debate, let us do it with civility. You have been kind to us.

Senator CONRAD. I am trying to be civil. I am just asking a question.

Mr. KEMP. Well, could I make a point then?

Senator CONRAD. Yes.

Mr. KEMP. Our report does not go into whether the new automobile is going to have new windshield wipers or not, but we are very sympathetic to the idea that there should be retention of the charitable contribution and mortgage interest deduction because it is a wash to the Treasury. You do not lose money to the United States Treasury if the lending institution pays tax on the interest it earns from your mortgage.

Senator CONRAD. Well, all I can say is, I was responding to Pete's answers.

Mr. KEMP. Well, I have said it twice now. It is a straw man. I have said it twice. We favor it, he does not.

Senator CONRAD. But Pete does not favor it.

Mr. KEMP. But he is speaking for himself, not the commission.

Senator CONRAD. I understand. I was asking the question and Pete made the point that he does not favor that, he does not favor the mortgage interest deduction, and he does not favor the charitable deduction.

Mr. KEMP. He is not speaking for the commission.

Senator CONRAD. I understand.

The CHAIRMAN. We are going to have to move on. The time of the Senator has expired.

Senator Moseley-Braun?

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman. At the outset, again, I want to congratulate the commission for starting this conversation and debate because it is a very important one, given the level of frustration out there in the country about taxes, about our tax structure.

To start off with something like a tax, which I guess is next to death in terms of things that people prefer to have, and then add the complications of our current system, there is a lot of feeling that we ought to do something, but deciding what that something is is what this commission has to work on.

I think we have to be very clear in terms of the language that we use and what it is that we tell people about the various proposals around, because, quite frankly, as we talk about flatness of the tax it is almost like beauty being in the eye of the beholder.

At any given revenue yield, a single-rate tax does not necessarily achieve a lower marginal rate than a multiple rate system. So in

that regard, flat does not necessarily mean lower. Would you agree with that assumption, that flat automatically means lower?

Mr. KEMP. If there is a generous exemption with deductibility of payroll tax, you get progressivity for the poor. That is why Eleanor Holmes-Norton calls her flat tax a progressive flat tax, because it is de jure flat and de facto progressive by the generous exemption for low-income people.

Senator MOSELEY-BRAUN. That gets kind of to the second point, which is that when you start talking about adding exemptions and deductions to a flat tax, or if you come up with something, a progressive flat tax, is that not what they call an oxymoron? Are you not talking about a non-flat flat tax when you have exemptions and deductions such as have been proposed in some of the many different proposals?

Mr. KEMP. It is oxymoronic unless one takes a look at the actual outcome. In effect, we are talking about a maximum tax rate beyond which you would never go. So flat tax, in and of itself, does not connote the right system.

What we are actually saying is, no matter how hard you work, and no matter how much you invest, and no matter how hard you spend your capital to build your business, or whatever, you will never be taxed beyond X. You establish what X should be, that is all. We think it should be closer to 19 percent than to 40 percent.

On capital gains, the proper right is zero, not 60 or 70 percent. It is a maximum rate, in effect, with progressivity for the poor. But, for lack of better words, we called it a single-rate system with a large exemption for the poor.

Senator MOSELEY-BRAUN. But, again, even with regard to the poor, right now we have an Earned Income Tax Credit, for example, that impacts on the amount of tax that poor people, working people, pay.

Mr. KEMP. Right.

Senator MOSELEY-BRAUN. So when you are talking about flattening this progressive flat tax or flattening the multiple rate structure, things liked the Earned Income Tax Credit go out the window.

Mr. KEMP. No, they do not have to.

Senator MOSELEY-BRAUN. That is retained in your proposal?

Mr. KEMP. Well, why is it in there? It is in there to offset the payroll tax. So if you allow——

Senator MOSELEY-BRAUN. Oh. You convert it.

Mr. KEMP. I am saying that you can make up your own mind, Carol, with regard to whether or not you want an EITC or a refundable EITC. There is an argument to be made that it should be sacrosanct in the current system, but if you go to a new system with a single rate, deductibility of the payroll tax and a large exemption for the poor, you may decide that you do not need as large an EITC as you do right now because you will not have the same burden on the poor as you have under the current Code.

But we are not making a decision for you, we are saying, here is a road map, you make the final decision about whether or not there should be an EITC, or whether you should privatize Social Security, or whether you should allow it to be deductible. That is fair.

Senator MOSELEY-BRAUN. One of the things that commends this report, as opposed to some of the earlier flat tax proposals and definitions, is that it does make judgments that suggest, for example, that Social Security payroll taxes should be credited against. I mean, that is a recommendation. But, again, we have set up one category that is not going to be included in the tax base when we say we take the payroll taxes out.

Mr. KEMP. Well, we established the principle——

Senator MOSELEY-BRAUN. The principle. All right.

Mr. KEMP [continuing]. That if you have a single tax you ought not to tax a tax, so that follows logically from the premise.

Senator MOSELEY-BRAUN. I think we are in agreement on that point.

Mr. KEMP. Good.

Senator MOSELEY-BRAUN. The second point is that, with with regard to other areas of controversy—and we have already mentioned the mortgage interest deduction, we have already mentioned charitable deductions—there are specific impacts that will affect both revenue to the Treasury, on the one hand, and the private sector and the market on the other.

Mr. KEMP. Right.

Senator MOSELEY-BRAUN. Specifically with regard to mortgage interest, and I do not know who you said it to or who made the statement earlier, but the statement was made that the deduction for mortgage interest would have no impact on the Treasury, that it was a wash.

Mr. KEMP. Basically a wash.

Senator MOSELEY-BRAUN. Their numbers, however, indicate that it will have an impact to the tune of about $53.5 billion.

Mr. FONG. Well, Senator, you can set it up two ways. You can set it to be revenue-neutral, where you are taxing the financial institution and then letting the individual deduct it, or you can make it cost the government by two points, we were told. So if your revenue-neutral rate is 20.8 percent, then add 2 percent to that, if you do not want to tax the financial institutions. So you can set it up either way.

Senator MOSELEY-BRAUN. So you are talking about an adjustment to compensate then for the mortgage interest deduction, which gets to a third question, again, just with regard to mortgage interest specifically. That has to do with the impacts on the other side of the equation, on the private sector.

In that regard, it has been estimated that a change, elimination of the current interest deduction, will result in—and there have been various estimates—between 15 percent and 22 percent decline in the value of real estate. Again, that is the range, from 15 to 22 percent decline in the value.

Mr. KEMP. Who estimated that?

Senator MOSELEY-BRAUN. Well, all right. Some of the academicians estimated 15 percent, and the interest groups estimated 22 percent decline in real estate prices.

Mr. KEMP. What if you left the interest mortgage deduction in, would there still be a decline?

Senator MOSELEY-BRAUN. Then that would increase the base on which the tax rate has to be posed.

Mr. KEMP. We challenge that. We challenge that. You can design it, as Matt Fong said, so the family that deducts the interest on the mortgage, which might lose money for the Treasury, would be gained back from the fact that the lending institution would pay tax on the interest they earned from the mortgage. So we believe that it could be designed to be revenue-neutral.

But stop and think. Stop and think. If you eliminate the capital gain tax on the sale of any asset, how could the value of the asset go down? It would go up.

Senator MOSELEY-BRAUN. The capital gains, obviously, would probably stimulate activity in that area, but it would be activity stimulated at a lower real price for the real estate being traded, sold, or bought.

Mr. KEMP. Well, I find that hard to believe, that the price would go down. Do you think the stock market would go down if you eliminated——

Senator MOSELEY-BRAUN. That is another——

Mr. KEMP. Well, stop and think. Would financial assets go down if you had no capital gain tax on the sale of a bond or a stock?

Senator MOSELEY-BRAUN. We are not talking about capital gains right now, I was talking specifically about the price, the real prices, on real estate. Those real prices would decline, which, of course, given the fact that you have eliminated the capital gains on the real estate, would have an impact on the amount of activity. But it is estimated that the real prices for that real estate would, in fact, decline.

Mr. KEMP. That beggars imagination to think how that could happen. If there is no tax on a piece of property for the sale of that piece of property and you stimulate economic activity, most people, it seems to me, left and right, would acknowledge that the value of the property would rise.

Senator MOSELEY-BRAUN. What you are doing is positing an increase in value on the capital gains side versus a decrease of value in the loss of the mortgage interest deduction. You are kind of talking apples and oranges, in a sense, and I do not know that anybody has calculated what those different values are.

But let us move to my next set of questions. Again, I am just exploring this and I am not trying to be contentious in any way.

Mr. KEMP. I appreciate that.

Senator MOSELEY-BRAUN. That gets to the issue of transition, and the transitional rules for transitioning from, again, the very situation that you posit. How do you go from a mortgage interest deduction being calculated as a part of real estate prices versus the change that you suggest would happen with the capital gains change.

Mr. KEMP. Carol. Carol, please.

Senator MOSELEY-BRAUN. Wait. How does the market make that transition in the absence of guidance from us? I mean, that is what we are supposed to do.

Mr. KEMP. All right. Please read it before you make the statement that we take out the interest on mortgages. We do not. We do not make that judgment, Mr. Chairman. We do not make that judgment, we leave it up to you.

Senator MOSELEY-BRAUN. Jack, if I may, that is kind of the problem. You have given us a very nice report, and it is beautiful to use the word, but that is why I started off saying it is in the eye of the beholder. I do not think that anybody can read the report and say, boy, these people are really just awful people. It sounds wonderful. The question is, how do we get there?

Mr. KEMP. I agree.

Senator MOSELEY-BRAUN. How do you transition yourself from the system that we have to that without exploring the particulars and the specifics of the various rules and the various impacts that will be created? That is what this committee has got to do. I am just asking you to try to give us, since you have had time to go over in the writing of the report, what was the thinking of the commission membership on transition.

Mr. KEMP. The thinking of the commission was to make a transition from the current system to a new system. We laid down a predicate: it should be pro-growth, it should be fair, it should be simple, it should be not tax taxes, and it should tax income but once, and it should be fair to the middle class, and it should remove barriers to low-income people getting access to capital so they can be upper income people.

N w, on that premise we put out a road map, not a street map. We did not make a decision about the deduction of interest on mortgages or charitable contributions, albeit we say in here it is totally determined by the people who write the Code. You will write the Code.

Senator MOSELEY-BRAUN. Right. I guess maybe I am looking for—I do not want to continue, because I do have, Mr. Chairman, one last question that is kind off this point.

Mr. KEMP. And there has to be a transition.

Senator MOSELEY-BRAUN. I have to make the point to you, I was last night looking at a fashion magazine and I saw a gorgeous dress. I said, boy, I would look great in that dress. The problem is, it is a size eight. I have a lot of weight loss to do before I can get into a size eight dress.

Now, what you are saying is, here is a beautiful dress.

Mr. KEMP. Sure.

Senator MOSELEY-BRAUN. Let us go into it. But you are not giving us any guide as to how we get into it.

Mr. FONG. Senator, using your example, you have made the decision that you like that new dress.

Senator MOSELEY-BRAUN. Right.

Mr. FONG. Therefore, if you decide that you want it, then you will figure out a way to transition to get to the size eight.

Senator MOSELEY-BRAUN. I have been working on that for a while, trust me. [Laughter.]

Mr. FONG. But we felt that, with the limitations of time and the resources—we were self-funded—we did not have the ability to get down to the details of transition. We said, why get into it if after all of this people do not want the new dress.

Senator MOSELEY-BRAUN. That is correct.

Mr. FONG. Maybe they want something else. So why get into the transition problems? We recognize that there are transition challenges.

Senator MOSELEY-BRAUN. All right. That is all.

Then the final unrelated question is not on transition. One of the questions that was raised last year when we had discussions about the Hall-Rabushka plan, which is different, obviously, than what the commission has recommended, was that there was some testimony that suggested that what they call the initial elderly, that is people a little bit older than me who are just about to be senior citizens.

Mr. FONG. Like me.

Senator MOSELEY-BRAUN. Junior senior citizens. They would be impacted more negatively than any other group with this transition. That is the testimony, here is the report.

Mr. KEMP. From whom?

Senator MOSELEY-BRAUN. Good question. I do not have my glasses on.

Mr. KEMP. You can retire with no estate tax. You can retire with no tax on your savings.

Senator MOSELEY-BRAUN. This is testimony, a prepared statement, by Lawrence Kotlikoff, who is a Ph.D. Professor of Economics at Boston University. He testified last year and he made some statements. He went on to say—and I would like you to take a look at this because we do have to look at generational and distributive impacts of this transition—that these people might suffer a 23 percent decline in their final years' consumption at age 55.

Mr. KEMP. What is his premise?

Senator MOSELEY-BRAUN. Well, I cannot recall.

Mr. KEMP. He may be arguing logically from his premise, but we do not accept his premise. How is it possible that somebody could retire on a lifetime of savings that are not taxed twice, with a zero capital gain tax and a zero inheritance tax; how is it possible their earnings could go down? It seems to me inconceivable.

Senator MOSELEY-BRAUN. I can share with you, he was actually supportive of the consumption tax.

Mr. KEMP. Oh, consumption tax.

Senator MOSELEY-BRAUN. I had mentioned this was last year and this was on some of the earlier and other proposals he was supportive of, but he did say that it had an impact on the elderly.

My question to you is, did the commission take a look at the generational aspects and distribution by age, and if so, what conclusions have you reached?

Mr. KEMP. Well, we heard from a lot of people, many of whom were in their golden years, as is moi. Some would say my wilderness years. Again, every farmer in Nebraska, every small businessman and woman in South Central Los Angeles, every person who wanted access to capital said, do something about the double, triple, and quadruple taxation of my savings, my investments, my salary. So we have come up with a plan. We did not go into the distribution tables, per se, because we think they are mightily flawed.

My answer, off the top of my head and from my heart, is that this would increase the after-tax income and the after-tax portfolio of every American. But, more importantly, Mr. Chairman, it would give people who do not have any portfolio a chance to someday own a portfolio.

The CHAIRMAN. It is almost 1:00, so we are, Carol, going to have to move on.

Senator MOSELEY-BRAUN. I have nothing further. Thank you, Mr. Chairman, for your indulgence.

The CHAIRMAN. Thank you for your question.

I would like to call on Senator Bennett, first.

Senator BENNETT. Thank you, Mr. Chairman. I appreciate your indulgence in allowing me to be in the committee. Under the rules of the Senate, as long as Senator Hatch is a member of this committee, I never will be. I consider that a great deprivation on my part, although I recognize the contribution he makes.

This is a subject in which I have invested a lot of interest, and intend to continue. I just have a few observations that I would like to make, Mr. Chairman.

First, Jack, I can report to you authoritatively that the Dole TV spot has been pulled. So, that disappears from the debate, I trust.

Mr. Fong, I was interested in your comment about the bunker oil, and it ties to the experience with the boat tax, that the imposition of the tax destroyed the industry so that the revenue was zero.

However, before we get too congratulatory, those of us who believe this doctrine, Senator Packwood pointed out to me, while he was Chairman of this committee, as we were talking about this that the revenue from the imposition of the luxury tax on automobiles was three times what was projected at the time the tax was imposed, which brings me to my principal point.

None of these projections can be considered accurate. The Treasury will come down to a point of a point in telling you what will happen if this is imposed, and they are wrong. Governor du Pont will wax eloquent as to what is going to happen, and he is going to be wrong. Anybody who has been in business knows that the issue of price sensitivity on the price you put on a product can only be tested in the marketplace.

You sit around in the board room and tell yourself you are going to make X zillion dollars by raising your price on this product, as Ford did when they raised the price on their Taurus—and the people at Ford are not stupid—but the market reacted to that in such a way that the new Taurus now has a $600 rebate connected with it, as they have discovered, like Jack Kemp, that the best way to move the product and save the company is to cut the price, because they made a mistake in their projections. We do not seem to learn that lesson in government.

The best way to save the boat industry is to cut the price, not raise it. But we hit the boat industry at a time of over-capacity and over-production with a 10 percent mandated price increase and we destroyed it, whereas on the luxury car circumstance we discovered that people do not buy luxury cars for price, they buy it for some other reason. All of a sudden, this was not price sensitive. And, while I hate to have to say it, we were wrong on the low side of that one.

So I congratulate the commission on the work they have done. I think they are on the right track. I summarize my reaction to all of this, Mr. Chairman, with three comments that I think we can be sure of and not that it is going to raise the deficit by $180 billion. Nobody knows. Nobody knows to that kind of specificity.

We are crazy if we try to debate these kinds of numbers because the market will always defeat us in our forecasting. But these three observations I leave with the committee and thank the Chair for your indulgence.

Number one, the compliance costs of the present system are real and they are significant. No amount we are talking about can change that. We are spending hundreds of billions of dollars every year as a society to try to keep up with the present complexities.

Number two, the disincentives for wise investment built into the present system that apply to those who have alternative wealth to do something with are real.

The disincentives for the Merten's probably do not exist. The Merten's do not have any real choices. They are spending everything they can for food, clothing, shelter, and education for their kids.

But the people who have choices by virtue of where they are have very real disincentives built into the present Tax Code that cause them to do things that they would not otherwise do that are probably not good.

So, I come to the conclusion that the current system is, in fact, as a result of the first two statements I have made, a drag on the economy and thereby holds down growth.

So, while I may not embrace the specific numbers of Governor du Pont and others, I end up, Mr. Chairman, in their camp—that has a nice ring, the Kemp camp—because I see that the present system is not producing what we need to produce.

I say to the former Chairman of the committee, I think developed economies can growth at between 3–3.5 percent, as the United States did for over a century while the British were, indeed, the dominant economy in the world.

But we were catching them, and the reason we caught them over that century is because we grew at about a tenth of a point more than they did over a 100-year period. I think we can get back over the 3 percent and go for that tenth, and I think the tax system can be reformed in a way that can get us there. I thank the Chair.

Senator MOYNIHAN. Mr. Chairman, may I make a response to my friend?

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. I hope you are right on the growth issue. Could I ask you, just for the arcana of these matters, on luxury cars. You say that for people who buy luxury cars, price does not matter. What if it turned out that, indeed, price is everything, and the higher the price the more desirable the product?

Senator BENNETT. There is no question but what that phenomenon occurs in the marketplace. One of the worst things that Cadillac ever did was to produce a cheap car. It destroyed the image of the company. They are now trying to get the image back by producing the biggest, most comfortable boats in the world that cost a tremendous amount of money, and they are prospering.

Mr. KEMP. Would the Senator yield for arcana?

The CHAIRMAN. Please proceed.

Mr. KEMP. When the top tax rate in Britain prior to Margaret Thatcher was 98 percent, Rolls-Royce sold more cars. Consumption

goes up and risk, savings, and investment go down when you have high marginal tax rates.

Senator MOYNIHAN. Nice point.

Mr. KEMP. Because consumption then is something you can have right now, savings and investment takes deferred gratification and risk, ergo, you get hurt by high rates.

Senator MOYNIHAN. Well, Mr. Chairman, what I want to say in closing is that we are very much in the debt of this splendid man and his company. We were talking earlier about Henry George, Progress in Poverty in 1879.

George did something very important. He broke out of economics of the dismal times and started speaking of the optimistic economics of abundance. He said, tax all that property that is not being used, spread it around to get things going. I do not know if he is right or not, but by God, it feels good to have him in the room, does it not? Thank you, sir.

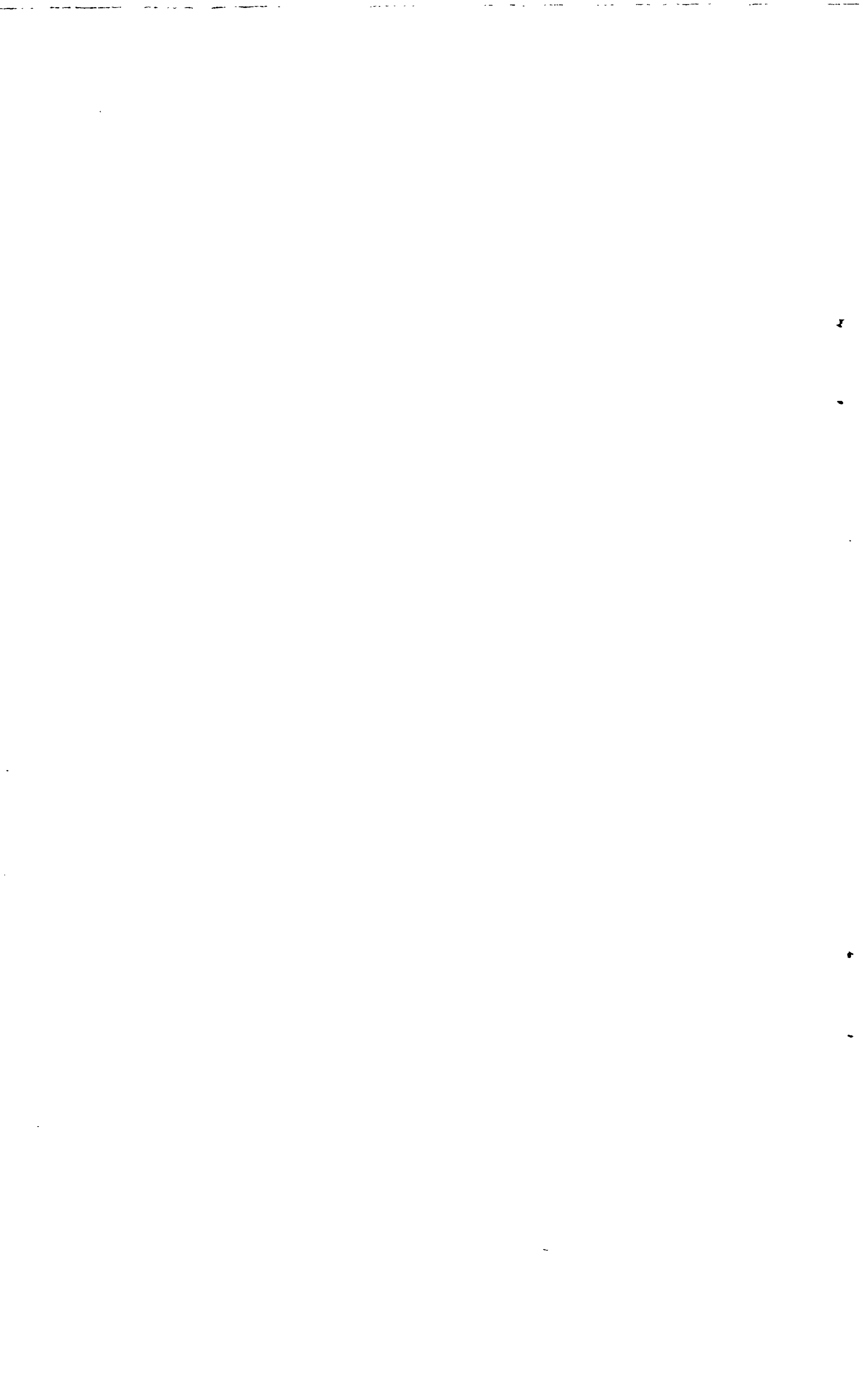
Mr. KEMP. Thank you, sir.

The CHAIRMAN. Well, I want to congratulate and thank each one of you. I think the hearing has been helpful. I have a number of additional tough questions I would like to ask, but will put them in writing to you.

I would ask and hope that the commission will be available for further questions as we proceed with this tax reform.

Thank you, gentlemen, very much.

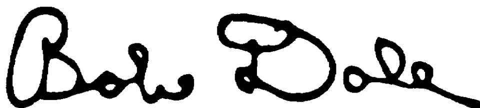
[Whereupon, at 12:55 p.m., the hearing was concluded.]



APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF HON. BOB DOLE



NEWS FROM: U.S. SENATOR FOR KANSAS
SENATE REPUBLICAN LEADER

FOR IMMEDIATE RELEASE
Wednesday, January 17, 1996

Contact: Clarkson Hine
(202) 224-5358

NATIONAL COMMISSION ON ECONOMIC GROWTH & TAX REFORM

DOLE WELCOMES PRINCIPLES OUTLINED IN KEMP COMMISSION REPORT; AMERICA NEEDS NEW TAX SYSTEM BASED ON ECONOMIC GROWTH, FAIRNESS, SIMPLICITY & STABILITY

Last spring, Speaker Gingrich and I appointed Jack Kemp to head a National Commission on Economic Growth and Tax Reform.

We asked him to bring together a group of distinguished economists, entrepreneurs, and business leaders to determine how our current tax system hinders economic growth, job creation, and opportunity.

We asked him to start with a blank sheet of paper and to lay out the principles for a new tax system for the 21st century.

And, finally, we asked him to do something that comes naturally to Jack--to be bold, aggressive, and innovative in his recommendations.

Jack, I think both the Speaker and I can stand here today and congratulate you and the entire Commission for fulfilling that mandate.

Principles Serve as Starting Point for Debate

The principles articulated in this report will serve as a starting point for a great national debate on tax reform. These principles--economic growth, fairness, simplicity, and stability--provide the philosophical building blocks for an entirely new tax system.

They create the foundation for a tax system based on economic growth instead of redistribution of wealth; a tax system that encourages entrepreneurship instead of stifling innovation; a tax system that unleashes the full potential of our nation instead of limiting our ability to grow.

No one who reads this report can defend the current system or deny the need for fundamental change.

Need for New Tax Code

The problems of today's tax code are clear. With the latest Clinton tax increase, the top rate now stands at almost 40%. High marginal rates are discouraging work, reducing the rewards of entrepreneurship, and discouraging job creation. Middle class families are being forced to work harder and harder just to keep up--their hopes for a better life taxed away by government.

As the tax code has grown more complex, the IRS has grown more powerful and their agents have grown more aggressive toward individuals and small business owners alike. And, as the Commission's report so powerfully demonstrates, the complexity of the code wastes millions of hours in compliance efforts; and it costs businesses and individuals billions of dollars to meet the ever-changing rules of the IRS.

I agree with the Commission that America needs a new tax code to move us toward our goals.

<u>Tax Relief for Working Families</u>

The central concern of any tax reform intiative must be to provide tax relief for the millions of working families who are shouldering the burden of the current system.

We can never achieve our goal of greater economic growth and opportunity for all Americans by raising taxes on the middle class, or by hindering our ability to reach a balanced budget.

<u>Congressional Hearings & Tax Reform Legislation</u>

There is no doubt that tax reform will be one of the major priorities of the next Congress and the next president. My hope is that the principles in this report--which I am forwarding to Chairman Roth and the Senate Finance Committee--will form the basis for future congressional hearings and debate--and ultimately for tax reform legislation.

During much of the past century, tax policy has been a primary tool with which government has wielded power, fed the bureaucracy, and redistributed wealth.

Deleting the whole twisted wreck of federal tax law and starting anew is the surest way I can imagine to deliver real and lasting economic change to the American people. Because the efforts of Jack Kemp and this Commission, we have taken a giant step toward fulfilling that goal.

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TIME FOR A NEW TAX SYSTEM

Pete du Pont
Member, National Commission on Economic Growth and Tax Reform
Policy Chairman, National Center for Policy Analysis

Thank you Mr. Chairman, and distinguished members of the Committee, for this opportunity to testify on the problems inherent in our nation's current tax code and the work of the National Commission on Economic Growth and Tax Reform to develop a tax code that addresses those problems.

Our nation's current tax system is unjust, unfair and too complex. Its enforcement ranges from lax to nasty, and it is riddled with loopholes. In 1979, 20,000 taxpayers with incomes greater than $100,000 paid more than 40% of their income in taxes, yet another 20,000 with the same income paid less than 15%. The income tax takes up to 40% of what we earn each year, and half of anything leftover when we die - the family farm, the small business we have built, or the savings we have worked so hard to accumulate.

It has gotten so out of hand that, in Montana, it is actually possible to pay a tax rate of 113% on your earnings. If you are a sixty-four year old working in Montana and earn an additional dollar, you have to pay 46 cents in federal taxes, 12 cents in payroll taxes, 5 cents in state taxes, and you receive 50 cents less in social security benefits. Think about that, work to earn an extra dollar and you have to pay 63 cents in taxes and you lose 50 cents in benefits. You do not have to be a tax expert to know there is a problem with any tax system that allows that to happen.

It all started so innocently. The federal income tax instituted in 1913 did not even apply to 98% of American families. By 1916, the top marginal rate had increased from seven percent to sixteen percent. By the fifties, it had risen to the confiscatory rate of ninety percent. Presidents Kennedy and Reagan each cut the top rate so that by the time Reagan left office, it stood at 33%, but it has inched up to over 40% again.

It's not only the top earners who are suffering the consequences. Under the guise of taxing the rich, the government has, in fact, seized the prosperity of everyone else. Author Frank Chodorov described what happened: "at first it was the incomes of corporations, then of rich citizens, then of well-provided widows and opulent workers, and finally the wealth of housemaids and the tips of waitresses." By failing to increase the dependent deduction, Congress has reduced its value for median income families by 75%. In 1948, the median income American family paid 3% of its income to the federal government. Today, it is paying 25%.

The effect of all this on America's families can be devastating. James Glassman, who writes for The Washington Post, recently talked about an Iowa family - Bonita and Kenny Merten and their two children - who are having great difficulty surviving financially on their family income of just over $32,000. They are hard-working people who are not making ends meet. Glassman points to "the stupid and cruel tax system" that is "confiscating a big chunk of what" the Mertens "manage to earn each year." You see, out of their $32,000, the Mertens pay $2500 in federal income taxes, $1100 in Iowa state taxes, and almost $2400 in Social Security and Medicare payroll taxes. Throw in property taxes and the Mertens are paying $7500 a year in taxes, a fourth of their income. They skimp, buying powdered milk and substituting beans for meat, while the federal government lives high at their expense.

You don't believe it? In twenty years, 1973 - 1993, the real incomes of the lowest 40% of families - people like the Mertens - did not grow. They remained flat; static. In roughly the same period, 1973 - 1995, the real take home pay of the federal government increased by 58%. There's fairness for you: government income up 58% and working people's income up not at all.

It all reminds me of our revolutionary ancestors complaint against King George, as set forth in the Declaration of Independence: "he has sent hither swarms of officers to harass our people and eat out their substance."

The National Commission on Economic Growth and Tax Reform was not created to tinker around the edges of the current tax code to make it a little better. That approach has been tried for fifty years. Our goal was to start over: to devise a tax code that creates jobs, expands opportunities, and increases the living standard of all Americans. Our nation needs a tax code that channels the powerful energies of Americans into seeking opportunities for growth, instead of seeking tax shelters; a tax code that rewards entrepreneurs and investors for taking risks, and is simple enough so that parents could spend April 15th taking their kids to a baseball game instead of doing their taxes.

We began by listening - at public hearings across the country - from Boston to Palo Alto, Harlem to Charlotte. We heard an earful. Many of the responses reflected deep cynicism about any attempt to truly and permanently reshape tax policy. After all, there have been 4000 changes to the tax code since the last "reform" in 1986, and things are worse, not better. A tax accountant from Wyoming noted that he makes his living from preparing other people's taxes, but still felt "disgusted" with the current system and urged us to "completely abolish the Internal Revenue Code and start over." A couple from Florida said the current code was "way out of date with the real world," and that it was "too complicated with too many loopholes." They added "dump it." Accountant Ted Krauss said that our current tax code's high marginal rates, coupled with multiple taxation of saving and investment, act as a "double-barreled shotgun aimed at the American economy."

The Tax Foundation estimates America spends two hundred billion dollars and 5.4 billion hours each year complying with the complex provisions of our tax code A real estate developer in Nebraska pointed out that this "time and effort and money did not educate a single child, it didn't feed a single family, and it didn't produce a single tangible object to improve the life of anyone."

The Commission's recommendations address the problems inherent in the current tax code and the warning bells sounded by the American citizens that testified at our hearings or that

wrote to us with their comments. First, the Commission believes we must repeal the current tax code in its entirety. Not just reshape the current code or tweak it to make it a little better, but rather, we should take a sledgehammer to it. Our report concluded "we believe the current tax code cannot be revised, should not be reinvented, and must not be retained. Therefore, the commission is unanimous: It is time to throw out the seven-million-word mess of tax laws and regulations and begin anew."

Second, we must replace our current code with one that taxes income once, at a uniform, low rate, with a generous personal exemption. The commission did not set the tax rate to be used or the amount of income that would be free of tax. Obviously, one affects the other - a higher exemption will require a higher tax rate - but we felt that should be a decision made by the members of the United States Congress. There was, however, an informal consensus on the Commission - and I think it deserves emphasis here - that the rate should be less than 20% and that taxes for middle income Americans should go down.

Third, given the importance of letting the American people live with a set of groundrules that are not constantly shifting, this low rate should be very difficult to raise, requiring a two-thirds vote in each house of Congress - the same as a veto override.

Such a tax system would be fair. It would be simple. It would be progressive. All income above the threshold would be taxed at a uniform rate. The loopholes would be gone. Everyone would pay and everyone would understand what everyone else is paying. No longer would savers find themselves taxed more than consumers; older people more than young. All taxpayers would pay the same rate of tax, which is presumably what the Constitution means by "equal protection of the laws."

I should point out that taxing income only once has real consequences. Currently, it is taxed four times: when earned, when the after-tax earnings are invested, when the investment grows (the capital gains tax) and confiscation of one-half of whatever is left at death. Taxing income once means death taxes would be gone; so would capital gains taxes and the alternative minimum tax.

The commission's proposal is founded on a simple concept: a family with five times the income of another should pay about five times the tax, not just three times the tax by using loopholes, or ten times the tax due to the punishing rates of today's tax code. A computer programmer working 60 hours a week is penalized for his additional work, compared to one who works 40 hours, by paying a higher tax rate on his extra effort and productivity. That seems counter-productive. Don't we want to encourage people to work harder, longer, and smarter?

There are reasons of equity to replace our current tax code. There are reasons of simplicity. But, the primary reason is to increase opportunity for all Americans. In the words of President John Fitzgerald Kennedy, "it is a paradoxical truth that tax rates are too high today and tax revenues are too low, and the soundest way to raise the revenues in the long run is to cut the rates now . . . the purpose of cutting taxes now is not to incur a budget deficit, but to achieve the more prosperous, expanding economy which can bring a budget surplus."

The original Hall-Rabuska flat tax proposal was estimated to increase economic growth two to four percentage points per year. Increasing growth by just one percentage point per year would mean six million new jobs over the next eight years, an additional $2 trillion in economic

growth, and $700 billion in additional tax revenues to spend or pay down the deficit. The National Center for Policy Analysis calculated that the flat tax that former Democratic Governor Jerry Brown of California proposed in 1992 would have created 2 million new jobs in two years and increased the Gross National Product by 10% by the year 2000.

President Kennedy's 1960's tax cut jumped the annual growth rate of the U. S. economy from 3.5 to 5.2%. President Reagan's 1980's cut raised it from 0.4 to 4.3%. Professor Dale Jorgenson, Chairman of the Economics Department at Harvard, estimates that this level of economic growth would increase the income of middle income families by $4,000-6,000 per year.

So the debate has begun. It will be long, loud, and lively. The very ideas of lower rates, single rates, and taxing income only once will have vigorous opponents. Those who back larger government will see it as a threat; others will oppose too much prosperity for the successful; the beneficiaries of today's loopholes will fear the end of their privileged status. All will insist upon the status-quo.

At the beginning, the only people for it will be people like the Mertens, the people who do America's work, bowl on Thursday night, and buy beans instead of meat. A recent Roper study found uniformity among Americans of every race, sex, income, education level, and political affiliation, that no one should have to pay more than 25% of their income in taxes. That sounds much like what the tax reform commission concluded.

By discouraging investment, innovation, and the taking of risk, the current tax code is restraining the U.S. economy's growth rate to about 2.5% per year. With a progressive flat tax, the economy could be growing 4%, or perhaps more, which would bring real increases in their quality of life to millions of families across our nation.

That is the goal of the Tax Reform Commission's proposal: to increase jobs, growth, income, and the quality of life. With our current tax code, these things are impossible. With a progressive flat tax, they can be achieved.

# # # # #

DRAFT

Testimony
Before the
United States Senate
Committee on Finance

Matt Fong, Treasurer
State of California

January 31, 1996

Mr. Chairman and Members,

As the elected Treasurer of the State of California and a member of the Tax Reform Commission, I am honored to be a part of this very important hearing and to be here with Jack Kemp and Governor DuPont representing the work of the Commission.

You have heard from critics of the Commission's work who claim that the Commission's report is full of principles and lacks technical detail; that it recommends a rate but doesn't specify a number; and that it recommends a tax system that will either bust the budget or bust the middle class. In effect these critics say the report is a waste of time. I STRONGLY DISAGREE.

I like to analogize our charge on the Commission to the approach one takes when buying a new car. You don't start with the decision about all the options you want on the car such as power seats, power locks, and a CD player. You start with the decision that you NEED A NEW CAR. The old car is outdated, outmoded, and can't be repaired. The current IRS code IS outdated, outmoded, and IS beyond repair.

The problem with today's debate on tax reform, as I see it, is that after people agree that a new tax system is needed, they get lost talking about the options such as the home mortgage deduction. Before you decide on all the bells and whistles, you have to decide which basic tax structure (i.e., flat tax, sales tax, value added tax) you think best fits the needs of the country.

At the outset, we found that we needed a framework to guide us through the different proposals being debated. We ultimately reached consensus on six principles.

- ***Economic growth*** - encourage initiative, hard work, savings
- ***Fairness*** - treat all citizens alike
- ***Simplicity*** - understandable by all
- ***Neutrality*** - eliminate bias against savings and investment
- ***Visibility*** - an honest accounting of the cost of government
- ***Stability*** - an ability to plan for the future

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Critics have ignored the Commission's identification of these important principles as if we simply made up the list from a high school Government text. Nothing could be further from the truth.

We used our six principles to develop a basic tax system that we felt would correct those problems. Let me illustrate by using one principle that was very important to all the Commissioners...VISIBILITY. Using the principle of visibility, the Commissioners, by consensus, not only placed a high value on having citizens know the cost of their government but they eliminated recommending the Value Added Tax which failed this principle miserably.

The ***tax rate is the price tag of government.*** Critics have faulted our report for not recommending a specific tax rate. I would counter that we HAVE set a specific rate. It is the rate that will continue to operate government at its current size.

By establishing a specific number, we would have left the back door open for a new debate...whether to reduce the size of government. Debating the size of government was not our charge. Again, tax reform would have become muddled in the larger debate.

I, like Chairman Kemp, believe the peace time tax rate should be less than 20%. If the price tag of government as expressed as a revenue neutral tax rate happened to be 23%, for example, I hope that taxpayers would believe, as I do, that at that price government costs too much (i.e., the rate is too high) and would put pressure on their elected officials to reduce the cost.

Critics also have complained that our reports a single tax rate rather than a multiple tax rate system. Every Commissioner believes strongly that the principle of fairness should be one of the cornerstones of a new tax system. Each taxpayer must be treated equally. That is, proportionately everyone should pay the same tax.

Proponents of a multiple rate system are clear in their objective. The result of harder work, and higher pay is a greater share of your income for taxes. In the Commission's eyes, this fails the fairness test.

Throughout our hearings, citizens told us that what they want more than anything else in a tax code is the knowledge that everyone, from one end of the income scale to the other, is being treated the same. That is the beauty of a flat tax.

Therefore, Senators, I believe you have two paths. 1) Design a tax system that only collects revenue for the purpose of funding reasonable government expenditures; or 2) Create a tax system that collects tax revenue AND also redistributes wealth.

Finally, we have heard from critics of the flat tax that it will "cost" the government billions of dollars, will create a windfall to the rich and increase the tax burden on the middle class. Again, I disagree.

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Critics fail to account for the economic growth that can be generated from a tax system that rewards savings and investment. In addition, defenders of the status quo ignore the benefits of redirecting the $200 billion that is currently being spent to comply with a complex system and to search for loopholes.

The current complex tax system also wastes America's creative intellect. The president of a high-tech think tank in Palo Alto, California testified before the Commission that his competition for intellectual talent does not come from other firms in the high-tech industry. The competition comes from the Big Six accounting firms and big law firms that take bright minds into the dark recesses of an outdated tax code.

Furthermore, a simpler and fairer system of taxation with a single low tax rate will result in the collection of more revenues. Andrew Mellon once wrote, "(t)he history of taxation show that taxes which are inherently excessive are not paid." Americans are overtaxed not undertaxed. And many spend a lot of time hiding income from the government and creating fictitious deductions and other loopholes.

As the former Vice-Chairman of California's tax board, I can personally tell you higher taxes mean lower revenues. Not long ago, the State Legislature created a new sales tax on bunker fuel at California ports. According to the "revenue estimates" by staff, the new tax on bunker fuel was to yield almost $100 million for the state. With a sales tax rate of over 8%, you can readily guess what happened. Ships simply took on bunker fuel at ports in Mexico, Oregon and other West coast ports. Refueling operations in our ports dried up and the state only collected approximately $1-$2 million in revenue -- probably more was spent on welfare for the out-of-work families who lost their jobs as a direct result of the imposition of this new tax.

The scoring of tax reform plans and the generation of tax distribution tables will employ hundreds of static analysts inside the Beltway alone. Static analysis simply will not work. It is simplistic and is not fit for use in the 90s world of high tech modeling.

This country will have a very difficult time moving to ANY new tax system if we listen to the advice of static analysts. It was static analysis that the Wall Street Journal criticized and saw as the reason for the federal government's collection of only 25%-30% of the original staff estimates of the revenue to be raised from President Clinton's tax increases.

I urge you and the members of your staff to study the framework outlined in the Commission's report. Debate it, find out if you agree with the principles or disagree with the principles. This first step is vital to the success of the tax reform debate. Once the basic system is selected, the rate should set the price tag so that every citizen knows the cost of government. Finally, we urge you to utilize dynamic modeling when testing the new system for its revenue generating ability.

Thank you.

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MATT FONG
Treasurer
State of California

March 6, 1996

The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate
Washington, D.C. 20510-6200

Dear Mr. Roth:

Thank you for the opportunity to testify before your committee regarding the findings of the National Commission on Economic Growth and Tax Reform. The interest of committee members was encouraging and it is my hope that the tax reform debate will continue through the year.

I am happy to provide responses to the questions contained in your February letter. The responses to your questions are enclosed. My sincere apologies for not responding sooner.

If you have any questions regarding my answers to these questions, please do not hesitate to call. Again, thank you for the chance to express my views on this very important topic.

Warmest regards,

Matt Fong
State Treasurer

MKF:LSS:kna
Enclosure

915 CAPITOL MALL ROOM 110, SACRAMENTO, CALIFORNIA 95814 (916) 653-2995 (916) 653-3125

The Honorable Matt Fong
Answers to Questions for the Record from Senator Roth
March 6, 1996

1. Should the tax code be neutral, seeking only to raise revenue in the least harmful way, or should it incorporate an agenda, seeking to foster social policies?

The tax code should establish the least obtrusive system possible to raise revenue for the operation of the federal government. Raising revenue should be the sole objective. Social policies of the government should be debated by Congress and implemented through other means.

2. If tax reform is to benefit the average working man and woman, is it not essential that there be a deduction for FICA taxes?

Both the income tax and FICA taxes are based on the working man and woman's paycheck. It is, perhaps, the clearest form of double taxation for these individuals. To help mitigate this double tax, the National Commission on Economic Growth and Tax Reform (Commission), recommended that payroll taxes be fully deductible for individuals.

3. What comments did you hear at the public hearings about the effects that the various tax proposals will have on state revenues?

The comments on the effect of tax reform on state revenues were mixed. Most could not accurately estimate the impact. There was some written testimony received by the Commission that claimed that local government property tax revenues would suffer if the mortgage interest deduction were eliminated and property values declined as a result. We also heard other testimony that supported the theory that with the prosperity and growth that would result from increased savings and investment, home prices would actually increase.

4. Many of the tax reform proposals replace the current income system. One of the criticisms is that they may adversely affect the states, which, in many cases rely on the federal income tax system as a basis for their tax systems. What would you recommend the state do if the federal income tax system were eliminated?

Many states that rely on the federal tax code for the basis of their state income tax system, usually conform state statutes to the federal tax code as of a certain date. My state of California uses this method to conform to the federal tax system. If the federal income tax system were eliminated, California would not immediately lose its income tax system. The state would simply keep its conformity to the old code. The Legislature would have the option to: 1) adopt its own version of the old federal income tax code, 2) conform to the new federal system, or 3) design a completely new tax system. The important point is that state revenues would not be in immediate jeopardy if the federal income tax system were repealed with any other kind of system (i.e., flat tax, national sales tax, or value added tax). One method that I have advocated in an

effort to eliminate state tax bureaucracy by "piggybacking" the state tax on the federal tax liability. State residents would simply multiply their federal tax liability by a percentage and mail it in to the state.

5. The world is becoming more economically interconnected and competitive. Considering the trend toward globalization and importance of trade, how important is border adjustability in any tax reform plan?

U.S. products can compete in the global economy if their price is not encumbered with tax. The tax reform debate must include the issue of border adjustability. Currently, the tax code actually encourages some multinational companies to locate jobs outside the United States. Any modification of the system of taxing international trade, however, should take care to protect the edge we currently hold in the area of research and development.

6. The Commission's report recommends that tax reform should make the U.S. tax system territorial. That is, a U.S. business' overseas earning should be exempt from tax. How do you answer the concern that a territorial system might lead to businesses shifting operations overseas?

I am a full blooded "free enterpriser." If we design our tax system and our business environment competitively, we will have jobs and growth here in the U.S. If we do not price our system competitively, businesses will shift their operations elsewhere. We must design a tax system that does not stand in the way or discourage businesses from investing in the U.S.

UNLEASHING AMERICA'S POTENTIAL

A pro-growth,

pro-family

tax system

for the

21st century

The National Commission on Economic Growth and Tax Reform

JANUARY 1996

Members of The National Commission on Economic Growth and Tax Reform

JACK KEMP
Chairman of the Commission
Co-Director
Empower America

EDWIN J. FEULNER, JR.
Vice Chairman of the Commission
President
The Heritage Foundation

LORETTA H. ADAMS
President
Market Development, Inc.

J. KENNETH BLACKWELL
Treasurer
State of Ohio

HERMAN CAIN
Chairman and CEO
Godfather's Pizza, Inc.

CARROLL A. CAMPBELL
President and CEO
American Council of Life Insurance
Former Governor of South Carolina

PETE DU PONT
Policy Chairman
National Center of Policy Analysis
Former Governor of Delaware

JACK FARIS
President
National Federation of
Independent Business

MATT FONG
Treasurer
State of California

THEODORE J. FORSTMANN
Founding Partner
Forstmann Little & Co.

DEAN R. KLECKNER
President
American Farm Bureau Federation

SHIRLEY D. PETERSON
President, Hood College
Former Commissioner of the IRS

JOHN SNOW
Chairman, President, and CEO
CSX Corporation

JOHN WIELAND
President
John Wieland Homes, Inc.

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Letter to the Commission

Foreword

To the Members of the National Commission on Economic Growth and Tax Reform

"Taxation without representation is tyranny." Those are the words that helped to ignite the American revolution over two centuries ago.

As we approach the 21st century, the crescendo for tax reform continues to build, year after year, election after election. Americans have looked at a tax system constantly increasing in both rates and complexity, and concluded that taxation with representation wasn't so good either.

The current tax system is indefensible. It is overly complex, burdensome, and severely limits economic opportunity for all Americans.

We made clear on the very first day of the 104th Congress that our top priority would be to change the status quo and to bring fundamental change to America. And we agreed that there is no status quo that needs more fundamental changing than our tax system.

We envision:

- A tax system that is fairer, flatter, and simpler.
- A tax system that promotes, rather than punishes, job creation.
- A tax system that eliminates unnecessary paperwork burdens on America's businesses.
- A tax system that recognizes the fact that our families are performing the most important work of our society.
- A tax system that provides incentives for Americans who save for the future in order to build a better life for themselves and their families.
- A tax system that allows Americans, especially the middle-class, to keep more of what they earn, but that raises enough money to fund a leaner, more efficient federal government.
- A tax system that allows Americans to compute their taxes easily, without the need for a lawyer, an accountant — or both.

To help make this vision a reality, we named Jack Kemp, one of America's most innovative thinkers on economic policy, to head the National Commission on Economic Growth and Tax Reform — a commission that included thirteen more outstanding Americans.

The entire commission worked diligently for the past several months, holding public hearings in eight cities, while constantly thinking about how to create a better tax system.

Their final report is guaranteed to stimulate this important national dialogue. It will surely serve as a catalyst for congressional hearings and debate. We hope that it will also trigger conversations around kitchen tables, water coolers, and in town hall meetings across the country.

We invite all those who read this report to write us with your thoughts on its recommendations and conclusions, and to share with us other suggestions on how we can create a tax system that promotes economic growth and opportunity for all Americans.

Senate Leader	House Speaker
Bob Dole	***Newt Gingrich***

A New Level of Thinking

Preface

"They act like all that money is *born* in Washington, D.C." Perhaps no comment has better summarized the problem with our nation's capital than this observation by Ed Zorinsky, the late Democratic Senator from Nebraska. And nowhere is this governmental conceit expressed more destructively than in the workings and effects of our Internal Revenue Code.

Many previous attempts at tax reform have been marred by the inside-the-beltway assumption that the wealth of the nation belongs to its government. This position has perpetuated what could be called the "tin-cup syndrome" – an environment in which the political competition over scarce resources replaces the economic competition that produces growth, creates jobs, spurs innovation and productivity. As a consequence, the tax code has over the years become increasingly politicized, and is seen less as a simple tool for raising revenue than as an instrument for social and economic engineering. In turn, this has spawned a virtual industry of tax specialists and special interest lobbyists, while exponentially increasing the complexity of the code.

The National Commission on Economic Growth and Tax Reform set out with a different set of assumptions, beginning with the belief that the purpose of the tax code is to raise money while leaving citizens as free as possible to pursue the American dream. Our charge from Senate Leader Dole and Speaker Gingrich was clear: Listen first and learn from the American people. We listened to ordinary taxpayers in hearings around the country. What we heard was a great deal of frustration, concern, and, yes, anger with the current system. Our hope has been to channel those frustrations into a set of concrete principles and recommendations that any new tax reform legislation must follow if it is to meet the needs and expectations of the American people.

From June until September 1995, we heard from a cross-section of American taxpayers in Boston, Omaha, Charlotte, Palo Alto, south-central Los Angeles, Harlem, Cleveland, and Washington, D.C. We listened to and learned from family farmers and high-tech entrepreneurs, small businessmen and women, medium-sized and large manufacturers, governors and mayors, congressmen and senators, leading economists and local activists.

Unlike previous "reform" commissions, our activities were financed without a dime from the American taxpayer. Expenses were met through private contributions from more than 1,500 donors. The fourteen commissioners received no compensation for the long hours and hard work, save the tremendous reward of knowing their sacrifices would help shape American history. This is an extraordinary group of American citizens who have demonstrated through untold hours of hearings, deliberations, and study their dedication to chart a course that will lead to a better America for their children and grandchildren. We believe we have set that course.

In 1941, in a famous essay for *Life* magazine, Henry Luce anticipated that the 20th century would be remembered as the American Century. The decades and events that followed – the defeat of Nazi Germany, the collapse of Communism, the expansion of American influence abroad – bore this prediction out. Today, many Americans fear they see that era of American preeminence slipping away. The optimism and boundlessness that have always defined America are seen by some as fond but faded relics to be quietly folded away.

This report reflects the firm conviction that America can do better. None of the members of this commission would have accepted this challenge if we did not believe in the possibility of real progress and real reform.

Albert Einstein observed that "the problems of today cannot be solved at the same level of thinking on which they were created." We have concluded that the complex tax code of the 20th century is poorly suited for dealing with the complex world of the 21st. The vision outlined in the following pages cannot be realized by simply rearranging the deck chairs on the Titanic we call our current tax code. A brand new tax code, modeled on the principles and recommendations proposed in this report, can chart the economic waters ahead and launch our country on its voyage toward the next American century.

Edwin J. Feulner
Vice Chairman
National Commission on Economic Growth and Tax Reform

Setting the Eagle Free

Introduction

"In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low, and the soundest way to raise the revenues in the long run is to cut the rates now...The purpose of cutting taxes now is not to incur a budget deficit, but to achieve the more prosperous, expanding economy which can bring a budget surplus."

John F. Kennedy
Economic Club of New York
December 14, 1962

These words of President Kennedy were a great inspiration to me as the tax reform movement was launched in the early 1980s with the Kemp/Roth tax cut. Kennedy's vision and courage can serve as examples for all Americans as we struggle to make this nation better for our children and grandchildren. His remarks from the Economic Club of New York ring as true today as they did in 1962.

At the first meeting of our commission back in June, I held up a blank sheet of paper and said. "This is what we start with." That was our charge: Senate Majority Leader Bob Dole and House Speaker Newt Gingrich appointed the National Commission on Economic Growth and Tax Reform to study the current tax code, listen to the suggestions and ideas of people from around the country, and submit to Congress our recommendations for comprehensive reform. A very diverse and dedicated group of 14 people, with the help of an invaluable, overworked, and underpaid staff, set out to design an entirely new tax system for America's 21st century; one which would promise a booming economy, promote job creation, and ensure the greatest possible opportunity for all Americans to work, save, invest, and reach their potential. We operated under the premise that an economic growth rate of 2.5% is unacceptable to the American people.

This commission was empowered not merely to offer superficial reforms, to trim a rate here and close a loophole there, but to begin with a *tabula rasa* and map out a totally new tax structure for America's next century. We also wanted to help inform the whole world, particularly the emerging democracies, that the goal of tax policy is raising revenue, not redistribution of wealth.

Our nation has arrived at a unique moment in history. With the passing of the Cold War, we are standing at the edge of a new millennium with extraordinary possibilities. Our country is poised to help lead the world into a new era of economic growth fueled by an information-age technological revolution that can yield unparalleled expansion in jobs, productivity, innovation, and prosperity. We must embrace this opportunity and challenge. However, such an embrace will prove difficult, perhaps impossible, if we remain saddled with our current tax code. The current system is indefensible: it is riddled with special interest tax breaks, and it overtaxes both labor and capital. We must construct a tax system that reflects our highest values and unleashes our greatest potential.

The comments and concerns we heard from the American people over the last several months, coupled with a systematic review of the current tax code, helped us establish certain principles to guide us to our conclusions. Surely, a tax code which is simple and fair must generate sufficient revenue so that the federal government may carry out its legitimate tasks. Second, it must not place a tax burden on those members of society least able to bear one. And, perhaps most important of all, it must not restrict the innovative and entrepreneurial capacities of Americans upon which rising living standards and our general prosperity so greatly depend. Our proposals are in keeping with these principles.

Wildly excessive and unjust taxes have locked away access to capital and credit necessary for lower-income Americans to launch the next generation of entrepreneurship. Today, sadly, we see the American people's sense of dynamism and hope, their ability to strive and compete diminished by a tax code

which penalizes success, retards investment, and sends capital fleeing overseas. The commission is united in the belief that only a pro-growth tax code can restore America's confidence at home and her greatness abroad. We want a tax code and an overall economy that will liberate the American dream and remove the barriers to upward social and economic mobility. The American ethos of entrepreneurship and optimism made America great once before. We believe these proposals will bolster that ethos again and help restore integrity and honesty to our system.

The author John Gardner has observed that there are many contributing factors to the rise of civilization — accidents of resources, geography, and military power. But whatever other ingredients comprise the greatness of nations, he writes, "There occurs at breathtaking moments in history an exhilarating burst of energy and motivation, of hope and zest and imagination, and a severing of the bonds that normally hold in check the full release of human possibilities. A door is opened, and the caged eagle soars." That eagle, the symbol of our nation, represents the creative spirit, talents, and aspirations of the American people. The charge of this commission and the intent of our recommendations is to open the door and help set that eagle in all of us free.

Jack Kemp
Chairman
National Commission on Economic Growth and Tax Reform

IMAGINE AN AMERICA

WITH A PRO-GROWTH, PRO-FAMILY TAX CODE

The National Commission on Economic Growth and Tax Reform recommends to the Congress and to the President of the United States that the current Internal Revenue Code be repealed in its entirety.

The present system is beyond repair — it is impossibly complex, outrageously expensive, overly intrusive, economically destructive, and manifestly unfair.

It is time to replace this failed system with a new simplified tax system for the 21st century: a single low rate, taxing income only once with a generous personal exemption and full deductibility of the payroll tax for America's working men and women.

This system will reduce the tax burden on middle-income people and will help remove the barriers that keep low-income Americans from reaching their fullest potential.

These changes, once in place, should be sealed with a guarantee of long-term stability, requiring a two-thirds vote of the U.S. Congress to raise the rate.

This new system is predicated on a commitment to expanding growth and opportunity. We believe the changes we propose will help double the rate of economic growth.

A stronger economy will create more jobs, raise family incomes, expand ownership and entrepreneurship, and ensure greater opportunity for our children and grandchildren. It will also produce additional revenues for balancing the budget and reducing the burden of national debt.

The principles and recommendations contained in this report comprise the "Tax Test" — the standard to which any new tax system must be held. We ask that Congress not pass nor the President sign any tax legislation that fails to pass this test. And we encourage the public to use the goals and guidelines we offer as a road map through the coming national debate on tax reform.

Our aim: to introduce a new system of taxation that brings out the best in the American character, that plays to our strengths and not our weaknesses, that speaks to our hopes and not our fears. **Our recommendations are based on a vision of America that places the individual — not the government — at the center of society:**

- We believe that government does not create opportunity; citizens do, if government will get out of their way.
- We believe that government is not the engine of economic growth; it is, more frequently, the monkey wrench in the machine.
- We believe that taxpayers' earnings and savings — their property — are not assets on loan from the government. The government is power on loan from the people.

One of the most serious shortcomings of previous attempts at tax reform has been the inability of average Americans to make their voices heard above the chorus of special interests. We have tried a radically different approach: Listening to the people first.

In his first debate with Stephen Douglas, Abraham Lincoln remarked that "with public sentiment, nothing can fail; without it nothing can succeed." We believe that any major legislative attempt to replace the current tax code will falter unless it is first preceded by a national debate on what the new system should look like.

Many previous attempts to reform public policy have failed to achieve their aims because they substituted closed meetings for democratic dialogue, focusing too much on expert analysis and too little on citizens' concerns. By including the public in the deliberations over tax reform, this commission seeks to build broad-based consensus behind a new tax system for America's next millennium.

It was with this spirit that the commission held cross-country public hearings – from the historic home of the Boston tea-party to the heart of south-central L.A. At every hearing in every city, we asked people to tell us what they saw as the problems with the current system and the goals any reform plan should achieve.

- *In Omaha*, farmers pleaded for simpler filing and the freedom to pass family farms on to their children without fear – of federal confiscation.
- *In the Silicon Valley*, high-tech entrepreneurs told of the countless ideas conceived but never born because of a scarcity of investment capital.

- *In south-central Los Angeles*, small business-owners voiced frustrations at not being able to expand or hire new workers because of a tax bite that eats away their profits.
- *And in Harlem*, inner-city entrepreneurs expressed both bitterness and bewilderment at a tax code which sucked revenues out of their neighborhoods while preventing investment from flowing in.

In our nation's capital, we heard from elected officials in both the House and the Senate who have for many years been leaders in tax reform. Because of their tireless public service, tax reform is a priority issue on the nation's agenda.

We also heard from many of the finest economists in the country who shared their knowledge and research with us at every hearing.

After our hearings, we held a series of working sessions to analyze what we had heard and to begin discussing our recommendations for change. During one of our working sessions, the commissioners put aside the charts and graphs for a moment, stepped back, and tried to imagine what kind of world they would like America's next generation to grow up in. We were asked to think about how replacing the tax code might help bring that world about:

- Imagine an America enjoying a decade of economic growth at nearly twice the present rate — creating jobs, expanding opportunities, and lifting living standards for all.
- Imagine an America in which more dreams born in basements and garages grow into multi-million dollar businesses because abundant capital seeks out good ideas, and entrepreneurs and investors are confident that their risk-taking will be rewarded, not punished.
- Imagine an America where it is easier to get a job than to get on welfare, and where our inner cities share in America's growth and prosperity. Imagine these neighborhoods ringing out, not with sirens in the night, but with the sounds of new storefronts being opened and new businesses being built.
- Imagine an America where home ownership and higher education are within the reach of every American so that each citizen owns a stake in the system and shares a common interest and responsibility for its future.
- Imagine an America where young couples aren't asked to take a tax hit in order to exchange their marriage vows, and where young families can save for their future without being punished for their thrift.
- Imagine an America where Americans have enough to give, not just to and through their government, but to their churches, synagogues, mosques, their charities, and neighbors in need.
- Imagine an America where the I.R.S. becomes the "TPA" — a Taxpayer Protection Agency — to ensure that no one pays more than is owed. Imagine a customer-friendly approach to raising revenue, based on a belief in the basic honesty of the American people, that treats them with dignity and respect.

We believe that replacing our tax system with one that is simpler and fairer can help to make these American dreams come true.

America was not founded on envy or resentment. The American idea was never to keep everyone at the same mean level, but to give everyone the chance to rise as high as his or her effort, initiative and God-given talent would allow. It was a promise of equal opportunity, not of end results, the confidence that whatever you aspired to become — be it artist, inventor, or entrepreneur — you could make it happen here.

As the country pursues this change, how we transition from the existing bankrupt system to the new system will be important. Complicated issues will arise. Nonetheless, we are confident that the Congress and the President will solve these transitions in order to bring about this new tax system. Dramatic change never is easy, and complicated issues will arise in the transition. But change we must, confident that, with the leadership of the Congress and the president, the American can-do spirit will prevail.

A new tax system, as envisioned in the following pages of this report, can take a first step toward renewing that sense of hope and possibility by unleashing a cascade of benefits, beginning with greater economic growth, lower interest rates, and expanded job opportunities for working Americans.

In this spirit, we invite the American people and their elected leaders from both political parties to use the Tax Test as a checklist as they move forward in replacing the current tax code. We urge the Congress and the President to base any new legislation on the principles and recommendations submitted in this report. Furthermore, we urge President Clinton to appoint a presidential task force or commission to bring the recommendations offered by this congressionally appointed commission to the next level of public debate.

At The Boiling Point

"My grandmother used to tell me the folk tale of the frog," recounted Commissioner Herman Cain of his childhood in Atlanta, Georgia. "If you put a frog in a pot of hot water, he would jump right out. But if you put him in a pot of cool water and gradually turned up the heat, he wouldn't notice the rising temperature and would eventually boil to death."

The American taxpayer is in hot water. Escalating marginal tax rates, increasing complexity, and advancing intrusiveness have created a system that has reached the boiling point. Over the years, Americans have surrendered more and more of their freedom to higher taxes. The result has not been to enhance economic security or to close the gulf between rich and poor. Instead, it has led to fewer jobs, slow economic growth, diminished hope and opportunity, an erosion of trust and confidence in government, and an ebbing of the American spirit of enterprise. It is a history that echoes James Madison's warning that "there are more instances of the abridgment of the freedom of the people by gradual and silent encroachments...than by violent and sudden usurpation."

The time has passed for incremental reform. The problems with the current system have grown too deeply entrenched to be solved with quick fixes and cosmetic repairs.

We believe the current tax code cannot be revised, should not be reinvented, and must not be retained. Therefore, the commission is unanimous: It is time to throw out the seven-million-word mess of tax laws and regulations and begin anew.

Marc Negri of Santa Rosa, California, wrote to tell us that, "The current system is so wrong and such a disincentive to the every-day worker that it cannot be saved." Lawrence Madsen of Mills, Wyoming, prepares peoples' taxes for a living, and yet wrote: "I am so disgusted with the [system] that I must urge you to completely abolish the Internal Revenue Code and start over." A couple from Astor, Florida, was even more blunt: "The current tax structure is way out of date with the real world, too complicated with too many loopholes. We say dump it!"

Americans' eagerness for real change reflects in part their frustration with a system that in the past forty years has seen 31 "significant" reforms and an astounding 400 additional "revisions" through public laws. And yet the tax code is more complex, more costly, and more economically destructive than ever. This is the story of how we got here.

The Road to Tax Oppression

The *New York Times*, in a 1909 editorial opposing the very first income tax, predicted: "When men get in the habit of helping themselves to the property of others, they cannot easily be cured of it." The history of our tax code, in economic terms, mirrors the course of most addictions: advancing dependence, diminished returns, and deteriorating health of the afflicted.

Supporters of the Sixteenth Amendment touted the income tax as the rich man's burden — forcing "the Carnegies, the Vanderbilts, the Morgans, and the Rockefellers" to pay while sparing the middle class from pain. Indeed, after the income tax was enacted in 1913, fewer than two percent of American families were required to file a tax return. Rates ranged from 1 to 7 percent — with the highest rate applying only to Americans who had the equivalent of $7.7 million in income in today's terms.

The rates did not stay that low for long. In 1916 the top rate doubled. A year later, on the eve of America's entry into World War I, it soared to 67 percent. With the Second World War, the rate was raised to 94 percent. In the 1950s the top rate remained at the sky high level of more than 90 percent. President Kennedy initiated legislation that cut the top rate to 70 percent, but it was not until the Reagan growth years that the top rate was lowered dramatically to 28 percent. Under the current administration, the rate has resumed its ascent, with combined federal taxes pushing the top rate above 40 percent, including Medicare taxes and phase-outs.

With every attempt by politicians to "soak the rich," the water mark has risen on the middle class. Author Frank Chodorov has summed up the incremental march of encroaching taxation: "At first it was the incomes of corporations, then of rich citizens, then of well-provided widows and opulent workers, and finally the wealth of housemaids and the tips of waitresses." Congress expanded the income tax into the ranks of the middle class for the same reason Willie Sutton robbed banks: that's where the money is.

This shift was mainly achieved by gradually multiplying the number of taxpayers required to file income tax returns and by raising average tax rates on ordinary citizens. Until World War II, the average tax rate (that is, the total tax paid divided by income) on a family with a 1991 income of $50,000 never rose above 4 percent. Since World War II, it has never fallen below 14 percent.

Marginal rates on the middle class have risen even more dramatically. Marginal rates are the "tax bracket" rates that apply to any extra dollar of income — such as raises, overtime, bonuses, or a second family income. The marginal middle class tax rate never rose above 8 percent prior to World War II. Since then, it has never fallen below 22 percent, rising as high as 33 percent during the high-inflation, bracket creep years of the 1970s.

Today, there are three principal defects of our income tax system that must be fixed immediately.

- **Economically Destructive:** Steeply graduated tax rates on both labor and capital destroy jobs, penalize saving and investment, and punish personal efforts to get ahead through hard work.
- **Impossibly Complex:** The mind-boggling complexity of the current tax code imposes an unacceptable burden on taxpayers and a huge cost on the economy.
- **Overly Intrusive:** The vast enforcement powers conferred on the I.R.S. are increasingly seen as infringements of privacy and personal freedom.

ECONOMICALLY DESTRUCTIVE

In the famous Supreme Court case, *McCulloch v. Maryland*, Chief Justice Marshall wrote: "The power to tax involves the power to destroy." Some of the ways in which the current tax code destroys our economic vitality include:

- High marginal tax rates that weaken the link between effort and reward, depress productivity, and kill jobs.
- Multiple layers of taxation on work, saving, and investment that dry up new capital for investment.
- Capital gains taxes that act as a barrier to capital formation – preventing the flow of investment to new enterprises and would-be entrepreneurs.
- An "alternative minimum tax" that imposes immense compliance costs on businesses, sapping resources that could otherwise be put to constructive use.
- Double-taxation of corporate income which shrinks business investment and encourages companies to take on extra debt.
- Estate and gift taxes that force families to sell their businesses or family farms.

A fundamental principle of economics is that the more you tax something, the less you get of it. And if you tax success, you get less success. The current confiscatory system begs the questions: Why work harder if each extra dollar earns you less? Why save for tomorrow when spending today is cheaper? Why dream bigger, when little dreams are less expensive? The disillusioned answer of many Americans is simply: Why bother?

But the current system does not simply sap the initiative and aspirations of *individual* taxpayers, it undermines the economic strength of our nation as a whole. As President Kennedy once observed: "An economy hampered with high tax rates will never produce enough revenue to balance the budget, just as it will never produce enough output and enough jobs."

High marginal tax rates combined with multiple taxation of work, saving, and investment act as a "double-barreled shotgun aimed at the American economy," accountant Ted Krauss told the commission during a hearing in Washington. The price tag was estimated by Professor Dale Jorgenson of Harvard University who told the commission that the income level in the United States could be 15 percent to 20 percent higher than today if these biases did not exist.

This translates to losses of as much as $4,000 to $6,000 per year for typical middle-income families. The tremendous economic drain caused by an anti-work, anti-saving, and anti-growth tax system does not even take into account the enormous waste of resources — the time, money, and brainpower — lost in trying to comply with the current code.

IMPOSSIBLY COMPLEX

Today's tax code is so complex that many Americans despair that only someone with an advanced degree in rocket science could figure it out. They are wrong. Even a certified genius such as Albert Einstein needed help in figuring out his Form 1040.

Consider this example from the Internal Revenue Code's rules on the Earned Income Tax Credit. Here's how they describe the little human creature we call a child:

> (A) IN GENERAL.—The term "qualifying child" means, with respect to any taxpayer for any taxable year, an individual—
>
> (i) who bears a relationship to the taxpayer described in subparagraph (B),
>
> (ii) except as provided in subparagraph (B)(iii), who has the same principal place of abode as the taxpayer for more than one-half of such taxable year,
>
> (iii) who meets the age requirements of subparagraph (C), and
>
> (iv) with respect to whom the taxpayer meets the identification requirements of subparagraph (D).

This may look like English to the experts, but it is total gibberish to most other Americans. If nothing is done to simplify the impossible language of the current tax code, every American *will* need a laptop just to figure it out.

Professor James Eustice of NYU Law School once defined an "expert" as "a person who avoids small errors as he sweeps on to the grand fallacy." The problem with the tax code, he says, "is that it has been written and interpreted by so many 'experts'

that it has lost sight of the fact that [real people] have to function under this system." The result is a tax code so complex that even the 'experts' themselves can't figure it out. This was illustrated by an annual survey of tax experts conducted by *Money Magazine*. Each year, the magazine would send a hypothetical tax return to 50 professional tax preparers, and every year it got back a startling range of responses, often encompassing 50 different answers. Needless to say, if the "experts" have trouble understanding the tax system, the odds are stacked against the rest of us.

Convoluted rules and regulations force small businesses to hire expensive accountants, forgo expansion or new opportunities, or in some cases avoid the entire mess by going underground. Tim Sabus of Denver, Colorado, wrote to the commission: "As an entrepreneur, I experience first hand the horrors of our tax system. It has grown into a monstrous predator that kills incentives, swallows time, and chokes the hopes and dreams of many. We have abandoned several job-creating business concepts due to the tax complexities that would arise."

Another exasperated business owner, Frank Goodnight, told the commission at our Charlotte hearing that "during the recession of 1992, our company paid our accounting firm more money than we paid in taxes." He is not alone: in 1991, the Tax Foundation reported that small corporations spent a *minimum* of $382 in compliance costs for every $100 they paid in income taxes.

According to 1995 I.R.S. estimates, businesses will spend about 3.4 billion hours and individuals will spend about 1.7 billion hours embroiled in tax-related paperwork. That means nearly three million people — more people than serve in the U.S. armed forces — work full time all year just to comply with tax laws, at a cost of about $200 billion a year, according to the Tax Foundation. In economic costs, this is like taking every new car, van, and truck that General Motors builds in a year and driving them off of a cliff.

In a recent hearing before the House Ways and Means Committee, William Dakin, senior tax counsel of Mobil, brought with him a six foot high stack of bound papers, weighing 150 pounds. These were Mobil's corporate tax forms for 1993. It cost Mobil an estimated $10 million, and the equivalent of 57 people working full time for a year, just to figure how much tax the company owed. This is the essence of a brutally complicated tax system.

Jeff Renner, a real-estate developer from Bellevue, Nebraska, voiced the concern of many witnesses about the costly burden of compliance: "That time and effort and money did not educate a single child, it didn't feed a single family, and it didn't produce a single tangible object to improve the life of anyone." And Roger McCarthy who runs an engineering firm in Menlo Park, California, complained of how the tax industry absorbs the high-tech talent that could be working in productive fields: "It is disturbing that we are not competing with companies like Intel and Hewlett-Packard for these top stars, but rather with Big Six accounting firms."

Overly Intrusive

There is no simple way of administering a monstrously complex tax code, just as there is no fair way of enforcing an unfair system. Former Treasury official Ernest S. Christian told the commission: "The present federal income tax code is a national disgrace that...has characteristics that would be condemned in any human personality. It is inexcusably class conscious, it is hypocritical, it is meddlesome, it is overbearing, it is mean and hurtful, it is covetous, and above all, it is downright foolish." It is no wonder that the agency charged with enforcing such a system has become the object of increasing public ire.

Perhaps the most troublesome consequence of our modern-day income tax system is the enormous power that Congress has conferred on the Internal Revenue Service to force taxpayers to comply with the tax code. Twice as big as the C.I.A. and five times the size of the F.B.I., the I.R.S. controls more information about individual Americans than any other agency. Without a search warrant, the I.R.S. has the right to search the property and financial documents of American citizens. Without a trial, the I.R.S. has the right to seize property from Americans. What the I.R.S. calls its own "presumption of correctness" leaves many taxpayers feeling that they are "guilty until proven innocent" — a standard which turns norms of justice upside down.

Even those w[illegible] the I.R.S. hierarchy concede the inquisitorial nature of the powers granted the agency. Fred Goldberg, former Commissioner of Internal Revenue, laments that "while it is unfair to the many fine people who work there, the I.R.S. has become a symbol of the most intrusive, oppressive, and non-democratic institution in our democratic society."

The code is so complicated that the I.R.S. itself has trouble understanding it. "As a retired revenue agent, I feel qualified to attest to the monstrosity that the Internal Revenue Code has become," a citizen from Michigan wrote to the commission. "When people who are employed to enforce the tax laws have difficulty understanding its complicated and sometimes incomprehensible provisions, it's time for a change." Of the liens the I.R.S. filed in 1990, a General Accounting Office study found 16,000 errors. The error rate for penalty notices to employers on tax deposits has stood as high as 44 percent.

Even when the I.R.S. is not in error, many of its practices make little sense. For example, tax documents are not treated as "timely filed" if sent by Federal Express rather than the U.S. Postal Service. The I.R.S. charges taxpayers interest even when the taxpayer is due a refund. In another example, one particularly exasperated citizen wrote to the commission and enclosed a notice just received from the I.R.S. assessing a penalty against his company. For an underpayment of one cent on his tax

returns, the company received a letter from the I.R.S. imposing a penalty of more than $150. Others should be so lucky. Many who testified before the commission told tales not just of tax penalties, but of thousands of dollars in legal fees and countless hours with lawyers in efforts to rectify minor and unwitting infractions, or clear their records of unjust charges.

In Charlotte, businessowner Jean Hodges recounted a tale of horror in which she was forced to pay tens of thousands of dollars and spend untold hours trying to correct an error made by her company's bookkeeper. "I would like to see Congress pass legislation affording small businesses relief from onerous and intimidating I.R.S. regulations," she said.

The preceding pages illustrate what is wrong with the current tax system. But the case for a 21st century tax system must be made by more than a mere indictment of the status quo. To paraphrase Peter Drucker: You have to decide what's right before you decide what's possible. The following chapter outlines principles upon which a better future can be built.

WORKING PRINCIPLES

...FOR THE WAY AMERICA WORKS

When a group of architects sits down to design a new building, they don't start by picking out the draperies and choosing the color of the carpet. They begin by creating the basic outlines for the structure to come. Similarly, the charge and purpose of this commission is not to dictate the finishing touches of finalized legislation. Instead, it is to establish the foundation upon which a new system can be raised.

The commission's six working principles for a 21st century tax system are not isolated ideas, randomly grouped, but rather principles that link together to form a sequence — a chain of economic DNA — that can renew the health of our economy and release the potential of the American people.

ECONOMIC GROWTH, the engine of opportunity and prosperity, can only be unleashed by a tax code that encourages initiative, hard work, and saving.

Such a system must be based on **FAIRNESS**, treating all citizens equally.

The system should achieve **SIMPLICITY** so that anyone can figure it out.

A fair tax system also requires **NEUTRALITY**, because the tax code should not pick winners or losers, or tax saving more heavily than consumption.

The new tax system also needs **VISIBILITY** so that everyone gets an honest accounting of government's cost.

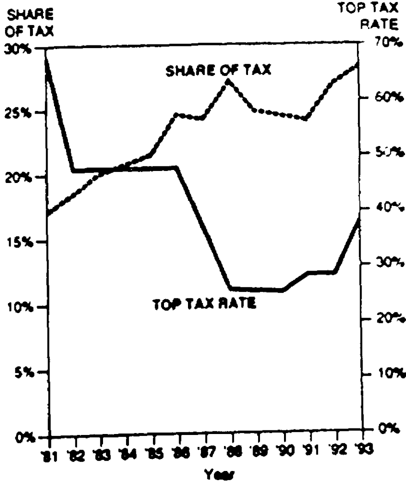
A visible tax system will have **STABILITY** so that people can plan for their futures.

ECONOMIC GROWTH

...Because expanding opportunity, prosperity, and social mobility form the foundation of a free and healthy society.

None of the myriad challenges confronting our nation — be they poverty, crime, racial tension, welfare-dependence, or the budget deficit — can be solved without strong economic growth. Therefore, any new tax system must be predicated, first and foremost, on a commitment to revitalizing the American economy and lifting barriers to opportunity.

No nation has ever taxed its way to prosperity. Indeed, one of the world's fastest growing economies over the past 20 years, Hong Kong, has one of the lowest marginal tax rate systems – 15 percent or less – on labor and capital. Throughout the ages, higher taxes have been inversely related to higher productivity and higher growth. Our own history provides evidence of this axiom.

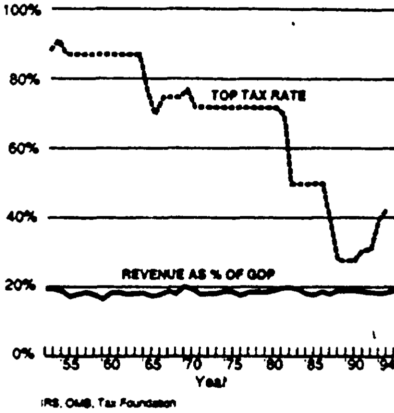


There is an inverse relationship between revenue collections from the wealthy and high marginal tax rates.

America has experienced three periods of very strong economic growth in this century: the 1920s, the 1960s, and the 1980s. Each of these growth spurts coincided with a period of reductions in marginal tax rates. In the eight years following the Harding-Coolidge tax cuts, the American economy grew by more than five percent per year. Following the Kennedy tax cuts in the early 1960s, the economy grew by nearly five percent per year and real tax revenues rose by 29% from 1962 to 1968 (after having remained flat for a decade). In the seven years following the 1981 Reagan tax cuts, the economy grew by nearly four percent per year while real federal revenues rose by 26 percent.

Over the years, we have seen economic output rise as tax rates *fell* (and fall as tax rates rose). But federal revenue raised as a percentage of national output has remained *flat*. As the accompanying chart indicates, the federal government historically collects about 19 percent of gross domestic product – regardless of how high the tax rate has been pushed.

Top Tax Rate and Total Federal Revenue



The top line represents the top personal tax rates from 1952 to 1995. The bottom line shows revenue to the federal government expressed as a percentage of total economic output.

High rates simply mean a smaller economy — and less income to tax. Clearly, 19 percent of a small economy brings in less revenue than 19 percent of a big economy. One more reason why economic growth should be the goal of any new tax system.

FAIRNESS

...Because democracy is based on the principle of equality before the law.

One of the main themes the commission heard in hearings around the country is that taxpayers are willing to shoulder their share of the burden, as long as others pull their own weight as well. The current tax code — with its confusion of proliferating rates, deductions, exemptions, and transfers of wealth from one constituency to another — contributes to the overwhelming conviction of many Americans that the present system is unfair.

The definition of fairness that emerged from hours of testimony before the commission was clear and unambiguous: Any new system must satisfy three simple goals:

Tax equally: Does it treat taxpayers equally?

True progressivity: Is it compassionate to those least able to pay?

Lower tax rates: Does it keep the tax rate low?

TAX EQUALLY

To most Americans, fairness means that the rules apply to everybody and everybody plays by the rules. Christine Perkowski of Richboro, Pennsylvania, wrote to the commission: "I do not mind paying my fair share as long as everyone else does, but I feel that many, many people and companies are not paying their fair share because they have the money to hire smart accountants and lawyers."

Under a simpler, fairer system, no one will get out of paying their share — no matter how many "smart accountants and lawyers" they can afford to hire. By streamlining the current Rube Goldberg contraption of multiple rates and rules, we can reduce the number of moveable parts that are manipulated by those who seek to take advantage of the system. Clearly, under the current multiple-rate system, any tax "loopholes" — deductions, exemptions, and credits — are more valuable to the wealthy than to those in lower brackets, reinforcing the perception that the rich do not pay their fair share. A single-rate system would level the playing field by eliminating the current distortion in which tax breaks are worth more when a person's income is higher.

Melvin Barlow of Las Cruces, New Mexico, argued this definition of fairness in a letter to the commission: "It is not right that the harder a man works, the more he is taxed" because the government imposes a higher rate on each additional dollar he earns. A single-rate system keeps pace with the taxpayer as he climbs the hill of economic opportunity and does not weigh him down more heavily with higher rates at every step he tries to take.

For taxable income above the personal exemption, if one taxpayer earns ten times as much as his neighbor, he should pay ten times as much in taxes. Not twenty times as much — as he would with multiple and confiscatory tax rates. Not five times as much — as he might with special loopholes. Ten times as much income, ten times as much taxes. That's the deal.

True Tax Progressivity

Americans must first be able to feed, clothe, and house their families before they are asked to feed the federal spending machine. A generous personal exemption will allow those citizens at the bottom of the economic ladder to gain a foothold and begin their climb before taxes take effect.

Today, those who try to move from welfare to work face the highest marginal tax rates in America when lost benefits are included — facing effective tax rates that can actually exceed 100 percent. For example, if a single mother on welfare takes a job, she stands to lose more than a dollar for every dollar she earns. Her first paycheck may be more than canceled-out by the economic hits she takes when she loses Aid to Families with Dependent Children, Medicaid, Food Stamps, and public housing allowances. In addition to losing benefits, she now *also* must pay Social Security and Medicare taxes, federal and probably state income tax, while facing a host of work related costs, including transportation and child care.

We need a tax system that expands opportunity and furthers economic independence by strengthening the link between effort and reward, not by slapping poverty-inducing tax rates on people as soon as they get their heads above water. True progressivity can be achieved by a single tax rate with a generous personal exemption. With an exemption, a "single rate" does not mean that everyone pays the same percentage of income in taxes. A generous personal exemption would remove the burden on those least able to pay; as incomes rise, the average tax rate would gradually rise up to the single rate.

Lower Tax Rates

The consensus of the majority of witnesses who wrote to the commission can be summed up in two words: lower taxes.

Historians may point to America's beginnings and a revolution deeply rooted in reaction to taxation of the original thirteen British colonies. Others reference religious traditions, including Moses' warning to Pharaoh that he may tax up to one fifth and no more — before demanding that he "let my people go." Indeed, Commissioner Dean Kleckner of Iowa touched a chord with many when he observed, half-jokingly, that "the Bible says we ought to tithe and give 10% to the Lord. I have a hard time with the concept of giving more to government than we're asked to give to God."

We suspect that most taxpayers have reached their conviction that taxes are too high not by consulting their history books or the Scriptures, but simply by comparing their weekly paychecks to their family budgets and counting all the sacrifices they must make simply to pay the government. While any new tax code must raise sufficient revenue to run the government, it must also be mindful of the burdens these taxes place on America's working families. One way to reduce this burden would be to restrain government spending. By restoring the balance of power between the federal government and the citizens who pay its bills, we can restore basic faith in the system and keep the tax rate low.

Simplicity

...Because life is too short and peace of mind too precious to waste your time and lose your temper trying to figure out your taxes.

Filing tax returns will never be anyone's favorite pastime, but neither should it be what it has become: one of life's most nerve-wracking, gut-wrenching, and mind-numbing chores. With a simpler system, taxpayers will be able to file their returns on a single piece of paper in less time than it takes to finish your morning crossword puzzle.

As detailed earlier, the current tax code is exceedingly expensive to comply with, increasingly difficult to enforce, and nearly impossible to understand. Ambiguities and inconsistencies in the current tax code increase the likelihood that taxpayers will make mistakes and fall victim to enforcement techniques considered by many to be infringements of personal liberties.

Long ago the authors of the *Federalist Papers* warned, "It will be of little avail to the people that the laws are made by men of their own choice if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood." A simplified, fairer tax system will let Americans get a handle on their taxes, a grip on their government, and a hold of their future.

Neutrality

...Because the tax code should not pick winners or play favorites, but allow people freely to make decisions based on their own needs and dreams.

The tax code should be used to raise revenue to run the government while doing the least possible damage to the economy. This means leaving individuals free to make decisions and to set priorities based on economic reality — not on the bureaucratic whims of Washington, D.C.

Taxes cannot help but raise the cost of everything they fall on. But at least they should fall on things neutrally without penalizing one form of economic behavior and promoting another. As Senator Robert Bennett of Utah recently pointed out, "Neutrality means that the tax code should not be used to punish the bad guys and reward the good guys. We have other laws for that." Unfortunately, the current code strives to act as economic traffic cop — giving green lights to certain economic activities and red lights to others.

The result of the biases and distortions in the current system is to make the market less free, the system less fair, and families less financially secure. As Frank Hayes, a public accountant who testified before the commission in Omaha, remarked: "If there's a way to make things simpler and take the tax aspect out of making day-to-day decisions, I think everybody would become productive."

Perhaps the single most irrational and economically damaging aspect of today's code is the layer upon layer of taxes on saving and investment. By hitting income saved and invested harder and more frequently than income consumed, the current system prompts taxpayers to spend today what they might otherwise save for tomorrow. This is particularly alarming considering the problems facing public retirement programs and the need to strengthen private retirement saving. The Bipartisan Commission on Entitlement and Tax Reform offered analyses and proposals on this subject.

Visibility

...Because those who pay the price of government have a right to see the bill.

The history of hidden taxes, rapidly rising rates, and perpetual budget deficits proves that what you don't know can hurt you. The current system hides the cost of government behind a chronic deficit and a maddening multiplicity of taxes — many of which are virtually invisible to the taxpayer who pays them. How much did we pay in payroll taxes last year? What excise taxes were hidden in the prices of the products we bought? What are the tax cost of exclusions, deductions, and corporate income taxes? Few of us know the answers.

When it comes to these hidden levies, ignorance is expensive bliss indeed.

One of the biggest political fictions in American history is the progressive taxation of "Mr. Nobody" – the illusion that "painless" taxes can be levied on businesses and on the goods and services they sell. But goods and services do not pay taxes. People do. While businesses collect taxes, the burden of paying the "business" taxes ultimately falls on each one of us as investors, workers, or consumers.

Moreover, the invisibility of many taxes perpetuates the fantasy that government is free — even as its real costs shrink our paychecks, sap our savings, drain our economy, and inflate the budget deficit to ominous proportions. Bob Genetski, an economist and author who testified at hearings in Omaha, told the commission: "The cost of government is not obvious to people. If you hide the cost of government, people are going to demand more government than they otherwise would." By severing the connection between government's cost and its consumption, the current system deprives citizens of the information they need in order to make rational choices about what they want to buy from Washington and how much they are willing to spend.

A visible system gives taxpayers an ***honest accounting*** of government's expense and will make it far more difficult for politicians to tinker with the tax code without the democratic consent of those taxed.

The incurable cynic H.L. Mencken once said, "Conscience is the inner voice which warns us somebody may be looking." By making taxes visible, we can ensure that someone always will be.

Stability

...Because taxpayers should be able to plan for their future without the rules being changed in the middle of the game.

Everyone has heard the old saw that there are only two things in life that are certain: death and taxes. Given the constant changes to the tax code over the past few decades, the certainty of taxes has taken a perverse twist. Like walking blindfolded down a ship's gangplank, you know the end is out there — you just don't know when it'll arrive, how far you'll fall, or how long you'll be able to keep your head above water.

This uncertainty has a debilitating effect on the economy, making it very difficult for families and businesses, particularly small businesses, to plan for their future with confidence. This exacts a tremendous cost from those taxpayers and business owners who must struggle to keep up with ever-shifting rules and regulations. The retroactive tax increases passed in 1993 packed a double-whammy — changing the rules when the game was half over. A stable tax code must allow individuals to start a business, buy a house, take out a loan, put money into savings, or plan for their children's education without fear of what might lurk behind the next election cycle.

We know what works...Freedom works. And only principles for tax reform that maximize freedom can yield the opportunities, economic growth, and untold possibilities for human advancement that are its fruits. In his last public address, Abraham Lincoln declared that, "Important principles may and must be inflexible." By laying down these important principles, this commission hopes to help build a future of growing prosperity for many generations to come.

A NEW TAX SYSTEM FOR THE 21ST CENTURY

RECOMMENDATIONS

Among the hundreds of testimonies and citizen letters reviewed by this commission, one of the most compelling was that of Van Woods, owner of Sylvia's Restaurant. Mr. Woods and his family run a successful soul food establishment in the heart of Harlem, a community with painfully high unemployment. In concluding his testimony to the commission, he said, "Opportunity is the ability to look in the face of my son and say: 'I don't know if you *will* succeed, but you *can*.'"

The objective of this commission, the aim of its members, is to help make that promise a reality — not just for Mr. Woods' children, but for every child in every neighborhood in America's 21st century.

In submitting these recommendations, the commission does not seek to toss yet another piece of legislation on the table. Nor was its goal to pick and choose among existing plans, or worse, create a bodgepodge compromise from elements of existing alternatives. What we are offering to the American people and their elected officials is a set of standards — a quality control — that any new plan must meet if it is to meet the bold objective of replacing the current tax code with a fair and simple system. The preceding chapter provides one half of the check-list: the principles that any new system should embody. This chapter provides the other half: key recommendations that any new system should follow.

The core recommendations of the National Commission on Economic Growth and Tax Reform are:

- **Adopt a single, low tax rate with a generous personal exemption**
- **Lower the tax burden on America's working families and remove it on those least able to pay**
- **End biases against work, saving, and investment**
- **Allow full deductibility of the payroll tax for working men and women**
- **Require a two-thirds super-majority vote in Congress to increase tax rates**

We believe that, with a pro-growth, pro-family tax system, we can achieve these goals within the context of budget equilibrium. The commission believes that this new tax system can satisfy our six working principles:

- **Economic growth** through incentives to work, save, and invest;
- **Fairness** for all taxpayers;
- **Simplicity** so that anyone can figure it out;
- **Neutrality** so that people and not government can make choices;
- **Visibility** so that people know the cost of government; and
- **Stability** so that people can plan for their future.

The following pages explain the core recommendations in light of these principles, and explore some of the trade-offs involved in reaching a system that meets these goals. This chapter also touches on a few of the corollary points that flow from these main recommendations. Staff discussion papers are provided for those who seek more detail on the concepts involved.

RECOMMENDATIONS

Single Tax Rate. A single rate is a fair rate. One tax rate, coupled with a generous personal exemption, together produce a progressive average tax rate. Low income taxpayers would owe little or no tax. But everyone who earns enough to cross the threshold of the exemption would face exactly the same tax rate on any additional income.

A single-rate system is not only fair, it also can satisfy the principles of simplicity, visibility, and stability. A single rate is clearly simple, and it is highly visible: one rate — as opposed to the current, confusing mess — will stand out and be remembered by all. A simple, visible system also can be stable: by keeping our eyes on the single rate, we can keep politicians' hands off it.

Nobel Prize-winning economist F.A. Hayek described economic redistribution through multiple tax rates as "the chief source of irresponsibility" in politics and "the crucial issue on which the whole character of future society will depend." A system of graduated marginal rates violates the principle of fairness — that if a law applies to citizen A, it must equally apply to citizen B.

Take, for example, two wheat producers, each farming the same-sized plot of land. One of them produces 1,000 bushels of wheat; the other, through harder work and more careful land management, produces 1,200 bushels. To tax the income represented by the additional 200 bushels of wheat more heavily than the income represented by the first 1,000 would be demonstrably unfair to the more productive farmer. And yet, that is the nature of a multi-rate tax system: it takes more from people for their hard work, creativity, and success.

The added output – and the resulting added income — of one taxpayer does not diminish his neighbor, and is not earned at his neighbor's expense. Indeed, it expands economic opportunity, increases the availability of goods and services, and helps others be more productive as well.

True progressivity requires a low tax rate coupled with a generous personal exemption. This would grant low-income Americans an "economic head-start" — allowing them to begin their climb toward economic independence before they are asked to shoulder their share of government's cost. The larger goal is to move beyond merely maintaining low income Americans at subsistence level livelihoods toward giving them an opportunity to permanently escape poverty.

Here, as elsewhere, there are trade-offs involved. The goal of protecting those least able to bear the burden of taxation conflicts with the principle of visibility: those exempt from taxes don't see the price of the government services we all pay for.

BIAS AGAINST SAVING AND INVESTMENT.

Multiple taxation creates a huge bias against saving and investment that must be eliminated in a new system. Consider, for example, the effect of the current system on a family in the 28 percent tax bracket that earns an extra $1,000.

Of that $1,000, they will pay $280 in federal income tax and keep $720. If they spend that $720, say, taking the family to Disneyland, they incur no further federal tax, no matter how many times they ride the Space Mountain.

But suppose, instead, they decide to invest the income in stocks to create financial security for their future. Bad move, says the current tax code.

First, they already had to pay income taxes to have the $720 to invest. Second, the company in which they invest will generally pay tax at a 35 percent rate on the returns on the amount invested. Third, if the company pays dividends, the family will pay a 28 percent tax on the dividends they receive. Alternatively, if the company retains the after tax income for reinvestment or finds other ways to boost future earnings, the stock price will rise. The future earnings will be taxed, and if the family sells the stock, it will pay a capital gains tax at a 28 percent rate (see below). Fourth, if they hold the proceeds of the sale until death, they will be subject to an estate tax that can go as high as 55 percent.

Both the investment in the stock market and the investment in the family trip produce returns — one yields warm memories of the past, the other provides real hope for the future. The returns on the investment in the trip are not subject to tax; the returns on the investment in the stock market are. (Staff discussion papers contain further information on the tax code's bias against saving and investment.)

The commission believes that the costs — both economic and moral — of burdening low-income people with taxes that can bar them from reaching their fullest potential outweigh competing concerns. By offering low-income Americans a window of economic opportunity, the personal exemption can help liberate those whom the public sector has failed to help and the private sector has failed to reach.

Lower Tax Rates. The commission recommends that the single rate be as low as possible. We encourage the adoption of such a low rate within the framework of budget equilibrium. Furthermore, we strongly urge that the rate be lowered over time as a growing economy yields rising revenues. *We recommend that added revenues be considered, not as more Monopoly money for Washington, but as a "growth dividend" to be paid out to the American people.*

Eliminate biases against work, saving, and investment. The principles of fairness and neutrality require that all income be taxed the same, whether it is used for consumption or saving, whether it is produced in small businesses or large corporations, and whether it is earned by employees or the self employed.

Under the current system, income that is used for consumption is taxed once, while income that is saved is taxed again and again. For businesses, complex depreciation rules mean that income from investment in buildings and equipment is overstated. This forces people to pay taxes before they have recovered the cost of their investment.

The box at left provides an example of the problems created by the current tax code.

The biases result in less work, saving, and investment, lower productivity and wages, fewer jobs, less income to spend on housing and education, and fewer assets to furnish income in retirement than would otherwise be the case. As the example at left demonstrates, these biases affect every family that is trying to save for the future.

In order to end these biases, the tax system must either *let savers deduct their saving or exclude the returns on the saving from their taxable income.* It must *end double-taxation of businesses and their owners* and *permit expensing of investment outlays.* It must also address the following issues:

Capital Gains Taxes. If a new tax system is to eliminate biases against saving and investment, it also must **abolish separate taxation of capital gains.** As commissioner Ted Forstmann said, "The biggest depressant on the rate of capital formation is the risk of confiscation by the government." The United States now imposes some of the highest tax rates on capital of any developed nation – a 28 percent tax on long-term capital gains unindexed for inflation. Compare that with a 16 percent rate in France; a 1 percent rate in Japan; and a zero tax on capital gains in Hong Kong, Germany, South Korea, Singapore, and Malaysia.

The result is to punish risk-taking, shrink the pool of capital needed for investment, and deprive would-be entrepreneurs of a chance to climb the ladder of economic opportunity. "The tax on capital gains," argued President Kennedy in 1963, "directly affects investment decisions, the mobility and the flow of risk capital...the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy."

By shrinking the supply of available seed corn, the capital gains tax acts as a future tax on wealth to be realized, businesses to be built, and jobs to be created. Those hardest hit are not the wealthy – who by definition have their capital gains, their wealth, behind them – but rather all those who have yet to realize their capital gains: the poor, the young, and minorities.

"Death" Taxes. It makes little sense and is patently unfair to impose extra taxes on people who choose to pass their assets on to their children and grandchildren instead of spending them lavishly on themselves. Families faced with these confiscatory taxes often find themselves forced to sell off farms or businesses, destroying jobs in the process. "We must help to save the family farm, ranch, and business," said Commissioner Jack Faris.

Unfortunately, family businesses often get hit hardest because they can't afford to hire expensive lawyers and accountants. As Douglas Darch of Wake Forest, North Carolina testified to the commission: "There is something wrong with a tax system that results in the systematic dismantling of small businesses to meet estate tax obligations."

The tragedy is that while these taxes cause much suffering for taxpaying families, they generate a relatively small amount of revenue. Estate and gift taxes appear to count for less than 1% of federal revenues – but even that low figure is exaggerated and misleading. Professor Douglas Bernheim of Stanford University testified before the commission that the estate tax may not really raise any revenue at all, because more income tax is lost from "estate planning" than is ultimately collected at death.

Full Deductibility of Payroll Taxes for All Working Americans.

The Commission recommends that federal payroll taxes be fully deductible — both for employers and employees. Many employers and employees pay more in payroll taxes than they do in federal income taxes. Making these taxes deductible for both employers and employees will reduce obstacles to hiring more workers and will fuel America's job growth into the 21st century.

Under the current tax system, workers pay income tax on their Social Security tax — a tax on a tax. Employers can deduct their half of the payroll tax, but employees cannot. The combined burden of both income and Social Security tax is particularly hard on workers with incomes too high to be eligible for the Earned Income Tax Credit (roughly $25,000), but too low to be below the threshold where the Social Security tax stops being taken out of paychecks (about $63,000).

When employer and employee payroll taxes of 15.3% are taken into account, workers in the 28% tax bracket actually face a brutal marginal tax rate of more than 43% on any additional income they earn. A single low tax rate would help relieve this demoralizing tax penalty on work and saving. But it still leaves a tax on a tax.

Making the Social Security tax deductible would help reduce the combined marginal tax rates on middle-income taxpayers who get hit by both taxes. A one-earner couple with a $40,000 income currently pays tax as though the couple really received the entire $40,000 — even though they have already paid over $3,000 as their share of the payroll tax, leaving less than $37,000 on which they could possibly pay income taxes. By making the payroll tax deductible, income taxes would be calculated on the basis of working families' real net incomes.

This need for change was highlighted in a citizen letter to the commission from Spencer Riedel of Flagstaff, Arizona, who described the Social Security payroll tax as "a huge heartache...Is there no way to stop this 'hidden' tax?...If we could eliminate this unfair mandated tax, our business would hire two more people."

A Two-Thirds Majority Vote in Congress To Raise The Tax Rate. The commission recommends that the new system be guaranteed both stability and longevity by requiring a super-majority vote of both houses of Congress to raise the rate.

In hearings across the country, one depressing but all-too-familiar response from taxpayers could be bluntly paraphrased as: "Change, schmange. That's what you guys said the last time you talked about tax reform." The roller-coaster ride of tax policy in the past few decades has fed citizens' cynicism about the possibility of real, long-term reform, while fueling frustration with Washington. The initial optimism inspired by the low rates of the 1986 Tax Reform Act soured into disillusionment and anger when taxes subsequently were hiked two times in less than seven years. The commission believes that a two-thirds super-majority vote of Congress will earn Americans' confidence in the longevity, predictability, and stability of any new tax system.

The goal: A single low rate on income with a generous personal exemption, a lower burden on working families, an end to biases in the tax code — all set in the stone of a congressional super-majority. The recommendations in this chapter form the core framework for a new 21st century tax system.

OTHER ISSUES

Deductions and Exclusions

Concerns about special provisions in the existing tax code have the potential to derail debate over the merits of a new tax system and the tremendous benefits it could bring to the American

economy. There are important social and economic consequences of certain deductions and exclusions. The commission believes they should be considered with an eye to their impact on the tax rate, the costs to the Treasury, and the consequences of change — and within the context of the values of the American people. For example, the home mortgage interest deduction has spurred home ownership in America; an important goal of our commission is to spread ownership to give more people a stake in the system. And, at a time when America needs a renaissance of private giving and commitment to overcome those social problems which government programs have either failed to improve or made worse — we need a system which encourages people to take more responsibility for communities and neighbors in need. We welcome debate over the best way to protect these institutions and preserve the values they represent within the context of the dynamic new tax system we envision.

Simplify International Taxation: Congress should consider a territorial tax system. The current system of taxing international business operations is one of the most complicated parts of the Internal Revenue Code. It leads to enormous costs of compliance and enforcement, raises little revenue, and damages the competitiveness of U.S. businesses operating abroad. Further, it encourages them to keep reinvesting profits abroad rather than bringing the money back home where it could be reinvested in America.

Whatever new tax system is chosen, there must be a clearer, simpler, and more certain determination, relative to current practice, of what income is foreign or domestic or what international transaction is taxable. In addition, attention must be given to the proper tax treatment of foreign source license fees, royalties, and other intangibles so as not to discourage research and development in the United States.

Strengthen Private Retirement Saving: The commission is particularly concerned that Americans are not saving enough for their own retirement. A tax system that eliminates the bias against saving is essential to encourage people to accumulate more assets throughout their lives. There is, however, no guarantee that all individuals or families will save enough to be secure and financially independent in their retirement, even under a new tax system.

With the problems facing public retirement programs, it is essential that private retirement saving be strengthened. Without sufficient retirement saving, many people will become dependent upon the government in their old age, necessitating either sharp increases in taxes on future generations or a significantly diminished standard of living. Providing strong encouragement for individuals and families to take responsibility for their own retirement will go a long way toward preventing uncontrolled growth of government while ensuring a more comfortable, more secure, and more independent retirement.

Therefore, any tax system should encourage people to save for their own retirement. Further, the commission recommends that Congress begin the process of policy changes that will result in people taking more responsibility for their own retirement saving. Other changes within the overall income and payroll tax systems also should be considered.

Measuring Results

One of the chief objectives of adopting a new tax system is to promote economic growth. If we are successful, the added growth will provide the tax revenues to pay for a portion of the change in the tax law. Failure to count these added revenues will make it appear more difficult to make the necessary tax changes.

One couldn't catch the blossoming of a rose in a split-second single-frame exposure, or capture a speeding bullet with time-lapse photography. Similarly, the tools with which we anticipate and examine changes in government policies, including tax policy, must mirror the way the economy actually changes as a result of these actions.

When a bill is being debated before Congress, members are required to produce estimates of the costs of the legislation. For years, Congress has used what are called "static revenue estimates" to produce these figures. Static revenue estimates attempt to predict future government revenues by applying the new law to today's economy as though it would not be affected by the new law. History has shown that these estimates are limited in their ability to predict revenues.

We recommend that Congress instead use estimates that measure the impact policy changes will have on people's behavior and on future economic activity, and that therefore more accurately predict implications for future revenue collections. Use of this "dynamic" scoring, of course, must be based upon realistic assumptions regarding tax rates, tax revenues, and economic activity. It is essential to avoid overly optimistic as well as overly pessimistic projections. (Further details are provided in the staff discussion papers.)

Transition Issues

The defenders of the status quo will say that our recommendations for a new tax system will mean a tax increase on the middle class or cause a flood of red ink.

We strongly disagree. The thinking behind our current tax system is a model that does not fit tomorrow's world. Complainers fail to understand the new world that this new system will create. The tax reform we envision will create a different climate for economic growth. It will lift incomes. It will reduce interest rates. It will put people to work. It will reduce the use of tax shelters. It will reduce the need for social safety-net spending. It will foster millions of new businesses and jobs. In the process, the transition will help to pay for itself.

That doesn't mean there will not be difficult issues to address

during the transition. In particular, policy makers must take care to protect existing savings, investments, and other assets. Whatever the challenges this change presents, we believe that none of the issues is insurmountable.

Whatever equivocations there may be toward the future, we must not let them rob us of the unparalleled economic growth, the unimagined opportunities for human fulfillment and advancement that now lay trapped within the cage of the current system, waiting for us to open the door.

Conclusion

The recommendations outlined here can lay the groundwork for a pro-growth, pro-family tax code for America's 21st century. As construction of the new system moves forward, there will be many decisions to be met and made along the way. While we have tried to raise a number of those issues here, and clarify others in the discussion papers, it is impossible to anticipate every question that will arise as we move toward a new system.

We urge that the American people participate in this debate at every step of the way. This is all the more crucial given the critical nature of the transition issues involved as replacement of the current system gets underway. Half a century ago, the economist Joseph Schumpeter described capitalism as inseparable from "the perennial gale of creative destruction." In the transition to a fairer system and a freer market, the winds of change are bound to increase. Those who have a stake in the status quo will not welcome change; others may prefer the cramped confines of the familiar present to the uncertainty of a yet realized future.

If the taxpayer testimonies we listened to and letters we received bear any evidence of the broader mood of the country, we believe that Americans are overwhelmingly eager to make that change, ready for its challenges, and look forward to its opportunities.

It has been a privilege for us to serve on this commission, and each of us has taken the responsibility very seriously. We have been educated and inspired by the many, many Americans we have talked with. While the tax system is in serious disrepair, the American spirit and will for change are stronger than ever. We thank Senate Majority Leader Dole and Speaker Gingrich for giving us this opportunity by delegating us to do this important work.

We quote in this report many of the citizen witnesses who wrote to us and who testified at our hearing. We thank them and the many expert witnesses who prepared testimony and answered our many questions about the intricacies of tax reform.

We are very much indebted to the lawmakers who have spent years of their careers studying tax reform, inspiring serious debate on the flaws of the current system, and developing proposals for major tax reform. Among them: House Majority Leader Dick Armey, Ways and Means Chairman Bill Archer, Senate Budget Chairman Pete Domenici, Senator Sam Nunn, Joint Economic Committee Chairman Connie Mack, Senator Bob Bennett, and Congressman Dick Gephardt. Others whose work has been invaluable to the process include Senator Richard Shelby, Senator Richard Lugar, Senator Arlen Specter, ranking Ways and Means Committee member Sam Gibbons, and many others.

It has been said that every breakthrough in human understanding has come in the form of a simplification. The complex, bureaucratic tax code of the 20th century will not enable us to keep pace with the complex and rapidly changing world of the 21st century. A simplified tax code would have an instant impact on peoples' lives —freeing up time, energy and resources currently wasted in costly compliance for productive endeavors.

The impact on the economy would be immediate and profound, putting the goal of a doubled economic growth rate within our reach. The moment the dead weight and distortions of the current tax system are lifted from our economy, the explosion of new investment, new businesses, and new jobs would transform the economic and social landscape of our country. A newly galvanized economy would create work for all those who wanted it, unleash unimagined innovations, act as a magnet for capital from all over the world, and boost wages and living standards for America's working families.

We also believe that a new tax code can help replenish the wellsprings of public trust — in our government, in each other, and in ourselves. By treating citizens equally and with respect, a new tax code can restore faith in the basic fairness of the system. A simplified system will eliminate the fear that special advantages hide in complexity, while restoring citizens' confidence in their own ability to comply with the code.

This vision of the future is rooted in both a realism about human nature and an idealism about human potential. We recognize that a new tax code, no matter how radical, cannot solve all problems. It cannot make fathers love mothers or guarantee children happy homes. Government reform, however vast or vaunted, cannot change hearts.

But it can lift hopes. At its best, it does this by seeking, as Lincoln did, "to elevate the condition of men — to lift artificial weights from all shoulders — to clear the paths of laudable pursuit for all."

By freeing citizens from the costly encumbrances of the current tax code, by restoring the link between effort and reward, by allowing individuals to save and invest in their future, and by unleashing the pent up power of our economy, this new system can lead to Lincoln's "new birth of freedom," and launch us into the next American century.

BIOGRAPHIES

Chairman ***Jack Kemp*** is founder and current co-director of Empower America, a public policy and advocacy organization. Kemp served as Secretary of the U.S. Department of Housing and Urban Development in the Bush Administration, and represented the Buffalo, N.Y., area for 18 years in the U.S. House of Representatives. He played professional football for 13 years as quarterback for the San Diego Chargers and Buffalo Bills. His father was a small-businessman who helped start a small trucking company in and around Los Angeles, CA.

"If you tax something, you get less of it. If you subsidize something, you get more if it. The problem in America today is that we are taxing work, savings, investment, and productivity; and we're subsidizing debt, welfare, consumption, leisure, and mediocrity."

Vice Chairman ***Edwin J. Feulner, Jr.*** is president of the Heritage Foundation, a leading public policy group in Washington, D.C. He also serves as chairman of the Institute for European Defense and Strategic Studies in London. Feulner, who has a Ph.D. from the University of Edinburgh, served as consultant for Domestic Policy to President Reagan, and was the Chairman of the U.S. Advisory Commission on Public Diplomacy.

"Our tax code has become a complex web of penalties, disincentives, loopholes, and preferences. No amount of tinkering at the edges will save the system. The only answer is to replace it with a new system that rewards work, saving and risk-taking."

Loretta H. Adams, started her professional career as a management trainee at the Panama City, Panama, Sears store on a $25-a-week salary. Ms. Adams later immigrated to the United States and went on to become founder of the San Diego-based Market Development, Inc., a consumer, marketing, and opinion research firm with nearly 100 employees. Since 1978, her company has serviced Latin-American consumers in the United States and Latin America and has become one of the top 100 research firms in the country.

"The conditions that produced the current tax system no longer contribute positively to a 21st century global economy. We now have the opportunity to create a tax system that is more responsive to our times, situation, and needs and, hopefully, we will grasp it fully."

J. Kenneth Blackwell lived in public housing for the first seven years of his life only to later pioneer housing reforms as the Deputy Undersecretary of the U.S. Department of Housing and Urban Development. Today, he serves as Treasurer of the State of Ohio, having previously held public office on the Cincinnati City Council before becoming mayor of Cincinnati. He is a member of the Council on Foreign Relations in New York, and previously served as U.S. Ambassador to the United Nations Human Rights Commission and as vice president of Xavier University in Cincinnati.

"There is something fundamentally wrong with a tax system that costs Americans $250 billion to comply. A simpler tax system would help break the chains that currently bind entrepreneurial spirit."

Herman Cain learned the value of hard work from his father who concurrently worked three jobs — one of which was as a janitor at The Pillsbury Company in Atlanta. At age 12, Herman went to work with his father at Pillsbury, helping him as "assistant janitor." Twenty-two years later Cain would become a Pillsbury vice president (computer systems) and later be selected as president of the firm's then-subsidiary company, Godfather's Pizza, Inc. In 1988, he successfully led a group of Godfather's Pizza, Inc. senior management in purchasing the chain from Pillsbury. He currently serves as chairman and CEO of Godfather's Pizza, Inc. Prior to his tenure at Godfather's, Cain worked for the U.S. Navy as a mathematician, the Coca-Cola Company as a business analyst, and was an executive with Burger King Corporation.

"One of America's greatest strengths is its ability to change...our 82 year old tax 'mess' is long overdue for dramatic, sensible change."

Carroll Campbell served two, four-year terms as one of the most popular and innovative governors in South Carolina's history. His legacy as governor includes government reform, record job expansion, net tax cuts, economic growth, and investment in his state. Campbell launched his political career in 1970, first serving in the state House and Senate and later in the U.S. Congress, where he served on the Banking, Appropriations, and Ways and Means committees. He also served as chairman of the National Governors' Association, the Republican Governors' Association, and the Southern Governors' Association, as well as Chairman of the Southern Growth Policies Board. Today he is president and CEO of the American Council of Life Insurance.

"The tax system should encourage investment and job creation, foster long-term savings, and increase the focus on individual and family economic responsibility. In short, tax policy should encourage long-term savings for retirement."

Pete du Pont, during his tenure as governor of Delaware from 1977-1985, implemented a highly successful pro-growth tax policy by dramatically lowering marginal tax rates, causing the state's economy to boom and overall tax collections to jump, and enacting a constitutional amendment that limited both tax and state spending increases. He also served as a state legislator and Congressman and ran as a Republican candidate for President of the United States. He currently serves as policy chairman of the National Center for Policy Analysis, and writes a weekly column on public policy that is distributed to more than four hundred newspapers across the nation.

"The men and women who spoke to us reflected an American consensus: Our tax system is destroying our opportunities. It's time to replace it."

Jack Faris started working at age 13 earning 50 cents an hour at his parent's service station. Faris learned early in life the challenges of running a small family business and the importance of hard work. After running his own business in Nashville, Tennessee, he became president and CEO of the National Federation of Independent Business (NFIB), the nation's largest small business advocacy organization with more than 600,000 members.

"Regulation and taxes are strangling small business on main street. Give us relief and we will create the jobs and build America's future for our children and grandchildren."

Matt Fong serves as Treasurer of the State of California. Prior to his election, Fong served as Vice Chairman of the State Board of Equalization, California's tax agency. Fong streamlined the agency, cutting millions of dollars of waste, reformed the state's tax code sponsoring changes to the unitary tax, and made the agency more "taxpayer friendly." A graduate of the U.S. Air Force Academy currently holding the rank of Lt. Col. USAFR, he earned an MBA and law degree, started a small business, and worked for Sheppard, Mullin, Richtor and Hampton as a transactional corporate attorney.

"Too many Americans are sitting on the economic sidelines. A progressive single rate flat tax will radically jump start job creation, moving the unemployed off the sidelines to jobs."

Theodore J. Forstmann is one of the most admired entrepreneurs in America with an unrivaled record of successful investments. Forstmann splits his time between running his firm, speaking out on behalf of economic opportunity and growth, and helping children worldwide. He has poured his energies and resources into leading relief efforts in Bosnia, sponsoring charities in South Africa, and funding scholarships and teaching students in America's inner cities. He is the senior partner of Forstmann Little & Co.

"The current tax system is ridiculously complicated, economically destructive, and morally corrosive. We desperately need a new tax code that puts the individual — not government — at the center of the equation."

Dean Kleckner took over the rented family farm in Iowa at the age of 18 when his father died. Kleckner served in the Army and later returned to Iowa where he started on his own with a dozen sows, a dozen cows and 300 chickens. Today he owns a 350-acre corn, soybean, and hog farm, and serves as President of the American Farm Bureau Federation, a post he has held since 1986. He also serves on the U.S. Advisory Committee on Trade Policy, a post to which he was first appointed by President Reagan, and reappointed by Presidents Bush and Clinton.

"Our tax system must be simple and equitable for all taxpayers, with no loopholes. It has to let hard-working taxpayers keep more of the money they have earned."

Shirley Peterson is president of Hood College in Frederick, Maryland. Prior to assuming the college presidency, she practiced tax law and also served as Commissioner of Internal Revenue under President Bush and Assistant Attorney General (Tax Division) at the U.S. Justice Department under President Bush. She was raised on farm in Colorado.

"Citizens from around the country told us that the current law is too complex. This complexity breeds disrespect for the law and for our government. It time to repeal the Internal Revenue Code and start over."

John Snow worked his way through college as a sports coach. Today he serves as chairman, president, and CEO of CSX Corporation in Richmond, Virginia, and has been with the company since 1977. Snow, who has a Ph.D. in economics from the University of Virginia and a law degree from George Washington University, also served as Deputy Undersecretary of the U.S. Department of Transportation, as a private attorney and a college professor.

"The current tax system dims our prospects for the future and must be replaced by a new system for the 21st century which helps Americans to capitalize on opportunities — not stifle economic growth and entrepreneurial activity."

John Wieland always worked part-time growing up, from working at a gas station to delivering newspapers to stocking vending machines. Today, he is a president of John Wieland Homes, Inc., of Atlanta, employing more than 700 full-time employees and thousands of subcontractors. For Wieland, success has meant the ability to give back to his community by providing housing for the working poor and working with Habitat for Humanity, formerly serving as a member of the International Board of Habitat.

"The consensus of the American people demands a completely new, simple, and fair tax code. Increased prosperity for ALL will be the outcome. The time is now."

TRC Advisers and Staff

Grace-Marie Arnett, Executive Director

Alan Reynolds, Research Director

Richard Myers, Public Relations Counsel

Economic and Technical advisers

Stephen Entin, Institute for Research on the Economics of Taxation
Daniel Mitchell, Heritage Foundation
Steven Moore, CATO Institute
Bruce Bartlett, National Center for Policy Analysis
Also, David Wentworth, Judy Shelton, John Mueller, Arthur Hall

Staff of the National Commission on Economic Growth and Tax Reform:

Elizabeth Kern and Scott Sundstrom
Also, Melinda Schriver, Gilbert Pringle, Brian Pleva

Tax advisers

Pamela Olson	Gary Gasper
Donald Korb	Jeanne Hoenike
Fred Goldberg	Mark Weinberger

Senior Writer: Jennifer Grossman

Special Advisers:

Prof. Wayne Angell
Senator Robert Bennett (R-UT)
Dr. Norman Ture, Institute for Research on the Economics of Taxation

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Arnold Havens	Jamie Wickett
Melba Kidd	Pat Wolff
Ross Korves	Kathy Woodall
Kent Knutson	Sharon Zelaska
Charles Kupperman	Brad Zuber

The commission would not have been able to do its work without the dedicated and expert assistance of these people who volunteered their time and talents. And finally, thank you to the many people who provided financial support, to our witnesses, to those who wrote us, and to the hundreds of others who helped facilitate our work.

The Tax Test

Six Points of Principle

- Economic growth through incentives to work, save, and invest
- Fairness for all taxpayers
- Simplicity so that anyone can figure it out
- Neutrality that lets people and not government make choices
- Visibility to let people know the cost of government
- Stability so people can plan for the future

Six Points of Policy

- A single tax rate
- A generous personal exemption to remove the burden on those least able to pay
- Lower tax rates for America's families
- Payroll tax deductibility for workers
- Ending biases against work, saving, and investment
- Making the new tax system hard to change

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METROPOLITAN SQUARE
1450 G STREET, N.W.
WASHINGTON, D.C. 20005-2088

TELEPHONE: 202-879-3939
TELEX: DOMESTIC 892410
TELEX: INTERNATIONAL 64363
CABLE: ATTORNEYS WASHINGTON
FACSIMILE: 202-737-2832
WRITER'S DIRECT NUMBER
202 879 3898

April 12, 1994

Hon. Daniel Patrick Moynihan
Senate Office Building
Washington, D.C. 20510

Dear Pat,

I have just filed my tax returns for 1993, by mail. As I have mentioned in writing to you previously, it seems to me that our government makes unreasonable demands on its citizens -- not in terms of the aggregate amount of money which they are called upon to pay, but rather because of the enormous amount of paperwork which is required in the process.

My filings included nine separate returns, sent to six different addresses. These include Social Security returns and Unemployment Insurance returns (all on a quarterly basis) as well as the Federal and D.C. Income Tax Return, and the Federal and D.C. Estimated Tax Return for 1994. Since the Social Security and Unemployment taxes are all the result of my wife's disability, it seems to me that a case could be made that we should rather receive an appropriate credit for providing employment to others who need it.

Near my desk here, I have a federal tax file which is three inches thick, and (I estimate) contains more than six hundred pieces of paper. I will have to keep this for several years, in order to be able to respond to any questions which may arise. In addition to the federal tax itself, the booklet supplied to taxpayers contains not only Form 1040 with many schedules, and references to other schedules, which must be applied for, but there are forty-nine pages of "Instructions," which must be carefully examined. These forty-nine pages are mostly three columns each of small print. I estimate that there are at least 1,225 worlds per page. This brings the total of "Instructions" to a total of 50,000 words. But, in addition to the Instructions, there are over thirty-six pages relating to various schedules. The grand total of material accompanying the return is at least 94,000 words, the equivalent of a moderate-sized book.

These Instructions include a great number of "worksheets." I am enclosing Xerox copies of two of these, both of which must

be virtually incomprehensible to the ordinary citizen. In particular, I call to your attention the Itemized Deductions Worksheets on page A-5, where you multiply a line by 80%, and then four lines farther along you multiple a line by 3%, all to get a figure which must be quite beyond the understanding of those taxpayers who have to use it, and of the many others who have to find their way through it to see if it is something they have to use in order to complete their returns.

The net result is an enormous task, at which I spent just short of a hundred hours. Among other things, if you find, on checking, that a mistake has been made somewhere in the process of filling out the return, then the whole thing has to be done over again, including all of the complicated computations.

I do not blame the Internal Revenue Service for this extreme complexity. They have no choice. They have to take the law as it is written by Congress. I do think that Congress has failed to meet its basic responsibility to enact legislation that is reasonably comprehensible, and then not to change the statute too often. This was a role which Wilbur Mills handled very carefully and skillfully, but it has been almost completely neglected in recent years. The key man on this is the Chairman of the Ways and Means Committee of the House of Representatives, but the Chairman of the Senate Finance Committee can also have a very considerable impact on it.

Much of the problem goes back to the "reorganization" of Congress which was carried out close to fifty years ago under the leadership of the younger Senator LaFollette from Wisconsin. He was trying to get away from the "Solid South," and the domination of the two Houses of Congress by a few Southern members, who, in effect, had life terms. The net result of the change then made, though, was to weaken the leadership so that there are now 535 different and essentially independent parties in Congress. Each member has his own responsibility for fund-raising, and the result is that there is very little party leadership in Congress. This of course makes it very difficult for Committee Chairmen.

For example, the problem with respect to the Itemized Deductions Worksheet arises because some members (or the Treasury) wanted to save some part of the tax involved by the deductions allowed by Schedule A without "raising rates." So we have this frightfully complex computation, which is quite unfathomable to most taxpayers. I mention Schedule A only as an illustration. There are many other places where the computations are incomprehensible to ordinary citizens. This Form, and the many other Forms that are required, create a bitter feeling among our citizenry.

45-868 98 - 4

For better or for worse, I am one of those who keep his own records and makes out his own tax return. Practically everyone else, whether of substantial or modest income, feels that he must use a "tax advisor" or consultant, at considerable aggregate cost -- which cost is deductible in determining the tax. The reason that I make out my own return is that I have been doing so for more than sixty years. I started when the tax could be comprehended, and have not been willing to stop. It is only in the past eight or ten years that the task has become very burdensome. I could have my returns prepared by an accountant, but I figure that it would be nearly as much work for me to gather together the necessary factual material as it is for me to make out the returns. Moreover, I resent the fact that my government forces me to use an accountant for such a matter, particularly when my career in law has been largely in the tax field, and I taught federal taxation in law school for a third of a century, between 1934 and 1967 and published the first casebook devoted solely to Federal Taxation. Paying an accountant to do the work seems to me to be a little like the Civil War practice of hiring a substitute in order to avoid the draft. That does not look very good today, and so it is with a system which forces many taxpayers to have their returns made out by people with the most sophisticated computers.

And now the Treasury, with reason, is about to require more paper in order to meet the new rule that there must be a signed receipt for a high proportion of charitable contributions, including a statement that no benefit is received. These receipts must then of course be retained for a number of years.

I venture to suggest that, somehow or other, a better solution to these problems must be found. A tax law can never be as precise as the drafters have been trying to make it over the past several years. It is my earnest hope that the Ways and Means Committee, and the Finance Committee, through the energetic enterprise of their respective chairmen, will take steps to simplify this whole operation, making it possible for the ordinary citizen to comply with his responsibilities, and understand what he is doing in the process.

Keep up the good work.

With best wishes,

Very truly yours,

Erwin N. Griswold

IRA Worksheet 2—Lines 24a and 24b (keep for your records)

1. If you checked Filing Status box:	1 or 4, enter $36,000 2 or 5, enter $50,000 3, enter $10,000 ($35,000 if you lived apart from your spouse for all of 1993)	1. ______
2. Enter the amount from Form 1040, line 23		2. ______
3. Add amounts on Form 1040, lines 25 through 29, and any amount you entered on the dotted line next to line 30 . .		3. ______
4. Subtract line 3 from line 2. If the result is equal to or more than the amount on line 1, none of your IRA contributions are deductible. Stop here. If you want to make a nondeductible IRA contribution, see Form 8606		4. ______
5. Subtract line 4 from line 1. If the result is $10,000 or more, stop here and use Worksheet 1		5. ______
6. Multiply line 5 above by 20% (.20). If the result is not a multiple of $10, round it up to the next multiple of $10 (for example, round $490.30 to $500). If the result is $200 or more, enter the result. But if it is less than $200, enter $200. Go to line 7 .		6. ______

Deductible IRA contributions		(a) Your IRA	(b) Your working spouse's IRA
7. For each person, enter wages and other earned income from Form 1040, minus any deductions on Form 1040, lines 25 and 27. Do not reduce wages by any loss from self-employment . .	7.	______	______
8. Enter IRA contributions you made, or will make by April 15, 1994, for 1993. But do not enter more than $2,000 in either column	8.	______	______
9. Enter the smallest of line 6, 7, or 8. This is the most you can deduct. Enter on Form 1040, line 24a, the amount from line 9, column (a), you choose to deduct. Enter on Form 1040, line 24b, the amount, if any, from line 9, column (b), you choose to deduct. If line 8 is more than line 9, go to line 10	9.	______	______
Nondeductible IRA contributions			
10. Subtract line 9 from the smaller of line 7 or line 8. Enter on line 1 of your Form 8606 the amount from line 10 you choose to make nondeductible	10.	______	______

If filing a joint return and contributions were made to your nonworking spouse's IRA, go to line 11.

Deductible IRA contributions for nonworking spouse	
11. Enter the smaller of line 7, column (a), or $2,250	11. ______
12. Add the amount on line 9, column (a), to the part of line 10, column (a), that you choose to make nondeductible . . .	12. ______
13. Subtract line 12 from line 11. If the result is zero or less, stop here. You cannot make deductible or nondeductible IRA contributions for your nonworking spouse	13. ______
14. Enter the smallest of (a) IRA contributions made, or that will be made by April 15, 1994, for 1993 for your nonworking spouse; (b) $2,000; or (c) the amount on line 13	14. ______
15. Multiply line 5 above by 22.5% (.225). If the result is not a multiple of $10, round it up to the next multiple of $10. If the result is $200 or more, enter the result. But if it is less than $200, enter $200	15. ______
16. Enter the amount from line 9, column (a)	16. ______
17. Subtract line 16 from line 15	17. ______
18. Enter the smaller of line 14 or line 17	18. ______
19. Enter the smallest of line 6, 7, or 18. This is the most you can deduct. Enter on Form 1040, line 24b, the amount from line 19 you choose to deduct. If line 14 is more than line 19, go to line 20	19. ______
Nondeductible IRA contributions for nonworking spouse	
20. Subtract line 19 from line 14. Enter on line 1 of your spouse's Form 8606 the amount from line 20 that you choose to make nondeductible	20. ______

Schedule SE. Then, enter on Form 1040, line 25, one-half of the self-employment tax shown on line 6 of Short Schedule SE or line 15 of Long Schedule SE, whichever applies.

Line 26

Self-Employed Health Insurance Deduction

If you were self-employed and had a net profit for the year, or if you received wages in 1993 from an S corporation in which you were a more than 2% shareholder, you may be able to deduct part of the amount paid for health insurance on behalf of yourself, your spouse, and dependents. But if you were also eligible to participate in any subsidized health plan maintained by your or your spouse's employer for any month or part of a month in 1993, amounts paid for health insurance coverage for that month cannot be used to figure the deduction. For example, if you were eligible to participate in a subsidized health plan maintained by your spouse's employer from September 30 through December 31, you cannot use amounts paid for health insurance coverage for September through December to figure your deduction. For more details, get Pub. 535, Business Expenses.

If you qualify to take the deduction, use the worksheet on page 23 to figure the amount you can deduct. But if either of the following applies, do not use the worksheet. Instead, see Pub. 535 to find out how to figure your deduction.

- You had more than one source of income subject to self-employment tax.
- You file Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion.

Caution: *If you can file Schedule EIC, Earned Income Credit, you may also be able to claim the health insurance credit on that schedule. If you do claim that credit, do not use the worksheet on page 23. Instead, get Pub. 596, Earned Income Credit, to figure your self-employed health insurance deduction.*

Line 27

Keogh Retirement Plan and Self-Employed SEP Deduction

If you are self-employed or a partner, deduct payments to your Keogh (HR 10) plan or simplified employee pension (SEP) plan on line 27. Deduct payments for your employees on Schedule C or F.

Caution: *You must be self-employed to claim the Keogh deduction. There are two types of Keogh plans:*

- A defined-contribution plan has a separate account for each person. Benefits are based on the amount paid to each account.
- Payments to a defined-benefit plan are determined by the funds needed to give a specific benefit at retirement. If you deduct payments to this kind of plan, enter "DB" next to line 27.

Get Pub. 560, Retirement Plans for the Self-Employed, for more details, including limits on the amount you can deduct.

If either 1 or 2 applies to you, fill in Form 2106 for all your job expenses. Then, enter on line 19 the amount from Form 2106, line 11.

If you don't have to fill in Form 2106, list the type and amount of each expense on the dotted lines next to line 19. If you need more space, attach a statement showing the type and amount of each expense. Enter one total on line 19.

Examples of expenses to include on line 19 are:

- Travel, transportation, meal, or entertainment expenses. Note: *If you have any of these expenses, you must use Form 2106 for all of your job expenses.*
- Union dues.
- Safety equipment, small tools, and supplies you needed for your job.
- Uniforms your employer said you must have, and which you may not usually wear away from work.
- Protective clothing required in your work, such as hard hats, safety shoes, and glasses.
- Physical examinations your employer said you must have.
- Dues to professional organizations and chambers of commerce.
- Subscriptions to professional journals.
- Fees to employment agencies and other costs to look for a new job in your present occupation, even if you do not get a new job.
- Business use of part of your home but only if you use that part exclusively and on a regular basis in your work and for the convenience of your employer. For details, including limits that apply, call Tele-Tax (see page 30) and listen to topic 509 or get Pub. 587, Business Use of Your Home.
- Educational expenses you paid that were required by your employer, or by law or regulation, to keep your salary or job. In general, you may also include the cost of keeping or improving skills you must have in your job. For more details, call Tele-Tax (see page 30) and listen to topic 513 or get Pub. 508, Educational Expenses. Some educational expenses are not deductible. See Examples of Expenses You May Not Deduct on page A-4.

Line 20

Other Expenses

Enter the total amount you paid to produce or collect taxable income, manage or protect property held for earning income, and for tax preparation fees. But do not include any expenses deducted elsewhere such as on Schedule C, C-EZ, E, or F. List the type and amount of each expense on the dotted lines next to line 20. If you need more space, attach a statement showing the type and amount of each expense. Enter one total on line 20.

Examples of expenses to include on line 20 are:

- Tax return preparation fees, including fees paid for filing your return electronically.
- Safe deposit box rental.
- Certain legal and accounting fees.
- Clerical help and office rent.
- Your share of the investment expenses of a regulated investment company.
- Certain losses on nonfederally insured deposits in an insolvent or bankrupt financial institution. For details, including limits on the amount you may deduct, see Pub. 529.
- Deduction for repayment of amounts under a claim of right if $3,000 or less.
- Expenses related to an activity not engaged in for profit. These expenses are limited to the income from the activity that you reported on Form 1040, line 22. See Not-for-Profit Activities in Pub. 535, Business Expenses, for details on how to figure the amount to deduct.

Line 25

Other Miscellaneous Deductions

Enter your total miscellaneous deductions that are not subject to the 2% AGI limit. List the type and amount of each expense on the dotted lines next to line 25. If you need more space, attach a statement showing the type and amount of each expense. Enter one total on line 25. Only the expenses listed below can be deducted on line 25.

- Gambling losses to the extent of gambling winnings. Report gambling winnings on Form 1040, line 22.
- Federal estate tax on income in respect of a decedent.
- Amortizable bond premium on bonds acquired before October 23, 1986.
- Deduction for repayment of amounts under a claim of right if more than $3,000. Get Pub. 525, Taxable and Nontaxable Income, for details.
- Certain unrecovered investment in a pension. Get Pub. 575, Pension and Annuity Income (Including Simplified General Rule), for details.
- Impairment-related work expenses of a disabled person.

For more details on these expenses, see Pub. 529.

Total Itemized Deductions

Line 26

People with higher incomes may not be able to deduct all of their itemized deductions. If the amount on Form 1040, line 32, is more than $108,450 (more than $54,225 if married filing separately), use the worksheet on this page to figure the amount you may deduct.

Itemized Deductions Worksheet—Line 26 (keep for your records)

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COMMUNICATIONS

TAX DIVISION
OF THE
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

SENATE COMMITTEE ON FINANCE
HEARINGS ON THE NATIONAL COMMISSION
ON ECONOMIC GROWTH AND TAX REFORM'S
REPORT ON TAX REFORM
JANUARY 31, 1996

WRITTEN COMMENTS FOR THE RECORD
FEBRUARY 16, 1996

Introduction

The AICPA is the national, professional organization of certified public accountants comprised of more than 320,000 members who advise clients on federal, state and international tax matters was well as prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-size businesses, as well as America's major businesses, including multi-national corporations. Many serve businesses as employees. It is from this base of experience that we offer our comments on comprehensive restructuring of our tax system.

Americans want fundamental tax reform and, more than ever before, the U.S. Congress is inclined to grant their wish. Many proposals now before Congress would entirely eliminate the $700 billion in annual revenue from the individual and corporate income tax. To replace this lost revenue, a variety of new tax systems have been proposed. These new taxes come in all shapes and sizes, but they have one common characteristic. They are taxes on *consumption* and, as such, have the potential to improve America's international competitiveness--primarily by increasing private savings. In addition, because entirely new systems are being devised, there is tremendous opportunity for simplification.

No matter how simple the new system, however, the transition to it involves enormously complex political, economic, and technical issues. It is true that most industrialized countries have adopted consumption taxes. But these taxes, for the most part, just served as replacements to poorly functioning excise taxes. No major industrialized country has ever repealed its personal or corporate income taxes. And nothing in U.S. history can serve as precedent. Such sweeping legislation as the Reagan tax cuts of 1981 and the income tax reforms of 1986 pale in significance compared with the proposals now being floated.

Clearly, as this nation moves closer to fundamental tax reform, it moves deeper into uncharted territory. The AICPA issued on January 4, 1996 a study, *Flat Taxes and Consumption Taxes: A Guide to the Debate*, to help all interested Americans begin to understand how consumption taxes will affect their economy, their businesses, and their own personal finances. Copies of this study were provided to all members of Congress, key congressional and administration staff members, and other individuals interested in the debate. The following testimony summarizes the discussions and findings of the study.

1. The Major Alternatives

There are many types of consumption taxes, but there are four that are critical to understanding the upcoming debate: retail sales tax as levied by most states; value-added tax (VAT) as levied by every major industrialized country, except the United States and Australia; Flat Tax as proposed by House Majority Leader Dick Armey; and the Unlimited Savings Allowance (USA) Tax as proposed by Senator Sam Nunn and Senator Pete Domenici.

A. Retail Sales Tax

A Federal retail sales tax at first appears to be an attractive alternative to current law because individuals would no longer file tax returns. A heavy burden would, however, be placed on retailers and tax administrators, particularly if legislators provide exemptions for favored businesses and products.

Even without special exceptions, there are substantial problems, including evasion by small retailers that do not report sales and by business owners that purchase items for personal use. These problems would be particularly severe if a Federal retail sales tax had rates in excess of 20 percent--which would be required to replace revenues los from the repeal of the income tax

A retail sales tax also faces the large political hurdles of being a highly visible regressive tax and of encroaching on the states' sales taxes. While a Federal retail sales tax might be administratively feasible as a supplement to the current income tax, it does not seem likely that such a tax would be a good replacement for the current system.

B. Value-Added Tax

Value-added is the difference between the value of a business's sales and its purchases from other businesses. A value-added tax is a tax on businesses that is collected as goods move through different stages of production. Most value-added taxes in place throughout the world are *credit-invoice* value-added taxes. These taxes require firms to keep a detailed record of each sale and purchase. In the United States, there is currently little interest in a credit-invoice value-added tax.

One alternative to the credit-invoice method of implementing a VAT is known as the *subtraction* method. The subtraction method is widely considered to be simpler than the credit-invoice method because such taxes may be implemented without new recordkeeping requirements and may instead use existing books and records. The two leading alternatives now being considered for the United States, the business components of the Flat Tax and the USA Tax, are variants of a subtraction method VAT.

C. The Flat Tax

The Armey Flat Tax has two components: a business tax and the individual tax. The 17 percent *business* tax is imposed on all businesses, not just corporations. The business tax base is business receipts reduced by (1) wages and (2) purchases from other businesses. Under this new tax, the entire cost of new plant and equipment may be deducted in the first year, and overseas subsidiaries of U.S. businesses are exempt from tax. These advantages to businesses are offset by the loss of deductions for interest payments and for fringe benefits.

Under the *individual* Flat Tax, a 17 percent tax is imposed on wages and pension distributions. Interest, dividends, and capital gains are exempt. Large personal and dependency exemptions would remove tens of millions of taxpayers from the tax rolls. Under proposed Armey legislation, a family of four would only be subject to tax for wages in excess of $31,000.

Except as described above, the Flat Tax has no other deductions or credits. Most notably, there are no deductions for home mortgage interest, charitable contributions, state income taxes, and property taxes.

It is important to recognize that with a 17 percent rate, a Flat Tax that replaces current income taxes would likely be a large revenue loser. Some economists have argued that a Flat Tax rate of at least 23 percent would be required to avoid revenue losses.

D. The USA Tax

Like the Flat Tax, the USA Tax has a business tax and an individual tax. The USA *business* tax has a rate of 11 percent and is imposed on *all* businesses. Also, like the Flat Tax, the entire cost of new plant and equipment may be deducted in the first year and overseas subsidiaries of U.S. businesses are exempt from tax. There are three key differences between the USA and Flat business taxes. Under the USA business tax, (1) the deduction for wages is replaced with a payroll tax credit in the amount of 7.65 percent of most wages, (2) exports are exempt from tax, and (3) an 11 percent duty is imposed on imports.

The USA *individual* tax has graduated rates up to 40 percent. For a family of four the 40 percent rate could apply to incomes as low as $41,000. Unlike the Flat Tax, there are deductions for charitable contributions and for mortgage interest. There is also a new deduction for income that is saved. In addition, individuals get a 7.65 percent tax credit on most wages.

2. The Big Policy Issues

A. Impact on Saving and Economic Growth

There is no dispute that saving is critical to economic growth. Saving provides the funding for capital formation that gives U.S. workers the tools to be more productive and competitive. There is also no dispute that the U.S. rate of saving is low whether compared with other countries or with past U.S. rates. The replacement of the current U.S. tax system with a consumption tax would increase the after-tax return to capital and would eliminate the bias inherent in the current tax against capital formation.

There is dispute, however, as to how much such tax changes can increase private saving. Even under the most optimistic set of assumptions, it is unlikely that a switch from an income tax to a consumption tax can increase the rate of U.S. saving to a level comparable to that of its major trading partners.

Nevertheless, even modest changes in the rate of saving can have a positive impact on economic growth over the long term. Thus, although there is a high degree of uncertainty, legislation that would replace the current income tax with a consumption tax has significant upside potential from the standpoint of promoting U.S. competitiveness.

B. Balance of Trade

Most consumption tax systems exempt exports and impose tax on imports. (The Flat Tax is an important exception to this rule.) Although these "border tax adjustments" are often perceived as beneficial to a nation's balance of trade, there is broad agreement among economists that these adjustments are unlikely to have any significant impact on trade. Consumption taxes can, however, improve the trade balance to the extent they are able to increase domestic saving.

C. Redistribution

Consumption taxes are widely perceived as placing an undue burden on the poor and elderly. Any politically realistic consumption tax will likely be supplemented by features to alleviate the burden on low-income households.

Most of the states with retail sales taxes and other countries with value-added taxes exempt necessities such as food, clothing, and health care from the tax base, with the intent of reducing the tax burden on the poor. The exemption of necessities, however, is not particularly effective in mitigating the regressivity of consumption taxes.

Some form of tax credit or standard deduction will likely play an important role in alleviating the regressivity of any new consumption tax enacted into law.

D. Simplification

The proposed new consumption taxes have tremendous potential for simplification. This is particularly true because, under the proposals, some of the more complex areas of current law--namely the tax treatment of pensions, of international income, and of corporate acquisitions--become obsolete.

New tax systems, however, may entail new compliance requirements that add complexity. For example, the USA Tax must have complicated rules to determine "new" saving that is eligible for deductions, and under the Flat Tax, businesses must be able to differentiate between business expenses (which are deductible) and fringe benefits (which are not deductible).

In addition, much of the complexity of the current tax Code is attributable to dozens of targeted tax benefits. Proposed tax laws often appear simpler than existing taxes because existing law has been subject to successive legislative amendments that add complexity. It is highly probable that any new consumption tax would accrete substantial complexity (at the outset as well as in subsequent legislation) as Congress found it necessary to provide tax relief for a variety of taxpayers. Finally, there will be costs to government and taxpayers of transitioning from one system to another.

E. Transition

Without special transition rules, the replacement of an income tax with a consumption tax would haphazardly subject many individuals and businesses to large tax penalties. In the absence of transition relief, saving and investment done prior to enactment would have to pay significantly higher tax than under prior law. (In contrast, new saving and investment would be tax-free.) These retroactive tax increases would unfairly burden not only elderly individuals who are no longer saving, but also mature businesses that are no longer investing. In addition, without adequate transition relief, tax reform proposals could have a large and significant impact on the financial statements of many firms.

Transition relief is expensive both in terms of lost revenue and in terms of administrative and compliance costs.

F. Inflation

A consumption tax is unlikely to have any sustained impact on the rate of inflation. There may, however, be a one-time impact on the overall price level if the Federal Reserve responds to the tax change with an expansion of the money supply.

3. The Impacts on Different Types of Businesses

A. Corporate Businesses

In general, under both the Flat Tax and the USA Tax, labor-intensive firms--such as those in the construction, service, and transportation sectors--bear a greater share of the total corporate tax burden than they would under the current corporate income tax. Capital-intensive industries--like those in the communications and public utilities sectors--are likely to pay less taxes.

The exclusion of exports from gross receipts provides large tax benefits to those firms that export. For a typical manufacturing exporter, the exclusion of exports available under the USA Tax can easily cut a business's tax liability in half. In contrast, the Flat Tax does not exempt exports

B. Noncorporate Businesses

Both the USA proposal and the Flat Tax impose new tax burdens on noncorporate businesses. For a "typical" small business, the USA Tax imposes a greater business tax burden than the Flat Tax.

One way of assessing the impact on noncorporate business is to compare the combined individual and business tax burdens before and after the imposition of a new consumption tax. The combined burden for the owners of unincorporated businesses under the Flat Tax appears to be less than under current law. In contrast, the total tax burden under the USA Tax appears to be greater than current law, particularly for high-income owners of unincorporated businesses whose compensation would be subject, under the USA Tax, to a combined business and individual tax rate in excess of 50 percent.

4. The Impact on Individuals

Relative to current law, the USA Tax generally provides tax relief to low- and high-income taxpayers, and a modest tax increase to middle-income taxpayers.

The Flat Tax appears to provide tax relief to nearly all individual taxpayers (except those low-income households receiving refunds under current law from the earned income tax credit). This tax relief is particularly large for high-income taxpayers because interest, dividends, and capital gains are exempt from tax.

5. Some Important Details

A. Housing

In most other countries with consumption taxes, new housing is subject to tax and existing housing is exempt. Under both the USA Tax and the Flat Tax, new residential construction is subject to business tax.

Under the individual Flat Tax, the elimination of the deduction for mortgage interest (along with the loss of deductions for property taxes) adversely affects homeowners. Under the individual USA Tax, which allows deductions for mortgage interest, housing continues to enjoy its tax-favored status.

B. Banking, Insurance, and Other Financial Service Providers

Because it is difficult to identify and value services provided by financial institutions, no other country with a consumption tax has been able to properly tax financial services. Any rules that can be devised to include financial services in a new U.S. consumption tax are likely to be extremely complex and--if not carefully formulated--could significantly impact the competitive balance among various financial service providers.

C. State and Local Governments

State and local governments could suffer financial hardship if their taxes are not deductible against Federal tax--as is the case under both the Flat Tax and the USA Tax. In addition, a new Federal consumption tax might encroach on the states' ability to levy their own sales taxes. Repeal of the Federal income tax will surely complicate administration of state income taxes.

D. Charitable Organizations

Under some tax reform proposals, donors to charitable organizations lose the benefit of deductions for contributions, and the charitable organizations themselves are liable for tax on their activities.

E. Estate and Gift Taxation

It is an open question whether estate and gift taxes would be retained or repealed under any tax reform proposal enacted into law. The Armey Flat Tax repeals estate and gift taxes. The USA Tax retains the current estate and gift tax structure. (The USA Tax also amends current law by replacing tax-free step-up basis with carryover basis at death.)

Conclusion

As much as lawmakers may want to satisfy the public's desire to eliminate the income tax and replace it with a simple tax, there are no easy solutions.

There are unresolved questions concerning the impact of these tax changes on saving, productivity, trade, interest rates, and inflation. There is debate about the compliance and administrative costs of these new proposals and about the amount of revenue they raise. There are a host of unresolved technical issues--transition relief, banking and financial products, and housing.

Finally, there are numerous political issues that have not even yet begun to sort themselves out because so few taxpayers understand the impacts of the proposed new taxes. There is, of course, the age-old issue of rich versus poor. And, if that were not enough, politicians must still address concerns surrounding redistribution of the tax burden from the young to the elderly, from low-tax to high-tax states, from capital-intensive to labor-intensive industries, from exporters to importers, and from corporate to noncorporate businesses.

The AICPA study attempted to introduce readers to some issues that are likely to receive attention in the upcoming consumption tax debate. However, no one study can do justice to the enormous issues involved in totally revising Federal tax policy. In conclusion to this testimony, we raise some questions about consumption taxes that deserve further attention and research as the debate advances.

A. Questions of Tax Administration

- Will the Internal Revenue Service administer the new tax? Will its budget over the transition have to be increased?
- What are the additional administrative costs of transitioning into a new consumption tax?
- How much time is needed after enactment to prepare for administration of the new tax?
- How will tax administrators be trained? Over what time period?

- What new audit procedures need to be developed? How will they be coordinated with State audits? How will they be coordinated with on-going income tax audits?
- What new forms and instructions will have to be produced?
- What new regulations will need to be written? How quickly can these regulations be written?
- What implications does a replacement consumption tax have for existing tax treaties and new tax treaties?
- Should the new system be phased in over a number of years?

B. Questions for State and Local Governments

- Would a national sales tax force States to conform to Federal rules?
- How would States administer their income taxes in absence of the Federal income tax? How would taxes be calculated without reference to the Federal return? Would States need to increase their income tax audits? (Indeed, how much simplification is their for taxpayers who must still file State income tax returns?)
- If a replacement consumption tax reduces property values, what effect will this have on property tax revenue?
- What activities and services of State and local governments will be subject to this new tax?

C. Questions for Businesses

- What will be the new recordkeeping and reporting requirements? How should computer software and information be changed? How will tax staffing requirements change? How will tax staff be retrained? What are the costs of these changes?
- Should businesses reconfigure their multinational operations that are currently structured around current rules?
- How are plans for business reorganizations affected by the change to a replacement consumption tax?
- Given that interest is unlikely to be deductible under these taxes, should businesses be reducing their indebtedness?
- Given that fringe benefits are unlikely to be deductible, should businesses continue to provide health insurance to their employees?
- Should partnerships and sole proprietorships consider incorporating now that they are subject to the same tax as corporations?
- With all forms of savings tax favored under a consumption tax, should pension plans be altered?

D. Questions for Households

- How should financial planning be adjusted in anticipation of this tax? Will there be an estate and gift tax under the new system? Could the returns on existing investments be adversely effected by incomplete transition relief?
- Should some types of investments not favored under the current system (e.g., stock with high dividends, certificates of deposit) be given additional weight in personal portfolios?

- Should some types of investments currently tax-favored (municipal bonds, whole life insurance) receive less weight in personal investment portfolios?
- If there are no deductions for charitable giving, should contributions be accelerated before the effective date? Should charitable giving be reduced over the long term?
- If there are no deductions for state and local income and property taxes, should relocation decisions be reconsidered because cost differences between low- and high-tax jurisdictions will increase?

E. Economic Questions

- Will consumption taxes have adverse pre-enactment effects? For example, will taxpayers delay capital purchases until date the new system takes effect in order to expense their purchases. Will taxpayer delay exports, and rush imports, before border adjustable taxes take effect? Will taxpayers defer recognition of capital gains until the effective date?
- What quantitative effect will consumption taxes have on employment, wages, inflation, and productivity? How long will it take for any positive effects to take hold?
- What effect will these consumption taxes have on the distribution of income?
- What effect will a replacement consumption tax have on Federal revenues? If there is a shortfall or excess in revenue from predicted levels will there be automatic adjustments in tax rates? Will pre-enactment behavioral responses significantly reduce revenues in the early years of the tax?
- What effect will a replacement consumption tax have on real estate values?

F. Political Questions

- What is to prevent the political process from weighing down any replacement consumption tax proposal with amendments that result in additional complexity? This applies not only to the original legislation, but also to actions by subsequent Congresses?
- Will likely "losers" under a consumption tax (e.g., realtors, insurance companies, State governments, unincorporated businesses, retailers, etc.) be accommodated with special tax relief? If so, how?
- Is there any room for compromise on the notion of totally replacing the current income tax system? Could a new consumption tax be used to reduce income tax rates? Or perhaps just eliminate the corporation income tax?
- Can a replacement consumption tax be enacted without strong presidential leadership?

NILS BJERG
CERTIFIED PUBLIC ACCOUNTANT
945 VICTORIA DRIVE
ARCADIA, CALIFORNIA, 91007

February 8, 1996

Editorial Section
United States Senate
Committee on Finance
Washington, D. C. 20510

Re: National Commission on Economic Growth & Tax Reform's Report Hearing January 31, 1996

Gentlemen,

I understand that the Senate Finance Committee is soliciting the views of individuals that have an interest in the overhaul of the present Federal tax system. Having spent a greater portion of my life dealing with tax filings, planning, research and appeals, I have solicited the thoughts and opinions of many of my constituents, clients and associates regarding the various current approaches to correcting a tax system that has long since become incomprehensible, unjust, unfair and onerous. This is obvious when one understands that a high percentage of the responses from IRS agents to any tax question are incorrect, and that given one set of facts to 50 professional tax consultants yields 43 different amounts of tax due.

The individuals that I have discussed the issues with concur with the following mandates for the overhaul of the present system:

A. Repeal the existing Internal Revenue Code, Internal Revenue Regulations and Revenue Proclamations and eliminate the existing Federal Income Tax.

Justifications:

1. Because of the multiplicity of objectives of the current tax system, the present Internal Revenue Code and Internal Revenue Regulations has become a labyrinth that even tax professionals cannot comprehend.
   a. If one can get through to the IRS, which is unlikely, a high percentage of the answers to tax questions, given by the agents, are incorrect. To make matters worse, if the tax filer uses this incorrect information and upon later examination is subsequently assessed additional tax, interest and penalty plus the cost of the personal time and that of the professional representative, these costs are rarely recoverable.
   b. In experiments to assess the ability of tax professional to correctly interpret the Code and Regs., a very high majority of these professionals arrived at different amounts of tax liability given the same facts, which only serves to prove that the system is unworkable.

2. The existing system is unfair.
   a. The underriding premise of the existing tax system is one of self assessment. Because the majority of the taxpayers cannot understand how to assess themselves, they are forced to retain professionals who will charge them from $20 to many thousands of dollars to prepare the filings. Many taxpayers pay more to their tax preparer than they pay in taxes themselves.
   b. Because the current system taxes "reportable income" it gives rise to the "underground economy" where unreported income flourishes. Billions of dollars flow through the "underground economy" escaping taxation thus placing a higher tax burden on those who honestly try to adhere to the law.
   c. Because the existing system taxes earning capacity at increasing rates, it unfairly assesses individuals who succeed in increasing their earning capacity through education, ambition and hard work.

B. Establish a new system that adhere to the following mandates:

1. Must provide regulations that are simple and easily understood by all citizens.

2. Must treat all citizens equitably and fairly.

3. Must adequately fund national programs and the federal government.

4. Must encourage individual saving, investment and wealth accumulation.

5. Must encourage individuals to increase their earning capacity.

6. Must be easy and inexpensive to administrate so that a minimum needs to be spent on collection and enforcement of tax.

7. Must move toward the elimination of the National Debt within a reasonable time period. It would seem that 25 to 30 years would be considered to be a reasonable time period.

8. Must tax consumption and not earning capacity.

It appears that the single rate consumption tax (National Sales Tax) comes the closest to adhering to the above eight mandates.

1. A single rate consumption tax is simple and easily understood by all. The great majority of the states have enacted this type of tax and there appears to be a minimum of misunderstanding on the requirement.

2. A single rate consumption tax treats all individuals fairly and equitably. The more and individual spends and consumes, the more tax is collected from that individual. Certain basis necessities of life should be exempted from the tax and therefore each individual can control the amount of tax they pay by controlling their consumption.

3. A single rate consumption tax will adequately fund national programs and the federal government and is easily adjustable by adjusting the tax rate.

4. A single rate consumption tax will encourage individual saving, investment and wealth accumulation because when savings and investment expenditures are not taxed, it encourages individuals to convert consumption to savings and investment.

5. A single rate consumption tax will encourage individuals to increase their earning capacity because when earning capacity is not taxed, increased earnings increase individual net worth dollar for dollar.

6. A single rate consumption tax is easy and inexpensive to administrate and significantly less will need to be spent on collection and enforcement of tax than is currently dedicated to the IRS. A Federal audit agency will need to be established to insure that retailers are properly charging, collecting and forwarding the correct tax amounts. However, this agency should be far smaller and less costly to administrate than the IRS.

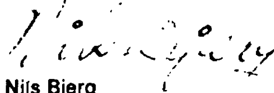
7. A single rate consumption tax can move toward the elimination of the National Debt as easily as any other type of tax. The key is how to control expenditures on the National level and much will the American people be willing to spend to reduce the debt each year. These are the same criteria that face any tax system.

8. A single rate consumption tax by definition taxes consumption and not earning capacity.

Currently, the closest tax reform concept advocating these mandates is one that has been advanced by Sen. Dick Lugar. While there may be a number of refinements that will be necessary to make this concept workable, it follows all the mandates set out above. All the flat tax proposals that have been advanced suffer from the same principal; that is they all tax earning capacity, not consumption and further would preserve the IRS or another namesake and the enforcement of the flat tax would be as costly as the current IRS. In addition, all flat tax concepts would be far more complex and difficult to understand that a single rate consumption tax.

I appreciate your serious consideration of these mandates.

Sincerely,



Nils Bjerg
Certified Public Accountant

An " HONEST NO HOLES " FLAT TAX can save everyone money. Even the government tax reform hearing January 31, 1995

Editorial Section
United States Senate,
Committee on Finance
Washington, D. C. 20510

Dear Mr. Joseph H. Gale:

The first object is to take away " all " the so called " loop holes ". This means that every ones tax must be programmed from the same record. Every one, from the smallest baby to the oldest human being, regardless of sex, white, black or what ever, shall be treated as one unit. Each unit will be taxed on his, her or its income for one year at a time. It matters nothing as to where the income comes from. Sale of stock, bank interest, gambling or just plain every day labor. The tax will be figured on a " percentage " basis and will be the same for each person or Unit.

You, as a human being, have certain things that you must pay for, in order to continue to live. I do also, same as the man, the lady or the child that is alive. Therefore the only exemption given will be given to each unit or person in order that the unit or person may live and continue the same as his fellow human. A family may group their income but each will be treated as only one unit and only blood relation may be treated as a group. The amount allowed as a living deduction may be varied only as the cost of living goes up o› down.The cost of living, and the percentage tax should be set by congress on a five year basic period in order that the unit will have the opportunity to make plans for his future living conditions.

As an example we will start with two people or units. One has a total income of $30,000 and the other has a income of $210,000. Each person will be allowed a deduction of $19,000. Each person will pay a 15% tax as per congress. This means that the

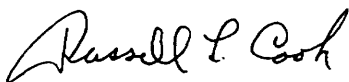
person earning #30,000 will pay a tax of $1650. The other person that made $210,000 will pay $28,650. Each unit or person knows exactly what the tax will amount to and can make plans on how to organize his or her future.

If each of those people acquired a family of a wife and one child and they did not earn an income it would come out like this. $30,000 (- 19,000 x 3) = -27,000 and no tax while the other earning $210,000 (-19,000 x 3) = $153,000 x .15 = $56.999.85.

These figures are only for the example and need to be based by congress on what the cost of living for a person would be and just how much the government needs to continue. The government and its present tax plan does not allow a person enough money to live on before it tries to tax a person to pay for progress. All people expect to pay for honest laws but the saying ,"The rich get richer and the poor get poorer", has to stop or there will be internal rebellion just as is happening in the smaller countries

The greedy need to be taught that money will not buy happiness or health. Enjoy every penny you work for but do not expect the public to like you when you can not spend what you have. The rotation of all the money is the law of Economics to continued success. The government involvement in the banking business only prolongs the time when the equalization process will work. After having gone through three depressions, I am happy to say I will not be around for the next one. It will be a Block Buster.

Yours truly,



Russell L. Cook
Stonehedge Park # 27
39820 U. S. 19 North
Tarpon Springs, FL
34689-8347

C:\WP51\LETTERS\SENATE.JOE *January 29, 1995*

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Testimony of Steven B. Cord

(Professor-Emeritus, I.U.P., & Editor, Incentive Taxation)
on behalf of the Henry George Foundation of America

A LAND VALUE TAX CAN BE BETTER THAN A FLAT TAX

at

THE U.S. SENATE FINANCE COMMITTEE

hearing on the report of the

National Commission on Economic Growth & Tax Reform

January 31, 1996, SD-215

A Flat Tax may be better (simpler) than the current income tax, but it has two serious problems:

(1) A rate of 17% or 20% won't be high enough to replace the current income tax. Milton Friedman estimates in Reason Magazine (1995) that it might have to be 40%.

(2) A rate of 0% would be better. The federal government should tax instead something which is not produced by human labor - i.e., land - rather than a commodity whose produdtion a flat tax will discourage. The rest of this paper will discuss the advantages and the means of land taxing.

Why tax land values?

(1) It encourages owners to use their sites efficiently (otherwise the tax expense would exceed the income from an inadequate improvement). Even if the land tax revenue were thrown away, economic development would be encouraged.

(2) A land tax can provide revenue to reduce income taxes from current levels.

(3) If land values are taxed, the price will be lower, which will make it easy for non-rich people to get land and go into business. Also, most

voters will pay less with a land value tax than with any other tax it would replace (and not only because commercial and industrial property owners will help them pay the land value tax).

Much more could be said about this tax which hundreds of cities throughout the world, some in the U.S., are using with good results (studies of their experience are available upon request). Many well-known endorsers back this tax.

Isn't such a tax the province of local and state governments only? NO! The federal government taxed land values in 1798, 1811 and 1861. Since it is a direct tax, the federal government can levy a $400 per capita tax on each state and specify that the states are to collect the revenue with a tax on land values. There are thirteen other ways by which the federal government can promote the taxation of land values. Those who are interested to know more about this tax can call this organization, which has experience with such a tax and has performed many studies of it.

If we continue to tax Free Enterprise, we will kill it. Tax land values instead.

STATEMENT OF JACK E. GREGG

This statement is regarding the *January 31 hearing on tax reform.* It addresses four tax categories.

1. EXCESS IMPORTS TAX

A *new tax* is needed to protect our good jobs. *We cannot endure huge trade deficits;* we must defend against countries which, one way or another, have large trade surpluses.

Since 1970, we have experienced a growing trade deficit which resulted in a decline of our industries. We no longer make significant numbers of radios, televisions, VCRs or other consumer electronics. Our steel and textile industries have withered, and we make about half as many cars as we used to. The list goes on and on, and *if this trend is not stopped, we will become a non-industrial (i.e. poor) nation!*

Of course, this loss of industries, resulted in the loss of millions of well paid manufacturing jobs. This, in turn impacted many service businesses, that depend on the spending of industrial workers, causing further loss of good jobs. This job loss is decimating our middle class.

The best measure of the health of our middle class is our *median wage.* Lester Thurow said that: since 1973 our *real* (inflation adjusted) *median wage has decreased more than 10%.* This is unprecedented, and is due, primarily, to the loss of our good industrial jobs to other countries.

We must not tolerate a large trade deficit with any country. All imports from countries such as China or Japan, with which we have *large* trade deficits, should be taxed. A good name for this tax is *Excess Imports Tax (EIT).* We should not be greedy, like we were in 1930 with the Smoot Hawley tariff (or like China and Japan are now). We should *never again use import restraints to build a trade surplus!* Therefore the EIT should *not* be used where our trade deficits are *small,* as is the case with Canada.

I suggest we start with an EIT of 10%, applied to all imports from any country which has a trade surplus with us, greater than 25%, and then remove the EIT when that surplus sinks below 5%. Canada would not be affected because its trade surplus with us is well below 25%.

The EIT will encourage Americans to buy less from the offending country, and/or it will encourage that country to buy more from us (to remove the EIT). Either way, our industries will prosper, and our tax revenues will increase.

In summary, we should drop our quest for "free trade", because that will not ensure small trade deficits. Instead, we should *use the EIT to keep our trade deficits small.*

2. A FLAT TAX

I am opposed to a flat tax because it will either *reduce tax revenues, or increase taxes on the non-rich.*

Most of the proposals, from Congress and presidential candidates, have been for a fixed rate of about 15%, and while this will not hurt the non-rich, it will surely reduce tax revenues to the point where it will be impossible to balance the budget without severe spending cuts.

Some, who misinterpret the Laffer curve, say that cutting taxes on the rich to less than 39.6% will induce them to invest more and thus expand the economy so as to create more tax revenues. Baloney. *I think the peak of the Laffer curve should be at about 75% instead of the 50%, often shown.* Some, who have plenty of money, might be tempted to retire at rates of 75%, but there would be some who would work harder, to keep the same take home pay as they had with a 70% rate.

The result of the cut in the top tax rate from 70% to 28% in the early 1980's, shows the folly of expecting *all* tax cuts to raise revenues. Between 1980 and 1992, the national debt *quadrupled* from about $1 trillion to about $4 trillion! About the only economic parameter that went up is the Dow Jones Industrial average, and that has little real effect on the economy, as will be discussed in the third section. To keep from reducing revenues, a flat tax would have to have a rate close to the present top rate of 39.6%, because *most of our tax revenues come from the very rich.* This rate would be very unfair to the non-rich and would force many, with marginal incomes, into poverty.

It is said that a "flat tax is a simplification". What could be simpler than the *present tax table?* After figuring your taxable income, it only takes about *5 seconds* to look up your tax in the tax table, and the table can be as progressive as needed to raise adequate revenue, while not hurting the non-rich. *A single tax rate would not even save one second!*

In summary, I strongly believe in progressive taxes, and recommend four rates of: 15%, 25%, 35%, and 45%.

3. TAXES ON INVESTMENT INCOME

The three types of investment income, in alphabetical order, are: capital gains, dividends and interest. Generally, they don't deserve tax breaks, but because they are degraded by inflation, they should be indexed for inflation. *Only real (inflation adjusted) income should be taxed.*

Capital gains get the best tax treatment, but are generally the least deserving! Probably 99% of capital gains accrue from resales of old stock, say from Smith to Jones, and the company, that issued that stock, couldn't care less who owns it! Resales only create jobs for stock brokers, and are what Ross Perot called: "a dice throw on Wall Street". Buying old stock is *gambling,* just like buying a lottery ticket.

Even new stock, issued by an established company, may not create any jobs, because it is often part of a reorganization which could result in downsizing, including layoffs! The vast majority of real capital gains should be taxed at the same progressive rates as for wages. To determine the *real* capital gain, the purchase price of the capital asset should be converted to current dollars.

The only capital investment that should be encouraged, is *new stock for a start up company, that truly creates new jobs.* The burden of proof should be on the tax payer, to convince the IRS that a capital gain was the result of job creation. Only then, should a portion of the real capital gain be exempt from tax.

Dividends should only be taxed once, so the *issuing company should not be taxed for any profit that is distributed as dividends.* The *stockholder should pay* tax on his *real* dividends at the same progressive rates as for wages.

Interest is probably the most deserving of tax breaks because it is the result of *savings, which should be encouraged.* Savings make money available to banks, etc., to lend out to builders, manufacturers, etc., which create jobs. As a minimum incentive for saving, *interest should be indexed!*

To index dividends and interest for inflation, the taxable income should be reduced by the ratio of the real income rate to the apparent rate. For example, if the CPI is 2%, and the apparent income rate is 5%, then the real income rate is 3%.

In summary, I recommend *no special rates for investment income, but those incomes should be indexed for inflation.* Interest, and a very few capital gains, may deserve more, but with our huge debt, indexing is enough of a "tax break".

4. TAX ON SOCIAL SECURITY BENEFITS

To keep the Social Security Trust Fund solvent, many believe that Social Security Benefits (SSB) should be means tested so that the very rich (who don't need it), will receive no SSB. The following is a way to do this, using the income tax.

My plan consists of 4 parts:

1. Do not include any portion of SSB in the income section of form 1040 (line 20b should be eliminated).
2. Compute the tax on SSB separately from other taxes, as a function of Adjusted Gross Income (AGI) and SSB.
3. Report this tax on SSB, separately, in the "Other Taxes" section of Form 1040.
4. The IRS should return all taxes on SSB to the Social Security Trust Fund.

At present, the very rich will have 85% of their SSB taxed, but, especially if they have a lot of exemptions, will pay only a small portion of this in taxes. Also, this tax is buried in the total tax on form 1040, and so cannot readily be returned to the Social Security Trust Fund.

The following table shows that those with an Adjusted Gross Income (AGI) of $200,000 pay a tax on SSB, which is only about 30% of their SSB. By rights, they should pay back 100%! The table compares present (1995) taxes on SSB with my proposed tax on SSB, for two example amounts of SSB.

TAX ON SOCIAL SECURITY BENEFITS FOR JOINT FILERS

AGI*	SSB = $10,000		SSB = $20,000	
	PRESENT**	PROPOSED#	PRESENT**	PROPOSED# $
32,000	$ 0	$ 0	$ 0	$ 0
36,000	300	300	300	300
40,000	600	600	600	600
44,000	900	900	900	900
50,000	1,464	1,350	1,665	1,200
60,000	2,380	2,100	4,494	2,700
70,000	2,380	2,850	4,760	4,200
80,000	2,380	3,600	4,760	5,700
100,000	2,380	5,100	4,760	8,700
120,000	2,635	6,600	5,270	11,700
140,000	2,635	8,100	5,270	14,700
160,000	2,978	9,600	5,788	17,700
180,000	3,060	10,000##	6,120	20,000##
200,000	3,060	10,000##	6,120	20,000##

* AGI is Adjusted Gross Income, similar to line 31 on 1995 Form 1040, except it includes Tax-exempt interest, and instead of using a special calculation of taxable SSB, it includes just 1/2 of SSB (AGI is like line 7, in the 1995 SSB worksheet on page 18 of the form 1040 instructions).

** Calculated for joint filers, both over 65, using the standard deduction, with no tax-exempt income, and using numbers from the 1995 form 1040 instructions.

Zero for AGI less than $32,000; 7.5 cents for each dollar the AGI exceeds $32,000 up to $50,000; $1,200 plus a "percentage" of each dollar the AGI exceeds $50,000. For these higher incomes, the percentage is 7.5 times SSB divided by $10,000. Thus the percentage is 15% for SSB = $20,000, etc. Note: if the computed tax on SSB exceeds the SSB, then the tax on the SSB is limited to 100% of the SSB.

The proposed tax is limited to 100% of SSB.

Note, in the table, that the proposed tax on SSB is the same as the present tax for low values of AGI, and is generally less for AGI between $50,000 and $70,000. For AGI higher than $70,000 (about twice the median income) the proposed tax on SSB rises above the present tax, until it reaches 100% of the SSB at an AGI of about $170,000 (about 5 times the median income).

Note also that: this table shows proposed taxes on SSB for *joint filers*. Similar tax rates, but with lower applicable values of AGI (e.g. $25,000 in place of $32,000), should be provided for single filers.

In summary, I suggest we *tax Social Security Benefits Separately from other income*, at very progressive rates so that *for high incomes (more than 5 times median), the tax on SSB is 100%*. Then, *list this tax under "Other Taxes" so that it can be identified, and returned to the Social Security Trust Fund.*

Sincerely, Jack E. Gregg

Jack E. Gregg
1100 S. Belcher Rd. Lot 366
Largo, FL 34641
(813) 535-1980

HOWARD PARSONS
14075 Cooper Rd Spring Hill Florida 34609
(904)-688-9619
>Internet: 72270,2013 @Compuserve.Com

United States Senate
Committee on Finance
Washington DC 20510

Gentlemen:

The Flat Tax as such is of very little importance to me. The difference in my present day taxes and those under Mr. Steve Forbes' flat tax proposal are insignificant.

I do however have a proposal that I believe the IRS should consider. I recommend that the IRS put on line each year a downloadable piece of software that will allow anyone who's on line to download it and prepare his or her taxes and file them electronically. I'm sure you are aware how much time and money this will save IRS and their annual cost of return processing. Those returns filed electronically using software distributed by the department can and will be checked automatically, electronically.

The Software could readily be distributed by the commercial networks like Compuserve, America on Line, or Prodigy and others, probably at minimum cost.

I know that commercial software is available, but the price is prohibitive for a senior citizen like me. There are many of us who must file and were you to follow this suggestion both of us would save money annually.

Very Truly Yours

Howard C. Parsons
122 09 2486

STATEMENT OF VHA INC.
TO THE COMMITTEE ON FINANCE
OF THE UNITED STATES SENATE

IN CONNECTION WITH THE HEARING ON
TAX REFORM COMMISSION REPORT
January 31, 1996

Submitted by Mr. Daniel P. Bourque
Senior Vice President
VHA Inc.
220 East Las Colinas Blvd.
Irving, TX 75039-5500

VHA Inc. (formerly, Voluntary Hospitals of America, Inc.) appreciates the opportunity to submit this testimony on the National Commission on Economic Growth and Tax Reform's report on tax reform. Structural tax reform is of great interest to not-for-profit organizations nationwide, and a serious matter for charitable hospitals throughout the United States.

VHA is an alliance of over 1,300 not-for-profit hospitals and health care organizations in the United States. The purpose of VHA is to offer health care organizations information, products, and services to improve community health, clinical quality, and operational efficiency.

VHA's mission is directly related to the viability of the not-for-profit community hospital in the face of increasingly competitive economic pressures. Indeed, the need to develop economic strategies to ensure not-for-profit hospitals' ability to achieve their mission is a principal objective of VHA programs and activities.

<u>Summary of Comments and Recommendations</u>

Not-for-profit health care providers play a critical role in meeting community health needs. Federal tax benefits are important in helping such organizations to carry out their mission and to meet their needs for capital.

VHA strongly supports efforts to make the tax code fairer, simpler, and more efficient. However, tax reform proposals (including the flat tax recommended by the National Commission on Economic Growth and Tax Reform) raise various unanswered questions, such as:

- Whether the new taxes will apply to not-for-profit organizations;
- Whether essential tax incentives, such as the exclusion for tax-exempt bond interest and the deduction for charitable contributions, will be eliminated or diluted; and
- Whether increased state taxes would be triggered by any change in federal tax status of charitable health care organizations.

VHA looks forward to working with Chairman Roth and the Committee to address these concerns in a creative and appropriate manner.

Role of the Not-for-Profit Sector

Historically, the not-for-profit sector has filled an important role in American society. First, it has served to lessen the burdens of Federal and State government. It has done so by taking on tasks which might otherwise fall to governmental agencies, but which are handled more efficiently and humanely by publicly supported charities. Such tasks have included providing food and shelter for the poor, and urgent and routine medical care for the indigent. Second, it has provided goods and services deemed to be inherently beneficial to the public--e.g., education, care for the elderly, and community-focused health care. Traditionally, the not-for-profit sector has used volunteers and funds provided by charitable contributions to subsidize the cost of such goods and services so that they may be distributed more widely.

The National Commission on Economic Growth and Tax Reform, chaired by former Congressman and HUD Secretary Jack Kemp, has been charged by Senate Majority Leader Bob Dole and House Speaker Newt Gingrich with the task of listening to taxpayers from across the country to determine how the tax code should be reformed. The Commission has concluded that the current Internal Revenue Code should be repealed in its entirety and replaced with a simplified tax system based on a flat tax. The Commission was mindful of the needs of not-for-profit organizations which rely on tax -eductible charitable giving for survival. Thus, it called for "a renaissance in private giving and commitment to overcome those social problems which government programs have either failed to improve or made worse...." However, the Commission provided no specific recommendations pertaining to not-for-profit organizations. Rather, it welcomed national debate over how such organizations should be treated under a new tax system.

We are greatly encouraged by the Commission's recognition of the important role of the not-for-profit sector and applaud the Commission's conclusion that "America needs a renaissance of private giving." We would also welcome a national dialogue on how to best protect and preserve not-for-profit institutions so that they can continue to serve their vital social and economic role in American life.

Special Role of Not-for-Profit Health Care

Not-for-profit hospitals continue a centuries-old tradition of healing and comforting those who suffer -- the sick and dying, victims of accidents and crime. Through them, the burdens of meeting the health care needs of communities and the special populations within them are shared with government. Historically, they have shouldered with the Federal, State and local governments the responsibility for meeting a broad range of health care needs of the communities in which they are located. Indeed, throughout American history, most general hospital care, institutional outpatient services, and formal home care have been provided by not-for-profit, non-governmental organizations. Moreover, many of the critical improvements in medical care have been developed at not-for-profit institutions.

Not-for-profit hospitals, which comprise approximately 60% of all community hospitals in the United States, have consistently provided a broad range of services. Not-for-profit hospitals provide medical research, education, community health care services, and specialty services. They are also committed to providing essential -- if sometimes unprofitable -- services such as 24-hour emergency rooms, neonatal intensive care, burn units and care for AIDS patients. Not-for-profit hospitals are social charities as well as providers of medical services. Volunteers provide a wide range of practical help from transportation to hospital visits.

Not-for-profit hospitals today have grown into sophisticated health care provider organizations, but their charitable role is no less important. Moreover, Congress' decision not to enact universal health reform legislation means that voluntary hospitals may be required to assume even greater burdens now and in future years. Impending Medicaid and Medicare budget cuts will pose additional challenges for community-based health care providers. As in the past, not-for-profit charitable hospitals will be called upon to meet community health needs that Government is unable or unwilling to fulfill.

Importance of Tax Benefits for Not-for-Profit Organizations

The exemption from income tax of charitable and other not-for-profit organizations is long-standing.[1] The exemption permits not-for-profit organizations to set aside or retain earnings for future capital improvements. It also provides a uniform foundation for many state tax exemptions.

A second key provision is the deduction for charitable contributions. Congress has long sought to encourage charitable donations through the tax system. The deduction for charitable giving has existed almost as long as the income tax itself. Charitable giving goes hand

[1] Prior to the enactment of the first corporate income tax, the tax "exemption" of non-profits existed primarily by statutory omission. Customs and excise taxes applied only to specified business entities and activities. When the income tax of 1894 imposed a flat two percent rate on all corporate income, Congress provided exemption for not-for-profit charitable, religious and educational organizations, as well as certain not-for-profit mutual organizations. Comparable measures were subsequently enacted after the Sixteenth Amendment was ratified, firmly establishing the principle of tax exemption of not-for-profit organizations.

in hand with volunteering as the primary means by which many not-for-profit organizations are able to carry out their mission. In the health care context, individual and corporate contributions are essential funding sources for medical research and education.

A third tax provision that directly benefits charitable organizations is the exclusion for tax-exempt bond interest. Charitable organizations with significant capital needs, such as hospitals and universities, rely on tax-exempt financing to lower their cost of capital. Since not-for-profit hospitals cannot by law issue stock to raise money through the equity markets, debt and retained earnings are their only sources of capital for much needed expansions, renovations and consolidations.

Income Tax Restructuring

VHA strongly supports the Commission's recommendation to make the federal tax system simpler and more efficient. It also applauds Chairman Roth for pursuing reforms that would encourage savings and investment, improve the international competitiveness of U.S. business and increase tax revenues from the underground economy and non-compliant taxpayers.

However, the movement to completely replace the federal tax system poses a number of problems for not-for-profit organizations. It is our hope that these problems will be faced squarely and resolved creatively so that the unique role of not-for-profit organizations will not be compromised or their influence eroded.

Issues Posed for Not-for-Profit Organizations by Structural Tax Reform

Structural tax reform could adversely affect many not-for-profit organizations. Issues that particularly concern VHA as an alliance of not-for-profit health care organizations include the following:

- Whether the New Taxes Will Apply to Not-for-Profit Organizations

  It is unclear whether the "Business Tax" portion of the proposed "Flat Tax" would apply to tax the income that not-for-profit organizations derive from activities related to their exempt purpose. Many consumption-based tax proposals apparently would apply to not-for-profit organizations that provide goods and services. Exemption from such taxes may be tied to a particular service or product, rather than the type of entity that supplies it. **VHA believes that Section 501(c)(3) organizations should be exempted from any such new taxes, except with respect to unrelated business income that would be subject to tax under current law.**

- Whether Exemption May Result in Partial Taxation

  Exemption from income tax completely eliminates tax on not-for-profit organizations. Exemption from a consumption-based tax only exempts the value added by the not-for-profit organization from tax, not the tax on the goods and services it purchases from other businesses. Under Canada's goods and services tax ("GST"), charitable not-for-profit organizations are exempt with regard to most of their services, but also are allowed a 50 percent input credit. **VHA strongly suggests that the Committee consider a mechanism to enable a not-for-profit organization to receive a credit for tax previously paid on inputs, as well as an exemption for its own value added.**

- Whether Essential Tax Incentives Will be Eliminated or Diluted

  Not-for-profit organizations depend not only on exemption from income tax, but also on current law incentives for charitable deductions and tax-exempt bond financing. Many of the reform proposals, by eliminating or diluting the exclusion for tax-exempt bond interest, would sharply increase not-for-profit hospitals' "cost of capital" at a time when they simply cannot afford it. Such proposals would also eliminate or restrict the tax incentives for individual and corporate donations that fund medical research and community health initiatives. **VHA would like to work with Chairman Roth and his staff to maintain appropriate incentives for meeting not-for-profit hospitals' capital needs and charitable giving objectives.**

- Any Erosion in the Federal Tax Exemption for Charitable Health Care Organizations May Trigger Increased State Taxes

  Many State tax exemptions derive at least in part from exemption from federal income tax under Section 501(c)(3). Even hospitals that operate on extremely narrow margins or at a loss for income tax purposes would have substantial property tax liability if exemption standards were altered. In addition, repeal of Section 501(c)(3) could trigger adverse income and sales tax consequences in many States. **VHA urges the Committee to retain Section 501(c)(3) even if it changes the basic framework of the tax code.**

Conclusion

The not-for-profit sector contributes significantly to the public good by lessening the burdens of government. It provides many essential services efficiently and compassionately. It promotes and nurtures American values of altruism, volunteerism, and pluralism. In view of anticipated cuts in Medicaid and Medicare, not-for-profit hospitals and health care organizations will be challenged to do more than ever before to maintain access to quality care for all Americans.

Although VHA strongly supports the Commission's tax reform initiatives, it has several concerns regarding the possible impact of any new tax system on not-for-profit organizations. These include concerns regarding (i) the scope and applicability of a consumption-based flat tax, and (ii) the difficulty of fashioning revenue-neutral exemptions, (iii) the potential elimination of essential tax incentives, such as the exclusion for tax-exempt financing or the deduction for charitable contributions, and (iv) adverse state consequences triggered by a change in the federal tax system..

VHA looks forward to the opportunity to work with Chairman Roth, the Members of the Committee, and their respective staffs to address these concerns in a creative and appropriate manner.

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Questions from Senator Roth

Question 1. Should the tax code be neutral, seeking only to raise revenue in the least harmful way, or should it incorporate an agenda, seeking to foster social policies?

Answer: In general the tax code should be neutral. There are several other ways to foster social polices, such as direct federal spending, block grants, and regulation. Two of the deductions that the commission recommended are good social policy, but are also good tax policy. A deduction for charitable giving supports private, local solutions to social ills. It is also good tax policy, on the principle that income should be taxed at the level of the individual who finally gets to enjoy it. In this case, the donor has transferred income to the recipient. The donor should not be taxed on income he no longer controls, and the recipient is presumably too poor to owe tax. In the case of the mortgage interest deduction, the mortgagee deducts interest paid, and the lender pays tax on the interest received. Again, it is good social policy and good tax policy. The most important neutrality recommendation the Commission made is that income used for saving and investment should not be taxed more heavily than income used for consumption. Saving and investment are socially and personally rewarding activities. We do not seek to favor or subsidize them, but we do urge that the current tax bias against them be eliminated, and that they receive equal treatment.

Question 2. If tax reform is to benefit the average working man and woman, is it not essential that there be a deduction for FICA taxes?

Answer: Yes. The Commission felt strongly that the deduction should be retained for the employer's half of the payroll tax and expanded to cover the emplyee's half of the payroll tax, with appropriate corresponding treatment of social security benefits. That would be a clear improvement over current law, and a good step to take until such time as it might be possible to reduce payroll taxes.

Question 3. Your report reminds us that Congress has conferred tremendous powers on the Internal Revenue Service. You point out that it is five times the size of the Federal Bureau of Investigation and twice as big as the Central Intelligence Agency. Perhaps the thing that concerns most of us is that the IRS controls an enormous amount of information about individual Americans, far more than any other agency. With this kind of power, the potential for abuse is great.

Does the Commission find that the IRS has adequate controls and procedures in place to identify and prevent instances of taxpayer abuse by IRS officials?

Answer: The Commission heard similar concerns as it listened to taxpayers around the country. Specific complaints, however, had more to do with complexity, and with sharp penalties required by law even in cases of unintentional violations of the tax regulations. We heard no testimony suggesting deliberate misuse of information. It seems to me that the complexity of the IRS code imposes burdens on the IRS as well as on taxpayers. When the code is so complicated that neither party can be sure of what the law means, there is enormous difficulty in compliance

and enforcement. We heard from IRS agents who were in complete agreement that the code cannot be fixed and should be scrapped.

Question 4. The world is becoming more economically interconnected and competitive. Considering the trend toward globalization and the importance of trade, how important is border adjustability in any tax reform plan?

Answer: One of the background papers in the Commission Report ("Simplify International Taxation") goes into considerable detail on this question. In brief, most economists are skeptical that border adjustment would be of any benefit to the over-all economy. We would take some resources now being devoted to producing goods and services for sale in the United States and devote them instead to production for export, and we would replace the missing products formerly sold here with imports. These changes would be facilitated by exchange rate adjustments. The over-all balance of trade and the levels of GDP and employment would be largely unchanged. What is more important with respect to the ability of American firms to compete abroad is the tax treatment of saving, investment, and labor. Saving and investment should be taxed no more heavily than income used for consumption. That would boost saving and investment, and restore some of the high value added manufacturing jobs that have been lost over time in the United States. The resulting higher U.S. productivity, combined with a low, flat tax rate, would make American labor the most employable in the world.

Question 5. The Commission's report recommends that tax reform should make the U.S. tax system territorial. Than is, a U.S. business's overseas earnings should be exempt from tax. How do you answer the concern that a territorial system might lead to businesses' shifting operations overseas?

Answer: Most of our major trading partners have taxes as high or higher than in the United States. Most of the potential U.S. tax liability of U.S. firms producing abroad is offset by tax credits against foreign taxes paid. In other words, these companies are basically taxed by the foreign government, not the U.S. government, even under current law. Territoriality would simply stop the charade of calculating a hypothetical U.S. liability and then canceling it out, and would end an enormous amount of tax complexity.

As for countries with low tax rates, there would be no mass exodus of U.S. producers to such places. These countries do not have idle resources waiting to be employed. Our firms would have to bid them away from other uses, raising their cost. Those other uses include whatever production they are selling to the U.S. or other nations under current law, resulting in a shift in the composition of their exports, but not necessarily an increase in their over-all trade surplus. The balance of payments must balance for these nations as well as for any other. If they were to earn more dollars, they would ultimately spend them somewhere, resulting eventually in more purchases from the United States by someone abroad.

Question 6. Senators Domenici and Nunn have labored hard and long to develop a tax reform proposal they call the "Unlimited Savings Allowance" or "USA". A noteworthy feature of the Domenici Nunn plan is a new deduction for a taxpayer's saving during the year. This feature of the Domenici-Nunn plan has the advantage of promoting saving, but has been criticized as

adding complexity to the tax code. My question to you is, recognizing the importance of spurring saving, is more complexity a fair trade-off in this instance?

Answer: If you look closely at the support documents of the Commission report ("Tax Biases Against Saving and Investment and How to Fix Them" and "Growth Friendly Tax Systems"), you will see that we listed two methods of treating saving neutrally. One is the "saving-deferred tax", which would allow savers a deduction for saving and tax the returns on saving on the individual's tax form. That is the method used in the USA tax, and for contributions to pensions and IRAs in current law. The other method, the "returns-exempt tax", is not to allow a deduction, but exempt the returns. That is the method used in the Hall-Rabushka approach, and for purchases of tax exempt bonds in current law. (In the Hall-Rabushka approach, businesses deduct their capital outlays and pay tax on the earnings of capital on the businesses' tax forms before the returns are distributed to individual lenders and shareholders.)

As the background papers illustrate, the two methods yield exactly the same improvement in the return to saving and the incentive to save. Your question implies that there may be a psychological advantage to the "saving-deferred" approach, in which individuals could take an immediate deduction. People will surely see the advantage for saving versus current law under either method, and, if they do not notice it right away, banks and brokerage houses will help them to see the advantage through advertising and advice under either type of reform.

The "saving-deferred" approach should not be branded as complex, however. Furthermore, there are advantages to showing the tax on capital clearly on the individual tax form. It would lay to rest the notion that the returns on saving are not taxed in an unbiased tax system, a charge sometimes leveled inaccurately with respect to the Hall-Rabushka alternative. If the saving-deferred approach were taken, it would be best if it were to involve a single flat tax rate, rather than the graduated rates in the USA Tax proposal. It would also be best for the individual tax to stand alone, at an appropriate tax rate, and not be supplemented by a VAT collected by business. The VAT is a hidden tax that hides the cost of government from the taxpayer.

The saving-deferred tax is not as complicated as the question makes it seem. The (deductible) amount saved each year (the net amount of saving less borrowing) would be reported to individuals by their financial institutions at year end as a single number, just as interest and dividends are reported under current law. The individual would not have to keep track of every deposit and withdrawal. It would be simpler, in fact, than the capital gains reporting that it would replace, in which the individual has to report date of purchase, purchase price, date of sale, sales price, and taxable difference, for every asset in which a sale occurred. Furthermore, a single saving-deferred tax would provide the ultimate in simplicity for business filers. All capital earnings would be taxed on individual tax forms. Businesses would be pass-through entities, like partnerships or subchapter-S corporations; they might have to withhold tax on behalf of workers and savers, and would have to report income distributions to workers, savers, and the IRS, but they would not have to file tax returns.

Questions from Senator Simpson:

According to the president's Fiscal Year 1996 budget, the current mortgage interest deduction cost the federal government over $54 billion in 1995 -- the third most expensive deduction. This deduction permits a taxpayer to deduct all the interest on his/her $1 million mortgage. This includes a principal residence as well as a beach house or ski house.

If the cap was lowered from $1 million to $300,000, only 4% of taxpayers would be affected and the deficit would be reduced by $7 billion per year. If we limited the deduction to just principal residences and not second homes, we'd reduce the deficit by almost $1 billion per year.

Question 1: Was there any agreement or consensus among commission members whether a home mortgage interest deduction must be included in a flat tax system?

Answer: The commission strongly favored retaining a deduction for home mortgage interest, on the condition that mortgage lenders continue to be taxed on the interest they receive.

Under the Hall-Rabushka approach, the borrower would no longer claim a deduction for mortgage interest paid, which would raise revenue, but the lender would no longer have to pay tax on the interest, which would lose revenue. The result would be close to a revenue wash for the Treasury (or perhaps a slight increase due to the presence of tax-exempt lenders such as educational and charitable institutions). When we propose that the deduction be retained, we do so on the condition that lenders continue to be taxed, rendering the retention of the deduction largely costless to the Treasury.

Your discussion contains the contention that the mortgage interest deduction costs the Treasury money. I believe that the figures you cite omit the tax received from lenders on the same interest. Only if one assumes that the saving should be double taxed would one claim that the deduction costs anything. The contention is in error in the context of a neutral tax system.

Question 2: Was there any thought given to whether the current deduction should be scaled back?

Answer: There was a very brief discussion at one commission meeting, but no recommendation at that level of detail. As the report makes clear, there are two ways to achieve an unbiased tax treatment of saving, in which there is no double taxation of income saved. The general tax principle is that, so long as the lender is taxed on the interest, the borrower should get to deduct it. If the borrower does not get to deduct it, the lender should not be taxed. That principle holds true for any loan, mortgage or otherwise, and for large mortgages as well as small, and whatever the nature of the building. The deduction limits in current law were imposed to raise revenue, not to conform to basic tax principles.

Question 3: It appears that the Commission's criteria for supporting a deduction in a flat tax system is whether it "encourages taxpayers to take more responsibility for communities and neighborhoods in need." This seems awfully broad and could be construed to fit almost any

deduction and credit we have today. What types of deductions and credits did the Commission members have in mind when they set forth this criteria?

Answer: We sought to urge the Congress to think carefully about any and every deduction, and to make sure that it did indeed conform both to basic tax principles and to a genuine social need before re-enacting it in the recreation of the tax system. In the past, the tax code has often been loaded up with deductions that were rationalized on the basis of a need that was, perhaps, not so great as to warrant the resulting economic distortion. There are far fewer special deductions in the tax code today than a decade or two ago.

The major deduction that the Commission did not take a firm position on was that for state and local taxes. Two differently-structured tax systems were described, one in which simplicity would be enhanced if the deduction were dropped, and one in which simplicity would be enhanced if the deduction were retained. Notes in the report's background papers ("Growth-Friendly Tax Systems" and "Deductions and Tradeoffs") discuss state and local taxes in some detail.

If one favors the principle that taxes should not be imposed on taxes, and that income should be taxed at the level of the final recipient, one would probably favor retaining these deductions. If one views local taxes as payment for services, such as trash pick-up, that would not be deductible for homeowners if purchased privately, one might favor disallowing some portion of the deduction. However, many of the activities of state and local governments are explicit or implicit transfer payments (welfare, education outlays) akin to charitable contributions or investment in human capital, or services to businesses that would be tax deductible if purchased from a private vendor. As the report points out, this is a gray area in the tax literature, and will have to be decided on the basis of what principles the Finance Committee, the Ways and Means Committee, and the Congress think are most important.

Questions from Senator Grassley

Question 1. It appears that under various "flat tax" proposals interest expense would no longer be deductible for income tax purposes. Therefore it seems likely that a highly leveraged small business person could have a highly negative accounting income or cash flow and a positive taxable income and tax liability in the same period. This lack of interest deductions would weigh disproportionately heavily on young persons, farmers, and other entrepreneurs since they generally carry more debt. How would such a flat tax system achieve economic growth and fairness with respect to highly leveraged small business persons and entrepreneurs? What consideration did the National Commission on Economic Growth and Tax Reform give to transition rules, and how will the Commission's plans for transition to a new Internal Revenue Code ease the difficulties of highly leveraged small business persons and others affected by the change?

Answer: You are raising a question about a difficulty that is largely a transition issue. There are several ways to deal with it.

One way is to achieve neutral treatment of saving by an alternate route, discussed in the Commission Report background papers "Tax Biases Against Saving and Investment and How to Fix Them" and "Growth Friendly tax Systems". Under the alternate system, a "saving-deferred tax," individuals and businesses would expense (deduct) saving and investment and pay tax on the returns. Interest would be deductible, and the recipients of the interest would pay tax on it, as is generally the case under current law.

The flat tax approach is a "returns-exempt tax" in which individuals and businesses do not deduct interest payments, but the lenders do not have to pay tax on the interest. It is important to look at both sides of the transaction, and to understand that new loans under a flat tax would carry a lower interest rate than under current law that would largely compensate borrowers for the loss of the interest deduction. The average tax rate on savers and borrowers is in the neighborhood of 25%. Assume, for example, that a lender is currently charging a borrower 8% interest. The lender must pay a quarter of the interest received to the Treasury, netting 6% after tax. The borrower gets to deduct the interest, saving the equivalent of 2%, and faces only a 6% interest payment after tax. Under the flat tax, the lender would only have to charge 6% to begin with, because the interest would not be taxed, and the borrower would experience the same net interest cost as under current law. Competition in the financial markets would ensure that the interest rate would fall by the amount of the current 2% tax premium. (For further discussion, see "How Would Tax Reform Affect Financial Markets?" by John Golob, Economic Review, Federal Reserve Bank of Kansas City, Fourth Quarter 1995.)

The lower interest rate would offset the loss of the interest deduction for new loans taken out after the effective date of the new tax system. However, there is a question as to what would happen to existing loans bearing the higher interest rates in effect before the reform. Even if no provisions were made for a transition, some of the existing loans could simply be refinanced at the new, lower interest rate. Refinancing involves service charges or points, however, and it would be inconvenient at best. Furthermore, some bonds do not have "call" provisions, and could not be redeemed early. In other cases, a business might have fallen on hard times since

the original loan was issued, and the lender might not be willing to refinance. All these difficulties could be eliminated by the simple expedient of permitting borrowers to retain current law tax treatment of existing loans until they mature. The interest on such loans would continue to be deductible by the borrower and taxable income for the lender, resulting in no revenue loss to the Treasury.

Question 2. Some argue that agricultural real estate prices could rise significantly in a world where a "flat tax" is the rule. This could occur since purchases would be deductible expenses in the year of the purchase, and conversely, sellers of land would not have the deduction of their original purchase price or basis in arriving at their taxable income. The entire sales price would be taxable. Did the National Commission on Economic Growth and Tax Reform consider this economic effects, and how are the principles of the Commission achieved in view of these effects?

Answer: If the excess layers of tax on saving and investment were removed, the after-tax earnings of businesses would be higher, and they would be worth more. This is as true for farms as for non-farm businesses. In particular, current law imposes a capital gains tax on increases in land values due solely to inflation if the property is sold. Expensing the property would eliminate that extra tax burden. The increase in the value of the property would be of no concern, however, if the price rose only in line with the higher returns, which is exactly what it would do in an efficient market.

Your question describes a problem for potential farmers only insofar as the new tax system might encourage a disproportionate rise in land prices due to some ability to "shelter" other income because of the expensing of the property. This problem does not arise if the new tax systems are properly constructed. In fact, this is another difficulty that disappears if one looks at both sides of the transaction or considers an alternate means of ending the tax bias against saving and investment.

Under the "saving-deferred tax" described above, the entire issue would disappear because of the tax treatment of the potential purchaser at the time of purchase of the property. Individuals and businesses would expense (deduct) saving and investment, including the purchase of land, stocks, and bonds; they would pay tax on the returns, including the sale of land, stocks, and bonds. Only net saving would be deductible. Borrowing would be considered negative saving, and would be added to taxable income.

For example, suppose one were to borrow $90,000 to buy a $100,000 property, adding $10,000 out of current income for the down payment. The $90,000 in borrowing would be added to taxable income, and the $100,000 land purchase would be deducted, for a net deduction of only $10,000. That same deduction of $10,000 would be available if one were to use current income to purchase stocks or bonds, or deposit it in a bank account. If one were to sell $100,000 of stock, or withdraw savings from a bank account, or sell another piece of property in order to purchase $100,000 of land, the sale or withdrawal would be taxable, and the land purchase would be deductible, for a net deduction of zero. Repayment of the loan over time would be considered deductible saving, but so would any other form of saving, such as purchases of stocks and bonds. In this system, the deduction for the purchase of land does nothing more to postpone tax on

income than does any other type of saving. There is no reason for expensing of land purchases to drive up the price of land in this system.

Similarly, under the flat tax, anyone selling other real estate or other deductible asset to buy a piece of land would have to take the proceeds of the sale into income before deducting the cost of the land, resulting in no net deduction. This obviates any ability to use the purchase to "shelter" other income, and eliminates any incentive the buyer might have to bid up the price of land relative to any other asset. However, under the flat tax, borrowing and the sale of stocks, bonds, or other non-deductible property would not be taken into income,. Would that feature of the system lead to higher land prices? No, it would not.

In the case of debt finance, the borrower would have to pay interest on the borrowed money, and repay it over time, none of which would be a deductible expense in this system. The present value of the debt service would equal the amount borrowed and spent on the property, providing no net deduction in present value for the debt-financed purchase.

Sale of other assets to buy the land would involve giving up non-taxable interest, dividends, or capital gains equal in present value to the price of the assets, in exchange for deductible land that would earn a taxable return. In present value, the transaction would be a wash. The land would earn a taxable return while held, if it is put to productive use, because, unlike financial investments in this system, it was deductible, and its returns would be taxable. The taxable returns would include the proceeds of any future sale of the land. The expected present value of the future taxes on the land would equal the tax saved by the deduction of the original purchase price, the same as for other deductible assets. The land would cost just as much in present value as any other use of income, such as buying stocks and bonds. There would be no bidding up of land values relative to other assets.

The fact that the seller of the property would have to include all the proceeds of the sale in taxable income would not lead the seller to demand a disproportionately higher price for the property. If the seller were to use the proceeds to purchase other deductible property, such as land or equipment, structures, or inventory relating to a business, the seller could defer the tax indefinitely. Alternatively, if the seller of the land were to pay the tax, he or she could and use the proceeds to buy stocks or bonds, the returns on which would be non-taxable in this system. The non-taxability of the returns would have the same present value as the tax on the proceeds of the land sale. There would be no present value advantage to the purchase of land over other assets, and no reason to think that there would be an artificial, tax-induced increase in land values.

Question 3. As a matter of simplicity for the average person preparing his or her income tax return, it is not the graduated, progressive tax rate schedule that makes compliance difficult. Rather, the difficulty of complying with the tax code is in finding all of the proper deductions in their proper amounts, keeping all the depreciation schedules, and determining what is exempt income, etc. Calculating the net tax given two or more rates is just mathematics, and the Internal Revenue Service gives you tables to help with that. Therefore, as a matter of aiding tax simplicity, having one rate seems no more simple than having two or more. How would a single

rate system be any more simple than the current tax code if the current code were relieved of many of its deductions?

Answer: The single rate does aid simplicity under one of the many potential unbiased tax systems, but that is not its primary advantage.

There is some gain in simplicity under a Hall-Rabushka type system. If one does not have to worry about the recipients of capital income being in different tax brackets, it is possible to withhold tax on capital income at the source. Businesses would not have to issue 1099 forms, individuals would not have to report interest, dividends, and capital gains, and the IRS would not have to match the income reported by businesses with the returns filed by lenders and shareholders. Some interest income that currently escapes tax would be taxed.

The chief advantage to the single rate, however, is with respect to fairness and economic efficiency. Income reflects what one contributes to the economy. It is unfair to punish people who earn additional income by working harder, saving more, learning skills, or acquiring additional education by hitting them with higher tax rates on their additional income from this effort. It is inefficient to discriminate among economic producers. If two individuals are considering producing additional output of equal value, it is bad economics to put a higher tax on the output of one than the other. Yet that is what happens under a graduated marginal income tax rate structure. If one producer has already produced a great deal, and earned a high income, and the other has not, then the added output of the more productive worker is taxed more heavily than the added output of the less productive worker. This is not only economic nonsense, it is discriminatory, and clearly fails to treat the two individuals equally under the law.

Question 4. As a matter of federalism, we need to remain aware of how tax low changes made by the federal government affect the various states and local governments and their revenues. It seems that in a flat tax environment that eliminates the mortgage interest deduction, residential property values will diminish in the short term, as would local property tax revenues. At the same time, individuals would not be able to deduct state income and property taxes. Finally, investors would have a lesser incentive to purchase municipal bonds because a flat tax would offer no preference to municipal bond interest income. If states must change or increase their tax schedules due to federal tax law changes, then how do persons realize the principles of the National Commission on Economic Growth and Tax Reform given that taxpayers live in a world of at least two masters, the federal and the state government?

Answer: You raise a number of concerns that have been expressed in recent months by realtors and homeowners, state and local government officials, and tax exempt bond dealers and bond holders. With so many people involved with the assets and budgets in question, the issues deserve careful scrutiny. Upon careful and objective examination, however, the concerns appear to be unfounded. Let me break your question into four issues.

i) Will the flat tax temporarily lower property values and property tax receipts because of the loss of the mortgage interest deduction and the loss of the deduction for property taxes?

The Commission suggests retention of the mortgage interest deduction, provided that lenders continue to be taxed on the interest as under current law. That step could be taken within the context of a modified flat tax, or within the context of the saving-deferred tax discussed in the Commission background papers and referred to above. Retention of the deduction would render that issue moot.

The alternative approach taken under the pure flat tax would eliminate both the deduction for mortgage interest and the tax on the interest received by the lender. Mortgage interest rates would drop by the amount of the tax premium in current rates, which is a bit over 25% of the rate. Competition in the financial markets would ensure that the interest rate would fall by the amount of the current tax premium. (For further discussion, see "How Would Tax Reform Affect Financial Markets?" by John Golob, Economic Review, Federal Reserve Bank of Kansas City, Fourth Quarter 1995.) A 25% drop in mortgage rates would more than offset the loss of the deduction for lower and middle bracket taxpayers, and slightly under-compensate top bracket taxpayers. Note also that many homeowners have paid off their mortgages, and that many who have mortgages do not itemize their deductions. The flat tax approach to the mortgage interest deduction should have no great over-all impact on home values. If anything, it would tend to make housing more affordable for lower income taxpayers who gain little from the current deduction, and a bit more expensive for upper bracket taxpayers, with little effect on average.

Of more consequence would be the loss of the (relatively modest) deduction of the property tax, for which there would be no corresponding offset. The Commission Report background papers discuss the pros and cons of the deduction for state and local taxes in some detail. These deductions could be retained in exchange for a lower exempt amount or a higher tax rate if Congress decides.

Taken together, the potential effect on home prices is very modest. A study by the consulting firm of Laurence H. Meyer, Inc. suggests a temporary dip of no more than 1 to 3 percent. (See also "DRI Study Distorts Flat Tax Impact on Home Prices", Congressional Advisory 50, Institute for Research on the Economics of Taxation, Washington, DC.) If a dip occurs, it would be temporary. The shift to an unbiased tax system would raise incomes and the demand for housing, quickly restoring and increasing property values. Professor Dale Jorgenson of Harvard told the Commission that the economy would grow by an additional 15% to 20% over a decade if the biases in the tax system were eliminated. Such growth would restore and increase home values, raise incomes and consumption, and reduce unemployment and poverty. Consequently, such a tax overhaul would raise state and local government income from property taxes, income taxes, and sales taxes, and reduce state and local outlays for welfare, Medicaid, and unemployment compensation.

ii) Will loss of the deduction for state and local taxes hurt state and local governments?

Taxes are the price we pay for government services and products. It is possible that the loss of the deduction for state and local taxes would reduce citizens' desire for the goods and services provided by state and local governments by exposing their full cost, now partly concealed. In the case of consumption services received by taxpayers, this is not necessarily a bad thing. However, many of the activities of state and local governments are explicit or implicit

transfer payments (welfare, education outlays) akin to charitable contributions or investment in human capital, or services to businesses that would be tax deductible if purchased from a private vendor. Consequently, there are also arguments to be made for retaining the deductions. If they are retained, they should be available to all taxpayers. The Commission Report background papers ("Growth-Friendly Tax Systems" and "Deductions and Tradeoffs") discuss the pros and cons of the deductions for state and local taxes in some detail. These deductions could be retained in exchange for a lower exempt amount or a higher tax rate if Congress decides.

iii) Will people be less willing to buy tax exempt bonds issued by state and local governments, and raise their borrowing costs?

This concern is based on a misunderstanding of the relationship between taxable and non-taxable securities and the functioning of the credit markets, and is without merit. Interest rates consist of a basic rate of return demanded by lenders, plus rate premiums reflecting differences in risk among various securities, expected inflation, and taxes. Tax exempt bonds do not have the tax premium. Taxable bonds do. Under the flat tax, the tax premium in currently taxable bonds would be removed. The interest rates on the taxable bonds would fall to current tax exempt levels. There would be no change in the tax treatment of tax exempt bonds. Their prices and interest rates would be largely unchanged.

The supposed differential between the two types of securities is an illusion. Yes, there is a differential between the pre-tax interest rates on taxable and tax exempt bonds, but there is no differential between the after-tax interest rates on the two types of securities. Note that under current law, upper-middle income savers receive roughly the same after-tax return from taxable and tax exempt securities. They are the swing buyers who can buy either type of bond, and alter their purchases to keep the returns equal. For them, an efficient credit market has competed away any advantage of one type of bond over the other. The only rate differential is the average marginal tax premium. Tax exempt bonds enjoy no advantage beyond that. Furthermore, taxable borrowers get to deduct interest payments, and, after-tax, pay only the same after-tax interest rate that is paid by state and local borrowers. The idea that there are two separate securities markets for taxable and non-taxable bonds is an illusion. The same pool of saving supplies all borrowers, and neither type of borrower gets an advantage, after-tax.

It is true that highest bracket taxpayers focus almost exclusively on tax exempt securities, on which they receive a slight after-tax advantage (because their marginal tax rate exceeds the average tax premium in the taxable interest rate). They would be equally willing to buy some currently taxable securities under the flat tax, and would no longer be a "captive market" for state and local securities. However, lower and middle bracket taxpayers now prefer taxable bonds (because their marginal tax rate is less than the average tax premium in the taxable interest rate) and have no interest in tax exempt securities. Under the flat tax, they would become equally willing to buy tax exempt securities. Each type of bond would lose some of its current buyers, and acquire some of the other type's buyers. The market for state and local government bonds would not shrink, and the borrowing costs of state and local governments would not rise by any significant degree.

The stronger economy brought about by the elimination of the tax bias against saving and investment would increase state and local tax revenues and reduce outlays on welfare and unemployment. State and local governments would have bigger budget surpluses or reduced deficits, less need to borrow, and better credit ratings. They would not be hurt by tax restructuring.

(Under the saving-deferred tax described in the Commission Report, the interest on currently taxable securities would continue to be taxable, but savers would be allowed to defer tax on the income used to purchase taxable bonds, an equivalent elimination of the "differential" vis-a-vis tax exempt bonds. This is also proper neutral tax treatment. The USA tax, however, would go beyond this, and recreate the differential by allowing a deduction for state and local bonds <u>and</u> exempt the interest. This double exemption is bad policy. It would totally exempt income invested in state and local bonds from tax, either when earned or when earning a return.)

4) Will states have to amend their tax laws to sustain revenues if the federal definition of taxable income is changed?

If states use the federal definition of income as their tax base, and if tax restructuring results in a net federal tax cut, then the states would have to adjust their tax rates or bases to stand pat on a static revenue basis. Ideally, the states would take the additional growth of GDP and income resulting from the federal tax change into account before resetting their rates.

The states that use federal definitions need to make adjustments in their taxes whenever federal taxes change. The types of tax changes the Commission contemplates would not be difficult for the states to adapt to, however. State would only have major difficulties if the federal government abandoned income taxation entirely in favor of a sales tax. Then there would be no federal definition of income for state law to refer to, or data gathering to share with state income tax enforcement agencies.

Under the income style taxes discussed in the Commission Report, such as the returns-exempt tax (flat tax) or the saving-deferred tax, all the definitions of various types of labor income currently defined in the federal tax code, and all compensation amounts reported to the IRS and shared with state revenue officials, would still be defined and reported for use in state law and tax enforcement. The redefinitions of taxable business income for use at the federal level would probably simplify business taxation at the state level, and revenue adjustments could be made by adopting the new federal base at an appropriate tax rate. Capital income would remain defined as under current law in the saving-deferred tax. If the federal government adopted a flat tax, states would have to have a definition of taxable interest and dividends for individuals, unless they wanted to end their own tax biases as well.

The Commission favors tax stability, once a sensible tax system is put in place. It recommended unbiased, single rate tax systems in the belief that such systems have a clear rationale for their structure and clear benefits for the nation, and would be highly visible to taxpayers. These elements would make the new system hard to change. In addition, the Commission recommended a super-majority requirement for raising taxes, making changes even

less likely. States, individuals, and businesses would enjoy far fewer disruptions and compliance burdens in the future under the Commission's recommendations.

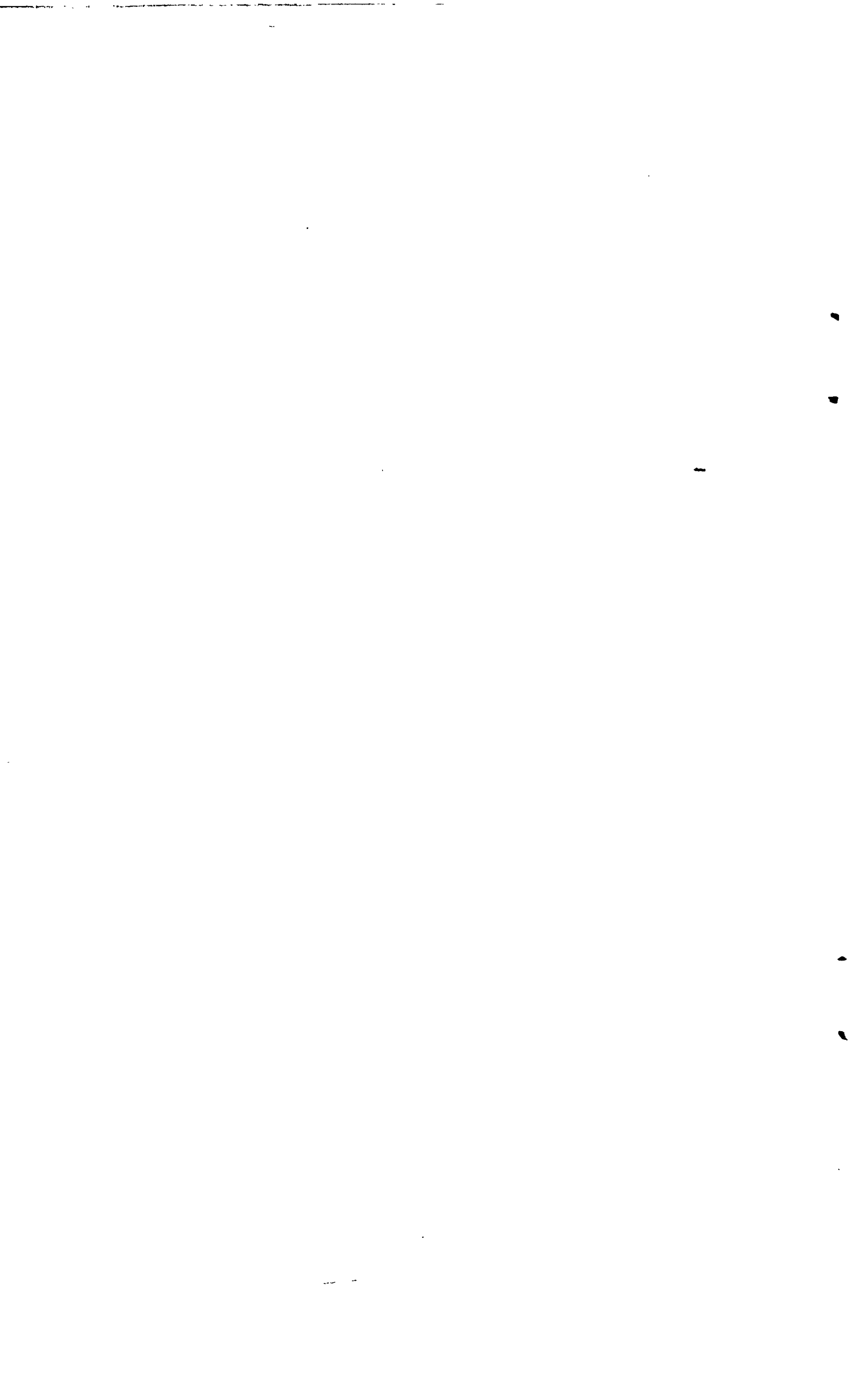
Question 5. The National Commission on Economic Growth and Tax Reform advises that a two-thirds Congressional super-majority be required to approve any future tax increase. Tax increases come in many forms. Which tax law changes would require a super-majority? For example, would a super-majority be required to increase rates, decrease deductions and exemptions, eliminate or decrease indexing adjustments, or reduce credits?

Answer: All of the above should require a super-majority.

Question 6. Recently, Congress has identified in excess of $20 billion or so of so-called "corporate welfare" that it seeks to eliminate. Other times, it identifies technical and drafting errors in existing statute. Would a super-majority be required to reduce corporate welfare or make technical corrections?

Answer: Under the principles in the Commission report, all income would be taxed once and only once, with income defined very carefully to acknowledge all the costs of earning the income. In such a system, there would be no unjustified special feature that could be labeled "corporate welfare", and none to need repealing. It is not clear what specific corporate welfare features you refer to. In the past, some items have been classified by the Congress as "tax expenditures" when, in fact, they were partial offsets to the tax bias against saving and investment in the current tax system. Any item that is an example of the tax treatment that would be universal in a saving-consumption neutral tax system is not properly called corporate welfare. Anything else would not exist in a properly reconstituted tax system.

One of the goals of a reconstituted tax system listed by the Commission is "stability". If a new and sensible tax system were carefully drawn, there would be little need for constant changes, and little need for the "technical corrections" bills that have followed upon everyone of the all-too-numerous, complicated, thousand-page tax bills that we have had in recent years that were debated, amended, and adopted in late night sessions of Congress. A true technical correction would have little opposition in the Congress. In some cases, technical corrections bills have been used to create substantial tax changes. No exception should be made for them.



How Would Tax Reform Affect Financial Markets?

ENCLOSURES FOR SEN. ROTH

By John E. Golob

The U.S. Congress is evaluating several proposals to reform the federal income tax system. Proponents of tax reform want to simplify tax preparation and stimulate economic growth by increasing the incentives for taxpayers to work, save, and invest.

While the primary objective of tax reform is a more productive economy, changing the tax laws would also affect financial markets. Several of the proposals would change the way interest expenses are deducted and change the way income from interest, dividends, and capital gains is taxed. These changes would affect interest rates and the prices of stocks.

This article analyzes the effects of income tax reform on U.S. financial markets. The first section of the article describes the general goals and features of tax reform. The second section analyzes in broad terms how tax reforms would affect financial markets. The third section examines the specific proposals that Congress is evaluating and ranks them according to their effects on interest rates and stock prices.

John E. Golob is an economist at the Federal Reserve Bank of Kansas City. Stephen Monto, a research associate at the bank, helped prepare the article.

The article reaches three conclusions. First, most proposals would reduce interest rates in credit markets where interest income is currently taxable, including bank loans, Treasury securities, and corporate securities. Second, all proposals would increase interest rates in municipal credit markets where interest income is not currently taxable. And third, most proposals would increase stock prices. All three of these effects could be substantial.

AN OVERVIEW OF TAX REFORM

Tax reformers typically agree that the broad goal of reform is to improve the well-being of U.S. taxpayers. One way to accomplish this goal is through tax simplification. Few taxpayers find pleasure in filling out their tax forms, and most would welcome a simpler, less costly way of performing this irritating annual ritual.

Another way to improve the well-being of taxpayers is to spur economic growth. Reformers would do so by minimizing the disincentives inherent in all tax systems. For example, economists have long recognized that taxing wages discourages work and taxing capital income discourages saving. Some tax systems distort economic decisions more than others. Proponents of reform want to minimize such distortions.

Goals of tax reform

Tax reformers want to simplify the tax system to lower the costs of tax compliance. Although all of the costs of complying with the tax laws cannot be measured, estimates of these costs are substantial. Compliance costs include the time taxpayers spend preparing returns and the money they pay to tax preparers. Taxpayers must also keep records, and the IRS estimates that the record-keeping time exceeds the preparation time for some tax forms. In a study of 1985 tax returns commissioned by the IRS, Arthur D. Little, Inc. estimated that tax preparation and record-keeping costs were $50 billion for individuals and $100 billion for businesses. Since then, both the number of taxpayers and the reporting requirements have increased. Proponents of tax reform argue that a simpler tax system would eliminate most of the compliance costs.

In addition to reducing the explicit costs of tax compliance, proponents contend that a simpler tax system would reduce taxpayer frustration. The tax system currently contains approximately 480 IRS forms, 280 IRS information pamphlets, and thousands of pages of supplementary documentation. *Money* magazine highlighted this complexity when it asked 41 tax professionals to prepare the return of a fictional family who owed $35,000 in taxes (Tritch). Even though all 41 preparers knew their results would be published in the national magazine, only two preparers calculated the tax within $500 of the correct amount, and 14 missed by over $5,000. As further evidence of the system's complexity, up to a third of the callers to IRS taxpayer assistance lines receive incorrect answers (Simon).

More important than tax simplification, tax reformers also want to reduce the disincentives in the tax system. Tax reform proposals would encourage individuals to work and save more, and would encourage businesses to invest and export more. In addition, the proposals would discourage investors from making unsound investments designed to reduce tax liabilities. Finally, the proposals would reduce the incentives for individuals and businesses to evade taxes by entering the "underground economy."

The greatest concern of tax reformers is the low U.S. savings rate. Reformers contend that the current income tax system encourages consumption over savings and that the United States needs to save more to keep its economy healthy. The U.S. savings rate has been declining since the 1960s, and the savings rate has been lower over the last ten years than in any other ten-year period in U.S. history (Bernheim and Shoven). The savings rate is also lower in the United States than in most other industrialized countries and is less than half the rate in Japan (OECD). Thus, all tax reform proposals include features to encourage taxpayers to save more of their income. Higher savings, in turn, would promote more investment spending, higher productivity growth, and ultimately, a higher standard of living.

The broad goals of tax reform are supported by many legislators, economists, and political analysts. Critics, however, are concerned about possible side effects. For example, provisions that encourage greater savings could also lead to a rise in income inequality. Critics are also concerned that certain sectors of the economy would be hurt by tax reform. For example, homeowners and the housing industry have benefited from the home mortgage deduction, and both are concerned about losing this implicit subsidy. Issues such as these will be important in the ongoing debate over tax reform and will need to be addressed in conjunction with the financial market effects addressed in this article.[1]

Features of tax reform

Tax reformers want to change several features of the tax code. To improve tax incentives, most proposals would reduce tax rates. But because lower rates could lead to less revenue, the proposals would

also eliminate many tax credits and deductions. Reformers also want to ensure that high-income households continue to pay higher average tax rates than low-income households.

This section describes the general features of tax reform being evaluated by Congress. Some of the features are common across multiple proposals, while others are unique to a single proposal. The features are broken into three categories. The first category contains the proposed changes to the individual income tax, the second category contains the proposed changes to the business income tax, and the final category describes the proposed direct taxes on consumption. Taxing consumption directly has been proposed as an alternative to taxing the income of individuals and businesses.

Individual income tax. Reformers have proposed seven key changes to the individual income tax:[2] (1) reduce marginal tax rates, (2) increase the income exempt from taxes, (3) reduce or eliminate deductions, (4) eliminate taxes on income from investments,[3] (5) allow a deduction for savings, (6) tax individuals for the interest income received from municipal securities, and (7) tax individuals on the value of their fringe benefits.

The first tax change for individuals would reduce marginal tax rates. The marginal tax rate is the rate taxpayers pay on the last dollar of their income. It is the rate economists consider most relevant for economic decisions (appendix). Marginal tax rates currently vary from 15 percent for low-income households to 39.6 percent for households earning over $250,000. Proponents of lower marginal rates say high marginal rates discourage work and encourage taxpayers to spend resources avoiding taxes.

To reduce marginal rates as much as possible some tax reformers propose a flat tax. Under a flat tax all income above a certain threshold would be taxed at a single rate. Proponents have proposed flat rates from 17 to 20 percent, depending on other features of the proposals. Not all tax reformers would flatten rates, however, and one proposal includes a multiple-rate structure that would increase the marginal rate for many taxpayers.

The second tax change for individuals would increase the personal exemption, which is the amount of income that is exempt from taxes. Households with incomes less than the personal exemption pay no taxes. The current exemption depends on filing status and ranges from $3,800 for single taxpayers to $6,350 for married taxpayers filing jointly.[4] All income tax reform proposals would raise this exemption. One proposal would raise the exemption to $13,100 for single taxpayers and $26,200 for married taxpayers filing jointly.

Tax reformers have two reasons for increasing the personal exemption. First, a high personal exemption eliminates taxes for many low-income households. Second, a high personal exemption ensures that the tax system is progressive, which means that high-income taxpayers pay a greater proportion of their income in taxes than low-income taxpayers.

The third tax change for individuals would reduce or eliminate many tax deductions. The three most important deductions are mortgage interest expenses, state and local taxes, and charitable contributions. Tax reformers would reduce these deductions to increase taxable income, thereby compensating for the reforms that would reduce revenue. Some reformers offer a second reason for eliminating these deductions. They want to minimize the importance of taxes in economic decisions. For example, the home mortgage deduction currently encourages households to buy rather than rent their residences. If this deduction were eliminated, households would no longer have to consider taxes when deciding whether to buy or rent.[5]

The fourth tax change for individuals would reduce or eliminate taxes on income from savings, also known as capital or investment income. Capital

income includes interest income, stock dividends, and capital gains from the sale of real or financial assets. Tax reformers contend that high taxes on capital income encourage taxpayers to consume rather than save.

Many economists are especially critical of the taxes on dividends and capital gains because these taxes are applied to income that has already been taxed. Earnings from capital invested in a business are taxed first as business income and second as dividends and capital gains. This double taxation can imply effective marginal tax rates on capital income of up to 60 percent.[6]

In addition to affecting incentives, eliminating taxes on interest income would simplify the tax system. If taxes on interest income and deductions for interest expenses were eliminated, the IRS could stop monitoring all interest payments. Currently, over a billion IRS 1099 forms must be filled out each year to keep track of the interest transactions in the U.S. economy.

The fifth tax change for individuals would allow a deduction for income saved. Under this proposed change, taxpayers would pay taxes only on the part of their income they consumed. Tax reformers have proposed the savings deduction as an alternative to eliminating taxes on investment income. Both strategies would increase the incentives to save.[7]

The sixth tax change for individuals would affect taxpayers receiving interest income from municipal securities. Taxpayers currently do not pay taxes on interest income from municipals, which include securities issued by both state and local governments. One proposal would increase federal tax revenue by taxing the income from municipals.

The final tax change for individuals would include fringe benefits as taxable income. Because fringe benefits are not currently taxed, many large companies have increased fringe benefits as a fraction of employee compensation. Taxing these benefits would generate substantial revenue. This change would also treat employees more equitably, since employees with substantial fringe benefits currently pay lower effective tax rates on their total compensation.

Business income tax.[8] Reformers have proposed six key changes to the business income tax system:[9] (1) reduce tax rates, (2) eliminate industry-specific deductions and credits, (3) eliminate taxes on income from financial investments, (4) eliminate deductions for interest paid, (5) allow immediate deductions for capital investments, and (6) eliminate deductions for fringe benefits.

The first tax change for businesses would lower tax rates on business income. Proponents give three reasons for reducing these rates. First and most important, taxing business income discourages business investment. That is, taxes on business income reduce the after-tax return on investment, which reduces the number of investments that are economically viable. Lowering these taxes would make more investments viable and leave businesses with more money to invest.[10]

A second reason tax reformers want to reduce the business tax rate is to help the United States attract more international business. Lower business taxes would allow companies to increase their after-tax profits by relocating to the United States from countries with higher taxes.

A third reason flat-tax proponents want to reduce the business tax rate is to make business and individual rates similar. If businesses and individuals paid the same rates, lawyers and tax accountants would be less able to avoid taxes by creatively moving income and expenses between the two tax systems. This flexibility caused federal revenues to fall substantially below projections after the 1986 Tax Reform Act (Poterba). Small businesses were able to reduce their tax liability by filing as

Subchapter S corporations, which allowed them to pay the tax rate for individuals rather than the higher tax rate for businesses.

The second tax change for businesses would eliminate all industry-specific tax credits and deductions. Critics contend these tax subsidies cannot be justified from a public policy perspective. They argue the tax code should not be used to conduct industrial policy because most "loopholes" grow out of effective lobbying campaigns rather than public need.

The third tax change for businesses would eliminate taxes on income from financial investments. Most of this income is from interest on liquid assets, but some businesses also have income from stock holdings. Proposals that would eliminate taxes on financial income for businesses are typically the same proposals that do so for individuals. Proponents give the same reasons as those already discussed, simplifying taxes and eliminating double taxation.

The fourth tax change for businesses would eliminate deductions for interest paid on debt. Currently, interest expenses are among the items businesses deduct from their revenues when they calculate taxable profits. Disallowing the interest deduction would substantially increase tax revenues, which would partly compensate for the revenue lost by eliminating taxes on interest income.

The fifth tax change for businesses would allow an immediate deduction for capital investments, which include expenditures on buildings, furniture, vehicles, and equipment. Businesses currently spread these deductions over several years, corresponding to the useful life of each investment. In each year the deduction compensates the business for the amount that the investment wears out, or depreciates, during the year. Allowing immediate deductions for business investments would reduce their taxable income and would encourage them to invest more. Although this change would ultimately benefit all businesses, many could suffer during a transition period. Some proposals would not allow depreciation deductions for previous investments, and these proposals would only benefit businesses with investments larger than their depreciation deductions.[11]

The final tax change for businesses would eliminate deductions for employee fringe benefits. The rationale for eliminating the deductions is that employees do not currently pay taxes on these benefits. Eliminating business deductions for fringe benefits would increase federal tax revenues without taxing employees directly.

Consumption tax. Several tax reformers have proposed replacing the income tax with a direct tax on consumption. Taxpayers would pay the consumption tax on retail purchases the same way they now pay state and local sales taxes. Supporters of the consumption tax estimate that a 17 percent federal tax rate could replace the revenue currently generated by the income tax system. To rally support for a consumption tax, proponents promise to abolish the IRS.

Tax reformers have proposed two alternative consumption taxes, a sales tax and a value-added tax. The two taxes would be indistinguishable to a taxpayer. In both cases, the retail price of goods and services would increase by the amount of the tax.

The difference between a sales tax and a value-added tax emerges when viewed from the perspective of a business. A sales tax is collected only by retailers. In contrast, a value-added tax is collected by each business that adds value to a product. Consider a manufacturer that builds a car from raw materials and then sells the car to a dealer. A sales tax would be collected only by the dealer. A value-added tax would be assessed on the supplier of raw materials, the manufacturer, and the dealer. The price the manufacturer pays for raw materials

would increase by the amount of the value-added taxes paid by the suppliers of the raw materials. The price the dealer pays would reflect the value-added taxes paid by both the raw materials supplier and the manufacturer. Finally, the price the consumer pays would reflect the value-added taxes paid by all three—supplier, manufacturer, and dealer.

A sales tax has both an advantage and a disadvantage relative to a value-added tax. Since a sales tax is collected entirely at the retail level, the tax is easier to administer. The disadvantage of a sales tax is that assessing the entire tax at one point increases the incentive to evade it. For example, the entire tax could be evaded by a black-market retailer. The value-added tax is more difficult to evade because it is not levied at a single point.

A direct consumption tax would be administered differently than an income tax, but both tax systems would have similar effects on financial markets. The effects would be similar because both tax proposals tend to put the tax burden on the part of income that is consumed. The similarity is explained further in the next section.

FINANCIAL MARKET EFFECTS OF TAX REFORM

Tax reform would have direct and indirect effects on financial markets. The direct effects would stem from changes in taxes on capital income and changes in the deductibility of interest expenses. The indirect effects would occur through changes in the economy. Reformers contend that changing the tax system would increase savings, investment, and economic growth, thereby indirectly affecting financial markets. This section describes both the direct and indirect effects of tax reform and explains why the direct effects are typically larger.

The analysis in this section assumes that tax reform would not affect the level of federal revenues or the federal budget deficit.[11] This assumption is reasonable because the sponsors have tried to design the proposals to be revenue-neutral. Nevertheless, Congress has not yet produced any official estimates of the revenue impact of tax reform. Previous tax reforms have shown that revenue changes can be difficult to forecast, and revenue uncertainty must be recognized as a risk in any reform proposal (Poterba).

Direct effects

The financial markets affected by tax reform can be broken into three categories. The first category contains debt contracts whose interest income is currently taxable, including bank debt, Treasury securities, and corporate securities. The second category contains municipal securities whose interest income is not currently taxable. The final category contains the stocks of publicly traded corporations.

Taxable interest rates. Two features of the proposed tax reforms would directly affect interest rates on securities that are currently taxable. First, many proposals would eliminate taxes on all interest income. Second, many proposals would either reduce or eliminate the deductibility of interest expenses. These changes would reduce the demand for credit and increase the supply, which would cause interest rates to decline.

Eliminating the deductibility of interest expenses would reduce the demand for credit. Businesses currently deduct all of their interest expenses. Individuals deduct the two largest components of their interest expenses, home mortgages and debt incurred for financial investments.[12] To the extent that interest deductions reduce a borrower's taxes, the effective after-tax costs of a borrower's loan are less than the payments to the lender. Eliminating the interest deduction would make borrowing less attractive, *causing the demand for credit to decline.* On a graph with interest rates on the vertical axis, the demand curve would shift to the left (Figure 1).

Figure 1
THE EFFECT OF TAX REFORM ON THE DEMAND FOR CREDIT

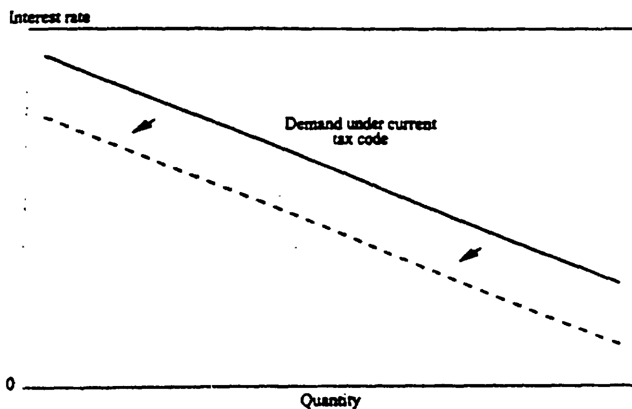
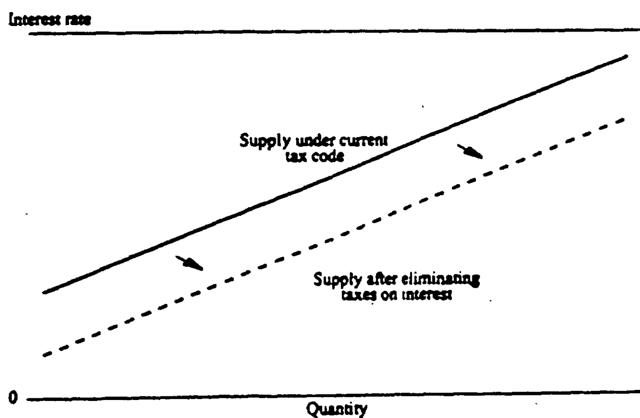


Figure 2
THE EFFECT OF TAX REFORM ON THE SUPPLY OF CREDIT



Just as interest deductibility affects credit demand, taxing interest income affects credit supply. If taxes were eliminated on interest income, lending would become more attractive, *causing the supply of credit to increase.* An increase in the supply of credit implies that the credit supply curve would shift to the right (Figure 2).

The equilibrium interest rate occurs where the credit demand and credit supply curves intersect. With the credit demand curve shifting to the left and the credit supply curve shifting to the right, the equilibrium interest rate would decline (Figure 3).

How much would rates decline? The shift in credit supply and demand curves can be estimated by considering how taxes affect borrowing and lending decisions. The analysis is based on the assumption that after-tax interest rates are the relevant rates when borrowers and lenders agree to debt contracts. The importance of tax considerations can be illustrated by comparing the interest rates on taxable Treasury securities with the interest rates on nontaxable municipal securities (Chart 1). Even though Treasury securities are less risky than municipals, municipals consistently pay lower interest rates. Credit suppliers are willing to accept the lower interest rate on municipals because the after-tax return on municipals is generally higher than the after-tax return on Treasuries.

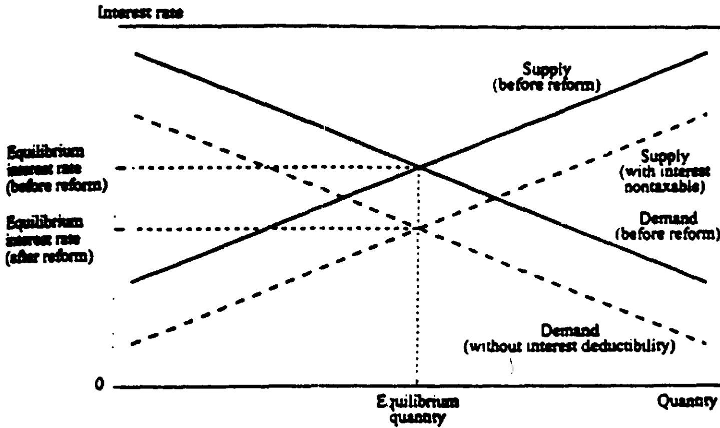
The shift in the credit demand curve is related to the tax rate of individuals and businesses that deduct interest expenses from their taxable income. Consider the credit demanded by a taxpayer paying a 25 percent marginal tax rate. For this taxpayer, an 8 percent tax-deductible interest rate is equivalent to a 6 percent nondeductible rate. That is, his taxes would be reduced by one-fourth of the 8 percent interest payment, causing his effective interest rate to be three-fourths of 8 percent, or 6 percent. This taxpayer would be indifferent if offered a choice between an 8 percent tax-deductible interest rate and a 6 percent nondeductible rate. If interest deductibility were eliminated and nothing else changed, the taxpayer would demand the same amount of credit at 6 percent as he had previously demanded at 8 percent. This quantifies the shift in the taxpayer's credit demand curve. On a graph with interest rates on the vertical axis, the taxpayer's credit demand curve would shift downward by a fraction corresponding to the marginal tax rate. Returning to the numerical example, the new credit demand curve would be 75 percent of the original curve.

The analysis of tax effects on credit demand for an individual extends to the U.S. economy. The analysis is complicated, however, by the fact that not all taxpayers pay the same tax rate. Marginal tax rates for individuals and small businesses begin at 15 percent and increase to 39.5 percent. Large businesses pay marginal rates according to a separate tax schedule, which taxes most corporate income at a 35 percent rate.

Because different taxpayers are taxed at different rates, economists often use the marginal tax rate paid by the "average" taxpayer when analyzing the economic effects of taxes (Barro and Sahasakul). This approach can be used to estimate the shift in the credit demand curve. Since both individuals and businesses deduct interest expenses, both of their tax rates are relevant. For individuals and small businesses the average marginal rate is about 25 percent. With a 35 percent tax rate for large businesses, the effective tax rate for interest deductions should fall between 25 and 35 percent. Thus, eliminating interest deductibility would lower the credit demand curve by 25 to 35 percent.

The shift in the credit supply curve is related to the tax rate of taxpayers with interest income. The analysis follows the same logic as the shift in credit demand. Consider a taxpayer with a 25 percent marginal tax rate supplying credit at 8 percent. One-fourth of the interest income goes to taxes, making the taxpayer's 8 percent interest rate before

Figure 3
THE EFFECT OF TAX REFORM ON THE SUPPLY AND DEMAND FOR CREDIT



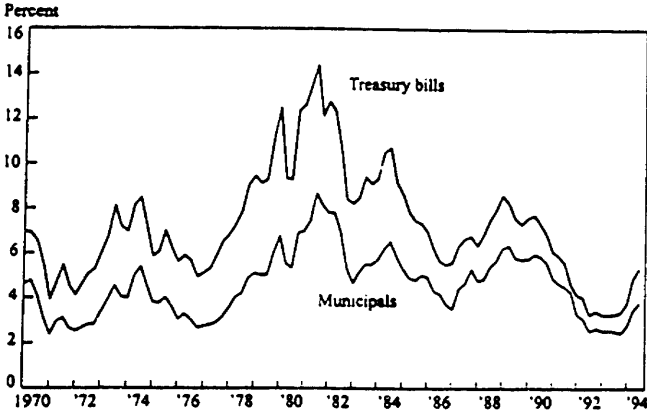
taxes correspond to a 6 percent rate after taxes. This taxpayer would be indifferent to a choice between 8 percent taxable interest income and 6 percent nontaxable interest income. If taxes on interest were eliminated, the taxpayer would supply the same amount of credit at 6 percent that he had previously supplied at 8 percent. That is, the taxpayer's new credit supply curve would be below the original curve by an amount corresponding to the fraction of interest income paid in taxes.

The effect of tax reform on the credit supply curve for the U.S. economy would be similar to the effect for an individual. The new credit supply curve would be below the original curve by an amount corresponding to the tax rate for the U.S. economy. Assuming the relevant tax rate is the same as for the credit demand curve, the new credit supply curve would be 25 to 35 percent below the original curve.

The lower credit demand and supply curves determine a new credit market equilibrium. If the same tax rate applies to both curves, both would decline by the same fraction. Under this assumption the equilibrium quantity of credit would not change (Figure 3). The equilibrium interest rate would be reduced by a fraction corresponding to the relevant tax rate. With marginal tax rates in the 25 to 35 percent range, tax reform would cause interest rates to drop to between 65 and 75 percent of their value before reform. An 8 percent interest rate before tax reform would drop to between 5.2 and 6.0 percent after tax reform.

Chart 1

INTEREST RATES ON 1-YEAR MUNICIPALS AND 1-YEAR TREASURY BILLS



The analysis of credit supply and demand has thus far assumed that all interest income is taxed and all interest expenses are deducted. This assumption is only an approximation, and some secondary factors need to be mentioned. Some interest income escapes taxation because businesses are more diligent in reporting interest deductions than interest income (Hall and Rabushka). Since tax reform would not affect the interest income that is already untaxed, this leakage suggests the credit supply curve would not decline as much as previously suggested. The decline in the credit demand curve would also be reduced because some interest expenses are already not deductible. For example, individuals currently cannot deduct interest on nonmortgage consumer debt.[14]

While the analysis illustrated in Figure 3 implies a 25 to 35 percent decline in interest rates, the analysis does not consider the secondary factors discussed above. These factors are considered secondary because most interest income is taxed and most interest expenses are deducted. The exact importance of the secondary factors is difficult to estimate. Nevertheless, these factors suggest the interest rate decline would probably be closer to 25 percent than to 35 percent.[15]

Interest rates on municipal securities. Under current tax laws, taxpayers do not pay taxes on the interest income from municipal securities. One tax proposal would remove this exemption, causing municipal rates to rise to the levels paid by other

taxable securities. Under the assumption that municipal securities would continue to be exempt from state and local income taxes, their interest rates would be marginally lower than the rates on corporate securities with comparable risk.

Most tax proposals would not change the tax exemption for municipals, but instead eliminate taxes on all other interest income. These proposals would also cause municipal interest rates to rise by eliminating the feature that attracts investors to municipals. Since some municipal investors would be attracted to other credit markets, the supply of credit to the municipal market would decrease. A decrease in the supply of credit implies that the credit supply curve shifts to the left, which would lead to higher municipal interest rates (Figure 4). Note that the demand curve for municipal credit would not change. The credit demand curve would shift if interest deductibility changed, but governments do not pay taxes and thereby do not deduct interest expenses on municipal debt.

Analysts cannot reliably predict how much tax reform would increase interest rates on municipal securities. The size of the increase would depend on two primary factors, neither of which can be easily estimated. First, the rate increase would depend on how rapidly state and local governments reduced their demand for credit as interest rates rose (elasticity of credit demand). Second, the rate increase would depend on the extent to which investors found substitutes for municipals in other credit markets (elasticity of substitution). Nevertheless, if municipal and Treasury securities were taxed the same, municipal interest rates would be higher than Treasury interest rates because municipals are riskier.

Stock markets. Several elements of the current tax laws affect stock prices. Because stocks represent a claim on the expected future income of a corporation, stock prices are affected by any change in shareholders' claim on this income. Owners of stocks pay taxes through both the individual and business income tax systems. Any income earned by a corporation is first taxed as business income. The remaining income is either distributed to shareholders as dividends or reinvested in the business. The dividends distributed to shareholders are taxed immediately. The income reinvested should increase the value of the stock, which is ultimately taxed as a capital gain when the stock is sold. Thus, taxes on business income, dividends, and capital gains all reduce the value of the corporation to the shareholder. Reducing these taxes would raise stock prices, and increasing these taxes would lower stock prices. Most tax reform proposals would reduce the effective tax rate on corporate income paid to shareholders and in turn lead to higher stock prices.

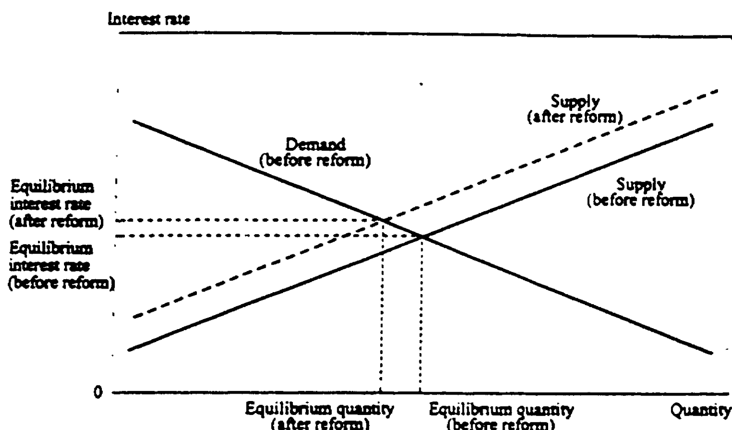
Eliminating all three taxes on capital income could lead to substantially higher stock prices. Market observers are uncertain, however, about the size of the increase. Recall that double taxation in the present system can imply tax rates of up to 60 percent on capital income. With such high rates, one market observer has suggested that stock prices could double in response to tax reform (Forbes). Predictions of stock prices need to be viewed skeptically, however, because economic models are notably unsuccessful in explaining past movements in stock prices (Roll).

Tax reform proposals would have different price effects on different stocks. Eliminating deductions and credits would tend to reduce the earnings and stock prices of companies that benefit most from special provisions in current tax laws. For example, a depletion deduction benefits oil and mining companies, and a tax credit for manufacturing in U.S. territories benefits pharmaceutical and electronics companies.[9] The stocks of companies not favored under current tax laws would respond more positively to tax reform.

Another reason tax reform would have differential effects on stock prices is many taxpayers pay different tax rates on dividends and capital gains.

Figure 4

THE EFFECT OF TAX REFORM ON THE MUNICIPAL CREDIT MARKET



Most capital gains taxes are paid on assets held more than one year, and the maximum tax rate on these "long-term" gains is 28 percent. For dividends, tax rates can be as high as 39.6 percent. Thus, eliminating taxes on dividends and capital gains would be more beneficial to stocks that pay high dividends than to stocks with income in the form of capital gains.

Changing the rules for deducting investment expenses could also have differential effects among different stocks. Allowing immediate deductions for all investment expenditures would be especially beneficial to firms that make large investments. For example, immediate deductions for investments would have contributed to a 75 percent reduction in Intel's federal tax bill in 1993 (Hall and Rabushka). Mature companies typically invest less than growing companies, and disallowing depreciation deductions for previous investments could lead to higher taxes for some mature companies.

Indirect effects

In addition to the direct effects of tax reform, financial markets would be affected indirectly by changes in the economy. Tax reformers contend that the current tax code discourages economic activity and that economic activity would increase if the disincentives were reduced. Reformers also contend that tax reform would reduce tax evasion.

The indirect effects of tax reform are even more difficult to quantify than the direct effects. The indirect effects are more uncertain because economists cannot reliably predict how the economy will respond to changes in tax incentives. Some economists have estimated tax reform would increase the level of economic output by 5 to 6 percent (Hall and Rabushka). Others have suggested the economy would respond only marginally to tax reform (Krugman). Without trying to resolve the debate regarding the responsiveness of the economy to tax incentives, this article will describe how financial markets would react if the economy responds to the revised tax incentives.

Many of the tax reform proposals would reduce the tax rate on capital income. Tax reformers contend that doing so would increase savings and investment, a view supported by the predictions of economic models (Blanchard and Fischer).[17] According to this view, increases in savings and investment would increase the capital stock, which in turn would tend to reduce interest rates. This conclusion is based on the economic principle that an increase in one of the factors of production will lower the return to that factor. Thus, interest rates would decline because increases in the capital stock would reduce the return to capital.

Increases in the capital stock would also affect the stock market. As the capital stock increases, the economy becomes more productive and economic output rises. A stronger economy implies higher corporate income, which would lead to higher stock prices.

In addition to the impact of higher domestic savings, proponents contend that tax reform would attract more investment from abroad. This effect would increase the capital stock even further, leading to additional downward pressure on interest rates and upward pressure on stock prices.

Tax reformers maintain that lower marginal tax rates would increase the labor supply by providing greater incentives to work. For example, researchers have found that lower marginal tax rates are especially effective in attracting married women into the labor force (Eissa). Increases in the labor force would lead to increases in both employment and economic output. Higher economic output would increase the return to capital, which implies higher interest rates (Dornbusch and Fischer). Since stock prices are positively correlated with economic output, stock prices would rise as employment increased.

On balance, the indirect effects of tax reform on interest rates are ambiguous. Increases in the capital stock would tend to lower interest rates, while increases in the labor force would tend to raise them.

Although the indirect effects of tax reform on interest rates are uncertain, the effects would certainly be smaller than the direct effects. Proponents acknowledge that tax reform would take seven years to increase the level of GDP by only 2 to 4 percent (Hall and Rabushka), and some economists have suggested that even these moderate effects are optimistic. The percentage change in interest rates from the indirect effects would be similar to the percentage change in GDP. Recall that the direct effects of tax reform are much larger, on the order of 20 percent. The indirect effects would also take several years to be fully realized, which further reduces their potential importance.

The indirect effects of tax reform on stock prices would reinforce each other. Increases in domestic savings and investment, the labor supply, and foreign investment would all cause stock prices to rise. Predicting the size of the effect, however, is more difficult than predicting the direction. But again, the size of the indirect effects would be smaller than the direct effects. Although corporate income fluctuates over the business cycle, over the long term it is a relatively stable fraction of GDP. Since stock prices are a claim on corporate earnings, the indirect effect of tax reform on stock prices

would be similar to the effect of tax reform on GDP. That is, stock prices might increase a few percent, which would be much less than the direct effects. Recall that the direct effects would be comparable to marginal tax rates, which can be as high as 60 percent on capital income.

FINANCIAL MARKET EFFECTS OF SPECIFIC PROPOSALS

This section examines the financial market effects of specific tax proposals. The proposals are diverse and their financial market effects could vary widely.

Congress is currently evaluating seven alternative tax proposals, which fall into three categories. Three of the proposals are in the flat tax category and have many common features (Table 1). The flat tax was first proposed by Representative Armey and is now cosponsored by Senators Craig and Shelby. Two variations of the flat tax have also been proposed, one by Senator Spector and another by Representatives Solomon and Souder. In addition, two income tax proposals contain *progressive marginal rates*, which are substantially different both from each other and from the flat tax proposals (Table 2). The first of these proposals, the USA (Unlimited Savings Allowance) tax, is jointly sponsored by Senators Nunn and Domenici. The second proposal, the 10 percent tax, is sponsored by Representative Gephardt. The final category contains *direct consumption* taxes, which include both the sales tax and the value-added tax. Senator Lugar is sponsoring a sales tax proposal and Representative Gibbons is sponsoring a value-added tax proposal (Table 3).[18]

The various tax reform proposals can be ranked according to their effect on interest rates and stock prices. The discussion begins with the proposal or proposals that would affect each market the most and continues with those having progressively smaller effects. The analysis is based primarily on the direct effects of tax reform.

Effects on taxable interest rates

Most of the specific tax reform proposals would cause interest rates to decline, but the size of the decline would vary across the different proposals. The primary reasons for the decline are the direct effects of eliminating taxes on interest income and eliminating the deductibility of interest expenses.

Three proposals would have the maximum direct effect. The sales tax, the value-added tax, and the Armey flat tax would eliminate all taxes on interest income and all tax deductions for interest expenses. As discussed earlier, these proposals would likely cause interest rates to decline to less than 80 percent of their current level.

The Spector and Solomon-Souder flat tax proposals would reduce interest rates slightly less than the Armey proposal. Both of these alternative proposals would allow deductions for some mortgage interest, which implies somewhat less downward pressure on interest rates. Nevertheless, both of these proposals would eliminate taxes on all interest income and eliminate all interest deductions by businesses, so the interest rate declines would still be substantial.

The Nunn-Domenici proposal is next in the interest rate ranking. This proposal would eliminate taxes on interest income and deductions for interest expenses, but only on business returns. Thus, the Nunn-Domenici proposal would affect interest rates less than the proposals that would change how interest is taxed for both individuals and businesses.[19]

The Nunn-Domenici proposal has a unique feature regarding the indirect incentive effects of tax reform. The proposal would allow a deduction for all income saved. This deduction would provide a larger incentive for taxpayers to save than proposals to eliminate taxes on capital income. Eliminating taxes on capital income would reward taxpayers in

Table 1

SUMMARY OF THREE FLAT RATE INCOME TAX PROPOSALS

Common features	Variations in specific flat tax proposals
• Personal exemption is increased • Tax deductions and credits are reduced or eliminated • Taxes are eliminated on interest income • Taxes are eliminated on dividends and capital gains • Individuals and businesses are taxed at same flat rate • Businesses are allowed immediate deductions for capital investments	*1. Sponsored by Representative Armey, Senator Shelby, and Senator Craig* • All deductions are eliminated, but a high personal exemption is allowed on individual returns • Individuals and businesses are taxed at 20 percent tax rate for two-year transition, 17 percent rate afterward *2. Sponsored by Senator Specter* • Interest deductions are allowed on mortgage debt up to $100,000 • Charitable contributions are deductible up to $2,500 • Individuals and businesses are taxed at 20 percent rate *3. Sponsored by Representatives Solomon and Souder* • Interest deductions are allowed on mortgage debt up to $100,000 • All charitable contributions are deductible • Individuals and businesses are taxed at 20 percent rate

the future for current savings. The savings deduction would reward savers immediately. Since the Nunn-Domenici proposal would provide greater incentives to save, it would have greater indirect effects. This increase in savings would tend to lower the return to savings, which would imply lower interest rates.

The Gephardt proposal is last in the interest rate ranking. The proposal would not change taxes on interest income or the deductibility of interest expenses for either individuals or businesses. Also, the proposal contains no incentives for taxpayers to save more. Thus, the proposal would affect interest rates only marginally. Since the proposal would reduce the marginal tax rates for some high-income taxpayers, interest rates might decline a little. But, these changes would be small relative to the typical interest rate moves over the business cycle.

Effects on municipal interest rates

All tax reform proposals would increase interest rates on municipals to some extent. The Gephardt proposal would have the largest effect on municipal interest rates. This proposal eliminates the tax exemption for municipal securities, so municipal rates would become comparable to other taxable interest rates. Municipal rates would be at least as high as the rates on Treasury securities with comparable maturity. Municipal rates would exceed the interest rates on Treasuries by the appropriate risk premium, which would likely be in the vicinity of 30 to 50 basis points for highly rated securities.

Table 2

SUMMARY OF TWO INCOME TAX PROPOSALS WITH PROGRESSIVE RATES

1. The USA (Unlimited Savings Allowance) tax sponsored by Senators Nunn and Domenici

- Deductions are allowed for all income saved
- Deductions are allowed for higher education (college or vocational) up to $2,000 per person, with a maximum of $8,000 for a family
- Deductions are continued for mortgage interest, charitable contributions, and alimony
- A tax credit is given for social security taxes
- Individuals are initially taxed at rates from 19 to 40 percent, but rates are lowered to from 8 to 40 percent over time
- Businesses are allowed immediate deductions for capital investments
- Businesses' deductions for wages and fringe benefits are eliminated
- Businesses are not taxed on revenues from exports
- Businesses are taxed at an 11 percent rate

2. The 10 percent tax sponsored by Representative Gephardt

- All deductions are eliminated, except interest on home mortgages
- Interest income from municipal bonds is taxed
- Income from interest, dividends, and capital gains continues to be taxed
- Employees are taxed on employer-provided fringe benefits
- Individuals are taxed at rates between 10 and 34 percent
- 75 percent of taxpayers are taxed at a 10 percent rate

Only the Gephardt proposal would change the taxation of municipal interest income, but the other proposals would still increase municipal interest rates. Other proposals would increase municipal interest rates by providing investors with alternative tax-free securities.

All three flat tax proposals and both consumption tax proposals would provide municipal investors alternative tax-free securities. As investors shifted to these other securities, municipal rates would rise until their rates exceeded the rates on Treasury securities by the appropriate risk premium. Municipal rates would be marginally higher under the Spector and Solomon-Souder flat tax proposals than under the other flat tax and consumption tax proposals. Recall that nonmunicipal interest rates would decline less with the Spector and Souder plans because both would allow interest deductions on mortgages up to $100,000.

The Nunn-Domenici proposal would affect municipal rates less than all of the other proposals. Municipals would retain their tax advantage for

Table 3
SUMMARY OF PROPOSALS FOR DIRECT CONSUMPTION TAXES

1. Sales tax sponsored by Senator Lugar	2. Value-added tax sponsored by Representative Gibbons
• Assessed on retail purchases • Collected by states • 17 percent rate is required to provide same revenue as current tax system • Replaces personal and business income taxes	• Assessed on value added at each stage of production • Value added is revenue minus costs • Revenue from exports and costs of imports are not included in calculation of value-added • Replaces personal and business income taxes

individual investors but would lose their tax advantage for businesses. Businesses would be encouraged to shift to other securities, but individuals would not. Thus, municipal rates would not increase as much as under proposals that change the attractiveness of municipals for both individuals and businesses.[30]

Effects on stock markets

Three taxes currently reduce the income available to a business's shareholders—the business income tax, the individual income tax on dividends, and the individual income tax on capital gains. Reducing any of these taxes would increase stock prices.

The proposals that would tax consumption directly, the sales tax and the value-added tax, would have the most positive impact on stock prices. These proposals would eliminate all three taxes on capital income. With this approach, income from capital would not be taxed until it is ultimately consumed.

The three flat tax proposals would eliminate taxes on dividends and capital gains but would continue to tax business income. By eliminating two of the relevant taxes, these proposals would also increase stock prices. Since business income would continue to be taxed, however, stock prices would increase less than under the consumption tax proposals.

The flat tax proposals contain another feature that would affect stock prices. While flat tax proposals would reduce tax rates on business income, by eliminating business deductions the proposals would increase the tax burden on businesses relative to individuals. In 1993, for example, individuals paid 81 percent of federal income tax revenues and businesses paid the remaining 19 percent. Under a flat tax, individuals would have paid 58 percent of federal tax revenues and businesses would have paid 42 percent (Hall and Rabushka).[31] This increase in business income taxes would dampen the increase in stock prices.

The effects of the Nunn-Domenici and Gephardt proposals on stock prices are ambiguous. Both proposals would retain all three taxes on capital income. Both proposals would also reduce marginal tax rates for some taxpayers with dividends and capital gains. Other taxpayers, however, would pay higher tax rates on capital gains. The net effect of these two changes is uncertain. Nevertheless, the

Nunn-Domenici and Gephardt proposals would certainly have smaller effects on stock prices than the other proposals.

CONCLUSION

With the U.S. savings rate near a historic low and taxpayers increasingly frustrated by the complexity of the income tax system, many economists and political analysts are recommending tax reform. By increasing the savings rate and simplifying the tax system, tax reformers hope to make the economy more productive. Critics are concerned that encouraging savings could lead to greater income inequality. Also, groups and industries favored under the current tax code are concerned about losing their preferential treatment. In addition to these issues, tax reform would have important effects on financial markets.

This article has examined the potential financial market effects of proposals to reform the U.S. income tax system. Most proposals would reduce interest rates in credit markets where interest income is currently taxable, which includes bank loans, Treasury securities, and corporate securities. Interest rates would decline because the supply of credit would increase and the demand for credit would decrease. Lenders would supply more credit because they would no longer have to pay taxes on their interest income. Borrowers would demand less credit because they could no longer deduct interest expenses from their taxes.

Tax reform would increase interest rates on municipal securities. One proposal would eliminate the tax exemption for interest on municipal securities. Under this proposal municipal interest rates would rise to levels similar to those on other taxable securities. Municipal interest rates would also be affected by proposals that eliminate taxes on all interest income. These proposals would lower the demand for municipals by creating many nontaxable substitutes.

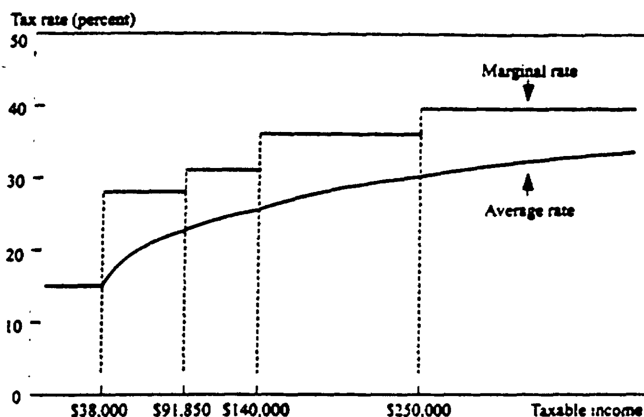
Finally, most tax reform proposals would increase stock prices. Three taxes currently reduce the fraction of a business's income that is available to its shareholders, the business income tax, the individual tax on dividends, and the individual tax on capital gains. Most proposals would reduce one or more of these taxes, which would lead to higher stock prices.

Financial market effects vary widely among the various tax proposals, and in some cases the effects are substantial. Anticipating these effects will be important both to Congress and to financial market participants.

APPENDIX

Chart A-1

TAX SCHEDULE FOR 1994



MARGINAL VS. AVERAGE TAX RATES

Economists consider the marginal tax rate to be the important tax rate for economic decisions. The marginal tax rate is the rate applied to the last dollar of income and is typically higher than the average tax rate. For example, in 1994 the tax rate for married taxpayers filing jointly was 15 percent for income up to $38,000 (Chart A-1). The rate increased to 28 percent for income between $38,000 and $91,850. For those in higher income brackets, the lower tax rate still applies to the first $38,000 of their income. Consider a married couple earning $76,000. The 15 percent rate would apply to the first $38,000, and the 28 percent rate would apply to the remaining $38,000. The average tax rate for this couple would be the average of 15 and 28 percent, which is 21.5 percent. But, if the couple increased their income by one dollar they would retain only 72 cents after taxes, so the 28 percent marginal rate is the important rate for economic decisions.

ENDNOTES

[1] The political implications of tax reform are discussed in separate articles by Gray and Richman.

[2] In addition to the seven changes discussed in the text, two other features are worthy of mention. First, one proposal includes a tax credit for social security taxes paid by individuals. This change would reduce income taxes by the amount of taxes paid to the social security system. Taxpayers whose tax payments to social security exceeded their income tax bill would receive a refund. The social security tax credit would reduce or eliminate income taxes for many low-income households.

Another proposed feature is a deduction for the cost of higher education. This deduction would subsidize the cost of higher education by providing tax relief for families with students in universities and vocational schools.

[3] Unlike income from financial investments, income from rental properties would be subject to business taxes.

[4] The personal exemption increases with inflation, and specific numbers given are for 1994 returns.

[5] The interest deduction for home mortgages creates what economists refer to as an economic distortion. By encouraging home ownership the deduction distorts the decision households would make in the absence of tax considerations.

[6] After applying a 35 percent tax rate to business income, 65 percent remains available to shareholders. If the income is distributed to shareholders in the form of dividends the marginal tax rate can be as high as 39.5 percent, so the taxpayer keeps 60.5 percent of the dividend. Thus, the shareholder ultimately receives 60.5 percent of 65 percent, which is 39.3 percent of the capital income. The effective tax rate is 60.7 percent.

Inflation can further increase the effective tax rate because taxes are applied to nominal rather real returns. Price inflation implies that real returns are less than nominal returns, so taxes are a greater proportion of real returns than of nominal returns.

[7] Although both the savings deduction and the elimination of taxes on investment income would encourage savings, these strategies have different consequences for some taxpayers. For example, consider a taxpayer living exclusively on investment income from assets that were either inherited or purchased with previous savings. If taxes on investment income were eliminated, the taxpayer would pay no taxes. Under the savings deduction, however, the taxpayer would pay taxes on the difference between income and savings. That is, the taxpayer would still be taxed on the amount consumed.

[8] This article will follow the convention of other authors and refer to the corporate income tax as the business income tax. In practice, many small businesses are taxed under the individual income tax rather than the corporate income tax.

[9] In addition to the changes discussed in the text, some tax reformers would like to reduce the U.S. current account deficit. These reformers have proposed encouraging exports and discouraging imports by changing how taxable income is calculated. Export sales would not be included as taxable revenue, and imports would not be included as costs when calculating taxable income.

[10] Reducing tax rates would not necessarily reduce taxes. By eliminating deductions while reducing tax rates, flat tax proposals would increase income taxes for many businesses.

[11] For example, in 1993 General Motors invested $6 billion and took $9 billion in depreciation deductions. Allowing deductions for new investments while disallowing depreciation deductions on previous investments would have increased General Motors' taxable income by $3 billion in 1993 (Hall and Rabushka).

[12] Economists generally believe that increases in the federal deficit would put upward pressure on interest rates.

[13] Not all interest on debt for financial investments is deductible. The deduction is only allowed if the investment generates income, and the interest deduction cannot exceed the amount of income that the investment generates.

[14] Of course, tax reform would not change the deductibility of interest on the national debt. In addition, IRAs and other pension plans allow taxes on interest income to be deferred. To the extent that these accounts lower the effective tax rate on interest income, the interest rate decline from tax reform would be reduced further.

[15] Further evidence regarding the relevant marginal tax rate can be found in the municipal securities market. The municipal interest rate should correspond to the after-tax interest rate on similar securities. Assuming that municipals contain a risk premium of 50 basis points, the one-year municipal market over the last five years is consistent with a marginal tax rate of 30 percent.

[16] The depletion deduction for oil and mineral companies typically exceeds the costs of exploration and recovery

Many pharmaceutical and electronics companies receive a tax credit for manufacturing in Puerto Rico. Congress may eliminate this tax credit before enacting a complete tax reform proposal.

[17] To the extent that capital can flow between countries, domestic savings do not have to equal domestic investment. Nevertheless, researchers have found that capital is not perfectly mobile. Feldstein and Horioka authored a widely cited paper on this issue, and Frankel confirmed their conclusion in more recent research.

[18] Representative Archer, Chairman of the House Ways and Means Committee, has endorsed the concept of a consumption tax. His committee will hold hearings on alternative proposals.

[19] The Nunn-Domenici proposal would also increase marginal tax rates for many taxpayers, which would further dampen the interest rate decline.

[20] Approximately half of the municipals are held by businesses. If substitution elasticities are comparable for businesses and individuals, the Nunn-Domenici proposal would increase municipal rates by about half as much as the flat tax and consumption tax proposals.

[21] Some income from small businesses would shift from individual to business returns under a flat tax, which accounts for part of the calculated increase in the tax burden on businesses.

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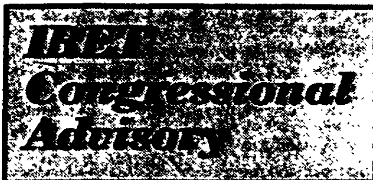

August 31, 1995 No. 50

DRI STUDY DISTORTS FLAT TAX IMPACT ON HOME PRICES

Introduction and summary

One of the major concerns posed by Majority Leader Dick Armey's flat tax proposal is its elimination of the mortgage interest deduction. The proposal would also repeal the deduction for state and local taxes, including property taxes.[1] Quite understandably, the National Association of Realtors, homebuilders, and others are worried about the flat tax's consequences for real estate activity.

The DRI study's findings are grossly exaggerated due to serious errors in the analysis and serious misconceptions or distortions of the Armey flat tax proposal.

The NAR commissioned a study by DRI/McGraw Hill of the effect of a flat tax on real estate. Although the study is entitled "Residential Construction Impacts of Flat Tax Legislation", there is little mention in the study of the effect of repeal of the deductions on homebuilding. Instead, the study focuses on the effect on the prices of existing homes. The study predicts a decline in home prices and wealth for middle- and upper-income homeowners, and a consequent decline in their spending, leading to a short term recession. These highly questionable predictions could frighten existing homeowners into opposing any tax overhaul proposal, to the great detriment of the whole country.

The flat tax's elimination of the mortgage interest deduction would not reduce home prices because interest rates would drop, leaving mortgage borrowers and lenders virtually unaffected on an after-tax basis.

The DRI study's findings are grossly exaggerated due to serious errors in the analysis and serious misconceptions or distortions of the Armey flat tax proposal.

The flat tax's elimination of the mortgage interest deduction would not reduce home prices because interest rates would drop, leaving mortgage borrowers and lenders virtually unaffected on an after-tax basis. The repeal of the property tax deduction, involving far smaller amounts, would somewhat increase the cost of home ownership, but not by as much as DRI assumes, and not by enough to hurt housing in the buoyant economy that the flat tax would generate.

Contrary to DRI's assertions, there would be no loss of wealth for upper-income homeowners, whose stocks and bonds would rise in value under the flat tax, and no short term recession due to a drop in spending by upper-income homeowners. In fact, there would be an increase in wealth at all income levels due to the resulting stronger economy.

Higher incomes and employment under the flat tax would increase the demand for housing. Construction of homes would rise.

DRI study distorts Armey flat tax proposal

The DRI study presented a caricature of the flat tax proposal of Representative Dick Armey (R-TX). The Armey bill eliminates all itemized deductions, including deductions for mortgage interest and property taxes, in exchange for a single 17 percent tax rate and a large exempt amount for individuals and families. The bill provides a net tax reduction for nearly all households. It also exempts all types of interest

income from tax (and denies deductions of all types of interest payments), which would reduce interest rates. The reduction in interest rates would reduce the interest expense of home ownership.

DRI, however, assumed a revenue neutral flat tax (no net tax cut), with a tax rate about 30% to 50% higher than in the Armey proposal (22%-25% vs. 17%), and apparently understated the effect of the bill's reduction in the tax on lenders. These and other analytical mistakes render the study useless as a guide to what would occur in the housing market if the Armey bill were to be enacted.

Contrary to DRI's assertions, there would be no loss of wealth... and no short term recession... Higher incomes and employment under the flat tax would increase the demand for housing. Construction of homes would rise.

DRI estimates

DRI estimates that elimination of the income tax deduction for mortgage interest and property taxes on owner occupied homes would reduce their value by an average of 15% nationwide. They assume that home prices would drop to offset the capitalized value of the higher taxes that homeowner would have to pay over time if the deductions were eliminated. Since the value of the deductions is zero for low income taxpayers who do not itemize, and highest for upper income taxpayers facing the highest marginal tax rates, DRI expects the price of the most expensive homes to fall the most (in excess of 30%) and the least expensive homes to fall by much less than the average, if at all. Taxes saved by the mortgage interest deduction are about three times that of the property tax deduction. DRI, therefore, attributes about 75% of the predicted potential drop in home values to the elimination of the mortgage interest deduction.

Mortgage interest rates would fall due to the exclusion of the interest from the taxable income of the lenders under a flat tax...[and] should provide homeowners, on average, a complete offset to the loss of the deduction.

Mortgage interest deduction loss offset by interest rate cuts

In reality, the loss of the mortgage interest deduction would be largely, if not entirely, offset by a drop in mortgage interest rates. Consequently, there would be little or no increase in the cost of home ownership, and little or no drop in home prices in the aggregate, as a result of the loss of the mortgage interest deduction.

Mortgage interest rates would fall due to the exclusion of the interest from the taxable income of the lenders under a flat tax. The tax on lenders who receive mortgage interest under current law is generally at least as high as the tax saved by mortgage borrowers due to the deduction. Consequently, the interest rate adjustment should provide homeowners, on average, a complete offset to the loss of the deduction.

For example, assume that lenders and borrowers are in the 25% tax bracket, and that mortgage rates are currently 8%. Under existing law, the tax deduction for mortgage interest reduces the borrower's tax liability by a quarter, equal to 2 percentage points of the interest, resulting in an after-tax rate of 6%. The lender pays tax on the interest, equal to 2 percentage points of the interest, and keeps 6% after tax. Under the Armey flat tax, the borrower could not deduct the interest, but the lender would not be taxed on the interest. The borrower would not want to pay more than 6% to avoid an increase in the net of tax rate, but the lender would be willing to take 6% because it is the same net of tax rate as under current law. The mortgage interest rate would fall to 6%, leaving both parties no better off and no worse off than before.

In fact, lower-, middle-, and upper-income borrowers are in different tax brackets under current law, and they would experience different effects from elimination of the mortgage interest deduction. An interest rate reduction equal to the average amount of the current tax premium in interest rates would tend to over-compensate low income borrowers and under-compensate high income borrowers. There might be an increase in the price of more modest homes and a reduction in the price of expensive homes from this effect. In total, however, there should be no significant net increase in the aggregate cost of home ownership nationwide, and no aggregate loss of home equity value from the elimination of the mortgage interest deduction.

New homebuyers, or current homeowners seeking to move, would receive the lower interest rates automatically. Existing homeowners would have to refinance their homes to get the lower interest rates. Refinancing involves significant fees, and a sudden rush to refinance could strain the processing capacity of mortgage lenders and might raise fees further. To avoid such costs, a flat tax proposal could "grandfather" existing mortgages, leaving the interest tax deductible for the borrowers and taxable to the lenders, as under current law. Since borrowers and lenders would be in identical tax brackets under the flat tax, grandfathering would involve no revenue loss to the Treasury. (DRI forgot that lenders would pay tax on interest on grandfathered mortgages, and erroneously assumed that grandfathering would lose revenue and require a higher tax rate.) Grandfathering would slightly complicate tax compliance and enforcement, but these effects would disappear over time as existing mortgages were paid off.

To avoid [refinancing] costs, a flat tax proposal could "grandfather" existing mortgages, leaving the interest tax deductible for the borrower and taxable to the lender, as under current law.

The DRI study acknowledges that a reduction of interest rates would offset, to some extent, the effect of the loss of the mortgage interest deduction. However, DRI understates one of the features of the flat tax that would act to depress all currently taxable market interest rates, and consequently underestimates the degree to which mortgage interest rates would fall and the extent of the offset. DRI assumes that interest rates would fall to a limited degree because borrowers would resist paying the old mortgage rate if interest were not deductible. However, DRI gives little weight to the fact that, under the flat tax, lenders would not be taxed on the interest income, and would accept a lower rate. Both sides in the transaction would be content with a lower rate. Thus, the offset should be complete, not partial.

DRI assumes that many mortgage lenders are already tax exempt, giving them a lower tax rate than borrowers, reducing the spread between taxable and non-taxable interest rates, and reducing the amount by which one would expect interest rates to drop under the flat tax. In particular, DRI claims that foreign lenders are currently not subject to tax on their U.S. interest income, lowering the average tax rate on lenders and limiting the amount by which interest rates would fall. Since July 1984, foreigners are generally not subject to U.S. tax withholding on most U.S. government securities, but are generally subject to tax on interest income in the United States, or, with few exceptions, in their home countries after a foreign tax credit for taxes paid in the United States. The correct statement of the situation is that a flat tax would reduce the global tax on foreigners' U.S. interest income where U.S. tax rates exceed those abroad, but not otherwise. Much of the foreign saving entering the U.S. is from nations whose citizens could expect to benefit from lower U.S. taxes.

DRI also errs in claiming that mutual funds are tax exempt lenders; each year, the funds' income must be passed through to the funds' shareholders, who are taxed. In any event, tax exempt lenders do not constitute major sources of incremental funds for the mortgage market.

DRI estimated the size of the reduction in mortgage interest rates from adoption of a flat tax by comparing rates on 10 year Treasury bonds and tax exempt bonds. DRI assumed that the interest rate on mortgages would decline by about as much as the difference in yield between the Treasury bonds (subject to federal tax, but not to state tax) and tax exempt state and municipal bonds (not subject to federal tax, nor to state tax if held by a state resident). That differential is only about 0.9% to 1.3%, less than the roughly 2.5% interest rate drop required to offset the loss of the mortgage interest deduction for upper bracket taxpayers at DRI's assumed rate of discount.

However, tax exempt bonds are riskier than Treasury bonds (as shown by the Orange County bankruptcy, the WHOOPS debacle, and the California budget crisis of a few years ago), which raises the interest rate on tax exempt bonds closer to that on taxable federal securities. If Treasury bonds were as risky as tax exempt bonds, the interest rate on Treasury bonds would be higher than at present, and the interest differential would be greater.

In short, one must look at the taxes collected currently at the margin on mortgage interest, not interest rate spreads between two types of non-mortgage securities with different levels of risk, to

judge the interest rate effect of making mortgage interest transactions non-taxable.

Property tax deduction

Armey uses the added revenue from elimination of the property tax deduction to further reduce the flat tax rate, meaning that, on average, consumers of housing and other goods and services would not be injured in terms of disposable income by the loss of the deduction. Indeed, the lower tax rate would lower the cost of housing and other production by as much as repeal of the deduction raised it, and a taxpayer's disposable income would buy at least as much as under current law (and probably more, given Armey's net tax cut and the incentives to save and invest). There would be no loss of purchasing power.

Elimination of the deduction for property taxes means that, in effect, the Armey bill would levy the income tax on the property tax. It is not clear, however, that this imposes a higher burden on home ownership than on any other type of asset or product. Property taxes are imposed on all types of real estate, whether owned directly by individuals or by businesses: on owner-occupied homes, on rental housing, on commercial, office, agricultural, and industrial structures. In addition, personal property taxes are imposed on many big ticket items, including business equipment, motor vehicles, boats, aircraft, and other personal property items. The disallowance of the deduction for property taxes would raise the cost of owning all of these assets and products. Elimination of the property tax deduction would affect the value of the businesses that underlie alternative assets such as stocks and bonds, and, therefore, would not put a home at a disadvantage as an investment asset. Elimination of the property tax deduction would affect the rent on rental housing, and would not put owner-occupied housing at a significant relative disadvantage as a source of housing services. Similarly, loss of the deduction would not raise the cost of housing services relative to the cost of most other goods and services, which would be impacted as well.

Armey uses the added revenue from elimination of the property tax deduction to further reduce the flat tax rate, meaning that, on average, consumers of housing and other goods and services are not injured in terms of disposable income by the loss of the deduction.

The relative price of homes would slip only if property taxes are a higher fraction of the cost of owner-occupied housing services than of rental housing services or of the cost of other goods and services. It would injure homeowners only if it were to generate an increase in the relative cost of owning real estate compared to most other assets. Property taxes may be a relatively higher part of the cost of single family owner-occupied housing than some other goods and services, but DRI has not quantified that differential. Home prices might fall relative to the prices of other assets, goods and services by at most that differential fraction of the cost of the property tax times the flat tax rate. Even the full value of the deduction accounts for only one-quarter of the DRI result. If one accepts the rest of DRI's assumptions, the immediate effect of the flat tax on home prices could be, at most, a temporary decline of less than 4% on average, not the 15% claimed in the study, and probably a good deal less. Any such decline would soon be swamped by the increase in income due to the tax restructuring and the resulting increase in the demand for housing.

If there were some modest effect on existing home prices, it would be temporary, and would cause no injury to people who are not planning to sell their homes in the very near term. Any price effect would be temporary because homes are a stock of durable capital that can change over time. If the higher cost of the property tax slightly raised the cost of owning a home, then, for a short period of time, home prices might need to be lower than otherwise to attract potential buyers. The dip in prices would temporarily slow construction of new homes, reducing the growth of the housing stock relative to demand until the price of existing homes recovered lost ground. With lower production and maintenance costs tending to reduce prices of homes and other goods and services, and higher incomes tending to increase demand for homes and other goods and services, it is not clear whether prices of existing homes would ultimately rise or fall relative to prices of other products, but the effect would not be the one calculated by the DRI study.

Armey tax and spending cuts would boost housing

The Armey bill reduces federal spending to pay for a net tax cut. DRI did not want to complicate its

analysis by changing federal spending, and assumed this provision of the bill did not exist.

Reduction in federal spending in the Armey bill, however, would reduce government absorption of labor and materials. It would also permit a net tax cut to reduce taxes, both on average and at the margin, on labor, capital, and the cost of everything they produce. Consequently, it would free up and reduce the cost of resources for expanded private sector activity, including homebuilding. Houses, along with other products, would cost less to produce, to buy, and to maintain. There is no reason to suppose a drop in home prices relative to the prices of products the homeowner might wish to buy, including replacement housing if the homeowner were to sell the home and move.

The Armey bill reduces federal spending to pay for a net tax cut. DRI did not want to complicate its analysis by changing federal spending, and assumed this provision of the bill did not exist.

These same features of the Armey bill would unambiguously strengthen the demand for homes by raising real incomes. Spending reduction and a net tax cut would shift resources to the private sector, and increase capital formation and productivity. Pre-tax and after-tax incomes would rise. The added income would be spent, in part, on housing. This increase in investment, income, and the demand for housing is recognized by DRI, but is assumed, unrealistically, to come after considerable delay, and is not factored into their calculation of the effect of a flat tax on home prices.

The DRI study also fails to incorporate the effect of reduced taxation of saving on the ease of building up a downpayment for a home, and the resulting increase in affordability of housing. With a higher down payment, a homebuyer's mortgage debt and mortgage interest rate would be lower, reducing the interest cost of homebuying.

The DRI study also fails to incorporate the effect of reduced taxation of saving on the ease of building up a downpayment for a home, and the resulting increase in affordability of housing.

Effect on household wealth

DRI is concerned that the assumed reduction in home prices would reduce the wealth of homeowners, leading to an immediate increase in saving and a reduction in consumption spending by such households, and a recession. This is mistaken. Assets or "wealth" have value because they produce future after-tax income. DRI's calculated drop in home prices is the present value of the drop in after-tax income in all future years due to the loss of the deductions. Armey, however, would use the revenue from the elimination of the deductions to eliminate the tax on lenders and to lower the general tax rate; there would be no tax increase, no loss in after-tax income, and no drop in wealth from the elimination of the deductions when all taxpayers are considered, although there might be a slight shift of that income from upper income to lower income taxpayers, and a reallocation of wealth across assets. By looking only at one type of wealth and ignoring matching changes in other types of wealth and after-tax income, DRI creates a net loss when there is none.

DRI predicts the greatest drop in home prices and wealth would occur at the upper end of the market, on homes of above average price, and, consequently, that the loss in home equity values would occur chiefly for middle- and upper-income homeowners. There are several problems with this line of reasoning.

Much of the property tax effect in the Armey bill comes from the tax rate reduction, not the elimination of the property tax deduction per se. Even if it were retained, the value of the property tax deduction (and the mortgage interest deduction) would be less at a 17% tax rate (the rate proposed by Armey) than at current tax rates, and would be zero for people dropped from the tax rolls. When a tax rate is reduced, a deduction that sheltered income from the tax loses value in proportion, but if the deduction is only a fraction of taxable income, the taxpayer comes out ahead. The tax rate cut and the net tax reduction in the Armey bill would more than make up for the additional loss of value of the property tax deduction due to its complete elimination. Homeowners would gain. Their incentive to buy a house as opposed to some other asset may be reduced, but their income,

wealth (including the value of their human capital, the present value of their lifetime after-tax labor income), and ability to afford a house must be greater, not less, as a result of the tax rate cut.

Even if prices were to fall on the homes of middle- and upper-income people, theu wealth would not decline under the flat tax. Middle-income and high-income households have a relatively greater percentage of their assets in stocks and bonds, and a relatively smaller percentage in homes, than do lower-income households. The Armey bill would increase stock prices and the value of mutual fund holdings, raising household wealth via assets other than owner occupied housing. Middle- and upper-income households would benefit greatly from higher stock prices, suggesting that their wealth would not be depressed as severely as DRI contends, if at all. Middle- and upper-income households do the bulk of the nation's saving, and would clearly benefit, not suffer, from the elimination of the tax bias against saving. Realtors might be concerned if households choose to hold relatively more of their wealth in financial assets and relatively less in housing, but household wealth would be higher, not lower, under the flat tax than under current law.

DRI admits that, longer term, the flat tax would boost growth due to the incentives it provides to invest in plant, equipment, and commercial and residential rental properties.

DRI's notion that a drop in wealth (the capitalized amount of future income) would raise saving is mistaken in any case. If wealth – permanent income – were to decline, both saving and consumption would decline. The flat tax, of course, aims to increase saving and investment. DRI's notion that a higher saving rate (whatever caused it) would lead to recession is mistaken. In fact, a higher saving rate would not depress the economy, even temporarily; it would quickly lead to more investment, which is as good or better at generating jobs than consumption spending, and would lead to an increase in income and wealth.

Interest rate increase due to growth

DRI admits that, longer term, the flat tax would boost growth due to the incentives it provides to invest in plant, equipment, and commercial and residential rental properties. They err, however, by assuming that the faster growth would tend to raise interest rates in the financial markets, partly undoing the drop in rates stemming from the removal of the tax burden on interest and injure housing. Their concern is based on outdated Keynesian "loanable funds" analysis that is increasingly rejected by the research community.

First of all, there is no historical correlation between higher rates of economic growth and higher market rates of interest.

More fundamentally, the DRI analysis of the effect of an improved investment climate on interest rates is badly flawed. Interest rates are determined by basic factors such as the after-tax real rate of return people demand to give up a unit of consumption to add to saving, risk, inflation expectations, and the tax component of interest. The Armey bill should be understood to reduce the combined tax rates on saving and investment relative to consumption, compared to present law, so the amount of saving to finance additional investment would increase. The desired expansion of the manufacturing and commercial real estate sectors would not drain the credit markets and starve the residential mortgage markets of funds.

At a given level of income, people save and invest more, the less it costs them to do so. The smaller the tax bite on the returns their saving and investment provide, the less the cost of saving and investment. With a smaller tax bite, savers-investors are willing to accept a smaller pretax return in order to have the same after-tax return. Businesses are prepared to accept lower pretax earnings on their capital outlays, hence are willing to undertake capital projects that would not have yielded a sufficiently high pretax return at the higher tax rate.

Of course, as capital outlays increase and the stock of capital increases, the pretax return on the marginal unit of capital decreases, unless Congress and DRI have managed to repeal the law of diminishing returns. The growth in capital outlays will slow as the pretax returns decline. On the new and higher growth path, the level of saving and capital formation will produce pretax returns that afford after-tax returns just adequate to warrant the cost in terms of foregone consumption.

To be sure, as this adjustment occurs, the net of tax return to owners of existing capital could go up,

principally in the form of increases in the market value of equity. This does not represent an increase in the cost of saving or an increase in real interest rates. On the contrary, it results from a decrease in the tax on what capital produces.

DRI's "loanable funds" analysis confuses the transitory increase in after-tax returns that would be received by the owners of capital following a tax cut with a (non-existent) increase in the after-tax interest rate demanded by savers to undertake the marginal dollar of saving. The higher initial returns on existing savings would not take the form of higher interest rates. Instead, the returns would materialize via an immediate jump in stock, bond, and commercial and rental residential property prices, which would rise in line with the higher after-tax earnings of the assets, and which would keep interest rates and dividend rates from rising. The higher after-tax returns would be an unexpected reward to people lucky enough to have been owners of capital when the tax was reduced. There is nothing about a tax cut that would cause an increase in the after-tax interest rate savers demand, and there would be no upward pressure on market interest rates on additional saving.

The flat tax's repeal of the mortgage interest deduction is purely for simplification... Mortgage interest would disappear from the borrower's and the lender's tax returns... If, instead, the deduction were retained, and mortgage lenders continued to be taxed as under current law, there would be virtually no tax revenue or tax rate consequence, and only a bit of simplification would be lost. The whole dispute is a tempest in a teapot.

Much of the additional saving would flow into investment via the equity markets, as higher share prices induce additional issuance of shares, or via direct investment by businesses, both domestic and foreign.

DRI's concern that saving will not rise sufficiently to finance all the desired additional investment, and thereby drive up financial market interest rates, is unfounded. Business and individual saving and investment are, jointly, a demand for more real, physical capital, not, respectively, the supply and demand for "loanable funds" or "credit". Saving is historically very responsive to enhanced investment opportunities. If anything, the financial markets move faster than business's ability to build new structures and acquire big ticket capital items.

Furthermore, a significant portion of existing U.S. saving now flows abroad. These amounts could be redirected to domestic investment in a more favorable tax climate. In its discussion of cross-border saving, DRI failed to note that domestic savers and lenders would generally receive a greater tax reduction on their U.S. interest and dividends than on their foreign source interest and dividends. They would increase their total saving, and, where they are subject to foreign taxes on foreign source interest and dividends, they would have an incentive to repatriate their savings and reinvest it in domestic markets. Such tax changes can have a dramatic effect on the behavior of domestic lenders. For example, following the tax rate reductions and investment incentives of the Economic Recovery Tax Act of 1981, U.S. bank lending abroad dropped by roughly $100 billion in two years, from $121 billion in 1982 to $24 billion in 1984, and was shifted to domestic lending.

Furthermore, domestic saving need not be the sole source of financing additional investment. The United States no longer constitutes the bulk of the world's free market economies. Foreign saving in world capital markets exceeds a trillion dollars annually. A very small shift of that saving toward the United States would guarantee ample saving for all forms of investment, including housing. It is true that some foreign lenders would not benefit from lower U.S. taxes on interest income. However, much of the foreign saving flowing into the U.S. takes the form of direct and indirect business investment, which would certainly benefit from the reduction in taxation of business investment in plant, equipment, and real estate under the flat tax, and would free up domestic saving to finance the mortgage market. There would be nothing left of the "loanable funds" pressure on the credit markets that DRI assumes would raise interest rates.

Conclusion

DRI's estimates of the effect of a flat tax on owner occupied housing if the mortgage interest and property tax deductions are eliminated are exaggerated.

If history is a guide, home prices will not be damaged if lower tax rates accompany the elimination of the real estate deductions, encouraging saving and lending at lower interest rates and boosting income growth. The Kennedy/Johnson (1963) and Reagan (1981) tax rate cuts, which simultaneously reduced the value of the mortgage interest deduction and the tax on interest income of lenders, did not hurt the housing sector.

The flat tax's repeal of the mortgage interest deduction is purely for simplification; the borrower would not deduct the interest, and the lender would not have to pay tax on the interest. Mortgage interest would disappear from the borrower's and the lender's tax returns. Interest rates would drop to leave both parties virtually unaffected on an after-tax basis. If, instead, the deduction were retained, and mortgage lenders continued to be taxed as under current law, there would be virtually no tax revenue or tax rate consequence, and only a bit of simplification would be lost. The whole dispute is a tempest in a teapot.

Elimination of the tax bias against saving and investment would result in expansion of the over-all economy and the stock of capital... Owner-occupied housing might constitute a diminished share of an expanded capital stock, but is unlikely to suffer any significant decline in absolute value... Indeed, with higher incomes across the board, Americans would be likely to increase their spending on homes in the future, and construction in general would boom.

Elimination of the tax bias against saving and investment by adoption of a flat tax would result in expansion of the over-all economy and the stock of capital, especially in those industries where the current bias has most severely constrained activity, including manufacturing and commercial and rental real estate.

Reduced taxation of saving that induced growth of the manufacturing and commercial real estate sectors would not adversely affect homeowners. Potential homebuyers looking at the value of home ownership over many years would be unlikely to be influenced by transitory changes in returns on other assets. The public would not demand a higher after-tax return on housing, and the investment boom would have no permanent effect on housing prices via interest rate effects.

Owner-occupied housing might constitute a diminished share of an expanded capital stock, but is unlikely to suffer any significant decline in absolute value. In fact, as their real wealth increased along with their real incomes, people would demand more housing -- more luxurious, larger, more valuable, not less. Realtors dealing only in single family homes might see a relative decline in their product line, but builders, existing homeowners, and even realtors dealing in commercial and rental property would not suffer, and would likely gain from the move to a flat tax. Indeed, with higher incomes across the board, Americans would be likely to increase their spending on homes in the future, and construction in general would boom

Tax restructuring may well result in shifts in the relative importance of some sectors of the economy, and people with narrow parochial interests in those sectors might prefer the status quo. That hardly constitutes a reason for rejecting the gains to the over-all economy that would result from a more sensible tax system.

Stephen Entin
Resident Scholar

Notes

1. Flat tax proposals generally repeal all or most itemized deductions in return for a single low tax rate. The flat tax proposal by Representative Dick Armey (R-TX) would repeal all itemized deductions, including the mortgage interest deduction and the deduction for state and local income and property taxes. This treatment of interest on mortgage debt is identical to that accorded interest on other types of debt under the Armey bill. Borrowers would not deduct interest paid on any type of loan, including business borrowing, and lenders would not pay tax on interest received. A variant of the flat tax proposed by Senator Arlen Specter (R-PA) would retain the mortgage interest deduction. If the deduction is retained, mortgage lenders should be taxed on the interest.

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.

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