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MARGINAL TAX RATE REDUCTIONS

HEARING

BEFORE THE

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MARGINAL TAX RATE REDUCTIONS

WEDNESDAY, MARCH 7, 2001

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

The hearing was convened, pursuant to notice, at 10:00 a.m., in room 215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Nickles, Thompson, Snowe, Baucus, Breaux, Graham, Kerry, Torricelli, and Lincoln.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. I thank everybody for their patience for us to get started on time, and thank the members of the committee who were here on time.

We will proceed with our first hearing after the administration witness that we had last week on the issues of the tax proposals before us and the tax relief for working men and women.

Senator Baucus and I have called this hearing to address an issue on which Republicans and Democrats all agree. Now, we do not agree on details, but the Federal Government is over-collecting taxes. Most everybody in the Congress is for some reduction of taxes.

The current and projected U.S. tax receipts are far in excess of the amount needed to operate the Federal Government. The bulk of these excess collections comes from income taxes imposed on individual taxpayers.

The Congressional Budget Office, in their January 2001 report to Congress, shows that in 1992 collections from individual income taxes were 7.7 percent of our GDP. That percentage has risen steadily each year.

As of the year 2000, the percentage is an astronomical 10.2 percent of GDP. Now, think in terms of that. 7.7 versus 10.2 is just about a 50-percent increase. Individual income taxes now take up the larger share of GDP on record, even above the levels that were imposed in the time of World War II.

As further evidence that the current surpluses are borne by American working men and women, corporate taxes during the past 10 years have increased from 1.6 percent GDP to 2.1 percent GDP, and estate taxes have remained essentially unchanged.

So, as you can see, and I thought we had charts that showed that but evidently we do not, the main source of the current surpluses is from huge increases in individual tax collections.

Unfortunately, most of the excess collections are attributable to the tax increase of 1993, one that a former member of this committee, Senator Moynihan, described in that year as being the biggest increase in the history of the world, after Bob Dole had said it was the biggest tax increase in the history of the country.

As I noted above, in 1992 the collection rate was 7.7 percent GDP and it now stands at 10.2 percent. Admittedly, some of this increase is due to our booming economy.

The White House has estimated that approximately 20 percent of this increase is attributable to real gains in wages which has forced people into ever-higher tax rate brackets. This is the bracket creep effect. Those same individuals also lose a portion of their deductions and exemptions through various phase-out provisions, which we will discuss later today.

Nonetheless, the Joint Economic Committee of the Congress has estimated that just repealing President Clinton's 1993 individual income tax hikes would yield tax relief of over $1 trillion for 10 years.

So I think we can all agree that individual taxpayers are the ones most deserving of the relief from Federal Government overtaxation, even if we might not agree on the amount of relief that should be given at this time.

Because whether that relief we enact is going to be $900 billion, as suggested by my Democrat colleagues, or the $1.6 trillion that is requested by President Bush, that is not the issue that we are here to address today.

Now, some members may want to bring that up, and that is all right, but we are not here to talk about the appropriate level of tax relief. We all agree that relief is needed. The question we address today is whether marginal rate reductions is the best way to grant tax relief from an economic management standpoint.

In designing tax legislation, I would like to employ three fairly general principles, but very important principles: efficiency, equity, and simplicity. What I mean by efficiency, is that changes to the Tax Code would grow our economy.

At the end of the day, we have failed as tax policymakers, Republicans and Democrats alike, if we impair the American economy's capacity to grow. Many believe that there is a direct link between lower tax burdens and higher rates of economic growth. The question before us today is whether the most efficient way to promote economic growth is through marginal rate reductions.

My second principle is equity, or more often stated as fairness. I want to make tax policy changes that address inequities in the Tax Code. There are many such inequities, and we will hear about some of those today.

My third principle is simplicity. Everyone who fills out a Form 1040 knows about the complexity of the Tax Code, or those of us who do not fill it out because it so complicated that we pay others who do it. All across this country Americans are dealing not only with the burden of paying Federal taxes, but the added burden of tax complexity.

One of the complexities that will be addressed today are the impenetrable phase-outs of tax benefits, personal exemptions, and deductions that are arbitrarily imposed on taxpayers across the entire spectrum of income levels.

Our witnesses today will address those complexities and explain how they actually operate as back-door tax hikes that effectively impose marginal tax rates far beyond rates specified in the Code.

Whatever we decide to do in this committee, our actions must make sense with respect to these principles of efficiency, equity, and simplicity. Our first panel will consist of two distinguished economists, Mr. Stephen J. Entin of the Institute of Research on the Economics of Taxation, and Dr. Henry Aaron of The Brookings Institute.

These gentlemen will address whether marginal rate reductions are the simplest, fairest, and more efficient way of distributing tax relief to American working men and women.

Our second panel will explain how the various phase-outs and limits increase effective marginal tax rates, operate to cut off taxpayers from their personal exemptions and legitimate deductions, and needlessly complicate tax laws. This panel will also focus on payroll tax and the Earned Income Tax Credit.

In his budget message to Congress, the President expressed his dismay that, under the present Tax Code, many low-income families are now facing higher marginal tax rates than wealthy individuals, due to the combined effect of the phase-out of the Earned Income Credit and the income and payroll taxes.

Certain Senators on this committee have rightly expressed similar concerns, so we want to see whether the Earned Income Tax Credit is effective in alleviating the burden.

In addition, the General Accounting Office today will give us an update on the efforts to address fraud in the Earned Income Tax Credit program. Sadly, according to the Department of Treasury, approximately 25 percent, one-quarter, of all of the ETC payments are inappropriately made. Any effort to expand the EIC program has to face that reality and we ought to be dealing with that reality.

Finally, the committee will hear about efforts of the States to expand EIC programs. It may come as a shock to many here in our Nation's capital that the answers do not always come out of Congress, because several States, including my own State of Iowa, have taken the lead in creating their own Earned Income Credit program that are an add-on to the Federal EIC program. Eleven States now are involved in those programs.

This is a first of a series of hearings the Finance Committee will have on President Bush's tax proposals. I believe that these hearings will provide a very useful overview of the different aspects of the President's efforts to give tax relief to American working families.*

Now, to Senator Baucus, the distinguished Ranking Member.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

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

*For more information on this subject, *see also*, Joint Committee on Taxation staff report, "Overview of Present Law and Economic Analysis Relating to Marginal Tax Rates and the President's Individual Income Tax Rate Proposals," March 6, 2001, JCX–6–01.

As you have indicated, today we begin serious, and I think very important, hearings on various components of a broad-based tax cut proposal.

I think it is a good idea to examine each of these components in separate hearings. I think this will result in the American people's and members of Congress' better understanding of the proposal, and also to give us a chance to decide which of them make the most sense. This is going to have a very real impact on the lives of Americans.

In fact, in some sense, I think that these four weeks, maybe the first 4 months, will be the most important, for not only this year, but perhaps of the decade. We are probably going to set in place tax provisions and some budget decisions which will have effect for the decade. So, it is very important that we do our best to get this right.

Today we discuss individual income tax rate reductions and marginal tax rates. I appreciate the witnesses that we have today.

Before we dive in, though, I want to reiterate my support for a significant cut in taxes. There should be a significant cut in taxes. You mentioned that yourself, Mr. Chairman.

I have three principles myself. They somewhat dovetail with yours, Mr. Chairman. Yours were efficiency, equity, and simplicity. Mine are, first, we should give relief to all taxpayers; second, we should be honest and fair—like your equity principle; and third, I think tax cuts should encourage work and bolster, but not threaten, the economy. That is very similar to your efficiency principle, Mr. Chairman.

Let me say a few words about relief to all taxpayers. First, tax cuts, as I said, should give relief to all. It is important to keep in mind the breadth of our Federal tax system.

The Federal Government today collects about $1.6 trillion a year in Federal taxes from individuals. About $1 trillion of the $1.6 trillion comes from individual income taxes, and another $600 billion from payroll taxes. Lesser amounts are generated from excise taxes and estate taxes. These are the four main taxes that combine the Federal tax burden on individuals.

It is difficult to collect data on how much Americans pay in excise taxes, since reporting is not done at the individual level. We will talk about estate taxes at another date. Today, we focus on income and payroll taxes.

In 1998, Americans filed 125 million individual income tax returns. Most of them had income tax liability. To be precise, 97 million—that is, 77 percent—owed income tax, and 28 million—about 23 percent—did not owe any income tax. If they had income taxes withheld from their paychecks, they got it all back in a refund.

For the same year, 106 million—that is, 85 percent of taxpayers—reported wage income. These 106 million paid payroll taxes. Now, there are some who will say that we should give tax cuts only to those who pay income taxes. I, frankly, think we must look broadly at the overall tax burden, and that certainly includes those who pay payroll taxes.

In my State of Montana, half of all taxpayers report under $20,000 in income. For most of these, the Federal income tax liability is zero. That is because the income is offset by the standard deduction and by the personal exemptions, or their tax is offset by the child credit, or education credits. In Montana, one of six returns claims the Earned Income Tax Credit.

Second, tax cuts should be honest and fair. We need to be honest with ourselves and the American people about what we are doing. We should not advertise tax cuts that we actually do not deliver because of the Alternative Minimum Tax, or phase-outs, or income limitations and eligibility criteria.

Third, a tax cut should bolster work and encourage the economy, not threaten the economy. With respect to encouraging work, I think we should examine whether certain tax rates and the Earned Income Credit provide incentives or disincentives to work.

We know that the Earned Income Credit moves 2.3 million children, and about 4.14 million Americans out of poverty each year. That is not an unimportant statistic. We need to examine how it encourages people to leave welfare and to go to work. We need to consider whether improvements can be made in the credit.

With respect to the economy, I hope we will hear testimony regarding the relative impact of various-sized tax cuts on our economy. We also should ask which kinds of tax cuts will best spur the economy. Finally, examine the proper timing of tax cuts.

I am pleased to note that these hearings have been put together, Mr. Chairman, on a totally bipartisan basis. It speaks well of you, Mr. Chairman. I look forward to this committee continuing to operate on that principle, and look forward to the rest of this hearing.

The CHAIRMAN. I would say to you that your staff, and you, have been very cooperative as well.

I want to welcome our first panel. Some introduction has already been given. I would add to what I have said about Mr. Entin, that he is former Assistant Secretary of Treasury for Economic Policy. Prior to joining Treasury, he was a staff economist for the Joint Economic Committee here in the Congress.

Dr. Aaron, currently a Bruce and Virginia McLawrey Senior Fellow in Economic Study at The Brookings Institute, taught economics at the University of Maryland for 30 years, and also served as Assistant Secretary of Planning and Evaluation at the Department of Health, Education and Welfare. In 1979, he chaired the Advisory Committee on Social Security.

If it is all right with you, I will go with Mr. Entin, then Dr. Aaron. Thank you. Please proceed. We will have both of you testify, then we will have five minutes for each member to question each of you in the order of attendance.

STATEMENT OF STEPHEN ENTIN, PRESIDENT AND EXECUTIVE DIRECTOR, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, WASHINGTON, DC

Mr. ENTIN. Thank you, Mr. Chairman, Mr. Baucus, members of the committee.

My name is Stephen J. Entin. I am president of the Institute for Research on the Economics of Taxation. Thank you for inviting me to address the need for marginal tax rate reduction.

President Bush's proposed tax rate reductions would trim marginal income tax rates over 5 years and cut the income weighted average marginal rate by about 10 percent.

These additional rewards to work, saving and investment would boost production and would create between 1.5 million and 2 million additional jobs over the next decade. It would ultimately add about 2 percent to the GDP. The higher GDP and higher incomes would return between a quarter and a third of the static revenue cost of the tax cut to the government.

The plan would also provide marginal tax rate relief in other forms: to two-worker couples subject to the marriage penalty, to workers hit by the EITC's phase-out, and by eliminating the estate and gift tax.

President Bush has previously proposed eliminating the remaining portion of the Social Security earnings test, which is an implicit 50 percent add-on tax on incremental wage income for some retirees.

I would note, as you have mentioned, Mr. Chairman, that the phase-outs of the child credit, itemized deductions, and personal exemptions, and other phase-outs in the Code can push effective tax rates above the statutory levels.

For upper income families, the phase-outs of personal exemptions and itemized deductions can add about 4 percentage points for a family of four under the statutory rates. Eliminating phase-outs would provide significant additional marginal rate relief.

As Mr. Baucus has noted, there is a problem with the AMT. It would be wise to alter the AMT to allow taxpayers to receive the full benefit of the President's proposed tax rate reductions. Ideally, the AMT should be abolished.

Why should we cut marginal tax rates? This gets to the efficiency and growth arguments. Tax cuts do not boost the economy by giving people more money to spend, or in other words, by pumping up "demand." The same amount of money would be given back to Federal bondholders if taxes were not cut.

Rather, tax cuts work to improve the economy if, and only if, they increase at the margin the after-tax wage on additional hours worked, or raise the interest and dividend returns on added saving, or raise the rate of profit on capital investment.

By affecting these incentives, tax rate reductions expand capacity. They raise output and income simultaneously, increasing supply in line with demand. Consequently, marginal tax rate cuts are not inflationary. In fact, they are disinflationary because they lower the cost of labor and the cost of capital.

Marginal tax rates are rising and threatening the expansion. They should be cut. Over the last 10 years, the Federal Government's revenues have risen by nearly 2.9 percent of GDP, and 85 percent of that increase was due to increases in the individual income tax as a share of GDP, as your chart illustrates.

The remainder of the increase was due to slight increases in the share in corporate taxes and estate taxes, whereas social insurance taxes and other taxes declined slightly as a share of GDP.

As Chart 1 in the written testimony shows, marginal Federal income tax rates, weighted by income, have been rising in recent years as a share of GDP. The Bush proposals would push them back down to rates a bit below those at the beginning of the decade.

These marginal rate increases have been reducing the incentives to work, save, and invest, and have been weakening the economic expansion.

What about the timing? Would we be enacting a tax cut just as the economy was going to be recovering anyway, for example? Well, incentive-based tax rate cuts are beneficial whether they are enacted at the bottom of a downturn, in the middle of a recovery, or at the top of a boom.

The current economic slow-down is simply an additional reason for moving ahead promptly with the President's rate cuts. But if marginal rate cuts are to have any significant effect on the economy in 2001, they need to be enacted promptly, have as deep a marginal rate cut as possible up front, and not be put in question by triggers.

The first installment of the multi-year rate cuts should date back to January 1, 2001. Even better would be to front-load the rate cuts rather than stringing them out over 5 years.

Please do not put in a trigger. A trigger would make tax cuts less certain and, therefore, would reduce their effectiveness at promoting growth. If people can count on the tax cuts, they will produce more in anticipation. If people doubt the cuts will occur, growth will be delayed, the revenue reflows would be less, and the net cost higher than otherwise.

The tax cut is not too big, it is too small. The President's tax proposals are about 1 percent of GDP over the 10-year budget window. Relative to GDP and in terms of the percentage of rate reduction, these cuts are about half the size of the Kennedy tax cut, and about 40 percent of the size of the individual rate cuts in the 1981 Reagan tax bill.

We can afford them for several reasons. First, the CBO budget projections are for just over $3 trillion in on-budget surpluses over 10 years. There would still be an on-budget surplus, even with the tax cut.

Second, off-budget Social Security surpluses will total nearly $2.6 trillion, and will also be buying back the public debt. Third, the estimated cost of the tax rate cut is static, not counting the added economic growth the rate cuts would make possible, and about a 30 percent recovery of the tax revenue.

Fourth, Congressional Budget Office estimates of the surplus may be on the low side, per dollar of GDP. Finally, the CBO and administration budget forecasts contain conservative real GDP growth assumptions, which are 3.1 percent per year for CBO, and 3.2 percent per year for the administration. The private sector forecasts are about 3.4 percent.

Let me also note that, as you move through the budget windows over the next several years, you will be dropping years of $300 billion surpluses and adding years of $900 billion to $1 trillion annual surpluses. You will have money coming in over the next several revisions to the budget numbers for further tax cuts and further tax bills down the road.

I do not think we should rush to pay down the debt. We surely have better things to do with the surplus. Lowering the debt is not the best way to spur investment and national saving, because the higher tax revenues associated with the surplus generally come straight out of national investment and saving. By contrast, cutting taxes would boost investment and growth.

Letting the economy slump would be bad for the budget. If Congress wants to make sure that surpluses continue and the debt is paid off, it should reign in Federal spending and cut tax rates to keep the economy moving forward. Tax rate reduction at the margin is the key to a successful tax cut.

Once you have completed this bill, I hope you will move on to fundamental tax reform with all of that added money I have promised you from the future years' revisions. Thank you.

The CHAIRMAN. Thank you.

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

The CHAIRMAN. Now, Dr. Aaron?

STATEMENT OF DR. HENRY AARON, SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. AARON. Thank you very much, Mr. Chairman, Mr. Baucus, members of the committee.

I have framed my testimony around five questions and some tables. It would probably be most helpful if you took a look at those tables.

The first question I pose, is whether the projected cost of the tax cut, $1.6 trillion, is a reasonable estimate. As indicated in Table 1 in my testimony, the answer to that question is a clear "no."

It is a clear no for three distinct reasons. First, according to the Joint Tax Committee, the cost of the rate reductions is larger than that estimated by the Treasury, to the tune of about $150 billion.

Second, as a number of people have mentioned already, no allowance is made for the need to change the Alternative Minimum Tax, to avoid making a mockery of the rate reductions for approximately 35 million taxpayers by the year 2011, according to recently released estimates.

Third, the calculation of $1.6 trillion in tax cuts does not allow for the added interest costs that would be generated as a result of not paying down the public debt.

If you add those numbers together, a more plausible estimate of the cost of the Bush program is $2.5 trillion, not $1.6 trillion. If one adds in, additionally, various other provisions, including other tax provisions that have been passed by Congress by significant majorities in the past year, the cost of reasonably anticipatable tax initiatives is in excess of $3 trillion.

So I think the first step in having a rational debate on this subject is to begin to talk about real numbers, not fairytales.

The second question, is whether the projected budget situation justifes a tax cut of the magnitude proposed by the administration? For that, I would ask you to turn to the second table in my testimony on page 5.

If one begins with the CBO baseline of $3.1 trillion, the same logic that has led virtually every member of Congress to agree that Social Security surpluses should not be used to justify either spending increases or tax cuts applies with equal force to reserve accumulation in the Federal employees' retirement system and to the accumulations in the Medicare hospital insurance trust fund.

In my testimony I have some comments on administration's arguments that the HI trust fund should not be subtracted from projected surpluses. I believe these arguments will not stand scrutiny, but I am not going to spend time now on that. I will come back to it in questions, if you would like.

In addition, there are various administration policy proposals, the cost of which, I believe, is very conservatively estimated in the budget document that the President released within the last 10 days. If one allows for those, the projected surplus realistically available to finance either other spending increases or tax cuts down to about $1.5 trillion.

I would note in closing, on this table, that Senator Domenici chastised Mr. Daniels just last week for his unduly conservative projections regarding discretionary spending, and suggested that a higher number would be appropriate.

I added 1 percent to the Administration's assumed 4 percent growth in disoretionary spending over 10 years. If one does that, and allows for added interest costs, the pool of money available for either tax cuts or other spending increases is on the order of $1.2 trillion.

That $1.2 trillion should be compared with the fairly estimated cost, of the tax plan of about $2.5 trillion. This comparison indicates that there is no contingency reserve—of $860 billion or any other amount. To speak of a $1 trillion contingency reserve is to invoke a mythical beast.

My third question is whether a tax cut should be enacted as part of an anti-recession strategy? I agree with Mr. Entin that the answer to that question is "no."

Is the proposed distribution of tax cuts fair? I would ask you to look at Tables 3, 4, and 5. Table 4 details the growth in after-tax income that occurred in the decade from 1989 to 1998. As we all know, that is heavily concentrated at the very top of the income distribution.

Table 3 shows the distribution among the same income classes of the entire Bush proposal and of H.R. 3. That, too, is heavily concentrated at the top of the income distribution.

Finally, on this point, I ask whether, taking up Senator Baucus' point, it makes sense to say that cutting taxes just on the personal income tax would be fair, given the actual facts regarding who pays taxes.

As Table 5 indicates that the payment of income taxes is concentrated more at the top of the income distribution than are other taxes. If one wanted to cut taxes for all American taxpayers, say in a roughly proportional manner, one would have to distribute tax cuts more to low and middle income taxpayers than doexs President Bush's plan.

My testimony closes with some remarks regarding other tax changes that I think would be more desirable at the present time and deplores a lost opportunity for achieving tax reform. I might say that I am almost equally critical of both the Republican and Democratic proposals in this respect.

Something more than rate reductions is needed. Rate reductions can smooth the way into tax reform. I would hate to see us miss that opportunity.

I am sorry for running over. Thank you for your leniency.

The CHAIRMAN. You do not need to apologize. We like to have people finish their thoughts, if it just does not take too long. You did not take too long.

[The prepared statement of Dr. Aaron appears in the appendix.]

The CHAIRMAN. The order of questioning would be the Chairman, then the Ranking Member, then Mr. Graham, Mr. Kerry, who is not here but will retain his position if he does came back to ask questions, Mr. Thompson, Mr. Nickles, who is not here but who will retain his position, Mr. Breaux, then Mr. Torricelli.

Would you start the lights for 5 minutes? I am going to start with you, Mr. Entin.

You heard in my opening remarks that I would like to have efficiency, equity, and simplicity be our guiding principles as we go into this. Do marginal tax rate reductions help grow the economy, and are they the most efficient way to promote economic growth?

Mr. ENTIN. Marginal rate cuts are the most efficient way, on the individual side, I think, to grow the economy. They reduce the tax burden on both labor and saving income, they encourage work effort, they encourage employment, they encourage additional saving. They are certainly simple to enact, and reasonably simple for the taxpayer to follow.

If you want the most bang for the buck in prompting growth, you do need to address, in fundamental tax perform a bit later perhaps, the disparity in tax treatment of income used to create capital versus income used for consumption.

Most of the major tax reform plans go to a tax system that is neutral in its treatment of saving versus consumption. These systems include the national sales tax, the individual cash flow tax, the Nunn-Domenici USA tax, and the Flat Tax. These address the bias in the income against saving and investment.

Things that you can do that fall short of that would involve expanding IRA and pension treatment of saving, moving write-offs for plant and equipment toward full expensing to allow full recapture of the cost of those investments, getting rid of some of the most bizarre of the phase-outs and tax spikes, such as the tax treatment of Social Security, and other such things that definitely penalize the act of investment or act of saving, or in the case of Social Security taxation, the act of working.

These are some of the things that are specifically supportive of growth by removing some of the very bad elements of the tax system. Fundamental tax reform will not be done in the next few weeks; you will have to come back to that issue.

If you wish to do something now that will promote employment, and saving, and investment, then I think the marginal tax rate reductions are efficient. They are certainly more efficient than targeted credits or non-marginal give-backs.

The CHAIRMAN. All right. You addressed——

Dr. AARON. Senator, could I just say one brief thing about that?

The CHAIRMAN. Yes. I think normally we would do it this way, except I think the way we have divided the panel, you will have an opportunity to bring your views out. But let me assure you that, before you leave the table, if there is something that you want to say that has not been said, I will let you say it.

I would like to ask about the issue of the fairness of marginal rate cuts, to comment on what you hear from people who are opponents of marginal rate cuts, opponents then of President Bush's tax cut benefitting upper income taxpayers more than lower income taxpayers, claiming that any rate reduction should be targeted and made available only to taxpayers in certain income tax ranges.

Mr. ENTIN. Rate cuts have the particular characteristic that they cut taxes in proportion to the taxes people pay. If you pay more taxes and there is a proportional rate cut across the board, then you get a bigger tax cut in dollars than someone who pays less in taxes.

In fact, as incomes rise in our progressive tax system, the rate of tax paid goes up. For example, the top 1 percent pays something like 35 percent of the income tax, but they have less than 19 percent of the income, and they pay at a higher rate than people with lower incomes.

The tax cuts that are being offered are, in fact, skewed toward the lower end, not simply in the rate reductions, but in some of the other elements such as the EITC offsets and child credit provisions. But the upper income get only about 22 percent of the tax cut, where they are payiny 35 percent of the income tax. You will find this throughout the schedules.

So the taxes are skewed toward the top, but the cuts that are being offered are skewed toward the bottom. If you are really upset about a proportional rate cut, such as the Kennedy cut or the Reagan cut, being more in dollar terms to the upper income than the low, then you have to understand that this stems from the fact that people's incomes are distributed the way they are, and that the tax burdens are higher on the upper income than on the lower.

If you are going to quarrel with the distribution of income in the country that is leading to the adjusted gross income on the tax form, then you have to be quarreling with the market distribution of pay for work done. In fact, people are paid broadly in line with what they contribute to the economy, either by working or providing capital services.

I think the only way to resolve that problem is to get more capital, intellectual and physical, into the hands of the lower income by encouraging them to get more education, more training, and to save more. That way you would address the income distribution that is at the heart of these figures.

The CHAIRMAN. Thank you, Mr. Entin.

Now, Senator Baucus?

Senator BAUCUS. Thank you, both of you, very much.

I was particularly intrigued by your comments, particularly you, Dr. Aaron, about how we are potentially squandering an opportunity for tax reform. I think there is a lot of merit in that statement.

I say that because, although Americans certainly would not mind having a tax cut, there is also an opportunity for Americans to have a much more simple and reformed tax system. There is a lot of momentum in this town that prevents us from looking down the road and doing what is right that has an effect many years later.

Rather, there is a tendency to focus on the immediacy of them, the now. The attention spans around here are very short. But, nevertheless, I am going to personally give some thought to what you said, because I think there is a lot of merit in it.

There are many, I think, who are concerned that the tax cut proposed by the President may be too large and, combined with the uncertainty of the 10-year projections in the budget, think that perhaps we should have a trigger.

Maybe it makes more sense to not take the entire riverboat and gamble, but just a part of it. That is, maybe after a few years a trigger will go into effect which either will lower the tax cuts even more, or prevent further tax cuts from going into place.

Mr. Entin, you were very solid in your thoughts against a trigger. But I would like both of you to just discuss with us a little bit about how we deal with that real concern that a lot of Senators have, that we may be going too far and we do not want to lock in tax cuts for 10 years if it turns out that the budget estimates are significantly incorrect. Yet, still, we want to have a tax cut. So how do we do both here?

Dr. AARON. Well, I think the concern about the reliability of the budget surpluses is well placed. The Congressional Budget Office, in fact, this year includes a graphic on page xviii of its baseline report that I commend to your attention, indicating the range of uncertainty surrounding its own projections. It is very candid.

As early as 2004, it indicates that the confidence interval that it is using includes budget deficits. It also includes much larger surpluses than it is projecting. For the year 2006, the range covered by that confidence interval just for the 1 year is $1.2 trillion. This is not a precise science.

In my view, no responsible business executive would, confronting the projections that we now have, with the uncertainty we know is associated with them, commit not only all, but as I have suggested more than all, of the projected surpluses.

As far as triggers are concerned, I believe that technically they are exceedingly difficult to design and difficult to adhere to. In my judgment, the more prudent course would be to enact today a tax cut significantly smaller than the administration has proposed.

If the bad news comes in, you will not have to raise taxes to avoid deficits in a recession. If good news comes in, I have every confidence that, in an even-numbered year divisible by four, you will find it in your hearts to cut taxes yet again. [Laughter.] So I would urge upon you caution. Go slow. There will be chances to address the Tax Code yet again.

It is worth upping the ante, I would suggest, if there is more reform in the proposal than if there is less. Then you are buying something in addition with the tax cut, and then it may be worth taking somewhat more chances.

Senator BAUCUS. I will let you speak, Mr. Entin. But basically you are saying no to a trigger. There are better ways, is what you are saying.

Dr. AARON. I believe there is a better way.

Senator BAUCUS. All right.

Mr. Entin?

Mr. ENTIN. I agree. There are better ways to handle it, if you are really that worried about it. I think with a $3 trillion on-budget surplus, even if you added $1 trillion to the accounting for the tax cut—and by the way, the President does estimate the debt service expense in his budget—I think you have room for the tax cut.

You have a tax bill virtually every year. If something horrendous happened and you had to revisit it next year and take some of it back, you would. You did that to Mr. Reagan in 1982, 1983, 1984, 1985, and 1986. So, I am not afraid of that.

Senator BAUCUS. A lot of members of Congress do not like increasing taxes or delaying. In fact, the whole body, the Senate and House, changed because of those votes.

Mr. ENTIN. Then maybe that is a reflection of the fact that the constituents would like to have a tax cut they can count on.

Senator BAUCUS. I think we are going to, at some future date, just increase taxes or delay the reduction of taxes.

Mr. ENTIN. If the tax cut is made uncertain, then the person looking to buy a share of stock, or a 30-year bond, or even a 5-year bond, will not know what rate he is going to pay in tax on the interest or on the dividend.

The employer, thinking of adding to the workforce, will not know what the taxes are going to be on those wages and what wage demands might turn out to be 2, 3, 4 years down the road. If the tax cut is certain, everybody is more likely to proceed to do the work, or to do the saving.

If you have a situation where you are somewhat concerned about the strength of the economy, the last thing you want to do is make the tax cut uncertain, because that destroys whatever effect you might get up front from it.

Now, these rate cuts are phased in so very slowly that, as it is, there is not going to be much effect this year, particularly if it is going to be made effective next January 1 instead of this January 1.

Senator BAUCUS. My time has expired. Thank you very much.

The CHAIRMAN. Now, Senator Graham.

Senator GRAHAM. The question of tax cuts, size, and composition should be de-linked from the state of the economy at the time those decisions were being made. I would have to say I disagree if that is, in fact, your position.

I was one who, 18 months ago, said we should not consider a tax cut because I thought, in the highly over-heated economy of 1999, that a tax cut had more potential for negative consequences than positive.

Conversely, in the economy of today, I believe that a tax cut for the specific purpose of demand-side stimulation is justified. I am not alone in those feelings.

Two economists who had also opposed tax cuts 18 months ago have more recently said that they would support an appropriate tax cut. One of those is the chairman of the Federal Reserve Board, Alan Greenspan, who stated in January that tax cuts would do "noticeable good should the current economic weakness be prolonged."

In a series of articles, including one today, Robert Samuelson of the Washington Post has stated that "a tax cut is now common sense. It would make it easier for consumers to handle their heavy debts, and to some extent, bolster their purchasing power."

Today Mr. Samuelson says, “There is a certain common-sense appeal to bolstering people’s purchasing power by reducing their taxes.”

I would join Mr. Samuelson and Chairman Greenspan in their analysis of the relationship of a tax cut to the state of the economy.

I would like to probe why you believe that Samuelson and Greenspan are in error when they make the argument that a tax cut, for stimulative purposes, would do noticeable good.

Dr. Aaron seems to primarily focus on the weaknesses of the President’s tax bill as an economic stimulus, and I would agree with that analysis. But is that a general condemnation that there is no tax bill that could be constructed that would have a positive effect during this current period of economic downturn and uncertainty, Dr. Aaron?

Dr. AARON. First of all, I want to emphasize that we do not know the nature of the current economic downturn with reliability yet. It could be a down turn. It could be a full-fledged recession.

Senator GRAHAM. I think, if I could say, Chairman Greenspan has recently come to use the term “economic insurance policy” to describe the tax cut for exactly that reason, that if this downturn proves to be deeper and longer than some anticipate, that this would be an insurance policy to give some stimulus during that period.

Dr. AARON. I will tell you why I am of a different mind on this issue, and it is not a position I came to easily. As I learned economics and taught it for a long time, I was in exactly the position you were.

There was a big debate in the economics profession about whether to use fiscal policy to fight recessions. Mostly conservative economists argued that we consistently, almost without exception, time the reductions in taxes poorly so that they come when the economy is already recovering.

I am going to leave aside the issue of incentive effects which Mr. Entin raised, which seems to argue that there is never a bad time for a tax cut. I understand that point of view.

But if one is looking to stimulate the economy in the short run, the timing has been consistently bad. Our historical record is poor. The proposal that is before Congress now looks to be a repetition of the historical record: little cuts when the economy is weak, big cuts later on, when the economy has recovered, as it will do if monetary policy is as successful as it has been consistently, and not just under Mr. Greenspan. Tax cuts that take effect at that time would cause the Federal Reserve to boost internet rates in order to restrain the economy.

I am not personally averse to trying to use activist policies to combat bad events. Unfortunately, in this case, the historical record indicates that activist policies work poorly. The conservative economists who argued with the position I used to believe in won that debate. I no longer have the faith that any of us can time the interventions just right.

The CHAIRMAN. Thank you, Senator Graham. I should not have presumed, even though your time ran out, if you had a statement you wanted to quickly make before we move on. You looked at me like you wanted to say something.

Senator GRAHAM. I thought Mr. Entin was going to comment on that.

The CHAIRMAN. If he wants to comment on your question, he should be given that opportunity, and you should be given that also, Senator Graham. So, please go ahead.

Mr. ENTIN. Thank you, Mr. Chairman.

Conservative economists did disagree with that timing problem, but they had a further disagreement. Some 35 years ago, Milton Friedman asked, “If the government is spending $500 billion and cuts taxes to $450 billion, where does the $50 billion difference come from, the tooth fairy?”

Then he answered his own question, saying, either the Federal Reserve bought the debt, in which case you have pumped up the money supply, which is where the stimulus came from, or the government had to borrow the tax cut back from the public and there was no demand stimulus.

This gets to my point in the testimony, that when you cut taxes you are not pumping up demand because you would have given the same money back to the bondholder, or the government would have spent it.

Taxes do not work by stimulating demand. They work by encouraging labor and capital to enter the marketplace where they are hired, they produce, the product is sold, they are paid, and they use their money to buy their product. Supply and demand go up together.

So if you have the right kind of tax cut, you can put it in place any time because it is expanding capacity. If you happen to be in a weak situation, you get the serendipitous additional effect that you happen to be countering a downturn. So we do not like to do timing, but we do like to get the type of tax cut right.

Senator GRAHAM. Mr. Chairman, I want to come back to this discussion on my next round.

The CHAIRMAN. Thank you.

Now we go to Senator Kerry from Massachusetts.

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

Mr. Entin, I gather, during the moments I was in here, that you, with some refreshing candor, talked about the realities of the AMT. I certainly appreciate that. I think it is important to put that on the table.

I just want to couple that with the overall cost for a moment and see if we are sort of talking the same language here. A couple of days ago, the Joint Committee on Taxation gave us new estimates, saying that the four top rate bracket cuts that have been proposed will cost $59 billion additional over 10 years than is currently stated in the President’s budget.

In addition, accelerating the introduction of the 10 percent bracket that was passed by Ways and Means last week cost another $67 billion more than the President’s budget states. The interest level lost as a result, the increased payment on interest, would be an additional $54 billion. So that is a total cost of $180 billion over 10 years additional cost.

Do both of you concur with those judgments?

Dr. AARON. Yes. Table 1 of my testimony incorporates the Joint Tax Committee estimates.

Senator KERRY. Mr. Entin, you do, too?

Mr. ENTIN. Yes.

Senator KERRY. All right.

So, in effect, the Bush plan that we are now looking at is, in effect, a $2.2 trillion plan, not a $1.6 trillion plan. Is that correct?

Mr. ENTIN. It depends. Yes, as far as they went.

Senator KERRY. That is before we get to the marriage penalty, before we get to estate tax. Do you both concur with that?

Dr. AARON. The estimate I came to was just about $2.1 billion. Even though $100 billion is real money, I think we are in the same ball park.

Senator KERRY. I assume you would both agree that it is almost axiomatic, that with the marriage penalty and estate provisions yet to be re-estimated by Joint Tax, that is going to go up also. The total is going to go up.

Dr. AARON. I would not want to second-guess the Joint Tax Committee.

Senator KERRY. Fine. That is fair. There is no reason to. Why do we not leave that there?

Let me come back then to a question. We were sort of talking about the marginal rate cut and what we are going to achieve by it. I would assume both of you would feel that fairness is something we all ought to be thinking about as we approach this question of distribution. Is that something we should be thinking about, Dr. Aaron?

Dr. AARON. Could I use this opportunity to return to a point I wanted to make in response?

Senator KERRY. I guess. But it does not come off my time.

Dr. AARON. Well, it is in response to your question.

Senator KERRY. All right.

Dr. AARON. The issue concerns fairness and the effect on efficiency of the economy.

Senator KERRY. Sure.

Dr. AARON. One of the great success stories of economic policy during the 1990's has been the whole range of reforms that make work pay for low-income earners. Along with the welfare reform legislation, they have contributed massively to the reduction in the welfare rolls around the Nation for which many members of this committee can justly take credit.

It remains the case, as the Chairman pointed out, that among the highest marginal tax rates are those paid by low earners. In the name of both fairness and economic efficiency, I would urge you seriously to consider extending the phase-out range, raising the phase-out range of the Earned Income Tax Credit. In addition, I urge you to extend the benefits of the child credit to those whose incomes currently do not permit them to make full use of it.

I would urge you to provide the benefits of the child credit to any full-time worker, whether or not they have positive income tax liability. The goal should be to encourage labor supply by low- and moderate-income households. There is a real opportunity for progress here. I hope you will seize it in this legislation.

Senator KERRY. I appreciate your comment. I will come back to it in a moment. I want to get Mr. Entin also on this.

Mr. ENTIN. Fairness is, of course, important. It depends on how you define it. Mr. Bush approaches the Earned Income Tax Credit tax bite, which can approach 50 percent for a low-income worker, by eliminating the income tax liability during the phase-out range, which takes 15 percent off of that rate. Dr. Aaron recommended changing the phase-out rate itself. There are a variety of ways of approaching this.

Senator KERRY. Well, let me come to that. I regret it is with the yellow light on. But 80 percent of Americans pay most of their taxes through the payroll tax. Because the Bush plan is a cut in marginal rates on income tax, 25 to 28 million Americans get no benefit at all because they do not pay the income tax. But they do pay taxes, the payroll tax, which is the largest bite out of their check.

There are some, like the Senator from Oklahoma, that have questions about the Earned Income Tax Credit, some of the problems that exist within it. Let us say we want to avoid that.

Would it not make sense to have a credit, a tax credit, also refundable so that you do not run into a problem in reducing the books with respect to Social Security, but you actually give a benefit to those people at the lower end of the income scale who are working hard, playing by the rules, paying taxes, but get no benefit at all from the Bush tax cut. Would that not be fair?

Mr. ENTIN. That has been the purpose of several increases in the Earned Income Tax Credit. But the resulting phase-out has boosted the marginal tax rates on the other side. You have a problem when you try to get too targeted.

If you really want to do something about Social Security (and Mr. Bush has a proposal and we will have a commission), I will most certainly assure you that most economists would like you to go ahead and revisit that entire system.

Lowering the payroll tax rate by shifting people out of——

Senator KERRY. It does not lower the rate. It is a credit and it is refundable.

Mr. ENTIN. Yes.

Senator KERRY. There is no change in the rate.

Mr. ENTIN. But to get at the people who are paying too high a payroll tax, the best thing to do is to lower the rate by bringing that system's outlays under control and shifting workers into private savings accounts.

Senator KERRY. That is another argument. That is a completely different issue. The question I asked is still, in essence, unanswered by you with respect to the credit itself, which does not reduce the rate, but gives them a benefit that they do not get under the Bush plan.

Mr. ENTIN. You are then suggesting something like increasing the Earned Income Tax Credit. I am warning you——

Senator KERRY. It does not have any of the problems that some of our colleagues would allege exist in the EITC.

Mr. ENTIN [continuing]. That will be difficult to design.

The CHAIRMAN. Thank you, Senator Kerry.

Now, Senator Nickles.

Senator NICKLES. Mr. Chairman, thank you. Thank our panelists, and the next panel, for participating in this hearing. This is educational and, I think, helpful.

Mr. Entin, you talked a little bit about maximum rates. I am going back in my 20 years in the Senate, and the maximum rate was 70 percent. At the end of the Reagan Administration it was 28 percent. At the end of the Bush Administration it is 31 percent. I am trying to determine what it is right now.

Some people say, well, in the Clinton Administration it was 39.6 percent, but that was not all that President Clinton did. He increased the maximum rate from 31 to 39.6, but he also said that there is no limit on the Medicare tax. Am I correct? You can add 2.9 percent, because now that is in income tax.

Then you also said above certain levels, I believe of $100,000 some, you eliminate a couple of the deductions. What are those two deductions?

Mr. ENTIN. You begin losing the itemized deductions and the personal exemptions.

Senator NICKLES. You said that was equal to about 4 percent.

Mr. ENTIN. Depending on family size, it is anywhere from 1 to 6. But four is in the middle.

Senator NICKLES. You said about 4, and that is what I am trying to calculate. I have always been kind of fuzzy, trying to figure out, what is the maximum income tax rate now? So if it went to 39.6, then you add 2.9, then you add 4 percent on top of that, if my math is correct, it went to 46.5.

Mr. ENTIN. Do not forget the State income tax.

Senator NICKLES. We are going to leave the States alone and let the States do what they want to do. I am talking about Federal income tax. It went from 31 percent to 46.5. That is a 50 percent increase. That is a 15.5 percent increase.

Now, President Bush has proposed reducing the tax rate from 39.6 to 33, but he also has not talked about eliminating the phase-out of the deductions. He also has not talked about reducing the Medicare tax, the additional tax, the 2.9 that is added to all income.

So really, in effect, his maximum rate is not 33 percent, but his maximum rate is more like 39.9 percent, which is still 28 percent higher, if my math is correct, than it was 8 years ago. Eight years ago it was 31 percent. I would just make mention of that. There was an enormous tax increase in 1993 on upper income individuals.

Some people criticize President Bush's proposal, but even if we enacted every piece of his proposal dealing with the income tax rates, the maximum income tax rate is still about 39.9 percent because he does not eliminate the phase-outs.

Now, Dr. Aaron just said maybe we should extend the tax credits per child, and so on, but a lot of those are phased out at certain levels. So, I would mention that.

There is a great, big tax increase. Even if we enacted his tax cut for the upper income, you still have tax rates of about 28 percent higher than they were back in 1991. So, I would mention that.

Also, I would mention, I find interesting, people say, hey, a lot of people pay a lot more in payroll tax than they pay in income tax. Right now, and Senator Bob Kerrey probably enunciated this better than any, we had humongous tax increases on Social Security as a result, I guess, of the 1983 package, bipartisan, by and large. It did not have this Senator's vote, but it passed overwhelmingly. Senator Moynihan, Senator Dole.

But it increased the maximum tax. Just looking at it, in 1983, the maximum payroll tax, Social Security, on income, it was a base of $35,700 and totaled $3,337. Now it is a total of about $12,240. It is an increase of about $9,000, because the base went up from $35,000 to, today, $80,000. The rate went up substantially. It went from about 9.3 percent to 15.3 percent, if you add the two together.

So, anyway, we had a real, big increase in payroll taxes. That, frankly, is what is paying down the debt. We are having payroll taxes pay down the debt, which a lot of people would make comment on.

One other comment. Some people say, well, maybe we need an increase, or an increase in the phase-out of EIC, and to pay payroll taxes. For somebody that is making $15,000, EIC, with two children, pays 314 percent of their payroll tax. If they are making $10,000, it pays 500 percent of their payroll tax.

So for lower-income people, EIC, right now, is paying, in some cases, three, four, or five times what their payroll tax is. So it is more than accomplishing that purpose. I just want people to know some of the facts.

Mr. Entin, one question to you. You said the top 1 percent are paying what percent of the taxes, and they have what percent of the income?

Mr. ENTIN. May I look up the exact figures? I have been reading so many thousands of figures this week, I cannot remember them all. But they are paying a good deal more than their share of the income, and they are receiving a tax cut that is a good deal less than their share of their tax liability. So, if I could get those figures to you more precisely, I would like to do so.

Senator NICKLES. I appreciate that.

To both of our panelists, thank you.

[The following information was subsequently received for the record:]

Senate Finance Committee Hearing on Marginal Tax Rate Cuts
March 7, 2001

Submitted by Stephen Entin in response to a question from Senator Nickles:
Senator Nickles requested the following information on income shares and shares of taxes paid by various income groups.

Individual Income Tax Shares, Average Tax Rates, and Adjusted Gross Incomes by AGI Percentiles

Adjusted Gross Income Share (percentage)

Year	Top 1% of Filers	95% - 99%	90% - 95%	75% - 90%	50% -75%	Bottom 50% of Filers
1981	8.3%	12.5%	11.2%	24.7%	25.6%	17.7%
1985	10.0%	12.6%	11.1%	24.2%	24.8%	17.3%
1989	14.2%	13.7%	11.2%	23.3%	22.8%	15.0%
1993	13.8%	14.0%	11.3%	23.4%	22.6%	14.9%
1997	17.4%	14.4%	11.0%	22.2%	21.1%	13.8%
1998	18.5%	14.4%	10.9%	21.9%	20.7%	13.7%

Total Income Tax Share (percentage)

Year	Top 1% of Filers	95% - 99%	90% - 95%	75% - 90%	50% -75%	Bottom 50% of Filers
1981	17.9%	17.5%	12.9%	24.2%	20.2%	7.4%
1985	22.3%	17.0%	12.6%	22.4%	18.6%	7.1%
1989	25.2%	18.7%	11.8%	21.4%	16.9%	5.8%
1993	29.0%	18.3%	11.9%	20.0%	15.9%	4.8%
1997	33.3%	18.7%	11.3%	18.4%	14.0%	4.3%
1998	34.8%	19.1%	11.2%	17.6%	13.1%	4.2%

Average Tax Rate (percentage)

Year	Top 1% of Filers	95% - 99%	90% - 95%	75% - 90%	50% -75%	Bottom 50% of Filers
1981	34.2%	22.2%	18.2%	15.5%	12.5%	6.6%
1985	30.9%	18.7%	15.8%	12.9%	10.4%	5.7%
1989	23.3%	18.0%	13.9%	12.1%	9.8%	5.1%
1993	28.0%	17.5%	14.0%	11.4%	9.4%	4.3%
1997	27.9%	18.9%	14.9%	12.0%	9.6%	4.5%
1998	27.1%	19.1%	14.8%	11.6%	9.1%	4.4%

Sources: Internal Revenue Service, Letter to the Honorable Jim Saxton, Vice Chairman, Joint Economic Committee, from Daniel F. Skelly, Director, Statistics of Income Division, stamped received on October 12, 2000; Internal Revenue Service, SOI Bulletin, Spring 1993, "Individual Income Tax Ratesand Tax Shares, 1988-1989," tables 5 and 6.

The CHAIRMAN. Thank you, Senator Nickles.

Now we go to Senator Breaux of Louisiana, then Mr. Torricelli, then Mrs. Lincoln, then Ms. Snowe.

Senator BREAUX. Thank you, Mr. Chairman.

I thank the panelists. This has been very informative and, as Senator Nickles said, very educational as well.

When we had Secretary O'Neill before the committee the last time I tried to ask him a question which I never understood the answer to, and maybe I will try it on you two.

In the rate cuts that are before us in the President's bill, the 39.6 percent down to 33 percent in the top rate. When I calculate that reduction, it is a 16.6 percent reduction; the 36 down to 33 is an 8 percent reduction; 31 down to 25 is a 19.3 percent reduction; while the 28 percent bracket going down to 25 percent is a 10.7 percent reduction. Obviously, keeping 15 at 15 is no reduction.

I know there are other things in the bill, the marriage penalty, the estate tax, the child credit, and all the other things that are out there.

But if we are just looking at the rate reduction, I have always felt that if you have a rate reduction, you give the reduction at the same percent to everybody in their income category, and that that's pretty fair. The people in the top bracket will get a much larger dollar amount, but their percent reduction will be the same.

Now, tell me what I am missing by that logic. He ended up telling me in Egyptian hieroglyphics that that was not right. I am missing something in his answer. He says, no, it is all the same. But if you just look at the rate reductions, why is my concern not legitimate? I will ask that to both Dr. Aaron and Mr. Entin.

Mr. ENTIN. It is one of those horrible iron rules of arithmetic that is getting involved here. Averages and marginals are not the same thing. If I give you the higher child credit and the 10 percent rate, which everybody gets a cut on, that could lower the average tax rate of people near the bottom very enormously.

It could even wipe out their tax liability entirely. But they might still be just entering the 15 percent bracket and their marginal rate would not have moved at all. Then you get these changes in the rates above that.

Granted, they are different percentage changes in the marginal rate, but because they are also all getting these changes at the bottom, their reduction in average tax liability may be much more uniform than the changes in the marginal rates. It is just arithmetic.

The economic incentive effect is in the marginal rates, which is why, back in the 1970's, people began looking at those instead of the averages. So we have a situation where fairness is sort of viewed as changes in average liability, or dollars, and incentives are viewed in changes in the marginal rates. That is why you sometimes get this conflict going on.

Senator BREAUX. All right.

Dr. Aaron, do you agree with that?

Dr. AARON. I would ask you to look at Table 3 in my testimony. It seems to me, you can cut through all of the marginal and average stuff and simply look at what the impact of the tax cuts is on after-tax income.

Table 3 in my testimony on page 8 shows the percentage change in after-tax income of the entire Bush program, including the estate taxes estimated by the Treasury Department, and of H.R. 3, plus the estate taxes estimated by the Treasury Department.

Senator BREAUX. That is the total package that President Bush is recommending?

Dr. AARON. Total package. Yes, sir.

Senator BREAUX. All right.

Dr. AARON. It is very heavily skewed toward the top 1 percent. To put it in plain terms that anyone can understand, when fully implemented, the average tax cut for the top 1 percent, in dollar terms, will exceed the annual income of half of American families.

Let me repeat. The annual cut in taxes for the richest 1 percent of filers will exceed the total income of half of all American families.

I would also be very careful of the statements regarding the percentage distribution of tax burdens. The 22 percent figure that Mr. Entin used does not refer to the fully implemented plan. It is based on the proposed law as of 2005, before all of the tax cuts have been put into effect, and it excludes the estate and corporate tax from the distributional estimate.

These are admittedly hard to assign, but hard does not mean impossible and it does not mean one should ignore them entirely.

Senator BREAUX. Thank you both. I agree with the concept on the trigger. I think it is very difficult to design. I think it could, in effect, put a tax increase into place when the economy slows down, which would be the worst time to have a tax increase.

Dr. Aaron, what about the prospects of doing a smaller tax cut, in doing it not on these 10-year estimates which are so very uncertain, but doing it on a shorter timeframe, say a 5-year timeframe?

Dr. AARON. A former colleague at Brookings, now president of the Urban Institute, Bob Reischauer, you know him well from CBO days, proposed what I think is a prudent and sensible approach. Under that approach one would treat as available for either tax cuts or spending increases substantially all of surpluses projected over a very brief window, 2 or 3 years, and only a declining fraction of projected surpluses beyond that period. He suggested phasing down to 40 or 50 percent of the long-term projected amounts.

That would be the amount that you would consider available to you for spending increases or tax cuts today. The reason for caution is the projections are uncertain and you can revisit these decisions later on. I think that is a sensible and prudent way to go. I can get you, or I am sure he can supply you, more details on that proposal, if you would like.

Senator BREAUX. My only comment is, we cannot predict the weather for this coming weekend, which we proved last weekend, so we really do not want to predict something 10 years out in the future.

Thank you very much.

The CHAIRMAN. Thank you, Senator Breaux.

Now, to Senator Torricelli.

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

In this debate there appears to only be one absolute: people are uncertain about the proper level of surplus the United States should maintain. Our different social objectives in health care and education appear variable, and only the certainty that the appropriate level of debt to the U.S. Government is zero appears to be a firm fixture in the debate. That appears peculiar to me.

The European Union community, for entre, has a fixed number of acceptable levels of debt. The United States has always previously operated, believing that there was an appropriate level of national debt consistent with our ability to borrow.

Fortunately, in recent days the administration appears to have moved to a position that there is a certain amount of debt that is unredeemable, therefore, presumably, acceptable.

At the risk of losing all of my time, so I will ask you to be brief about this, help move this Congress forward. What is the appropriate level of debt with which the United States can, and should, operate, if you accept my premise that, under any perspective, that number is not zero?

Mr. ENTIN. We should borrow when what we are going to do with the money is more valuable than the cost of the borrowing, just as any family will do to buy a house, or send a child to college, or to invest if the returns are higher on the borrowing than on the debt service.

Senator TORRICELLI. So taking your answer directly, because I have used this exact argument in my own caucus, if indeed the U.S. Government is able to borrow at 5 percent in good conditions, in good economic times, with a clear ability to pay it, and the designated use of the money was revenue not otherwise available, is to expand access to college or improve secondary education, proving to a near certainty that the result of that investment is significantly greater than the cost of the borrowing.

A sound economic decision is to use that limited ability to borrow for a demonstrated economic purpose, not to mention the social benefits that accompany it.

Mr. ENTIN. Yes. What an extraordinarily good answer. [Laughter.]

Senator TORRICELLI. Dr. Aaron?

Dr. AARON. I may not be quite so good. I think that if one can demonstrate to everyone's satisfaction that something is worth having, it may be worth paying for today, which means not borrowing for it, but actually using current revenues.

Senator TORRICELLI. My time is limited, so I have got to be a little difficult with this.

To return to my initial premise, something is wrong when the international community is looking at these levels of borrowing. The European Community has said, I do not know their number, it is 3 or 4 percent of gross national product it maintains for reducing national debt for entre.

We have had different benchmarks before. We have moved to this absurd number of zero. Do you have a number that you actually think should be a guide for this Congress, that in these kind of economic times, is a gauge of how much we should have in outstanding debt?

Dr. AARON. I think today we should be saving as much as we can. Whether that is through public saving or through private saving is a matter of social policy and judgment that you are going to have to make. This Nation is going to face sizeable obligations in the future.

Currently, we are enjoying a big trough in the costs for retirement pensions, because the people reaching retirement age are people like me, born in the Great Depression, and there are not many of us. Following me come the baby boomers. Senator Breaux has spoken about that.

Senator TORRICELLI. That is the crowd we are really worried about.

Dr. AARON. You folks. You are the ones. You are going to be expensive. So, I would urge us to try and save as much as possible today.

Senator TORRICELLI. All right, doctor. Let me move then on the question of savings, because in good economic times where the numbers obviously are otherwise impressive in most measures of our economy. The one that troubles me the most, is the country moving into a negative savings rate.

Now, I recognize that our measure of that is different than most countries', and there are reasons why it is not as bad as it appears. Nevertheless, most Americans have very little equity, are living paycheck to paycheck.

Savings has become somewhat irrational in the country on a tax basis. The one thing we used to have until 1986, was a small exclusion on taxation on interest was eliminated.

I have tried to encourage my colleagues to revisit this issue by an exclusion for the first several hundred dollars, or $500 on dividends, capital gains, or interest on savings to encourage people to accumulate some savings for their retirement, or simply for family security, the loss of a job, an illness, a divorce, something to get people off paycheck to paycheck. I am trying to design such an amendment.

Could you comment on the advisability of returning to some kind of an exclusion to help working families gather some financial security?

Dr. AARON. I hate to be difficult, Senator.

Senator TORRICELLI. This is a chance to at least bat 500.

Dr. AARON. I thought I had hit a home run.

Mr. Entin said one thing that I very definitely agree with. To the extent that you want to affect the efficiency of the economy and promote incentives, what you want to do is focus the tax changes that operate on marginal decisions.

We have a variety of tax sheltered savings vehicles today for low earners. An exclusion of $300, $400 of interest income is not going to affect the marginal tax rate on most taxable interest income and, therefore, will not affect the decisions that affect most saving.

What I would suggest instead, is that we try to simplify and coordinate the conflicting and confused tax rules for the many different tax sheltered savings accounts that we now have.

If you are like me, you have a drawer full of separate accounts, each of which has different rules, and you have got to keep track of all of them. There is no reason why Congress could not consolidate the various tax sheltered savings vehicles into one, or at most two, different classes of vehicles with a common set of rules, and simplify the lives of those of us who are trying to save.

Mr. ENTIN. I have a short paper on this I could send you, but I am generally in agreement with Dr. Aaron. An exclusion, if not capped at $400, is the same treatment given a Roth IRA. Indeed, if you consolidate such things and make fewer of them, and put fewer restrictions on them, it is easier for the taxpayers to make use of them.

The CHAIRMAN. Mrs. Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman.

It has certainly been clear to me in my work with Senator Lugar and the bill that we have introduced on AMT reform that it is necessary, and I am assuming from both of your testimonies you have indicated that as well, that this is an issue that has to be dealt with.

The problem, however, is that there has been no provision included in President Bush's budget to account for the reform that is necessary in AMT. I think, according to the Joint Tax Committee, the full repeal would come in at about $215 billion. The plan that Senator Lugar and I put in is about $60 billion less than that.

I guess my question to both of you gentlemen, is if it is so necessary and absolutely critical in order not to put many taxpayers at a complete disadvantage from this tax plan, where would you find the revenues to pay for it?

Mr. ENTIN. I would find the revenues by noting that your proposal, and Mr. Bush's proposal, would encourage some additional GDP and that you would get about 25 to 33 percent of your money back, and go ahead and do it. Without AMT relief, the rate cuts are greatly diminished and the incentive effect for the affected people is greatly reduced.

Getting the AMT relief will mean that you get the full value of the growth out of the tax plan. As long as you are hamstrung by the static revenue estimates, and as long as you do not want to spend the full, on-budget $3 trillion, you have trouble doing both. I would say, go for it.

Just remember, if indeed the economy softens and some of these numbers do not come in quite so strong, that is all the more reason to have gone ahead and done something to keep the country growing.

Senator LINCOLN. But you are saying that you are only going to recoup 25 percent of it. Is that what you just said?

Mr. ENTIN. Twenty-five to 33 percent of marginal rate cuts would probably come back in additional revenue from higher growth. There are other tax provisions that give you more of your money back, and there are many tax provisions that give you virtually none of your money back because they do not have the incentive effects.

AMT relief would, in conjunction with ordinary rate relief, be one of those types of tax changes that would give you a fair chunk of your money back.

Senator LINCOLN. But not enough.

Mr. ENTIN. Not all of it.

Senator LINCOLN. Right. But my question is, if we are going to do that, where do you see that revenue coming from? You are saying, 25 percent may be recouped in the benefits from the reform. I understand there is another chunk still to come.

Mr. ENTIN. Let us suppose we take a $2.2 trillion tax cut and boost it to $2.5 or $2.6 trillion by adding AMT relief, and you recover $600 billion from added growth and drop the net cost down to $1.9 trillion. That is a good deal, and you still have plenty of room for it in the budget.

Dr. AARON. This sounds to me like the old joke about economists and how you open a can on a desert island—assume a can opener.

The fact of the matter is that there are abundant studies of the impact of tax cuts. The effects on labor are positive, as Mr. Entin suggested. The effect on capital accumulation is negative, because if the government cuts taxes there is that much less national savings. The tax cut means that the government is buying back that much less debt. As a result, fewer funds are available for private investment at home or abroad.

On balance, the effect of the tax cut will not be to increase GDP, because it reduces saving at the same time it has a positive effect on labor supply. They offset each other. It is about a wash, but slightly negative, in fact.

So Mr. Entin's assumption that you will recover 30 percent of any tax cut through increased economic activity is not justified by the best current empirical research. In addition, you will have a minimum tax problem whether you pass President Bush's bill or not.

Senator LINCOLN. He does not have a bill, does he?

Dr. AARON. Well, his proposal. The reason is that the minimum tax is not indexed and it is going to end up affecting about 20 million people by the end of the decade even if you do not lift a finger. If you enacted his proposal it would go to 35 million. You will not let that happen. You have got to do something about it to reduce the bite of the AMT.

Some propose repealing it. I think that is probably a bad idea because it is a back-stop to the excessive use of various deductions and credits, the use of which was curbed in the Tax Reform Act of 1986. But it should not apply to typical Americans.

Given that you have to do something about it, that is one of the tax provisions that represents a claim on the pool of resources available for tax cuts and spending increases, that is for rate cuts, changes in marriage penalty, and reductions in the estate and gift tax. All of these likely changes should be factored in. There are a further factor arguing for being conservative, in the traditional sense of the word, regarding the size of the tax rate cuts you enact.

Senator LINCOLN. You both confirmed that we definitely need it, but that we do not know how we are going to pay for it, obviously.

My time is up, Mr. Chairman. I have more questions for later.

Mr. ENTIN. May I make one small comment?

The CHAIRMAN. Yes.

Mr. ENTIN. I very strongly disagree with Dr. Aaron's contention that raising Federal revenues reduces Federal borrowing and, thereby, adds to national saving.

If you graph individual tax liabilities and Federal borrowing over the last few years, you find that, as individual taxes have gone up, individual saving has gone down although government surpluses have gone up, you have not had that much change. In other words, when individuals——

Dr. AARON. That is factually incorrect. Saving has gone up dramatically in the last 5 years in the United States. Private saving, to be sure, has declined, but government saving has more than offset that. It is one of the factors that has contributed to our very strong economic growth.

Mr. ENTIN. National saving has gone up far less than the rise in Federal revenues because there has been a substantial offset on the personal saving side. The most dramatic effect has been the surge in capital gain revenues that people had to pay for out of current income, and were therefore unable to use to add to their portfolios. We do not measure saving properly in these accounts.

When you raise taxes in a manner that keeps people out of IRAs, that raises taxes on capital investment, that substantially boosts the marginal rate on incremental saving, and people react by saving less, the government may be borrowing less, but the private saving pool is also reduced. The net effect is not much of a gain in national saving. The direct effect of the higher taxes on the saving and investment is negative.

The CHAIRMAN. I think what we should do, some members had additional questions. I am going to allow each member to ask just one question, if you would, very quickly, because we do have another panel. Also, maybe that the answers can be a little bit shorter.

I want to ask Mr. Entin, how much of the current surplus do you estimate is attributable to bracket creep, meaning real growth and wages, and what are the future economic implications if we were to keep up this bracket creep? Then I will turn to Senator Baucus.

Mr. ENTIN. The Congressional Budget Office has done a little piece on this in their budget book. They referred to roughly 24 percent of the rise in revenues as a share of GDP as coming from the effect of bracket creep, and another 20 percent from the changing wage patterns as many new high-income jobs have been created.

The combined effect is over 40 percent of the gain, and it is a very substantial effect. It goes on every year. It is getting worse and worse. I suggest that we find some way to lower the rates and then perhaps adjust the tax brackets more, for real wage growth as well as just inflation.

The CHAIRMAN. So you are saying the future economic implications, if we continue down that road, are bad.

Mr. ENTIN. Yes, they are. Eventually, if everyone gains income, they are all going to be in the top tax brackets.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. I just have one question of timing. In 1997, we reduced the capital gains tax, beginning this year. From 20 percent, the rate will drop to 18 percent for assets held 5 years.

The real question I have is, when does this have an economic impact? When it is enacted? When it is in effect? How much? When it is talked about? I mean, my guess is, we did that mostly, and we had a lot more taxes, but when is the economic impact here?

Mr. ENTIN. Going from 20 to 18 is not that big a change, but it does have an effect insofar as people look forward.

Senator BAUCUS. Ours just went.

Mr. ENTIN. Insofar as people look forward, it would have an effect when it was enacted. But the problem with the particular drop that you have in mind is, I think, that it only applies for assets purchased after the beginning of this year going forward and held five years. Under that provision, in current law, if you want to get the extra two points off on existing assets, you have to pretend you sold the assets on December 31, or January 2nd, I forget which, marked-to-market, and pay the added tax on the accrued gain, then get the lower rate later on one subsequent gain when you sell it.

Depending on how long they are going to keep the assets, I suspect very few people will take advantage of this on old assets. So it will begin to take effect now, this year, for assets purchased from now on that you intend to hold 5 years or more.

Senator BAUCUS. So when will the second 5 years of the Bush tax proposal take effect, really? I mean, people anticipate today that it is going to be lower five years from now, so will they make decisions today based on knowing that?

Mr. ENTIN. They will, yes, in a myriad of ways affecting their work and paving.

Senator BAUCUS. You trust the Congress that much not to change it?

Mr. ENTIN. Well, people will discount the tax cut if they are uncertain. They will assume part of it. The closer it comes to being realized, the more they will take it seriously. But if you are thinking of going to school and earning additional income and you know your taxes are going to be lower throughout your working life than they are now, if you really think Congress is going to do fundamental tax reform, if you think taxes on interest are going to be substantially lower than they are now, you are going to be more inclined to do these activities than if these things are not even on the horizon. Just how much the public trusts the Congress and how much you can bind a future Congress is problematical.

Senator BAUCUS. I would like, Dr. Aaron, your thought on that point.

Dr. AARON. Yes. Well, you have asked one of the most difficult questions. The true answer is, nobody knows. The reason nobody knows that alternative assumptions about future tax rates are equally plausable one could assume that current rates, as you pass them this year, will remain in effect until the sun cools. Or you could assume that Congress is going to change them in some direction, but God knows which, in the future.

Some people make very long-term calculations, and others do not. It is easy to make assumptions in economic models and to publish journal articles with based on extrapolations of arbitrary assumptions, but actually describing how a tax law is going to operate in the real world where people are making economic decisions is a much harder task.

I think the answer is, nobody knows for sure. There is some short-term effect. There will be some effect later on as decisions get made if the rates stay in effect.

Cutting rates does affect decisions at the margin by some amount, and the effects, I think, are spread over time. If that is a wishy-washy answer, so be it. I think it is the truth.

The CHAIRMAN. Now, Senator Graham of Florida.

Senator GRAHAM. Thank you, Mr. Chairman.

I am returning to my questions about the potential stimulative effect of a tax cut. Some economists, including Chairman Greenspan, have suggested that a significant part of our current economic slow-down is due to an over-supply of inventory and that this excess inventory must be sold before the economy will begin to move aggressively forward again.

If that is a significant part of our current economic slow-down, would not a speedily-enacted, front-loaded, marginal tax rate reduction targeted at those families most likely to spend help create the consumer demand which would result in a reduction of this excess inventory?

Dr. AARON. The answer is yes. Inventory recessions tend to be short and relatively sharp. If you want to affect the current economic downturn, you want to enact your cut faster and get it incorporated in withholding tables, which can be done in three to four weeks, according to Fred Goldberg, whom I asked this question of just a week ago.

You do want it front-loaded, although people do not react as much to temporary cuts as they do to permanent ones. You would want to focus it on lower income households who are likely to spend the money relatively quickly and in larger proportions than would upper income households, as far as personal cuts are concerned. Business cuts are much slower to play out in their effect on the economy, but they may have larger effects down the road.

Mr. ENTIN. I would urge you to get the tax cuts as large as possible and as deep as possible in the rates, and as soon as possible, including being retroactive, not just in the bottom rate, but in the higher rates where more income is earned and more response is likely.

I do not analyze it in terms of giving people money to spend. You would have given the money back to the bondholders, it would have gone into the credit markets, the same people would have borrowed and spent it anyway.

But the production incentives and the work incentives would be in place earlier and stronger, and that is how you get out of the situation sooner. That is why the recovery would be stronger.

The CHAIRMAN. Now we go to Senator Breaux.

Senator BREAUX. I do not have any questions. I would just like to thank the panelists. There is a wealth of information down there, and we would like to be able to call on you gentlemen in the future as we develop this legislation.

The CHAIRMAN. All right.

Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman. I believe Dr. Aaron has touched a little bit on what I wanted to just mention. But after the election, the rhetoric surrounding the tax plan kind of swung from giving tax cuts to those who pay taxes to, we need a tax cut to stimulate the economy. However, the tax plan did not change any. It is still the same tax plan.

The average family income in Arkansas is $29,000, roughly. Fifty percent of the tax returns in Arkansas have gross incomes of smaller than, or just under, $20,000. Eighty-three percent of our returns in Arkansas have an AGI under $50,000. So, clearly, very few dollars of this tax cut are going to come to our State. We are not going to see a tremendous amount of that. I would imagine there are other States similar.

But my question is, can this Bush plan really be described as a vehicle for economic stimulus? I know that Mr. Entin has just mentioned that those returns need to go to the upper brackets where their investments are elsewhere, but it seems to me that not only are all the cuts pushed into the out years, but they seem that the people like my constituents, who have a very high propensity to consume, the people who need to pay off their bills, to buy new clothes, the people who need to buy a washing machine, a microwave, whatever, those people are not going to get any of these tax cuts.

Mr. ENTIN. When I said "upper brackets," I meant above 10 percent. So, that includes the 15. I did not just mean the very top.

Senator LINCOLN. Still, 75 percent of us in the State are——

Mr. ENTIN. If you want to help your constituents more and longer term, it is important to get the pre-tax wage up and their ability to save up. You can give them a $100, $200, $300 tax cut, but if you can raise their salaries by $2,000 or $3,000, they are better off. Ultimately, restoring growth and productivity gains does more good and it is the efficiency-related tax cuts that do that.

They are better off with those than just getting a short-term give-back on what they are already paying on their current low incomes. That is why we have to look ahead to the growth effects of the cuts.

I do not think you are going to get too much demand stimulus, even in the short run, because, as I said, you would have been paying down the debt and that would have been going into the credit markets and being spent anyway.

Dr. AARON. I find it hard to see how one can argue that a tax cut for the top 1 percent that exceeds the annual income of half of American families is fair because it would be a good idea to give college loans to low-income families that is one is currently proposing to increase.

I think all families deserve the chance to educate their children, but it would also be a step up in fairness to make sure that any tax reductions are spread equitably across the income distribution.

Senator LINCOLN. Thank you, gentlemen, for your testimony.

The CHAIRMAN. Thank you, Senator Lincoln.

Before the panel goes, one of the things that Senator Lincoln asked about was the AMT, and I agree on that. I only would like to point out that the President's budget does, to some degree, respond to this by taking the child credit out of AMT permanently.

Then, also, I am not encouraging dialogue on this unless I am wrong, but Senator Kerry, in your discussion and also from his discussion with Secretary of Treasury Paul O'Neill, this business of counting foregone interest as a specific add-on to the cuts only. I do not think Senator Kerry takes into consideration that the interest is already counted in the President's budget.

So, I think what I would like to make clear for everybody, so we are all singing off the same song sheet, that $1.6 trillion is a tax figure that we hope to get from the Budget Committee, and that any additional figures are irrelevant for budget accounting purposes because they are taken into consideration in the bottom line.

Now, also today Senator Kerry seemed to be counting additional proposals, like marriage tax relief, the death tax, and adding these items to the $1.6 trillion. I want to make clear that they are included in the President's budget in that $1.6 trillion figure.

So even before the President said he did not want to cede $1.6 trillion, I was saying that $1.6 trillion is the figure that we hope to be working with, and we hope the budget resolution allows that up to that point.

I thank each of you for your kind participation. You have been very patient for an hour and 40 minutes.

It is now my privilege to call to the table Carol Markman. She has more than 20 years accounting and tax preparation experience. Her firm is in the income tax return service for individuals, small business, estates, and not-for-profit organizations.

She happens to chair the Tax Policy Committee and is a member of the board of directors of the National Conference of CPA Practitioners. She will be representing them today. She is accompanied by Mr. Robert Goldfarb and Mr. Alan Feldstein, also of the National Conference of CPA Practitioners.

Then we go to Michael Brostek, testifying on behalf of the General Accounting Office. He is director there of Tax Administration and Justice Issues.

Then we have Glen Bower, director of Revenue, State of Illinois. Last year, Mr. Bower received a 2-year appointment to the IRS's Electronic Tax Administration Advisory Committee. He served at one time as chairman of the Railroad Retirement Board, and he also served as a member of the Illinois House of Representatives, and State's Attorney in Illinois.

Our final witness, Jeffrey Liebman, assistant professor of Public Policy, Harvard, Kennedy School of Government, teaching courses in tax and budget policy. His previous work has examined the impact of the Earned Income Tax Credit on labor supply, taxpayer compliance.

He is currently working on the evaluation of housing mobility and studies dealing with Social Security reform options. He served at one time as Special Assistant to the President for Economic Policy, and coordinated the Clinton Administration's Social Security reform technical working group.

We will start with the way we introduced you, so we start with Ms. Markman.

STATEMENT OF CAROL MARKMAN, CERTIFIED PUBLIC ACCOUNTANT, WESTBURY, NY

Ms. MARKMAN. Good morning, and thank you for inviting us.

I would like to just tell you that the membership of our organization, the National Conference of CPA Practitioners, is the only professional organization representing only certified public accountants in public practice. Our membership consists of CPAs located throughout the country, with a concentration of chapters in the Northeast section.

Many of our members are also members of the American Institute of Certified Public Accountants, an organization with which you all are already familiar. The AICPA membership includes practicing CPAs, but also includes non-practicing CPAs such as educators, accountants in private industry, and government.

More than 65 percent of the total AICPA membership do not work within the public accounting arena. The members of NCCPA deal with the Internal Revenue Code on a daily basis directly with the public.

We live the Internal Revenue Code each day, and sort through its complexities constantly. We estimate that our members serve more than a half a million businesses and individuals throughout the country, and we very much appreciate the opportunity to speak with you today.

Until the Tax Reform Act of 1986, if there was a deduction or credit in the Tax Code, it was available equally to almost every taxpayer without regard to their adjusted gross income.

The 1986 Act changed the Code from 15 brackets to 2 brackets, 15 and 28 percent. The offset to this simple rate structure was the beginning of the phase-in and phase-outs of deductions and credits.

In 1998, for the first time the personal exemption began to be phased out. Most miscellaneous itemized deductions, including unreimbursed employee business expenses, were deductible only to the extent that they exceeded 2 percent of adjusted gross income.

Beginning in 1987, only 80 percent of business meals and entertainment expenses were deductible. For the first time, only taxpayers who were not active participants in employee pension plans and those with very limited incomes could make deductible IRA contributions. The 1986 Act also eliminated the deduction for sales tax, credit card interest, and other consumer interest.

At that time, the Alternative Minimum Tax rate was 21 percent. Beginning in 1991, most taxpayers with income above $100,000 began to lose a portion of their itemized deductions. The only taxpayers with incomes below $100,000 that also lost their itemized deductions were taxpayers who filed married, filing separately.

This limitation is calculated after all of the other limitations, and up to 80 percent of itemized deductions can be lost as a result of this provision. Since that time, as you know, tax rates have increased to the current stated maximum of 39.6 percent. But phaseouts have proliferated, effectively raising this marginal rate far beyond the stated rate.

As new tax benefits have been introduced, many are limited by adjusted gross income. The public's perception is that the Tax Code gives benefits, deductions, and credits with one hand, and takes them away with the other.

There are some provisions of the Code, such as education credits, that, in our experience, are only available to taxpayers such as single parents who received untaxed child support. A newly-married couple with income of $111,000 who rent an apartment in New York City cannot deduct the $1,400 in student loan interest that they paid. They are ineligible.

Deductible IRA contributions, in my practice and others, seem only to be able to be made by divorced individuals who receive alimony payments from their former spouse, because they are not available to many other taxpayers. Those taxpayers that have the funds to make contributions are not permitted to do so if they have pension plans at their place of employment.

A taxpayer that would prefer to make an IRA contribution early in the year to take advantage of the maximum tax deferral may not be able to do so, because an unexpected event at the end of the year may render the IRA contribution ineligible.

Prepared with regard to this testimony was a chart that was handed out separately. It shows some of the current phase-outs.

Many of these phase-outs are based on filing status. Others are different only for married, filing separately. Some phase-outs have kept pace with inflation, others have not.

The phase-out ranges are different for various deductions and credits, even for the same filing status. This causes massive confusion and complexity. In addition, the phase-out ranges are different depending upon which credit or deduction is being phased out.

One of the most serious problems with the phase-out that we, as practitioners face, is that you cannot sit down with a taxpayer and prepare a projection if the taxpayer is married, if their income is above $52,000, using only a pencil, paper, and a calculator.

The Code is so complex and provides so many phase-outs with different ranges, beginning and ending points, that it is impossible to prepare anything without being armed with serious worksheets, schedules, and charts.

The phase-out provisions exacerbate the problem of the marriage penalty. The present system of separate tables and schedules for single and married taxpayers has its roots going back to 1986, when most households had a single wage earner. Exemptions are phased out for high income taxpayers beginning at about $130,000 for single, but $190,000 and some for joint.

However, the reduction for itemized deductions for the same high income taxpayers begins when adjusted gross income is about $130,000, whether single or married. Why are there different amounts? There is no explanation, except for the fact that these laws were passed at different times and attached to different indices.

The phase-outs have an erosive effect on tax compliance and tax practitioners are forced to tell clients that many tax-saving provisions that they read in the press at this time of the year do not apply to them. They are considered rich, yet they struggle to make ends meet, living an ordinary lifestyle in some of our higher-income States.

My colleagues and I think it is prudent to permit taxpayers to utilize the deductions and credits currently available in the tax law before focusing entirely on lower rates. The elimination of the phase-outs will greatly simplify the tax law and make it more fair.

If the phase-outs must be continued, there should be uniform phase-out limits for most provisions and the limits should be adjusted to reflect the cost of inflation, and also living in the higher income States.

Thank you very much, on behalf of the National Conference of CPA Practitioners.

The CHAIRMAN. Thank you.

[The prepared statement of Ms. Markman appears in the appendix.]

The CHAIRMAN. Now, Mr. Brostek?

STATEMENT OF MICHAEL BROSTEK, DIRECTOR, TAX ADMINISTRATION AND JUSTICE ISSUES, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. BROSTEK. Thank you, Chairman Grassley, Ranking Member Baucus, other members of the committee.

I am pleased to join you today as you address a number of tax issues. You asked that I cover two areas: how payroll taxes fund Social Security and Medicare hospital insurance, and non-compliance issues associated with the Earned Income Tax Credit.

Payroll taxes are so named because they represent taxes imposed on wages. They provide funding for the Social Security program, including both the Old Age, Survivors Insurance program and the Disability Insurance Program. In addition, they fund the hospital insurance portion of Medicare known as Part A.

Because these taxes are earmarked to fund specific retirement, disability, and medical benefits to which workers become entitled through their qualified employment, they are fundamentally different from income taxes which are imposed on certain segments of the population and which are not earmarked for a specific purpose.

Payroll taxes, in total, represent 15.3 percent of covered wages. This amount is split evenly between the employer and the employee. Of the 15.3 percent total, 10.6 percent goes to the retirement portion of Social Security, 1.8 percent goes to disability insurance, and 2.9 percent goes to Medicare.

Social Security's retirement and disability insurance benefit payments are calculated based on a formula that replaces a larger portion of wages for low-wage earners than for high-wage earners. For those retiring in 2000, low-wage earners had about 52.8 percent of their wages replaced by Social Security payments versus 23.7 percent replacement rate for recipients who had been at the maximum Social Security wage level.

In contrast, hospital insurance benefits do not vary on the basis of an individual's wage history. Any actual benefits depend on the health circumstances of the individual.

Although the trust funds supported by these payroll taxes are solvent today, it is important to be mindful that demographic trends indicate that these programs will impose an increasing burden on the Federal budget in the future.

The trust funds will begin experiencing negative cash flows at various times between 2006 and 2015. When the trust funds begin drawing on their balances, the government will have to raise taxes, cut spending for other programs, increasing borrowing from the public, retire less debt if there is a surplus, or some combination of those.

As the Comptroller General testified last month, absent a fundamental change in the two programs, ultimately the government would do little more than mail checks to the elderly and their health care providers.

Referring now to the Earned Income Tax Credit, it is intended to encourage low-income persons to seek work rather than welfare. It does this, in part, by increasing the take-home pay of covered workers by reducing or eliminating their tax liabilities.

The Joint Committee on Taxation estimated that 87 percent of the EIC in 2000 would be in refunds over and above the income tax liability of individuals. These refunds more than offset the payroll taxes paid by many recipients, including, in many cases, both the payroll taxes paid by the individual and by their employer.

For example, in 2000, a head of household filer who had two children and earned $15,000 in wages would have earned an Earned Income Credit of $3,396. This credit would have been $1,076 more than the entire tax liability of the individual and the employer's portion of Social Security taxes.

A long-time concern associated with the EIC, however, has been its relatively high level of non-compliance. Most recently, IRS estimated that over 31 percent of EIC amounts claimed for tax year 1997 were over-claimed amounts.

The cause of these over-claims has also been a matter of concern. Many analysts and practitioners consider the EIC rules to be among the most complex provisions in the Code. Therefore, some non-compliance could simply be due to the complexity of the rules.

On the other hand, some portion of EITC over-claims, like non-compliance with any tax provision, could be due to intentional errors on the part of taxpayers.

IRS has not officially reported any information that identifies what portion of non-compliance may be due to confusion versus intent.

However, in conducting an earlier study in 1994, IRS asked its staff to make a judgment about whether they believed the errors were intentional. The staff judged that about half of the returns with over-claimed amounts, representing about two-thirds of the total over-claimed dollars, were due to intentional errors.

It is important to understand, though, that these judgments were subjective and may or may not represent the portion of non-compliance that was, in fact, intentional.

Concerned about compliance problems, Congress and IRS have taken various steps. Congress gave IRS authority, for instance, to treat invalid Social Security numbers as math errors. This enables IRS to disallow EITC claims with invalid Social Security numbers and to adjust any refund to the taxpayer.

In addition, for the 5-year period beginning in 1998, Congress provided IRS with about $143 million a year for an EIC non-compliance initiative. IRS has used its new math error authority to deny about $675 million in EIC claims in 1999 and 2000. Additional audit efforts on IRS's part have identified about $800 million in over-claims in those 2 years as well.

Although the new tools made available by Congress and the stepped up efforts on IRS's part to address non-compliance seem to be having positive results, IRS does not yet have data showing whether the overall compliance level has improved. Such data may be available as IRS completes its EIC compliance studies for tax years 1999 and 2001.

That concludes my oral statement. I would be happy to take questions.

The CHAIRMAN. Thank you, Mr. Brostek.

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

The CHAIRMAN. Now, Mr. Bower?

STATEMENT OF GLEN BOWER, DIRECTOR OF REVENUE, STATE OF ILLINOIS, SPRINGFIELD, IL

Mr. BOWER. Thank you, Mr. Chairman, Senator Baucus. thank you for the invitation to testify this morning.

Tax relief has been atop Governor George H. Ryan's agenda for Illinois. He has championed returning money to taxpayers, a theme that President Bush has sounded on the Federal level.

In the current fiscal year, Illinois citizens will enjoy more than $1 billion in tax relief that was not available when Governor Ryan took office.

As part of tax relief, Governor Ryan and State lawmakers enacted a series of tax relief programs in the spring of 2000, under which 2.3 million homeowners received tax rebates, senior citizens saw expansion of our Circuit Breaker Program, particularly the portion that helps purchase prescription medicines, and low-income working families were given a State Earned Income Credit which is 5 percent of the Federal EIC. It is non-refundable.

The Illinois EIC adds one line to the Illinois tax return and a simple worksheet in the booklet. We anticipate that 700,000 residents will receive the Illinois EIC in the first year, and the total credits will be about $35 million. The average payment will be about $50.

So far this filing season, we have seen 290,000 taxpayers claim the credit, 24 percent of all the filers to date, for $24.2 million in payments, or an average of $84 per return.

As constituted, the Illinois EIC represents affordable tax relief that can be effectively administered. The bottom line for these filers is that they receive a larger State income tax refund when they file their State tax returns.

The Illinois EIC fits with Governor Ryan's and President Bush's goals of reducing the burden on taxpayers. Illinois and four other States—Iowa, Maine, Oregon, and Rhode Island—have non-refundable credits. Nine States—Colorado, Kansas, Maryland, Massachusetts, Minnesota, New Jersey, New York, Vermont, Wisconsin, and the District of Columbia—have refundable credits. I have submitted a table displaying the characteristics of the various State EIC programs with my written testimony.

In Illinois, we can accommodate a non-refundable credit within the structure of our refund fund, which receives a fixed percentage of all income tax collections in order to repay any taxpayer's overpayment of taxes.

We expect to see math errors and other mistakes involving the Illinois EIC. The non-refundable nature of the Illinois credit will reduce exposure to fraud, because a taxpayer cannot receive an Illinois refund larger than what he would have paid in Illinois taxes.

Illinois performs some edits before allowing the EIC, but much of our compliance will be as a result of Internal Revenue Service actions. The same is true for other States with an EIC.

A recent General Accounting Office report showed that one-quarter of the Federal EIC claims are erroneous, and I just heard it was 30 percent. When the IRS reduces or disallows a Federal EIC, that will affect Illinois and other States.

The biggest drawback to this whole program, is the complexity of the Federal EIC, which must be determined before a taxpayer calculates the State credit.

To claim the Federal EIC, taxpayers must navigate seven pages of EIC instructions and worksheets included in the Federal 1040 tax booklet. There is a separate, whopping, 56-page instruction booklet just on the EIC. The entire Illinois 1040 booklet is only 36 pages long.

So far, 90 percent of those who have claimed the Illinois EIC have used a tax preparer. There are limited numbers of volunteer sites that provide free assistance, and the IRS is cutting back on its return preparation in Illinois. It is unfortunate that many of these taxpayers have to pay to have their returns prepared.

In recognition of the complexity of the program, the IRS has offered to calculate the Federal EIC for taxpayers who submit information on paper returns. Taxpayers who choose that option would have to wait to file their Illinois return, or file an Illinois amended return, in order to claim their Illinois EIC.

I would encourage three things. Any simplification of the Federal EIC that is possible should be enacted. The current complexity increases errors and reduces participation in the program.

Given that compliance, accuracy, and participation in State programs are largely contingent on Federal programs, such simplification will improve both State and Federal programs.

I believe that the IRS has some proposals in this regard that would align definitions of earned income and dependent children between the EIC and the Federal Tax Code, and make other simplifications.

Additional resources to allow the IRS to assist taxpayers who cannot afford to go to a preparer would also save low-income taxpayers money and assure that Illinois and other States receive accurate returns.

Finally, given the historic problems with the Federal EIC and the linkage with Illinois and the EIC, the IRS could be given authority to recover both Federal and State EICs that were issued incorrectly. This would leave taxpayers dealing with only one tax agency.

Thank you. I am happy to answer questions.

The CHAIRMAN. Thank you, Mr. Bower.

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

The CHAIRMAN. Now, Mr. Liebman?

STATEMENT OF JEFFREY B. LIEBMAN, ASSISTANT PROFESSOR OF PUBLIC POLICY, KENNEDY SCHOOL OF GOVERNMENT, HARVARD UNIVERSITY, CAMBRIDGE, MA

Mr. LIEBMAN. Mr. Chairman, Ranking Member Baucus, I want to thank the committee for the opportunity to testify about the Earned Income Tax Credit, one of the great success stories of recent American economic policy.

The Earned Income Tax Credit was enacted 25 years ago under economic circumstances remarkably similar to those that we face today.

When President Ford assumed office, the country was in a recession. In his first State of the Union Address, President Ford proposed a large tax cut, with the goal of getting the economy moving again.

This committee, under the leadership of Chairman Russell Long, modified the President's proposal, adding a new program called the Earned Income Tax Credit, to ensure that all working families received a boost to their incomes as part of the economic stimulus package. Thus began the process of redesigning the U.S. system of income support into one that makes work pay.

The expansions in the EITC, enacted with the support of Presidents Reagan, Bush, and Clinton, have continued the process of making work pay for low-wage workers.

As recently as 1993, a single-parent family with two children and a full-time minimum wage worker made about $12,000 in today's dollars with the Earned Income Tax Credit, well below the poverty line. Because of the expansions in the EITC during the 1990's, that family now makes over $14,000, a 17 percent boost that puts the family above the poverty line.

Moreover, the expansions of the EITC have dramatically changed the work incentives facing single mothers. In 1986, a single mother who left welfare and took a job paying $10,000 a year would have received an increase in her income of only $1,861, lost welfare benefits, and increased taxes would have offset 81 percent of her earnings. Thus, there was hardly any incentive for her to leave welfare. In 1998, in contrast, she would have received an increase of $6,875.

These changes in work incentives have been a major factor in the reductions in welfare case loads and the increases in work that we have seen in recent years. In 1986, only 73 percent of single mothers worked at some point during the year. By 1993, that number had risen slightly to 75 percent. But over the past decade, this number has reached 89 percent.

While the successes of the EITC in boosting the incomes of low-wage workers and making work pay are truly remarkable, there are two potential problems with the credit that deserve additional attention from policymakers.

First, the phase-out of the credit creates high marginal tax rates for some EITC recipients. Second, a significant fraction of EITC payments are made in error. For families with incomes above $12,700, the EITC is phased out at a rate of about 16 percent for families with one child, and about 21 percent for families with two or more children.

Because some families affected by the EITC phase-out also have positive pre-EITC Federal income tax liability and therefore face a marginal tax rate of 15 percent, the total marginal tax rate from the Federal personal income tax for these families can be as high as 36 percent. Only very high income taxpayers face higher marginal tax rates.

Second, a recent IRS study of taxpayers claiming the ETIC in 1997 found that about 26 percent of EITC dollars were paid in error. While there are a number of reasons why this number overstates the true cost to the Treasury of erroneous EITC payments, it is clear that there continues to be a significant EITC compliance problem.

Most EITC errors are associated with the complicated Tax Code provisions governing family issues. Examples of these kinds of errors include a divorced father who shares custody of the child and who provides child support, but incorrectly claims the EITC because the child spends slightly more than half the nights of the year at the mother's home, and the mother who is ineligible to claim her child because she lives in her own mother's home, and her own mother has slightly higher income than she does.

President Bush's tax proposal would make significant progress in reducing the high marginal tax rates faced by EITC recipients. However, a substantial number of families with one child would still face high marginal tax rates.

Moreover, the President's plan would do nothing to reduce the complexity created by the different eligibility rules for the Earned Income Tax Credit, the child credit, and the dependent exemption. It also does less than it could to reduce marriage penalties related to the EITC.

I would urge members of this committee to use this year's tax bill not only to cut taxes, but also to simplify the Tax Code. By combining the EITC, the child credit, and the exemption for dependent children into a single tax credit, it would be possible both to eliminate the high marginal tax rates and marriage penalties faced by some EITC recipients and to greatly reduce the complexities that produce the EITC compliance problem.

In conclusion, the EITC has been remarkably successful in moving people from welfare to work. Now it is time to remove the barriers that could prevent these new workers from moving into the middle class.

The CHAIRMAN. Thank you, Mr. Liebman.

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

The CHAIRMAN. I am going to call on Senator Baucus to ask the first questions.

Senator BAUCUS. Thank you, Mr. Chairman.

To the panelists, this is all very interesting. I basically hear three themes. One, the ETIC helps a lot of low-income people and helps get people on the work rolls and off the welfare rolls. Second, I hear it is extremely complex. Third, I hear that there is significant overpayment by the IRS in the program. I am wondering if all four of you agree with those three basic observations.

[Nodding of heads.]

Senator BAUCUS. I see four heads nodding, for the record.

Now, the next question is, what do we do about all this? That is, how do we enhance what works and remedy what does not work.

Let us talk, first, about the complexity. How much does the complexity prevent full utilization of EITC in a proper way, not in a fraudulent way?

Mr. LIEBMAN. I think the best evidence of that is a few years old from some studies that Karl Scholz, at the University of Wisconsin, did. He found that something like 85 percent of eligible taxpayers took advantage of the EITC, which is a slightly higher number than, for example, the percentage of eligible food stamp recipients or AFDC recipients who receive benefits from those programs.

So it appears that by using the Tax Code, with its low administrative cost and its lack of stigma, to transfer money to low-income families, we are actually getting more eligible taxpayers, to receive the dollars that they are entitled to.

Senator BAUCUS. So it does not bother any of the four of you—and it does bother some, not this Senator—that on that basis some people get back a refund that is more than, say, their payroll tax?

Mr. LIEBMAN. I would actually like to say something about that, because Senator Nickles commented on this earlier.

Senator BAUCUS. Yes. Right.

Mr. LIEBMAN. I think I would like to give a slightly different interpretation to the kind of numbers he was using.

When economists think about the burden of the payroll tax, it is not simply the part that the worker pays. Economists think that, because the employer also has to pay a portion, the worker's wage is presumably lower than it would be otherwise. Therefore, when you think of the burden of the payroll tax, you need to add both the employer portion of it and the employee portion of it.

So the kind of numbers that Senator Nickles described would not look nearly as high if you take into account the fact that the full burden of the tax is borne by the worker, regardless of whether it is paid by the employer or the employee.

That said, it is quite clear that there are EITC recipients who receive more in the EITC than they pay in the payroll tax, and those are basically EITC recipients, if they have one child, with incomes below $14,000, or with two children, if they have incomes below $18,000.

So, the people who are getting more in the ETIC than they pay in the payroll tax are exactly those working families who would be poor if it were not for the EITC.

Senator BAUCUS. How do we simplify in a way that makes good sense? Who wants to take a crack at that, the things we do to simplify?

Ms. MARKMAN. The Earned Income Tax Credit is so complex, that the people who come to practitioners such as myself and my colleagues who are not eligible for the Earned Income Tax Credit. Many of them do not have the funds to hire a paid preparer.

This may be part of the issue with the non-compliance, the fact that they go to their friends who have mastered it in some fashion, or they go to some government program, like VITA, that does provide people who do prepare these returns.

As practitioners, we are really frightened of doing these returns because there are specific penalties in the law that, if we prepare a return and we have not done our due diligence, and the EITC is eventually determined to be inappropriately requested, there are specific penalties that we would be subject to on that one part of the law.

So, that discourages paid professionals from even doing EITC returns. So what the law has done, is it has created a disincentive to have people, professionals, help people prepare their tax returns.

Senator BAUCUS. Let me ask this question. What is the root? What is the main reason for the fraud?

Ms. MARKMAN. In my opinion, one of the issues with the fraud has to do with the fact that there are some people who work both on the books and off the books. This is from the employer side, as well as the employee side. They arrange their affairs so that they maximize their Earned Income Credit. But this is not easily uncovered.

Basically, this is a criminal act. There has got to be a conspiracy. There are a lot of issues here and it is very, very complicated. I believe that that really happens. We have anecdotal evidence that it does. So on the one hand, yes, it is helping people that it needs to help, but it is also providing funds to are not entitled to it.

Senator BAUCUS. You want us to simplify it, so we want to know what to do. We want to know what is right. So you are the experts. What do we do?

Mr. BROSTEK. If I could at least let you know what the most frequent error is that has led to the non-compliance rate that IRS found. That error has to do with the definition of the qualifying child, and meeting that definition.

The definition of a qualifying child differs from the definition of a dependent in the Tax Code. It is confusion about that definition, or exploitation of the difference of that definition, that has led to the highest portion of the non-compliance that the IRS uncovers.

Senator BAUCUS. So what do we do about that?

Mr. BROSTEK. There have been a number of suggestions to try to merge together the definition for a dependent child and the EIC so there are not separate definitions, and to simplify one or both of them.

Senator BAUCUS. Other thoughts? Yes, Mr. Bower?

Mr. BOWER. Senator, as Ms. Markman referred to, when you have a 56-page instruction booklet and a 7-page basic worksheet——

Senator BAUCUS. It is daunting, to say the least.

Mr. BOWER [continuing]. And it is aimed at the lowest economic level, then as I indicated in my testimony, the Illinois experience is that the vast majority of people who have thus far filed have gone to tax preparers. Those are the people who are least likely to be able to afford to pay tax preparers. There are never enough of those sites available and people to help prepare lower income people.

Our experience in Illinois is that, thus far, you have to have the Federal EIC first to calculate ours. But 44 percent of the problems this year are math errors, then the remaining 56 percent are for people who just do not qualify for one reason or another.

Senator BAUCUS. I think the Chairman is about to make suggestions in this area, which I agree with.

The CHAIRMAN. I was going to suggest to you that maybe you and I could have our staffs look at our drafting a joint letter that would go to IRS, and ask them to look at what the root cause of the problem is, and maybe make some suggestions, and, most importantly, how to simplify it.

Senator BAUCUS. Yes. Right.

The CHAIRMAN. Because part of the fraud is because of complexity. If you would like to do that——

Senator BAUCUS. Yes.

The CHAIRMAN. All right. I appreciate that very much.

Did you have a further question?

Senator BAUCUS. No. I am fine, thank you.

The CHAIRMAN. All right.

Mr. Liebman, I had a conversation with Mr. Entin on the first panel in which he commented that one way to address a payroll tax burden for low-income families would be to enact President Bush's proposal to set aside 2 percent of the payroll tax for private savings accounts.

You have done work in this area. Would you agree that this would be a way to allow workers to keep some of their payroll tax money, albeit it would be a forced savings under most proposals?

Mr. LIEBMAN. I guess it would depend on the specifics. But if basically what was happening was that instead of paying 2 percent in payroll tax and then getting a Social Security check later they took 2 percent and put it in an individual account and got a comparable amount back when they retired from their individual account, it really would not change how well off these families were at all.

The CHAIRMAN. Well, it would in the sense that they would get credit for the interest and it was invested, and the Social Security fund today would get credit for that investment, plus the fact that it would be part of their estate, plus if it is done like Federal workers would do it, which is one of the suggestions, it would be a government-managed account, it would generally bring in about twice the rate of interest on a 100-year average of the stock and bond market compared to what Treasury bills do today, so they would have that additional. It would not be a wash.

Mr. LIEBMAN. It would depend. At the moment, the current Social Security benefit rules are somewhat favorable to low-wage workers, although the fact that they have lower life expectancy offsets a lot of the benefit that they should get from the system, since they do not get benefits for as many years, as higher wage workers do.

But the issue in terms of thinking about the potential for them getting higher returns, and therefore higher benefits, is of course we would somehow have to pay the benefits for all the current retirees, and we are currently expecting to use the payroll tax revenue to pay benefits to those folks.

So the question is, how would we come up with the extra revenue for that? If we did it in a way that was putting a higher share of the burden on higher income folks than with the payroll tax, we could probably make lower income folks a lot better off in this transition.

The CHAIRMAN. But if you lowered the payroll tax today, you would have that same problem of having enough money coming in for existing retirees, the same way.

I would follow up with you again, or any other members of the panel that might want to respond to this question. There has been a lot of debate, and we have just had it stated here, about the regressive nature of the payroll tax and the need for some offset, and whether to do that in this package.

There is no doubt about the payroll taxes being regressive. You have already stated about how the payout would be a little more progressive, offsetting the regressivity of the payroll tax. We always talk about one, regressivity, but we do not talk about the progressivity of the payout. So, hopefully across the board of a lifetime, it is a wash.

But, regardless, my question goes to the point that there is no income tax benefit for low-income payroll taxpayers. The EIC was designed to offset the payroll tax burden for low-income workers. Furthermore, the EIC was expanded four times over 22 years, in 1978, 1986, 1990, and 1993.

So it seems to me that we have a situation, Mr. Liebman, where I hope you would agree it is true, that our tax system already includes refundable tax credits to offset the regressive nature of the payroll tax for low-income workers.

Mr. LIEBMAN. It certainly does for the workers up to, say, about $14,000. They get back about as much from the EITC or more than they pay in payroll taxes. Above that point, they pay more in payroll taxes than they get back from the EITC.

The CHAIRMAN. Yes. Then also consider the fact that we have had four major tax increases on taxpayers since we have had two tax decreases of income tax. We had a tax decrease in 1981 and 1997, and we have had tax increases in 1982, 1984, 1990, and 1993.

Would anyone disagree with the notion that there is more apt to be an increase in payroll tax credits through the EIC than there would be income tax cuts? We have had two income tax cuts, we have had four increases in the EIC credit.

So I think Congress has been much more in a hurry to respond to the regressive nature of the payroll tax through the EIC than they have been to decrease taxes on payroll taxes. You saw from this chart up here what a dramatic increase we have had in income taxes, a fairly steady rate of taxation for social insurance.

Would anybody disagree with the Congressional Budget Office data that the on-budget surplus has largely been generated by the record levels of income taxes, and not payroll taxes that has been shown on that chart? Are we in agreement on that, all of us?

Mr. BROSTEK. I do not have a basis, actually, to opine on that. I am not familiar with the analysis.

The CHAIRMAN. Well, we tried to show it here. The payroll tax has been very constant. Even corporate rate tax is fairly constant, other taxes. But we have had big increases in income taxes.

In fact, if you take the big increase in income taxes and take what less we are spending on defense, this accounts for all of the balancing of the budget and paying down of the debt that we have done. Is that right? I had better just make sure. Yes. One other item, as my staff just reminded me, the interest that has just been paid.

Where did that chart come from? I thought we had that chart. [Laughter.] Anyway, would you take a good look at that? [Laughter.]

Senator BAUCUS. I am taking a good look, Mr. Chairman.

The CHAIRMAN. All right.

Now, this will be my last question, and it would be for you, Ms. Markman. It is in regard to your practice and people you deal with, and the issues of the phase-outs and the Ps provisions.

Are there individuals that you deal with that are very extremely wealthy, like maybe does your practice comprise millionaires?

Ms. MARKMAN. I have a few. I wish I had more. [Laughter.]

The CHAIRMAN. Give me kind of a first-hand description of your clientele's personal situations then before I go on.

Ms. MARKMAN. Well, I do have some people, because of circumstances, who have had incomes that have been quite substantial as a result of stock options that came due, companies that are merging, and therefore people are losing their jobs so they have to exercise these stock options. The largest W–2 I have ever held in my hand was over $8 million, and it was scary. This gentleman——

The CHAIRMAN. Now, these are very much a minority, though, of you practice.

Ms. MARKMAN. Oh, absolutely. Absolutely.

The CHAIRMAN. Let us go back to the vast majority.

Ms. MARKMAN. The vast majority, I would say, have incomes of perhaps in the $100,000 to $200,000 range. Because of where my practice is located, it is very hard, very difficult to live on a lot less.

The CHAIRMAN. From the standpoint of New York City, that does not make them extremely wealthy.

Ms. MARKMAN. I am not in New York City. I am in one of the suburbs of New York City.

The CHAIRMAN. What are their responses when you tell them that they are not eligible for the deductions, for instance, for personal exemptions?

Ms. MARKMAN. When they start to phase out, the question is why? Why me? I am barely making ends meet. Why is this happening to me? What can I do to change it? The answer is, there is nothing that anyone can do. It is very easy to say we will make less money, but that does not work.

The CHAIRMAN. To what extent do the phase-outs complicate your work, such as return preparation and calculating the estimated tax payments?

Ms. MARKMAN. You really cannot do it without a computer because of the number of charts that are required. I brought a visual aide. This is something that I bought. You need this to sit down with a taxpayers to calculate a tax projection. It is really scary.

It also undermines our confidence, because I do not know, sitting here today, if you ask me a specific phase-out for a specific provision, I could not tell you without looking at a chart. That is not good. You are not able to do good tax planning.

Someone says to me, what is my marginal tax rate? Well, tell me your income. All right. I can look up their income, but it does not tell me what their marginal tax rate is because I have to determine, all right, what other provisions were you subject to? Did you lose miscellaneous itemized deductions because of the floor? Did you lose your medical? Are you affected by AMT?

I have had people say to me, well, I am thinking about selling a stock. What would it do to my taxes? I know you told me I am in the 31 percent bracket. Capital gains is 20 percent.

But the answer is, if your incomes are above these thresholds, your capital gain rate is not 20 percent, it is more like 22 percent because of the phase-outs of your itemized deductions, your exemptions, and other things.

What happens is, your actual tax rate is not clear. You cannot say definitely that a dollar increase in your income will result in a certain percentage change in your taxes. Also, two people with the same income will pay different taxes depending upon what their deductions are.

If your deductions are straightforward, you have real estate taxes and income taxes and some charity, and you are not subject to the AMT, I can give you a definitive answer that you may lose some of them, but I can give you a definitive answer.

On the other hand, if you have employee business expenses or other miscellaneous itemized deductions, I cannot give you a definitive answer without doing a whole lot of calculations. That is not good tax. It is not simple, it is not fair, it is not equitable.

I think Congress really needs to consider how to make the law such that it has been in the past. All of these provisions have come in basically in the last 15 years. The only phase-out that we had prior to that was on medical expenses. So, all of these have been introduced since the 1986 Tax Act. I think it is time to begin to roll them back. They were done, I believe, for economic planning policies. They could only have been designed by a computer.

You sitting here could not design a Tax Code like this without your economic models that say, we want to target this group so we will fix that, and we want to target that group so we will make that adjustment. But you cannot do it with a pencil, piece of paper, and a calculator. It is way too complex. I think that is has permitted a law that has gotten out of hand. It really has.

The CHAIRMAN. Mr. Bower, if we were to simplify the EIC, would it encourage your State and other States to expand their EIC?

Mr. BOWER. I would think that it probably would. This is our first year. It is experimental, for three years. It is going to cost us $35 million. If we were to make it a refundable tax, we estimate that this year it would cost about $27 million more.

If we had a simpler Federal calculation, after we have had our experiment in Illinois, we might well expand it. But the Governor has already indicated that he believes that it ought to be expanded in Illinois.

The CHAIRMAN. Mrs. Lincoln, did you have any questions?

Senator LINCOLN. Thank you, Mr. Chairman.

I would like to compliment Mr. Liebman on his testimony. I am hoping he is probably aware that Arkansas is one of the highest EITC populations in the country. I look forward to working with him to come up with some helpful initiatives that we can present that are going to be beneficial, so that a tax plan can be beneficial to all Americans.

Just briefly, to follow up with Ms. Markman. There have been several today who have urged the elimination of the phase-outs of personal exemptions and the itemized deductions, as you were talking about just previously.

In your opinion, does that create another problem in terms of AMT? As I understand it, the personal exemptions and the itemized deductions are not allowed under AMT. Is that correct?

Ms. MARKMAN. That is not entirely true. Some itemized deductions are permitted under AMT. Investment interest is still permitted, casualty losses are still permitted. They are very, very limited, however.

This all came about when the law was changed with regard to AMT. Prior to 1986, you took your income, you looked at your adjusted gross income, and based on that, you were either subject or not subject to the AMT. That is what we called a top down tax. We now have a bottom up tax, where we start with taxable income and add things back to determine AMT.

The answer is, yes. If you start doing this, if you put the deductions back but do not modify the AMT, more and more people will become subject to the AMT, as I believe will happen even with the President's tax bill, because that will create a second structure.

Senator LINCOLN. Absolutely.

Ms. MARKMAN. With an AMT rate of 26 or 28 percent, and the highest rate of 33, I think you are going to have more and more people subject to AMT, which allows almost none of the deductions. It is going to discourage giving to charity, it is going to discourage a lot of activities that we have, in this country, attempted to encourage.

Senator LINCOLN. Thank you.

Mr. Bower, I had the opportunity to speak to your group, the State Treasurers, earlier. I guess, yesterday, it was. We discussed some of the effects of what President Bush's tax plan would have on State revenues, due to piggy-backing and lost revenues from estate tax collections. We did not have a great deal of time to talk about it, and I wish we had had more.

But my State of Arkansas, as well as many of the States who have passed tax cuts in the recent years, such as Virginia and Texas, I know, are already experiencing trouble in balancing their budgets.

While you are here at the committee, I would be interested to have your input, and certainly your answer, as to ask you if you have an idea of how much revenue the State of Illinois would lose as a result of the passage of the proposed Bush tax bill.

Mr. BOWER. I do not have those figures. I can tell you that Illinois has a strong economy. Governor Ryan believes that tax cuts are beneficial to the people of Illinois, and will probably help stimulate the economy in Illinois. I think that obviously revenue growth is not as great as it has been, but we have a strong economy. The Governor is in general support of the President's program.

Senator LINCOLN. So you do not believe you would see any revenue loss in your State?

Mr. BOWER. Well, you may see some losses in one place, and hopefully offset by increases in others.

Senator LINCOLN. I was just curious. When talking to the treasurers, they had indicated that there would be a sizeable decrease, probably, in your revenue, just from the estate tax reduction.

Mr. BOWER. Well, the treasurers are a slightly different group than my group.

Senator LINCOLN. Right.

Mr. BOWER. Well, Governor Ryan, Speaker Hastert, and I were all members of the Illinois House when we eliminated the inheritance tax in Illinois.

Senator LINCOLN. Right.

Mr. BOWER. We think a death tax is basically an inappropriate tax. There is a consequence, because we have the pick-up tax in Illinois.

Senator LINCOLN. I do no necessarily disagree with you. I just think it is very important for us to take into consideration, as we look at this plan, everything that is going to happen and what kind of effects it is going to have on our States in terms of lost revenue, because many of them are suffering in other ways. But the indication from the treasurer of your State, was that there would be a sizeable decrease.

Mr. BOWER. There would be a decrease in revenue from that source, there is no question. I cannot speak for the Governor on that specific aspect of the program, because I am not certain what it is, but he is in general support of the President's tax proposal.

Senator LINCOLN. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. My staff was just pointing out to me, Senator Lincoln, that in regard to the States being affected by what we do about the estate tax, that the Democratic proposals in the Ways and Means Committee would also eliminate revenue that States receive from the estate tax as well.

Senator LINCOLN. My concern is just that we are all prepared for what is going to happen down the road as we look at this and weigh it out against all of the other proposals. Absolutely.

Thank you, Mr. Chairman.

The CHAIRMAN. I do not have a final question.

Senator Baucus?

Senator BAUCUS. Just a couple of points. I have just a summary of the EITC simplification and compliance Treasury proposals. Essentially, they cover some of the items that you have mentioned, the definition of earned income, a qualified child/dependent child conformity, which was mentioned. Abandoned spouse. I think that was mentioned. AGI tie-breaker. That was mentioned, too. Math error authority. I do not know if that was mentioned, but it is on the list.

I am sure you all have seen all of those, and you probably have some other ideas, the degree to which we would like to, and we ask this of you, give us other thoughts on how we can constructively simplify the EITC, it would be very helpful to this committee.

Mr. BOWER. Senator Baucus, the executive director of the Federation of Tax Administrators is here with me, and I am sure that our organization would survey the States to see if we have any suggestions that might be made.

Senator BAUCUS. Good.

I might say, too, Mr. Bower, I was very impressed with your Governor when, not too long ago, it turned out that someone who was incarcerated on death row in an Illinois prison was totally and improperly incarcerated, and was set free.

There are other, similar examples in Illinois. Your Governor had the courage to suspend any further executions of any prisoners on death row until all those matters were straightened out in Illinois. I just want you to know, I admire your Governor for his courage and for the action that he took.

Mr. BOWER. I will convey that to the Governor. He supports the death penalty, but he said that in the last few years there have been, I believe, 13 different people on death row who it was determined were not appropriately there. He said, as the last person who could make that decision, until there were major reforms in the law in Illinois, he was not going to allow any further executions. I will pass that on to the Governor.

Senator BAUCUS. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Ms. Markman, just before the panel goes—and I do not want you to repeat what you said in the last statement to my question—you are basically saying that targeted tax credits are really complex tax benefits to administer.

Ms. MARKMAN. They are extremely, extremely difficult. In certain ways, because of the nature of these phase-outs, it creates these cliffs where one additional dollar of tax can have a really significant impact on a person's tax, specifically with regard to the way in which the itemized deductions are phased out and the exemptions are phased out. So, it becomes very difficult to administer and very difficult to make those calculations. So, we need to work on that.

The CHAIRMAN. Let me say to all the members who attended here, and we had a pretty good turn-out, considering most Congressional hearings, that I appreciate very much the members who have come and participated. I hope their staff who are still here will relay my thanks to them, and particularly to the diligence of Senator Baucus.

To each of you who were on this panel, thank you, some of you, for coming a long ways to be with us. Thank you very much.

Thank you.

[Whereupon, at 11:36 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF HENRY J. AARON [1]

Mr. Chairman:

Thank you for the invitation to testify this morning before your committee on proposed legislation to lower personal income tax rates. My testimony will be framed as answers to five questions that I believe are central to appraisal of this proposal. I pose the questions, answer them briefly, and then amplify on those answers below.

Question 1: Is $1.6 trillion a reasonable estimate of the cost of the tax cuts now under consideration?

Answer: No. If all elements of President Bush's proposal are enacted, the cost is likely to be at least $2.5 trillion. To begin with, the direct cost of the cuts he has asked for is actually above $1.6 trillion, based on Joint Tax Committee estimates. Furthermore, the full cost of the plan includes added interest payments and the eventual, but inevitable, adjustments in the alternative minimum tax so that filers will receive promised cuts.

Question 2: Does the prospective budget situation justify a tax cut of the magnitude proposed by the administration?

Answer: The budget situation is favorable, but uncertain. While a tax cut of some size may be desirable, H.R. 3, which embodies the Administration's income tax rate reductions, is excessive. Furthermore, this tax cut and the various other announced plans of the Administration and Republican leadership in Congress are jointly inconsistent with future budget balance. Something has to give. You and other members of Congress will have to weigh these competing priorities. But until you have done so through the budget resolution, it is precipitate to move ahead with tax legislation.

Question 3: Given the pervasive signs of economic weakness, should a tax cut be enacted as part of an anti-recession strategy?

Answer: The tax reductions proposed by the Administration and embodied in H.R. 3 would have an undetectably small anti-recession effect. They are heavily concentrated in out-years when the nation will be long past any slowdown that may now be occurring. They are focused on income brackets whose members spend relativey little out of each additional dollar of income. More generally, discretionary changes in tax rates almost invariably come at the wrong time, a judgment that is well documented by liberal and conservative economists alike. Furthermore, accommodative monetary policy is necessary if tax cuts are to stimulate demand, and it is sufficient to stimulate demand, even without tax cuts. Tax policy, most economists now agree, should be designed with long-term objectives in mind specifically, how large the government should be and how much, if at all, the government should contribute to national saving.

Question 4: Is the proposed distribution of tax cuts fair?

Answer: The proposed tax cuts would lower the total tax burdens and increase after-tax incomes most for people in upper-income brackets who have enjoyed disproportionate increases in their before- and after-tax incomes over the past decade. Judgments about fairness are inevitably subjective. *You and other elected officials will have to decide whether you want to enact a tax cut that will reinforce the dramatic increase in economic inequality that has occurred in the past quarter century*.

Question 5: Is there a better way?

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[1] Bruce and Virginia MacLaury Senior Fellow, The Brookings Institution. This testimony reflects my own views and does not necessarily represent the opinions of the trustees, officers or other staff of the Brookings Institution.

Answer: Yes. The proposed tax cuts squander a rare and precious opportunity to dramatically simplify the U.S. tax system and to reform it to promote economic efficiency. Former House Ways and Means Committee chair, Dan Rostenkowski, recently commented in The Wall Street Journal, that tax reform is easiest when rates are cut. Tax cuts ease the pain of those who lose tax breaks repealed to achieve simplicity. If taxes are to be cut as much as the administration proposes, it would be possible to "buy" a lot of reform. The Administration's proposals contain little reform and in some ways further "complexify" the tax code.

IS $1.6 TRILLION A REASONABLE ESTIMATE OF THE COST OF THE TAX CUTS NOW UNDER CONSIDERATION?

The presentation of the Bush plan has been marked by inconsistency and incompleteness (see table 1). The description of the plan and illustrations of how those provisions will affect people do not agree with the amount President Bush has committed to reduce taxes. Furthermore, it now appears that the Treasury Department's estimates of the plan's cost are somewhat lower than those of the Joint Tax Committee.

If enacted, the Bush plan would subject many taxpayers to the minimum tax. By 2011, if H.R. 3 passes, an estimated 35.7 million filers would be subject to the minimum tax, 15 million more than if that bill is not enacted. Yet the examples used to illustrate the effect of the Bush plan do not point up the fact that those filers would not receive the tax savings promised by the rate reductions. To make sure that the tax cuts promised by H.R. 3 actually flow through to taxpayers would raise the direct cost of the plan by an estimated $292 billion from 2002 through 2011.

The full budgetary impact of any tax or spending bill includes its effects on interest obligations of the federal government. It is well understood that spending increases or tax cuts cost more than their direct cost because they increase public debt outstanding and the associated interest cost of that debt. Similarly, spending cuts or tax increases reduce interest payments. Some administration spokespersons have criticized the inclusion of interest costs in estimates of the price of the tax cut plan. It is hard to know how to respond to such remarks. Perhaps those who utter them have not lately run a credit card balance, taken out an auto loan, or negotiated a home mortgage.

The Cost of Tax Cuts Under Active Consideration		
Provision	Cost (billions of dollars)	
	Direct	Interest
Bush Tax Program		
H.R. 3	$958[1]	$ 253[3]
Adjustment of Alternative Minimum Tax (AMT) for rate cuts	292[1]	50[3]
Remainder of tax plan	809[2]	184[3]
Subtotal	***$2,059***	***$487***
Total Cost of Bush Program	***$2,546***	
Additional Tax Initiatives		
Additional marriage penalty relief, repeal telephone excise, raise IRA limits, lower inclusion of Social Security benefits	*$380*[3]	*$103*[3]
Total Cost: Bush Plan, plus Congressional Initiatives	***$3,029***	

[1] Source: Joint Committee on Taxation, #01-1 029, 28 February 2001
[2] *A Blueprint for New Beginnings*, Table S-9.
[3] Author's calculations

Table 1 displays the cost of the Bush plan taking these adjustments into account. Table 1 includes the Joint Tax Committee's estimate of the cost of H.R. 3, $958 billion. This estimate somewhat exceeds that of the Administration as reported in A Blueprint for New Beginnings. If one adds the Administration's estimates of elements of the plan not included in H.R. 3, the direct cost is not $1.6 trillion, but $1.77 trillion, ignoring added interest and modifications of the alternative minimum tax.

The bottom line is that the total cost of the Bush plan, with the JTC estimates, correction of the AMT, and interest outlay effects, is not $1.6 trillion, but a bit over $2.5 trillion. This figure does not include the cost of various other tax cut initiatives that have enjoyed strong Congressional support. Nor should it, because these cuts are not Administration policy. But prudent legislators cannot ignore that Congress may enact tax legislation in addition to the president's request. There was strong support in Congress last year for various additional tax cuts that may be added in the course of Congressional debate. I am not suggesting that Congress would blithely inflate the size of President Bush's requested tax cuts. But I do believe that the possibility that Congress might pass some of these provisions should cause it to temper the rate cuts it enacts now.

DOES THE PROSPECTIVE BUDGET SITUATION JUSTIFY A TAX CUT OF THE MAGNITUDE PROPOSED BY THE ADMINISTRATION?

The prospective budget surplus over the next ten years is $3.1 trillion according to the Congressional Budget Office. There is unanimous agreement, I believe, that the separate $2.5 trillion in reserve build-up in the Social Security trust funds should not be used to finance on-budget spending increases or tax cuts. It would make no sense for a business to declare a dividend because its employees' pension plan had a good year. This reserve build-up and much more besides will be required to provide the benefits promised under current law. To be sure, Congress may modify Social Security, but until it does so, these additions to reserves are "spoken for."

Pension Reserves. If one accepts the logic that additions to Social Security reserves should not justify on-budget spending increases or tax cuts, it is difficult to see how accumulations in the pension reserves held for federal employees should be used for current on-budget spending or tax cuts. Additions to those funds are projected at approximately $419 billion over ten years (see table 2).

Medicare. Similarly, if one agrees that Social Security reserves should not be used to underwrite tax cuts or spending increases, the same logic applies with equal force to accumulations in the Medicare Hospital Insurance trust fund, projected to run a bit under $400 billion. This accumulation should not justify tax cuts or on-budget spending increases, because the accumulating reserves and much more besides will be necessary to deliver on currently promised Medicare benefits, to say nothing of the additional costs that will be necessary to provide an adequate prescription drug benefit and to implement other reforms that members of both parties agree are desirable.

In *A Blueprint for New Beginnings*, the Administration argues that the Hospital Insurance (HI) surplus should be available to pay for tax cuts or spending increases because the overall Medicare system HI and Supplemental Medical Insurance (SMI) together will spend more than provided by payroll taxes and premiums. In a long life of seeing peculiar arguments, I must say that this one is among the most bizarre. The Administration points to the long-term financing problems of Medicare as one reason for prompt reform of that program, a sentiment that I completely endorse. At the same time, it argues that the admittedly inadequate reserves of the HI fund should be available to underwrite tax cuts or on-budget spending increases. But one cannot have it both ways. A system whose parlous long-term financial state supports prompt reform is not a system whose reserves can be treated as an on-budget piggy-bank.

Table 2
Disposition of the On-Budget Surplus

(Trillions of dollars)

Projected On-budget Surplus		**$3.12**
Less already committed funds		
Federal Employees Retirement	.42	
Medicare HI	.39	
Equals **Available On-budget Surplus**		**$2.31**
Less Administration Proposals		
Medicare drug benefit	.15	
Discretionary spending initiatives	.26	
Defense increases and missile defense	(.20)	
Added interest costs	.18	
Equals **"Revised Available" On-budget Surplus**		**$1.52**
Less Additional Spending		
Additional growth of discretionary spending	.26	
Additional interest costs (Discretionary Adds)	.08	
Equals **"Plausibly Available" On-budget Surplus**		**$1.18**

If one subtracts the build-up of federal employee pension reserves and of HI Trust Fund reserves, the remaining on-budget deficit properly available to underwrite tax cuts or spending increases falls to $2.3 trillion.

New Administration Initiatives. The Administration has also announced that it wishes to commit $153 billion to a Medicare drug benefit and to Medicare reform. That sum is insufficient to achieve the Administration's stated goals and I believe that Congress will go beyond these amounts if it passes legislation, but it is the Administration's policy. The administration has also called for increases in discretionary spending, other than missile defense and other defense increases that may come after the defense policy review, totaling $260 billion.

The president has refused to boost defense spending increases (beyond pay raises) until the completion of a thorough defense policy review. That restraint is admirable. But the presentation of a budget that relegates likely increases to a contingency reserve that is largely imaginary is not. I have assumed arbitrarily I admit that missile defense and other additions to defense expenditures add $200 billion over ten years to the defense budget.

Taking account of these items, plus the added interest outlays they will require, the revised available on-budget surplus drops to $1.5 trillion.

Additional Plausible Discretionary Outlays. The administration also proposes $230 billion in unspecified discretionary spending cuts. I have not included them in table 2. To begin with I am old enough to remember "Magic Asterisks" and I strongly believe in the old saying: "fool me once, shame on you; fool me twice, shame on me." In addition, I think all Americans should pay close attention when a highly respected Senate Budget Committee chairman, whose credentials as a conservative are unimpeachable, admonishes the director of the Office and Management and

Budget that the Administration's discretionary spending targets are too low. Discretionary spending has actually grown at an annual rate of 5.3 percent from 1998 through 2002 (projected under current policy by CBO). *If discretionary spending growth slows to 4 percent a year over the next decade, which would result in the steady decline of such spending as a share of GDP from 6.3 percent (its current level) to 5.8 percent, it would exceed the Administration's estimate by $490 billion cumulatively over ten years*. Since I have already excluded the claimed savings, that represents an addition to discretionary spending of $260 billion. One should also allow for the added interest costs that will result from increased discretionary spending.

The result is a projected surplus of $1.18 trillion. I believe that the $1.18 trillion estimate for the budget surplus is still unrealistically high as 4 percent growth in nondefense discretionary spending seems low because it is based on unrealistic assumptions for discretionary spending and provides no allowance for the sorts of budgetary surprises that led a graduate school friend to remark ruefully that "Each month a nonrecurring expense ruins my budget."

But even this quite generous estimate of available budget surpluses is less than the $1.6 trillion President Bush has indicated he wishes to apply to tax cuts and more than $1 trillion less than the more accurate measure of his tax program's cost. *It will not have escaped your notice, I am sure, that these calculations indicate that the so-called "trillion-dollar" contingency reserve does not exist.*

Uncertainty. So far, I have talked as if projections were reliable. Such a belief, as you know better than I, is ridiculous. The extremely talented and dedicated economists and budget forecasters, in government and in the private sector, seldom get budget projections even a few years in the future quite right; often they are not even close. The job is so hard that the phrase "accurate budget forecasting" is an oxymoron. The Congressional Budget Office this year dramatized that point with a splendid graphic on page xviii of *The Budget and Economic Outlook: Fiscal Years 2002–2011*. It shows that as soon as 2004 the range of reasonably plausible outcomes encompasses a possible budget deficit and surpluses as large as 820 billion. By 2006, the difference between the 5th and 95th percentile of the projection range is more than $1.2 trillion just for that one year.[2]

The bulk of the projected budget surpluses are far enough in the future that it would be rash to commit all of them now. *More than three-quarters of the surpluses projected by the Administration and CBO do not occur during the current terms of the incumbent president or 94 percent of the members of Congress.*

No responsibly managed business would commit all of the budget surpluses projected for the next decade. To be sure, future surpluses may be larger than the best current guesses of the CBO and the Administration. I certainly hope they are, so that future Congresses will be able to cut taxes even more than the Administration now requests. I also hope that future events do not put unanticipated demands on our public sector. But we cannot be sure.

GIVEN THE PERVASIVE SIGNS OF ECONOMIC WEAKNESS, SHOULD A TAX CUT BE ENACTED AS PART OF AN ANTI-RECESSION STRATEGY?

The answer to this question is a short, simple "no." For several decades, conservative economists argued that activist fiscal policy the attempt to vary public spending or taxes to combat economic fluctuations was ill-advised. Milton Friedman wrote journal articles showing that even slight mistiming of fiscal interventions would make business cycles worse even under the assumption that fiscal policy actually affected overall demand, which he doubted. Murray Wiedenbaum showed in his doctoral dissertation that use of defense contracting for countercyclical purposes was counterproductive. Friedman, Jerry Jordan, and others argued, more fundamentally, that fiscal policy that was not supported by monetary policy would have little short-run and no long-run effect on aggregate demand. And monetary policy on its own, they argued, could provide the needed stimulus to fight all but the deepest and most protracted recessions. I believe that they have largely won that debate. At the same time, so-called automatic stabilizers are vitally important to maintain and strengthen because they soften the effects of economic downturns on vulnerable families and individuals.

For this reason, the argument heard recently from the Administration and some members of Congress from both parties, that tax cuts are a good tool for fighting the sort of slow-down we are now experiencing is simply wrong. But even if it were right, the tax cut embodied in H.R. 3 would have essentially no effect on aggregate demand. In 2001 it would amount to only 5 one-hundredths of 1 percent of GDP. Even if ag-

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[2] Congressional Budget Office, *Uncertainties in Projecting Budget Surpluses: A Discussion of Data and Methods*, February 2001, Table 5.

gregate demand rose by $2 for each $1 of tax cut an implausibly high estimate, since the tax rate cuts would provide disproportionate benefits to families subject to the top rates, whose current consumption purchases are unlikely to be constrained by cash flow the impact on aggregate demand would be an undetectable one-tenth of one percent of GDP.

In short, there are good reasons for having a debate about tax cuts. The current economic slowdown is not one of them.

IS THE PROPOSED DISTRIBUTION OF TAX CUTS FAIR?

If one believes that income in the United States is too equally distributed and that the sharp increases in inequality over the past two decades are moves in the right direction, the income tax rate reductions in President Bush's tax plan are well designed. If one holds other beliefs, one has reason to question the fairness of the Bush plan which would disproportionately increase the after-tax incomes of the well-to-do (see table 3).

Table 3

Percentage Increase in After-Tax Income from the Bush Budget Cut

Income Group	Citizens for Tax Justice + Treasury estate tax estimates Bush Plan	Citizens for Tax Justice + Treasury estate tax estimates H.R. 3
Bottom Quintile 0-20 percentile	0.6 %	0.5 %
Second 20 % 21-40 percentile	1.2 %	1.0 %
Middle 20 % 41-60 percentile	1.9 %	1.2 %
Fourth 20 % 61-80 percentile	2.3 %	1.2 %
Next 15 % 81-95 percentile	2.4 %	1.1 %
Next 4 % 96-99 percentile	1.4 %	0.6 %
Top 1 percent	6.2 %	3.8 %

Source: Center for Budget and Policy Priorities, 6 March 2001.

To raise such issues is not, as some Administration spokespersons have alleged, an act of class warfare, but the exercise of responsible discussion in a democracy. Deciding how taxes are distributed is one of the central responsibilities of any legislature. These decisions inevitably are and should be political, in the highest sense of the word. To label as class warfare a discussion about the fairness of the Administration's tax cut is to ignore how democracy does and should work.

For let us be clear, most of us would be delighted to pay less tax than we do. The state uses its power to collect taxes because that is the only way in a democracy that we can support whatever government services we decide to have. Whether a tax bill makes the system more or less fair is at least as important as deciding how it affects economic efficiency or fiscal policy.

Table 4 shows the changes in after-tax income that have occurred in the United States over the past decade and the impact of the Bush tax plan taken in its entirety. Over the past decade, those in the

Table 4
Gains In After-Tax Income, 1989-1998

Period	**Groups of Tax Filers** *Percent Change in After-Tax Income*			
	Top 1 Percent	95th-99th Percent	90th-95th Percent	0 to 90th Percent
1989-1993	**– 12.2**	**– 1.0**	**– 3.3**	**– 3.3**
1993-1998	**+60.0**	**+18.9**	**+13.6**	**+8.8**
1989-1998	**+40.4**	**+17.8**	**+9.8**	**+5.2**

Source: Internal Revenue Service, as reported by Isaac Shapiro, "The Latest IRS Data on After-tax Income Trends," Center on Budget and Policy Priorities, February 28, 2001; http://www.cbpp.org/2-26-01tax.htm and Robert Greenstein, "How Would Families at Different Income Levels Benefit from the Bush Tax Cut?" Center on Budget and Policy Priorities, February 6, 2001; http://ww.cbpp.org/2-6-01tax3.htm.

very top of the income distribution have enjoyed the largest percentage and absolute increases in after-tax income. All of the increase has occurred since 1993, and it has been dramatic a 60 percent jump in after-tax income for the top 1 percent, double digit increases for the rest of the top decile and more healthy, single-digit increases on the average for the rest. *It is legitimate to enquire whether, in the face of such a striking swing in the income distribution now is the time to enact a tax plan that provides tax cuts to the top 1 percent of the distribution averaging about $40,000 more than the annual income of half of all U.S. households in 1999.*

The proposed rate reductions apply only to personal income taxes. But for an estimated 74 percent of families who pay income or payroll taxes, payroll taxes exceed personal income taxes. Table 5 shows the share of income taxes as a proportion of all taxes by income class. This table makes clear

Table 5
Income Taxes, as a Share of Total Taxes

Income Percentile	**Income Taxes as Percent of Total Taxes**
Bottom QUINTILE (0-20)	[Negative]
Second QUINTILE (21-40)	18.6
Third QUINTILE (41-60)	33.5
Fourth QUINTILE (61-80)	38.5
Next 10 percent (81-90)	44.7
Next 5 percent (91-95)	49.4
Next 4 percent (95-99)	58.0
Top 1 percent	65.7

Source: Congressional Budget Office, "Estimates of Federal Tax Liabilities for Individuals and Families by Income Category and Family Type for 1995 and 1999," May 1998; http://www.cbo.gov/showdoc.dfm?index=527&sequence=0&from=1.htm

that a cut in income taxes is bound to exacerbate income inequality unless cuts for moderate income families are proportionately larger than those for upper income families and unless some way is found to provide relief to low-income families who pay taxes other than income taxes.

IS THERE A BETTER WAY?

Mr. Chairman, this committee is a leading arena in the fight to reform the personal income tax. You and others have not yet succeeded in that fight. On the contrary, in the fifteen years since the Tax Reform Act of 1986, tax legislation has repeatedly added complexity and increased economic distortions. The record has included some bright spots, most notably the liberalization and extension of the earned income tax credit to provide relief to low-earners who may pay little positive personal income tax but face payroll taxes from the first dollar they earn. This change, together with other legislation and a tight labor market, has helped make work pay, contributing to a massive increase in labor supply among low earners—especially single women.

A major reason why tax reform is so difficult is that it, first and foremost, redistributes taxes. Tax reform may promise eventual improvements in economic efficiency and higher incomes. But as far as tomorrow's paycheck or next year's tax return is concerned, such gains are just promises. At the instant rules change, some people will pay more tax and some will pay less, and the gains will just about equal the losses. Rate cuts could alleviate the sting caused by repeal of provisions that help particular taxpayers and help the prospects for reform. The 1986 reform worked because it cut rates and those rate cuts were possible because taxes were shifted from individuals, who vote, to corporations, which don't.

Either the Administration's proposal or the smaller, Democratic alternative offers a sufficient cushion for a number of important reforms. But such reforms are not under discussion. This hearing is not the time to go into detail on the form that such legislation might take. But a short list would include a greatly increased standard deduction (with no above-the-line deductions) so that fewer more people could fill out the one-page EZ return or form 1040A, an end to phase-outs of personal exemptions and itemized deductions so that rate schedules mean what they say, replacement of the welter of tax sheltered savings vehicles by a single plan with simplified rules, replacement of the truly comical complexity of capital gains rates and holding periods with a single inclusion fraction for long-term gains, reform of both the individual and corporate minimum taxes, and an aggressive campaign to introduce a return-free income tax system such as other countries now use.

But it is the place of today's witnesses to remind members of this committee that today's budget surplus can achieve purposes other than simply returning the people's money to them. It can also be used to pay off the people's public debt. It can be used to make sure that the people's public services are adequate. It can be used to simplify the people's tax system so that they can understand that system and to reduce tax-induced distortions that retard investment, labor supply, and overall growth.

Prepared Statement of Glen L. Bower

Tax relief has been atop Gov. George H. Ryan's agenda for Illinois. Gov. Ryan has championed returning money to taxpayers, a theme that President George W. Bush has sounded on the federal level. In the current fiscal year, Illinois citizens will enjoy more than $1 billion in tax relief that was not available when Gov. Ryan took office, including higher personal exemptions for all Illinoisans, refinements to the corporate income tax apportionment formula, suspension of sales tax on motor fuel, and enactment of a new tuition tax credit.

As part of that tax relief, Illinois Gov. Ryan and state lawmakers enacted a series of tax relief programs in the spring of 2000 under which:

- 2.3 million homeowners received rebates,
- senior citizens saw expansion of our Circuit Breaker program, particularly the portion that helps purchase prescription medicines, and
- low-income working families were given a state Earned Income Credit.

The Illinois Earned Income Credit is 5 percent of the federal EIC. It is non-refundable.

The Illinois EIC adds one line to the Illinois tax return and a worksheet to the tax booklet.

We anticipate that 700,000 residents will receive the Illinois EIC in the first year, and that total credits will be about $35 million. The average Illinois EIC will be about $50.

So far this filing season, we have seen 290,156 taxpayers claim the credit (24 percent of all filers) for $24.2 million, or an average of $84 per return. We believe those with largest EICs file early, and we anticipate both the percentage of filers and the per return credit amount will decline as the tax season progresses.

As constituted, the Illinois EIC represents affordable tax relief that can be effectively administered. The bottom line for these filers is that they receive a larger state income tax refund when they file their tax returns.

Under a flat rate income tax, as mandated by Illinois Constitution, two things can be done to reduce the burden on low-income filers:

1. The personal exemption can be increased, and
2. A state Earned Income Credit can be given.

Illinois has done both. The 2000 returns mark the final step in a three-year phase in of a doubled personal exemption and include the new Illinois EIC.

The Illinois EIC fits with Gov. George H. Ryan's and President George W. Bush's goals of reducing the burden on taxpayers. For example,

Single mother, one child, earning $9 per hour gets an Illinois EIC of $69 reducing her Illinois taxes by 15.7 percent.

Single mother, two children, earning $12.50 per hour gets an Illinois EIC of $54, reducing her taxes by 9.1 percent.

Single person between ages 25 and 65 earning $8,000 per year gets an Illinois EIC of $9, reducing his or her taxes by 5.1 percent.

Illinois and four other states, Iowa, Maine, Oregon, and Rhode Island have non-refundable credits.

Nine states (Colorado, Kansas, Maryland, Massachusetts, Minnesota, New Jersey, New York, Vermont, and Wisconsin) and the District of Columbia have refundable credits. A table displaying the characteristics of various state EIC programs is attached.

In Illinois we can accommodate a non-refundable credit within the structure of our refund fund, which receives a fixed percentage of all income tax collections in order to repay any taxpayer's overpayment of taxes owed.

We can not accommodate a refundable credit within this structure because it would require payment of amounts never paid in by taxpayers. The amount of the EIC that exceeded taxpayers' liability would require an additional funding source or would result in a shortage of money to repay those taxpayers who overpaid their taxes.

We expect to see errors involving the Illinois EIC math errors and other mistakes. The non-refundable nature of the Illinois credit will reduce exposure to fraud, because a taxpayer cannot receive an Illinois refund larger than what he or she paid in Illinois tax.

Illinois performs some edits before allowing the Illinois EIC, but much of our compliance will be as a result of Internal Revenue Service actions. The same is true for the other states with an EIC. A recent General Accounting Office report showed that one quarter of the federal EIC claims are erroneous. When the IRS reduces or disallows a federal EIC, that will affect Illinois.

Quite frankly, the biggest drawback to this whole program is the complexity of the federal EIC, which must be determined before a taxpayer calculates the state credit. To claim the federal EIC, taxpayers must navigate seven pages of EIC instructions and worksheets included in the federal tax booklet. There's a separate 56-page federal instruction booklet for the federal EIC; the entire Illinois tax booklet is only 36 pages long.

So far, 90 percent of those who have claimed the Illinois EIC have used a preparer. There are limited numbers of volunteer sites that provide free assistance and the IRS is cutting back on its return preparation in Illinois.

It's unfortunate that many of these taxpayers have to pay to have their returns prepared.

In recognition of the complexity of the program, the IRS offers to calculate the federal EIC for taxpayers who submit information on paper returns. Taxpayers who choose that option would have to wait to file their Illinois return or file an amended Illinois return to claim their Illinois EIC.

I would encourage three things:

- Any simplification of the federal EIC that is possible should be enacted. The current complexity increases errors and reduces participation in the program. Given that compliance, accuracy and participation in state programs are largely contingent on the federal program, such simplification will improve both state and federal programs. I believe that the IRS has some proposals in this regard that would align definitions of earned income and dependent children between the EIC and the federal tax code and make other simplifications.
- Additional resources to allow the IRS to assist taxpayers who cannot afford to go to a preparer would save low-income taxpayers money and assure that Illinois and other states receive accurate returns.
- Given the historic problems with the federal EIC and the linkage with the Illinois EIC, the IRS could be given authority to recover both federal and state EICs that were issued incorrectly. This would leave taxpayers dealing with only one tax agency.

State Earned Income Credits

	Rate	Refundable	Same Standards as Federal	No. of Returns (2000)	Amount Paid (2000)
Colorado	10%	Yes	Yes	192,700	$25.4 million
D.C.	10%	Yes	Yes	1st Year	1st Year
Illinois	5%	No	Yes	1st Year	$35 million[1]
Iowa	6.5%	No	Yes	75,500[2]	$6.0 million[3]
Kansas	10%	Yes	Yes	131,100	$21.6 million
Maine	5%	No	Yes	N/A	N/A
Maryland	15%	Yes	Yes	N/A	N/A
Massachusetts	15%	Yes	Yes	270,000	$40 million
Minnesota	25-45%[4]	Yes	Yes	N/A	N/A
New Jersey	10%	Yes	No[5]	1st Year	1st Year
New York	22.5%[6]	Yes	Yes	1,160,000	$361 million
Oregon	5%	No	Yes	161,800	$10.3 million
Rhode Island	26%	No	Yes	58,780[7]	Unknown[8]
Wisconsin	4-43%[9]	Yes	Yes[10]	185,000	$59.1 million
Vermont	32%	Yes	Yes	31,000	$11.4 million[11]

[1] Estimate
[2] 1999 filing year.
[3] 1999 filing year.
[4] Credit is structured like the federal credit. Amount of credit is based on number of qualifying children and income of household. Credit also contains a phase-out. State credit rates convert to a range of 25 to 45 percent of the federal credit for the various income ranges.
[5] Must claim federal credit, but also meet criteria of having at least one qualifying child, income of less than $20,000 and meet certain filing status criteria.
[6] Credit was 20 percent in 1999; moving to 30 percent by 2003.
[7] 1999 filing year.
[8] Not known. Credit taken at federal level before tax rate is applied.
[9] Credit is 4 percent of federal credit for households with one child, 14 percent for 2 children and 43 percent of the federal credit for households with three or more qualifying children.
[10] No credit is allowed for households that do not have a qualifying child.

Prepared Statement of Michael Brostek

Chairman Grassley, Ranking Member Baucus, and Members of the Committee:

I am pleased to join you today as you address a number of tax issues. You asked that I cover two areas of taxation: (1) how payroll taxes fund Social Security and the Medicare Hospital Insurance programs and (2) noncompliance associated with the Earned Income Tax Credit (EITC) and efforts to deal with that noncompliance. My testimony is based primarily on work we have done in the past. I will summarize my main points and then cover the two tax issues in greater detail.

Payroll taxes are so named because they represent taxes imposed on wages. They provide the funding for the Social Security program—including both Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI)—and for the Hospital Insurance (HI) portion of Medicare—referred to as part A. These taxes are paid in equal portions by employees and their employers—and have on occasion been called "contributions" since they are to be used to fund these social insurance programs. Once workers have paid taxes and worked sufficient time in covered employment, they and their families are considered to have earned the right to future benefits. Social Security benefit payments are calculated based on a formula that replaces a larger portion of wages for low wage earners than for higher wage earners. Hospital insurance benefits do not vary on the basis of individuals' wage histories; any benefits paid depend on the health situation of covered workers. As we have reported in the past, demographic trends indicate that these programs will impose an increasing burden on the federal budget and the overall economy in the future.

The EITC is a refundable tax credit established by Congress in 1975. The EITC offsets much of the impact of Social Security taxes paid by low-income workers and is intended to encourage low-income persons to seek work rather than welfare. There are significant compliance problems associated with the EITC that have led to our listing the Internal Revenue Service's (IRS) administration of the credit among the high risk areas for the federal government. Congress and IRS have taken various steps to reduce EITC noncompliance, and, as a result, IRS has denied about $1.5 billion in erroneous EITC claims over the past 2 years. However, information is not yet available with which to determine whether those steps have been effective in reducing the overall rate of noncompliance associated with the credit. IRS has also not reported any data on the extent to which EITC overclaims were due to taxpayer errors, which may flow at least in part from the complex provisions of the credit, or from fraud.

Payroll Tax Financing of Social Security and Medicare Benefits

Payroll taxes are the main source of financing for Social Security—which includes OASI and DI—and for the HI program in Medicare—also referred to as Medicare part A. The payroll taxes for these programs are levied on wages and on the net self-employment income of workers under the Federal Insurance Contributions Act (FICA) and the Self-Employment Contributions Act (SECA).[1]

Although Social Security is often discussed as a retirement program, Social Security (OASDI) is a social insurance program that provides cash payments to persons or families to replace income lost through retirement, death, or disability. Workers make "contributions" in the form of payroll taxes that are then credited by the Treasury to the Social Security trust funds. Once individuals have worked a sufficient time to qualify, they become eligible for benefits under the program.

Medicare HI is a nationwide health insurance program for the aged and certain disabled persons. It covers inpatient hospital stays, skilled nursing care, hospice, and certain home health services. Most Americans age 65 or older are entitled to Medicare on the basis of paying HI taxes on earnings during their working careers. Medicare also has a part B—Supplementary Medical Insurance—that covers physician and outpatient hospital services, diagnostic tests, and certain other medical services and supplies. Medicare part B is not funded by payroll taxes, but rather by premiums of enrollees (about 25 percent of total annual funding) and appropriations of general funds (about 75 percent of total funding).

While both the Social Security OASDI and Medicare HI are overwhelmingly financed by payroll taxes, those trust funds receive some general revenues in the form of income taxes paid on a portion of the Social Security benefits of upper-income retirees.[2]

Collection of the payroll taxes that fund OASDI and Medicare HI is administered by IRS. However, because these payroll taxes are earmarked to fund specific retirement, disability, and medical benefits for which workers become eligible through their qualified employment, they are fundamentally different from income taxes, which are imposed on certain segments of the population and which are not earmarked for any specific purpose.

Who Pays Payroll Taxes and How?

Under FICA, employees and their employers each pay one-half of the OASDI and HI tax, which in aggregate represents 15.3 percent of covered wages.[3] The employer's portion of the payroll tax is a deductible expense for income tax purposes for employers, but the employee portion is not tax deductible by individuals.[4] The

[1] Over 95 percent of all jobs were subject to OASDI and HI payroll taxes in 1999. Several categories of workers are not subject to these taxes. For example, certain state and local government workers who participate in alternative retirement systems and federal government workers hired before 1984 may not be subject to OASDI taxes.

[2] As is discussed later, the trust funds receive interest on their balances. The Medicare HI trust fund also receives some income from other sources, such as premiums of voluntary enrollees.

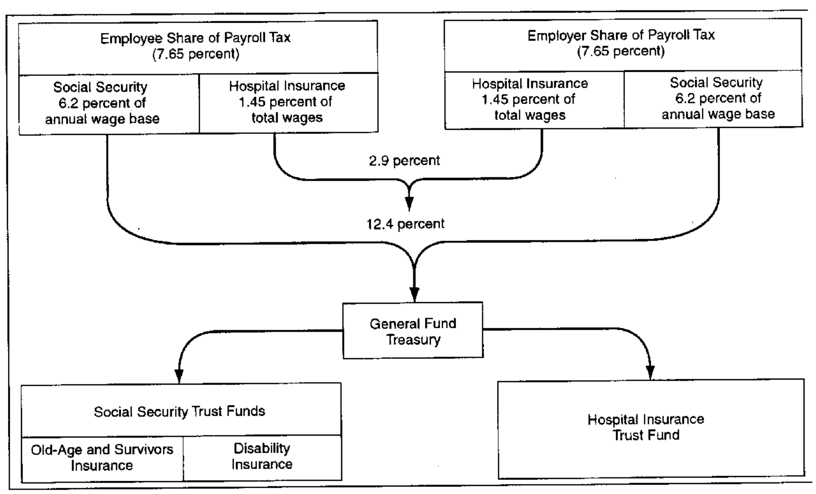
[3] Most economists agree that employees bear most, if not all, of the burden of the employer's share in the form of lower wages or lower fringe benefits.

[4] Under SECA, the same 15.3 percent payroll tax rate is levied on self-employed persons' earnings, with the same split between OASDI and HI as occurs under FICA. For many years, the self-employed paid a lower rate than the combined employee and employer rate under FICA.

Continued

OASDI tax is imposed on workers' earnings up to a maximum of $80,400 in 2001. This "taxable wage base" is adjusted annually based on the growth of average wages in the economy. In 2001, the combined OASDI tax (employer and employee, OASI and DI) is 12.4 percent—broken down into 10.6 percent for OASI and 1.8 percent for DI. The HI tax is 2.9 percent, divided evenly between the employee and the employer. Until 1994, the wage base for HI was identical to that for OASDI. Since 1994, however, the HI tax has been imposed on all of a worker's wages and self-employment earnings. Figure 1 illustrates the flow of payroll taxes into the Social Security and Medicare trust funds.

Figure 1: Distribution of Payroll Tax Funding for Social Security and Medicare



Source: GAO analysis.

How Are Benefits Determined?

Although a number of specific rules apply in determining eligibility for OASI benefits, in general, workers who have earned a sufficient number of credits for time worked establish eligibility for themselves, their dependents, and their survivors. Reduced retirement benefits are available at age 62, and full benefits have been available at age 65. However, the full retirement benefit age will gradually move to age 67, beginning with persons who reached age 62 in 2000. Numerous rules based on individuals' work histories and wages earned—but not on FICA taxes actually paid—apply in determining the specific amount of retirement benefits that will be paid to them or their survivors. Overall, while FICA taxes apply at a fixed rate, up to the maximum wage level, OASI provides greater proportional benefits to low wage earners than to higher wage earners. Table 1 illustrates that retirement payments to low income wage earners replace a larger portion of their earnings than do the payments to higher wage earners.

Since 1990, the SECA tax structure has been designed to achieve parity between employees and the self-employed. The base of the SECA tax is adjusted downward to reflect the fact that employees do not pay the employer's portion of the tax. The adjusted base is equivalent to net self-employment earnings (up to the taxable wage base) less 7.65 percent. In addition, self-employed workers are allowed to deduct half of their SECA tax liability for income tax purposes to reflect the fact that employees do not pay income tax on the employer's portion of the FICA tax.

Table 1: Social Security Replacement Rates for Entitlement Year 2000

Replacement Rates[a]		
Low earnings[b]	Average earnings[c]	Maximum earnings[d]
52.8	39.2	23.7

[a]Total monthly benefits payable for year of entitlement at full retirement income (at age 65) expressed as a percentage of earnings in the year prior to entitlement for workers with steady career incomes.

[b]Earnings equal to 45 percent of the Social Security average-wage index.

[c]Earnings equal to the Social Security average-wage index.

[d]Earnings equal to the maximum wage taxable for Social Security purposes.

Source: Committee on Ways and Means, U.S. House of Representatives, "2000 Green Book: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means," Oct. 6, 2000, p. 57.

As with retirement benefits, a number of rules apply in determining who is eligible for disability benefits. Generally, a disability is defined as the inability to engage in "substantial gainful activity" by reason of physical or mental impairment. Workers who have become fully qualified for OASI benefits and who become disabled are also generally qualified for disability benefits. Workers who become disabled before becoming fully qualified for OASI benefits may nevertheless qualify for disability benefits under certain circumstances. Payments to disabled individuals, like those to retirees, take into account personal work histories and wages earned. As with retirement benefits, lower wage earners have a larger portion of their wages replaced than do higher wage earners.

Part A Hospital Insurance (HI) benefits are automatically available to almost all persons age 65 or older through eligibility established by time spent in covered employment during their working careers. Those under 65 who are receiving Social Security disability payments also may be covered after a 24-month waiting period. Most persons needing a kidney transplant or renal dialysis may also be covered, regardless of age. Medicare payments go to those providing the covered medical service rather than to the covered individual. For certain types of medical services, patients may be required to pay deductibles or additional charges.

How Are Payroll Taxes Collected, Transmitted to the Government, Accounted for, and Used?

Under current law, employers withhold OASDI and HI payroll taxes from employees' pay along with federal and state income taxes, if any. Both the employees' and the employers' shares of FICA taxes are deposited—along with other federal taxes—to a designated Federal Reserve bank or other authorized depository. All federal taxes are then deposited in the Treasury. Treasury credits the Social Security and HI trust funds for the applicable amounts. Neither eligibility for benefits nor the amount of benefits is based on the amount of taxes paid by an individual, and neither IRS nor the Social Security Administration (SSA) directly credits to the individual the annual and cumulative FICA taxes paid by or on behalf of each individual.

Cumulatively, the OASDI and HI taxes collected represent dedicated receipts. They are accounted for in earmarked funds: the Social Security OASI trust fund, Social Security DI trust fund, and Medicare HI trust fund. These trust funds hold funds in the form of special nonmarketable U.S. Treasury securities that are backed by the full faith and credit of the U.S. government. They are an asset to the trust fund and a legal claim on—or an obligation of—the general fund of the Treasury. When benefits are to be paid, securities sufficient to fund those benefits are redeemed, and benefits are paid by the Treasury.

Virtually since their creation, Social Security and Medicare HI have been funded on a "pay-as-you-go" basis in the sense that taxes collected from current workers are used to pay benefits to current beneficiaries. Because it is important that the trust funds always have sufficient balances to cover required payments, some reserves are necessary. These reserves—that is, the excess of current receipts over current benefit payments—have been lent to the Treasury. The proceeds to the Treasury are used either to meet other general government expenditures or to pay down debt held by the public. In a time of budget deficits, borrowing from these trust funds serves to reduce the need for the government to borrow from the public.

In a time of budget surplus, borrowing from the trust funds can generate cash to pay down debt held by the public. The trust funds earn interest on the funds lent to the Treasury. This interest is paid in the form of additional Treasury securities. Until 1983, program revenues and expenses were closely matched, and the reserves were modest. After the 1983 Social Security Commission recommendations were enacted, balances grew. As a result, interest credits have become a more important source of revenue for the OASDI trust funds.

Longer-Term Outlook

As we have reported,[5] both Social Security and Medicare face serious financing challenges. Today, taxes paid into the trust funds exceed benefits paid out. However, as more and more of the "baby boom" generation enters retirement, this will change. The combination of a larger elderly population, increased longevity, and rising health care costs will drive significant increases in health and retirement spending when the "baby boom" generation begins to retire.

Over the long term, the trust funds are not solvent. SSA projections show that, absent a change in the structure of the program, the OASDI trust funds will only be able to pay full benefits through 2037.[6] However, as we have reported,[7] because a trust fund's accumulated balance does not necessarily reflect the full future cost of existing government commitments, it is not an adequate measure of the fund's solvency or the program's sustainability. The cash flows for these programs will create pressure on the federal budget long before these so-called trust fund exhaustion dates.

Beginning in 2015, OASDI funds will begin to experience a negative cash flow that will escalate as time passes. HI cash deficits are projected to begin in 2009. When the cash deficits begin, the funds must redeem their securities. To obtain the cash to redeem those securities and pay benefits, the government would have to raise taxes, cut spending for other programs, increase borrowing from the public, or retire less debt (if there is a surplus)—or some combination of these. As the Comptroller General testified last month, our long-term simulations show that, absent a change in the design of Social Security and Medicare, ultimately the government would do little more than mail checks to the elderly and their healthcare providers.[8]

The EITC and Noncompliance

The EITC is a refundable tax credit established by Congress in 1975. The credit offsets the impact of Social Security taxes paid by low-income workers and encourages low-income persons to seek work rather than welfare. The EITC is available to taxpayers with and without children and depends on the nature and amount of qualifying income and on the number of children who meet age, relationship, and residency tests. The amount of EITC allowed to an individual is first applied as a payment against any income tax liability of that individual. Any remaining amount is refunded to the individual. Workers can receive the credit as a lump sum payment after filing an income tax return or in advance as part of their paycheck.

Table 2 shows, for the past 3 years, the number of EITC recipients, then relatively small number of those who reported receiving an advance EITC, and the total EITC amount.

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[5] *Long-Term Budget Issues: Moving From Balancing the Budget to Balancing Fiscal Risk* (GAO–01–385T, Feb. 6, 2001).

[6] OASI is solvent through 2039, while DI is solvent until 2023. After cash flows become insufficient to cover expenses, incoming payroll taxes will cover a decreasing portion of expenditures as more and more retirees enter the system.

[7] *Federal Trust and Other Earmarked Funds: Answers to Frequently Asked Questions* (GAO–01–199SP January 2001).

[8] GAO–01–385T.

Table 2: Number and Amount of EITC Claims

EITC	Calendar year 1998	Calendar year 1999	Calendar year 2000
Total number of recipients	19.7 million	19.4 million	19.2 million
Number who reported receiving an advance EITC	216,238	185,027	169,002
EITC amount	$29.7 billion	$30.6 billion	$31.2 billion

Source: IRS.

In December 1998, the Council of Economic Advisers concluded that "the EITC is one of our most successful programs for fighting poverty and encouraging work."[9] Among other things, the report said that the EITC had lifted 4.3 million Americans out of poverty in 1997, had reduced the number of children living in poverty that year by 2.2 million, and had increased the labor force participation of single mothers.

For many EITC recipients, the credit is more than enough to fully offset Social Security taxes. Most EITC recipients earn credits that exceed their income tax liabilities. The Joint Committee on Taxation has estimated that 87 percent of the credit earned in 2000 will be refunded as direct payments to taxpayers. For many of the recipients these refunds will be more than enough to offset their payroll tax burdens. For example, a head-of-household filer who has two children and earns $15,000 in wages would have earned an EITC of $3,396 in 2000. This amount would have exceeded her precredit income tax liability of $24 plus her $1,148 portion of payroll tax liability. It would also have been more than enough to offset her employer's $1,148 share of the payroll tax, which most economists believe to be borne by the employee. However, many low-income individuals and couples, especially those without children, do not earn the EITC. Looking at all low-income taxpayers together, the Congressional Budget Office estimated that in 1999 households with cash incomes between zero and $10,000, on average, received EITC refunds equal to 4.1 percent of their incomes. This average refunded credit was enough to offset the average payroll tax liability of these households, but it would not have completely offset the burden of the employer's portion of the payroll tax. The average refunded credit for households with cash incomes between $10,000 and $20,000 typically would not have been sufficient to offset any of the employer's share of the payroll tax and only a portion of the employee's share for those households.

EITC Noncompliance

Since 1995, we have identified EITC noncompliance as one of the high-risk areas within IRS because such noncompliance exposes the federal government to billions of dollars of risk through overpayments of the EITC.[10] Although IRS has estimated that billions of dollars have been overpaid to EITC recipients, it has not reported on the portions of noncompliance that may be due to unintentional errors, perhaps attributable at least in part to the complexity of the EITC, or to fraudulent efforts to obtain the credit.

In April 1997 and September 2000, respectively, IRS reported on the results of two EITC compliance studies—the first involving tax year 1994 EITC claims accepted by IRS between January 15 and April 21, 1995,[11] and the second involving tax year 1997 claims processed by IRS between January 20 and May 29, 1998.[12] Although changes in IRS' study methodology as well as legislative changes between

[9] *Good News for Low Income Families: Expansions in the Earned Income Tax Credit and the Minimum Wage*, The Council of Economic Advisers, December 1998.

[10] We had identified IRS tax filing fraud as the high risk area until this year, when we renamed the high-risk area "noncompliance with the EITC" to better reflect the focus of our current concern—billions of dollars for EITC claims that IRS paid but should not have.

[11] *Study of EITC Filers for Tax Year 1994*, IRS, April 1997.

[12] *Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns*, IRS, September 2000.

1994 and 1997 made the results of the two studies noncomparable, both studies documented a significant amount of EITC noncompliance.[13]

- Of $17.2 billion in EITC claimed during the first study period, IRS estimated that $4.4 billion (about 26 percent) was overclaimed.
- Of $30.3 billion in EITC claimed during the second study period, IRS estimated that $9.3 billion (about 31 percent) was overclaimed.[14]

The largest source of taxpayer error identified by IRS in both studies related to EITC requirements that are difficult for IRS to verify—principally those related to eligibility of qualifying children. Currently, to be a qualifying child, a child must (1) be the taxpayer's son, daughter, adopted child, grandchild, stepchild, or eligible foster child (i.e., meet a relationship test); (2) be under age 19, under age 24 and a full-time student, or any age and permanently and totally disabled (i.e., meet an age test); and (3) have lived with the taxpayer in the United States for more than half the year or for the entire year if an eligible foster child (i.e., meet a residency test). Failure to meet the residency test was the most common qualifying child error identified in both studies.[15]

IRS' studies identified the following as other sources of EITC errors.

- Complicated living arrangements—when a child meets the rules to be a qualifying child of more than one person, the person with the higher modified adjusted gross income (AGI) is the only one who can claim the EITC using that child.[16] The person with the lower modified AGI cannot use that child to claim the EITC even if the other person does not claim the EITC. This rule does not apply if the other person is the taxpayer's spouse and they file a joint return.
- Misreporting of filing status—these errors involved married taxpayers filing as single or head of household when they should have filed as married filing separately. Persons who file as married filing separately are not eligible to claim the EITC.
- Income misreporting—these errors included misreporting of earned income and underreporting of investment income.

EITC "noncompliance" as identified in IRS' studies and as referred to in this testimony includes errors caused by mistakes—possibly due to the complexity of the EITC—or an intent to defraud. Both of these potential sources of error have been of concern to IRS and others. Some analysts consider the EITC to be a complex tax provision that challenges those applying for it to properly understand and follow the qualifying rules. On the other hand, the credit's possible susceptibility to fraud has also been a concern to Congress and IRS for many years. Although being able to differentiate between these different causes may be important in identifying appropriate corrective measures, IRS' primary goal in conducting its compliance studies was to identify the level of overall EITC noncompliance. Determining the causes of overpayments is more challenging and costly, especially determining whether an EITC claim is fraudulent, which requires knowing the difficult-to-prove intent behind the taxpayer's actions.

IRS' reports on its two compliance studies did not discuss the extent to which EITC overclaims were due to mistakes versus fraud. However, as we discussed in a July 1998 report on IRS' first study, IRS examiners and case reviewers did make a determination of intent for almost every case involving an overclaim.[17] Based on those determinations, about one-half of the returns with an EITC overclaim and two-thirds of the total amount overclaimed were considered to be the result of intentional errors. Because these assessments were judgmental and made without any specific criteria, they were considered too imprecise to be included in IRS' report.

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[13] Both studies were designed to estimate the amount of EITC claimed erroneously. Neither study was designed to detect or quantify EITC claims that taxpayers could have made but did not.

[14] In both studies, IRS also estimated the amount of overclaims that it would have caught through its enforcement programs. After netting out those estimates, the overclaim rates for 1995 and 1998 were reduced to about 24 percent and 26 percent, respectively.

[15] We reported on the advance payment option in 1992; *Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public* (GAO/GGD–92–26, Feb. 19, 1992). Although information in that report is dated, it did indicate that there were potential compliance problems associated with the advance payment option. Many individuals who received the advance payment did not report that receipt on their tax return, thus setting up the possibility that they could receive the credit again as a lump sum payment.

[16] To compute their modified AGI, taxpayers have to add certain amounts, such as tax exempt interest and some other gains and losses, to their AGI. According to IRS, for most people the modified AGI is the same as the AGI.

[17] *Earned Income Credit: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance* (GAO/GGD–98–150, July 28, 1998).

However, as we said in 1998, the results did indicate that IRS' compliance efforts should include activities aimed at taxpayers who intentionally misclaim the EITC.

Efforts to Reduce EITC Noncompliance

Concerned about the level of EITC noncompliance, Congress and IRS have taken various steps to reduce it. After the 1994 compliance study, Congress took the following steps:

- According to law, an EITC is not to be allowed unless the tax return contains the EITC-qualifying-child's Social Security number (SSN) as well as the SSNs of the taxpayer and the taxpayer's spouse, if any. Before 1997, if IRS identified a return with an invalid SSN, it had to resolve that issue through its normal audit procedures.[18] Because those procedures are resource intensive, IRS was not able to follow up on most of the invalid SSNs identified. In 1995, for example, IRS stopped the refunds on about 3 million returns with invalid SSNs.[19] However, IRS was only able to follow up with taxpayers on about 700,000 of those returns. For the other 2.3 million returns, IRS released the refunds without any follow-up. In 1996, Congress authorized IRS to treat invalid SSNs as "math errors," similar to the way that IRS had historically handled computational mistakes. With that authority, IRS has been able to (1) automatically disallow any EITC claim associated with an invalid SSN and (2) make appropriate adjustments to any refund that the taxpayer might be claiming.
- Congress passed the Taxpayer Relief Act of 1997, which, among other things, (1) required paid tax return preparers to fulfill certain due diligence requirements when preparing EITC claims for taxpayers;[20] (2) provided that taxpayers who were denied the EITC as the result of an IRS audit are ineligible to receive the EITC in subsequent years unless they provide evidence of their eligibility through a recertification process; (3) gave IRS access to the Department of Health and Human Services' (HHS) Federal Case Registry of Child Support Orders, a federal database containing state information on child support payments that could help IRS identify erroneous EITC claims by noncustodial parents; and (4) required SSA to collect SSNs of birth parents and provide IRS with information linking the parents' and child's SSNs.
- Congress began providing IRS with appropriated funds (about $143 million a year) for a 5-year EITC compliance initiative beginning in fiscal year 1998.

As part of the 5-year compliance initiative and using the tools provided by Congress, IRS implemented a plan that calls for reducing EITC noncompliance through expanded customer service and public outreach, strengthened enforcement, and enhanced research. In implementing its plan, IRS has taken several actions, with some significant results. For example:

- In 1999 and 2000, IRS identified a total of about 3.4 million "math errors" related to the EITC, about 24 percent of which involved invalid SSNs.[21] According to IRS, it denied about $675 million in erroneous EITC claims during fiscal years 1999 and 2000 because of EITC-related "math errors."
- Other types of EITC noncompliance are not as easy to identify as invalid SSNs. These types of noncompliance can be detected only through an in-depth review. For the past few years, IRS has targeted for in-depth review certain types of EITC claims, such as those involving the use of a child's SSN on multiple returns for the same year, that IRS had identified as important sources of noncompliance. Returns identified by IRS were to be audited to determine if the EITC claims were valid. During fiscal years 1999 and 2000, according to IRS, it completed more than 500,000 of these audits and identified about $800 million in overclaims.
- In the fall of 1999, IRS began an integrated EITC education and compliance effort directed at tax return preparers. IRS designed this effort because data indicated that 62 percent of returns with EITC claims were prepared by paid preparers. IRS divided preparers into five groups based on a preparer's filing history, with each group getting a different type of visit. Last year, for example, IRS visited about 1,000 preparers for the purpose of determining if they com-

[18] IRS considers an SSN invalid if it is missing from the return or if the SSN and associated name on the return do not match data in SSA's records.

[19] These invalid SSNs were for EITC-qualifying children and dependents. How many involved the EITC is unknown.

[20] To demonstrate due diligence, preparers, among other things, must complete an EITC worksheet or the equivalent and must have no knowledge that any of the information used to determine the taxpayer's eligibility for, or the amount of, the EITC is incorrect. The 1997 Act provides for a penalty of $100 for each failure to comply.

[21] Other EITC math errors include such things as errors in computing earned income and in figuring the EITC.

plied with the due diligence requirements. According to IRS, its examiners proposed penalties totaling about $435,000 for 143 of those preparers. We do not know how, if at all, IRS' visits resulted in improved due diligence by preparers. That question may be addressed in IRS' report on the results of its visits, which, according to IRS, will be issued about May 1.

- IRS implemented a program to enforce the recertification requirements of the Taxpayer Relief Act of 1997. According to IRS data, (1) about 312,000 taxpayers were required to recertify after being denied the EITC for tax year 1997 and (2) about 193,000 of those taxpayer did not claim the EITC on their tax year 1998 returns. IRS sees these results as an indication that recertification has reduced the number of improper claims.[22]
- IRS expanded its EITC outreach and educational efforts. For example, it developed partnerships with groups that are advocates for low-income taxpayers and with businesses and large employers who include EITC information in monthly billings or employees' pay statements. IRS also refocused its media campaign and publications toward educating the public about EITC eligibility requirements.
- IRS developed a database that can be used to help verify the accuracy of taxpayers' claimed dependents and EIC-qualifying children. It incorporates data from an assortment of sources including the HHS and SSA information provided for in the 1997 Act. According to IRS, the database is used to screen returns during processing for potential compliance issues and to select for pre-refund audits those with the highest potential. Also, according to IRS, the returns being selected are primarily ones filed by EITC claimants.

Despite these initiatives, it remains to be seen how, if at all, Congress' and IRS' efforts have succeeded in reducing the 31-percent EITC overclaim rate identified by IRS' tax year 1997 EITC compliance study. IRS is doing a study of tax year 1999 returns and plans to study tax year 2001 returns. The results of those studies, when compared to the results of the tax year 1997 study, should provide a basis for assessing the impact on overall EITC noncompliance.

Although well-designed and effectively-implemented processes should help reduce EITC noncompliance, certain features of the EITC represent a trade-off between compliance and other desired goals. Unlike income transfer programs, such as Temporary Assistance for Needy Families and Food Stamps, the EITC was designed to be administered through the tax system. Accordingly, while other income transfer programs have staff who review documents and other evidence before judging applicants to be qualified to receive assistance, the EITC relies more directly on the self-reported qualifications of individuals. This approach generally should result in lower administrative costs and possibly higher participation rates for the EITC than the other assistance programs. However, EITC noncompliance may also be higher. This is especially true when eligibility depends on information that cannot be readily and rapidly verified by IRS as it processes tax returns. EITC eligibility, particularly related to qualifying children, is difficult for IRS to verify through its traditional enforcement procedures, such as matching return data to third-party information reports. Correctly applying the residency test, for example, often involves understanding complex living arrangements and child custody issues. Thoroughly verifying qualifying child eligibility basically requires IRS to audit individual tax returns, as was done in the tax year 1994 compliance study—a costly, time-consuming, and intrusive proposition.

I appreciate this opportunity to appear today to provide a basic description of the payroll taxes funding Social Security and Medicare hospital insurance and to discuss what is known about EITC noncompliance. Mr. Chairman, that concludes my prepared statement. I would be happy to answer any questions you or other Members of the Committee might have.

[22] It is also possible that some taxpayers did not reapply because they were confused about the recertification requirements. We are reviewing IRS' implementation of that program at the request of the Oversight Subcommittee of the House Committee on Ways and Means.

Appendix I

Related GAO Products

Payroll Taxes

Long-Term Budget Issues: Moving From Balancing the Budget to Balancing Fiscal Risk (GAO-01-385T, Feb. 6, 2001).

Federal Trust and Other Earmarked Funds: Answers to Frequently Asked Questions (GAO-01-199SP, January 2001).

Medicare Reform: Issues Associated With General Revenue Financing (GAO/T-AIMD-00-126, Mar. 27, 2000).

Medicare Reform: Leading Proposals Lay Groundwork, While Design Decisions Lie Ahead (GAO/T-HEHS/AIMD-00-103, Feb. 24, 2000).

Social Security: Evaluating Reform Proposals (GAO/AIMD/HEHS-00-29, Nov. 4, 1999).

Social Security Reform: Implementation Issues for Individual Accounts (GAO/HEHS-99-122, June 18, 1999).

Social Security: Different Approaches for Addressing Program Solvency (GAO/HEHS-98-33, July 22, 1998).

Earned Income Tax Credit

Tax Administration: Assessment of IRS' 2000 Tax Filing Season (GAO-01-158, Dec. 22, 2000).

Earned Income Credit: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance (GAO/GGD-98-150, July 28, 1998).

Tax Administration: Earned Income Credit Noncompliance (GAO/T-GGD-97-105, May 8, 1997).

Earned Income Credit: IRS' 1995 Controls Stopped Some Noncompliance, But Not Without Problems (GAO/GGD-96-172, Sept. 18, 1996).

Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public (GAO/GGD-92-26, Feb. 19, 1992).

PREPARED STATEMENT OF STEPHEN J. ENTIN

President Bush has proposed a tax reduction package that has, as its centerpiece, a reduction in marginal income tax rates. Other features of his tax and budget plans address peculiar features of the tax code that result in high implicit marginal tax rates on the poor, the elderly, and some two earner married couples. The President's focus on marginal tax rate reduction is key to restoring incentives to work, save, and invest, to maintaining and strengthening the economic expansion, and to renewing job growth and real income gains. His proposals should be implemented as soon as possible.

The main elements of the tax proposal.

Marginal tax rate reduction. The President's tax plan would trim marginal income tax rates over 5 years. The 39.6% and 36% rates would fall gradually to 33%. The 31% and 28% rates would drop to 25%. The bottom portion of the 15% rate would drop to 10%.

Based on the 1997 income distribution (last available year), the Bush proposals would reduce the income-weighted average marginal rate from 25.4% to 22.9%, about a ten percent drop. (See Chart 1.) By comparison, the Kennedy and Reagan marginal tax rate reductions were between 20 and 25 percent. Chart 2 shows the reduction in marginal income tax rates under the Bush plan for couples at various income levels, assuming they have two children and are not subject to the alternative minimum tax.

At the margin, on an income-weighted basis, and accounting for payroll and state income taxes, the President's proposed rate cuts would raise the after-tax wage on incremental effort by about 4 percent, and the after-tax return on incremental saving and non-corporate investment by about 3 percent. We estimate that these additional rewards to production would create between 1.5 million and 2 million additional full-time equivalent jobs over the next decade, and ultimately add close to 2% to the GDP. Individuals would not only benefit from the lower tax liabilities, they would experience higher pre-tax wages and increased employment opportunities as well. The taxes collected on the increased personal and business income from the higher GDP would eventually return between a quarter and a third of the static revenue cost of the tax cut to the government.

These employment and GDP calculations do not include the additional beneficial impacts of the President's proposals relating to the marriage penalty and the earned income tax credit (EITC), nor do they allow for the adverse effects of the alternative minimum tax.

Rate relief for two-worker couples subject to the marriage penalty. The President's proposed "second worker exclusion" is designed to provide relief to two earner couples in rough proportion to the degree of marriage penalty they are experiencing under current law. The couple could deduct 10% of the lower earner's first $30,000 of wages (a deduction of up to $3,000) from taxable income. The deduction would trim the tax liability of such couples. In addition, where the lower earning spouse has less than $30,000 in labor income, this would represent a further 10% cut in the marginal tax rate on incremental earnings, and thereby encourage further effort. (For example, it would effectively reduce the 15% tax rate to 13.5%, and the proposed 25% tax rate to 22.5%.)

Rate relief for workers hit by the EITC phase-out. The refundable earned income tax credit (EITC) eliminates the income tax and much of the payroll tax for several million low income workers. As incomes rise, however, the credit is phased out. The phase-out for a couple or single parent with one child is at a 15.98% rate between incomes of $13,090 and $28,280; for parents of two children, at a 21.06% rate between incomes of $13,090 and $32,120; for couples with no children at a 7.65% rate between incomes of $4,760 and $5,950.

When income is in the phase-out range, each additional dollar of income costs the taxpayer $0.1598, $0.2106, or $0.0765 of the credit. In addition, the taxpayer is subject to the employee's half of the payroll tax at a rate of 7.65%; to the first 15% income tax bracket rate; and, in most states, a state income tax. Assuming a state tax rate of 5%, the combined marginal tax rate on an added dollar of income in the phase-out range for a worker with two children is 48.71%. The government is taking nearly half of any additional income that this low-earning taxpayer struggles to make. Such high marginal tax rates are a serious disincentive to work and earn one's way out of a near poverty situation.

The President's proposal would reduce the work disincentives on low income workers created by the phase-out of the EITC in two ways. First, the plan would cut the 15% tax rate to 10% for the first $6,000 of taxable income for a single filer, $10,000 for a single parent, and $12,000 for a couple filing jointly. Second, it would increase the child credit from $500 to $1,000. These steps would eliminate the income tax for many recipients of the EITC, thereby reducing by 15 percentage points the marginal tax rate that they face on income in the phase-out range. Their EITC would be fully phased out before they begin to pay income tax, and they would not be subject to the explicit income tax rate and the implicit phase-out tax rate on the same income. Chart 2 shows the reduction in the marginal tax rate spike due to the EITC for a couple with two children.

This approach does have a drawback. It exempts several million additional people from the income tax. It is not a good idea to have a large part of the voting public thinking that on-budget government services are free goods.

Elimination of the estate and gift tax. The President's proposal would also phase out the estate and gift tax. This tax is a serious impediment to small business survival in particular, and to saving and investing in general. It even discourages work by seniors who are thinking of deferring retirement to add to their bequests. The estate and gift tax rates can reach 55% at the margin (60% in the surtax region as the lower rates are "recaptured") for an ordinary estate, and nearly 80% for a generation skipping trust. Combined with payroll and income taxes, it can result in marginal tax rates on additions to bequests of between 70% and 91%, clear disincentives for the elderly to work and save. (See Chart 3.) Elimination of the tax would be good for the economy. It would save as much in wasteful legal costs as it raises in revenue. It would probably pay for itself in two ways. First, when high tax bracket parents give money away during their lives to their low tax bracket children to avoid the estate tax, the taxes on the current earnings of the assets are reduced, costing the government current revenue; ending the estate tax would reduce such losses. Second, ending the estate tax would increase total saving, investment, output, and taxable income, yielding a dynamic revenue gain.

In removing the estate and gift tax, some people would propose ending step-up in basis for capital gains at death. I would advocate retaining step-up in basis. It is consistent with the saving/consumption neutral treatment of capital gains found in major tax reform proposals. If saving has received pension or IRA treatment, the gain will be taxed under current law as ordinary income to the heir (although such tax would better be deferred until the assets are sold for consumption). If the saving did not receive pension or IRA treatment, the gain should remain untaxed, as in a Roth IRA. If step-up is eliminated, the heir should not have to pay capital gains tax at the time of inheritance, but only later when the assets are sold and the gain is realized.

Making the R&D credit permanent. The plan would make the research and development credit permanent, giving businesses a more certain foundation on which to plan their investment in basic science, technology and new products.

Above the line charitable contributions. The President would allow taxpayers who do not itemize to deduct their charitable donations. This is good tax policy as well as social policy. Income transferred to others is no longer the property of the donor and should not be taxed as such. It should be treated as income to the recipient (who, in the case of a charitable donation, would be an individual too poor to owe tax, or be a tax exempt institution).

Social Security earnings test repeal. President Bush has previously proposed eliminating the remaining portions of the Social Security earnings test. While not technically a tax proposal (it raises Social Security outlays), the earnings test acts as a 50% add-on tax rate on incremental wage income above a low exempt amount for beneficiaries ages 62 to the normal retirement age. The test has been eliminated for retirees above the normal retirement age. The normal retirement age was 65, but is rising in stages to 66 for people turning 62 between 2000 and 2005, and to 67 for people turning 62 between 2017 and 2022. Thus, people ages 65 and 66 will again become subject to the test. Removing the remaining earnings test would sharply reduce an outrageously high tax rate on older workers, and restore work incentives to some of our most experienced and productive citizens. If this cannot be done in the first tax bill, it should be considered for the next available vehicle.

A picture of the marginal incentive effects of the tax proposals.

Chart 2 shows marginal tax rates for married couples with two children at various income levels under current law and the Bush plan. The marginal rate reductions across a wide range of incomes provide the incentives to boost production and output that are the major economic benefits of the proposal.

Note that the phase-outs of the child credit, itemized deductions, and personal exemptions push effective tax rates above the statutory levels. For a family of four, under current tax rates, the exemption and deduction phase-outs add nearly 4 percentage points to the tax rate (a bit more or less depending on the specific tax bracket). Eliminating these phase-outs would provide significant additional marginal rate relief, and would bring the top rates down to a true 25 or 33 percent.

There are many other provisions in the tax code that implicitly boost marginal tax rates, such as the tax treatment of Social Security benefits, income related limitations on IRAs, and the loss of various credits. A complete list with details is available in IRET Economic Policy Bulletin No. 83, "Phaseouts Increase Tax Rates and Tax Complexity," (forthcoming in March in hard copy and on the web at www.iret.org).

AMT relief.

The regular income tax relief proposed by President Bush could subject several million additional taxpayers to the AMT unless the AMT is reformed or repealed. It would be wise to alter the AMT to allow taxpayers to receive the full benefit of the President's proposed rate reductions, and the full value of the child credit and the EITC.

Chart 2 assumes that the families are not thrown into the alternative minimum tax. If they fall under that tax, the marginal tax rates for the upper income families would be slightly higher or lower at various points. (See Chart 4.) The statutory AMT marginal tax rates, 26% and 28%, are lower than under the ordinary income tax, but imposed on a broader base to collect more revenue than the ordinary tax. However, the 25% phase-out rate of the AMT exempt amount has the effect of boosting the marginal tax rates in the phase-out range to 32.5% and 35%. (See Chart 5.) Thus, at the margin, the AMT rates would not be much less than the ordinary income tax rates in the Bush plan for many affected taxpayers.

Even under current law, the AMT is poised to strike millions of additional taxpayers with middle-class incomes. The number of individual taxpayers owing the AMT jumped by 38% in 1998 alone (from about 620,000 to about 850,000). The IRS Taxpayer Advocate projects that unless the law is changed, "Over 17 million taxpayers will be subject to the Alternative Minimum Tax by the year 2010. [And by that year] taxpayers with an adjusted gross income of less than $100,000 will owe "60% of the nation's Alternative Minimum Tax . . . " The AMT is in need of urgent attention.

Why cut marginal tax rates?

The type of tax reduction is important. Tax cuts do not boost the economy by giving people more money to spend (to pump up "demand"). The same amount of money would be given back to federal bondholders if taxes were not cut. Private sector spending power and demand do not change just because federal revenues are reduced. That is why President Ford's $35 rebates in 1975 were such a failure; the money was just borrowed back to cover the added federal deficit. Such hand-outs simply use up money that could be used for more beneficial tax changes. Thus, a tax cut should not be thought of, or worse, designed as a counter-cyclical Keynesian "stimulus" to demand.

Tax cuts work to improve the economy if and only if they increase, at the margin, the after-tax wage on additional hours worked, or raise the interest and dividend returns on added saving, or raise the rate of profit on capital investment. These tax cuts first promote an increase in the supply and employment of labor and capital resources, which are used to create added goods and services. The suppliers of the resources are paid the value of their added output for their trouble, and they can then use their added income to buy the added output they have produced. The output, factor payments, and sales all stem from the production process. Demand rises together with supply or not at all. If the tax cuts are not "at the margin," they do not increase demand, or production, or income.

Marginal tax rate cuts are not inflationary; they are disinflationary because they lower the cost of labor and the cost of capital. Tax rate reductions expand capacity; they raise output and income simultaneously, increasing supply in line with demand. Put another way, they encourage creation of additional goods and services, and with costs down and more goods "chasing" the same amount of money supply, the price level is reduced. Because such tax cuts are disinflationary, there is no reason for the Federal Reserve to oppose them by tightening money.

Tax changes "at the margin" may either be reductions in the statutory marginal rates or changes to the tax base on which the rates are imposed, so long as the result is a reduction in the tax on incremental income. Thus, fixing the tax base to end multiple taxation of income used for saving and investment is also a tax cut at the margin, and is the key to fundamental tax reform. The best tax cuts would move the code in the direction of fundamental tax reform.

Marginal tax rates are rising and threatening the expansion; they should be cut.

As Chart 1 shows, marginal tax rates have been rising in recent years due to enacted tax rate increases in 1990 and 1993, to "real income bracket creep," and to changes in the work force and job mix. These marginal tax rate increases have been reducing the incentives to work, save and invest. Put another way, the tax rate hikes have been increasing the cost of labor and reducing the profitability of investment, resulting in slower growth of labor and capital inputs, output and income than would otherwise have occurred. Left untreated, rising marginal tax rates would gradually slow the economic expansion.

Chart 1 traces the history of income-weighted average marginal income tax rates. (The rates are weighted by taxpayer income as a proxy for hourly earnings of taxpayers in each tax bracket. It does not include payroll taxes, nor calculate the effect of the growing impact of the alternative minimum tax.)

Marginal income tax rates soared in the inflationary 1970s through 1980 as rising nominal incomes forced taxpayers deeper into the progressive tax rate structure. The result was falling real after-tax incomes, rising labor costs, strikes, unwillingness to accept overtime, and a rapid increase in non-taxable fringe benefits. Other adverse tax effects of inflation crippled business investment.

The 1981 tax rate reductions (the Economic Recovery Tax Act of 1981, ERTA) lowered marginal tax rates over the next four calendar years. ERTA then stabilized the rate cuts by means of tax indexing, which enlarges the personal exemptions, the standard deduction, and the dollar levels at which each tax rate bracket begins in line with inflation. Indexing prevents a cost of living allowance from forcing taxpayers into higher tax brackets (bracket creep). With indexing, taxpayers do not experience a tax rate hike unless their incomes rise in real terms, that is, faster than inflation. However, indexing does not prevent real wage gains or rising real family incomes from increasing tax rates.

The Tax Reform Act of 1986 further reduced individual marginal income tax rates in 1987 and 1988. There was a minor increase in marginal tax rates in the 1990 tax bill, offset by the dip in income in the 1990–91 recession and the subsequent sluggish recovery of output and real income. The 1993 tax increase raised marginal tax rates on upper income earners.

Resumption of stronger real income growth since about mid-1995 has kept marginal tax rates rising ever since. Some of this increase in marginal tax rates is due to real bracket creep as workers in various occupations have experienced real wage growth. Some is due to rising family incomes as more families become two worker households. Some is due to increased numbers of high tech, high value added, high paying jobs.

Insurance against recession.

The current economic slowdown is an additional reason for moving ahead promptly with the President's tax plan. Whatever plan is adopted should still be the right type of tax cut, one that promotes growth by increasing production incentives at the margin for workers, savers and investors and removing biases in the current tax system against investment and saving. Otherwise the tax cut will have no effect either short term or long term.

Recession offset? The President originally proposed that his rate cuts be phased in between January 1, 2002 and January 1, 2006. Due to the weak economy, however, it has been suggested that it would be better to advance the cuts by a year, with the first installment effective January 1, 2001. Opponents protest that the economic slowdown may be over before the tax cuts are passed, and that they may "overheat' the economy.

Incentive-based tax rate cuts are beneficial whether they are enacted at the bottom of a downturn, in the middle of a recovery, or at the top of a boom. By expanding productive capacity in line with spending, they improve the economy in all cases. They should be viewed as a policy for the long term, not as counter-cyclical fine tuning. Nonetheless, if marginal rate cuts happen to be enacted at a time of economic weakness, they can help to restore growth by encouraging employment and investment. They would lift economic output at any time; that this effect would be especially welcome in a period of weakness is merely an added benefit.

Again, tax cuts do not work simply by giving people money to spend (to pump up "demand"), and they are not inflationary. In times of deficit, a tax cut is borrowed back by the government to maintain spending; in times of surplus, a tax cut reduces repayments to the bondholders. In neither case is there any increase in the amount of money in circulation "chasing" too few goods and driving up prices. Only the Federal Reserve can create inflation by over-expanding the money supply relative to the availability of goods and services.

Retroactive? If the marginal tax rate cuts are to have any significant effect on the economy in 2001, they need to be enacted promptly, have as deep a marginal rate cut as possible up front, and not be put in question by "triggers."

The tax cuts do not need to be made retroactive to give people money to spend (because they would not do so). However, tax rate cuts must be effective as of the start of the year if they are to achieve the full incentive effect on production behavior implicit in the percentage rate reduction. Delaying a tax rate reduction until mid-year, for example, would cut the incentive effect of that year's rate cut in half. If one of the objectives of the tax rate reductions is to head off current economic problems, the first installment of the multi-year rate cuts should date back to January 1, 2001. Even better would be to front-load the rate cuts rather than string them out over five years.

Individual income taxes are collected on a calendar year basis. The IRS does not distinguish between income earned in January and income earned in December. Tax rate cuts occurring mid-year are pro-rated by means of a "blended rate," and do not have their full marginal incentive effect their first year. For example, a hypothetical 10% across the board rate cut effective July 1, 2001, will effectively cut the marginal tax rate on all income earned in 2001 by 5%, because all calendar year income is lumped together for tax purposes. The full effect of the marginal rate cut will not be felt until 2002, when it is in place for the full calendar/tax year. The earlier in the year a rate cut is made effective (including retroactive to January 1), the more nearly the tax rate reduction will have its full incentive effect.

Rate cuts work well, when implemented promptly.

The Kennedy tax cuts of the 1960s were implemented quickly to fight the back to back recessions of 1957 and 1961. Kennedy created the investment tax credit (ITC) and reformed depreciation rules in 1962, and cut the corporate tax rate in two steps, from 52% in 1963 to 48% in 1965. His famous individual income tax reductions (passed under President Johnson) were a roughly 25% across the board cut in marginal rates, phased in over two years, 1964 and 1965. The economy was strong and inflation was modest in the mid 1960s. Subsequent monetary excesses and tax increases hurt the economy 1969 and the 1970s.

In 1980, President Reagan proposed a 30 percent across the board tax rate cut, to be phased in at 10 percent a year, each January 1, for three years. Due to budget concerns, he was persuaded to delay and scale back the tax cut. As passed in the Economic Recovery Tax Act of 1981 (ERTA), the total tax rate cut was trimmed to 25% across the board. The first installment was cut to 5 percent and delayed until October 1, 1981. The second and third installments of 10 percent each were moved from January 1 to July 1 for 1982 and 1983.

The result was a blended marginal rate cut of 1.25 on 1981 income, a 10% cut for 1982 income, 20% for 1983 income, and a full reduction of 25% only for 1984 income. The pitiful 1.25% rate cut for calendar year 1981 was more than offset by a scheduled payroll tax rate increase and by inflation-induced rate hikes due to bracket creep. Tax rates actually rose in 1981. Another round of payroll tax hikes and bracket creep in 1982 offset that year's tax rate cut as well. There was no significant net marginal tax rate relief until 1983.

These cutbacks and delays were ill-advised. They made it impossible for the tax reductions to avert or moderate the impending 1981–1982 recession. The Federal Reserve had begun tightening monetary policy in November 1980, the day after the election, to battle the double digit inflation then rampant, and because the Fed erroneously expected the promised tax cuts to pump up demand and add to inflationary pressures. The economy softened rapidly, contrary to Federal Reserve expectations, and was already entering a recession in the summer of 1981 even as the tax bill was finally coming up for a vote in Congress. The economy did not rebound until 1983, the first year of real net tax rate relief. The rate of inflation collapsed much faster than was anticipated by the Federal Reserve and the Congress. The disinflation and eventual resumption of strong real growth and job creation (which the tax cut did eventually generate) could have been accomplished more quickly and with less pain if key policy officials had better understood the disinflationary nature of the tax cuts and allowed them to take effect sooner.

No triggers, please.

Some Members of Congress want to impose a "trigger" on President Bush's proposed across the board cuts in marginal tax rates. Under a trigger, the various installments of the rate cuts would only go into effect if projected budget surpluses arise as forecast. A trigger would make the tax rate cuts less effective in strengthening the economy and could lead to the bad budget outcome its advocates claim to fear.

An invitation to over-spend. Tying tax cuts to the budget surplus would let Congress block the tax cut just by spending too much. There would not even be an explicit vote to hold the Members accountable. If the surplus is the issue, rather than the urge to splurge, why not propose a trigger on federal spending instead of tax cuts?

A trigger makes a tax cut cost more. Making the tax cut uncertain would reduce its effectiveness at promoting growth. If people can count on the tax cuts, they will produce more in anticipation. If people doubt the cuts will occur, growth will be delayed. The revenue reflows would be less, and the deficit higher than otherwise.

Every year we do not have a tax cut, productivity gains and real wage hikes actually raise tax rates on workers and cost some jobs that would otherwise occur (because tax indexing only offsets the inflationary component of tax bracket creep, not the kind due to real wage growth). If, instead, employers know that the tax burden on workers will be dropping over time, and after-tax wages will be rising, they will expect wage demands to remain moderate. They will be more likely to hire people, today, on that assurance, than if taxes are not going to be cut.

But what are employers to think if a tax bill says "We might lower taxes for the next five years, or maybe not?" They'll hold off on the hiring until they see the green of the tax cuts. Similarly, savers and small business owners will wonder what tax rates they will pay on future interest and business income, and will cut their saving and investment accordingly.

The tax cut is not too big, it is too small.

The President's tax proposals are not too big. Indeed, to have a significant effect on the 2001 economy, the rate reductions would have to be phased in faster. As presented, they are barely over 1% of GDP over the 10 year budget window. Relative to GDP, that is about half the size of the Kennedy tax cut and about 40% the size of the individual tax reductions in the 1981 Reagan tax cut. The Bush rate cuts would be phased in over five tax years. The Kennedy rate cuts were implemented over two tax years, and the Reagan cuts over four.

Some tax cut opponents fear that the size of the Bush tax plan is understated. They would raise the estimated cost of the Bush plan from the original $1.6 trillion by $500 billion if the tax cut is made retroactive to January 1, 2001, expiring AMT offsets are renewed, and the full tax cut is given to people who would otherwise be thrown into the AMT by lowering ordinary tax rates. They would raise the estimate by another $400 billion to $500 billion for interest if the debt is drawn down more slowly. The total, they claim, could reach $2.6 trillion over ten years, and leave little money "on-budget" to retire the federal debt.

There are several reasons not to be concerned. First, the CBO budget projections are for just over $3 trillion in on-budget surpluses over ten years. Even with the augmented tax cut, and counting the added debt service, there would still be an on-budget surplus.

Second, "off-budget" Social Security surpluses will total nearly $2.6 trillion. Even with the tax cut, publicly held debt and interest payments to the public would be gone in ten years in the absence of further tax reductions or spending increases.

Third, the estimated cost of the tax rate cut is "static," not counting the added economic growth the rate cuts would make possible. The stronger economy would return about 30 percent of the projected revenue loss to the Treasury. That puts the cost of the rate cuts far below the projected on-budget surplus, even adjusting for added interest expense.

Fourth, CBO estimates of the surplus may be on the low side. The graduated income tax takes in a rising share of income as the country becomes more prosperous, and more taxpayers run afoul of the unindexed AMT each year. Increased factor productivity should also boost corporate income and corporate taxes as a share of income over time. Yet CBO projects tax revenues per dollar of GDP to fall over the next decade in a pattern at odds with historical experience. CBO assumes, among other things, a drop in capital gains revenues to more "historical" levels over time. Capital gains receipts may in fact fall sharply from last years elevated peaks due to the recent market dip. Nonetheless, the stock market remains substantially higher than 10 or 20 years ago relative to GDP, and gains should be higher, on average, as a share of current income for a long time to come.

Fifth, the CBO and Administration budget forecasts contain conservative real GDP growth assumptions, 3.1 percent per year for CBO and 3.2 percent per year for the Administration. The private sector consensus is nearer 3.4 percent. There is substantial room for revenue surprises on the upside in the CBO and Administration budget forecasts.

Surplus estimates will be rising for several years to come. Moving the budget window out one year would drop FY2002, with a surplus of just under $300 billion, and add FY2012, with a surplus of nearly $900 billion. That would boost the surplus projection by nearly $600 billion. Similar increases would occur in each of the next several years. There will be ample money available for additional tax relief in a later bill.

No rush to pay off the debt.

President Bush has proposed paying off about $2 trillion in debt, with the remainder of the surplus used for tax relief and the associated debt service, plus a "contingency" fund and Medicare reform. This would leave a bit over $800 billion in federal debt in the hands of the public (including state, local, and foreign governments) in 2011.

Some would ask, "Why not pay off the entire debt?" The President replies in his budget papers that paying off debt that has not matured would involve substantial premium payments to the bondholders, making repayment a bad deal. Also, requiring people to redeem U.S. savings bonds would destroy an excellent savings program. Furthermore, holding U.S. securities is a great convenience to risk-averse savers and to other governments. An additional point is that the Federal Reserve normally controls the money supply by buying and selling federal securities. It would have to use other assets or other techniques if the marketable U.S. government debt disappears.

Perhaps a better question is, "Why pay off the debt anyway?" There are surely better things to do with the money. (I would nominate fundamental tax reform, providing personal saving accounts to cushion the necessary adjustments to Social Security when the baby boom retires, and medical research to utilize the fruits of the human genome project to cure disease.). Federal debt is risk-free. It is accorded some of the lowest real interest rates on the planet. Using the surplus to promote the growth of the economy would yield the country and the government a higher rate of return than drawing down the debt at a faster clip.

Tax cut foes contend that lowering the debt faster is the best way to increase saving and investment. They are wrong. Paying down more debt instead of lowering taxes would have virtually no impact on global interest rates. The additional debt reduction would be a drop in the bucket compared to the amount of financial assets outstanding in the world credit markets (some $80 trillion to $100 trillion). Such small differences in the repayment schedule would have no effect on world interest rates, but the higher taxes would come straight out of private saving and investment.

Therefore, faster debt reduction would not boost investment and employment. By contrast, cutting taxes on capital, at the margin, would increase saving and investment. Examples include marginal tax rate reduction, enhanced IRA or pension treatment of saving, and faster recognition of the cost of investment for tax purposes (accelerated depreciation write-offs). Cutting taxes on labor, at the margin, is also pro-growth because people work more for higher after-tax wages. Not all tax cuts spur enterprise, but the various rate reduction features of the President's tax plan are definitely pro-growth.

In effect, the country is in the position of a family with a $50,000 mortgage, $40,000 in annual income, and $35,000 in annual expenses (including the mortgage payments). Should the family put its $5,000 surplus in the bank or the stock market, or use it to pay down the mortgage faster? That depends on how high the interest rate is on the mortgage, what returns the family could get from the bank or the stock market, and what it might need the money for in a few years. If the mortgage rate is 6% and the interest, dividends and capital gains returns on bonds and stocks are 8%, the family would be better off saving the money. If Junior is just starting high school, and the family needs to add an additional $20,000 in savings over the next four years to complete Junior's college fund, it would be better off keeping the money. If it paid down the mortgage instead, it would only have to borrow the money back four years hence to make the tuition payments. Debt reduction makes sense only if it is the most valuable use of the money.

Tax issues for a later bill that would move toward fundamental tax reform.

Other features of the tax code have resulted in high, sometimes outrageous marginal tax rates, with a substantial tax bias against saving and investment. These biases and abnormal tax rates could all be corrected by moving to a fundamental tax reform that establishes a saving/consumption neutral system. Short of fundamental reform, there are many steps that can be taken to reduce the distortions and biases.

Shorten all asset lives in the capital cost recovery system. This step would reduce the cost of capital at the margin on new investment. It would give the most bang for the buck for long term growth and have a quick effect on the economy. It addresses the slump in investment that is part of the current softness. The ultimate goal should be expensing, as in a saving/consumption neutral tax system.

Enhance IRAs and 401(k)s as in last year's Portman-Cardin bill. Expanding pension treatment of saving is a step towards fundamental tax reform, in which all saving would receive that treatment. It would be useful to combine all retirement and education saving incentives into one large, simple program. Penalties, withdrawal restrictions, and contribution and income limits should be eased or ended.

Reform the tax treatment of Social Security benefits. The formulas for taxing Social Security benefits impose very high marginal tax rates on wages and savings income by boosting the 28% tax rate to an effective 42% or 52% as up to half or 85% of benefits become subject to tax. Combined with the earnings test and the payroll tax, marginal rates on wage income can exceed 100%. Taxation of benefits needs to be completely redesigned and decoupled from other income to avoid this tax spike.

Eliminate the phase-outs of personal exemptions and itemized deductions (and other phase-outs where feasible). Ending these phase-outs is equivalent to an additional marginal rate cut of about 1 percentage point (single filer) to 6 percentage points (couple with four children) , and would simplify tax filing.

Get rid of the personal and the corporate AMT. The AMT distorts the definition of income and accelerates tax payments in an inappropriate manner. In the process, it makes investment less profitable and reduces the capital stock, productivity, and wages.

Reform Social Security by diverting 2 or more percentage points of the payroll tax to personal accounts.

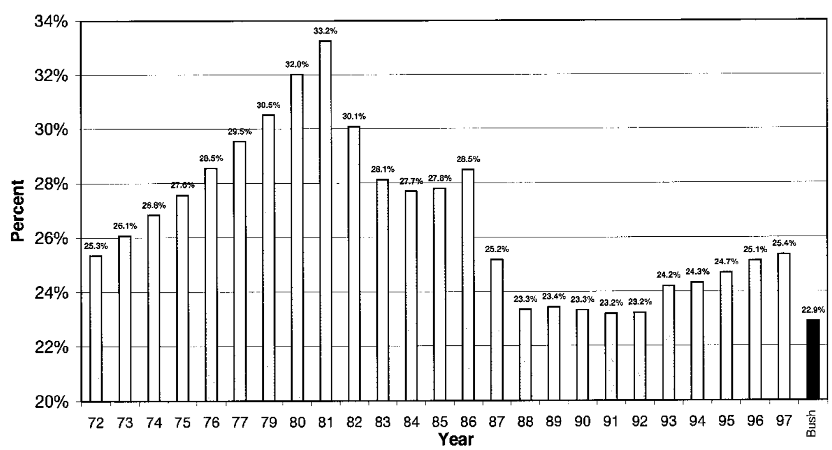
Conclusion

Letting the economy slump would be bad for the budget. If Congress wants to make sure that surpluses continue and the debt is paid off, it should rein in federal spending and cut tax rates to keep the economy moving forward. Tax rate reduction, at the margin, is the key to a successful tax cut. Taxes do not boost the economy by giving people money to spend. They work by increasing the reward, at the margin, for incremental effort, saving, and investment. They may do so by cutting explicit marginal tax rates on labor and capital income, or by amending the tax base to eliminate the mismeasurement and multiple taxation of income used for saving and investment.

President Bush has proposed marginal rate cuts and the elimination or reduction of certain tax rate spikes that are triggered by some peculiar provisions of the tax code. His bill is an excellent place to start. It is not too big; if anything, it is too small. It should be implemented more rapidly than originally proposed. It should not be constrained by a "trigger." It should not be watered down in favor of faster elimination of the public debt.

The President's bill should be followed by further tax changes that lead toward fundamental tax reform. The goal should be to eliminate the tax biases against saving and investment at the individual and business levels, and to eliminate the tax spikes and complexities created by peculiar rules regarding deductions and credits in the current code.

Chart 1 Weighted Marginal Individual Income Tax Rate



Data Sources: Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, various issues; Internal Revenue Service, Statistics of Income Bulletin, various issues. (1978 omitted because IRS did not publish marginal rate data for that year.) The last bar shows what the weighted marginal tax rate would have been in 1997 if the rate brackets proposed by President Bush had been in effect then.

Chart 2 Individual Income Tax's Marginal Rates: Current Law Versus President Bush's Proposed Rate Brackets

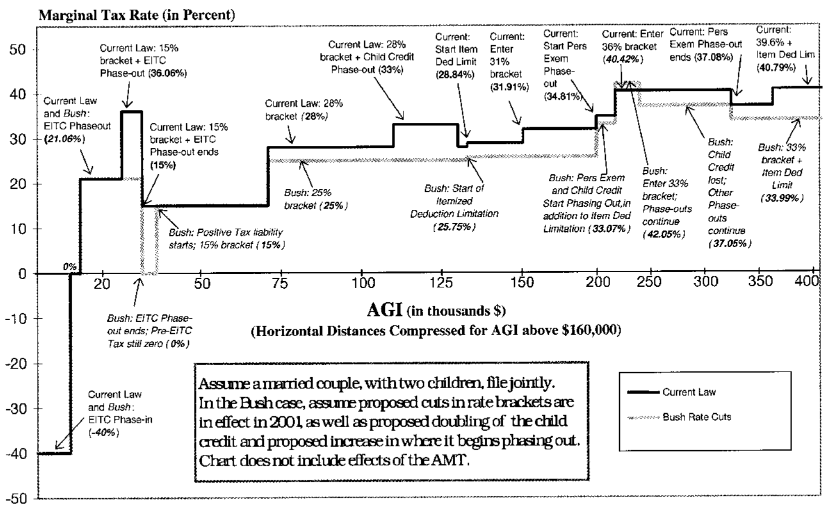
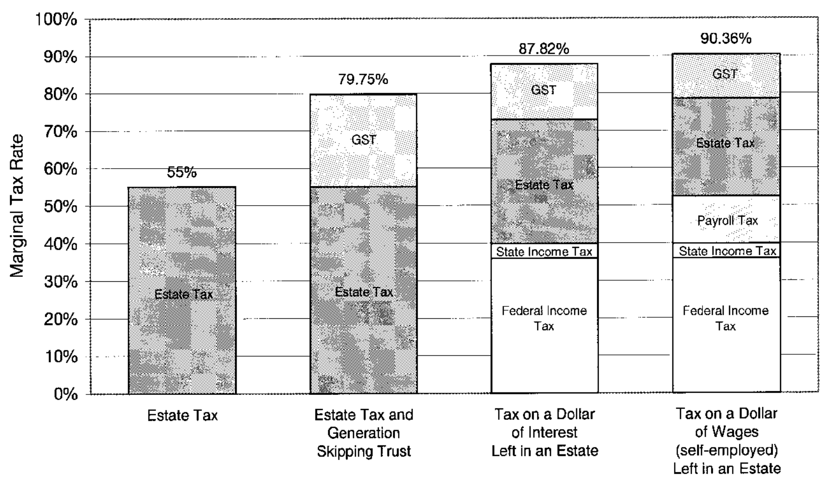


Chart 3 Marginal Tax Rates On Estates And Income Contributed To Estates



Assumes married couple in 36% tax bracket, who are self-employed, with a 6% state income tax as an itemized deduction.

Chart 4 Individual Income Tax's Marginal Rates: Current Law Versus President Bush's Proposed Rate Brackets

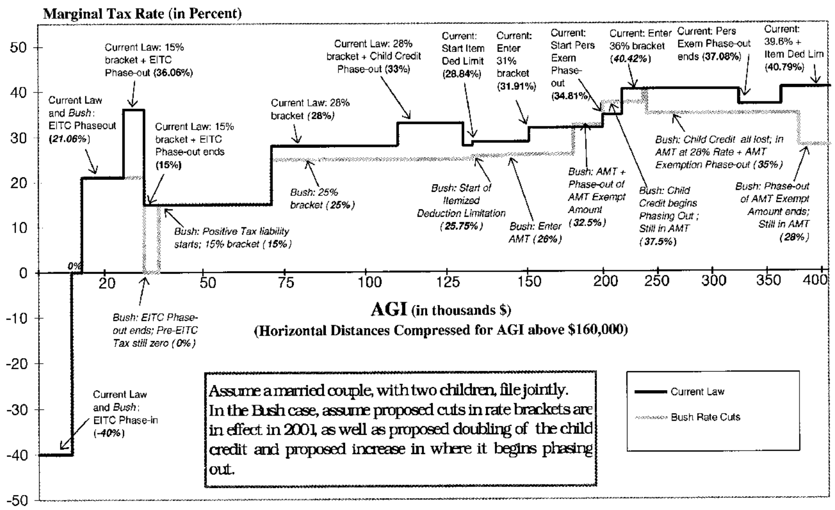
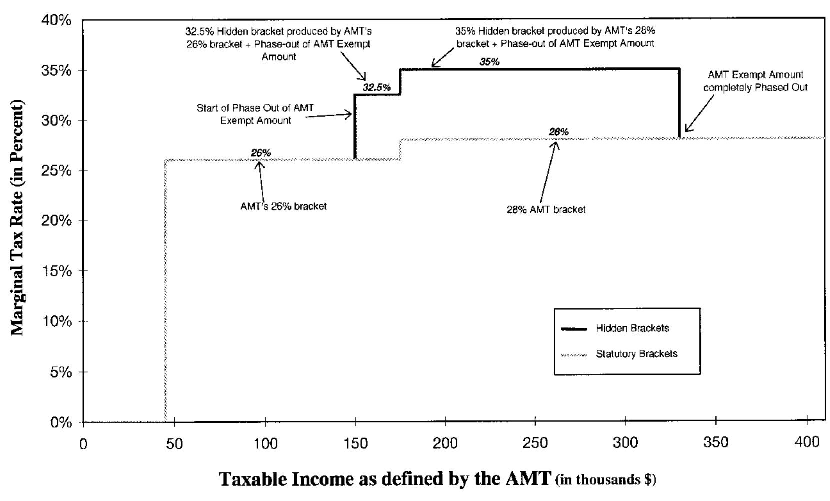


Chart 5 The AMT for Individuals Has Two Hidden Rate Brackets Due to the Phase-Out of the AMT Exempt Amount Married Couples Filing Jointly



PREPARED STATEMENT OF CAROL MARKMAN

My name is Carol Markman. I am the Chairperson of the National Tax Policy Committee and a Board Member of the only professional organization representing only Certified Public Accountants in Public Practice, the National Conference of CPA Practitioners, NCCPAP. Accompanying me is Robert Goldfarb, the President of NCCPAP, and Alan Feldstein, Vice President of our national organization. Mr.

Goldfarb was recently named as one of the 100 most influential accountants in America. He is also a past Chairperson of our National Tax Policy committee. Mr. Feldstein is a member of our National Tax Policy Committee and our Legislative Liaison.

The membership of NCCPAP consists of Certified Public Accountants in public practice located throughout the United States with a concentration of chapters in the Northeast section of the country. Many of our members are also members of the American Institute of CPAs (AICPA), an organization with which you are already familiar. The AICPA's membership includes practicing CPAs, but also includes non-practicing CPAs, such as educators, accountants in private industry and government. More that 65% of the total AICPA membership do not service the public. The members of NCCPAP deal with the Internal Revenue Code on a daily basis directly with the public! We live the Internal Revenue Code every day and sort through its complexities constantly. We estimate that our members serve more than 500,000 businesses and individual clients throughout every state of the country. We appreciate the invitation to participate in this hearing.

Until the Tax Reform Act of 1986 was enacted, if there was a deduction or credit in the tax code, it was available equally to almost every taxpayer without regard to their adjusted gross income. The 1986 Act changed the tax code from 15 brackets ranging from 11 to 50 percent to two brackets, 15 and 28 percent. The offset to this simple rate structure was the beginning of the phase-ins and phase-outs of deductions and credits. In 1988, for the first time, the personal exemptions, then $1,950, began to be phased out when the adjusted gross income for a joint filer was $149,250 and completely eliminated when income exceeded $171,650. Most miscellaneous itemized deductions including unreimbursed employee business expenses were deductible only to the extent that they exceeded two percent of adjusted gross income. Beginning in 1987, only eighty percent of business meals and entertainment expenses were deductible. For the first time, only taxpayers who were not active participants in an employer pension plan and those with very limited incomes could make deductible IRA contributions. The deductions for sales taxes, credit card interest and other consumer interest were eliminated and many other changes were made to the Tax Code. Also the Alternative Minimum Tax rate was set at 21 percent.

Beginning in 1991, taxpayers with income above an "applicable amount" ($100,000 for all taxpayers except married filing separately) began to lose a portion of their itemized deductions. This limitation is calculated after all the other limitations. Up to eighty percent (80%) of itemized deductions can be lost as a result of this provision.

Since that time, tax rates have increased to a current maximum rate of 39.6 percent but the phase-outs have proliferated effectively raising this marginal tax rate beyond the stated rate of 39.6 percent. As new tax benefits have been introduced, many are limited by adjusted gross income. The public's perception is that the tax code gives benefits, deductions and credits with one hand and takes them away with the other. There are some provisions of the tax code such as the education credits that, in our experience, are available only to taxpayers such as single parents who receive untaxed child support. A newly married couple with wages of $60,000 for the husband and $55,000 for the wife who rent an apartment in New York City are precluded from deducting the $1,400 in student loan interest that they paid.

Deductible IRA contributions can be made by divorced individuals who receive alimony payments from their former spouse but is not available to very many other taxpayers. Other taxpayers that have the funds available to make the IRA contributions are not permitted to do so because they have pension plans at their place of employment. A taxpayer that would prefer to make an IRA contribution early in the year to take advantage of the tax deferral may not be able to do so because an unexpected event at the end of year may render the IRA contribution ineligible.

The attached chart details some of the current phase-outs. Many of these are based on filing status. Others are different only for married taxpayers filing separately. Some phase-outs have kept pace with inflation others have not. As you can see from the attached chart, the phase-out ranges are different for various deductions and credits, even for the same filing status. This causes additional confusion and complexity. Additionally some phase-out ranges are $10,000, others are $15,000 and still others are $25,000. The phase-out range for Alternative Minimum Tax can be as much as $180,000.

One of the most serious problems with the phase-outs is that even a seasoned tax professional cannot sit down with a married taxpayer and prepare a tax return or projection if their income is above $52,000 using only a pencil, paper and calculator. The code is so complex and provides for so many phase-outs with different ranges, and different beginning and ending points. It is impossible to prepare even a tax projection without being armed with a series of worksheets, schedules and charts. Some phase-out limits change annually, others do not, so the preparer can never be sure of the applicable limits for specific phase-outs without resorting to numerous reference materials.

One example, identified by one of our members, concerns Qualified Performing Artists. Code section 62(b)(1) and (3) of the 1986 Tax Act defines the term "qualified performing artist." The section permits an above the line deduction for the professional expenses of a performing artist but only if the individual's adjusted gross income is below $16,000. The constraints of this provision are so narrow as to preclude any benefit to the vast majority of low income performing artists who live in high cost areas such as California, Massachusetts, Texas or New York. This is a perfect example of giving with one hand and taking away with the other.

During the last several years NCCPAP developed the following related issues:

The Taxpayer Relief Act of 1997 established education incentives in the form of tax credits for qualified tuition and related expenses to eligible post-secondary educational institutions. These credits were designed to benefit low and middle-income taxpayers. Income limits were established for single taxpayers with the phase-out beginning at $40,000 of AGI and ending at $50,000 of AGI. For married taxpayers filing jointly, these phase-out levels were doubled. The Act did not differentiate between a single taxpayer and a single taxpayer with dependent children (Head of Household). The cost of living is significantly different when an individual must pay maintenance for additional family members yet they are subject to the same phase-out limits as a single taxpayer. An expense such as child care so that the parent can go to school is not considered. Code Section 25A should be expanded to permit taxpayers claiming Head of Household status a higher income phase-out than single taxpayers in order to allow more single parents to claim tuition tax credits or the phase-outs for education credits should be made uniform or eliminated.

The phase-out provisions exacerbate the problem of the marriage penalty. The present tax system of separate tax tables and schedules for single and married taxpayers has its roots back in the Tax Reform Act of 1969. At that time the majority of households had a single wage earner. Currently, a single individual taxpayer has a standard deduction of $4,400 and an initial tax rate of 15% for taxable income up to $26,250 and a tax rate of 28% for the next $37,300 of taxable income. A married couple has a standard deduction of $7,350 and an initial 15% tax rate on their first $43,850 of taxable income and a 28% tax rate on the next $62,100 of their taxable income. Exemptions are phased out for "high-income" taxpayers beginning at $128,900 for a single taxpayer and $193,400 for joint filers. The reduction of itemized deductions for "high-income" taxpayers begins when adjusted gross income exceeds $128,950 whether single or married filing jointly. Another issue previously identified by NCCPAP is the treatment of employee business expenses. Internal Revenue Code section 67(a) requires an employee, who incurs ordinary and necessary business expenses in the performance of his/her duties who are not reimbursed by his/her employer to list those expenses on Form 2106. This total is transferred to Form 1040, Schedule A, as a miscellaneous itemized deduction which is required to be reduced by two percent (2%) of the taxpayer's adjusted gross income. The deduction for these expenses can be further reduced by the phase-out of itemized deductions. In many cases these reductions cause the expenses to be eliminated and the employee is denied these legitimate deductions for tax purposes. In addition, employee business deductions are not an allowable expense for AMT purposes.

"Statutory Employees" and businesses in all forms, i.e., corporations, partnerships, LLC's, LLP's and sole proprietorships, are allowed to deduct all business expenses in full against gross income (subject to certain limitations such as 50% of business meals and entertainment that effect all taxpayers equally). The only business expense not allowed to be deducted in full are those incurred by employees. This is unfair to the typical wage earner.

> The total of all employee business expenses listed on Form 2106 should be allowed as a deduction before arriving at Adjusted Gross Income. It should not be listed on Form 1040, Schedule A, as a miscellaneous itemized deduction, nor be an addback for the Alternative Minimum Tax.
>
> The phase-outs have an erosive effect on tax compliance and tax practitioners are forced to tell clients that many tax saving provisions that they read about in the press at this time of the year do not apply to them. They are considered "rich" yet struggle to make ends meet living an ordinary life style in high-income states. My colleagues and I think it is prudent to permit taxpayers to utilize the deductions and credits currently available in the tax law before focusing on lower tax rates. The elimination of the phase-outs will simplify the tax law and make it fairer.

If the phase-outs must be continued, then there should be a uniform phase-out limit for most provisions and the limits should be adjusted to reflect the costs in high tax states.

Respectfully submitted,
ALAN FELDSTEIN, CPA
ROBERT GOLDFARB, CPA
CAROL MARKMAN, CPA
on behalf of the National Conference of CPA Practitioners

ADJUSTED GROSS INCOME PHASE OUT RANGES FOR 2000

DESCRIPTION OF BENEFIT	MARRIED FILING JOINT/ QUALIFYING WIDOW(ER)	SINGLE OR HEAD OF HOUSEHOLD	MARRIED FILING SEPARATELY	NTERNAL REVENUE CODE SECTION(S)	FOOTNOTE
ADOPTION CREDIT/EXCLUSION	75,000-115,000	75,000-115,000	NO CREDIT	23,137,221(b)(2)	1,6
ALTERNATIVE MINIMUM TAX EXEMPTION	150,000-330,000	112,500-247,500	75,000-165,000	55(d)	7
ELDERLY/DISABLED/ (IF BOTH ELIGIBLE)	10,000-20000/-25,000	7,500-17,500	5,000-12,500	22	4
ITEMIZED DEDUCTIONS	AMOUNTS OVER 128,950	AMOUNTS OVER 128,950	AMOUNTS OVER 64,475	68	3
PASSIVE RENTAL LOSS EXCEPTION	100,000-150,000	100,000-150,000	NOT APPLICABLE	469(I),221(b)(2)	1,6
PASSIVE ACTIVITY BUSINESS LOSS	100,000	100,000	50,000	469(I),221(b)(2)	1,6
PERSONAL EXEMPTIONS	193,400-315,900	128,950-251-450(SINGLE) 161,150-283,650(HOH)	96,700-157,950	151	3
SAVINGS BOND INTEREST	81,100-111,100	51,100-69,100	NO EXCLUSION	135,221(b)(2)	1,3
CHILD CREDIT	110,000-119,000	75,000-84,000	55,000-64,000	24	1,5
EDUCATION IRA	150,000-160,000	95,000-110,000	95,000-110,000	530	1
EDUCATION LOAN INTEREST EXPENSE	60,000-75,000	40,000-55,000	NO DEDUCTION	221(b)(2)	1,3
HOPE EDUCATION CREDIT	80,000-100,000	40,000-50,000	NO CREDIT	25A	1,3
IRA DEDUCTION WITH PENSION COVERAGE	52,000-62,000	32,000-42,000	0-10,000	219(g),221(b)(2)	1,2
IRA DEDUCTION WHEN SPOUSE HAS RETIREMENT COVERAG	150,000-160,000	NOT APPLICABLE	NOT APPLICABLE	219(g)(7), 221(b)(2)	1
LIFETIME LEARNING CREDIT	80,000-100,000	40,000-50,000	NO CREDIT	25A	1,3
ROLLOVER ROTH IRA	100,000	100,000	ROLLOVER NOT ALLOWED	408A,221(b)(2)	1
ROTH IRA	150,000-160,000	95,000-110,000	0-10,000	408A	1

FOOTNOTES
1 - MODIFICATIONS TO ADJUSTED GROSS INCOME APPLY
2 - INCREASES FOR FUTURE YEARS ARE SPECIFICALLY PROVIDED IN THE STATUTE
3 - ADJUSTED GROSS INCOME LIMITED ARE ADJUSTED FOR INFLATION
4 - MARRIED FILING SEPARATELY CAN ONLY CLAIM THE CREDIT IF THEY LIVED APART DURING THE ENTIRE YEAR
5 - SIZE OF PHASEOUT RANGE DEPENDS ON THE NUMBER OF QUALIFYING CHILDREN IN FAMILY
6 - SPECIAL RULES APPLY FOR DETERMINING MARITAL STATUS WHEN SPOUSES DO NOT LIVE TOGETHER THE ENTIRE YEAR
7 - PHASEOUT APPLIES TO ALTERNATIVE MINIMUM TAXABLE INCOME RATHER THAN ADJUSTED GROSS INCOME