S. HRG. 110–1044

CRACKING THE CODE: TAX REFORM FOR INDIVIDUALS

HEARING

BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

MAY 13, 2008

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

56–740—PDF WASHINGTON : 2008

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON FINANCE

MAX BAUCUS, Montana, *Chairman*

C O N T E N T S

OPENING STATEMENTS

WITNESSES

ALPHABETICAL LISTING AND APPENDIX MATERIAL

COMMUNICATION

CRACKING THE CODE: TAX REFORM FOR INDIVIDUALS

TUESDAY, MAY 13, 2008

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

The hearing was convened, pursuant to notice, at 10:04 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Wyden, Salazar, Grassley, Hatch, Snowe, Smith, Bunning, and Roberts.

Also present: Democratic Staff: Bill Dauster, Deputy Staff Director and General Counsel; Kathy Koch, Senior Advisor, Tax and Economics; and Tiffany Smith, Tax Counsel. Republican Staff: Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; Nick Wyatt, Tax Staff Assistant; and Ellen McCarthy, Tax Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Yale Law Professor Michael Graetz has said, "The tax law is the primary link between the Nation's citizens and the government. Many more people file tax returns than vote in presidential elections." The numbers bear that out. For the last presidential election, 10 million more people filed income tax returns than cast presidential ballots.

Individual income tax returns are the primary source of the Nation's revenue. Individual income tax collections account for about half of the revenues that the Federal Government collects. As the former head of the Joint Committee on Taxation testified in 2001, the burdens of complexity fall particularly on individual taxpayers. So it is only fitting that today's tax reform hearing focuses on tax reform for individuals.

The IRS estimates that it takes people an average of 26.4 hours to complete the individual tax form. That is more than a complete day just to figure out how much you owe the Federal Government; clearly too long. That is only the average. Some people take a lot longer to figure out their taxes. That number does not count up all the time actually spent. Most of us do not just sit down and work out our taxes in one sitting. Most taxpayers spend a lot of time gathering information. People spend days, even weeks, compiling information before sitting down to fill out a tax form. On top of that, many people have to calculate the Alternative Minimum Tax.

Why is filing your taxes so complicated? One reason is because the tax code has multiple functions. The government raises revenue with taxes, and then the government also uses the tax code to implement social policy, as well as economic policy. For example, through the Earned Income Tax Credit, people are raised out of poverty. Through college education credits and deductions, college is more affordable and accessible. Through tax cuts, Congress can give a boost to the economy during hard times.

As we begin the task of tax reform, we will have to determine priorities: how can we make the tax code fairer? How can we make it simpler? How can we reduce its drag on the economy? And can we do all these things at the same time?

On April 15, I began this series of hearings with a broad overview of tax reform. Today we will consider what our priorities should be in the individual area. Future hearings will address small businesses, corporations, and international competitiveness, among other topics.

So let us see if we can make the primary link between the Nation's citizens and the government just a little less painful. Let us see if we can make the primary source of the Nation's revenue a little fairer. Let us see how we might lessen the burdens of the tax code on America's individual taxpayers.*

Senator Grassley?

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Thank you, Mr. Chairman.

Just about everybody agrees that the tax code is very, very complex. The tax form instruction book is probably the most unwelcome piece of mail many taxpayers get. The complexity means that taxpayers cannot be confident that they received all the breaks coming to them or that they have not paid more than they owe.

As last month's tax filing deadline came to a close, millions of hardworking American taxpayers knew about the complexity first-hand. As we note the complexity, we should also note a point one of the key 1986 Tax Reform architects has made several times. This is what Senator Packwood, then-chairman of the committee, was fond of saying: "Many taxpayers accept complexity that favors them."

When we consider the complexity of the regular tax system and the creeping effect of the Alternative Minimum Tax, you have a recipe for disaster. As an example of the problems from the AMT side, if we do not extend the hold-harmless, or patch for 2008, 25 million tax filers, mostly families, will be affected by the AMT. Twenty-five million families. Think about that. Because of the way the AMT is structured with no indexing, the AMT problem grows exponentially from year to year.

The revenue loss for last year's patch was $50 billion, and it grows to $65 billion this year, so we are facing a train wreck. So, there is no question that we have big problems. It is a problem that the committee should focus on. Let me say that I have no pre-

---

*For further information on this subject, *see also,* "A Reconsideration of Tax Expenditure Analysis," Joint Committee on Taxation staff report, May 12, 2008 (JCX–37–08), *http://www.jct.gov/publications.html?func=startdown&id=1302.*

conceived notions of which direction we should go, whether we are talking about a flat tax, a national retail sales tax, a value-added tax, or substantial modification of the current system.

Let me also note that more than 3 years ago I instructed the Finance Committee tax staff on our side to develop a simplification proposal in all income tax areas. The staff have worked up some proposals. While we all agree something should be done and we should be open-minded about what reform would look like, I would like to remind folks that there is a key premise to tax reform that needs to be fleshed out. The premise I refer to is whether we assume current-year law levels of tax relief in effect or whether we assume that the bipartisan tax relief plans of 2001 and 2003 expire.

If we use the latter assumption, which is that the post-2010 record-level tax increase goes into effect, then tax reform really becomes a historic tax increase. According to the latest figures from the nonpartisan Congressional Budget Office, individual income taxes will go up by more than 10 percent in terms of a share of GDP. Said another way, American taxpayers will, on average, be sending an additional 10 percent in taxes to Washington, DC for Congress to spend instead of the marketplace deciding how it will be divided up. That is simply because the bipartisan tax relief expires.

Now, it can be said yet a different way from the standpoint of the typical worker. Everything else being equal, that worker will see his or her take-home pay shrink by an extra 10 percent in taxes. I raise this point because we are talking about individual income tax reform. If we are to enter the tax reform playing field, we need to know the rules, including the size of the playing field in revenue terms. Are we assuming tax reform is not possible without a record tax increase? This is a question that all policymakers should have to answer.

This is a question that presidential candidates will have to speak to before the end of the election. I hope the answer is that the goal of a tax reform exercise ought to be to maintain the levels of taxation in effect before the Armageddon nearly every taxpayer faces in 2011. If the goal is different—a record tax increase upwards of 10 percent on the American taxpayer—then I have very serious reservations about whether we can—or more importantly should—undertake the effort. So I look forward to the testimony of our distinguished panel today, and hopefully we can understand how this possible tax increase works into tax reform.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator, very much.

Our first witness is Dr. Leonard Burman. Dr. Burman is the director of the Tax Policy Center and a senior fellow at the Urban Institute. The second witness is Dr. William Gale. Dr. Gale is the vice president and director of economic studies at Brookings. Next, is Mr. Stephen Entin, who is president and executive director of the Institute for Research on the Economics of Taxation. Finally, Dr. J.D. Foster, who is a senior fellow in the economics of fiscal policy at The Heritage Foundation.

Thank you all for coming. Our usual practice is that each of you will speak for 5 minutes, and your statements automatically will be in the record.

Dr. Burman, why don't you proceed?

STATEMENT OF DR. LEONARD BURMAN, DIRECTOR, TAX POLICY CENTER; AND SENIOR FELLOW, URBAN INSTITUTE, WASHINGTON, DC

Dr. BURMAN. Thank you, Mr. Chairman, Ranking Member Grassley, and members of the committee. It is a real pleasure to be invited to speak about tax reform to this panel, in particular. I actually came to Washington in 1985 to work on what became the Tax Reform Act of 1986, and I remember the pivotal role that this panel played in developing that historic bipartisan legislation. I am excited about the prospect of playing a similar role in our next tax reform.

In the 1980s, there was a huge need for tax reform. Tax shelters had gotten completely out of control. There were empty office buildings that were built just because of the tax benefits, and people widely perceived the tax system to be unfair.

Arguably, right now there is an even greater need for tax reform, for at least four reasons. One is the expiration of the tax cuts at the end of 2010. I do not think anybody thinks that the tax cuts should just be allowed to expire with nothing happening in their place, but there is a real question as to what we can afford in terms of future tax cuts. That is actually exacerbated by the AMT problem which Senator Grassley referred to. We are counting on the AMT to raise $1 or $2 trillion of revenue over the next 10 years depending on whether the tax cuts are extended. If you take the Bush tax cuts, AMT, all of the other things that are perpetually extended and you add them all together, plus the additional interest on the debt, those would increase the national debt by the end of 2018 by $4.6 trillion.

Now, if revenue were pouring into the Treasury, that might not be a huge problem, but in fact that would bring revenues well below their historic levels, and at a time when there will be unprecedented demands on the government. The baby boomers are starting to retire now, and they are going to be drawing Social Security and medical care that, over time, would basically lead us to bankruptcy if our current revenues were continued.

Of course, the last problem which you referred to is that the income tax is a mess. It is complex, it is widely perceived to be unfair, and it is definitely not conducive to economic growth. So how could we get tax reform? Obviously it requires presidential leadership. I think it is a good sign that in this campaign, both—or I guess all three—of the presidential candidates are talking about how they can work with people across party lines and how they can get things done. The fact that this is a change election, I think, is a really good sign. It obviously needs to be bipartisan. If one party decides to run with tax reform, the other party will be able to cream them because any kind of meaningful tax reform would raise taxes on some people.

It needs to address the concerns of both parties. It needs to be progressive. It needs to raise enough revenue to finance the government. If a Democrat is elected, it needs to dovetail with health reform. It needs to lower the tax burden on capital. We need to have a credible way to control spending. Of course, it needs to be simple, fair, and pro-growth.

I outline a proposal which I think would move forward in all of these directions. I note—and I should have noted more clearly in my testimony, that Senator Wyden has also been moving forward with a similar proposal in many respects. One main element is to have a value-added tax that is dedicated to paying for health care: Medicare, Medicaid, and basically a voucher that will provide an adequate level of health care for everybody. This would allow substantial income tax cuts.

One of the things that made the Tax Reform Act of 1986 happen was that there was a big corporate tax increase, which most people did not think they had to pay, and that made it possible to cut individual income taxes, which made tax reform much more palatable. I argue that the VAT, the value-added tax, devoted to paying for health care, could produce a similar kind of a trick. The details are in my testimony; obviously I do not have time to go through them in great length.

But the basic idea is that the new income tax system would have a very broad base, it would be vastly simplified. Tax rates would be cut dramatically. The top rate would be 25 percent, or possibly even lower. Most people would not have to file income tax returns. That is, withholding on wages, interest, dividends would be sufficient to determine tax liability at the end of the year. There would be a small exemption for capital gains, so the people who had a small mutual fund or something like that would not have to file simply because of that. There would be a simplified refundable tax credit for children and to encourage working, along the lines of what Michael Graetz has suggested. I think you heard from him a couple of weeks ago.

The VAT dedicated to health care would have a number of advantages. One is that, for the first time, everybody in the public would see a connection between health spending and taxes. Everybody would have to pay the value-added tax. If health spending continued to grow faster than the economy, the VAT rate would grow over time. That would make it possible to do the kinds of sensible things to limit health care cost increases that might otherwise be politically difficult.

It would help lower- and middle-income working families and small businesses and would be a relatively efficient way to raise revenues. Because we get rid of the exclusion on employer-sponsored insurance, it would bolster the Social Security trust fund. So I do not pretend that I have the answers to all of our problems. I understand that these things are a lot more difficult than I outline even in my written testimony. But I think, thinking along these lines, we might be able to do something that would be of benefit, that would make the economy stronger, and make the tax system a lot simpler and fairer for most Americans.

Thank you very much.

The CHAIRMAN. Thank you, Dr. Burman. That was very interesting.

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

The CHAIRMAN. Dr. Gale?

STATEMENT OF DR. WILLIAM GALE, VICE PRESIDENT AND DIRECTOR OF ECONOMIC STUDIES, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. GALE. Thank you very much. Thank you for inviting me to testify at this hearing on individual taxpayers and tax reform. I think everyone agrees that the tax system needs reform. What I would like to focus on are six over-arching goals or guidelines to focus on or think about as we endeavor to change the tax system.

The first thing is, although it is good to focus on how taxes affect individuals, it is important to realize there is not really a bright line between taxes on individuals and taxes on businesses. So that could be used to your advantage, as Len mentioned happened in 1986, but it is important to understand that the burden of the tax ultimately does fall on individuals.

Any tax on a business ultimately burdens some individuals, whether it is the shareholder, the worker, the customer, the supplier, et cetera. In short, you cannot reduce the overall burden on individuals by shifting the collection of taxes to the business sector. Ultimately it filters back to individuals.

The second point is, people will talk about a whole lot of issues in tax reform, but there is one thing that needs to happen to reform the system, and that is to change the base of the tax system, the tax base. There is a lot of talk about whether we go to a consumption tax or an income tax. In my view, either of those would be better than the system we have right now. We call it an income tax right now, but the thing that is taxed bears very little relation to any economic notion of income.

So for argument purposes, let us focus on an income tax. The key to reform is to broaden the base, to tax all income, tax it at one rate, tax it at the full rate, tax it only once. So you do not want double taxation, you do not want sheltering. You want a very comprehensive tax base where everything is taxed at the same full-rate structure. This is not an argument for flat taxes, this is an argument for a broad base.

This does several things for the tax system and for the American public. First, it levels the playing field, so it reduces the distortion across different activities that come from taxing different activities at different rates. Second, it allows you to reduce the overall rate structure because the base is more comprehensive. That in turn further reduces the extent to which taxes affect or distort economic actions. Third, it makes taxes simpler. If you think about where the complications in the tax system come in, it is all in the base, figuring out which types of income are taxed at which rates, which types of deductions and exemptions, et cetera, that people get to use. So regardless of what you want to do in tax reform, fixing the base is the first step, is the key step. It is not a sufficient step, but it is a necessary step.

My third point. After that is done, after you have dealt with the base, the third thing to do is think about the current structure of exemptions, deductions, and exclusions, et cetera. Deductions tend to be overly regressive, they tend to be overly expensive. They are not justified, in most cases.

The only time a deduction is justified is if there is a reduction in ability to pay taxes. If you look carefully at most of the deductions in our system, they do not relate to ability to pay taxes, they relate to social goals. Those should be structured as refundable credits so that everyone gets them rather than just high-income taxpayers.

So that is an opportunity in terms of restructuring deductions. That is an opportunity to save money, to be more efficient, to give better incentives, and to be less regressive in the tax system.

The fourth point is that it is time to eliminate the AMT. We are never going to have a partial reform of the AMT. As long as it is there, it is going to be a mess. The AMT is really evidence of a failure in the underlying tax system. So when I say it is time to reform the AMT, there are two big caveats associated with that. One is, you have to replace the revenue and the baseline that the AMT generates, and the other is, you have to shut the loopholes in the regular tax that would be there if the AMT were gone. But it would be relatively simple to do that, and you could remove the whole AMT structure with some relatively simple reforms.

The fifth point is just that a revenue system that is not adequate to finance government spending will ultimately not be sustainable. It will not be stable. We will end up with situations like we have in 2010, where tax cuts expire and we have to figure out how to deal with them.

The extension of this is, government spending is a tax issue. In fact, it is the only reason that we have taxes, to pay for government spending. So, when we talk about Social Security or Medicare reform, those are tax issues, and it may well be that the way to get to tax reform is to put all those things in one big bowl and come up with some grand resolution for the entitlement issue, the tax reform issue, and the budget issue.

Along those lines, Len mentioned the value-added tax. Let me just toss carbon taxes into the mix. There are both good environmental reasons and good revenue and efficiency reasons to consider taxing carbon.

My last point—I will be real quick here—is that I cannot overemphasize the importance of making the system simpler. Tax policy, as you know, has enormous debates about how high taxes should be, who should pay taxes, what should be subsidized. There are all sorts of disagreements about tax policy. The one thing—the only thing—that everyone agrees on is that the system is too complicated, yet every year the system gets more complicated. So, when we head into tax reform, I think that is an important cautionary story, that, if you do not make simplification the most important thing, it will take a back seat and you will end up with a more complicated system, which is how we got to where we are now.

Thank you.

The CHAIRMAN. Thank you, Dr. Gale.

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

The CHAIRMAN. Mr. Entin?

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

Mr. ENTIN. Thank you, Chairman Baucus, Ranking Member Grassley, and members of the committee. I thank you for including me in the witness panel today to testify on tax reform.

It was one of the first issues I worked on when I came to Washington with Senator Bob Taft, Jr., in 1975 when I was his aide for the Joint Economic Committee. It is still unfinished business, and I would like to retire one of these days, so please let us get on with it. [Laughter.]

There are good tax reforms and bad ones. The Kennedy-Johnson corporate and individual tax changes of 1962 and 1964 got the economy moving again, as did the 1981 Reagan cuts, and the 2003 Bush tax changes. In contrast, the 1986 Tax Reform Act savaged saving and investment, especially real estate, and along with two payroll tax hikes, contributed to the 1990–1991 recession. It did get rid of some unwanted loopholes, but it went way too far in the taxation of capital.

The main focus of fundamental tax reform should be to end existing tax biases against saving and investment. Current tax law puts heavier taxes on income used for saving and investment than on income used for consumption. This reduces saving and investment, which reduces employment of labor, productivity, and wages. It is also the source of much of the complexity in the tax system.

Most of the tax burden on capital is shifted to labor in the form of lower wages. A man operating a backhoe can dig a lot more ditch than a man with a shovel, and is paid accordingly. Tax the backhoe, and you end up breaking the worker's back and his wallet. The workers would be much better off if these tax biases were eliminated.

Of every additional dollar of GDP made possible by added investment, about 50 cents goes to labor income after taxes, about 33 cents goes to Federal, State, and local governments as taxes, about 12 cents goes for depreciation, and about 5 cents is left for savers and investors after tax. Workers gain 10 times as much as capital owners; governments gain 6 times as much.

There are two fundamental concepts of taxable income, which is the tax base that Bill Gale has referred to: one is comprehensive income, the other is comprehensive consumption. The committee and the Congress should study the advantages of moving toward a consumption base. If we want more growth and higher incomes, especially for workers, we must settle on a consumption-based tax reform.

A pure comprehensive income tax, even if evenly applied, would tax individuals on the income that they save and also tax the returns to their saving. That is a basic bias of the income tax. The income tax cannot be even; it is not saving-consumption neutral. It would not allow pensions, IRAs, or deferral of tax on capital gains, but in its purest form would at least adjust the gains for inflation. It would employ depreciation instead of expensing of capital outlays. The U.S. version adds a corporate tax and estate tax to the other two hits on saving.

A pure consumption tax would either tax savings or the returns to saving, but not both. All saving would get pension or IRA treatment of one sort or another. It would not double tax corporate income, nor impose an add-on estate tax. Investment, productivity, and wages would be higher under a consumption base for any given amount of revenue raised.

The U.S. income tax has features of both systems. Some saving is allowed pension or IRA treatment. Capital gains are taxed when realized (but are not adjusted for inflation). Some investment is expensed. There is a partial offset to the double tax on corporate income from the 15 percent tax cap on dividends and capital gains.

Moves toward a comprehensive income base, as in the Tax Reform Act of 1986, reduce domestic saving, investment, productivity, jobs, and wages. They also chase capital off-shore or cause it not to be formed at all. Moves toward a consumption base, as in 1962, 1964, 1981, and 2003, tend to promote saving, investment, productivity, jobs, and wages, and attract capital from abroad.

There are several saving-consumption neutral taxes to choose from. You have seen before you in previous proposals things such as the business activities tax, a flat tax, a VAT, or a sales tax. My favorite would be a consumed-income or cash flow tax. It would be the most visible to the taxpayer/voter. It would be reasonably simple, and, with modest exempt amounts and reasonably low rates, it would be eminently fair. By any reasonable measure, these taxes are far simpler, far more efficient, and far fairer than the current income tax system.

Moving to a consumption tax base could raise incomes across the board by between 10 and 15 percent, or between $5,000 and $10,000 for middle-income families. That is a bigger benefit than some of the credits and handouts we now give.

I hope you would acknowledge the revenue feedback from pro-growth tax reform, but, if you do not want to do dynamic scoring, at least please have the Joint Committee on Taxation compute for you at every stage of your deliberations whether the tax bill you are working on raises or lowers the tax at the margin on capital. In particular, ask them to measure for you the service price of capital, the return necessary to make an investment possible on an after-tax basis.

If your tax bill raises that service price, as in 1986, it will retard economic growth and hurt workers. If it lowers it, it will be good for the economy. If you do not have that guide before you, you will not know as you work on the bill whether you are helping or hurting your constituents.

I hope you will also consider paying for the bill with spending restraint and not find other taxes to pile on and have a complex system where you would have many types of taxes in the mix. Bill Gale has already told you that only people pay taxes. That is absolutely true. Taxes hidden at the business level make the voters think they are not getting billed for government spending, and that is bad in a democracy.

I would suggest to you that these things that promote growth are also good for simplification. I do not think there is inherent conflict there. I think if you got busy on a pro-growth tax reform, the Nation, and all of your constituents, would be better off.

Thank you.

The CHAIRMAN. Thank you. That was very interesting.

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

The CHAIRMAN. Dr. Foster?

STATEMENT OF DR. J.D. FOSTER, NORMAN B. TURE SENIOR FELLOW IN THE ECONOMICS OF FISCAL POLICY, DOMESTIC POLICY STUDIES, THE HERITAGE FOUNDATION, WASHINGTON, DC

Dr. FOSTER. Thank you, Mr. Chairman, Senator Grassley, members of the committee. I appreciate the opportunity to testify this morning. I will be summarizing my written testimony.

The individual income tax is flawed in many ways, all of which are known to the members of this committee. However, rather than provide a catalog of problems and recommendations, I will instead emphasize the threat to two broad principles and then turn to a specific area, the taxation of education expenses.

Traditionally, tax reform discussions assume revenue neutrality, imposing a very useful discipline on theoretical discussions to emphasize the centrality of trade-offs. Tax legislation, however, is not a matter for the blackboard. Government must decide the level of taxation and the tax structure, so, among the many issues before the committee, I believe these two principles are paramount: first, the level of individual income tax collection should be low, and the marginal rates of tax imposed should be low.

The great risk for individual income tax reform is that both principles will be significantly violated. Over the next 2 years, Congress will debate whether to impose or prevent a massive tax hike on the American people, largely by raising marginal income tax rates. Such a tax hike in individual income tax rates would be individual income tax reform writ on a grand scale, moving entirely in the wrong direction.

Whatever other reforms this committee considers and whatever other benefits might follow therefrom, failure to prevent this tax increase would be profoundly negative for tax reform, for the economy, and for American taxpayers. This arises, of course, because tax cuts enacted at the start of the decade expire at the end of the decade.

Some suggest that extending these tax provisions, provisions that will then have been in the law for 8 to 10 years, is somehow a tax cut; respectfully, but emphatically, no. Extending current policy, or better yet making it permanent, prevents a tax hike.

This debate is muddied by a fundamental and longstanding flaw in the way tax provisions are scored. The issue here is the construction of the Congressional Budget Office revenue baseline. As it is always done under Republican and Democratic directors, the CBO revenue baseline reflects current law. In contrast, CBO's spending baseline correctly reflects current policy. CBO assumes current policy will extend throughout the budget window, even if the authorizing law expires during the budget window.

Appropriated spending illustrates the propriety of the current policy assumption. Should CBO assume no future appropriated spending? Of course not.

This current policy assumption extends naturally to other major programs such as SCHIP and the Farm Bill. In each case, spending levels are assumed to continue in the baseline even though the program expires. This is sound practice, and it is consistent with current services' budgeting principles.

In constructing baselines, revenue provisions and spending programs should be treated alike. Spending programs and tax provisions that expire should be assumed in their respective baselines to be extended. They should both reflect current policy, not current law. This is a matter of leveling the playing field, and it is a matter of basic fairness. It is a matter of getting it right.

If revenue provisions and spending provisions are treated alike, reflecting current policy, then scoring the extension of tax provisions would accurately show that, in terms of policy changes, nothing happens. And in terms of the ongoing deficit picture, nothing changes.

The AMT patch demonstrates the problem. There is strong support for extending the patch. Many members acknowledge that allowing the patch to expire would impose a huge tax increase, yet the revenue tables show extending the AMT patch to be a tax cut. The revenue baseline assumes the patch expires, so the patch's extension is shown as a revenue loss. The members are right, the baseline is wrong. Correct the baseline, and extending the patch in its current form would properly be shown to have no revenue consequences and no deficit consequences relative to current policy.

Let me turn now, if I could, to the issue of education. Education, or human capital formation, is essential to our Nation's future, and so is physical capital formation. Tax policy presumes there ought to be some deduction for investment in physical capital. This is fundamental to the income taxation of business. Similarly, some deduction for investments in human capital formation is fundamental to income tax levied on individuals.

The individual income tax already includes many provisions reflecting the importance of education. I note the Hope credit, the Lifetime Learning credit, the recent higher education tax deduction, and a host of other provisions.

These provisions in total reflect Congress's understanding of the importance of tax policy for education. Unfortunately, there are some tax policy voices who do not seem to understand this connection. I note a recent text from the Joint Tax Committee which states, "Other subsidies for education provided by the tax code"— emphasis on the word "subsidies," that is a critical errant term. Allowing a deduction for investment expenses is not a subsidy as a matter of principle, whether the investment is in a piece of equipment or in the education of the individual who works that equipment.

This is an area of tax policy, I believe, in which conservatives, moderates, and liberals can find common ground. We can find common cause for substantive individual income tax reforms that would be good for families, for students, and for our long-term prospects for international competitiveness, wages, and jobs.

Thank you, Mr. Chairman.

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

The CHAIRMAN. Thank you all very, very much.

Clearly, if we are going to have significant reform, there is going to have to be significant agreement. Dr. Gale made a point that, if this becomes partisan, we are not going to get very far. I just very much hope that this committee can lead the way in working together to try to find ways to address how it would properly reform the code. A concern I have, frankly, is American competitiveness—which the last two witnesses touched on to a degree—and a system which is biased against savings or not. I think it is an honest question.

On the other hand, we also want a system which is sufficiently progressive, as well as simple, et cetera. So I am wondering, as you all listen to each other, where is there some common ground? If you did not anticipate that question, it would be hard to kind of figure that out at this point. But where is there some common ground if you stop and think about what we need to do? Because I am trying to figure out a way where we can make significant changes in a way that makes the most sense, makes the code simpler, helps promote growth, and has the requisite amount of social policy that seems to make sense here.

I agree very much with basically the tenor of the witnesses, mainly, we have an income tax base which is corroded. I mean, it is just falling apart. We, Congress—the administration, too—makes the code more complex every year, with all new changes, and so on and so forth. It is hard to say no to groups, to come in and say, well, the general rule might make sense but we are the exception. We are a little different than the general rule. So let me just start out by trying to figure out an area, and anyone who wants to can go first, and where you think you all might want to agree. Where do you think you might agree and start building toward some commonality here? Who wants to take it?

Dr. GALE. I will take a crack at that.

The CHAIRMAN. All right.

Dr. GALE. I think, knowing all the witnesses fairly well, I think it is obvious we agree that the current system is a mess, particularly in two ways. One is that the complications that we have are not worth the benefits. The issue is not, how complicated is the system. The issue is, are the complications that we have worth what we get for it? J.D. talked about education. That is a perfect example of a mess. There is a separate education subsidy for every income level, basically. We do not need to have that. We ought to be able to conform that. We ought to be able to clarify that.

The other area where I think we are in agreement is that the uneven taxation of all sorts of things creates bad things. Steve wants to go to a comprehensive consumption base. I would personally prefer a comprehensive income base. The difference between those two views is nowhere near as big as the difference between either of those systems and the current system, and so the current system layers taxes more than once on some types of income, it completely exempts other types of income or consumption. So I think if you could get it simple and even, you probably would get a long way toward consensus.

The CHAIRMAN. All right.

Dr. Burman, you had your hand up.

Dr. BURMAN. Yes. The other thing I suspect we agree on is, if you could broaden the base and lower the rates——

The CHAIRMAN. First of all, on the last point, do the other three of you basically agree with what Dr. Gale said?

Dr. FOSTER. I basically agree with him. The distortions we now have in the tax code are not worth the price in terms of complexity and lost economic growth. Ultimately, the debate will fall onto whether or not we should have comprehensive consumption or comprehensive income as the starting point for our tax system. The starting point is critical. But I think if left to our own devices, we could probably come up with a fairly decent consensus that would meet none of our preferences perfectly, but would be far preferable to the tax code we have currently.

The CHAIRMAN. All right. Dr. Burman? I cut you off. Sorry.

Dr. BURMAN. One key point is, whatever tax system we have, if you can broaden the base and lower the marginal rate—there is probably some disagreement on this, but I would obviously like to maintain a level of progressivity—but meeting those objectives at a lower rate means that, whatever flaws there are in the tax system, it will have less of a cost on the economy. There is an economic theory that says that the higher the rate is, basically the cost of the economy grows in proportion to the square of the rate.

So when you double the rate, the cost quadruples. You might want to go to a comprehensive consumption tax, but if you have a high rate there is a strong incentive to convert and make ordinary income look like capital income and be exempt from tax. There will be tax shelters under any system. Those take a huge cost out of the economy. So whatever system you have, if you can keep the rates low, the overall cost to the economy is a lot lower.

The CHAIRMAN. Mr. Entin?

Mr. ENTIN. I would like to talk a little bit more with Bill Gale about exactly which elements of the uneven treatment of capital he was willing to get rid of, and then if you could get a low rate, then the difference between the income and the consumption base might not be too bad, depending on how far he is willing to go in that regard. He did mention the importance of getting the tax on capital lowered.

You had mentioned whether this can be bipartisan. I do not see why growth and higher wages are necessarily a partisan issue. In 1979 and 1980, when I was on the Joint Economic Committee staff, Congressman Bud Brown, who was my boss, and Senator Lloyd Bentsen, who was the chairman of the committee, got together, and we had a 2-year bipartisan report. We were faced with a very serious inflation-related hit on capital formation in the country; productivity was falling and real wages were going down. That report focused on the effect of inflation on the tax treatment of capital and why we needed to reverse that in some way or other.

Now, Senator Bentsen preferred to give the reduction in the tax on capital in the form of faster depreciation allowances to businesses when they actually did the investment. I think Mr. Brown would have been just as happy dealing with it either at the business end or at the shareholder end, in the case of the corporation. Of course with the proprietorship, they are one and the same. That little difference apart—and I have to say I think markets make the difference moot, because as has been pointed out, people pay taxes, not businesses; businesses per se, are legal fictions—but they found a way to do it, and they worked together on it. It had quite an impact on the political debate at that time. I think this is a good bipartisan, pro-growth issue.

The CHAIRMAN. Well, thank you all very much.

Senator Grassley?

Senator GRASSLEY. Mr. Entin, I am going to start with you because in 2001 you testified before this committee on the issue of bracket creep, and I want to get back to that issue, as it might come up in the future if taxes go up. I mentioned in my opening statement that under current law, any discussion of tax reform must contemplate the spike in tax burdens in the individual income tax system that will kick in in 2011. The rate system will dramatically change and affect virtually every American taxpayer, especially married couples.

In 2001, before the 2001 tax relief legislation was considered, you mentioned marginal rates. You indicated that the rate structure then in effect was bringing back a form of bracket creep. If we return to that rate structure in 2011, would you have the same concerns? And I would like to have you respond separately for the regular tax system, and also on the Alternative Minimum Tax.

Mr. ENTIN. In 1981 we enacted, and in 1985 it came into effect, adjustments of the tax brackets for inflation. We did not go further, however, to adjust the brackets for real income growth. Now, it is true that the CPI slightly overstates inflation, but not by enough to offset the real bracket creep that we get as people get richer over time.

The more steeply progressive the system, the higher the rates are, the worse that real bracket creep gets to be. We also failed to adjust for inflation on capital gains. We do not adjust for inflation on the depreciation write-offs, and there is a table in my testimony to show how much we understate cost and overstate profit in the corporate sector or in the small business sector by not having expensing.

On the other side, we do not adjust interest payments and receipts for inflation. So, yes, there is a good deal of real and inflationary bracket creep still in the system. You would not get that in a consumption base because you would have expensing rather than depreciation. You would mitigate it with a lower rate structure, and with the appropriate treatment of saving—that is, all saving getting one form or another of IRA or pension treatment—you would eliminate the inflation-related bracket creep, and the real bracket creep to a considerable extent, in that system. So you have much less of that in the consumption base. It would be much worse if the old rate structure came back.

The AMT—and I have to confess, when that came in after 1986, and with the confusing tax treatment of foreign-sourced income, millions and millions of people had to go out and buy Turbo Tax who had been doing their own tax forms. You just could not deal with it. So if I answer your question on the AMT, I hope I am going to get it right.

The AMT is sometimes described as a sort of low-rate, flat kind of tax system. There are only two rates, and you have a lot of deductions that are eliminated. But a deduction should not be eliminated if it reflects the cost of doing business and correctly measures your income.

I agree with J.D. Foster, education outlays ought to be a deduction. I happen to feel that State and local taxes which go largely for education or other things relating to investment ought to be continued as a deduction, and investment ought to be expensed. There are some other cost-related things that ought to be done. The AMT tends to eliminate a lot of deductions that are legitimately reflecting the cost of doing business, and that makes it misstate income. It is even worse, perhaps, if there is inflation going on.

There are really four rates in the AMT, because during the phase-out range of the exempt amount you add another 25 percent to the taxable incomes for each dollar that your income goes up. If you earn one more dollar, you lose 25 cents in exemption and your taxable income goes up by $1.25, and your rates are not 26 and 28 percent, they are 32.5 and 35 percent, which is right up there near the top income tax rates under the ordinary income tax for a very large number of people under the AMT. It is not a good alternative tax system.

Senator GRASSLEY. Yes.

Dr. Foster, you will recall that the Treasury Department and Joint Tax came down with different revenue estimates on the first Bush administration's proposed capital gains rate reduction. There was a swing of $25 billion between the two organizations' revenue estimating. A similar level of difference occurred on the 20-percent rate that was adopted by Congress in the Clinton administration in 1997. It follows that the revenue-neutral capital gains rate will differ once again between the two groups of estimators. Whatever model we use, Dr. Foster, in analyzing tax reform plans, does it make any sense to stipulate the rate at any point above revenue neutrality?

Dr. FOSTER. No, Senator, I do not believe it does. The only conceivable purpose one would have for a higher capital gains tax rate under those circumstances is if one wanted to exact a special penalty for people who invest wisely. That would not seem to make much sense. Also, when we talk about revenue neutrality in the sense of the quasi-static analysis revenue estimators currently employ, we need to be very careful and consider the estimated revenue-neutral rate as an upper bound. It should be seen as an upper bound, with the understanding that there is a vast degree of uncertainty as to what the revenue-neutral rate would be in reality.

The estimators will provide a very specific revenue estimate associated with a proposed tax rate, but statistically there is an enormous confidence band around that point estimate. The estimators could easily be off by 2, 3, 4 percentage points up or down, both on the rate and in terms of the revenues received.

Furthermore, I would emphasize that, in terms of capital gains, the upper bound for the revenue maximizing rate should not be regarded as a target. The target should answer the question: what rate of tax can we impose on capital gains that will not have particularly bad consequences for the economy?

The capital gains tax, as we have seen time and time again, is extremely important to the kind of high-risk, high-return investment necessary for real prosperity in our economy. When you have a high rate of tax on capital gains, you are really going after the most productive investments, and that is unfortunate. That should not be the way we structure the capital gains tax. The rate should be as low as possible so as to minimize economic consequences.

The CHAIRMAN. Thank you very much.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

I want to thank our panel. I think you have all been excellent. Mr. Entin, I share your view: growth is certainly not a partisan kind of concern. I am a huge fan of Dr. Burman's, and constantly look to his articles and his scholarship in this area.

I do want to pick up on this area that Dr. Burman touched on, which is, it seems to me, that health care reform and tax reform are two sides of the same coin. The fact is, with health care you cannot get everybody covered without progressive reform of the health provisions of the tax code. That is just a reality. I think the only area where I have a bit of a disagreement, Dr. Burman, is on this VAT tax proposal.

Now, last week Senator Bennett and I got some very good news from the Congressional Budget Office and Joint Tax. They said that our proposal would essentially be self-financing a couple years in, and then in the third year we would actually start generating some surpluses. Now, given the fact we have a long way to go and we are going to have to do this in a bipartisan way with Chairman Baucus and Senator Grassley and others, would it not be possible, given what CBO and Joint Tax have said, to end up with the tax reform, the simplification, the progressivity, and the pro-growth without an additional tax hike or a VAT hike if we can change the incentives and behavior along the lines of what we are trying to do in the bipartisan bill?

Dr. BURMAN. I think that is right. Actually, I do not think there is as much difference between your approach and the VAT, at least from an economist's point of view, as there might see. I actually apologize for not citing it. I was busy with the gas tax for the last 2 weeks and I did not see the letter.

Senator WYDEN. No. We so appreciated your work.

Dr. BURMAN. But basically what you are proposing is to pay for premiums out of payroll, kind of a payroll tax that is obviously dedicated to actually paying for the cost of health care. Economists have long known that a payroll tax and a VAT are actually very similar in terms of long-run incidents. You would take the responsibility for financing those, as I understand it, out of income tax financing over time. The reason I think that is important is because the fastest-growing element of the Federal Government, the one that is the biggest concern over the long term, is spending on health care. So having a plausible means of controlling the rate of growth of health care inflation and getting that sort of 800-pound gorilla out of the income tax, I think would be a good start.

Senator WYDEN. We are going to be asking your counsel, I know. I just do not want to throw in the towel and say you have to have a massive tax hike or huge amounts of additional spending, because I think what CBO and Joint Tax are saying is that, if we could get the incentives right and start changing behavior, given the fact we are already spending $2.3 trillion today—I mean, literally enough so that every seven families in the country could have their own doctor—we can get health reform and also tax reform.

One last question for you. What is the sequencing of these two issues? Because clearly, even a committee as able, with Senator Baucus and Senator Grassley, can sort of take only one topic at a time. How do you deal with the sequencing of health reform and tax reform? Maybe we can even, if I can get it in, go right down the row, starting with you, Dr. Burman, and get your thoughts on how we ought to try to tee these up in a way that the digestive system can really handle.

Dr. BURMAN. I think it is likely that some kind of health reform is going to consume the attention of Congress after the next election, no matter who wins. The idea of doing health reform and tax reform simultaneously is probably beyond any Congress to accomplish. The nice thing about doing health reform first and getting that part of finances in order, is it might make it possible to make some more sweeping reforms on the income tax. But it will be a challenge.

Dr. Gale?

Dr. GALE. I am going to disagree with my colleague at the Tax Policy Center here. I think, politically, you are going to get one bite at the apple at the beginning of the next administration. I also think that each of these issues, whether it is health or budget or Social Security or tax, are sufficiently painful to certain groups, that it is going to be very hard to do them individually because everyone will identify where they lose and contest that as opposed to the areas where they win.

So I think the most likely scenario I can see is that the bigger the problem that is addressed, the more likely some sort of grand over-arching package gets put together. So, (A) these things are interrelated, and (B) I think because of the one-bite rule, you are going to have to deal with them as interrelated. So I would encourage you to think of them as related issues.

Senator WYDEN. Mr. Entin? Thank you, Mr. Chairman, to let these two finish.

Mr. ENTIN. You are the best judge of what Congress can accomplish. I would second Bill Gale's point about an over-arching situation here that needs to be coordinated. If you pick the wrong tax reform for health care and find it conflicts with what you later want to do on tax reform, you have created a problem for yourself. If the committee, which has jurisdiction over both areas, can act as sort of a committee of the whole rather than too many subcommittees taking too many pieces into separate corners, you might very well come out with a much better situation.

Having gotten it straight in your minds where you want to go in both cases, you might be able to get there incrementally in each area, step-by-step. Knowing where you need to go and having the basic principles in mind and the incentive arrangements that you are talking about which are key to all of this, would give you a better chance of coming out in the right place.

It would be a lot of work. Not everyone has put in the hours that you have on the health issue. I remember back in the late 1970s when Senator Hatch sat down for hours and hours each week going over the tax system and the economic models with the staff, much more work perhaps than the average Senator would ever have done. It is a lot of work to get it right. If the committee is willing to do it, you could do an awful lot of good for the country.

The CHAIRMAN. Thank you, Senator.

Senator Bunning? I am sorry. I am a little concerned about time. We have a vote coming up, and I want to make sure every Senator is able to ask questions.

Senator BUNNING. Dr. Burman, you said in your testimony that the percentage rate for your proposed VAT would depend on health care spending. I believe you said that. It would go up if the cost for your universal voucher went up. Would this not be inflationary? How would you control health care spending?

Dr. BURMAN. Well, the idea—and I actually should give credit to two other economists, Emanuel and Fuchs, who presented this at Brookings a year ago—is that with the funding source, basically the government is going to be paying for more and more health care over time no matter what. I think it is actually likely that, whether you like it or not, within the next 5 or 10 years government is going to be paying for virtually all health care.

So, I think it would be better to do it relatively sooner and think about a way that would get the incentives right and build in incentives to constrain costs. The advantage, I think, of having the value-added tax dedicated to health care is that people would see a connection between what we are spending as a country on health care and the prices they are paying.

Right now, people on Medicare, people on Medicaid, people who are getting free health care—actually, a lot of people, I think, who are getting insurance through their employers—do not really see any connection between rampant health care cost inflation and the taxes they pay or the costs to them, and I think that is a problem because the things you would do that would control health care costs over time would involve some pain. They will not be painless. They basically have to say that some kinds of procedures, medicines, other things that have very, very low value would not be paid for by insurance.

Senator BUNNING. Would they not be more aware if, in 2013, Medicare started to drift into insolvency? Would that not raise a red flag a little bit?

Dr. BURMAN. Well, I think it might. The problem is, how are you going to deal with that with tens of millions of seniors who are up in arms, writing letters and saying that you——

Senator BUNNING. Well, I know. But it sure would draw attention to the fact that what, who, and how we pay for it is inadequate to cover the amount of money that is being expended.

Dr. BURMAN. Right.

Senator BUNNING. Dr. Gale, in your testimony you pointed out that only people pay taxes. Who do you think would pay your proposed carbon tax, and how would you assure that the U.S. tax has an impact on global carbon emissions levels? Wouldn't China and

India take over all carbon-intensive industries and increase global emissions if we did not have a universal, global agreement?

Dr. GALE. Right. I think when we talk about the difficulties of implementing health reform and tax reform, and maybe budget reform at the same time, those difficulties actually pale compared to the difficulties of getting global coordination on carbon or climate change issues. I certainly do not have the answer to how you get China——

Senator BUNNING. We were looking for you to specifically give us an answer. [Laughter.]

Dr. GALE. Obviously it is an enormously complicated political issue because there are literally hundreds of countries that have their own sense of sovereignty, and the developing world does not want to pay for what they think of as a developed world problem. So I think everyone agrees—all economists agree, and I am going to emphasize the word "economists" here for reasons that will be obvious in a second—that taxes on energy need to go up in the long term, not down. The solution to the energy situation is to make it more expensive to use conventional energy, not less. How we do that exactly, whether it is carbon tax, whether it is auction permits, whether it is something else, is still up in the air. But the only way to get there from here is to make it more expensive to use conventional energy.

Senator BUNNING. But there is a real problem when you do that because you are pitting one State against another State in the United States. In other words——

Dr. GALE. That is correct. Some States are energy consumers, some States are energy producers.

Senator BUNNING. Well, all States are energy consumers, but some produce energy a lot cheaper than others produce energy, because they have no natural resources in their States.

Dr. GALE. Right.

Senator BUNNING. So you do not have a solution for our carbon problem?

Dr. GALE. Well, no. But all tax subsidies are like that. You pick health, mortgage, or anything else, they are going to vary by State. That is just something that you as the leaders of the country have to deal with.

Senator BUNNING. Thank you very much.

The CHAIRMAN. Thank you, Senator.

Senator Roberts, you are next.

Senator ROBERTS. Well, this has been very fascinating, especially the over-arching proposals by the witnesses and Dr. Gale's tax reform proposal which we will, I guess, put in the mixing bowl. Staff has prepared for me some very pertinent questions, but the current conversation regarding energy intrigues me. President Clinton proposed the BTU tax back in 1994, which led to a Republican takeover of the Congress. I agree with Senator Bunning—this is going to be a very difficult task.

The State of Kansas has determined that CO_2 emissions are a very dreadful thing and has closed down the possibility of a new clean coal energy plant.

In the meantime, China is producing one plant a week, and I do not see how you can get a BTU tax or a carbon tax unless in fact, as has already been said by Senator Bunning, we somehow resolve that. We now see all the nominees for President saying that there has to be a CO_2 standard. Well, if it is only followed by the United States and not by others, let alone State-by-State-by-State quarrels, how on earth do we ever get to tax reform through the energy tax? The same thing with health care. I am a little stunned by that in regards to what you are saying about health care and universal service. In 5 years, the government is going to pay the whole necessary thing. Right now, I am just trying to salvage what we have.

If you look at the Medicare reimbursement to a doctor, or to a hospital, or a home health care agency, or an ambulance driver, or to a druggist trying to implement Medicare Part D, we do not reimburse up to cost. So the consequence of that is, a lot of people are not serving Medicare patients any more. We have specialty hospitals. It is a novel plan by CMS. It is a wonderful plan to reduce Medicare spending. You just do not reimburse the cost to the provider, and the provider chooses not to provide Medicare. It is called triage. It is called rationing.

So if we cannot solve that in terms of the one entitlement that is probably going to become fiscally unsound sooner than anything else, how are we going to go to a larger system that encompasses a full-government universal service? I was trying to figure out how we did tax reform, and all of a sudden we have these other two items tossed in the mix. I understand that they are certainly integrated.

But for the witnesses, in 1 minute, there are a dozen proposals that have been introduced in the Congress—I am not going to name the sponsors—to revamp or reform the tax code, including proposals for a fair tax, a flat tax, or some other form of consumption tax. How do we move to any of these systems when many of them would do away with the popular exemptions and deductions, such as the deductions for mortgage interest payments? We are throwing tax credits at energy right now.

The same thing with the housing situation, with the proposals to address the mortgages. Education—you have already mentioned that. Charitable giving—we are not going to do away with that. We have now been able to make time changes to the tax code on agriculture an art form due to the genius of the chairman and others, which was the only thing we could do in regards to a Farm Bill. I just do not know how we get all this done and move to a consumption tax, which intrigues me. You mentioned 1986. I was the only member of the candidate's delegation to vote "no," and I caught hell from Bob Dole for doing that. But it put agriculture and the savings and loan industry and the housing industry right in the ditch. I think the best suggestion I have heard is the suggestion that we go to the Joint Tax Committee to make sure whatever we do does not impinge on our ability to raise capital and be competitive in the global marketplace.

And, Mr. Chairman, thank you very much for holding this hearing. I think it is intensely interesting. We are going to have to do it—I do not know how—with energy, health care, and tax reform.

The CHAIRMAN. It is going to be interesting.

Senator Hatch?

Senator HATCH. Well, thank you, Mr. Chairman.

Mr. Entin, based on your testimony, it seems that you believe it would be possible for us to greatly simplify the Internal Revenue Code, but not do a very good job with tax reform. Would you say that ensuring we keep effective incentives for saving, investing, and economic growth are paramount to simplicity?

Mr. ENTIN. Yes. Most of the complexity in the code revolves around the tax treatment of capital. I would have said 100 percent a few years ago, but then we invented the EITC and some of the child credits, which get a little complicated when you have five definitions of a child. But really, most of it is in the treatment of capital.

Senator HATCH. In your testimony you give the example of what the effect of allowing the 2001 and 2003 tax cuts to expire would be. It is obvious that you believe that not extending these tax cuts would be a colossal mistake. What if only the middle-class portions of the 2001 and 2003 tax cuts are extended, as some are saying, and those most affecting higher-income taxpayers were allowed to expire, as some were saying?

Mr. ENTIN. If you do the arithmetic, most of the increase in the service price of capital would come from eliminating the 15-percent caps on dividends and capital gains and raising the tax rates at the top. The 10-percent rate that was carved out of the 15-percent bracket affects, at the margin, less than 2 percent of the income produced in the country and has a limited impact on that behavior. Most of the change in activity comes from the other rate changes, and in particular the 15-percent cap on dividends and capital gains. So that would give you 99 percent of the adverse effect on capital formation.

Senator HATCH. It seems to me that a lot of that would be small business, too, would it not? It would affect them pretty drastically.

Mr. ENTIN. Yes. They would be affected by the rate hikes.

Senator HATCH. All right.

Now, Dr. Foster, in your testimony you mention two guiding principles for tax reform. The first is, that the level of individual tax collection should be low. Could you just elaborate a little bit more on that idea? For example, low compared to what?

Dr. FOSTER. Well, Senator, thank you. I specifically chose that language in order to avoid the trap of being in a position of having to suggest what the target ought to be. I regard tax reduction and reduction of tax rates, corporate as well as individual, as a little bit like going on a diet. You know you want to lose weight, so you pick an achievable target, and when you reach your goal you then consider whether you want to weigh less yet.

Right now, the concern should be, keep the rates and level of individual income taxes from rising, as you were just discussing. Do not allow the tax cuts from earlier in the decade to expire, and then see how much further you can go. That would be real tax reform. Let us see if we can get the level of collections down further, see if we can get the rates down further.

Senator HATCH. Well, one of the basic tenets of tax reform seems to be that of fairness. Of course, fairness lies in the eyes of the beholder. Some believe a fair tax system is an extremely progressive one, others believe that a flat tax is fair. The latest statistics from the IRS indicate that the top 1 percent of income earners pays 39 percent of all income tax, the top 10 percent pays 70 percent, and the top 50 percent pays 97 percent. This, of course, means that the other 50 percent only pays 3 percent of all income taxes.

My first question to each of you is—and maybe we will just go across the table—is the current income tax system too progressive, not progressive enough, or just right? I will start with you, Dr. Burman.

Dr. BURMAN. The ideal thing would be to deal with the underlying distribution of income. Part of the reason that people on the bottom pay so little tax is because they earned a tiny share of overall income in the country. And whether or not you think that is a problem, it is likely to be a political problem over time because inequality is growing and the populace will call for things like trade restrictions, which really could do damage. I think the income tax is a relatively efficient way to mitigate some of the difference in market outcomes. The Earned Income Tax Credit really helps low-income people to feed their families. So I would say the current level of progressivity, at least, is a good thing about our tax system.

Senator HATCH. Dr. Gale, then Mr. Entin?

Dr. GALE. You asked about whether the income tax was too progressive or not, or just the right amount. It is hard to answer a question like that in the context of a specific tax. What we care about is the overall system. A proportional system could have some progressive, some regressive taxes.

The overall system we have right now is moderately progressive, nowhere near as much as the income tax numbers suggest. I think we could get more progressivity out of the system with lower rates if we made the tax base more comprehensive. This comes back to the very first thing I said in my testimony, that getting the tax base right is the single most important thing. Once you do that, you have a lot of latitude with the rate structure.

Senator HATCH. Mr. Entin?

Mr. ENTIN. I would prefer to see a proportional tax with aid to the low-income people being handled through outlay programs that are specifically targeted to them. I think the tax code would be stronger and the incentives for growth would be greater if we could move in that direction.

You can have a progressive consumption-based tax, as well as a progressive income-based tax. That debate was held back in the 1930s, with Professor Simons and some other economists on the other side of the fence. The problem with the income tax base, where Dr. Simons said, let us tax saving and the returns to saving to get more progressivity, is that it interfered with saving and investment. He acknowledged it would, and said, if you want to redistribute income, you probably will have to have a significant adverse effect on total income. But that is all right, he said, because if saving gets depressed, we will have the government run budget surpluses to offset the problem. He was a little naive. [Laughter.] And it would not work for other reasons we do not have time to go into here. But I would refer you to IRET Bulletin 88 on tax incidence and tax shifting.

There are two bad features of the income tax relating to progressivity and fairness. One is that producers are treated unfairly. Income is the reward for producing something worthwhile that people want to buy from you. If you have a steeply progressive tax system, you punish people the more that they produce and the more they contribute to the economy. That is not fair. That is why a proportional system is fair, in my view. Remember, people produce income. It is not just manna from heaven and the person with the biggest shovel and the sharper elbows gets the biggest amount. You have to produce the income. If we keep that in mind, we will have a better system.

The CHAIRMAN. Dr. Foster, maybe in 30 seconds, please.

Dr. FOSTER. Thirty seconds, yes, sir.

Fairness. Asking an economist about fairness is asking them about an issue outside of their training. We have no more insight on fairness, necessarily, than we do on the Redskins' prospects in the coming year.

In terms of progressivity or proportionality, I agree with Stephen that a proportional system would be better because, as Dr. Burman noted, when you get a progressive system and marginal rates start getting higher, the economic costs start growing very rapidly.

Senator HATCH. Well, thank you.

The CHAIRMAN. Thank you very much.

Senator Salazar?

Senator SALAZAR. Thank you very much, Chairman Baucus.

Let me ask you a question with respect to fiscal responsibility and what we ought to be doing here in the U.S. Senate with respect to that issue. I look at the current national debt at $9, $10 trillion already, look at our annual deficit, running by some measures up to $650 billion a year, a war that we are fighting in Afghanistan and in Iraq, and we are not funding that war.

How, as we move forward with the discussion on tax reform, should we factor in the need for us in the government to be fiscally responsible? And why don't we just come down the line and each of you take 30 seconds or so to answer that question.

Dr. BURMAN. I think that is a fundamental question. I think the government is going to need more revenues over time. I think we need a tax system that is perceived as simple and fair that people want to comply with. I think we should reduce the relative reliance on taxes on capital, but I do not think we should eliminate it, because we need to preserve progressivity.

Now, if the Bush tax cuts were extended, we index the AMT and extend all the other expiring provisions, we would add $4.6 trillion to the deficit over the next 10 years, and taxes as a share of revenue would be below their historical norms at the same time the demands on the government are increasing.

So you can talk about big cuts in spending as a way to balance the budget, but it does not seem like that is feasible. We need to have a tax system that is capable of meeting the revenue needs of the country without impairing economic growth, because, if growth slows down, all of our fiscal problems would get even worse.

Senator SALAZAR. Dr. Gale?

Dr. GALE. Thank you. Earlier in the hearing the chairman asked the points of consensus among the four of us. I mentioned two of them. I think there is a third one which I should add, which is, I think, in the long run, the level of government taxes should be approximately the same as the level of government spending. So I think everyone thinks in the long run we should be fiscally responsible.

What that means, though, is that, if we reduce revenues, we have to be willing to reduce spending to match that. The extension of the Bush tax cuts is a good example of how that would play out. Congress rejected, in 2001, the notion that the tax cuts should be permanent, even though the 10-year baseline surplus at that point was $5.6 trillion.

In every year since then, the administration has proposed making those tax cuts permanent, and in every year since then Congress has said, no, they would not make it permanent. So it is not obvious to me that Congress intends to cut spending commensurate with the amount it would need to make the Bush tax cuts permanent.

To give you an example of what that number would be, if you took out Social Security, Medicare, and Medicaid, which you are going to have to cut anyway to bring them in balance, if you took out defense and Homeland Security, which we do not seem to want to cut because we are engaged in wars all over the world, and if you take out net interest, which we cannot cut because that is called defaulting, if you kept the rest of the government, you would have to cut that by more than half to pay for making the Bush tax cuts permanent. So, unless Congress is willing to make those kind of cuts, it would be fiscally irresponsible to make the tax cuts permanent.

Senator SALAZAR. Mr. Entin?

Mr. ENTIN. One attribute of a good tax system is visibility. People should not think that taxes have been paid by somebody else simply because they are hidden in the business sector. If you have a visible tax base so people truly see what they are paying, they will tell you how much government they want and how high a rate structure they are willing to sustain. They are not two separate issues. As long as you can borrow freely and hide the taxes somewhere else and people do not think they are paying for something, they are going to want more government, which will eventually mean a much higher tax rate structure. But they do not see it yet. Make it visible.

I would say the same thing is true for medical costs. The government, a number of years back, took upon itself, and then committed future Congresses, to your pain, to funding a huge amount of the outlays of the economy through the government. People do not see the costs, so they over-consume it, and then you have to levy taxes on them to get the money to do it, and the taxes further discourage them from working, saving, and investing, which makes it even harder to do. It is always better to have people buying something for themselves than going through government, because there is a double-whammy on the cost structure going through government, and it is going to put you in an impossible situation.

Senator SALAZAR. Dr. Foster?

Dr. FOSTER. Senator, as Bill Gale noted in his response earlier, government spending is a tax issue. There is nothing inevitable about the level of government spending. There is nothing inevitable about the rise in government spending to which Dr. Burman was alluding. You do have to be fiscally responsible. Fiscally responsible does not necessitate raising taxes on the American people. You have to make a choice, however, between allowing spending to be high and rising or maintaining a modest level of tax, a more moderate level of tax, and pushing it further down. I side with cutting spending.

Senator SALAZAR. My time is up.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

I am just curious of your thoughts, assuming the government needs revenue, all things being equal, the most efficient way to raise it. I know we talked about individuals, we talked about corporate, and capital, and so forth. We have to think about a lot of issues here. But all things being equal, does there tend to be a more efficient way to raise revenue compared to other ways?

Mr. ENTIN. Any of the saving-consumption neutral taxes would have about the same economic consequence, which is less damaging than using a tax system which taxes saving, taxes the returns on saving, adds a corporate tax, and adds estate tax. The neutral taxes do less damage per dollar of revenue raised.

The CHAIRMAN. And what would neutral be? An example of a neutral tax?

Mr. ENTIN. The business activities tax, the VAT, the flat tax, the sales tax, or the consumption-based income tax, where you put down your income, subtract net saving, and pay tax on the difference, which is my favorite, as described in my testimony. Any of those are really the same tax base.

The CHAIRMAN. All right.

Mr. ENTIN. But they are collected in different ways. Some would have it collected at the cash register, some would have it collected in stages as you pass from one level of production to another—that is called a value-added tax. The flat tax is collected in a slightly different way.

It is not the collection process that is the problem with the inefficiency in the tax system, it is the damage that the tax system does for every dollar raised in discouraging saving, investment, and work effort. The economic cost, for each dollar that you spend, is about another $1.50. Every dollar of spending you do costs about $2.50, even more if it is a tax on capital. That is the inefficiency you need to address.

The CHAIRMAN. All right.

Dr. Gale?

Dr. GALE. Thank you. There is sort of a local answer and a global answer. The global answer might be, if you could do anything you want not subject to parochial constraints, then I think a lot of what Steve said applies. If you are starting from the current system in a world with parochial constraints and a variety of other concerns that we have heard about, I think the best way to get to efficiency is to remove the uneven taxation of similar activities.

What that means is going after forms of income that are sheltered, removing the shelter, going after forms of income that are taxed two times, removing the double taxation, making sure everything gets into that base. I hate to sound like a broken record, but that comes back to the first thing I mentioned again, which is that broadening the tax base and then using that as an instrument of reform is probably the most efficient way right now.

The CHAIRMAN. Dr. Burman, did you want to address that or not?

Dr. BURMAN. Yes. I just wanted to say it would be easy to come up with an efficient tax system, but it would not be fair. Steve Entin made it sound like the reason that rich people are rich is because they work harder than poor people. I make 10 times as much money as my dad ever did, and I do work hard, but so did he. I was just lucky. I had great parents and got a good education. So I think there is a role in the tax system for mitigating economic inequality. That is really the trade-off.

The CHAIRMAN. And Dr. Gale, I am curious about how you would merge payroll tax with the income tax.

Dr. GALE. You can do it in a number of ways. The basic idea, or a simple way to do it is, if you do not want to merge the systems because the payroll tax pays for Social Security benefits, you can administratively get the same effect by offering a credit, a refundable credit in the income tax system for payroll taxes paid.

The CHAIRMAN. And do you think that is a good idea? Would you suggest that?

Dr. GALE. I think it is in the testimony. Yes, I think that is a direction that we should be looking at, reforming the system, in the sense of taxing all income once and taxing it under the same sort of low rate structure.

The CHAIRMAN. All of our discussion here has been assuming we are in the confines of the United States of America. We will have other hearings on international competitiveness. But give me any of your thoughts about what we are doing as Americans versus the degree we might be shooting ourselves in the foot. Should we be paying more attention to how other countries structure their systems, as we have this discussion here today on the individual side? Dr. Burman?

Dr. BURMAN. Yes. I think we do, but it is not so much that we are competing with other countries on the tax side, it is that we are affecting the efficiency of our own economy. So probably the biggest area in which we fall short is that we have a corporate income tax system that has among the highest rates in the world, and we collect relatively little revenue as a share of GDP because there are so many loopholes, preferences, and deductions.

Economists would probably mostly agree that the ideal thing would be to collect corporate tax, and basically collect it from individuals as an integrated tax system. But if we are not going to do that, there seems to be a preference to have this two-level tax system in the U.S. The better thing would be to broaden the base and try to lower the rates, and we could easily do that and bring it in line with corporate taxes among our major trading partners.

The CHAIRMAN. Anybody else?

Mr. ENTIN. You have to be careful about base-broadening. If you end up double-counting some income, you have said, all right, put down your income on line one, double it on line two, and then send in half the amount that you were sending in before as far as the rate is concerned, and you have not done anything. So be careful which of these loopholes that you close. We closed a lot of loopholes in 1986, and I am not sure there are that many left.

On the international side, we are not really competing with other countries. What we are doing, even if China did not exist, is living with a tax system that is very much biased against anything using physical capital, and to some extent against education and training. We are hurting ourselves that way.

If we went to a neutral system, we would have gone as far as we need to go, both domestically and in the international arena. At that point, the only thing we could do better would be to shed some of our spending obligations so that we could lower the rates. But if people want their spending to be done through the government, they will have to have the higher rates.

The CHAIRMAN. One thing I can take away from all of you so far, is base broadening: lower the rates, broaden the base in some way or another. Is that right? Dr. Gale thinks that. Do others of you think that? You talked about a consumption tax as a broad base.

Mr. ENTIN. I want to change the base from income, as Professor Simons and others since have defined it, and get more toward a consumption base. I will still make it progressive for you, but I do not want the double-taxation and triple- and quadruple-taxation you sometimes have on saving and investment. In a sense, I am narrowing the tax base, but you get a bigger capital stock and you get a bigger economy. In that sense, the base is broadened.

The CHAIRMAN. My time has expired, but the question I have is transition costs, too, when you move from an income tax system to a consumption-based system. Some suggest that that is an additional cost we just have to bear. I do not know how that is.

Senator Wyden?

Senator WYDEN. Mr. Chairman, you have been very gracious. I know Senator Hatch probably has a question as well. I just wanted to let you have a chance, Dr. Foster. Last round we did not get there in terms of sequencing on health care and taxes.

Dr. FOSTER. Thank you. That is very kind of you, Senator. In fact, I must say I was pleased to hear your emphasis on incentives and getting incentives right. That is precisely what tax reform is all about—getting the incentives right.

Health care and tax policy are obviously related. The tax policy we have today is tremendously distortionary to incentives, especially in terms of people's health care, how they purchase it, and how they finance it. It is going to be very difficult, I think, to have a grand plan that covers many issues comprehensively. I think your concerns about the ability of this committee or the Congress to handle so much material at once is right.

Nevertheless, it is important to have in the back of your mind an over-arching vision. You do not have to move all the legislation at once. You can move it sequentially over years, if necessary, but all following the same vision. In that respect, I think tax policy is going to have to be modified significantly if we are going to get those incentives right.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Hatch?

Senator HATCH. Well, we have to go vote, but let me just ask one question. It is my understanding we are sending $600 billion a year overseas for high-priced oil. I had a lot to do with putting both the alternative vehicles tax credit and the production tax credit into the tax law. Just this weekend, I attended the groundbreaking of a new geothermal power plant that would not have been built without the production tax credit. There will be hundreds, if not thousands, of other geothermal plants and solar plants because of those credits. What is your attitude towards doing things like that, giving incentives through the tax code that basically get us to where we should be, which we would not do otherwise? I mean, this is where we get in trouble, I know.

Dr. BURMAN. I think it is certainly a good idea to do this kind of research and development. The problem is that a lot of times the government cannot figure out what the right technologies are to subsidize. I think one example, which you might not agree with, is that the ethanol tax credit has had a lot of undesirable——

Senator HATCH. I am figuring it out for them.

Dr. BURMAN. I beg your pardon?

Senator HATCH. I am figuring it out for them. They are moving away from ethanol and moving into these renewable sources that could help us alleviate that $600 billion a year that we are just, in many ways, sending to our enemies.

Dr. BURMAN. One advantage of the carbon tax—and I understand the political disadvantages—is that it would give incentives for the markets to find ways to reduce carbon emissions and to do it in the most efficient way. It would basically unleash market forces. If you had to actually pay the cost of carbon emissions on the environment, then the market would figure out, it might be geothermal, it might be windmills, it might be something we have not even thought of. So that is why economists tend to favor that kind of an approach.

Senator HATCH. I see. You are each going to have to answer very shortly because we have to go vote.

Dr. GALE. The other advantage to the carbon tax is it generates revenues which then can be used for purposes like investment in geothermal or other options. So, I am completely on board with the idea that we should be investing in alternative energy sources. One of the advantages of taxing energy consumption, as well as subsidizing energy innovation, is you actually get the revenue and you can use it for the same purpose.

Senator HATCH. Mr. Entin?

Mr. ENTIN. I am skeptical of the degree of damage from global warming, and I would want to study it more before spending trillions of dollars. If it were just a market question on the oil, I would say you can get oil two ways. You can produce it here, but, if that is expensive, you might find it easier to grow a crop or produce a manufactured good and sell it and get oil from abroad. That might be the cheapest way of getting energy. The only problem I see is, if there is a defense-related issue, then you might have to intervene, otherwise I would not.

Senator HATCH. But I am talking about incentives to get more energy that would alleviate our dependency.

Mr. ENTIN. Well, in that case I wonder if we can act less expensively by removing obstacles to other forms of energy production that are obviously cheaper, which is the drilling in the eastern Gulf, the Atlantic, the Pacific, and the North Slope and offshore in Alaska.

Senator HATCH. But, see, we concluded those are almost impossible to do with the current——

Mr. ENTIN. Well, I agree with you. But I would stand here and yell at the Congress rather than spending money on something that was overly expensive. I would first try yelling louder.

Dr. FOSTER. Senator, tax reform is already very difficult, so I am reluctant to add further objectives to fairness, simplicity, and growth. I would note that, while what you are suggesting is perfectly valid, it is really of a different kind of subject. It is not really tax reform per se, it is energy policy, security policy, and so forth.

As we are going to go down that road, if we are going to have an objective to reduce energy consumption and address environmental concerns, the number-one approach should be, aside from transparency, simplicity.

We need to use the price mechanism in such a way that, as far as possible, Congress avoids picking winners and losers. That is why I would be concerned with any kind of a tax credit, for example, because then Congress must enumerate those things and activities which would qualify.

The CHAIRMAN. I am sorry. I am going to have to close this hearing down. We are way late for a vote and do not want to miss it.

Thank you, all four of you, very, very much. This has been very, very stimulating.

The hearing is adjourned.

[Whereupon, at 11:37 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON FINANCE
"Cracking the Code: Tax Reform for Individuals"
May 13, 2008

Thank you, Mr. Chairman.

Making changes to the tax code is always difficult and controversial, but we can't afford to ignore the task. Our trading partners are at work every day changing their tax laws to attract capital and high paying jobs, and our children's standard of living will be lower if we leave the current system in place.

If we work together, we have a chance to avoid that future, and I appreciate the Chairman's attention to this issue.

We collect over $2 trillion per year in federal income tax and payroll tax. This vast sum is far more than the gross domestic product of most countries, and yet we are told it's not enough.

Government projections that assume the continuing availability and expansion of generous entitlement programs and other benefits show that we will need much more money in the next two decades than today's tax rates will bring in to government coffers.

Make no mistake. We are at a cross-roads. We must either increase taxes substantially to pay for these benefits, or take a closer look at government spending. I have long advocated the latter course.

Raising taxes on "the rich" will have consequences that are not always acknowledged by those who advocate them. To begin with, the income tax is already so progressive that more than half of all tax collected is paid by about 3.5 million taxpayers in our Nation of 300 million. Raising taxes by enough to fund current entitlements and shifting more of the tax burden onto high income taxpayers will make the United States a less attractive place to live and to invest. This will impact growth.

Slower growth will make it more difficult to fund the benefit structure we have now, and, so, as I see it, we really have no choice. Proposing to tax ourselves out of the current budget crisis is nothing more than an illusory solution. It will lead us down the path towards a relatively poorer future. That's something we should try to avoid today, while we still have the chance.

I look forward to the witnesses' testimony today, and I thank the Chairman for holding this important series of hearings.

Statement of

Leonard E. Burman
Director, Tax Policy Center
Senior Fellow, The Urban Institute
http://www.taxpolicycenter.org

Before the
Senate Committee on Finance

A Blueprint for Tax Reform and Health Reform*

May 13, 2008

* I thank John Holahan, Stu Kantor, Karl Scholz, Gene Steuerle, Eric Toder, Alan Viard, Bob Williams, George Yin, and participants at the Virginia Tax Study Group for helpful comments and discussions. Julianna Koch and Carol Rosenberg provided valuable research assistance. Views expressed are my own and should not be attributed to The Tax Policy Center or The Urban Institute, its board or its funders.

Chairman Baucus, Ranking Member Grassley, and members of the committee: Thank you for inviting me to testify on tax reform.

It is a great honor to speak to you on this topic. The last great tax reform effort lured me to Washington away from academia to work for the Treasury Department in 1985. I remember when Chairman Packwood rescued reform from the abyss with his "27-percent solution"—a top rate so low it caught the public's attention and sustained momentum for what became the Tax Reform Act of 1986. The creativity and bipartisanship of this committee were key elements in the success of the 1986 Act.

In the mid-1980s, the tax system desperately needed fixing. Tax shelters were rampant, with investment decisions often motivated solely by the tax savings they could produce, rather than their underlying economics, which were often dubious. The public had lost confidence in the fairness of the tax system.

If anything, the need for tax reform is even greater now for at least four reasons. First, under current law most of the tax cuts enacted since 2000 are set to expire at the end of 2010 and the code will revert to that of 2000. In theory, this will trigger what tax cut advocates are already calling the largest tax increase in history, but extending the tax cuts seems fiscally reckless. Second, the baby boomers are beginning to retire and the costs of providing their Social Security and medical care will strain available federal revenues. Third, under current law, the reach of the individual alternative minimum tax (AMT), a pointlessly complicated and unfair element of the current code, is scheduled to mushroom, hitting 32 million taxpayers by 2010, up from 4 million in 2007. Were that to happen the middle class would scream in protest, but making up for the hundreds of billions of dollars in revenue that the AMT is projected to produce will be a huge challenge. Finally, there is growing public dissatisfaction with our federal tax system which is complex, riddled with loopholes, and widely perceived to be unfair. It is hard to see how these challenges can be tackled without a major tax reform.

Although tax reform is always a long shot, there are reasons for optimism. Politicians in both parties—and even current presidential candidates—understand that the current situation is unsustainable. A new president who had campaigned on a platform of working in a bipartisan way to advance objectives that matter to both parties may be willing to stake political capital on advancing tax reform. And the fact that both sides acknowledge that this is a "change election" bodes well for the next president's willingness to take political risks.

A successful tax reform should be designed to address the concerns of members in both parties. The reformed system will have to maintain progressivity, raise enough revenues to finance the government, and, if the Democrat wins the White House in November, dovetail with plans to provide universal access to health insurance. The tax system should be easy for taxpayers to understand and comply with, and it should be perceived as fair. Tax reform should enhance economic growth compared with the current system, which means lower income tax rates, fewer distortionary loopholes and tax preferences, and lower taxes on the returns to saving and investment. And it should include a credible mechanism to limit the rate of growth of federal spending.

I outline a plan that meets all of those criteria. In brief, it would combine a value-added tax (VAT) dedicated to pay for a new universal health insurance voucher with a vastly simplified and much flatter income tax. With a new financing source for health care, income tax rates could be cut sharply—the top rates could be cut to 25 percent or less. The health care voucher would also offset the inherent regressivity of a VAT, since the voucher would be worth more than the VAT tax paid by most households. Moreover, with the VAT rate (and the price of goods and services) tied to health care spending, the public would have a vested interest in reining in the growth of health care costs. That is, the financing mechanism would help control the fastest growing component of federal spending.

The simplified income tax would be designed so that most taxpayers would not have to file income tax returns. Tax incentives for working and child-related subsidies would be replaced with simplified refundable tax credits along the lines suggested by Michael Graetz (2008). And the alternative minimum tax would be eliminated.

And the plan would also bolster the solvency of social security and eliminate the Medicare payroll tax.

In my testimony, I will discuss in more detail the reasons why tax reform must happen and the prerequisites for successful tax reform, and outline the nature of such a plan.

I. Action-Forcing Events

Memos to policymakers that require a decision lead off with an "action-forcing event"—a reason why a decision has to be made. This is a key part of the memo, because decisions carry risks and politicians don't want to make them unless they must.

The action-forcing events that could lead to tax reform include the following:

- the expiration of most of the tax cuts enacted since 2001 at the end of 2010;
- the explosive path of the AMT;
- a likely budget crunch coming within the next 10 years if the tax cuts are extended and the AMT reformed or repealed;
- the retirement of the baby boomers and rapidly growing health care costs that threaten the nation with insolvency if not addressed; and
- a host of related factors, including the complexity and inefficiency of the income tax, concerns about rising economic inequality, and calls to use the tax system to mitigate it, and the large fraction of households that pay no income tax.

A. Expiration of Bush tax cuts

Almost all of the tax cuts enacted in 2001 and 2003 expire at the end of 2010. They include lower marginal income tax rates (the top rate was cut from 39.6 to 35 percent); a doubling of the child tax credit and a new refundable portion for households with earnings over $12,060 (in 2008); phasing out of the estate tax and its repeal for one year in 2010; marriage penalty relief; and lower tax rates on capital gains and dividends.[1]

It seems unlikely that Congress will simply let the tax cuts expire as scheduled. For one thing, the potential behavioral responses to the one-year estate tax holiday are too ghoulish to contemplate.

But extending all of the tax cuts would be costly—reducing tax revenues from 2008 to 2018 by almost $2.3 trillion according to the Congressional Budget Office (2008). (See table 1.) The benefits from extending all of the tax cuts would disproportionately accrue to households with high incomes. (See table 2.) With Democrats likely to retain at least one house of Congress, these factors make it unlikely that the tax cuts will simply be extended as a package.

Nonetheless, all the presidential candidates have agreed to make the "middle class tax cuts" permanent. And all have promised significant other tax cuts.

The candidates have also all pledged to be fiscally responsible, although they have left somewhat vague how this fiscal responsibility should be measured. Senators Obama and Clinton have promised to abide by Pay-As-You-Go (PAYGO) rules that would require new tax cuts to be offset by tax increases. If PAYGO is measured relative to a current-law baseline (assuming the tax cuts expire at the end of 2010 and the AMT remains in place), this pledge could severely limit their ability to extend any tax cuts, enact new ones, or advance spending priorities. Senator McCain has said that he'd cut spending, although he would have to cut spending to levels last seen in the Eisenhower administration to achieve budget balance if all of his tax cuts were enacted—a long shot, to say the least (Burman and Leiserson 2008).

B. AMT

The individual AMT is the poster child for pointless complexity in the tax system, but its theoretical revenue-raising potential makes it extremely difficult to reform or repeal. Originally intended to ensure that rich people paid at least some tax, the AMT has morphed into an incomprehensible shadow tax system, poorly suited to its original purpose (Burman 2007). The largest AMT "preference item" (generally, deductions allowed under the regular income tax but disallowed under the AMT) is the deduction for state and local income and property taxes—hardly most people's conception of a tax shelter. Personal exemptions are the second largest item.

The AMT's biggest defect is that, unlike the regular income tax, its parameters are not indexed for inflation. So every year more and more people become potentially subject to the tax. President Bush's tax cuts, which lowered regular income taxes but only offered a

[1] The 2001 act also increased contribution limits to defined contribution pension plans and IRAs and created a new nonrefundable tax credit for lower-income savers (along with other pension revisions). The Pension Protection Act of 2006 made those provisions permanent.

temporary fix for the AMT, also roughly doubled the number of taxpayers potentially subject to the AMT through 2010.

Congress has prevented the AMT from affecting too many taxpayers by a series of temporary fixes, but the last one expired at the end of 2007, and they get more expensive every year.

Under current law, more than 26 million people are scheduled to owe AMT in 2008. (See figure 1.) If the Bush tax cuts are extended, the number will explode to over 50 million (or about half of taxpayers) by 2017.

The AMT will in principle bring in an enormous amount of revenue over the next 10 years—$800 billion if the Bush tax cuts expire on schedule and twice that much if they are extended. (See figure 2.) Of course, that revenue bonanza won't materialize because it would mean more and more middle-income taxpayers would become subject to the tax over time. But the fiction of the AMT as a revenue machine masks the size of our budget problems. Given that any revenue-neutral AMT reform would create many winners and losers, it is not clear how it could happen except as part of a major tax reform.

C. Short-term budget challenges

If the Bush tax cuts were allowed to expire on schedule and the AMT took its course, our short-term fiscal situation could be very good. According to the Congressional Budget Office (CBO), tax revenues would increase continuously as a share of GDP. (See figure 3.) Indeed, the CBO projects a budget surplus from 2012 to 2018 under current law (assuming modest spending growth).

However, if the tax cuts, the AMT patch (which basically amounts to indexing the AMT for inflation), and other perpetually expiring provisions, such as the research and experimentation tax credit, are all extended, tax receipts would decline as a percentage of GDP through 2013 and remain below their historical norms through the budget period. Including additional interest on the national debt, these tax-cut extensions would add up to almost $4.9 trillion, more than offsetting the modest budget surplus in the baseline. (See table 1.) There would be substantial and growing deficits, exceeding $600 billion in 2017, or 2.8 percent of GDP. Under this scenario, the national debt would be $4.6 trillion higher in 2018 than it is now.

D. Retirement of baby boomers and long-term budget problems

We might take solace in the fact that a deficit-to-GDP ratio of 2.8 percent would not be unprecedented. The deficit-to-GDP ratio averaged 4.3 percent from 1982 to 1993 (Kogan and Aron-Dine 2006). However, Kogan and Aron-Dine note that this was the "*only period in the history of the United States* in which the government consistently ran large deficits—i.e., increased the debt-to-GDP ratio—during a time of peace and prosperity" (p. 2, emphasis in the original text).

There is an even more pressing concern about rising debt now. In the 1980s, the baby boomers' peak earning years were still ahead of them. Now they are entering retirement. Moreover, medical care costs—and the cost of federal health care programs for the elderly—have risen much faster than the economy, and are expected to continue to do so absent a major change in policy. Rising health care costs and the demographic surge threaten to create enormous long-term budget challenges. CBO projects that if health care expenditures continue to grow at roughly their historical rate, the three main programs for the elderly—Social Security, Medicare, and Medicaid (which pays for nursing home care) will together cost 18.1 percent of GDP in 2050. (See figure 4.) That is, those three entitlement programs would consume all federal revenues if tax collections remain at historic levels.

If other spending continues at historical levels and revenues do not increase, CBO projects that the national debt could reach nearly three times GDP by mid-century and balloon to more than eight times GDP by 2080. (See figure 5.) By comparison, the debt-to-GDP ratio was barely over one after World War II, and policies enacted thereafter tamed the debt through the 1950s and 1960s.

As bleak as these long-term projections are, they are in at least one sense wildly optimistic: they assume that the economy will continue to grow at historic rates. However, with such an explosion of public debt, the ability and willingness of foreigners and U.S. investors to hold U.S. government debt would quickly be exhausted. Interest rates would increase, raising debt service costs (exacerbating budget deficits) and stifling investment, home sales, and purchases of consumer durables. The economy would grind to a halt.

Of course, this is a perfect illustration of Stein's Law, "If something cannot go on forever, it will stop" (Stein 1997). The only ways to avoid the budget catastrophe are to raise taxes, reduce spending, increase the rate of growth of the economy, or some combination of the three. In my view, that creates an imperative for a tax system that can raise more revenues without taking an undue toll on economic growth combined with restraint on the growth of entitlement spending.

E. Other factors

1. The income tax is a mess

The AMT is but one indicator of the complexity and inefficiency of the income tax. For the past several decades, it has become the instrument of choice for advancing a host of social and economic goals. The deductions, credits, phase-ins, and phase-outs aimed at advancing these objectives are often ineffective (Steuerle 2004). Moreover, public perceptions about the income tax have changed. Americans once thought the income tax was the fairest tax. Now they perceive it as the least fair levy (Slemrod and Bakija 2004). This has prompted support for radical revisions, such as the flat tax and the national retail sales tax (called the FairTax by its supporters).

The corporate income tax draws special scorn. American companies face among the highest rates in the developed world, and yet the revenue yield from the tax is small by comparison with our trading partners. And, of course, a host of loopholes combined with high marginal tax rates creates both incentive and opportunity for tax sheltering. The corporate tax with its high rates and narrow base cries out for tax reform.

2. Concerns about rising economic inequality

Since the 1970s, the income distribution has been growing steadily less equal. Explanations include the growth of information technology, which substitutes for less skilled labor and raises the rewards to the most highly skilled (Autor, Levy, and Murnane 2003); globalization (Goldin and Margo 1992); the decline in such institutions as labor unions (Levy and Temin 2007); and the emergence of a winner-take-all society in which top performers earn many multiples of the income of those who perform almost as well (Dew-Becker and Gordon 2005). It is likely that all of these factors will persist. For that reason, some have called for more progressivity as an antidote to rising economic inequality (McMahon 2004; Burman et al. 2007).

This view, however, is far from universal. Penner (2003), for example, argues that the tax system is highly progressive when properly measured and the current level of progressivity is broadly consistent with public attitudes.

Bartels (2005) reported survey evidence that most voters (52 percent) thought that rich people paid less tax than they should, 44 percent thought that poor people paid too much, and only 8 percent thought the poor should pay more. About 46 percent reported that they thought they were overtaxed, although 48 percent thought they paid about the right amount. (Only 3 percent thought they paid too little.)

However, Bartels (2005) also reports that most of the people who thought the rich should pay more opposed the highly progressive estate tax. Slemrod (2006) reported evidence from the same survey that indicated that most people who say they favor more progressivity also favor the flat tax, which would be much less progressive than the current income tax.

This suggests that taxpayers are confused about the tax system and alternative policies. It might mean that if they understood the tax system, they would favor more progressivity. Or it might also mean that if they were better informed, they would be happy with the current level of tax progressivity or even favor a less progressive tax system.

3. Large fraction of households that do not pay income tax

Finally, there is a growing chorus of complaints, primarily but not exclusively from conservative quarters, about the large fraction of households that do not owe income tax. The Tax Policy Center estimated that, in 2007, more than 30 percent of tax units (households) were in the zero marginal tax bracket or did not file.[2] Almost 40 percent of tax units owe no income tax after tax credits.[3]

The concern is that households who do not owe income tax perceive government to be free and thus will always support new programs, even if they have very little value. Put differently, they have no stake in reducing spending.

II. Requirements for Reform

Experience with the Tax Reform Act of 1986 (TRA) suggests that tax reform requires presidential leadership, bipartisan participation, and a lot of luck.[4] The president would need to decide early that tax reform is a top priority. The Tax Reform Act of 1986, signed in August, started in January 1984, when President Reagan instructed the Treasury Department to produce a plan for release after the election (U.S. Treasury 1984). This suggests that for tax reform to be completed by the end of 2010 (because of the expiration of the Bush tax cuts), it would have to be a high priority from the day the next president takes office. Given that all of the candidates have promised to make health reform a priority, tax reform would have to be designed is such a way that it would dovetail with health reform, rather than compete for resources and attention.

Why would the president invest scarce political capital in a risky tax reform? First, of course, are the policy imperatives outlined in the previous section, which the president might find compelling. Second, political commentators of all stripes agree that this year's election will produce a mandate for change. The president might decide that there would be political rewards if he or she successfully tamed the income tax and put the nation on a more secure fiscal footing, especially if tax reform were combined with credible restraints on spending.

A second requirement for success is bipartisan investment in the process. If it were seen as a Democratic or Republican initiative, the other party could easily attack the president for the inevitable losers that would arise from any rationalization of the current tax system—especially if revenue increases were part of the package. In 1986, a Republican president, Ronald Reagan, worked successfully with the Democratic leadership of the House as well as the Republicans who controlled the Senate to bring TRA to a successful conclusion (Birnbaum and Murray 1987).

In fact, members of both parties recognize that we are on an unsustainable fiscal path and probably understand that spending cuts alone will not produce fiscal balance. The *Analytical Perspectives* volume of President Bush's FY 2009 Budget had virtually the same grim projection of the effect of extending current policies as produced by CBO (2007),

[2] Source: http://www.taxpolicycenter.org/T07-0086. Note that they do pay other federal taxes. We estimate that households at every income level owe at least some tax when you combine payroll, income, excise, and estate taxes.
[3] Source: http://www.taxpolicycenter.org/t04-0102.
[4] Birnbaum and Murray (1987) chronicle the story of TRA. In addition to presidential leadership and bipartisanship, they describe a number of occasions when TRA appeared to be dead, but something happened at just the right time to get the process back on track.

although the Budget implied that spending cuts alone would suffice to solve the problem. Republican economist Bruce Bartlett (2006) concluded that tax increases are inevitable and urged his colleagues to consider tax options that would be less injurious to growth than simply increasing income tax rates.

A requirement for bipartisan participation (and ultimate success) is that the process would have to address the major concerns of both parties. This means, on the Democratic side, it would have to be equitable, help low- and middle-income households, and guarantee enough revenues to finance an adequate level of government. As noted, if the Democratic candidate wins, tax reform has to be consistent with a program to provide universal access to health insurance.

To win Republican support, tax reform would have to be combined with a credible process to slow the growth of spending. Since entitlement spending accounts for a large and growing portion of spending, control of entitlements must be an integral part of the package. In addition, the reformed tax system should address concerns about the growing number of households that do not pay income tax. And a reform proposal should improve the economy. This means that income tax rate cuts need to be part of the package, as they were in 1986.

A final factor key to success in 1986 was a big increase in corporate income taxes (primarily through repeal of the investment tax credit and scaling back of accelerated depreciation). Although economists understand that corporate taxes are ultimately paid by people (investors, workers, and consumers), most Americans were apparently convinced that they would not pay the tax. At one point, corporate CEOs of large companies that would pay much higher taxes as a result of TRA lined up to support the plan because they, personally, would pay much lower income taxes (Birnbaum and Murray 1987). This was one of the pivotal moments and helped lead to TRA's passage.

A large corporate tax increase is probably not in the cards this time. There is no investment tax credit or highly accelerated depreciation to repeal or scale back and, if anything, there is pressure to reduce corporate taxes. However, it might be possible to introduce a new revenue source that is relatively palatable and widely accepted in the rest of the world—the VAT.

III. A Possible Reform

An approach that might meet all of the constraints above would be a combination of a VAT dedicated to paying for health care, similar to the proposal of Emanuel and Fuchs (2007); individual and corporate income tax cuts, including lower rates, a broader base, and elimination of the AMT; revenues sufficient to achieve budget balance over the short- and longer-terms; and a credible process to control spending, especially on entitlement programs. The package as a whole would also have to be designed to maintain or enhance progressivity.

A. The Health VAT*

A cornerstone of the package is a VAT dedicated to pay for all federal medical expenditures, including a new voucher to provide universal access to health insurance. A VAT is a tax on consumption, similar to sales taxes levied by states, except that it is collected in stages from each business that contributes to the production and sale of consumer goods.[5] It is universal in the rest of the industrialized world and generally thought to be relatively easy to administer and for businesses to comply with. Emmanuel and Fuchs (2007) estimate that a VAT rate of approximately 15 percent could pay for the fully phased in voucher program.

Two main complaints have been leveled at the VAT. One is that it would be a money machine and fuel the growth of government. A second is that it is regressive since lower-income households spend a much larger share of their incomes than higher-income households.

1. Health VAT and government spending

A VAT dedicated to paying for health care, including the new voucher, would seem to address both of these criticisms. The VAT would be reflected in retail prices and the VAT rate would have to increase over time if health care spending continues to grow faster than the economy.[6] Since everyone would pay the VAT, the higher rate could build widespread support for effective measures to control health care costs. Moreover, the lowest-income 40 percent of households would have a stake in controlling government spending, addressing one of the conservatives' major complaints about the current system.

The overall effect of the program on federal spending will depend on the nature of the health care voucher. Emanuel and Fuchs (2007) propose that the voucher pay for health care provided through a program like the Federal Employees Health Benefits Program. They argue that the voucher could squeeze waste out of the system because the federal government would have the market power to require that providers control costs (and presumably would be combined with other reforms that would reduce ineffective care). There is also evidence that much of the variation in health care costs is not related to differences in health status or quality (Congressional Budget Office 2008b). By tying the basic voucher amount to age, gender, and health status, but not regional variation in prices, pressure would be put on providers to conform their standards of care to the best practices.[7]

---

[5] See Yin (2006) for discussion of types of VAT and why it is superior on administrative grounds to a national retail sales tax, which several Republican presidential candidates (most notably Governor Huckabee) have endorsed.

[6] One of the concerns about the VAT is that it is an invisible component of product prices. This concern might be mitigated by urging or requiring retailers to break out the VAT on sales receipts.

[7] Even if this works, there would be issues during a transitional period if providers cannot immediately adapt.

Given that most working-age people and their families get health insurance through employers, there would be advantages to designing the voucher so that it could be used in concert with employer-sponsored insurance (ESI), especially for large employers that can provide such insurance relatively cheaply. One option would be to allow the voucher to be transferred to an employer that offers ESI either purchased directly or purchased through the publicly sponsored pool. To minimize adverse selection (employers with healthier-than-average workforces opting out of the public program), the voucher could be set at less than 100 percent of the cost per worker in the public pool.

A possible way to limit spending and improve the chance for bipartisan consensus would be to make the voucher pay for a high-deductible health insurance plan. Jonathan Gruber and Martin Feldstein (1995) proposed a universal voucher tied to plans with a deductible that varied with income. There are serious administrative issues to implementing this (or any means-tested health entitlement), but it could offset the prime complaint about high-deductible plans. The deductible could be set very low for households with low incomes and very high for those with incomes high enough to afford the higher risk. Alternatively, the high deductible plan could be combined with health savings accounts, as under current tax law, and the government could pay for all or part of the deductible for lower-income families.

Finally, the plan might include process reforms designed to limit the growth of entitlement programs. Penner and Steuerle (2005) propose caps and triggers for automatic cuts in entitlements that they claim would take those programs off auto-pilot. They also propose a super-majority requirement for the enactment of large new entitlement programs. However, enactment of these options might be delayed until policymakers see how well the automatic spending constraint built into the health VAT and voucher work.

2. Health VAT and progressivity

The new health care voucher paid for by the VAT would be most valuable to low- and middle-income households who either do not currently have health insurance or for whom the cost of health insurance is a very large portion of their incomes. Currently, health insurance averages more than 10 percent of compensation for employees who get it at work (Eibner, Kapur, and Marquis 2007). It is a larger percentage for those with lower incomes. Thus, the new health benefit will be worth far more than the additional tax paid through the VAT. For high-income people, in contrast, health insurance is only a fraction of income. The VAT will cost much more than the value of the new benefit.

Overall, distributional targets can be met by coordinating the income-tax changes with the VAT and the health voucher. A special consideration is that low-income people who currently qualify for free health care through Medicaid or the children's health insurance program, SCHIP, will receive less benefit from the voucher. Since food stamps are indexed for food price inflation and the refundable EITC is indexed to overall inflation, part of any effect of the VAT on prices would automatically be offset, but additional subsidies will be necessary for those with very low incomes.

3. VAT and seniors

A well-known feature of a VAT is that it is a tax on old capital. This especially affects older people, since they get relatively little benefit from the tax-exemption for new saving under the VAT while everything they buy becomes more expensive. Although this is probably a political disadvantage, seniors get so much more back in Social Security and medical care than they paid in, it makes sense to charge those who are able to pay for part of those costs. It is also important to note that those whose income comes mostly from Social Security would be relatively unaffected since those benefits are indexed to inflation.[8]

4. VAT and economic efficiency

The VAT is a relatively efficient revenue source. Since it taxes consumption rather than income, it does not discourage saving as does the income tax.

The biggest efficiency gain, though, could come from reductions in income tax rates. The VAT will cover the cost of current health care programs, offsetting federal spending on Medicaid, veterans' health programs, and the portion of Medicare paid out of general revenues. Although part of Medicare spending is covered by premiums and payroll taxes, more than $200 billion in FY 2009 will be financed with general revenues (Congressional Budget Office 2008a). Federal spending on Medicaid and other federal health programs adds another $240 billion. All told, the income tax would have to finance about $450 billion less in health spending than it does at present.

In addition, there would no longer be a tax exclusion for employer-sponsored insurance (ESI), a $169 billion income tax expenditure in 2008. Other potentially superfluous tax subsidies total about $12 billion. Thus, the income tax base would become substantially larger. As a result, with the VAT covering health care costs, tax rates could be cut by about a third across the board with no effect on the deficit.[9] And that is even before considering the additional revenues that could arise from base broadening.

With lower tax rates, the tax reform could also eliminate the differential between capital gains and other income (as in 1986), which would reduce the incentive and ability of individuals to engage in tax sheltering. More generally, the lower top rate would reduce the incentive for tax avoidance and evasion of all sorts.

---

[8] Burman, Gravelle, and Rohaly (2005) found that households over 65 were less affected by a VAT than younger ones, because Social Security benefits are indexed.

[9] CBO projects that individual and corporate income tax revenues will total $1,696 billion in FY 2009. After repeal of the ESI exclusion and other health insurance tax expenditures, tax revenues would be about $1,876 billion. Total general revenue financed federal spending on health care is about $628 billion (including the tax expenditures). Thus, income tax revenues could be cut by 628/1,876, or 33.5 percent, with no net effect on the deficit. These calculations ignore behavioral responses, which are ambiguous. Eliminating the ESI exclusion might encourage some taxpayers to find other ways to shelter wages from tax. On the other hand, lower marginal tax rates would reduce the incentive for tax avoidance, generating a positive revenue feedback.

5. Payroll tax cut

Since health care for the elderly would be financed through the VAT, the Medicare portion of payroll taxes (1.45 percent on employers and employees) would no longer be necessary. Moreover, elimination of the ESI exclusion would significantly increase contributions to Social Security, substantially bolstering its finances. On the other hand, to the extent that the VAT translates into higher prices, the Social Security trust fund would tend to be devalued. But higher prices would also devalue U.S. debt, so, on balance, the federal government's balance sheet could improve. Part or all of those savings could be transferred to Social Security, if necessary. Over the long term, the Social Security trust fund will be much stronger because more of wages are included in the Social Security tax base.

6. Effect on states

If the federal government takes over states' obligations for Medicaid, states will avoid an enormous and growing financial obligation. The federal government could ask states to pay a larger portion of other programs they currently share with the federal government. Alternatively, the federal government might forgive the states their current obligations for care for patients who are eligible for both Medicare and Medicaid—a $56 billion obligation in 2008—but require a state contribution toward the voucher equal to their states' other Medicaid spending. Even in this case, states' financial exposure would be substantially lower than under current law. The states' windfall might make them less resistant to sensible tax reforms, such as repealing the deductibility of state and local taxes and scaling back or eliminating the use of tax-exempt bonds, both of which are extremely inefficient subsidies.

B. Income and estate tax reform

The income tax reforms would reflect the traditional recipe: broad base (that is, fewer loopholes and deductions) and lower rates. The AMT would be eliminated. As noted, financing health care with the VAT would allow for significantly lower top marginal tax rates, even while eliminating the AMT. All of this would be accomplished while maintaining or enhancing the overall progressivity of the tax system (including the benefits from the new health care voucher). Simplicity would be achieved by relieving most taxpayers of filing requirements, and vastly simplifying filing for others.

There are several models that have some similarities to this plan. William Gale (2008) recently proposed a tax reform including integration of the corporate and individual income taxes for new investment and a VAT sufficient to raise 4 to 5 percent of GDP. Gale would eliminate the AMT (conditional on the AMT's anti-tax shelter provisions being incorporated into the tax code); eliminate many individual and corporate tax breaks; improve enforcement; simplify and consolidate tax breaks for education, retirement, and families; provide a new tax credit against payroll taxes on the first $5,000 of earnings; and introduce return-free filing for many taxpayers.

Michael Graetz (2008) has also proposed a VAT, but would use the revenues generated to exempt families with incomes below $100,000 ($50,000 for singles) from income tax. Under Graetz's scheme, the income tax would return to its origins as a tax on those with very high incomes. He would cut top individual and corporate income tax rates and would retain some variant of the refundable child tax credit and earned income tax credit to prevent low-income families from suffering a tax increase. Of course, this would require income assessment for such families, so it is not so different from Gale's proposal to simplify the tax system enough so that many low- and middle-income families do not have to file (their income tax is determined by exact withholding).

As Graetz (2008) notes, the exact details of the tax reform will be determined by the political process. Indeed, specifying too many details in advance might doom any tax reform plan to failure. TRA was successful in part because President Reagan gave very parsimonious instructions to his tax reformers: cut top tax rates and preserve a subsidy for homeownership. Everything else was on the table and negotiated with Congress (Birnbaum and Murray 1987).

A drawback of both the Graetz and the Gale plans is that they do not deal with health reform, meaning that either proposal would not be taken seriously in a Democratic administration until after health reform is completed (which could take a long time). Also, an add-on VAT that is not tied to health care might fuel conservatives' concerns that it would be a money machine that could spur the growth of government. And Graetz's plan would aggravate conservatives who complain that 40 percent of Americans owe no income tax. Under Graetz's plan, it would be closer to 90 percent.

Here is a rough outline of the nature of an income tax reform I believe could capture the best features of the Graetz and Gale plans while addressing bipartisan concerns. The goal would be to enable a return-free filing system for most households, which would require substantial simplification and flattening of the income tax. It is a more sweeping proposal than Gale's, which raises political issues as more sacred cows are jettisoned, but it would make simplicity a much higher priority than previous tax reforms have.

There would be two individual income tax rates—say, 15 and 25 percent (although the actual rates would depend on revenue and distributional targets), and the corporate tax rate would be set equal to the top individual income tax rate (so corporations do not become a tax shelter). Personal exemptions and the standard deduction would be eliminated. Itemized deductions would also become historical artifacts, as proposed by President Bush's tax reform panel. The mortgage interest deduction would be replaced by a flat 15 percent refundable tax credit paid directly to lenders. The deduction for charitable contributions would similarly be replaced by a 15 percent matching grant paid directly to qualifying nonprofits. (The U.K. does this now.) In each case, the match rate could be revised as part of congressional negotiations. Alternatively, taxpayers in the 25 percent tax bracket could be allowed to elect the deduction instead of the credit.[10] Education tax

[10] This would involve minor additional complexity. It could be implemented by allowing taxpayers to elect a full deduction and adding credits already received to taxes due. For taxpayers who use software or paid preparers, as most higher-income taxpayers do, the additional complexity would be imperceptible.

incentives should be replaced with an expansion of Pell grants and subsidized student loans. The deductibility for state and local taxes would be eliminated. (State governments could use their savings from the elimination of Medicaid to cut income and sales tax rates and increase their share of education financing, allowing local governments to cut property taxes, offsetting the effect of the lost tax deductions.)

Either traditional IRAs or Roth IRAs would be eliminated, as would nondeductible IRAs, which would simplify taxpayers' choices and accounting. The simplest option would be to retain only Roth IRAs, which feature nondeductible contributions and tax-free retirement withdrawals, eliminating all tax accounting requirements. The drawback of Roth IRAs is that they represent potentially large future reductions in the income tax base, since balances in these accounts are entirely tax-free so long as they are held until retirement, no matter how large they grow. Substantial growth in Roth IRAs could exacerbate our long-term budget challenges. In addition, rollover IRAs would need to be retained for balances in traditional 401(k) plans. But accounting for traditional IRAs would be more complicated.[11]

The savers credit should be converted into a refundable tax credit payable directly to the financial institution. The IRS would send taxpayers a certificate in May or June of each year indicating their eligibility and credit rate based on information returns for those who do not have to file and tax returns for those who do, which would be used by the financial institution to claim the credit.

The child tax credit, the child-related portion of the earned income tax credit, the adoption tax credit, and the child and dependent care tax credit would be replaced by a $2,000 per child fully refundable tax credit. (Again, the exact amount would be determined based on revenue and distributional targets.) The work subsidy in the EITC would be replaced with a 30 percent fully refundable payroll tax credit on the first $10,000 of earnings for each adult worker.[12] This may seem extremely generous, but the 15 percent income tax bracket starts on the first dollar of earnings, so the net subsidy compared with current law would be modest.

The eligibility criteria for these new credits would be much simpler than the current child tax credit and EITC since the new credits would not phase out with income or depend so much on living arrangements. (For example, it would not matter which parent claimed a child for the tax credit so long as only one did—something easily verifiable by tax authorities.) The child tax credit amount could also be designed to offset the tax increase due to the VAT for very low income families that currently get free health insurance

[11] Contributions to traditional IRAs could be matched with a federal match, as for charitable contributions, with the option of deductibility for those in the 25 percent tax bracket. Withdrawals would be subject to a 15 percent withholding tax (plus a penalty tax for early withdrawals). This would be final withholding for most taxpayers. Higher-bracket taxpayers would have to include distributions in income and would be able to claim a credit for withholding tax paid. Rollover Roth IRAs would also need to be preserved for rollovers from Roth 401(k) accounts.

[12] Although the amounts are different because the scope of my proposal is much broader, the idea of replacing the EITC and child tax credit with fully refundable work and child tax credits is similar to a proposal made by Forman, Carasso, and Saleem (2005).

through Medicaid or SCHIP, since they almost all have children and their expenditures subject to VAT are likely to be relatively small.[13]

Workers with earnings and family incomes below certain thresholds would not be required to file a W-4 withholding form. Their employers would withhold income tax at a 15 percent rate. Interest, dividends, and withdrawals from traditional pensions, 401(k) plans, and IRAs would be subject to 15 percent withholding as well. For most taxpayers, this would be final withholding, requiring no additional accounting on tax returns. Other conforming changes, such as eliminating the deduction for alimony and child support payments for donors and taxation of such payments to recipients, would also facilitate the return-free system. For most taxpayers, this simplification would produce the same overall tax burden as under current law, but it would result in higher tax in the case where the donor was in the top bracket and the recipient was not.

Up to $1,000 of capital gains (again, the amount is an example) would be exempt from tax every year. All other capital gains would be taxable as ordinary income.[14] To reach bipartisan consensus, providing a tax break on long-term capital gains may be necessary. As noted, a rate differential between capital gains and other income creates enormous opportunities for tax sheltering, but some view it as important to encourage investment, reduce lock-in (the incentive to delay sales of assets to avoid the tax), and offset the double-taxation of corporate income.[15] If capital gains (and dividends) are to be taxed at lower rates, the simplest way would be via an exclusion rather than the alternate rate structure that exists currently. For example, 60 percent of long-term capital gains and qualified dividends could be included in taxable income, creating a maximum effective tax rate of 15 percent (60 percent of 25 percent).

Under this plan, taxpayers in the 15 percent bracket would not have to file income tax returns unless they had a large capital gain or some other unusual tax situation. The only complexity would be how to convey the refundable tax credits. Graetz (2008) suggests that it could either be done through payroll adjustments by employers (as the advance EITC is done now) or through a debit card—an ATM card that would have the value of refundable credits based on earnings and number of children each year.

The estate tax is obviously fraught with controversy (Graetz and Shapiro 2005), but a reasonable compromise would be to extend the 2009 exemption of $3.5 million and top tax rate of 45 percent. This would exempt all but very wealthy estates from the tax and might defuse the issue politically. The estate tax could also be simplified, for example by allowing surviving spouses to carry over any unused estate tax exemption from the first spouse to die. This would effectively grant an automatic $7 million exemption for cou-

---

[13] Under the parameters specified above, a one-earner couple with two children earning $10,000 would get about the same refund, net of VAT, as under current law. Higher income couples would pay more tax, but presumably benefit more (on average) from the new health voucher.

[14] One issue is whether corporate income taxes should be integrated to eliminate double taxation. While this change would be desirable in principle, full integration is relatively rare in the rest of the world and may be hard for voters to comprehend. Given the significant reduction in individual and corporate income tax rates, the economic gains would also be smaller than they would be under the current system.

[15] See Burman (1997) for a discussion of the issues.

ples, which would significantly simplify tax planning for many couples. A more sweeping reform would be to convert the estate tax to an inheritance tax as described in Batchelder (2007).

Obviously many details are left out of this short sketch. Gale (2008) discusses individual and corporate income tax simplification, base broadeners, and compliance initiatives in more detail. There would also surely be significant administrative issues in setting up the new credits. In addition, some of the proposals are probably not politically feasible, and there would inevitably be a great deal of redistribution compared with current law. But the role of the political process is to vet the political and policy issues and balance them out. The key is for the president and congressional leaders to commit to keep the process moving toward the broad goals agreed to at the outset.

C. Other issues

There are many options to improve the income tax system that could be paired with the health VAT. For example, the income tax reforms outlined here could be replaced by those suggested by Michael Graetz (2008) or William Gale (2008) with relatively minor modifications. Senator Ron Wyden (D-OR) and Congressman Rahm Emanuel (D-IL) have proposed the Fair Flat Tax Act of 2007 (S. 1111), which would simplify tax filing and reduce the number of tax brackets, while recognizing that certain tax breaks are sacrosanct. If paired with the health VAT, the top individual and corporate income tax rates in that plan could be reduced from the proposed 35 percent to 25 percent or less (although refundable tax credits would need to be adjusted for low-income households currently receiving free health care that would be disadvantaged by the VAT).

A practical issue is sequencing of the major reforms proposed here, which include income tax reform, a new tax for the United States (a VAT), and health reform. It is probably an understatement to say that it is unlikely that Congress could accomplish all of this in one term. One option would be to extend some of the Bush tax cuts and index the AMT for inflation through 2012 (or some other fixed but not too distant date). In principle, the components of the reform outlined here could be enacted in stages. The challenge would be sequencing the pieces so that momentum for reform is not derailed along the way.

I applaud the committee for taking on the incredibly important task of tax reform. Obviously, it will not be easy, and I suspect I have only scratched the surface of the challenges you face. But nobody thought TRA would happen in 1986, and it did. The bipartisanship, creativity, and tenacity of Democrats and Republicans on this committee played a key part in making it happen. I hope that you can repeat and improve on that accomplishment.

That concludes my testimony. I am happy to answer any questions.

References

Autor, David H., Frank Levy and Richard J. Murnane. 2003. "The Skill Content of Recent Technological Change: An Empirical Investigation." *Quarterly Journal of Economics* 118:1279–1333.

Bartels, Larry M. 2005. "Homer Gets a Tax Cut: Inequality and Public Policy in the American Mind." *Perspectives on Politics* 3(1): 15–31.

Bartlett, Bruce. 2006. *Impostor: How George W. Bush Bankrupted America and Betrayed the Reagan Legacy.* New York: Doubleday.

Batchelder, Lily L. 2007 "Taxing Privilege More Effectively: Replacing the Estate Tax with an Inheritance Tax." Hamilton Project Discussion Paper, The Brookings Institution.
http://www.brookings.edu/~/media/Files/rc/papers/2007/06taxes_batchelder/200706batchelder.pdf.

Birnbaum, Jeffrey H., and Alan S. Murray. 1987. *Showdown at Gucci Gulch.* New York: Random House.

Burman, Leonard E. 1997. *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed.* Washington, DC: Brookings Institution Press.

———. 2007. "The Individual Alternative Minimum Tax: Assault on the Middle Class." *Milken Institute Review* Fourth Quarter: 12–23.

Burman, Len, and Greg Leiserson. 2008. "Scoring McCain's Tax Proposals." *Taxvox.* April. http://taxvox.taxpolicycenter.org/blog/_archives/2008/4/17/3644448.html

Burman, Leonard E., Jane G. Gravelle, and Jefffrey Rohaly. 2005. "Towards a More Consistent Distributional Analysis." *National Tax Association Proceedings of the 98th Annual Conference.*

Burman, Leonard E., Robert J. Shiller, Gregory Leiserson, and Jeffrey Rohaly. 2007. "The Rising Tide Tax System: Indexing the Tax System for Changes in Inequality." Draft manuscript, Tax Policy Center.

Congressional Budget Office. 2007. *The Long-Term Budget Outlook.* Washington, DC: U.S. Government Printing Office, December.
http://www.cbo.gov/ftpdocs/88xx/doc8877/12-13-LTBO.pdf

———. 2008a. *The Budget and Economic Outlook: Fiscal Years 2008 to 2018,* January 2008. Washington, DC: U.S. Government Printing Office, January.
http://www.cbo.gov/ftpdocs/89xx/doc8917/01-23-2008_BudgetOutlook.pdf

———. 2008b. *Geographic Variation in Health Care Spending.* Washington, DC: U.S. Government Printing Office, February. http://www.cbo.gov/ftpdocs/89xx/doc8917/01-23-2008_BudgetOutlook.pdf

Dew-Becker, Ian, and Robert J. Gordon. 2005. "Where Did the Productivity Growth Go? Inflation Dynamics and the Distribution of Income." *Brookings Papers on Economic Activity*, II.

Durante, Ruben, and Louis Putterman. 2007. "A Preliminary Analysis of the 2006 Pilot Study Responses to Questions on Progressivity of Taxes and Estate Tax." Ann Arbor, MI: American National Election Studies. ANES Pilot Study Report No. nes011887.

Eibner, Christine, Kanika Kapur, and M. Susan Marquis. 2007. "Snapshot: Employer Health Insurance Costs in the United States." California Healthcare Foundation, July. http://www.chcf.org/documents/insurance/EmployerHICostsUS.pdf.

Emanuel, Ezekiel J., and Victor R. Fuchs. 2007. "A Comprehensive Cure: Universal Health Care Vouchers." Washington, DC: The Brookings Institution. Hamilton Project Discussion Paper No. 2007-11 http://www.brookings.edu/~/media/Files/rc/papers/2007/07useconomics_emanuel/200707emanuel_fuchs.pdf.

Forman, Jonathan Barry, Adam Carasso, and Mohammed Adeel Saleem. 2005. "Designing a Work-friendly Tax System: Options and Trade-Offs." Tax Policy Center Discussion Paper No. 20. http://www.urban.org/UploadedPDF/411181_TPC_DiscussionPaper_20.pdf.

Gale, William G. 2008. "Fixing the Tax System Support Fairer, Simpler, and More Adequate Taxation." Washington, DC: The Brookings Institution. http://www.taxpolicycenter.org/UploadedPDF/1001128_fixing_tax_system.pdf

Goldin, Claudia, and Robert A. Margo. 1992. "The Great Compression: The Wage Structure in the United States at Mid-Century," *Quarterly Journal of Economics* 107:1-34.

Graetz, Michael J. 2008. *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States.* New Haven: Yale University Press.

Michael J. Graetz and Ian Shapiro. 2005. *Death by a Thousand Cuts: The Fight Over Inherited Wealth.* Princeton: Princeton University Press.

Levy, Frank S. and Peter Temin. 2007. "Inequality and Institutions in 20th Century America" MIT Department of Economics Working Paper No. 07-17

Martin Feldstein and Jonathan Gruber. 1995. "A Major Risk Approach to Health Insurance Reform." In James M. Poterba, ed., *Tax Policy and the Economy, vol. 9*, Boston: MIT Press.

Kogan, Richard, and Aviva Aron-Dine. 2006. "A 'Mere' $300 Billion: Should a $300 Billion Deficit Be Considered a Victory?" Washington, DC: Center on Budget and Policy Priorities. http://www.cbpp.org/5-22-06bud.pdf

McMahon, Jr. Martin J. 2004. "The Matthew Effect and Federal Taxation." *Boston College Law Review* 45(5): 993-1128.

Penner, Rudolph G. 2003. "Searching for a Just Tax System." Washington, DC: Tax Policy Center. TPC Discussion Paper No. 13. http://taxpolicycenter.org/UploadedPDF/410907_TPC_DP13.pdf

Penner, Rudolph G., and C. Eugene Steuerle. 2005. "A Radical Proposal for Escaping the Budget Vise." Washington, DC: The Urban Institute. *National Budget Issues* Policy Brief No. 3. http://taxpolicycenter.org/UploadedPDF/311192_NBI_3.pdf

President's Advisory Panel on Federal Tax Reform. 2005. *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System.* Washington, DC: President's Advisory Panel on Federal Tax Reform.

Slemrod, Joel. 2006. "The Role of Policy Misconceptions in Support for Regressive Tax Reform," *National Tax Journal* 59(1): 57–75.

Slemrod, Joel, and Jon Bakija. 2004. *Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform*, 3rd ed. Cambridge, MA.: MIT Press.

Stein, Herbert. 1997. "Herb Stein's Unfamiliar Quotations: On Money, Madness, and Making Mistakes." *Slate* May 16. http://www.slate.com/id/2561/.

Steuerle, C. Eugene. 2004. *Contemporary U.S. Tax Policy*. Washington, DC: Urban Institute Press.

U.S. Treasury. 1984. *Tax Reform for Fairness, Simplicity, and Economic Growth.* Washington, DC: Government Printing Office.

Yin, George K. 2006. "Is the Tax System Beyond Reform?" *Florida Law Review* 58(5): 977–1041.

Table 1. Effect of Extending Tax Cuts on Receipts and Deficit, Fiscal Years 2008-2018

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009-2018
Baseline receipts	2,654	2,817	2,907	3,182	3,442	3,585	3,763	3,941	4,131	4,334	4,548	36,649
Percent of GDP	18.7	19.0	18.6	19.3	19.9	19.9	20.0	20.0	20.1	20.2	20.3	19.8
Extend tax cuts	0	-3	-6	-147	-254	-281	-292	-304	-316	-329	-344	-2,277
Index AMT	-6	-75	-76	-71	-42	-49	-58	-68	-80	-94	-110	-724
Interaction	0	0	0	-18	-61	-69	-76	-83	-90	-97	-105	-598
Oiher expiring provisions	-6	-14	-22	-31	-38	-44	-49	-53	-58	-63	-67	-438
Receipts after tax cuts	2,661	2,744	2,822	2,934	3,067	3,161	3,308	3,453	3,608	3,771	3,941	32,631
Percent of GDP	18.7	18.5	18.1	17.8	17.8	17.5	17.5	17.5	17.6	17.6	17.6	17.6
Baseline surplus or deficit	-219	-198	-241	-117	87	61	96	117	95	151	223	274
minus tax cuts	-12	-92	-104	-267	-395	-443	-475	-508	-543	-583	-626	-4,038
additional interest on debt	0	-2	-7	-17	-34	-56	-81	-109	-140	-175	-213	-835
Surplus or deficit after tax cuts	-231	-293	-352	-401	-342	-439	-460	-500	-589	-607	-617	-4,600
Percent of GDP	-1.6	-2.0	-2.3	-2.4	-2.0	-2.4	-2.4	-2.5	-2.9	-2.8	-2.8	-2.5

Source: Congressional Budget Office; *The Budget and Economic Outlook: Fiscal Years 2008 to 2018*, January 2008.
http://www.cbo.gov/ftpdocs/89xx/doc8917/01-23-2008_BudgetOutlook.pdf

Table 2. Distribution in 2011 of Benefits from Extending Bush Tax Cuts set to Expire in 2010

Cash Income Percentile	Percent of After-Tax Income	Share of Tax Cut (Percent)	Average Tax Cut in Dollars
Lowest Quintile	0.4	0.5	41
Second Quintile	2.1	5.3	456
Middle Quintile	2.3	9.7	828
Fourth Quintile	2.2	15.3	1,309
Top Quintile	3.5	68.9	5,904
All	2.9	100.0	1,713
Addendum			
Top 10 Percent	4.0	56.5	9,673
Top 5 Percent	4.7	48.7	16,686
Top 1 Percent	6.7	37.4	64,154
Top 0.5 Percent	7.3	31.6	108,227
Top 0.1 Percent	7.8	18.9	323,621

Source: Tax Policy Center, Table T06-0284.

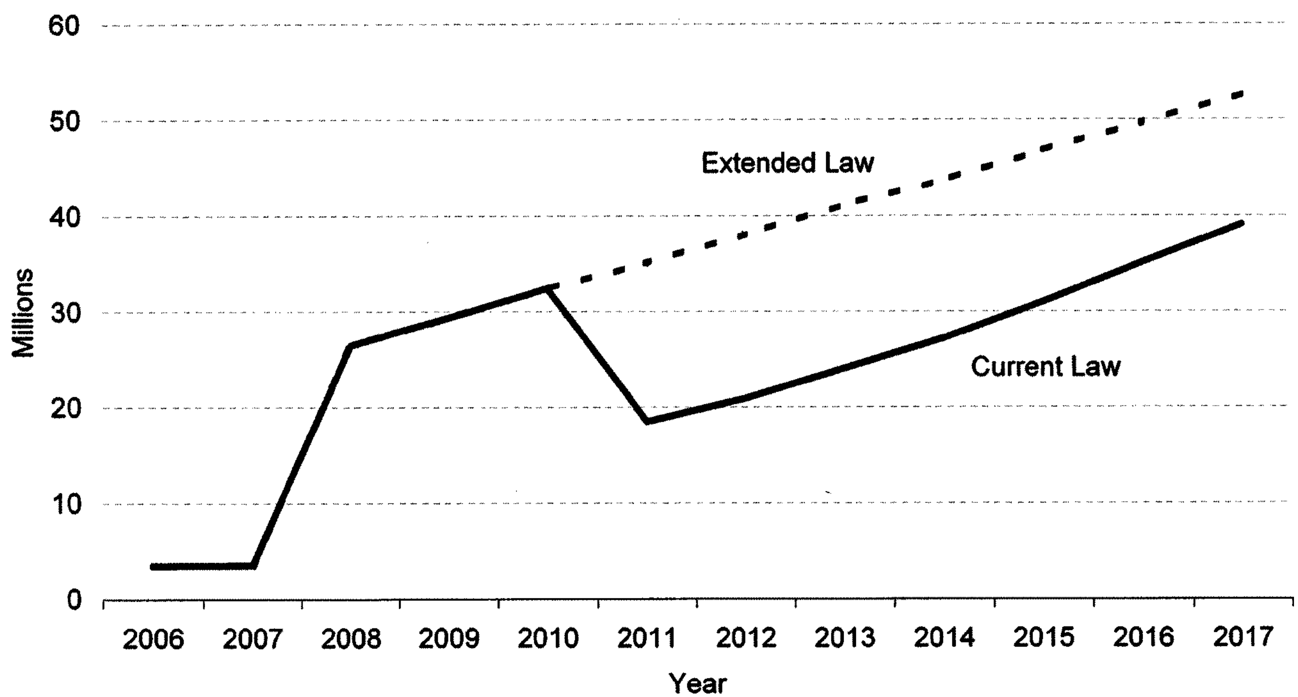
Notes: (1) Calendar year. Baseline is pre-EGTRRA law. Tax cuts include individual income and estate tax provisions in EGTRRA, JCWA, JGTRRA, WFTRA, AJCA, TIPRA, and PPA.

(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

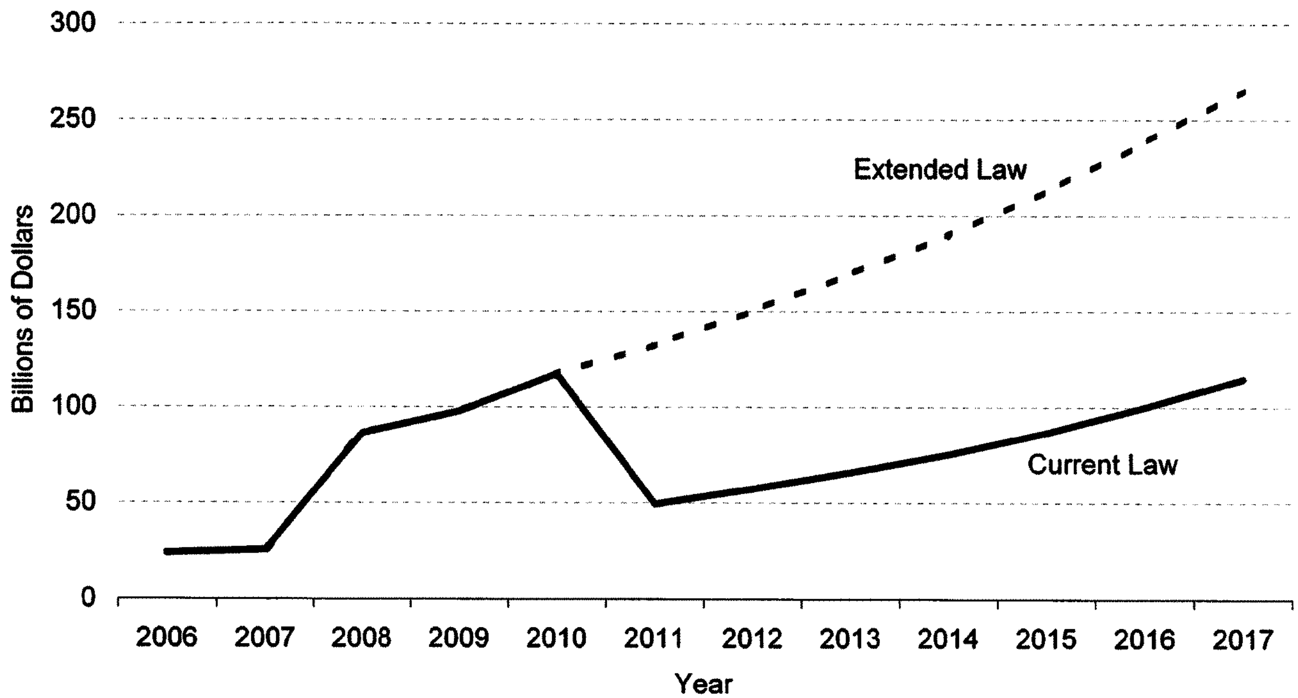
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

Figure 1. Number of AMT Taxpayers, 2006-17, With and Without Extension of Bush Tax Cuts



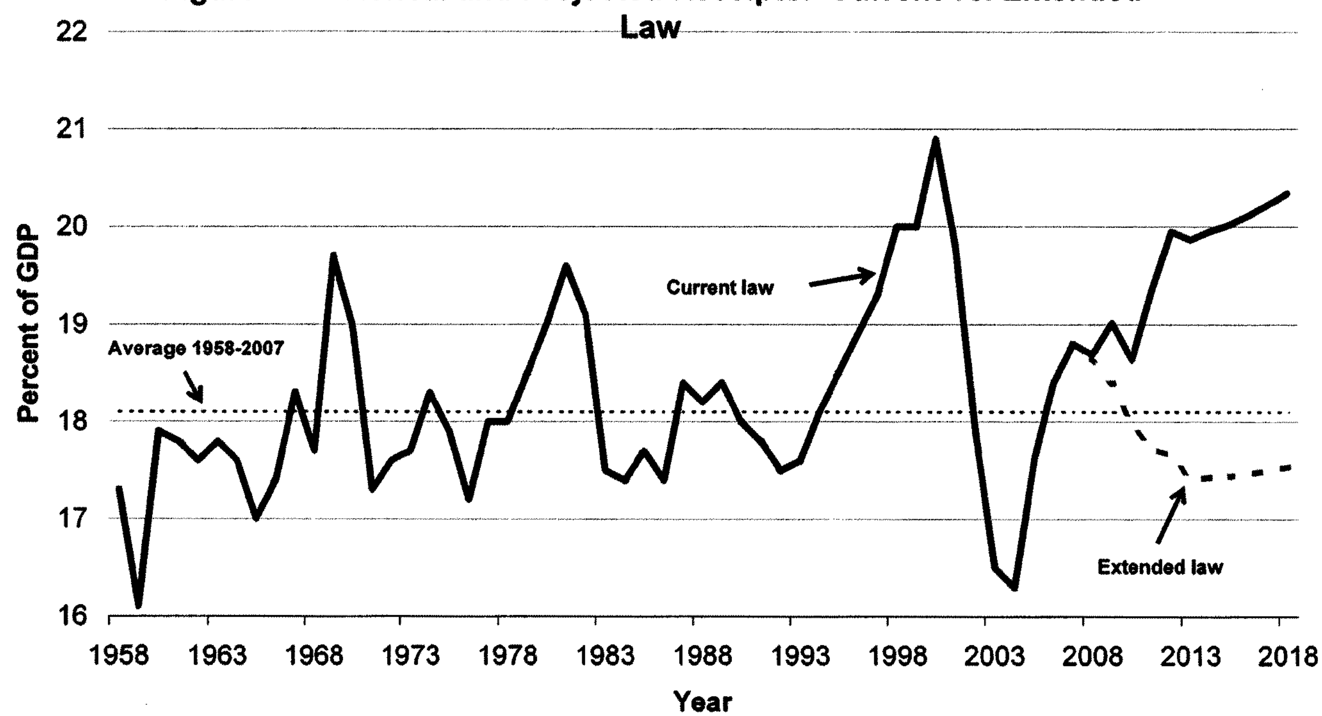
Source: Tax Policy Center, www.taxpolicycenter.org/T08-0043

Figure 2. AMT Revenue, 2006-17, With and Without Extension of Bush Tax Cuts



Source: Tax Policy Center, www.taxpolicycenter.org/T08-0043

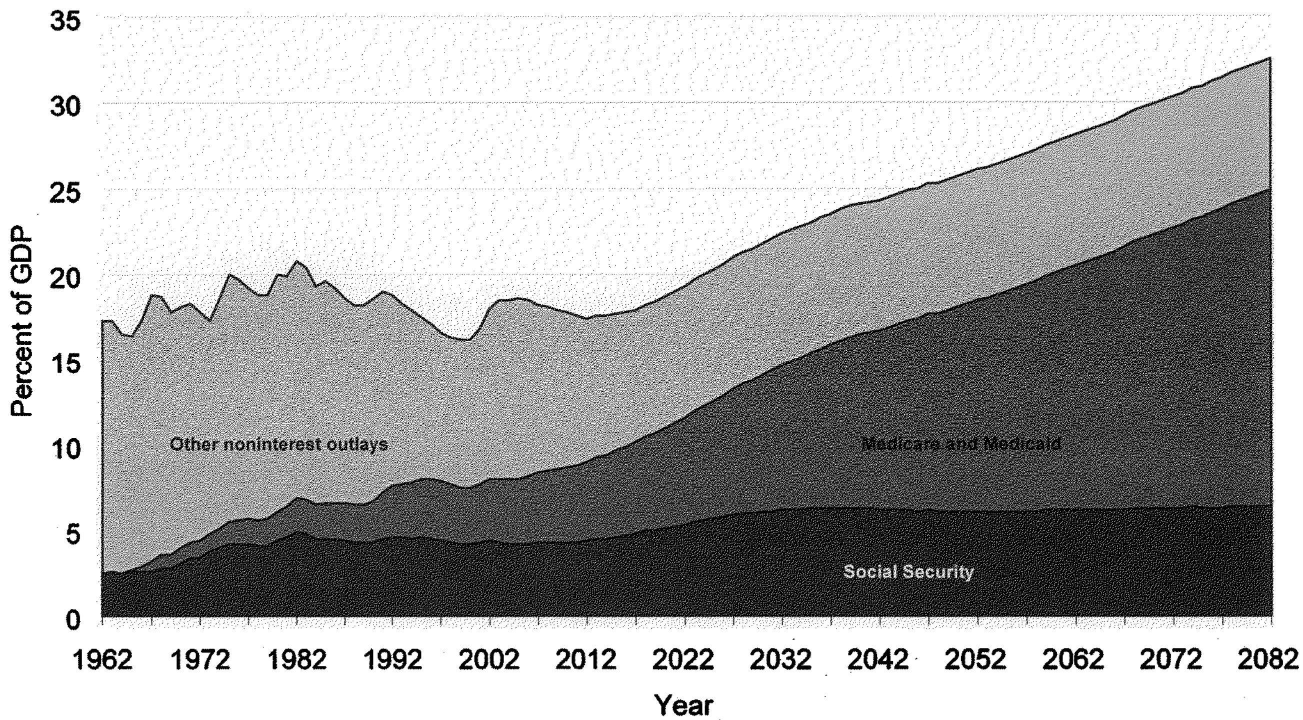
Figure 3. Historical and Projected Receipts: Current vs. Extended Law



Source: CBO Budget Outlook, 2008-2018, and Tax Policy Center

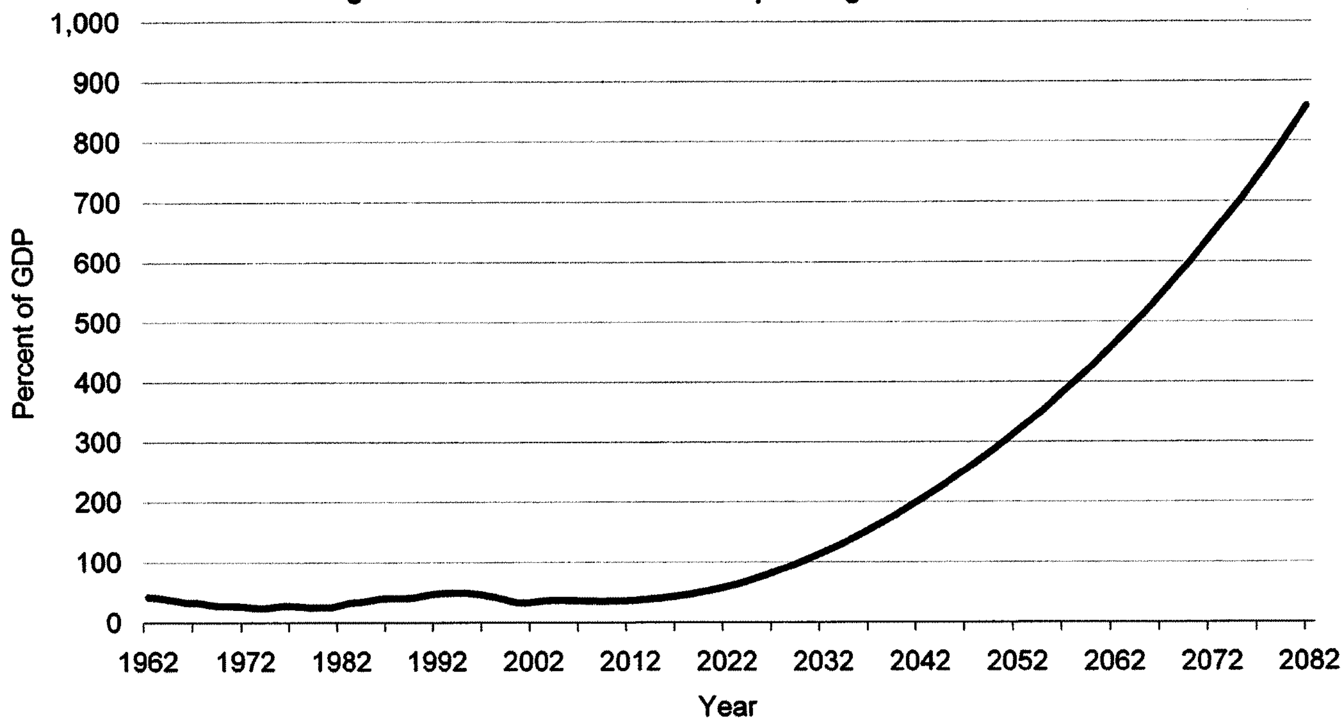
Note: extended law assumes extension of Bush tax cuts, AMT indexing, and other expiring provisions.

Figure 4. CBO Long-Term Spending Projections



Source: Congressional Budget Office (2007).

Figure 5. Debt Held by the Public, 1962-2082,
Assuming Current Policies and Health Spending Trends Continue



Source: Congressional Budget Office (2007).

United States Senate Committee on Finance Hearing
Cracking the Code – Tax Reform for Individuals
May 13, 2008

Questions Submitted for the Record

Questions for Dr. Leonard Burman:

Senator Baucus

1. Should simplification be the goal of individual tax reform? If so, what's the best way to simplify the system?

Simplification should be a goal, although not the only one. The others are fairness, efficiency, and revenues adequate to finance government operations. However, simplification often gets short shrift in tax legislation; that is unfortunate and can even undermine other goals. Complexity creates opportunities for tax avoidance and evasion, which are inefficient and reduce revenues. Also, taxpayers tend to view an overly complex tax system as unfair because they suspect that others are getting more than their fair share of tax breaks.

The tax system may be simplified by adopting a broad measure of income and minimizing the number of deductions and tax credits. To the extent that deductions and credits are warranted, it is simplest to make them available to everyone without complicated phase-ins and phase-outs. Phase-outs are often motivated by concerns about fairness or revenue, but those objectives could be achieved more simply by adjusting the tax schedule. If credits must be phased out, it would be best to combine and apply a single phaseout rate—e.g., 5 percent. That would be simpler and also avoid the very high—and inefficient—marginal effective tax rates that multiple phase-outs may create.

Hidden tax surcharges, like the personal exemption phase-out and the phase-out of itemized deductions, are especially hard to justify. It would be much better to simply eliminate them and raise tax rates to compensate. Similarly, the individual alternative minimum tax, as you have noted, is unfair and complex. It would be better to adjust tax rates to achieve the same level of revenues and progressivity and eliminate this alternative levy. The taxation of long-term capital gains and qualifying dividends is also pointlessly complex. A large part of Schedule D (taxation of gains and qualifying dividends) and Form 6251 (AMT) are devoted to taxing gains and dividends at lower rates. It would be far simpler to exclude a portion of capital gains and dividends from tax, as was done before 1987. For example, 50 percent of long-term capital gains and qualifying dividends could be included in AGI, making the effective top rate 17.5 percent. This would be a far, far simpler calculation.

It would be best to avoid multiple tax subsidies for the same activity. For example, college students and their families are now eligible for the Hope credit, lifetime learning credit, and deduction for higher education expenses, all subject to slightly different eligibility requirements and phase-outs. Choosing the best option is extremely complex. It would be much simpler to combine the credits and eliminate the deduction.

President Bush's tax reform panel made a number of proposals that would simplify the tax system, including some innovative accounting simplifications for small businesses, simpler taxation of social security benefits, and a slightly simpler replacement for the EITC. It would also have eliminated the AMT on a revenue-neutral basis.

Finally, sufficient simplification could make possible a system under which most taxpayers would not have to file tax returns. This is done in the UK and is theoretically feasible here. The proposal I outline in my testimony would, I argue, allow a return-free system for most tax filers.

2. How can the tax system be made fairer?

Reducing the number of targeted tax breaks and deductions, as suggested above, would result in fewer disparities in the taxation of taxpayers who have similar incomes. (That is, it would improve horizontal equity.) As noted, it would also improve perceptions of fairness, which I think are probably as important. In my view, the tax system should also be progressive, collecting the highest share of income from those most able to pay, although others clearly differ on the ideal level of progressivity. The tax cuts enacted since 2001 have made the tax system much less progressive. This is especially unfortunate in light of the increasing inequality in pre-tax incomes. By broadening the tax base (in particular, trimming or eliminating tax breaks that primarily benefit high-income people) and adjusting tax rates, the tax system could reduce disparities in after-tax income.

As I note in my testimony, distributional goals may also be advanced through spending programs. For example, if the government provided a voucher to pay for health care, low- and middle-class working people would be much better off than they are currently, because the uninsured would gain health insurance and those who currently have insurance would have more income available for other purposes. As I argue in my testimony, if a health care entitlement were paired with a value added tax (VAT), the combination could be both fairer and more efficient than the current system.

3. How can the system be made more efficient?

The traditional recipe for efficiency is a broad base and low rates. A broad base is more efficient because the tax system does less to distort choices among economic activities. Lower rates reduce the economic cost of any tax system. Switching from a tax based on income to a tax based on consumption would probably also produce some economic gains by reducing the tax bias against saving (although the gains are often overstated by advocates).

The trade-off is that flatter rates and shifting the tax base to consumption make the tax system less fair. A revenue-neutral, flat-rate consumption tax would produce huge tax cuts for high-income people and large tax increases on those with more modest incomes. My testimony outlines a compromise that would be much more efficient than the current system, by relying more on consumption taxes and lowering rates, while preserving or enhancing progressivity.

4. What are some of the negatives of doing what you suggest to meet the goals of simplification, fairness, and efficiency?

As noted, there are often trade-offs between efficiency and fairness. Simplification could result in less precise measurement of income (which could create new opportunities for tax avoidance) and limit the ability to target tax provisions. Also, tax reform can create significant transition issues. For example, the mortgage interest deduction is poorly targeted—mostly benefiting those with high incomes who least need help—and probably does little or nothing to advance homeownership, but eliminating it would likely reduce housing values and would impose significant burdens on current homeowners. And, as you are acutely aware, the losers from any major tax reform create a huge political hurdle to meaningful change.

5. What type of transition would be required to implement this system?

To the extent that you decide to eliminate or scale back tax breaks, you may wish to "grandfather"—for a limited time—those who are currently eligible and to phase in changes to avoid large effects on asset values. The drawback of grandfathering is the potential for lock-in: asset owners would have a strong disincentive to sell since the grandfathered benefit would not transfer to a buyer. Making grandfather provisions temporary mitigates that problem.

6. How would your proposal affect small businesses? Would there be an increased burden?

As noted, the president's tax reform panel proposed significantly simplified accounting for small businesses. Although that is not explicitly a part of my proposal, it would be worthy of consideration. My proposal would lower maximum marginal tax rates, which would help many businesses.

Firms of all sizes would have to collect the VAT, a new tax in the US but common throughout the world. A VAT would impose some compliance burden, but would be much simpler to comply with than the income tax. Also, under the credit-invoice VAT used in most OECD countries, small businesses could be exempted with little cost in terms of lost revenue or economic efficiency.

The most significant change, though, would be the voucher for health care, which would be a huge benefit for small businesses. They face much higher premiums for health insurance than large firms, and run an enormous risk of even higher premiums if an employee gets a serious illness. Furthermore, since small businesses often have lower-wage workforces than large firms, they find it harder to offer health insurance (since the employees cannot afford the lower wages necessary to offset premium costs). This puts smaller firms at a disadvantage in hiring compared with large firms.

7. What would be the IRS's role? What are some administrative issues with adopting your proposal?

In my proposal, I suggest that most filers would not have to file income tax returns. Income tax would be paid through exact withholding. The IRS would have to significantly improve its IT systems to enable matching of withholding to individual income taxpayers in real time. Currently, for example, the IRS does not even receive W-2 information from the Social Security Administration until well after the tax filing season, and while the IRS does receive information returns for some forms of asset income, there is generally no withholding on non-wage income.

Beyond that, the income tax would be simpler to administer than it is currently, with many fewer deductions and credits and many fewer returns filed by taxpayers. An added complication would be the need for the IRS to administer refundable credits for working and children. Although simplifying the complicated eligibility criteria for the EITC and child tax credit would make that task easier, more households would be eligible for the new credits.

The IRS would also have to administer a new VAT. That is not particularly difficult, but it would require additional IRS resources.

8. Is repeal of the AMT a viable option? If so, how can Congress get this done?

Yes. The challenge is making up the lost revenue. The best way to eliminate the AMT would be as part of tax reform, and virtually all serious tax reform proposals would eliminate the AMT. There are also incremental options. I outlined a number of them in my testimony before this committee on June 27, 2007. One option, similar to a proposal made by Ways and Means Committee Chairman, Charles Rangel, would be to replace the AMT with a 4-percent surtax on incomes above $200,000. This is by no means an ideal solution, but it would be much, much simpler than the current AMT and it would be progressive, shifting more of the burden on very high-income people who were the AMT's original target. And many taxpayers who would pay the surtax would owe less tax than they would under the AMT. My 2007 testimony outlined a number of other revenue-neutral incremental options.

Of course, if the AMT were easy to fix, you would have done it years ago as it has almost no constituency. Like fundamental tax reform, revenue-neutral AMT repeal would create winners and losers, and thus generate political opposition. And repealing the AMT without making up the lost revenue would create a huge fiscal hole—more than $1 trillion over the next decade—and would also be highly regressive—another large tax cut for relatively well off families.

9. If repeal is not viable, what can be done to stop this tax from applying to middle income taxpayers?

Bill Gale lists a number of reform options for the AMT in his answers to these questions, which would all be improvements over current law and fiscally responsible.

10. How do we replace the lost revenue?

See answers to previous two questions.

11. Dr. Burman, you recommend creating a VAT to pay for healthcare. How would the health VAT work?

Congress would dedicate revenue from the VAT to cover all health care expenses that are currently financed out of general revenues as well as the cost of a new health care voucher. A value added tax is a kind of consumption tax—like state retail sales taxes—that is collected in stages from all producers and retailers. There are two main variants. A "subtraction method" VAT is basically a cash flow tax. Businesses subtract the cost of goods sold from gross revenues and pay tax at the VAT rate—say 10 percent—on the difference. If the tax is collected at every stage of production, it is equivalent to a 10-percent (or whatever the rate is) tax on the value of the good sold at retail. Under a "credit invoice" VAT, producers owe tax on the entire sales price, but they may claim a credit for gross taxes paid by their suppliers, as verified by a tax invoice. This also adds up to a 10-percent tax on the final value of the goods sold. The credit-invoice VAT is thought to be largely self-enforcing since retailers and other businesses want to receive the invoice showing that the VAT had been paid by their suppliers. Otherwise, they have to pay the tax avoided by suppliers themselves. A subtraction method VAT offers more opportunities for evasion. (The least enforceable type of consumption tax is a retail sales tax. Since there is only one point of collection, the tax can be completely evaded if the retailer does not pay the tax.)

Under either form of VAT, the tax applies to imports and is rebated on exports. Many countries use such border-tax adjustment, which complies with international trade rules.

Dedicating a VAT to cover health care expenses would allow substantial reduction in income tax rates because the income tax would no longer need to finance the federal portion of Medicaid, Medicare, and S-CHIP and the income and payroll tax bases would expand substantially if the employer payroll tax exclusion for health insurance were eliminated. In addition, since the VAT rate would be tied to health care costs, there might be more political support for measures aimed at reducing the rate of growth of health spending, mitigating a substantial threat to long-term federal finances. And the VAT is a more efficient revenue source than the income tax.

12. One thing you state is that the government would have to control spending. Would this be overall or just for the spending relating to the VAT?

The government needs to control spending overall, but the fastest growing source of spending by far is health care. Indeed, it could be argued that some kinds of federal spending, such as for infrastructure (roads, bridges, dams, mass transit, etc.) should increase. Creating a dedicated revenue source to cover health spending would reduce the squeeze on other essential priorities that is coming if healthcare costs continue to rise faster than the economy and we rely almost entirely on income and payroll taxes.

13. Please explain in more detail, the effect of the VAT on seniors.

Absent transition relief, senior citizens would see a reduction in the real value of their savings if a VAT translates into higher prices for goods and services. As a group, older people would be slightly less burdened by a VAT than younger people because a large share of seniors' income comes from Social Security, which is indexed for inflation. However, wealthy seniors would experience a substantial tax increase. The effect on middle-income seniors could be entirely or partially offset by a temporarily higher standard deduction for the elderly or a refundable tax credit. Any such tax relief, however, should phase out over time because future elderly will have benefited from the new health care voucher (as well as the fact that the VAT is more friendly to saving than an income tax).

14. Please explain how the VAT would work with the rest of the tax system.

This is a good question. As noted above, a VAT works well in the rest of the world, but most other countries don't have state or regional sales taxes. States are concerned that a VAT would complicate compliance with sales taxes, but many state tax experts think those concerns are overblown. A VAT is less complex than many other taxes that currently apply to businesses, especially federal and state corporate income taxes.

Stanford economist, Charles McLure, who served in President Reagan's Treasury Department in the mid-1980s, is organizing a major conference on the practical issues related to administering a VAT in the US scheduled for February 2009. We should know more about this issue after McLure and his colleagues (including me) complete their work.

15. Senator Grassley asked Mr. Entin about bracket creep. What is bracket creep? Does bracket creep exist? If so, was it more of a problem prior to the 2001 and 2003 tax cuts?

I concur with Bill Gale's response.

16. What would be the revenue effects of making the 2001 and 2003 tax cuts permanent? What would be the revenue effects of making permanent the lower tax rate for capital gains and dividends?

I concur with Bill Gale's response.

17. What has been the economic result of lowering the tax rate for capital gains and dividends?

As Bill Gale noted, the economic effect of tax cuts depends on how the lost revenue is made up. The issue is more complex in the case of capital gains and dividends. Lower tax rates on capital gains have mixed effects on the economy. On the one hand, they reduce the incentive of investors to hold onto assets to avoid the tax and they might encourage risk-taking and entrepreneurship. However, as I conclude in my book, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed,* all of these effects are likely to be much smaller than tax cut advocates believe. In addition, the lower tax rates on gains and dividends reduce the double taxation of corporate income, but lower tax rates are a very blunt instrument to accomplish what economists call corporate tax integration. The lower rates apply whether or not the firm pays any corporate income tax. And capital gains tax breaks apply to much more than corporate stock.

Moreover, low tax rates on capital gains are notorious for fueling tax shelters. A wealthy person who can arrange to convert $10 million from ordinary income (e.g., wages) into capital gains stands to save $2 million in tax. My guess is that the lower tax rate on dividends could also be used to shelter income, but less is known about that. Tax shelter schemes are always economically inefficient. And, of course, the benefits of low tax rates on gains and dividends fall disproportionately on very high-income taxpayers.

18. Senator Grassley asked Mr. Entin about the gap in scoring between the Department of Treasury and the Joint Committee on Taxation in relation to the scoring for the 2001 and 2003 tax cuts. The estimates differ for the cost of making permanent the lower tax rate for capital gains. What are your thoughts on this issue?

I'm reluctant to second-guess the official revenue estimators. I know the estimators at both JCT and OTA and have been enormously impressed with their professionalism. Empirical estimates of the effects of capital gains taxes on sales of assets include a considerable amount of uncertainty. The estimates vary among different studies and there is a fairly large variance around each point estimate. I'd guess that the difference between the two organizations' estimates is not statistically significant and simply reflects different assumptions that are well within the bounds of our empirical knowledge.

19. During the hearing you stated that you favor a progressive tax system. What are some concerns that you have with a proportional tax system?

A proportional tax system would result in huge tax cuts for high-income taxpayers and large tax increases for others. Some flat-rate proposals include tax credits or "demogrants" to offset the increase in tax liability for those with very low incomes, but that means that the tax increase on middle-income households would have to be even larger. High income people have experienced enormous income gains in the past two decades (while incomes for everyone else have grown very slowly, if at all). I personally think that it is appropriate to expect high-income people to bear a disproportionate share of the tax burden.

I should stress, however, that this is my opinion. Economics does not tell us how progressive the tax system should be (unless one is willing to make strong assumptions about society's values).

Senator Grassley

1. This question is for the panel. I know that in testimony, concerns have been raised about "cherry-picking"—that is taking some reforms but not others. But as we all know, sometimes to get reforms we have to go one step at a time.

   So, I would like your comments on that—are there reforms that can be moved independently or separately from other reforms? For example, the New Family and Work Credits. And second, if there are reforms that can stand on their own, what would be your recommended priorities for action by this Committee? What should we be looking at first?

There are incremental reforms that could represent significant improvements in the tax code, although I believe that the tax system desperately needs more fundamental reform. The AMT could be repealed or reformed on a revenue neutral basis, as discussed above. The education credits could be consolidated. Lowering corporate tax rates and broadening the tax base on a revenue neutral basis, as proposed by Congressman Rangel, would improve economic efficiency. Replacing the alternative tax rate schedule on capital gains and dividends with a partial exclusion would be a significant simplification for those with such income. And the tax code could be made more progressive and raise more revenue by adjusting tax rates—although a more efficient option would be to eliminate deductions and preferences that primarily help high-income taxpayers.

If Congress is not going to tackle tax reform soon, something should be done about the estate tax, which is scheduled for repeal, but only for one year—2010. NYU law professor, Lily Batchelder, has argued that replacing the estate tax with an inheritance tax (paid by heirs rather than the estates of decedents) would be a significant improvement and I agree. Some fix should be enacted before the end of 2009 so we don't read grim stories about deadly estate tax avoidance schemes to take advantage of the one-year estate tax holiday.

My top priorities would be to enhance progressivity, repeal the AMT, cut corporate tax rates, and adjust rates so as to balance the budget over the next five years or so. That is, I'd like to lessen the tax burdens on my children.

2. All of you agree the alternative minimum tax ("AMT") needs to be repealed or reformed. I don't think you'll find many us behind the dais who will disagree with you. Where the panel differs and where we, on this side, differ with those on the other side, is whether a condition of AMT repeal or reform is replacement of revenue lost.

   According to the CBO in its current budget outlook document, there are expiring spending provisions that will cost $1.3 trillion. The expiring spending provisions, unlike expiring tax provisions, are not included in the CBO baseline and are not subject to pay-go. So, there's a double standard built into the system that favors continued spending and disfavors continuing tax relief.

   I'd ask the panel how folks can hold the view that we must continue an unfair tax, like the AMT, by scoring the AMT patch, which is the will of the Congress, and not account for expiring entitlement spending? Doesn't that strike you, like it does me, as fundamentally unfair?

I'm puzzled by your comment about bias in the scoring rules. The rules were agreed to as part of a bipartisan process and included in the Budget Enforcement Act of 1990. Entitlement increases and new entitlement programs are never scored as temporary. That would be an obvious and illegitimate scoring gimmick. Similarly, the full cost of permanent repeal of the AMT should be scored as a revenue loss relative to the baseline.

On the philosophical question of whether, since the AMT would tax people who were never its intended target, AMT revenues should never have been counted on, there is a logical inconsistency. That argument had at least as much salience in 2001, when AMT revenues were counted on to mask the true cost of proposed tax cuts. What's more, if the baseline should exclude the AMT, then projections should have recognized that the nation's fiscal position was worse than advertised, which might have limited the tax cuts.

In 2001, legislators understood that the AMT would "take back" a significant portion of the tax cuts and therefore keep their estimated cost within the tax bill's $1.35 trillion target. By 2010, the AMT will reclaim almost 28 percent of the individual income tax cuts, including more than 70 percent of the cut that would have gone to taxpayers making between $200,000 and $500,000.

Repeal of the AMT would be not only prohibitively expensive but also extremely regressive. TPC estimated in 2007 that nearly 96 percent of the tax benefits of AMT repeal would go to the top fifth of income earners and 80 percent would go to the top tenth. More than half would go to taxpayers with incomes greater than $200,000. After-tax incomes of taxpayers with incomes between $200,000 and $500,000 would rise by 2.7 percent, or an average of nearly $6,000. In contrast, taxpayers in the middle quintile of the income distribution would receive less than 1 percent of the benefits and would see their after-tax income rise by an average of only $5.

Senator Hatch

1. In citing the need for tax reform, two of you, Drs. Burman and Gale, indicated that one major factor is the need for more revenue because of the projected increases in entitlement program spending over the next decades. This question is for each of our witnesses. Should our goal be to make sure revenues match projected spending over the coming years, or should we focus on finding the optimum level of revenue that will keep our economy strong, growing and producing jobs, and then attempt to match our spending to that level of revenue?

These issues are completely intertwined. Taxes entail an economic cost, so if you are looking at taxes alone, you'd conclude that zero taxes are best for economic growth, but government provides benefits that we are willing to pay for. Government spending for national defense, education, the environment, national parks, research, infrastructure, courts, law enforcement, even Congress, may all produce high value and are worth paying for. Many people, including me, think that government also has a role in helping those who are less fortunate, and society seems to have agreed that government should provide income support and healthcare for the elderly and those with low incomes, especially children. The optimal tax and spending levels would be determined where the social benefit from the last (least productive) dollar spent by government equaled the cost (including efficiency costs) of the last dollar of revenue raised.

More fundamentally, we've tried the experiment of setting tax revenues below spending, and it hasn't worked out very well. I believe that requiring adequate taxes be raised to cover current spending serves as a brake on government since people do not like to pay taxes. If tax rates had increased to pay for the war, the new prescription drug entitlement program under Medicare, and other spending increases, Congress would have been under increased pressure to try to rein in spending. Cato Institute president, William Niskanen, has argued that deficit-financed spending gives people the misperception that government is available at a discount, which increases the demand for it.

And, even if low tax rates spur the economy in the short-term, the higher future tax rates needed to control ballooning public debt would more than offset any gains in growth. A constant (budget-balancing) tax rate would be better for growth in the long run than a low rate now and a high tax rate in the future.

2. As you all know, a big reason our tax code is so complex is that Congress has tried to accomplish many social and economic goals through its provisions. One more question for each of you. As we look to reforming the tax code, should we ideally focus exclusively on raising revenue and not try to meet other goals, no matter how worthy they might seem?

Again, the answer depends on the costs and benefits. Some tax subsidies probably produce so little value that they should be eliminated, but some produce high returns for society and are worth financing. Some of those may best be provided through the tax system. For example, the earned income tax credit, despite its flaws, is a relatively efficient way to reward work and augment income for low-income families and participation is high because there is no welfare stigma. Other programs might be advanced more effectively through direct spending programs than through tax expenditures. For example, the panoply of subsidies for higher education probably does little to help low- and moderate-income families pay for college. A better option might be to repeal the tax subsidies and use the revenue saved to expand Pell grants and subsidized student loans.

3. Dr. Burman, you mentioned in your testimony that almost 40 percent of households do not owe any income tax after the application of tax credits. Can you elaborate on the social and economic effects of this, and whether it is a good thing? In other words, should one of our goals be to even further reduce the number of the income tax rolls?

There are trade-offs. On the one hand, the tax system helps a lot of lower-income households who are struggling to make ends meet, and it is probably a more efficient mechanism for income support than other programs (and certainly less costly than most restrictions on trade or regulations of wages or prices). On the other hand, households that owe no income tax may perceive government to be a free good. This could increase the demand for government aid and services that are not worth their cost to society.

I try to address both the problems of disparities in income distribution and the incentive problem in my tax/heath reform proposal. In my proposal, all households would be subject to income and consumption taxes on the margin and thus would have a stake in limiting the growth in government. In particular, the VAT rate would be tied to the fastest growing source of government spending—health care—so this would naturally build support for measures to limit the growth of such spending. Moreover, the new healthcare voucher would be worth far more than the additional tax owed by lower- and middle-income households, so the tax and transfer system overall would become more progressive.

Senator Smith

1. Some tax reform proposals, such as the 2005 report from the President's Advisory Panel on Tax Reform, have recommended that various defined contribution plans be streamlined into one plan. But some of these proposals have made no specific mention of, or provision for, employee stock ownership plans (ESOPs). ESOPs are among the most effective retirement savings plans available to American workers. Indeed, in 1996 and 1997, Congress enacted legislation to allow ESOPs to own Subchapter S businesses. This has led to significant retirement savings for many workers—now employee-owners—in these companies, including in my own home state. Would you share with me your views about how—as tax reform

> moves forward—we can preserve and promote private ESOP-owned companies, and how we avoid making changes to tax laws that would inadvertently burden these structures?

I share Bill Gale's concern about the risk in ESOPs. Workers whose retirement savings is entirely invested in their own company face enormous risk if the company fails. They lose not only a job, which often entails a significant financial loss, but their largest financial asset. Workers who live in a company town may also experience a large reduction in the value of their home. Ideally, workers should diversify so that their wealth risk is not tied to their job market risk.

2. About three-quarters of small businesses are organized as pass through businesses, so they are paying their business tax at the individual level. What impact do you think raising the individual tax rate would have on small businesses?

    a. Small businesses have been a large job creator over the past decade. Would higher individual tax rates potentially have a negative impact on this job creation?

    b. What impact would higher individual rates have on the entrepreneurs who are thinking about starting a small business?

As I have noted, my preference is to broaden the base and keep marginal tax rates as low as possible while preserving progressivity. That said, most small businesses are taxed at relatively low rates because their owners have modest incomes, so the top rates have no effect on them. Also, high marginal income tax rates probably encourage entrepreneurship since entrepreneurs may earn low incomes for many years while they are building their companies. The economic cost of investing human capital (sacrificing earnings) is lower at a high tax rate than at a low one.

IRET Institute For Research On The Economics Of Taxation

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

Testimony of Stephen J. Entin
President and Executive Director
Institute for Research on the Economics of Taxation

to the

United States Senate Committee on Finance
Hearing on Tax Reform for Individual Taxpayers
May 13, 2008

Executive Summary

There are good tax reforms and bad ones. The Kennedy-Johnson corporate and individual tax changes of 1962 and 1964 got the economy moving again, as did the 1981 Reagan cuts and the 2003 Bush tax changes. In contrast, the 1986 Tax Reform Act savaged saving and investment (especially real estate) and, along with two payroll tax hikes, contributed to the 1990-1991 recession.

The main focus of fundamental tax reform should be to end existing tax biases against saving and investment. Current tax law puts heavier taxes on income used for saving and investment than on income used for consumption. This reduces saving and investment, which reduces labor productivity and wages.

Most of the tax burden on capital is shifted to labor via lower wages. A man operating a back-hoe can dig a lot more ditch than a man with a shovel, and is paid accordingly. Tax the back-hoe, and you end up breaking the worker's back, and his wallet. Workers would be better off if these tax biases were eliminated.

Of every additional dollar of GDP made possible by added investment, about 50 cents goes to labor income after taxes; about 33 cents goes to federal, state, and local governments as taxes; about 12 cents goes for depreciation; and about 5 cents for savers and investors after tax. Workers gain ten times as much as capital owners; governments gain six times as much.

There are two fundamental concepts of taxable income. One is comprehensive income. The other is comprehensive consumption. The Committee and the Congress should study the advantages of moving toward a consumption base. If we want more growth and higher incomes, especially for workers, we must settle on a consumption-based tax reform.

A pure comprehensive income tax would tax individuals on the income that they save and also tax the returns to their saving. (It would not allow pensions or IRAs, or deferral of tax on capital gains, but would adjust gains for inflation.) It would employ depreciation instead of expensing of capital outlays. The U.S. version adds a corporate tax and an estate tax to the other two hits on saving.

A pure comprehensive consumption tax would either tax saving or the returns to saving. (All saving would get pension or IRA treatment.) It would not double-tax corporate income, nor impose an add-on estate tax. Investment, productivity, and wages would be higher under a consumption tax base.

The U.S. income tax has features of both systems. Some saving is allowed pension or IRA treatment. Capital gains are tax when realized (but are not adjusted for inflation). Some investment is expensed. There is a partial offset to the double tax on corporate income from the 15% tax rate cap on dividends and capital gains.

Moves toward a comprehensive income base (as in the Tax Reform Act of 1986) reduce domestic saving, investment, productivity, jobs, and wages, and chase capital offshore or cause it not to be formed at all. Moves toward a consumption base (as in 1962, 1963, 1981, and 2003) promote saving and investment, productivity, jobs, and wages, and attract capital from abroad.

There are several saving-consumption neutral taxes to choose from: e.g., a business activities tax, Flat Tax, VAT, or sales tax. A consumed-income or cash flow tax would be the most visible to the taxpayer/voter, reasonably simply, and, with modest exempt amounts and reasonably low rates, eminently fair.

Moving to a consumption tax base could raise incomes across-the-board by between ten and fifteen percent, or by $5,000 to $10,000 for middle income families. That would be more valuable to people than new handouts to favored income or household groups. Letting the 2003 tax cuts expire would depress private sector incomes by about seven percent, risk recession, and yield no net revenue for the government.

The Committee should acknowledge that there will be revenue feedback from a pro-growth tax reform, and permit itself a net tax reduction (as measured by static scoring). But whether the Committee wants the tax package to involve a net cut or to be revenue-neutral on a static basis, it should require the Joint Tax Committee to calculate at every step what the evolving tax package does to the service price of capital (the required pre-tax return to make the investment possible). If your tax package raises the service price, it will lower the capital stock, productivity, wages, and employment. If it reduces the service price, it will raise incomes. You need that guide to avoid another blunder like 1986.

It would be better to pay for tax cuts by reducing spending. Each dollar the government spends costs the public about $2.50, because $1 in tax raised to pay for the spending does another $1.50 in economic damage (more if the tax is on capital).

As you work on the details of your tax reform, please remember a few key points:

- Income is payment for productive activity. Graduated tax rates punish people more the more they produce.
- Income is a net concept: revenues less the cost of generating those revenues. Education expenses, saving, and investment outlays and other business expenses must be deductible in full, or income is overstated and overtaxed.
- Only people pay taxes. Taxes collected by businesses fall on business owners, savers, workers, or customers. Taxes should not be hidden from voters by imposing them at the business level.

Tax reform is not just about simplifying the filing process. It is not about eliminating deductions randomly to broaden the base to pay for lowering the tax rates. It is not about taking million of people off the tax rolls. It is not about subsidizing families or green energy or housing. It is not about Washington and its budget and re-election concerns.

Tax reform is about getting to the correct tax base, one that does not bias activity, especially against saving and investment, does not retard growth any more than is necessary, and that lets all voters see the tax burden clearly so they know that government is not a free good.

Tax reform is about freeing the population to achieve the very highest level of income with the resources available, to develop their human capital to the fullest potential, and to save and invest for retirement unencumbered by onerous taxation.

Excess money creation cannot permanently increase growth. It can only lead to inflation, which hurts growth by raising tax rates on investment. We need to let the Federal Reserve focus on price stability and a trustworthy dollar. We need the right kind of tax reform to promote real economic growth. We need to rein in government spending to pay for it. We need to do it now.

Introduction

Tax reform is a tricky issue. The subject is complex and contentious, and the phrase is used to mean different things by different people. Some of the disputes are based on misunderstandings arising from the complexity of the issue. Some of the disputes are based on differences in objectives.

Tax reform can be very good or very bad for business and for the economy. For example, the Kennedy corporate and individual tax changes got the economy moving again, as did the 2003 Bush tax changes. In contrast, we surely do not want a repeat of the 1986 Tax Reform Act, which savaged saving and investment, especially in real estate, contributed to the 1990-91 recession, and which served as a model for the 1988 Japanese tax reform that led to a 15 year depression.

My testimony will cover basic concepts to help you judge future tax proposals. I shall also discuss what I regard as the optimal tax system. A reading list of IRET papers that relate to tax reform and the economics of taxation is attached. They have good bibliographies on other material for further study.

The current economic situation cries out for real tax reform.

We are drifting back into the economic malaise of the Ford/Carter years. Just as in the 1970s, Washington wants to tax and spend, rather than help the private sector grow, and is instead urging the Federal Reserve to grow the economy by pumping up the money supply. But that policy mix leads to stagflation. Excess money creation cannot permanently increase growth. It can only lead to inflation, which hurts growth. Proper tax and regulatory policy and a frugal federal budget are the only policy tools that can make the economy more efficient and boost real output and real incomes. Our current bad policy mix already has government spending and inflation ticking up. The dollar is in free fall. Investment spending is slowing. Higher inflation is raising tax rates on investment by overstating capital gains and by devaluing the capital consumption allowances. We are not subject to inflation-related bracket creep, thanks to President Reagan's tax indexing, but the adverse effect of inflation on the tax system is not dead.

There is talk in Congress about letting the 2001 and 2003 tax cuts expire, which would raise tax rates on capital and on entrepreneurs even higher. (See Charts 1 and 2.) The temporary rebates and credits that Congress has just passed are more of the same ineffectual handouts as the 1970s Ford/Carter tax changes (ineffectual except for the 1977 Steiger capital gains cut). They, and the housing bailouts now being considered, are not the answer to our short run needs or our long run reform goals. Tax cuts do not create growth by giving people money to spend. The Treasury has to borrow back an equal amount of money to pay for ongoing spending. Rebates do not boost demand. They do not boost incentives to produce, and they do not create jobs. Tax cuts boost growth if they alter the after-tax incentive, at the margin, to work longer, or, especially, to increase saving and investment.

We need to let the Federal Reserve go back to promoting price stability and a trustworthy dollar. We need a fiscal policy that promotes real economic growth. We need marginal tax rates on capital and labor to go down, not up. We need unbiased, across-the-board improvement in the tax treatment of saving and investment. We need to rein in government spending and regulation. There is a bipartisan history of good policy to draw on. We need the sort of tax changes for individuals and business that occurred in the Kennedy tax cuts (the investment incentives of 1962 and, completed by President Johnson, the personal and corporate marginal tax rate cuts of 1964-65). We need the policy mix recommended by President Reagan in 1981 (lower tax rates on personal and corporate income, lower tax penalties on saving, faster write-offs for investment — which were foolishly repealed before their effective dates — combined with lower government spending and regulation).

Understanding good tax reform can guide us to the right policy mix for dealing with the current economic troubles and for long run prosperity. Let us consider what a coherent tax reform should look like.

Two basic concepts vital to understanding taxation

What is income? Income is the earned reward for supplying labor and capital services to the market. Income closely matches the value of the effort and services provided by individuals to produce additional output.

Income is a net concept: revenues less the cost of generating those revenues. Costs include education expenses, saving, and investment outlays and other business expenses. These costs should be subtracted in full from revenues to arrive at taxable income. Otherwise income is overstated and overtaxed.

Who pays taxes, and with what? Only people pay taxes, and all taxes are paid out of income. Goods and services do not pay taxes; businesses do not pay taxes. Taxes collected by businesses fall on the income of the businesses' shareholders or other owners, lenders, workers, or customers in the form of lower returns, lower wages and/or higher prices.

Two purposes of a sound tax system

Raising revenue. A sound tax system must raise revenue to pay for government goods and services.

"Pricing" government. A sound tax system must "price out" government to let people know what they are being charged for government goods and services so that, as taxpayers and voters, they may decide in an informed manner how much government activity they wish to support with their votes.

An ideal system should achieve these purposes with minimal economic damage, and should not be diverted into schemes for social engineering.

Four attributes of a sound tax system

The four key attributes of a sound tax system are neutrality, visibility, fairness, and simplicity. The current tax system has none of these.

Neutrality: A neutral tax is one that does not distort people's behavior by changing the relative attractiveness of one economic activity versus another, such as labor versus leisure, and saving versus consumption. A tax system can come closest to neutrality by measuring income correctly and imposing an equal, low tax rate on all uses of income by all income producers. Neutral taxation minimizes the harm to economic growth and is far simpler with lower costs of compliance and enforcement than the current system. Some neutral systems are highly visible and transparent, which helps to increase confidence in the fairness of the system.

Visibility: A visible or transparent tax system is one that lets taxpayers see and feel taxes directly so that they are clear as to how much government costs, and that they are paying for it. Taxes are most visible when they are collected directly from people out of income (properly defined and measured). Visibility requires that revenues not be collected from taxes buried in business transactions. Visibility also requires that as many people as possible be subject to tax, excepting only the very poor, so that they can see that government is not a free good.

Fairness: Fairness requires that people pay taxes commensurate with their income, which is earned by producing goods and services. Disproportionate taxation is not fair to producers. It should not be possible for a majority of voters to shift most of the tax burden onto a minority of taxpayers. Charity requires that the very poor be relieved of the tax burden, but as far as possible, everyone should contribute something to the communal efforts of government. The tax system should not be used as an instrument of wealth and income redistribution or social engineering. Equality of opportunity should be a guiding force in our tax system, not equality of outcomes.

Simplicity: A simple tax system has a clear, well-defined tax base with few special exceptions beyond those needed to measure income accurately. Much complexity in the current tax code stems from its non-neutral treatment of income from capital, and its taxation of income from foreign sources offset by a tax credit for foreign taxes paid. Neutral (consumption-based) taxes imposed only on domestic activity (territorial taxation) are inherently simpler than the current non-neutral income tax imposed on worldwide income. Simplicity should mean making tax filing easier by cleaning up the complexity of the tax code. It should not mean making tax filing easier by dropping large numbers of people from the tax rolls, or eliminating periodic tax filing by individuals in favor of having businesses act as tax collectors.

The current tax system is far from neutral, and heavily biased against saving and investment

The current tax system is unnecessarily complicated. It has no coherent definition of taxable income. It is a hodgepodge of special provisions that seek to promote some activities or uses of income over others. It imposes different tax rates on different types of productive assets, on different forms of business (corporate and non-corporate), and on investment inside and outside the country. It subjects the foreign income of U.S. firms to U.S. tax in a manner that places them at a disadvantage relative to their foreign competition.

Under current law, graduated tax rates punish people who produce the most and earn the highest incomes. In some cases, income is excluded from tax altogether. Three of the largest examples are the health insurance premiums paid by employers or the self-employed, the value of shelter services provided by owner-occupied housing, and the personal exemptions.

The worst feature of the current tax law is that income used for saving and investment is taxed more heavily than income used for consumption, at both federal and state levels. This artificially reduces saving and investment, and expands consumption, to everyone's detriment. At the federal level there are at least four layers of possible tax on income that is saved:

1) Income is taxed when first earned (the initial layer of tax). If one uses the after-tax income to buy food, clothing, or a television, one can generally eat, stay warm, and enjoy the entertainment with no additional federal tax (except for a few federal excise taxes).

2) But if one buys a bond or stock or invests in a small business with that same after-tax income, there is another layer of personal income tax on the stream of interest, dividends, profits or capital gains received on the saving (which is a tax on the "enjoyment" that one "buys" when one saves). The added layer of tax on these purchased income streams is the ***basic income tax bias against saving***.

3) If the saving is in corporate stock, there is also the corporate income tax to be paid before any distribution to the shareholder, or any reinvestment of retained after-tax earnings to increase the value of the business. (Whether the after-tax corporate income is paid as a dividend, or reinvested to raise the value of the business, which creates a capital gain, corporate income is taxed twice — ***the double taxation of corporate income***. See Chart 2.)

4) If a modest amount is left at death (beyond an exempt amount that is barely enough to keep a couple in an assisted living facility for a decade), it is taxed again by ***the estate and gift tax***.

What is the better tax base, income or consumption?

There are two main concepts of what should be taxed, income or consumption. They differ primarily as to their treatment of saving and investment. As described above, an income tax is not saving-consumption neutral. A consumption-based tax is saving-consumption neutral. We have had tax reforms that have moved us first in one direction, toward a comprehensive or broad-based income tax, then the other, toward a comprehensive consumed-income base. The Committee and the Congress should study the advantages of moving toward a consumption base.

If we want more growth and higher incomes, especially for workers, we must settle on a consumption-based tax reform.

Moves toward a comprehensive income base tend to reduce domestic saving, investment, productivity, jobs, and wages, and chase capital offshore or cause it not to be formed at all. Workers suffer lower wages as a result of the added tax on capital income. Moves toward a consumption base tend to promote saving and investment, productivity, jobs, and wages, and attract capital from abroad. Workers get higher wages as a result of lower taxes on capital. If we want more growth and higher incomes, especially for workers, we must settle on a consumption-based tax reform.

Most of the tax burden on capital is shifted to labor in the form of lower wages. That may seem counter-intuitive, but it is the truth. A man operating a back-hoe can dig a lot more ditch than a man with a shovel, and is paid accordingly. Tax the back-hoe, and you end up breaking the worker's back, and his wallet.

By conventional definition, an absolutely pure "Haig-Simons" income tax would be based on the sum of current earnings and any change in the value of one's assets during the year. Put another way, it would tax income used for consumption, net saving, and add any additional increase or decrease in wealth over the year due to capital gains or losses (but would adjust them for inflation). This theoretical tax base deliberately incorporates the basic tax bias against saving; it would fall on income used for saving and on the returns to the saving. There would be no pension arrangements. Capital gains (adjusted for inflation) and dividends would be taxed as accrued as ordinary income. Under a pure comprehensive income tax, investment in equipment, buildings, and intangibles (e.g. software and copyrights) would be depreciated over time, according to its loss in value (economic depreciation) as it ages, and would not be counted immediately as an expense. However, a theoretically pure Haig-Simons income tax would not pile additional taxes on corporations and estates. In practice, the income tax in use today includes all three taxes. (It also deviates from Haig-Simons by deferring tax on gains until they are realized, but with no adjustment for inflation; by excluding the imputed rent on owner-occupied housing; by excluding employer provided health insurance; by having personal exemptions; and in many other ways.)

A pure consumption-based tax (also called a "saving-consumption neutral" tax or "consumed-income tax") would eliminate all the tax biases against saving and investment, including the basic bias. It would either tax saving, or the returns to saving, but not both. Under a consumption-based tax (of which there are several varieties and labels), all income that is saved would get the treatment given to pensions or IRAs, either by deferring tax on saving until the money is withdrawn for consumption (as in a regular IRA), or by taxing income before it is saved and not taxing the returns (as in a Roth IRA). An investment outlay would be counted as an expense immediately in the year it is made. Those steps would end the basic income tax bias against saving. The corporate-level tax bias would be eliminated by taxing the income either at the shareholder level or the business level, but not both. Estates would not be taxed (but inherited tax-deferred assets would be taxed when the heirs spend the money). Saving-deferred taxes, the Flat Tax, VATs, business activity taxes, and retail sales taxes are examples of saving-consumption neutral taxes.

Depreciation is part of the basic tax bias against saving and investment. Money used to buy an asset is tied up in the asset while it is held, and cannot be used for other purposes. This is the *opportunity cost* of having the asset, which depreciation and the income tax fail to take into account. Put another way, delaying the write-off of the asset reduces the present value of the deduction, which is eroded by the time value of money and inflation. The real value of the deduction is less than the up front cost, thus overstating the earnings of the asset over its useful life, and boosting the effective tax rate on its real income. These effects can be very large. (See Chart 3.) At zero inflation and a 3% discount rate, a 7-year asset's write-off is only worth 91 cents on the dollar in present value. At 5 percent inflation, the write-off is only worth 81 cents on the dollar. If the asset earns 9% above its $1 cost over its life (present value), it will be taxed on twice its real income at zero inflation, and at over three times its real income at 5 percent inflation. That makes the effective corporate tax rates 70 percent and 109 percent on the real earnings. This depreciation distortion occurs in an income tax base, but does not occur in neutral, consumption-based tax systems with immediate expensing.

The current tax system is a hybrid of the two tax concepts, containing elements of the income and consumption bases. It begins as a broad-based income tax which imposes multiple layers of taxation on income used for saving and investment, but it contains provisions that treat some amounts of saving and investment as they would be treated under a saving-consumption neutral system (or consumption-based system). These provisions include pension arrangements, regular and Roth IRAs, and tax-exempt bonds for individuals, and accelerated depreciation and partial expensing for businesses. The Treasury estimates that about a third of household financial assets receive the tax treatment that is normal under a consumption tax base, while the rest is taxed as it would be under a comprehensive income tax base. Lower rates of tax on dividends and capital gains are a partial offset to the extra layer of tax on corporate income. Under the current tax system, limited amounts of investment may be expensed immediately (Section 179), and the rest is allowed a form of depreciation that is somewhat accelerated compared to the economic depreciation concept in a "pure" income tax. These modifications to the pure income tax were put in place to mitigate the damage that a pure income tax would do to saving and investment behavior, and the resulting depression of productivity and wages.

The terminology "income" versus "consumption" is something of a misnomer. A good case can be made that consumption is a better measure of income than what we call "income" under current tax rules. Income is properly a net concept, revenue less the cost of earning the revenue. Saving and investment are costs of earning future income, and should be recognized as such. The optimum definition of taxable income would then be a person's revenue less his net saving (saving less borrowing), or for a business, revenue less costs, including the full cost of investment. The result is that the aggregate tax base would be the total amount of national income used for consumption, hence the terms "consumed-income tax" or "comprehensive consumption base."

Several types of neutral consumption-based taxes.

All the major tax reform plans — national sales tax, VAT, Flat Tax, the old USA tax (Nunn-Domenici), new USA tax (Rep. Phil English's bill) - have adopted one or another form of neutral, consumption-based system. We must choose among them on criteria other than neutrality.

A consumption-based tax could be collected either at the business level or at the individual level. If collected at the business level, as with a value added tax (VAT), the Flat Tax, or a business activities tax, the cost of plant, equipment, and inventory would be recognized via full immediate expensing of the investment outlays (rather than depreciation). If collected via a national retail sales tax, the tax should not be imposed on investment goods.

Under the Hall-Rabushka "Flat Tax" and the English bill, income from saving would be taxed at the business level, after expensing, while labor income would be taxed on individual returns. Individuals would not receive a deduction for saving nor owe additional tax on the returns (a *returns-exempt treatment* like that allowed today for a Roth IRA or tax-exempt bond). The Flat Tax over-simplifies by eliminating too many deductions, some of which are needed to measure income properly.

Under an individual cash flow tax, the tax on income from saving and from labor would be collected at the individual level. Saving and reinvested earnings from saving would be tax deferred, and any withdrawals from saving would be taxable (a *saving-deferred treatment*, resembling a tax system with a universal deductible IRA or 401(k) plan). Borrowing would be taxable, while debt service, including principal repayment, would be deductible. There would then be no separate business tax. Any business would be treated like a giant IRA; the owners would defer tax on their investment in the business, which would either pay out returns to be taxed at the individual level, or retain earnings for reinvestment which would be taxed only when the investor received dividends or distributions at a later date, or sold his stake in the enterprise.

This seems to me to be the ideal tax system. It is the most visible of the consumption-based taxes, yet is far simpler than current law. IRET's proposed "Inflow-Outflow Tax" is a simple, single-rate cash-flow tax. Tuition, gifts, charitable contributions, and state and local taxes would be deductible, because they are chiefly used either to fund transfers to others (who would have the final use of the money and would have to report it as taxable income), or to pay for investment in education (human capital), which should be expensed like any other investment. (Sample tax forms are attached - Chart 4.)

Other neutral systems may be easier on the individual tax filer than the cash flow tax, but they hide a portion of the tax at the business level. They would mask the cost of government, and might prove too easy to raise. Simplicity can be carried too far! It is also harder to exempt the very poor from the other neutral taxes. A system might be designed to collect part of the total consumption-based tax via one type of neutral tax and part by another (such as part by a sales tax and part by a consumed-income tax.) If both parts are neutral, then the total system will be neutral as well.

Where past reforms went astray

The 1986 Tax Reform Act moved the tax system away from the hybrid-base system we had in place at that time in the direction of a more comprehensive income tax base. It "broadened the base and lowered the rates." Unfortunately, it threw out deductions necessary to define income properly, and to mitigate the multiple taxation of capital income. As a result, it raised taxes on capital. In the process, it weakened the economy, paving the way for the next recession, which narrowed the tax base by reducing GDP and slashing people's incomes.

Specifically, the Tax Reform Act of 1986: 1) raised the tax rate on capital gains from 20% to 28%, 2) lengthened asset lives for purposes of tax depreciation (dropping the Treasury proposal to index the allowances for inflation to compensate), 3) eliminated the investment tax credit (ITC), 4) curtailed access to IRAs for upper income individuals, and 5) toughened the passive loss provisions for real estate investments not managed by the owners. The lower individual tax rates and lower corporate tax rate adopted in the bill did not make up for these tax rate hikes on capital.

The "hurdle rate of return" or "service price of capital" is the rate of pre-tax earnings necessary to cover the depreciation of the asset and the taxes owed on the returns, and still leave a normal after-tax return to the saver/investor. It is the rate of return that is barely sufficient to justify an investment. The 1986 Act raised the service prices, especially for structures. As a direct result, the sustainable capital stock shrank relative to where it would have been over the next few years. Investment and productivity gains slowed, and wage growth suffered. Capital was encouraged to flee the country. Even federal revenues were adversely affected. Capital gains realizations and revenues collapsed, and capital gains revenues did not recover as a share of GDP for over a decade. The 1986 Act was one of the causes of the stock market crash of 1987, and, with two payroll tax increases in 1988 and 1990, it paved the way for the recession of 1990-1991. We must not repeat that fiasco.

These relationships between taxes and economic performance are not unique to the United States. Japan adapted and expanded on our 1986 Act for their 1988 tax overhaul. That error, plus two national property tax hikes, triggered collapses in the stock market, land prices, and the banking system that brought on a 15 year depression. They tried and failed to spend their way out of the trouble, and only managed to boost their national debt service burden. They have never corrected their tax error. In Japan, the view is still that the problem was a banking issue. Neither the Finance Ministry, nor the academic and business community, nor the financial media understand what they did to themselves. On the positive side, countries that have reduced taxes on capital (including the corporate tax rate) in recent years have experienced strong growth of output, income, and wages.

To be a benefit to the economy, the next U.S. tax reform must move the tax system toward a consumption-based tax. It must lower, not raise, the service price of capital. It must lower, not raise, the combined tax rate on businesses and their owners. It must make producing goods and services in the United States more, not less, profitable, and make U.S.-based firms more, not less, competitive in their foreign operations. It must make earning extra income more, not less, attractive.

How can we convince people of the need to do so? We need to get the message across that a neutral tax system would result in a higher level of capital formation and more per capita output and income than would the income tax, and would also be simpler than the income tax in a number of ways.

What we would gain from a lower service price of capital

Economists are now coming around to the sensible conclusion that taxes on capital reduce the quantity of capital, which in turn lowers the wages of labor. Labor thus bears much of the burden of the tax on capital. The economic literature is filling up with studies that show that the optimal tax on capital for labor is zero.

Consider a small trucking company with five vehicles. Suppose that the rules for depreciating trucks for tax purposes change, with the government demanding that the trucks be written off over five years instead of three. The owner has had enough business to run four trucks flat out, and a fifth part time. He is barely breaking even on the fifth truck under old law. It is now time to replace one of the trucks. Under the new tax regime, it does not quite pay to maintain the fifth truck. The owner decides not to replace it, and his income is only slightly affected. But what happens to the wages of the fifth truck driver? If he is laid off, who bears the burden of the tax increase on the capital?

Tax reform done right would boost investment, employment, and income. Of every additional dollar of GDP made possible by added investment, about 50 cents goes to labor income after taxes; about 33 cents goes to federal, state, and local governments as taxes; about 12 cents goes for depreciation; and about 5 cents for savers and investors after tax. Labor gains the most.

How much would income go up, and is it worth the bother? Moving all the way to one of the neutral tax systems would add between ten and fifteen percent to national output and income. The higher household income would amount to about an extra $5,000 - $10,000 a year for middle income families. The present value of the added output would equal about 3-1/3 years national output, or about $43 trillion in present value. The tax spin-off would be almost $15 trillion in present value. Is that worth the effort to persuade the public, the press, and our political leaders to put aside quarrels over the presumed distribution of taxes and income, or the effects of international trade and investment, in favor of a sensible tax reform?

Steps to take

We well know which basic tax systems are superior. For example, the President's Panel on Tax Reform offered two plans unanimously. The first was a simpler income tax with some hybrid features maintained (chiefly the retirement saving incentives), which did little to boost growth. The second was a more growth-friendly plan with expensing that still kept some double taxation of corporate income at the individual level. The Panel also described beautifully, but could not quite get unanimous endorsement for, a full-blown reform that moved all the way to a neutral tax system, much like the Armey Flat Tax. Treasury estimates prepared for the Panel showed that the more growth-friendly reforms would add more to the GDP than the income tax reform, and that the nearer one got to a neutral system, the bigger would be the rise in income.

At a minimum, the 2001-2003 tax cuts should be extended. They are consistent with a shift toward a consumption base. They have amply demonstrated their power to boost growth. The 2003 Act brought forward the not-yet-phased-in tax rate reductions enacted in 2001, and added the 15% tax rate caps on dividends and capital gains. Only then did the economy finally shake off the 2000-2001 recession, and begin to give us some real growth and job creation. (See Chart 5.)

The key growth-related features of the 2001 and 2003 tax reductions were the lowering of the marginal tax rates in the top four brackets; the cut in the tax rate on dividends and capital gains to 15%, which may be viewed as a partial offset to the extra layer of tax on corporate income; and the elimination of the estate tax. The Acts also expanded neutral tax treatment of saving by raising contribution limits on retirement plans. The 2002 and 2003 Acts gave some very temporary "bonus expensing" for investment (as in the latest bill), but only for short time. (The cap on the tax rates on dividends and capital gains has generated a surge in tax revenue. See Chart 6.) Unfortunately, the Bush Administration never described these steps as part of a coherent and well-considered, coherent tax reform aiming for a consumption-based tax system, and the pieces are being picked apart.

If we raise taxes on capital by letting the 2001 and 2003 tax cuts expire, what would happen? The service price of capital (required pre-tax return) would jump by about 10 percent (from about 20% to 22%). To increase returns by enough to cover the added tax, the stock of private business capital (plant, equipment, inventory, and land) would have to fall by about 16 percent, giving back the increases since 2003. Hours worked would fall about 2 percent. Private sector wages and capital income would fall by about 7 percent. Total GDP would fall by about 5 percent to 6 percent.

Joint Tax Committee revenue estimators may tell you to expect to gain about $200 billion a year from letting these tax changes lapse. They assume no macroeconomic consequences from the higher tax rates. In reality, the drop in private sector income would reduce income tax revenues by about $140 billion a year. It would also reduce payroll tax, corporate income tax, and excise, customs, and estate tax revenues by about $85 billion a year. The dynamic losses would exceed the static gains. The net loss would be $25 billion. That does not include a figure from the likely collapse of capital gains realizations or reduced dividend payouts. The Congress will not see a cent. Worse, your constituents, including more than 250 million workers and retirees (almost all eligible to vote), will suffer a drop in income of some $700 to $800 billion a year.

The reduction in the capital stock would be about $2.5 trillion over a decade (over five years for downsizing equipment, ten years for downsizing the stock of buildings). That would slash investment spending by about 2% of GDP over the period (more in the first five years, less in the second five), tipping a slowly-growing economy toward recession.

Beyond extending the 2001-2003 tax reductions, we need to go further toward a consumption based reform, either all at once or gradually. End the AMT for both individuals and businesses. Expand saving arrangements until they cover all saving, and expense all investment outlays. End the extra layer of tax on corporations. Eliminate business level taxes, taxing capital income only when it is distributed to savers. Make the tax system territorial.

Service price analysis

The Committee should acknowledge that there will be revenue feedback from a pro-growth tax reform, and permit itself a net tax reduction (as measured by static scoring). Ideally, Congressional and Treasury staff would be in a position to do a good dynamic analysis of the economic and revenue effects of any proposed tax changes. Unfortunately, they are not yet in a position to do so. However, even using static scoring, they are in a position to tell you, at every stage of your deliberations, whether a proposed package of tax changes would raise or lower the service price of capital. They should also be able to tell you if it raises or lowers the income-weighted marginal tax rate on labor income. If the service price of capital is increased, investment, the economy, and the work force will suffer. If it is reduced, investment and wages will rise, and the work force will gain.

If the staff attempts to measure the service price, they should do so by focusing on equity-financed capital as the marginal source of funds, not debt-financed capital. They should not dilute the marginal service price by worrying about the limited amount of saving that is provided by tax-exempt lenders.

That service price indicator would be critical if you insist on static revenue estimation and a revenue neutral tax package. When you begin swapping a tax increase for a tax reduction, you run the risk of a bad outcome. Alternatively, if you were to pay for tax reform through spending restraint, there would be less danger of stumbling into another fiasco like 1986. Please understand that, on average, the taxes that you impose to pay for a dollar of federal spending do about $1.50 of damage to private GDP (even more for taxes on capital). The combined cost to the private sector of a dollar of federal spending is about $2.50 (or more). Everything you buy had better be worth a good deal more than its Federal Budget price tag, or the public is getting a bad deal.

Social Security reform

Tax reform ties in well with Social Security reform. We cannot afford the benefits being promised, and the current system is going bankrupt. We should move to universal pension treatment for all saving, combined with a redirection of part of the payroll tax to personal retirement accounts that would displace future promised benefits. With the higher returns on investment offered by a good tax reform, the retirement saving accounts would raise future income for retirees at a far lower cost than the current 12.4% (non-Medicare) payroll tax. It would also be real saving, and would boost GDP and incomes in the short run by raising saving and investment. Let's reform that too.

Conclusion

Tax reform is not just about simplifying the filing process. It is not about eliminating deductions randomly to broaden the base to pay for lowering the tax rates. It is not about taking million of people off the tax rolls. It is not about subsidizing families or green energy or housing. It is about getting to the correct tax base, one that does not bias activity, especially against saving and investment, does not retard growth any more than is necessary, and that lets all voters know that government is not a free good. It is not about Washington and its budget and re-election concerns. Tax reform is about freeing the population to achieve the very highest level of income with the resources available, to develop their human capital to the fullest potential, and to save and invest for retirement unencumbered by onerous taxation.

Chart 1 Marginal Individual Income Tax Rates Under Old Law and 2001 / 2003 Tax Acts

1986 Tax Reform Act*	1990 Tax Act	1993 Tax Act	2001 / 2003 Tax Acts			If Congress Lets Tax Cuts Sunset
1988 - 1990	1991 - 1992	1993 - 2000	2001	2002	2003 - 2010‡	2011 -
---	---	---	10%†	10%	10%	---
15%	15%	15%	15%	15%	15%	15%
28%	28%	28%	27.5%	27%	25%	28%
33%**	31%	31%	30.5%	30%	28%	31%
28%	---	36%	35.5%	35%	33%	36%
---	---	39.6%	39.1%	38.6%	35%	39.6%

** 1986 Tax Reform Act had transition rate for 1987, fully effective in 1988.*
*** The 5% surtax recaptured the "benefit" of the initial 15% rate, creating the 33% "bubble"; marginal rate returned to 28% after taxpayer had lost all "benefit" from the 15% rate.*
† Rebate in 2001 equivalent to 10% rate.
‡ 2001 / 2003 Tax Acts sunset at end of 2010. Old rates return in 2011 in the absence of further legislation.

Chart 2
Multiple Taxation of Corporate Income

	(a) Retained Earnings, Pre-2003 Act	(b) Dividend Payout, Pre-2001 Act	(c) Retained Earnings and Dividends, 2003 Act
1) Corporate Income	$1.00	$1.00	$1.00
2) Corporate tax at top rate	$0.35	$0.35	$0.35
3) After-tax corporate income: Either retained, raising stock price (columns (a), (c)), or paid as dividend (col. (b), (c))	$0.65	$0.65	$0.65
4) Individual income tax at top rate (dividends as ordinary income, retained earnings as capital gain)*	$0.13 (tax rate 20%)	$0.2574 (tax rate 39.6%)	$0.0975 (tax rate 15%)
5) Total tax	$0.48	$0.6074	$0.4475
6) Total tax rate	48%	60.74%	44.75%
7) Income left to shareholder	$0.52	$0.3926	$0.5525

** Top corporate rate excludes corporate surtaxes, and top individual rate ignores phase-outs of exemptions and deductions and taxation of Social Security, which may push effective top tax rates higher than statutory rates. Retained earnings are assumed to trigger a long-term capital gain with a maximum rate of 20% or 15%. Short-term gains are taxed at ordinary tax rates.*

Chart 3
Present Value of Current Law Capital Consumption Allowances per Dollar of Investment Compared to Expensing (First-Year Write-Off)

Asset lives:		3 Yrs	5 yrs	7 yrs	10 yrs	15 yrs	20 yrs	27.5 yrs	39 yrs
Present value of first-year write-off of $1 of investment:		$1.00	$1.00	$1.00	$1.00	$1.00	$1.00	$1.00	$1.00
Present value of current law write-off of $1 if inflation rate is:	0%	$0.96	$0.94	$0.91	$0.88	$0.80	$0.74	$0.65	$0.55
	3%	$0.94	$0.89	$0.85	$0.79	$0.67	$0.59	$0.47	$0.37
	5%	$0.92	$0.86	$0.81	$0.74	$0.60	$0.52	$0.39	$0.30

Assumes a 3.5 percent real discount rate, 3-20 year assets placed in service in first quarter of the year, 27.5 - 39 year assets placed in service in January.

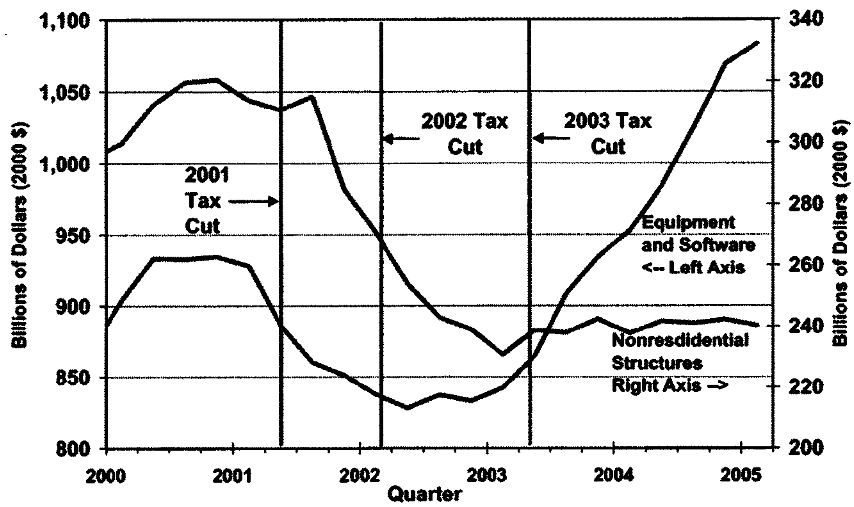
Chart 4
Inflow-Outflow Tax

Form 1040: Individual Tax Form, Inflow Outflow Tax	
1. Sum of: Labor compensation, Pension receipts, Taxable social security, Transfer payments (from W-2 forms)	$33,000
2. Net saving (+) or net withdrawals from saving (-) (from Schedule B)	$ 3,000
3. If line 2 is net saving (+), subtract the dollar amount from line 1; if line 2 is net withdrawal from saving (-), add the dollar amount to line 1.	$30,000
4. Other itemized deductions from Schedule A	$10,000
5. Subtract line 4 from line 3.	$20,000
6. Personal allowance times number of taxpayers and dependents: $5,000 x 2 =	$10,000
7. Subtract line 6 from line 5. This is your taxable income.	$10,000
8. Tax from table (or, line 7 times 20%).	$ 2,000
9. Amount withheld, from W-2, plus estimated tax payments.	$ 2,100
10. Amount due (+) or amount overpaid (-) (line 8 less line 9). If amount is due, pay Internal Revenue Service.	- $ 100
11. If overpaid, fill in: Amount to be refunded $100 ; or Amount to be applied to estimated tax ____.	

Schedule A, Itemized Deductions	
1. Sum of individual payroll tax (from W-2), state and local income tax withheld (from W-2) and estimated state and local tax less refunds from previous year, and local property taxes.	$ 5,000
2. Gifts, contributions.	$ 1,000
3. Qualified tuition, training expenses.	$ 4,000
4. Total. Enter on Form 1040, line 4.	$10,000

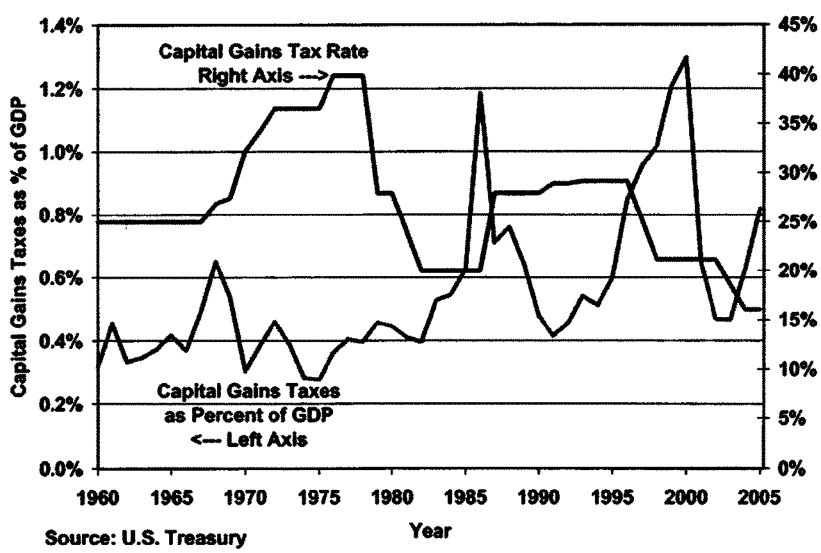
Schedule B, Saving	
List net saving (+) or withdrawals (-) from financial institutions reported on 1099 forms.	
First National Bank	-$ 1,000
Merrill Paine Schwab	$ 4,000
Total (if greater than zero, this is net saving; if less than zero, this is a net withdrawal). Enter on Form 1040, line 2.	$ 3,000

Chart 5 Real Private Investment And 2001, 2002, and 2003 Tax Cuts



Data Source: BEA, National Income and Product Accounts, Table 5.3.6, accessed via www.bea.gov.

Chart 6 The Capital Gains Tax Rate And The Amount The Tax Collects Often Move In Opposite Directions



Source: U.S. Treasury

Readings

Department of the Treasury, Office of the Assistant Secretary for Tax Policy, *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once*, January 1992.

David F. Bradford, *Blueprints for Basic Tax Reform, Second Edition, Revised* (Arlington, VA: Tax Analysts, 1984).

IRET Supply Side Economics Paper, "The Economics of Taxation and the Issue of Tax Reform," October 25-28, 2007, <http://iret.org/pub/New_Orleans_(2007).pdf>

IRET Congressional Advisory, No. 237, "Senate Stimulus Package," February 6, 2008, <http://iret.org/pub/ADVS-237.PDF>

IRET Congressional Advisory, No. 236, "Fiscal Stimulus Or Fiscal Folly?" January 28, 2008, <http://iret.org/pub/ADVS-236.PDF>

IRET Congressional Advisory, No. 235, "Stimulus Options To Avoid," January 18, 2008, <http://iret.org/pub/ADVS-235.PDF>

IRET Congressional Advisory, No. 209, "Analysis Of Tax Reform Panel Proposals (Part 2): Limitations Placed On The Panel Shaped The Outcome," September 20, 2006, <http://iret.org/pub/ADVS-1209.PDF>

IRET Congressional Advisory, No. 198, "Analysis Of Tax Reform Panel Proposals (Part 1)," June 19, 2006, <http://iret.org/pub/ADVS-198.PDF>

IRET Congressional Advisory, No. 190, "Extending The Fifteen Percent Tax Rate On Dividends And Capital Gains," June 30, 2005, <http://iret.org/pub/ADVS-190.PDF>

IRET Policy Bulletin, No. 88, "Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax?" September 10, 2004, <http://iret.org/pub/BLTN-88.PDF>

IRET Policy Bulletin, No. 75, "Introductory Discussion Of The Basic Concepts Of Depreciation And Expensing," March 10, 1999, <http://iret.org/pub/BLTN-75.PDF>

United States Senate Committee on Finance Hearing
Cracking the Code – Tax Reform for Individuals
May 13, 2008

Questions Submitted for the Record

Questions for Stephen Entin:

Senator Baucus

1. Should simplification be the goal of individual tax reform? If so, what's the best way to simplify the system?

   Answer: Simplification should be one goal of tax reform, but not the only goal. It should flow naturally from adopting a tax system with a coherent concept of income, carefully and accurately defined, neutral across income sources, and taxed at a uniform rate. Most of the complexity in the tax code stems from using broadly-defined income as the tax base (as opposed to a consumption base). The income concept imposes multiple taxation of income from capital, and, under our global tax system, tries to tax income earned abroad, which most countries do not try to do. Under a saving-consumption neutral tax that is territorial, nearly all the confusing elements of the tax system disappear. I favor a simple cash flow tax at the individual level, as presented in the testimony.

2. How can the tax system be made fairer?

   Answer: As I stated in my testimony, income is produced. It is the reward for offering labor and capital services to the market to create goods and services that are of value to others, who are then willing to pay for them. So all income is earned. With that in mind, a flat tax on consumption is the fairest tax because it treats all income producers alike, and treats income used for saving on a par with income used for consumption. It would also raise investment, productivity, and wages across the board. It is ironic and very unfair that the adverse tax treatment of capital designed to redistribute income from rich to poor actually reduces the incomes of the people who lack capital, hurting the very people the tax bias is intended to benefit.

   I would end phase-outs of deductions and exemptions with income, end the AMT, remove limits on participation in IRAs and other saving incentives, and reduce the graduation of the tax rates. I favor expensing, which treats all investment alike and does not punish capital intensive industries. We should exempt the poorest citizens from tax as an act of kindness, not "fairness". We should also have a reliable safety net provided through outlay programs, not the tax code. Some view "fairness" as any move that gives bigger tax rebates to the lower income, and taxes higher income people more. There is no way to put any kind of limit on that thinking, short of complete leveling of after-tax income. That would level all income down to next to nothing, because it would pay no one to take the trouble to produce.

3. How can the system be made more efficient?

   Answer: Efficient how? In taking in money with lower enforcement and compliance costs? Making for a more efficient economy, less distorted by actions taken for tax reasons that are not economically optimal? Any of the saving/consumption neutral taxes are far simpler, and far easier to administer and comply with, than the current system. For example, expensing is far less difficult to enforce and comply with and is more reflective of the real cost of investment than is depreciation, and it would improve economic performance and more allocate investment more efficiently. When we place several layers of tax on income used for saving and investment, and then observe some serious damage, and then provide limited exceptions from the excess tax layers for some acts of saving or investment but not others, we make a tax mess. Streamline the system by moving to a uniformly applied consumed-income base.

4. What are some of the negatives of doing what you suggest to meet the goals of simplification, fairness, and efficiency?

   Answer: Many thousands of tax preparers and tax lawyers and IRS agents would lose the use of their peculiar training, and would have to seek other employment. That is a negative for them, but freeing them to do more useful work is a positive for everyone else. There would need to be some restraint in Federal spending to accomplish these reforms without creating losers in the private sector. That means less money for Congress to spend, which is a drawback for the Members. It would also result in a tax system based on a few clear principles, with no exceptions, which would limit Congress's ability to tweak the tax code to favor interest groups. That would reduce Congressional power and influence. I urge you to make the sacrifice for the good of the country and your constituents. If their wages and profits rise 10 percent as a result of the pro-growth tax reform, they will forgive you for not bringing home some choice piece of pork or tax favor.

5. What type of transition would be required to implement this system?

   Answer: Transition problems are often overstated. There are none that cannot be handled quite reasonably. If you do not want to move to a neutral tax system such as the cash flow tax all at once, you could gradually expand the coverage of tax deferred or Roth style saving programs, and the amount of investment subject to expensing. One would have to decide what to do with unused depreciation allowances on old capital if one went immediately to expensing for new investment. There would probably have to be a longer carry-forward period for the unused write-offs. Expensing means more of the investment is written off sooner, and less later. It is mostly a timing issue, with an increase in present value of the investment deduction. It is not a great hit to federal revenue for very long. In does end what is in effect an interest free loan to the government by businesses that are denied the full value of the write-off under depreciation. However, instead of immediate expensing, one could adopt "neutral cost recovery," which delays the budget impact. NCRS in effect pays a market rate of interest on the still-delayed cost of the investment, such that the present value of the write-off equals the full purchase price (as with expensing). The budget hit is delayed until the additional investment has been put in place, and the government is getting higher revenue from other taxes due to the expanded economy and higher wages.

The estate and gift tax are already being phased out. That should be made permanent. Moving to a territorial system raises questions about what to do with unused foreign tax credits against previous tax payments. If your neutral reform retains a corporate level tax, the credits should be allowed over time. If there is no corporate level tax, then there is less reason not to just let them expire.

6. How would your proposal affect small businesses? Would there be an increased burden?

   Answer: A neutral cash flow system actually resembles the tax treatment currently applied to small (non-corporate) businesses. Small business expensing would apply to all investment by all businesses, and there would be only one layer of tax on business income instead of the additional layers of tax on corporate income. Small businesses are already closer to a cash flow system than corporations, so the move to a cash flow tax would not be a big adjustment for them.

   Ending the estate and gift tax would certainly help small businesses immensely. Otherwise, the family has to buy half of its business back from the government every generation. If a foreign government half-nationalized U.S. citizens' property on its territory every 20 years, we would be outraged. We certainly were when Castro nationalized U.S. citizens' property in Cuba, and imposed sanctions that are still in force today. We should be at least half as upset by the death tax.

   The cash flow tax is very good for start-up businesses or small businesses that are expanding either by borrowing or selling shares. In a saving-deferred cash flow system, saving is deductible, and borrowing or raising revenue from issuing new shares are taxed. When a saver lends to a small business (or large one), the business takes the borrowing or share issue proceeds into income and expenses the investment (say, the purchase of equipment or a building). That is a tax wash. The expensing for the asset purchase is in effect shifted to the saver, who deducted the loan or share purchase. So even if a start-up business has no income against which to take a deduction for the investment, the lender can still benefit from the expensing of the investment at his end. This greatly eases the small business's access to financing. It puts a start-up company on a par with an established firm, easing new entry and promoting competition and innovation.

7. What would be the IRS's role? What are some administrative issues with adopting your proposal?

   Answer: The IRS would do what it does now, but more easily, with less effort and expense. It would have simpler definitions of income to write rules about, fewer disputes to settle, and it would receive far simpler 1099 forms from financial institutions to match against taxpayer returns. There would be no distinction between capital gains and ordinary income, because in a saving deferred tax, all tax bases are zero and all withdrawals from saving are fully taxable, as in a regular IRA.

   In the individually-based consumed income tax, there is no separate corporate tax. The earnings of each publicly traded business would be treated as tax-deferred saving by the shareholders, much like a current IRA. The same holds for non-corporate businesses. All would expense capital outlays.

   Any retained earnings would be allowed to grow within the company on a tax-deferred basis, and the business would not be a separately taxable entity. It would have to report to its shareholders as a taxable amount any funds sent abroad, as money taken out of the country would be considered a taxable withdrawal by the owners of the business. In exchange, the earnings of already-taxed money sent for investment abroad would not be taxed here. (The treatment would be as in a Roth IRA.) There would be no taxation of foreign source income, eliminating much complexity and enforcement cost.

   The estate tax would be replaced by the standard cash flow treatment of being tax deferred saving (included inherited assets) until the money is taken out for spending. (This is also the treatment under a sales tax, VAT, or "Flat Tax".)

8. Is repeal of the AMT a viable option? If so, how can Congress get this done? If repeal is not viable, what can be done to stop this tax from applying to middle income taxpayers?

   Answer: Of course repeal is "a viable option." Congress enacted it, Congress can repeal it. The AMT does not utilize a reasonable definition of taxable income, because it disallows the immediate acknowledgment of many legitimate business costs, and disallows deductions needed to correctly attribute income to one taxpayer versus another. For example, if I am taxed to pay for the schooling of my neighbors' children, which is investment in human capital, then I should get a deduction for that investment. If my state taxes are given to the poor, the tax should come off my income, and the welfare benefit or Medicaid benefit should be reported as their income (although in practice they will be too poor to owe federal tax). The AMT should not be part of any coherent, simple, efficient, accurate tax system.

9. How do we replace the lost revenue?

   Answer: If you absolutely must have the money, then you will have to raise other tax rates. I would urge you instead to cut spending growth. Recognize that each $1 of tax you raise depresses private sector economic output and your constituents' incomes by about an additional $1.50. (More for taxes on capital.) You should recognize that each dollar of government spending costs the public about $2.50. You should not keep spending until the benefit at the margin from a program is barely equal to the apparent $1 on-budget cost. You should stop spending at the point where the marginal benefit from putting another $1 into a program is at least $2.50. That would send spending on many government programs tumbling.

10. From your perspective, what are two or three of the highest priorities on your list for consumption based tax reform, and why?

    Answer: Expensing (or neutral cost recovery) delivers a lot of reduction in the service price (hurdle rate of return) on new investment with relatively little budget impact. Retaining the 15% top tax rates on dividends and capital gains also lowers the service price and removes half of the double taxation of corporate income. Later on, if you move toward an individually-based cash flow tax, it would be the corporate tax that was eliminated, and the saving that leads to capital gains and dividends would be tax deferred, but taxed at ordinary rates on withdrawal for consumption, as in a pension or regular IRA or 401(k) plan. Estate tax repeal would cure a truly punitive, anti-investment double or triple tax that probably raises no money after taking into account the damage it does to employment and production.

11. Please explain the advantages.

    Answer: Lower taxes on capital would raise the capital stock, productivity, wages and employment across the board. The simplification would save tens if not hundreds of billions of dollars in compliance and enforcement costs.

12. You mention the tax code is biased against savings and capital, but doesn't the tax code already provide ample pro savings provisions? For example, the code provides deductions for IRAs, 401ks, exclusions on gains of home sales, etc. Could you please elaborate in more detail about the bias you speak of?

    Answer: There are some offsets to the bias, but they do not cover enough saving and investment "at the margin," and damage the incomes of everyone, workers, savers, and consumers alike.

Income is taxed when earned. If the after-tax income is used for consumption, there is no further federal tax (except on alcohol, tobacco, gasoline, and a few other excises). If we use the after tax income to buy a productive asset, or a claim on one, there is a tax on the returns. So we can buy a television and watch a stream of programming with no added federal tax, but if we buy a bond or stock, or invest in our small business, we must pay a tax on the stream of interest or dividends or capital gains or profit, a second layer of tax. That is the basic income tax bias against saving.

If the saving was used to purchase corporate stock, there is a corporate tax imposed even before the dividend is paid, and a capital gains tax on the share price increase resulting from retained after-tax earnings, a third layer of tax. Then there is the estate and gift tax on large amounts of assets whose cost and earnings have already been taxed several times, which is a third or fourth layer of tax depending on what assets the saving was invested in. Even when the estate consists of a tax-deferred IRA or pension, the heirs must take the distribution into taxable income, so the estate tax is always an extra layer of tax.

The tax literature contains illustrations of the bias. See "Blueprints for Basic Tax Reform" by David Bradford, available form Tax Analysts, Arlington, VA. Also look at our web site www.iret.org for my paper "The Economics of Taxation and the Issue of Tax Reform". It explains the understatement of business costs due to depreciation instead of expensing, the distortion caused by the multiple taxation of capital income (with arithmetic examples), and how the regular and Roth IRA treatment, pension treatment, and 401(k) treatment of saving offset the bias and restore neutrality. Also see IRET Policy Bulletin 88, "Tax Incidence, Tax Burden, and Tax Shifting: Who Really Bears the Tax?" That paper discusses the impact of the tax on capital for wages and employment, and shows that most of the tax burden on capital is shifted to labor by normal market forces.

A good tax system would not double tax some saving and relieve the double tax on other saving. It would face up to the biases and eliminate all of them, not only to raise incomes but also to be true to sound tax principles and on the fairness argument that you should treat all taxpayers alike.

In practice, it is not true that the partial offsets in the tax code from the limited saving vehicles are sufficient to cure the economic ills that the bias creates. People who have "maxed out" on their contributions or who are not eligible due to income limits find that the bias exists on any additional saving, which reduces their incentive to save and invest at the margin, where it counts. They, and the working people who would benefit from the added capital formation, are injured. The Congress errs when it fixes a punitive, economically damaging tax provision only for some people and not for others, or in a limited, infra-marginal manner with caps and restrictions, instead of completely and at the margin for all.

Senator Grassley

1. This question is for the panel. I know that in testimony, concerns have been raised about "cherry-picking" – that is taking some reforms but not others. But as we all know, sometimes to get reforms we have to go one step at a time.

   So, I would like your comments on that – are there reforms that can be moved independently or separately from other reforms? For example the New Family and Work Credits. And second, if there are reforms that can stand on their own, what would be your recommended priorities for action by this Committee? What should we be looking at first?

   Answer: Redesigning the personal and family allowances, or merging the saving provisions in the President's Tax Panel proposals, can be done separately from other provisions. Care should be taken to coordinate reform mainly in those cases that affect parties on both sides of a transaction, such as changing the treatment of buyers and sellers, leasees and lessors, lenders and borrowers, etc.

   The most important steps in the reform process are those that boost investment by lowering the service price of capital to create additional jobs and raise wages. Expensing, reducing double taxation of corporate income, and estate and gift tax repeal do a lot for growth at relatively little budget cost. The parts of the reform proposals that simplify without creating additional income and jobs are nice, and make the tax system more user friendly, but do are not as valuable to taxpayers as steps that raise incomes.

2. All of you agree the alternative minimum tax ("AMT") needs to be repealed or reformed. I don't think you'll find many us behind the dais who will disagree with you. Where the panel differs and where we, on this side, differ with those on the other side, is whether a condition of AMT repeal or reform is replacement of revenue lost.

   According to the CBO in its current budget outlook document, there are expiring spending provisions that will cost $1.3 trillion. The expiring spending provisions, unlike expiring tax provisions, are not included in the CBO baseline and are not subject to pay-go. So, there's a double standard built into the system that favors continued spending and disfavors continuing tax relief.

   I'd ask the panel how folks can hold the view that we must continue an unfair tax, like the AMT, by scoring the AMT patch, which is the will of the Congress, and not account for expiring entitlement spending? Doesn't that strike you, like it does me, as fundamentally unfair?

   Answer: Yes. This is especially galling when the tax reduces economic output and incomes, adding that additional hidden cost to the direct budget cost of the spending programs funded by the tax. Unless that spending provides benefits worth about \$2.50 for every \$1 in direct budget outlay, it is a bad deal for the public. (See my response to Senator Baucus's 9th question.) Also note that the AMT reduces output and income, so it does not really raise all the revenue attributed to it, and ending the AMT would not cost as much as is being estimated under the JCT static scoring methods. Note too the damage it is doing to the population. That cost is not on budget, it is on your constituents. If Congress is here to serve the public, it should take the damage the tax does to people into account.

3. What is the revenue maximizing capital gains rate? Is that something we should be aiming for if our goal is an optimally-functioning economy?

   Answer: The revenue maximizing capital gains tax rate is probably in the low teens, if you mean revenue coming directly from the tax on the gains. Even in the low teens, the tax reduces saving and investment somewhat, which trims revenues from the payroll tax, the corporate tax, other areas of the personal income tax, and from excises. The global revenue maximizing capital gains rate is probably nearer zero. The revenue maximizing rate of any tax is not the right thing to aim for if your objective is maximizing national wellbeing. As each tax reduces GDP and incomes, the "deadweight economic losses" from the tax must be added to the cost of the programs being funded. Spending and taxing should stop when the total marginal cost of a program begins to exceed its benefits. If \$1 spent on a program is funded by a tax that does an additional \$1.50 in economic damage, then the added program outlay has cost the country \$2.50. The spending on that program should stop as soon as the marginal benefit of an extra dose of the program has fallen to \$2.50. It should not be pushed to the level at which its marginal benefit has fallen to \$1.

Senator Hatch

1. In citing the need for tax reform, two of you, Drs. Burman and Gale, indicated that one major factor is the need for more revenue because of the projected increases in entitlement program spending over the next decades. This question is for each of our witnesses. Should our goal be to make sure revenues match projected spending over the coming years, or should we focus on finding the optimum level of revenue that will keep our economy strong, growing and producing jobs, and then attempt to match our spending to that level of revenue?

   Answer: We should weigh the cost of the added taxes, including the economic damage they do, against the benefits of the added spending, and stop taxing and spending when the added costs exceed the added benefits. We must never assume that some level of spending or entitlement eligibility is sacrosanct, and demand that we do whatever is necessarv to fund it. Nor can we sav that some level of taxation is optimal without knowing the value of what the revenue is to be spent on. For example, the optimal level of taxation in World War II was higher than during peacetime.

We should adopt a tax base that correctly measures income, and collect the tax in a highly visible way that lets the public see what government is costing them. The right tax base is revenue less the cost of earning the income, including the cost of saving and investment. That will give you a saving-deferred (consumption-based or consumed-income) cash flow tax. It should be imposed at the individual level, not on businesses, so that the taxpayer-voter can see clearly the full amount of taxes being taken, and make an informed decision as to how much government spending to support. Having gotten the right tax base, you then set the tax rates at the levels that the public is willing to pay to support the programs that they think are worth the cost. Let them decide that.

2. As you all know, a big reason our tax code is so complex is that Congress has tried to accomplish many social and economic goals through its provisions. One more question for each of you. As we look to reforming the tax code, should we ideally focus exclusively on raising revenue and not try to meet other goals, no matter how worthy they might seem?

   Answer: Yes, the tax code should primarily aim at raising revenues in a neutral (non-distorting), simple, highly visible, and fair manner (with "fair" meaning fair to all the people who generate income) so as to minimize the economic damage from the tax system and inform the voters of the cost of government. Safety net and other social policies are better handled through outlays, subject to annual Congressional review.

Senator Smith

1. Some tax reform proposals, such as the 2005 report from the President's Advisory Panel on Tax Reform, have recommended that various defined contribution plans be streamlined into one plan. But some of these proposals have made no specific mention of, or provision for, employee stock ownership plans (ESOPs). ESOPs are among the most effective retirement savings plans available to American workers. Indeed, in 1996 and 1997, Congress enacted legislation to allow ESOPs to own Subchapter S businesses. This has led to significant retirement savings for many workers – now employee-owners – in these companies, including in my own home state. Would you share with me your views about how – as tax reform moves forward – we can preserve and promote private ESOP-owned companies, and how we avoid making changes to tax laws that would inadvertently burden these structures?

Answer: All saving vehicles – including ESOPs – should get the same neutral tax treatment, either deferring tax on income that is saved and taxing any returns that are not reinvested, or taxing the income as it is saved and then not taxing the returns. Having said that, most economists are not fond of ESOPs because they encourage workers not to diversify. If your saving is tied up in the company you work for, and the company goes bust, then you have lost both your job and your savings. Economists and financial advisors urge people to own stock and bonds in companies other than those for which they work. Remember what happened to the Enron employees who had lots of Enron stock and options in their retirement accounts when that company collapsed.

2. About three-quarters of small businesses are organized as pass through businesses, so they are paying their business tax at the individual level. What impact do you think raising the individual tax rate would have on small businesses?

   Answer: When you tax something, you get less of it. When you raise the tax rate on the returns on work and investment in small businesses, you get less work, less investment, fewer businesses, and those that stay open are smaller.

   a. Small businesses have been a large job creator over the past decade. Would higher individual tax rates potentially have a negative impact on this job creation?

      Answer: Not "potentially." They would certainly have a negative impact.

   b. What impact would higher individual rates have on the entrepreneurs who are thinking about starting a small business?

      Answer: Entrepreneurs are in unusually risky situations and are especially sensitive to reductions in the expected returns on effort and investment. Their level of effort is even more likely to be affected by higher tax rates than that of people who are employed by others or who invest in financial assets involving large, established companies.

The Heritage Foundation
LEADERSHIP FOR AMERICA
214 Massachusetts Avenue, NE • Washington DC 20002 • (202) 546-4400 • heritage.org

CONGRESSIONAL TESTIMONY

Individual Income Tax Reform

Testimony before
Senate Finance Committee
United States Senate

May 13, 2008

J.D. Foster, Ph.D.
Norman B. Ture Senior Fellow
in the Economics of Fiscal Policy
Domestic Policy Studies
The Heritage Foundation

Mr. Chairman, Senator Grassley, Members of the Senate Finance Committee, my name is J.D. Foster. I am the Norman B. Ture Senior Fellow in the Economics of Fiscal Policy at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

I thank the Committee for the opportunity to convey my views on the vital matter of individual income tax reform. Though the federal individual income tax system works in the sense that it raises an enormous amount of revenue for the government – $1.2 trillion in 2007 – it is deeply flawed in many ways, all of which I suspect are known to the Members of this Committee.

Despite the many important issues to consider, I am going to resist the temptation to provide a catalogue of problems and recommendations, and instead first emphasize two broad principles. I will then turn to one specific area – the tax treatment of education expenses – about which I believe too little attention is given relative to its importance to the future of our economy generally, and to every American seeking to get ahead in this competitive global economy.

Application of First Principles

Traditionally, individual income tax reform discussions take place under the assumption of revenue neutrality. This convenient device focuses attention on the necessity of making choices, weighing alternatives. Policymaking is often about tradeoffs and so revenue neutrality imposes a useful discipline on the discussion.

Tax legislation and its consequences are not matters for the blackboard, however. Congress and the Administration must decide both the level of taxation, and how to structure the tax system. So, as the Committee considers individual income tax reform, among the many issues for consideration I believe these two guiding principles are paramount:

- The level of individual income tax collections should be low.
- The marginal rates of tax imposed should be low.

The great risk in tax policy, and for individual income tax reform, is that both of these principles will be significantly violated in the near future. Over the next two years Congress will debate whether to impose or prevent a massive tax hike on the American people, a tax hike centered largely on a significant increase in marginal income tax rates. This is individual income tax reform writ on a grand scale, but it threatens to move entirely in the wrong direction. Whatever other reforms this Committee considers and whatever other benefits might reasonably be expected to follow therefrom, if the Committee and the Congress fail to prevent this tax increase, the net effect will surely be profoundly negative for tax reform, for the economy, and for American taxpayers.

The issue arises, of course, because the 2001 and 2003 tax cuts are slated to expire at the end of 2010. This leads some to suggest that extending any or all of the tax provisions, provisions that will then have been in the law for eight or 10 years, is somehow a tax cut. Respectfully to those who make this argument, this is utter nonsense Washington style. Extending current law, or better yet, making it permanent, prevents a tax hike.

Make no mistake, the American taxpayer cannot be fooled, and despite all the rhetoric in the preamble to this debate, I doubt the Congress would ultimately be so foolish as to try to fool them. If these tax provisions were allowed to expire, it would be perfectly clear to the taxpayers that their taxes went up; it would be perfectly clear why they went up; and it would be perfectly clear who was responsible.

Flawed CBO Baseline Contributes to the Confusion

Some in this debate hope to use a fundamental and long-standing flaw in the way tax provisions are scored to provide a gloss of credibility to their argument that allowing tax relief provisions to expire is not a tax hike. The issue here is the construction of the revenue baseline by the Congressional Budget Office (CBO).

As it has always done, under both Republican and Democrat Directors, the CBO constructs the revenue baseline on the basis of current law. While not the correct approach, this has also not generally been a serious issue because in the past Congress has had in most instances the good sense to respect the importance of stability and predictability in the tax law. So, when the law was changed, the change was permanent at least in the sense that it was not accompanied by an expiration date. There are exceptions, such as the R&D tax credit, but these were few and by general agreement policy would be vastly improved in most cases by making them permanent.

In clear contrast, and correctly, when CBO constructs its spending baseline it assumes that current law will extend throughout the budget window even if the authorizing law expires during the budget window. The practicality of this assumption follows immediately in the case of appropriated spending and it extends naturally to other major programs, such as SCHIP, the farm bill, and the highway program. In each case, current spending levels are assumed to continue in the baseline even though the program expires. Consequently, the extension of current law is not shown to have budgetary consequences. This is sound practice, and is consistent with current services budgeting principles.

In the construction of baselines, revenue provisions should be treated the same way spending provisions are treated. This is a matter of leveling the playing field. It is a matter of basic fairness in budgeting. If revenue provisions and spending provisions are treated the same way, then the scoring of the extension of those provisions would accurately show that, in terms of policy changes, nothing happens, and in terms of the ongoing deficit picture, nothing changes.

AMT Patch a Current Example

Year after year we face a precursor of the consequences of the flaw in the CBO revenue baseline when Congress seeks to extend the AMT patch. There is strong and broad support for extending the patch, and many Members seem to understand, and many acknowledge, that allowing the patch to expire would impose a huge tax increase. They are right. Yet when the revenue tables are presented, extending the AMT patch is shown to be a tax cut. The same law cannot be both a tax cut and a tax hike. The Members are right; the baseline is wrong. Correct the baseline and extending the patch in its current form would then properly be shown to have no revenue consequences, no deficit consequences relative to today's law. It would still be necessary for Congress to enact legislation, there would still be ample opportunity to debate policy, to put forward alternatives, but the path would be straighter and more honest once the errant revenue baseline is corrected.

Education

Education, or human capital formation as scholars refer to it, is widely understood to be essential to our future as a nation and to the future of our economy. Capital formation, investing in new plant and equipment, and sometimes in new infrastructure, is vital to improving real wages and our standard of living. Investing in human capital formation is certainly no less vital.

While we may all have different notions about how best to invest in the education of our children, of college students, of technical and professional school students, and of those already in the workforce who seek new or better skills, it is clear the Congress and the nation understand the importance of education. It is clear in the debates over funding of pre-K education. It is clear in the debates over No Child Left Behind. It is clear in the debates over Pell grant amounts. It is clear in the recent debates over student loans in the context of the credit crunch.

The federal individual income tax has in recent years begun to reflect more fully the importance of education. The greatest examples include the Hope and lifetime learning tax credits. The Hope tax credit allows individual taxpayers a nonrefundable credit of up to $1,800 per student per year for qualified education expenses during the first two years of post-secondary education. The credit is 100 percent of the first $1,200 of expenses, and 50 percent of the next $1,200 of expenses. The credit phases out ratably for married filers with adjusted gross incomes between $96,000 and $116,000. The credit can only be claimed for one student per tax filing family per year.

The lifetime learning tax credit is a 20 percent nonrefundable credit, up to $2,000 a year, for qualified education expenses. The lifetime learning tax credit may be used for as many qualifying students as are included on the family's tax return, and may be claimed for an unlimited number of tax filing years. Like the Hope tax credit, the lifetime learning tax credit also phases out for married filers with incomes between $96,000 and $116,000.

The Congress has more recently added an additional provision, the higher education tax deduction. This is an above-the-line deduction of up to $4,000 for qualified education expenses. The deduction phases out for married filers with incomes between $130,000 and $160,000. In addition to these three, the individual income tax includes a host of other provisions, some of which are highly significant such as the exclusion for employer-provided educational assistance, the above-the-line deduction for student loan interest, and tax benefits for higher-education saving.

I believe this collection of provisions reflects a budding understanding of the fundamental importance of tax policy to education. This is not just a matter of providing tax relief to struggling families, as important as that is. It is the evolutionary adoption of sound tax policy. This collection of provisions also reflects a highly confusing and uneven area of tax law long in need of simplification and rationalization.

Unfortunately, tax policy voices seem to be among the last in the nation to understand the concept of human capital formation and its implications for income tax policy as evidenced by a recent Joint Tax Committee (JTC) report[1]:

> Other subsidies for education [aside from direct assistance, etc.] provided by the Code permit students to receive tax-free qualified scholarships, tax-free employer-provided educational assistance, tax-free cancellation of certain governmental student loans, and a deduction for student loan interest. Students and parents also are provided the benefits of the Hope and Lifetime Learning tax credits, the exclusion from income of earnings on Coverdell education savings accounts and qualified tuition programs, and the exclusion from income of the interest on U.S. savings bonds used to pay for post-second education.

The critical and errant word in this paragraph from the JTC is the second – "subsidies". Eliminating the tax on income used for investment purposes is not a subsidy.

In tax policy we debate the appropriate amount of a deduction a business should take in a given year for the purchase of a piece of equipment, but there is no real debate that some deduction should be allowed and that the deduction is not a subsidy. Depreciation deductions relating to capital formation are a fundamental attribute of the income tax levied on business. Similarly, deductions for human capital formation expenses ought to be a fundamental attribute of the income tax levied on individuals.

This testimony is not the proper place and this hearing not the proper time to be fully prescriptive in how the individual income tax ought to be reformed to reflect the reality of education as investment. However, there are some broad principles the Committee should consider to simplify, rationalize, and make more comprehensive the tax treatment of education expenses. These include:

---

[1] Present Law and Analysis Relating to Tax Benefits for Higher Eduation, Joint Committee on Taxation, April 29, 2008, http://www.house.gov/jct/x-35-08.pdf.

- Taxpayers should receive a deduction (or credit equivalent) for their own education expenses or those of their children.
- The deduction ought to be available for all qualified expenses irrespective of the level of education.
- The deduction should be computed on a family-wide basis.
- Taxpayers ought to have a single, simple means by which they can save for future education expenses.
- Earnings accruing in the accounts should be tax-free.
- States, educational institutions, and private financial institutions ought to be able to offer like services relating to educational savings accounts.
- Neither the deduction for current education expenses nor the treatment of saving for future education expenses ought to be subject to unfair and complicationg income phase-outs.

Conclusion

The first rule in individual income tax reform should be "first, do no harm". In application to the current situation, this rule means Congress should prevent taxes from increasing with the expiration of the changes made 2001 and 2003. Raising individual income taxes is a form of tax reform, and a bad form. Raising marginal tax rates as would occur if these taxes are raised is precisely the wrong course to take.

Doing no harm, however, is not enough. There are many areas of the individual income tax requiring significant reforms, each of which if done properly would help strengthen our economy and improve the finances of America's families and workers. Among those of the highest priority should be the correction of the tax treatment of education for expenses incurred at all levels. This would create a more neutral tax system, and it would lead to a more educated, more competitive, more flexible workforce.

****

The Heritage Foundation is a public policy, research, and educational organization operating under Section 501(C)(3). It is privately supported, and receives no funds from any government at any level, nor does it perform any government or other contract work.

The Heritage Foundation is the most broadly supported think tank in the United States. During 2007, it had nearly 330,000 individual, foundation, and corporate supporters representing every state in the U.S. Its 2007 income came from the following sources:

Individuals	46%
Foundations	22%
Corporations	3%
Investment Income	28%
Publication Sales and Other	0%

The top five corporate givers provided The Heritage Foundation with 1.8% of its 2007 income. The Heritage Foundation's books are audited annually by the national accounting firm of McGladrey & Pullen. A list of major donors is available from The Heritage Foundation upon request.

Members of The Heritage Foundation staff testify as individuals discussing their own independent research. The views expressed are their own, and do not reflect an institutional position for The Heritage Foundation or its board of trustees.

United States Senate Committee on Finance Hearing
Cracking the Code – Tax Reform for Individuals
May 13, 2008

Questions Submitted for the Record

Responses From Dr. J.D. Foster:

Senator Baucus

1. Should simplification be the goal of individual tax reform? If so, what's the best way to simplify the system?

   Response: The primary goal of individual income tax reform should be to reduce tax-based distortions to economic decision-making that diminish wage growth and international competitiveness. However, pro-growth tax policy can and should be pursued so as to simplify the tax code significantly. In practice, efforts toward a more pro-growth tax code will very often also result in substantial simplification.

   A pro-growth tax policy involves two basic elements: Keeping marginal tax rates low and reducing or eliminating the tax bias against saving and investment, including investment in human capital formation. If these two elements drive tax reform, then a third element, assuring uniform treatment over different kinds of investments and activities, naturally follows.

   A good example of how pro-growth reform and simplification go hand in hand is in the area of the taxation of retirement saving. The tax code presents retirement savers with numerous opportunities to save for retirement without the typical bias against saving inherent in an income tax. However the sum total of these opportunities is bewildering for all but tax experts. Substantial simplification, especially consolidating all tax-deferred retirement saving into a single vehicle, would encourage more retirement saving and would yield significant simplification for millions of taxpayers.

2. How can the tax system be made fairer?

   Response: Eliminating the various provisions intended for social and economic engineering, a key component of the kind of base broadening typically associated with tax reform, would be a major step toward a more fair tax code. A second major step would be to move more toward a low rate, proportional tax system after some general exclusion or allowance.

3. How can the system be made more efficient?

Response: Efficiency can be defined either in terms of economic consequences or the burden of compliance and administration. In responding, I will focus on the latter meaning.

The single most effective approach to improving tax efficiency is simplification generally. The Earned-Income Tax Credit is a good example of a tax provision designed to achieve a social engineering purpose but which creates enormous complexities for those it is intended to help, that creates tremendous administration problems for the IRS, and that in the process contributes mightily to tax evasion and the tax gap.

4. What are some of the negatives of doing what you suggest to meet the goals of simplification, fairness, and efficiency?

   Response: The greatest negative to the pursuit of pro-growth tax policies is that the resulting growth will so expand the revenues to the federal government that spending will be allowed to grow even more rapidly than it is already prone to do.

5. What type of transition would be required to implement this system?

   Response: I have not specified a defined system, but rather principles to follow in designing a new system. However, there are similar principles that apply to the issue of tax reform transition.

   Tax reform transition is often raised as a means of suggesting the impossibility of substantial tax reform, and often pursued on an ad hoc basis. Transition need not be an impediment to tax reform as long as the principles that guide it are systematic and sound. Above all, the guiding principle for tax reform transition should be the grandfather rule. That is, transactions undertaken prior to tax reform but that have tax consequences that extend beyond the date of tax reform ought to be grandfathered, i.e., remain subject to the tax law in effect when the transaction became legally binding on the parties.

   In application, for example, suppose tax reform replaced accelerated depreciation with expensing for new investments. What transition system is appropriate for investments subject to depreciation made prior to tax reform? They should be grandfathered, that is, remain subject to the old rules, allowing depreciation deductions over time according to the schedule in effect when the investment was made.

   The advantages of grandfathering are many. First, it avoids creating a new set of complexities because it uniformly applies a known system to pre-tax reform transactions. Second, it avoids inflicting windfall losses on and bestowing windfall gains for taxpayers. Third, it is eminently fair as taxpayers remain subject to the system in place when they agreed to the transaction.

6. How would your proposal effect small businesses? Would there be an increased burden?

   Response: Small businesses would greatly benefit both from simplification and from the stronger economic growth made possible by reducing the distortions in the economy arising from the tax code. Probably the greatest difficulty and burden for small businesses under the current tax code is simply the high statutory marginal tax rates to which their business income is subject at the federal level. This can be addressed directly by, first, preventing tax rates from rising as would happen if the 2001/2003 tax cuts are allowed to expire in 2010, and, second, by reducing the top rates further.

7. What would be the IRS's role? What are some administrative issues with adopting your proposal?

   Response: Adopting a pro-growth, simplification-oriented reform following the principles described above would greatly ease the administrative burden on the IRS, allowing it to dedicate more of its resources to compliance efforts.

8. Is repeal of the AMT a viable option? If so, how can Congress get this done?

   Response: The AMT is by near universal agreement a major problem in tax policy entirely lacking in justification. The repeal of the AMT is therefore not only a viable option, it ought to be a major goal of tax reform.

   Repeal of the AMT is facilitated if Congress avoids raising AMT burdens first. Specifically, the AMT "patch" should be made permanent, thereby preventing the number of AMT payers from soaring from about 5 million taxpayers to over 20 million taxpayers. With the AMT patch in place, repealing the balance of the AMT becomes a much easier proposition.

   From a budgetary perspective the most straightforward means of repealing the balance of the AMT is to reduce government spending, thereby preventing the budget deficit from attaining unacceptable levels. Fortunately, some of the spending programs most in need of reform and where significant amounts of federal spending occur are under the jurisdiction of the Senate Finance Committee.

9. If repeal is not viable, what can be done to stop this tax from applying to middle income taxpayers?

   Response: As note above, full AMT repeal is viable. However, full repeal may not be imminent and so intermediary, temporary solutions are also important. The simplest such intermediary approach is simply to continue with the AMT patch and index it for inflation.

A better approach would be to abandon the patch, but allow tax filers exemptions against their AMTI for children, thus making the AMT more family friendly. The exemption amount should be established so that the revenue effects are at least as substantial as would be the case if the patch were indexed and extended.

10. How do we replace the lost revenue?

    Response: The best way to replace the lost revenue is to reduce government spending as described above.

    However, there are alternative approaches to repealing the AMT that represent more of a revenue neutral approach. For example, I have written elsewhere that, under the circumstances, repealing the State and local tax deduction would be a sound approach to AMT reform, thus achieving a double dose of simplification. Tax reform is about making choices among competing objectives. Repealing the AMT and the State and local tax deduction represents a good choice.

11. Currently Norway has the highest per capita income out of OECD countries, and according to the OECD, in 2005 Norway's total tax ratio as a percentage of GDP was a little over 40% compared to the U.S.'s roughly 27% (state, local, and federal). When you discuss keeping income tax collections low, what GDP percentage benchmark do look at and what social and economic outcomes are you considering?

    Response: I do not refer to keeping income tax collections low because that would presume that income taxes are low today. They are not.

    However, there is no simple metric one can use to identify the correct level of tax, or when taxes are low or high. The modern average for all taxes of 18.3 percent of GDP is one useful measure, but it implies that the average is an appropriate target. There is no reason to suppose that it is, however.

    A more useful measure is real per capita tax levels, which have been rising steadily, annually hitting new highs, for both federal taxes and for taxes at all levels of government combined. This strongly suggests that taxes are not low today, but are rising with little sign of abatement.

    With respect to Norway, Norway enjoys significant income levels despite its high levels of tax in large part due to its significant exports of off-shore oil, much in the way Alaska enjoys a strong economy as measured by per capita income. Unfortunately, the Congress has repeatedly blocked attempts in the United States to expand domestic oil and gas production, thus denying the country the opportunity to enjoy additional income from such sources in the magnitudes that would be possible.

12. Based on panelist testimony and our tax reform discussions, if the 2001 and 2003 tax cuts were extended we could expect growing deficits. What are your suggestions to ameliorate this expected shortfall? Are there other tax revenue mechanisms that you would recommend to meet budget priorities?

    Response: As the Chairman surely knows, based on CBO data extending the 2001 and 2003 tax cuts, or better yet, making them permanent, would allow the share of taxes as a percent of GDP to rise slowly, but steadily. However, extending the tax cuts would not produce growing deficits. Rather, it would in the near term produce roughly stable deficits as a share of GDP throughout the 10-year budget window unless Congress shows itself completely incapable of restraining its spending tendencies.

    In subsequent years the deficits will begin to rise rapidly because of rapid growth in Medicare, Medicaid, and Social Security spending, during which period receipts as a share of GDP will continue to be above the modern average and will continue to rise. The deficits that could result from this rapid growth in spending are unsustainable in the long-run and will require a policy response. The appropriate response to excessive growth in spending is simple to prevent excessive growth in spending. These programs largely fall within the jurisdiction of the Senate Finance Committee and so the Committee bears the first responsibility in the Senate of addressing this spending surge.

13. You recommend low marginal tax rates, however according to the Congressional Budget Office, in 2005, the effective individual income tax rates were -6.5%, -1.0%, 3.0%, 6.0%, and 14.1% for the five income quintile households. The effective rates appear to be pretty low. If we lower the marginal tax rates, how much further would this lower the effective tax rates?

    Response: As the Chairman surely recognizes, the CBO data to which the question refers reflects average tax rates, not marginal tax rates. Further, both marginal and average tax rates differ significantly from the third type of rate mentioned in the question of "effective" tax rates which in context should refer to effective marginal tax rates.

    In fact, effective marginal tax rates remain quite high for labor, especially when income and payroll tax rates are considered, and recent Treasury analysis underscores how effective marginal tax rates remain quite high at 23.4 percent for the business sector as a whole. Both statutory and effective marginal tax rates on labor and capital should be lowered to raise prospects for future wage growth.

Senator Grassley

1. This question is for the panel. I know that in testimony, concerns have been raised about "cherry picking" – that is taking some reforms but not others. But as we all know, sometimes to get reforms we have to go one step at a time.

   So, I would like your comments on that – are there reforms that can be moved independently or separately from other reforms? For example, the New Family and Work Credits. And second, if there are reforms that can stand on their own, what would be your recommended priorities for action by this Committee? What should we be looking at first?

   Response: It is vital for improving the federal tax code that policymakers have a clear, correct, and internally consistent view of a perfected tax code. Discussions of fundamental, sweeping reforms are useful exercises for developing such a view.

   In modern practice, however, tax reform occurs one piece at a time. As it does so, reform should always be moving toward the ideal that would obtain if the most sweeping reform were enacted.

   In terms of "step at a time" individual income tax reform, I would suggest the following as priorities:

   1) Make Current Law Permanent: The most important step in tax reform is to make the 2001 and 2003 tax relief permanent. Allowing this relief to expire, and most especially the reductions in the tax rates and the elimination of the death tax, would be a giant step backward for the economy and a giant step backward for tax reform.
   2) AMT Patch: Make the AMT patch permanent, thereby ensuring limited growth of this misbegotten tax while protecting millions of taxpayers from unexpected and unwarranted tax hikes. More fundamental reforms of the AMT can then proceed as opportunities become available.
   3) Education: Reform the set of provisions that partially move the tax code toward the proper treatment of education expenses by eliminating the lot and replacing them with a single, substantial, above-the-line deduction or tax credit for qualified education expenses. This would be fair, pro-growth, pro-education, and significantly simplifying.
   4) Simplify Savings: There are now so many varied vehicles for tax deferred saving it daunts sophisticated taxpayers and deters the unsophisticated. These should be replaced en masse by a single, simple Roth IRA-type account which can be established by employers or individuals. The Administration's Retirement Savings Account proposal offers a good template.

2. All of you agree the alternative minimum tax ("AMT") needs to be repealed or reformed. I don't think you'll find many us behind the dais who will disagree with you. Where the panel differs and where we, on this side, differ with those on the other side, is whether a condition of AMT repeal or reform is replacement of revenue lost.

   According to the CBO in its current budget outlook document, there are expiring spending provisions that will cost $1.3 trillion. The expiring spending provisions, unlike expiring tax provisions, are not included in the CBO baseline and are not subject to pay-go. So, there's a double standard built into the system that favors continued spending and disfavors continuing tax relief.

   I'd ask the panel how folks can hold the view that we must continue an unfair tax, like the AMT, by scoring the AMT patch, which is the will of the Congress, and not account for expiring entitlement spending? Doesn't that strike you, like it does me, as fundamentally unfair?

   <u>Response:</u> The disparate treatment of expiring tax and spending provisions is deeply unfair and fundamentally wrong. The error is made plain under the present circumstances by the need to extend the AMT patch. The AMT patch is shown as a tax cut only because the Congressional Budget Office revenue baseline fails to extend the patch as policy into future years. This leads some Members to the mistaken view that fiscal discipline requires that an extension of the AMT patch be paid for with other tax increases. Consequently, some Members find themselves making the curious argument that in order to prevent a tax hike they must raise taxes.

   The correct treatment would be to carry expiring tax provisions in the revenue baseline by extending current policy, paralleling the extension of current spending policy in the spending baseline. Further, this simple correction requires only an expression of the Senate and House that the Congressional Budget Office should alter its procedures accordingly.

3. One of the key preliminary questions regarding tax reform is whether it should be done on a revenue neutral basis. Revenue neutrality is usually determined from current law.

   The revenue baseline from current law includes a large spike in revenue from the expiration of the tax relief in the bipartisan 2001 and 2003 tax relief plans. You can see the spike from projected revenue data. CBO, for instance, shows individual income tax revenue shooting up by 10% and trending upward. You can see the spike by taking a quick look at how widespread the 2001 and 2003 tax relief plans are. Virtually, every American income taxpayer would face a significant tax increase.

So, if we were to undertake individual income tax reform with the assumption that the reform plan would have to be revenue neutral, it would mean a tax increase of at least 10% on individual income taxpayers in 2011. You were involved in developing the tax relief policy inside the Administration. I'm pretty certain that you would agree that the revenue neutrality test ought to be employed assuming the bipartisan 2001 and 2003 tax relief plans were permanent. Would you care to comment on why revenue neutrality ought to be applied assuming current law levels of taxation are in effect after 2011?

Response: Revenue neutrality is a useful device, especially for theoretical consideration of tax reform options, because it enforces a discipline of making choices between alternatives. In practice, however, pro-growth tax reform can be pursued either through an assumption of revenue neutrality or preferably by assuming some level of tax relief.

In either event, revenue neutrality is inherently dependent on the baseline from which changes are measured. As of 2011, the tax relief enacted in 2001 and 2003 will have been the law of the land for between 8 and ten years. It reflects the level of tax collections the economy and taxpayers expect and to which they are accustomed. Revenue neutrality should, therefore, reflect the extension of current policy, that is the policy as of 2010, rather than reflecting current law which would imply an enormous tax hike.

Senator Hatch

1. In citing the need for tax reform, two of you, Drs. Burman and Gale, indicated that one major factor is the need for more revenue because of the projected increases in entitlement program spending over the next decades. This question is for each of our witnesses. Should our goal be to make sure revenues match projected spending over the coming years, or should we focus on finding the optimum level of revenue that will keep our economy strong, growing and producing jobs, and then attempt to match our spending to that level of revenue?

   Response: Policymakers should focus on finding the lowest level of taxation possible, and the simplest, most pro-growth tax structure possible consistent with that level of collections. Finding the lowest level of taxation possible, in turn, depends on maintaining firm control of federal spending. The projected funding shortfalls in Medicare and Social Security result entirely because promises made to past, current, and future retirees far outstrip the resources available under current law. The trouble arises not because of a dearth of revenues flowing into these programs, which in fact are projected to increase steadily in nominal terms and as a percent of Gross Domestic Product. The problem arises because rates of growth in spending are unsustainable. The problem is surging spending; the solution should be found by restraining spending.

Raising taxes to restore entitlement programs to sustainability is not necessary, nor would it be sufficient unless tax burdens were to rise to levels that would severely injure the economy as recent correspondence between the Congressional Budget Office and Congressman Paul Ryan makes abundantly clear.

2. As you all know, a big reason our tax code is so complex is that Congress has tried to accomplish many social and economic goals through its provisions. One more question for each of you. As we look to reforming the tax code, should we ideally focus exclusively on raising revenue and not try to meet other goals, no matter how worthy they might seem?

   Response: Many of the tax provisions that render the tax code complicated reflect policies to achieve economic and social engineering priorities. Individually, these provisions may appear justifiable in some respect and by themselves cause little harm in terms of complexity though they often significantly distort economic decision making and thus sap economic vitality. Over time, however, the steady accretion of such provisions renders the complexity of the whole far greater than that of the sum of the individual parts. The solution is precisely to eschew insofar as possible the use of the tax code for purposes other than raising revenue in the least distortionary manner possible.

3. Dr. Foster, I appreciate your emphasis on the need to recognize the investment in human capital that comes with education. Are you suggesting simply that we rationalize and simplify the Code in the area of education incentives, or do something more?

   Response: The first step is to rationalize and simplify the tax Code in this area by consolidating the various existing provisions into a single, simple element, either an above-the-line deduction or a tax credit. The complexity in this area is daunting and highly counterproductive to individuals who might otherwise recognize and respond to the incentives by pursuing additional educational opportunities.

   The goal, however, is not primarily to simplify the tax code. Nor is it to encourage the individual pursuit of education and skills. If that were the goal, then policymakers might be tempted to use the tax code as a means of providing education subsidies through the tax code rather than through the more appropriate approach embodied in spending programs such as Pell grants.

   The point of the matter is to enact a neutral tax policy with respect to human capital formation just as we seek a neutral tax policy toward physical capital formation. In all likelihood, this would require significantly expanding the now-simplified tax relief provision with respect to education.

Senator Smith

1. Some tax reform proposals, such as the 2005 report from the President's Advisory Panel on Tax Reform, have recommended that various defined contribution plans be streamlined into one plan. But some of these proposals have made no specific mention of, or provision for, employee stock ownership plans (ESOPs). ESOPs are among the most effective retirement savings plans available to American workers. Indeed, in 1996 and 1997, Congress enacted legislation to allow ESOPs to own Subchapter S businesses. This has led to significant retirement savings for many workers – now employee-owners – in these companies, including in my own home state. Would you share with me your views about how – as tax reform moves forward – we can preserve and promote private ESOP-owned companies, and how we avoid making changes to tax laws that would inadvertently burden these structures?

   Response: ESOPs are a useful device for transferring ownership of small and medium-sized businesses, and can also be beneficial component of an individual's retirement savings plan. I know of no reason why ESOPs should be disadvantaged relative to defined-contribution options even after the kinds of reforms suggested by the President's panel.

2. About three-quarters of small businesses are organized as pass through businesses, so they are paying their business tax at the individual level. What impact do you think raising the individual tax rate would have on small businesses?

   a. Small businesses have been a large job creator over the past decade. Would higher individual tax rates potentially have a negative impact on this job creation?

   b. What impact would higher individual rates have on the entrepreneurs who are thinking about starting a small business?

   Response: Profits and other tax attributes of small businesses typically pass through to the individual tax return of their owners and so these businesses are subject to individual income tax rates. A second aspect of small businesses is they typically rely on internal cash flow for much, most, and often all their capital needs.

   Raising individual income tax rates would therefore discourage small business growth, and it would constrain small business growth by depriving the business of cash flow needed to maintain or expand operations. The initial net effect would be a material diminution in the rate of job growth and the longer-term effect would be a material diminution in the rate of growth of real wages and benefits.

Individual Taxpayers and Federal Tax Reform

William G. Gale[1]
The Brookings Institution

Testimony before the United States Senate Committee on Finance
May 13, 2008

Chairman Baucus, Ranking Member Grassley, and other members of the Committee:

Thank you for inviting me to testify at this hearing on individual taxpayers and tax reform. The tax system needs to be simpler, more equitable, more conducive to prosperity, and sustainable. My remarks focus on some overarching principles that should guide reform efforts.

- **There is no clean line between individual taxes and business taxes.** In particular, individuals—not businesses—bear the burden of taxes imposed on businesses.

- **The key item in any tax reform is to broaden the tax base.** The goal should be to tax all income once, tax it only once, at the full, income tax rate. Broadening the base

  —taxes different types of activities at the same rate, and thus "levels the playing field," and reduces the extent to which taxes distort economic behavior;

  —allows for lower rates in order to raise a given level of revenue, or allows an increase in the revenue level, if needed; lower overall rates, in turn, further reduce the extent to which taxes distort economic behavior; and

  —makes taxes simpler.

- **After base broadening, special attention should be given to the form of any surviving tax preferences.** Deductions are regressive and are only justified if there is a true reduction in ability to pay, a condition that is rarely met among existing tax preferences. Converting the deductions to flat, refundable credits would in most cases be preferable on revenue, distributional, incentive, and efficiency grounds.

[1] Vice President and Director, Economic Studies Program; the Arjay and Frances Fearing Miller Chair; Codirector, Urban-Brookings Tax Policy Center.

- **It is time to eliminate the AMT, but only if the revenue is replaced and the loopholes that would be created are closed.**

- **A revenue system that is not adequate to finance government spending will be unstable and unsustainable.**

- **The importance of simplifying the system can not be overstated.** Taxpayers are overwhelmed by complexity, real and imagined, in the tax code. Oddly, although the need to simplify the tax system is the one goal everyone accepts in tax discussions, every year the system becomes more complex. If simplification is not the primary goal of reform, tax changes will likely make the tax system more complicated.

The remainder of my testimony elaborates on these comments.

Background

In the next few years, several factors will push tax issues to the forefront of policy discussions. First, under current law, almost all of the Bush Administration's tax cuts will expire at the end of 2010. The loss in revenues from making the tax cuts permanent would be enormous—equal to several times the resources needed to repair Social Security—and economic growth is unlikely to come anywhere close to covering that loss. As a result, the required spending reductions would be enormous, too. For example, if certain key programs—Social Security, Medicare, Medicaid, defense, homeland security, and net interest—were off-limits (since the first three need to be cut even in the absence of tax changes, and defense and homeland security are currently stressed), all other federal spending would have to be cut by *about half.*

A second factor is the rapid growth in the alternative minimum tax (AMT), which will increase the inequity and complexity of the tax system. Tax filers pay the AMT when their AMT liability exceeds their regular income tax liability. Designed in the late 1960s and strengthened in 1986, the AMT operates parallel to the regular tax system and was originally intended to capture tax on excessive sheltering activity. The tax has evolved, however, so that it does not tax many shelters and it does tax a variety of items—like having children, being married, or paying state taxes—that most people do not consider shelters. Moreover, the number of taxpayers facing the AMT is slated to grow exponentially, from about 3 million today to 30 million by 2010, because, the AMT is not indexed for inflation and because some temporary AMT tax cuts are about to expire.

A third issue—which may not require immediate action, but should nevertheless help frame the current debate—is the expected increase in government spending over the next several decades. Since 1950, tax revenues have hovered between 16 and 20 percent of GDP. Under current projections, however, government spending is projected to rise to about 27 percent of GDP by 2030. This increase is fueled mainly by increased entitlement spending for Social Security and especially Medicare and Medicaid. Unless elected officials are willing to suggest truly massive cuts in such programs, they will have to come to terms with the need for an increase in revenues to above 20 percent of GDP.

Despite these pressures on the system, tax changes are not inevitable, and achieving meaningful reform—that is, with substantial design improvements—will require strong political leadership.

Why Junking the Income Tax Isn't the Answer

Discarding the nation's existing Byzantine tax system and instituting "simple" flat-rate taxes have visceral appeal, and some candidates have endorsed reform proposals using this approach. However, when real-world implementation issues are considered, each of these proposals has significant drawbacks. The three primary flat-rate reforms are:

- a national retail sales tax (NRST), under which a single tax rate would apply to all sales by businesses to households. Sales between businesses and between households would be untaxed.

- a value-added tax (VAT), requiring each business to pay tax on the sum of its total sales to consumers and to other businesses, less its purchases from other businesses, including investments. Thus, the increment in value of a product at each stage of production would be subject to tax. Cumulated over all stages of production, the tax base just equals the value of final sales by businesses to consumers—in theory, the same as in an NRST.

- the flat tax, originally developed by Hoover Institution scholars Robert Hall and Alvin Rabushka, is simply a two-part VAT: the business tax base would be exactly like the VAT except that businesses would also be allowed deductions for wage payments and pension contributions. Individuals would pay tax on wages and pension income that exceeded personal and dependent exemptions. Businesses and individuals would be taxed at a single flat rate.

These three models are all flat-rate, broad-based consumption taxes. Some people would like to use such taxes to *replace* our current graduated-rate, narrowly-based income tax. Advocates claim that such fundamental reforms could boost economic growth significantly, slash tax burdens, simplify compliance, and eliminate the IRS. Unfortunately, a more realistic assessment is less optimistic.

In order to replace almost all existing federal taxes and maintain government programs, a national retail sales tax would require mark-ups at the cash register of *more than 40 percent*, not the 23 percent rate advertised by plan supporters.[2] This assumes there is little or no legal avoidance or illegal evasion of taxes. Experience in other

[2] Gale 2005, President's Advisory Panel on Tax Reform 2005.

countries, however, shows that a national retail sales tax would have difficulty controlling tax evasion if rates went much above 10 percent. Higher evasion, in turn, would require even higher tax rates to raise the necessary revenue.

The pure flat tax could theoretically replace the existing income and corporate tax with a rate of about 21 percent (and all federal taxes with a rate of about 32 percent) but could result in significant dislocation in the economy and declines in charitable contributions, real housing prices, and the number of households with health insurance. Businesses would find their tax liability varied dramatically from the current system and would no longer be based on profits. For example, Hall and Rabushka show that under their flat tax, General Motors' tax liability would have risen by a factor of 25, from $110 million to $2.7 billion, in 1993. In contrast, Intel's would have fallen by three quarters. More realistic versions of the flat tax—which would smooth out these problems by allowing transition relief; individual deductions for mortgage interest, charity, and state taxes; and business deductions for health insurance and taxes—would require flat tax rates of 30 percent or higher just to replace individual and corporate income taxes.. In addition, under the flat tax, which has never been tried as a stand-alone system anywhere in the world, it appears that firms could re-label cash flows and shelter significant amounts of income, which would require even higher tax rates..

Junking the current system and moving to a NRST, VAT or flat tax would provide massive tax cuts for the wealthiest households and increase the tax burden on low- and middle-income households. (The so called "X-tax" is a variant of the flat tax that would introduce graduated taxation of earned income. The X-tax would be more progressive than the flat tax and would reduce, but not eliminate, the distributional disparities.)

Many of the problems and tradeoffs created by these types of tax reform could be mitigated if they boosted economic growth dramatically. In their pure forms, the NRST and flat tax could have positive effects on economic growth, but when the taxes are subjected to the realistic considerations noted above, studies indicate that they would likely generate little if any net growth in the economy and actually could retard it.

Five Essential Reforms

The next Congress and Administration can propose a number of reforms that would make taxes significantly simpler, fairer, more conducive to economic prosperity, and responsive to likely government spending increases.

Tax all capital income once and only once at the full income tax rate

The taxation of capital income—the return from saving—in the current system is, in plain terms, a mess. A family's saving is the difference between its income and what it spends on consumption. Thus, the difference between an income tax and a consumption tax hinges on the treatment of saving. The current tax system's treatment of saving has features of both types of tax. In some cases—notably the treatment of 401(k) plan investments—the system operates like a consumption tax; in others, it operates like an income tax—for example, the interest income on a saving account is subject to tax every year. Unfortunately, by combining features of an income and a consumption tax, the system creates the opportunity to shelter income.[3]

Now consider the complexities of corporate taxation. The issue of "double taxation" of corporate income has received some public attention. This occurs when earnings are taxed at the corporate level and then paid to individuals as dividends, where they are taxed again. But today, no corporate income is fully double-taxed, since dividends are now taxed at only 15 percent. Corporate income can avoid taxes at the corporate level through shelters and at the individual level to the extent that the income accrues to nonprofits and pensions. As a result, only about a quarter of corporate income appears to be taxed at both the individual and corporate levels, whereas about one-quarter of corporate income is taxed at the individual level, but not the corporate level; one-quarter is taxed at the corporate level, but not the individual level; and one quarter appears never to be taxed at all.

The bottom line is that capital income is taxed at greatly different rates depending on the organizational form, the type of activity where the investment is deployed, the type of asset, the type of financing, and so on. This is inequitable, inefficient, and complicated. As a result of taxpayers' ability to use these conflicting rules to their advantage, some analysts conclude that the country collects little if any net revenue from capital income taxes. *The solution is to tax all capital income once and only once at the full income tax rate.* Reforming this part of the system would require policymakers to address several issues *simultaneously*.

- First, the integration of corporate and individual capital taxation should occur only for income stemming from *new* corporate investment. There is no reason to give tax breaks on the income stemming from old investments; those tax breaks would be windfall gains.

- Second, individual-level taxation of corporate dividends and capital gains (on new investments) should be removed only if the full tax has been paid on the income at the corporate level. To the extent that corporate taxes were not paid, then corporate dividends and capital gains should be taxed at the *full* individual rate (not capped at 15 percent).

- Third, efforts to shut down corporate tax sheltering need to be beefed up substantially. This could include both increased enforcement as well as altered accounting

[3] For example, if families borrow money by taking out a second mortgage, the interest payment is tax-deductible. But if they use the money to invest in a 401(k) plan, the tax on the interest is deferred until the withdrawal occurs. As a result, the effective tax rate on the investment is negative—investors can make money without risking any of their own capital simply by taking out a tax-deductible loan and investing in a tax-deferred asset.

procedures that require more conformity between income reported to shareholders (book income) and income reported to the IRS (taxable income).

- Fourth, a wholesale attack on corporate subsidies—for example, in agriculture, mining, oil, timber and so on -- would be a final, key element in this package.

If a new Administration successfully promoted this entire package of changes, it can expect to increase net federal revenues from corporate and capital income.

Tax labor income once and only once at the full income tax rate

Although much of the attention in tax policy debates is devoted to capital income taxes, wages and salaries represent the largest share of income for most people. Labor earnings are taxed under two separate systems: the personal income tax and the payroll tax. The liability for payroll taxes is, in legal terms, split equally between the employer and the employee. In practice, though, workers bear all or almost all of the burden of such taxes through reduced take-home wages. Payroll taxes are levied for Social Security contributions (12.4 percent of wages up to $94,200) and Medicare contributions (2.9 percent of wages without limit). Thus, net burdens are about 15 percent of wages up to the Social Security earnings limit and 3 percent on additional earnings. For about 70 percent of all households, and virtually all filers in the bottom 40 percent of the income distribution, these payroll tax burdens exceed income tax payments.

The payroll tax and the income tax could be integrated by providing a refundable income tax credit or abolishing the payroll tax on the first $5,000 of earnings or on all earnings, with the revenue loss made up by an across-the-board increase in income tax rates. Alternatively, the earnings ceiling on Social Security taxes could be raised or eliminated, or a tax on earnings above the Social Security earnings cap could be created, in which case an across-the-board reduction in the income tax rate could occur. Any of these changes would make the tax system more progressive and reduce the burden on low-income earners.

Rationalize the structure of deductions, exclusions and credits

The tax system subsidizes literally scores of economic activities through a variety of mechanisms. Exclusions, exemptions, and deductions reduce taxable income on a dollar-for-dollar basis. As a result, a $1 deduction is worth more to a high-income household with a high income tax rate than it is to a low-income household with a low or zero income tax rate. By contrast, credits reduce tax liability directly, so that a $1 credit reduces each household's tax liability by a dollar. For very low-income households, credits that are "refundable" can generate a negative tax liability and be paid back in cash, whereas "nonrefundable" credits merely reduce tax liability to zero. Clearly, nonrefundable credits are useless for households that do not have tax liability to begin with. On simplicity, equity, and possibly efficiency grounds, credits that are aimed at meeting social policy objectives should be made refundable, so that they provide benefits to the households who need the funds most.

Expenses that truly reduce taxpayers' ability to pay taxes should be deductible in full, but very few of the currently allowable "itemized deductions" completely meet that standard. Although they are immensely popular and subsidize activities thought of as "good," for the most part they subsidize activity that would have occurred anyway, as well as create numerous problems. They complicate tax filing and enforcement. They erode the tax base and are regressive, giving bigger benefits to high-income filers.

Finally, they hide subsidies that would be obvious if they were spending programs. Imagine that instead of a mortgage interest deduction, we had a program called "homeowner welfare," in which taxpayers earned a "welfare entitlement" equal to their annual mortgage interest payment times their tax rate. Anyone whose entitlement was below a certain threshold, say $6,000, would receive nothing. Anyone whose entitlement exceeded the threshold would receive the entitlement in cash. Such a program is not dissimilar to the way the mortgage interest deduction actually works.

The best solution would address each of the current deduction categories directly. *Charitable contributions* should be fully deductible; this preserves the largest incentive for giving for the highest-income households and it ensures that those who give away all of their income would not owe tax. The *mortgage interest* deduction should be converted to a refundable first-time home buyers' tax credit. This would generate revenue, would improve homeownership rates, and eliminate incentives to buy ever-bigger houses with ever-bigger mortgages. Deductions for *state and local taxes* could be eliminated as part of alternative minimum tax (AMT) reform; if the AMT is allowed to grow as under current law, very few taxpayers will have access to the state and local deduction anyway. Tax subsidies for *health insurance* should be handled in the context of a broader health care reform effort, but there is no question that they need to be restricted. Under the current system, where health insurance payments are tax-deductible, consumers do not face the full price of the health care benefits they demand.

Simplify Taxes and Improve Administration

Although Presidential candidates consistently say they would support a simpler tax system, every year taxes seem to become more complex. Some of the complexity is the by-product of using the tax system to achieve other policy goals, such as greater equity, but much complexity could be eliminated without any serious dent in other objectives. As a prime example, return-free filing could be achieved for as many as 50 million taxpayers with relatively minor changes in the tax code. Return-free filing already exists in dozens of countries around the world and would eliminate the hassles of filing and compliance for the households least able to cope with them.

The number of households that could avoid filing would be further increased and other simplifications would occur if the personal exemption, the child credit, and the earned income credit were consolidated and if the standard deduction were increased. Increasing the standard deduction by the value of a personal exemption and reducing the number of personal exemptions by one would be revenue-neutral, and would greatly reduce the number of people who must itemize. Similarly, education subsidies and retirement saving programs could be consolidated and streamlined.

The alternative minimum tax should be abolished, if—and these are some big ifs—the anti-tax-sheltering provisions of the AMT are brought into the income tax rules, dividends and capital gains are taxed as described above, and the revenue from AMT repeal is made up by adjusting income tax rates upward. Alternatively, the AMT could be retained, but reformed in a revenue-neutral manner that would (1) raise the AMT exemption substantially, in order to remove the middle class from the tax, and (2) tax dividend and capital gains at regular tax rates, so as to restore the AMT's goal of closing shelters.

An intelligent tax reform also would equip the Internal Revenue Service with the resources it needs to enforce and administer the system. Many taxpayers simply do not pay taxes they actually owe. Providing the IRS with additional resources for enforcement generally would boost revenues and produce a fairer distribution of the tax burden.

Pay for Long-Term Government Spending

Given the increased government spending trends noted earlier, presidential candidates must give serious thought to the best ways to raise *additional* revenues over the next decade. Extracting another 5 to 10 percent of GDP in revenues out of the current individual and corporate income tax system—with its narrow base and ubiquitous deductions—would be extremely difficult, because the increases in tax rates that would be required would generate significant avoidance and evasion activities.

The need for higher revenue makes it even more important to reform the current system to keep tax rates as low as possible and the tax base as broad as possible. This would increase the chances of raising significant new revenue from the individual and corporate income tax systems or payroll taxes if tax rates were increased in the future.

Alternatively, new revenue sources could be explored. The best bet here—and one where there is very strong evidence that it can be administered—is a VAT—as a complement to the current system, not a replacement.[4] A 10 percent VAT could raise an additional 4 to 5 percent of GDP in revenue if the tax base were kept fairly broad. The great advantage of a VAT over a national retail sales tax is that the VAT is a proven collection system in force in more than one hundred countries around the world. Exporters could follow established procedures for getting rebates at the border.

[4] Yale University Law Professor Michael Graetz (2004) also has proposed a VAT, but he would use the revenues gained to cut the income tax substantially—raising the exemption to about $100,000 and taxing income above that level at a flat 25 percent—and to cut the corporate tax rate in half. A significant concern with this proposal is that it leaves the government with virtually no options for funding what is likely to be a significant increase in future government spending.

"Green" taxes—levies on pollution or resource extraction—also could be considered. Besides raising revenues, these taxes can contribute to a cleaner, healthier environment by providing price signals to those who pollute. They have foreign policy benefits as well, as they plausibly reduce U.S. demand for oil and dependence on oil-producing nations.

Concluding Observations

Nobody likes to pay taxes. But the U.S. tax system does not have to be as complex and unfair as it currently is. Candidates should consider that the reforms proposed above would not only simplify the system from the taxpayer's point of view, they would make taxes more equitable and, importantly, they would provide the long-term financial resources for the government spending that the public demands.

Bibliography

Aaron, Henry J. and William G. Gale. 1996. "Introduction." In Henry J. Aaron and William G. Gale, eds. *Economic Effects of Fundamental Tax Reform*. (Washington, DC: The Brookings Institution), pp. 1-28.

Altig, David, Alan J. Auerbach, Laurence J. Kotlikoff, et al. 2001. "Simulating Fundamental Tax Reform in the United States." *The American Economic Review. 91*: 574-595.

Bakija, Jon and Joel Slemrod. 2004. *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform.* 3rd Ed. (Cambridge, MA: The MIT Press).

Batchelder, Lily L., Fred T. Goldberg Jr., and Peter R. Orszag. 2006. "Reforming Tax Incentives Into Uniform Refundable Tax Credits." *Brookings Institution Policy Brief 156.* August.

Burman, Leonard E., William G. Gale, and Jeffrey Rohaly. 2003. "The Expanding Role of the Alternative Minimum Tax." *Journal of Economic Perspectives. 17*:173-186.

Gale, William G. 2005. "The National Retail Sales Tax: What Would the Rate Have To Be?" Tax Notes. 107:7. May 16. 889-911.

Goolsbee Austan. 2006. "The 'Simple Return': Reducing America's Tax Burden Through Return-Free Filing." The Hamilton Project Discussion Paper 2006-04. July.

Graetz, Michael J. 2004. "100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System." Yale Law Journal 112: 263-313.

Hall, Robert E. and Alvin Rabushka. 1995. The Flat Tax. Stanford: Hoover Institution Press.

Hanson, Craig and David Sandalow. 2006. "Greening the Tax Code." World Resources Institute Policy Brief. Issue 1. April.

President's Advisory Panel on Federal Tax Reform. 2005. "Final Report." http://www.taxreformpanel.gov/final-report/

Rivlin, Alice M. and Isabel Sawhill. 2005. Restoring Fiscal Sanity 2005: Meeting the Long Run Challenge. Washington: Brookings Institution Press.

United States Senate Committee on Finance Hearing
Tax: Cracking the Code – Tax Reform for Individuals
May 13, 2008

Questions Submitted for the Record

Questions for Dr. William Gale:

Senator Baucus

1. Should simplification be the goal of individual tax reform? If so, what's the best way to simplify the system?

Simplification should be a primary goal of tax reform. Although policymakers consistently say they would support a simpler tax system, every year taxes seem to become more complex. Some of the complexity is the by-product of using the tax system to achieve other policy goals, such as greater equity, but much complexity could be eliminated without any serious dent in other objectives.

The best way to simplify taxes is to tax all forms of income under the same rate structure and to broaden the tax base. Taxing all income under the same structure would involve removing preferences for certain types of income, such as capital gains or qualifying dividends. Broadening the tax base would involve eliminating the plethora of exemptions, deductions, and credits that serve to complicate the tax code without providing substantial benefit in return.

Another way to simplify the tax system is to make filing less complicated. One example of such a reform is to allow for return-free filing, which would make tax filing easier for millions of Americans with relatively simple taxes. Return-free filing, though, would be most effective if implemented concurrently with other reforms that simplify the tax code.

2. How can the tax system be made fairer?

Fairness in the tax system is in the eye of the beholder. Broadly, there are three different elements of fairness. The first element – horizontal fairness – concerns how taxpayers with similar incomes, but different sources of income, are taxed. The second element – vertical fairness – concerns how the tax burden changes with income; that is, the tax burden of low-income taxpayers relative to wealthy taxpayers. The third element – generational fairness – concerns the relationship between the tax burden today compared to the tax burden borne by future generations.

Horizontal fairness can be achieved by taxing different forms of income at the same rate, and by limiting the extent to which taxpayers may take advantage of special deductions and exemptions. Vertical fairness can be achieved by structuring the tax system in a way that ensures that wealthy taxpayers pay their fair share and aren't provided opportunities to reduce their taxable income and/or benefit from low tax rates on certain types of income. Generational fairness can be achieved by raising sufficient revenue in the current tax year to pay for existing government services. Failing to raise sufficient revenue will result in the transfer of the tax burden to future generations.

3. How can the system be made more efficient?

An efficient tax system would limit the extent to which taxpayer decisions are distorted by the tax system. The current system includes a wide array of provisions that create incentives for such distortions; eliminating these provisions would make the tax system more efficient.

One key to increased efficiency is to tax all forms of income under the same rate structure. Another key is to broaden the tax base by eliminating many of the tax preferences that exist under the current tax code. A broad-based reform that equalized tax rates across income sources and broadened the base would allow Congress to concurrently lower overall tax rates while raising the same amount of revenue. Lower tax rates would lead to less distortions in taxpayer behavior and, subsequently, higher efficiency.

4. What are some of the negatives of doing what you suggest to meet the goals of simplification, fairness, and efficiency?

To the extent that there is any negative effect from changing the tax code, it would arise from the effects of equalizing tax provisions. For example, changing the mortgage interest deduction to a refundable tax credit for first-time homebuyers would reduce incentives for individuals to purchase larger and larger houses, which might negatively affect the value of the most expensive homes. Whether or not this represents a "negative" change would depend on an individual's perception of fairness.

Political constraints could also be considered a negative aspect to making the tax code fairer, more efficient, and simpler. Taxpayers have become accustomed to certain tax breaks, such as the mortgage interest deduction and deductible health insurance premiums. Changing these tax preferences could prove to be difficult politically.

5. What type of transition would be required to implement this system?

Little transition would be needed to institute these reforms, since the fundamental structure of the tax code would remain the same. Transition could be handled mainly through slow phase-in of new provisions. Other proposals for fundamental changes in the tax system, such as a flat tax, would incorporate significant transition costs; these costs are often overlooked in the evaluation of tax policy proposals.

6. How would your proposal effect small businesses? Would there be an increased burden?

These reforms, particularly the elimination of the preferential treatment of qualified dividends, would be beneficial for small businesses. Lower tax rates on dividends are harmful to small business for two reasons. First, the lower tax rate on corporate dividends makes investing in large companies more attractive relative to smaller ones that don't offer dividends, effectively drawing capital away from small businesses. Second, the lower tax rate on dividends makes investing in corporate stocks more attractive relative to bonds, requiring bonds to offer higher interest rates in order to compete with corporate stocks. The higher interest rates make borrowing more expensive for small businesses.

7. What would be the IRS's role? What are some administrative issues with adopting your proposal?

The IRS's role would remain the same. However, simplification of the tax code would make the IRS's job of administering the tax code easier, and might reduce the resources necessary for the agency to administer the tax code.

8. Is repeal of the AMT a viable option? If so, how can Congress get this done?

AMT repeal is a viable (but expensive) option if made in the context of broad tax reform that includes provisions to replace the revenue lost from its repeal. Replacing this lost revenue is a critical aspect to AMT reform: the nation is on the verge of a fiscal crisis as baby boomers start retiring and the cost of entitlement programs for the elderly balloons. Outright repeal of the AMT without offsetting measures would reduce revenue by more than $800 billion through fiscal year 2017 – even assuming that the 2001–2006 tax cuts expire as scheduled after 2010. If the cuts are extended, the Tax Policy Center has calculated that the 11-year revenue loss would nearly double.

Repeal of the AMT would not only be expensive, but would also be regressive. After-tax incomes of families with incomes between $200,000 and $500,000 would rise by 2.7 percent, or nearly $6,000 on average. Meanwhile, taxpayers in the middle-fifth of the income distribution ($35,000–55,000) would see their after-tax incomes rise by an average of only $5.

There are a variety of more realistic standalone options to finance AMT repeal that would be significant improvements over current law. One attractive approach would be to combine repeal with an extra 4 percent tax on gross incomes (before most deductions and exemptions) above $200,000 for married couples or $100,000 for individuals. This combination would sharply reduce the number of high-income tax filers who pay no federal income tax. And it would be revenue neutral over the next decade.

Alternatively, repeal could be financed by broadening the base of the regular income tax. Take the idea of eliminating the deduction for state and local taxes. This deduction is an inefficient way to help states make their own levies more palatable; it primarily benefits high-income earners, since lower-income filers usually do not itemize. Even when they do, the deduction is worth little to them because they are in low tax brackets. Assuming that the 2001–2006 tax cuts are allowed to expire as scheduled, repealing the state and local tax deduction would raise more than enough revenue to finance AMT repeal and even give Congress wiggle room to cut income tax rates a bit. The net effect of repealing the AMT, ending the deduction for state and local tax, and lowering tax rates would rearrange tax burdens very little among income groups. This follows from the fact that, although AMT repeal would be regressive, repeal of the state and local income tax deduction would be progressive. Loss of state and local tax deductions is the main reason taxpayers now face the AMT. This option would also increase incentives to work, save and invest. Roughly two-thirds of households would end up in lower brackets on ordinary income, while almost 14 percent would pay lower rates on capital gains.

Yet another approach would be to offset repeal of the AMT with a hike in regular tax rates for top income earners. For example, to pay for repeal, the 28 percent, 33 percent and 35 percent brackets could be increased by 15 percent, resulting in marginal rates of 32.3, 38.0, and 40.3 percent through 2010 (when the Bush tax cuts expire). Only the top 1 percent of households would face an average tax rate increase, amounting to about 2 percent of after-tax income.

Finally, AMT repeal could be used as an opportunity to rein in tax preferences (also known as shelters) in the regular income tax code. For example, rolling back the 2003 tax cuts on dividends and capital gains would reduce the incentive to convert ordinary income into these tax-preferred forms. It would also raise some revenue to allow for a smaller increase in ordinary income tax rates. The top three income tax rates would need to increase by 12 percent under this option.

9. If repeal is not viable, what can be done to stop this tax from applying to middle income taxpayers?

Rather than outright repeal, the AMT could be reformed in ways that shielded middle-income taxpayers from its effects. The simplest way would be to make the temporary exemption increase permanent and index the AMT for inflation. If indexation were applied to rate brackets and the phase-out as well as the exemption, only about 4 million taxpayers would be subject to the AMT in 2009– down from 30 million under current law. And the number of AMT payers with incomes less than $100,000 would fall by more than 98 percent.

A more comprehensive reform would also eliminate the middle-class preference items from the AMT – dependent exemptions, state and local tax deductions, deductions for miscellaneous expenses and medical expenses, and the standard deduction. This would reduce the number of AMT taxpayers to fewer than 500,000 in 2009 and would spare virtually all taxpayers with incomes below $200,000. However, these reforms would, of course, substantially reduce federal tax revenues. Indexing the AMT for inflation would probably reduce revenues by about $700 billion from 2009 to 2018, assuming the 2001–2006 tax cuts expire as scheduled. The comprehensive reform package would reduce revenue by almost as much as full repeal.

To offset the revenue loss from extending the higher exemption and indexing the AMT for inflation, the top three regular income tax rates could be increased by 12 percent. Under this option, the top rate would increase from 35 to 39.1 percent through 2010 and from 39.6 to 44.3 percent for 2011 and thereafter. The number of AMT taxpayers would fall to 3.3 million in 2010; only 100,000 of them would have incomes below $100,000. Only the highest-income taxpayers would pay significantly more tax. By 2011, the top 1 percent would pay additional tax equal to about 3 percent of income.

If the preferential rates on capital gains and dividends were disallowed for AMT purposes, the required increase in the top three regular income tax rates would be only 2 percent. The top rate, for example, would need to rise from 35 to 36 percent through 2010 and from 39.6 to 40.7 percent thereafter. This option would reduce the number of AMT taxpayers by more than 80 percent in 2010, to 5.5 million. The top 1 percent would see an average tax increase of about 4 percent of after tax income in the initial years of the reform, although the size of that tax increase would decline over time. Taxing capital gains in full under the AMT would also serve as a brake on tax shelters – most of which are now designed to convert highly taxed ordinary income into lightly taxed capital gains.

Since broad reform of the AMT, involving indexing and eliminating middle-class preference items, would costs substantially more, financing it would require larger increases in tax rates. For example, the increase required in the top three regular rates would be 14 percent, resulting in a top rate of 39.9 percent through 2010 and 45.2 percent thereafter. This option reduces the number of AMT taxpayers to only 500,000 in 2010, including fewer than 100,000 with incomes of less than $200,000. The average tax increase is about 3 percent of income for those in the top 1 percent after 2010.

10. How do we replace the lost revenue?

As discussed in the answer to the previous two questions, revenue lost from the repeal of the AMT can replaced through a variety of reforms. These reforms include broadening the base of the regular income tax by eliminating the deduction for state and local taxes; increasing the regular tax rates for top income earners, and levying an extra 4 percent tax on gross incomes above $200,000 for married couples or $100,000 for individuals.

11. You also state that we should eliminate loopholes that would be created from getting rid of the AMT. What loopholes are you referring to? How should we go about closing them?

The AMT disallows a variety of tax preferences allowed under the regular tax. Preferences are of two types: exemptions or deferrals. Exemption preferences broaden the AMT tax base and include the disallowance of personal exemptions, the standard deduction, and itemized deductions for miscellaneous expenses and state and local taxes. Deferral provisions change the timing of the recognition of income and deductions, typically to accelerate income and postpone deductions. Thus, they tend to raise the current-year tax base – and hence revenues – but only at the expense of future tax bases and tax collections.

If the AMT were repealed, it would be necessary to address the loopholes opened by the repeal of the deferral preferences. If the AMT did not exist to limit the extent to which taxpayers could take advantage of deferral provisions, wealthy taxpayers would have greater leeway in manipulating the timing of income and deductions, furthering their ability to avoid paying tax.

12. Dr. Gale, you suggest that the income tax system and the payroll tax system should be integrated so that labor income is only taxed once. Please explain this idea in greater detail. What would we have to do to accommodate for the lost revenue?

Labor earnings are taxed under two separate systems: the personal income tax and the payroll tax. The liability for payroll taxes is, in legal terms, split equally between the employer and the employee. In practice, though, workers bear all or almost all of the burden of such taxes through reduced take-home wages. Payroll taxes are levied for Social Security contributions (12.4 percent of wages up to approximately $100,000) and Medicare contributions (2.9 percent of wages without limit). Thus, net burdens are about 15 percent of wages up to the Social Security earnings limit and 3 percent on additional earnings. For the great majority of all households, and virtually all filers in the bottom 40 percent of the income distribution, these payroll tax burdens exceed income tax payments.

The payroll tax and the income tax could be integrated by providing a refundable income tax credit or abolishing the payroll tax on the first $5,000 of earnings or on all earnings, with the revenue loss made up by an across-the-board increase in income tax rates. Alternatively, the earnings ceiling on Social Security taxes could be raised or eliminated, or a tax on earnings above the Social Security earnings cap could be created, in which case an across-the-board reduction in the income tax rate could occur. Any of these changes would make the tax system more progressive and reduce the burden on low-income earners.

13. Dr. Gale, one of your 5 essential reforms is rationalizing the exemptions, deductions, and credits of the current tax system. What questions should Congress asked to determine how to move forward on certain exemptions, deductions, and credits?

For each exemption, deduction, or credit, Congress should first ask: what is the goal of this specific provision? The subsequent question is: is this goal worthy? Once Congress has decided on the purpose of a tax provision and its worthiness, it can decide on the best way to achieve its mission.

For example, consider the mortgage interest deduction. The income tax deduction for mortgage interest payments is possibly the best-known federal housing policy and is deeply ingrained in the economic and social fabric of the country. Evidence suggests, however, that the mortgage interest deduction does little if anything to encourage homeownership. Instead, it serves mainly to raise the price of housing and land and to encourage people who do buy homes to borrow more and to buy larger homes than they otherwise would. Most tax return filers, especially those with low or moderate incomes, do not itemize their deductions and therefore are not in a position to take advantage of the deduction if they were to buy a home. As a result, the deduction not only drains significant revenues from the Treasury every year, it also provides much larger benefits to high-income households than to low- or moderate-income households, and has at best a small effect on homeownership.

Instead, if Congress concludes that the goal of the tax provision is to improve home ownership rates, the mortgage interest deduction should be converted to a refundable first-time home buyers' tax credit. This credit would be fully refundable, making it available to low-income households who couldn't benefit from the mortgage interest deduction. In addition, the credit would be available only to households in which no members have owned a home in the previous three years; such a provision would be essential to accurately targeting new home buyers. This reform would generate revenue, would improve homeownership rates, and eliminate incentives to buy ever-bigger houses with ever-bigger mortgages.

Another example is the deduction for charitable contributions, which is limited to a certain proportion of an individual's income. If the goal of Congress is to maximize the incentives for charitable giving, charitable contributions should be fully deductible; this preserves the largest incentive for giving for the highest-income households and it ensures that those who give away all of their income would not owe tax.

14. Dr. Gale, in your written testimony you state there are ways to simplify the code and increase return-free filing. You state that this can be done without affecting other functions of the code. How could this be done?

Although many other countries have adopted return-free tax systems, most of them have much simpler tax codes than the United States. Implementing a return-free system in which most U.S. taxpayers could participate would likely require changes in the tax code that would bring the U.S. system closer in several important respects to those of other countries that use return-free filing. Common elements of such codes include a "basic" rate for most taxpayers, individuals (as opposed to families) as the unit of taxation, interest and dividend income taxed at one rate and at the source, exemption of some capital gains from taxation, and few deductions, allowances, and credits. But the current system could still accommodate return-free filing for tens of millions of taxpayers with just minor reforms. Most studies place the potential number of taxpayers that could relatively easily be accommodated by the current system as ranging from 10 million to 60 million.

The current system would have to be modified in several ways to eliminate a filing requirement even for most of the 20 million taxpayers with relatively simple returns (those in a low tax bracket with wage income only, no credits other than the earned income tax credit, and no itemization of deductions). The current withholding formulas are not designed to be exact for dependent filers, dual-income couples, or taxpayers with more than one job during the year. If dependent filers and filing units with income from more than one job were still required to file a return, only 8 million taxpayers with wage income could be exempted from filing. Even among these 8 million, changes in personal circumstances during the year could cause withholding errors. Without changes in the law, it may still be possible to fine-tune withholding formulas to meet the needs of most taxpayers, but the additional precision would add significant complexity to the Form W-4 and the computation of withholding allowances.

15. Senator Grassley asked Mr. Entin about bracket creep. What is bracket creep? Does bracket creep exist? If so, was it more of a problem prior to the 2001 and 2003 tax cuts?

Bracket creep occurs when real or nominal income growth pushes taxpayers into higher marginal tax brackets. Bracket creep is generally due to either inflation or real wage growth. Inflation no longer plays a significant role in causing bracket creep as marginal tax rates are indexed to inflation under the current tax code. Similarly, the slow growth rate of real wages in recent years means that few workers are being pushed into higher marginal tax rates due to real income growth.

The 2001 and 2003 tax cuts did not have much of an effect on bracket creep in the regular income tax, but the cuts did make bracket creep worse with respect to the alternative minimum tax (AMT). This is because the AMT exemption is not indexed to inflation (although it has been periodically modified), and AMT reform was not addressed by the earlier cuts. Thus, for certain taxpayers, the effect of the 2001 and 2003 tax cuts was to push them onto the AMT, where their marginal tax rates are higher than under the regular tax. This is particularly relevant with respect to capital gains taxation.

16. What would be the revenue effects of making the 2001 and 2003 tax cuts permanent? What would be the revenue effects of making permanent the lower tax rate for capital gains and dividends?

The Congressional Budget Office estimates the revenue loss due to the 2001 and 2003 tax cuts, given that AMT reform is extended, to be $2.9 trillion over the next decade. The Congressional Budget Office also estimates the revenue loss due to extending the preferential tax rates on dividends and capital gains to be $253.1 billion between 2009 and 2018.

17. What has been the economic result of lowering the tax rate for capital gains and dividends?

In general, broad-based reductions in taxes on capital income can result in a positive boost for economic growth as higher capital taxes act as a disincentive to invest. It's also true, however, that higher government deficits and lower national saving can have adverse economic effects. Moreover, changes in the taxation of particular types of capital income, rather than all capital income, can induce taxpayers to shift funds across assets and to use the targeted subsidies as shelters rather than incentives to invest. When that happens, the Treasury loses revenues, but little if any new investment occurs. Thus, the extent to which the lower tax rate on capital and dividend income affected the economy depends critically on not only the response by investors to the lower rates, but also whether the lower revenue resulting from the tax cut was compensated by higher taxes elsewhere, higher borrowing, or lower federal spending. The evidence does suggest that the tax changes increased dividend payments, at least on a temporary basis and most clearly at firms where the executives held a larger share of the stock (and hence benefitted personally from the dividend payments). The economic gain from higher dividend payments, however, is not clear.

18. Senator Grassley asked Mr. Entin about the gap in scoring between the Department of Treasury and the Joint Committee on Taxation in relation to the scoring for the 2001 and 2003 tax cuts. The estimates differ for the cost of making permanent the lower tax rate for capital gains. What are your thoughts on the issue?

The underlying assumptions for scoring tax policy changes encompass a high degree of variability, particularly with a tax on unpredictable income streams such as capital gains. Given this variability, it seems natural that there would be some discrepancy between two sets of estimates. However, it would be difficult to comment on the specific estimating procedure of either JCT or Treasury without having full and detailed knowledge of their methodology.

19. During the hearing you stated that you favor a progressive tax system. What are some concerns that you have with a proportional tax system?

A proportional tax system that taxes all income at a flat rate will be regressive relative to the current system, and will place an excessive tax burden on lower-income taxpayers. Some proponents of a proportional tax system claim that a large deduction would help to alleviate this concern. However, since flat tax proposals typically lower the marginal tax rate on the highest income tax brackets, these proposals usually amount to dramatic cuts in taxes for the wealthiest taxpayers. This reduced burden on the wealthiest taxpayers is then transferred to taxpayers at lower income levels.

Senator Grassley

1. This question is for the panel. I know that in testimony, concerns have been raised about 'cherry-picking' – that is taking some reforms but not others. But as we all know, sometimes to get reforms we have to go one step at a time.

   So, I would like your comments on that – are there reforms that can be moved independently or separately from other reforms? For example the New Family and Work Credits. And second, if there are reforms that can stand on their own, what would be your recommended priorities for action by this Committee? What should we be looking at first?

It would be possible to take a modular approach to tax reform, and to target specific issue groups for legislation. For example, Congress could target tax policy issues relating to education, retirement saving, etc. However, comprehensive tax reform is superior for two reasons. One, many of the problems in the tax code are best solved concurrently. For example, broadening the income tax base by closing certain loopholes while lowering marginal rates would make AMT reform much easier. Two, Congress is likely to have a limited number of chances to reform the tax code during the next Administration, and each chance for reform should be directed towards a comprehensive solution.

2. All of you agree the alternative minimum tax ("AMT") needs to be repealed or reformed. I don't think you'll find many us behind the dais who will disagree with you. Where the panel differs and where we, on this side, differ with those on the other side, is whether a condition of AMT repeal or reform is replacement of revenue lost.

   According to the CBO in its current budget outlook document, there are expiring spending provisions that will cost $1.3 trillion. The expiring spending provisions, unlike expiring tax provisions, are not included in the CBO baseline and are not subject to pay-go. So, there's a double standard built into the system that favors continued spending and disfavors continuing tax relief.

   I'd ask the panel how folks can hold the view that we must continue an unfair tax, like the AMT, by scoring the AMT patch, which is the will of the Congress, and not account for expiring entitlement spending? Doesn't that strike you, like it does me, as fundamentally unfair?

The process of scoring legislative proposals should be consistent and simple. This does not mean importing bad practices from one side of the ledger to the other; it means creating good scoring practices for both spending and revenue proposals. What's most important in scoring baselines is that the scores enable policymakers to understand the true cost of the legislative proposals. For example, one of the problems with scoring the AMT was that it made the Bush Administration tax cuts seem much less expensive, and deficits much lower, than they would have been given extension of AMT relief. The lower cost of the tax cuts and lower projected deficits were used by Congress and the Administration to justify the 2001 and 2003 tax cuts.

Senator Hatch

1. In citing the need for tax reform, two of you, Drs. Burman and Gale, indicated that one major factor is the need for more revenue because of the projected increases in entitlement program spending over the next decades. This question is

for each of our witnesses. Should our goal be to make sure revenues match projected spending over the coming years, or should we focus on finding the optimum level of revenue that will keep our economy strong, growing and producing jobs, and then attempt to match our spending to that level of revenue?

Ideally, the appropriate level and structure of spending and revenues would be determined simultaneously, accounting for the best interests of the economy. Deciding on the best level of spending or revenue without accounting for the other side of the ledger makes little sense. Determining a revenue level before deciding on the appropriate government services necessary to meet our nation's needs might result either in large cumulative deficits or inadequate provision of government services. In addition to the level of revenues and spending, however, policy makers should pay close attention to the structure of revenues and spending.

2. As you all know, a big reason our tax code is so complex is that Congress has tried to accomplish many social and economic goals through its provisions. One more question for each of you. As we look to reforming the tax code, should we ideally focus exclusively on raising revenue and not try to meet other goals, no matter how worthy they might seem?

Tax reform will be most effective if it's simple and consistent. That is, tax reform should aim to simplify the tax code while minimizing distortions to taxpayer's behavior (such as how much to work and save) and raising sufficient revenue to fund government services. Using tax reform to meet other social goals should not be ruled out, but it will tend to reduce the tax code's ability to efficiently raise revenue.

3. Dr. Gale, you mentioned the idea of return-free filing and how it could be achieved for as many as 50 million taxpayers with relatively minor changes in the Code. Could you elaborate on this idea?

Although many other countries have adopted return-free tax systems, most of them have much simpler tax codes than the United States. Implementing a return-free system in which most U.S. taxpayers could participate would likely require changes in the tax code that would bring the U.S. system closer in several important respects to those of other countries that use return-free filing. Common elements of such codes include a "basic" rate for most taxpayers, individuals (as opposed to families) as the unit of taxation, interest and dividend income taxed at one rate and at the source, exemption of some capital gains from taxation, and few deductions, allowances, and credits. But the current system could still accommodate return-free filing for tens of millions of taxpayers with just minor reforms. Most studies place the potential number of taxpayers that could relatively easily be accommodated by the current system as ranging from 10 million to 60 million.

The current system would have to be modified in several ways to eliminate a filing requirement even for most of the 20 million taxpayers with relatively simple returns (those in a low tax bracket with wage income only, no credits other than the earned income tax credit, and no itemization of deductions). The current withholding formulas are not designed to be exact for dependent filers, dual-income couples, or taxpayers with more than one job during the year. If dependent filers and filing units with income from more than one job were still required to file a return, only 8 million taxpayers with wage income could be exempted from filing. Even among these 8 million, changes in personal circumstances during the year could cause withholding errors. Without changes in the law, it may still be possible to fine-tune withholding formulas to meet the needs of most taxpayers, but the additional precision would add significant complexity to the Form W-4 and the computation of withholding allowances.

Senator Smith

1. Some tax reform proposals, such as the 2005 report from the President's Advisory Panel on Tax Reform, have recommended that various defined contribution plans be streamlined into one plan. But some of these proposals have made no specific mention of, or provision for, employee stock ownership plans (ESOPs). ESOPs are among the most effective retirement savings plans available to American workers. Indeed, in 1996 and 1997, Congress enacted legislation to allow ESOPs to own Subchapter S businesses. This has led to significant retirement savings for many workers – now employee-owners – in these companies, including in my own home state. Would you share with me your views about how – as tax reform moves forward – we can preserve and promote private ESOP-owned companies, and how we avoid making changes to tax laws that would inadvertently burden these structures?

One of the biggest problems with ESOPs is that they, by their nature, are not well-diversified mechanisms for retirement saving. A well-diversified portfolio is a crucial aspect of any employee's retirement saving agenda. There are several changes that can be made to make ESOPs a better mechanism for retirement saving. One, Congress should expand the diversification rights of ESOPs, with less stringent guidelines for the period at which workers are allowed to diversify. Two, Congress can retarget the special ESOP dividend tax deduction, so as to discourage employers from making pension contributions in the form of own-company stock. Such reforms would help to reduce workers' exposure to risk and make ESOPs better ways for workers to save for retirement.

2. About three-quarters of small businesses are organized as pass through businesses, so they are paying their business tax at the individual level. What impact do you think raising the individual tax rate would have on small businesses?

    a. Small businesses have been a large job creator over the past decade. Would higher individual tax rates potentially have a negative impact on this job creation?

b. What impact would higher individual rates have on the entrepreneurs who are thinking about starting a small business?

There are several misconceptions about the relationship between the tax code and small businesses. First, small businesses would benefit from an increase in the tax rate on dividend income, since a lower dividend tax rate makes small businesses a less attractive option relative to larger ones. Second, most small businesses are in lower tax brackets: in recent years, more than two-thirds of all returns with small business income were in the 15 percent or lower tax bracket, and 88 percent faced rates of 25 percent or below. Lastly, tax cuts can hurt small businesses if the net effect of the tax cut is higher government debt, since higher debt can lead to higher interests rates, which makes it more expensive for small businesses to borrow.

That being said, the extent to which higher individual tax rates affect small businesses depends on the level of the taxes, and the degree to which the tax rates are raised. In general, since most small business owners face relatively low marginal rates, incentives to operate will be preserved even if marginal taxes are raised.

Statement of Senator Gordon H. Smith
U.S. Senate Committee on Finance Hearing
"Cracking the Code: Tax Reform for Individuals"
May 13, 2008

Thank you Chairman Baucus and Senator Grassley for holding this very important hearing and beginning the dialogue on how best to reform our tax code.

Our tax code is extremely complex and the great majority of Americans don't understand how all of the rules work. As a result, Americans spend an extraordinary amount of money each year to figure out the maze of the tax rules. These extra fees are the equivalent of a tax for owners of small businesses and families that need professional help to comply with our tax rules.

Over half of all taxpayers used a paid tax return preparer to assist them with their individual tax returns. This is true for all income levels. Although those earning more than $100,000 were the most likely to use a paid preparer, 53 percent of taxpayers with income of less than $20,000 used a paid preparer in 2002.

This trend also occurs in my home state of Oregon, where over 50 percent of individual taxpayers used a paid tax return preparer in 2004. For Oregonians with incomes of less than $50,000, about 49 percent used a paid tax return preparer.

The bottom line is we need to simplify our tax rules. If we our going to require our citizens to pay significant sums of their hard earned money to the government, it is only fair that they understand how the tax rules work. However, I think it's safe to say that even the most sophisticated tax attorney doesn't understand all of our tax rules.

As a part of this process, I hope we can address one of my tax reform priorities – making the Bush tax cuts permanent. Although many opponents of the Bush tax cuts portray the provisions as primarily benefiting upper income earners, the facts show otherwise. The tax relief has actually shifted a larger share of the individual income taxes paid to higher income taxpayers. Since the measures went into effect, the tax share of the highest income group has increased, while the tax share of the bottom four income groups has declined.

If these tax cuts are not made permanent, they will have a real impact on middle income American. In Oregon, a single mom with two kids who earns $25,000 in wages will be hit with a tax hike of about $1,250. An Oregon family of four with two kids with $50,000 in wages will see a tax hike of $2,145. This is real money for Oregon families – many of whom struggle to pay for groceries, health care for their families and their monthly bills. We can't let these tax hikes go into effect.

It has been over twenty years since the last time Congress enacted comprehensive tax reform. The time has come to address this important issue again.

Thank you.

COMMUNICATION

THE ALLIANCE FOR A COMPETITIVE TAX POLICY

The Alliance for a Competitive Tax Policy (ACTP) is pleased to submit this statement for the record for the Senate Finance Committee's May 13, 2008, hearing on "Cracking the Code: Tax Reform for Individuals." The ACTP is dedicated to helping U.S. companies and their workers create a level, global playing field and preventing further unfair tax burdens on Americans working overseas. The Alliance is comprised of American Chambers of Commerce in Asia, U.S. corporations and other U.S.-based business groups.

As the Committee continues to gather information and seek public comments on potential changes to the U.S. tax code, the ACTP looks forward to working with Chairman Baucus, Ranking Member Grassley, and all of the Committee members to implement sound reforms to U.S. tax laws that benefit all Americans around the world.

Background

Unlike every other industrialized country, the United States imposes a tax on the income of its citizens regardless of where that income is earned. Americans working overseas are subject not only to the taxes levied by the country in which they reside and work, but also to U.S. taxes. This system fails to achieve equity in the tax law, a stated goal of the members of the current Congress, as it not only singles out those Americans working overseas who are perhaps the country's best ambassadors, but it also affects the ability of U.S. businesses to compete in the global marketplace. This provision of the U.S. tax code makes it more economical to hire more foreign workers for overseas jobs – even with American companies.

The U.S. Internal Revenue Code only partially offsets the burden of being subject to two tax systems. For over 80 years, U.S. tax law provided a limited exclusion for income earned by U.S. workers overseas (under Section 911 of the Internal Revenue Code). Congress understood then that the tax law had to be tailored so that Americans were not penalized for living overseas. *See*, H.R. Rep. No. 69-1, at 7 (1925). This provision had been in effect for so long because Congress understood that U.S. tax law plays an important role in promoting foreign trade and ensuring that U.S. citizens residing abroad are on equal economic footing as their foreign competitors.

This exclusion, though, does not eliminate the entire burden on Americans living and working overseas. Nor does it recognize the unique financial hardships and other challenges of working abroad, such as uprooting a spouse and children to live thousands of miles from friends and family and living in housing which is often smaller and more costly than the family's home in the United States. Furthermore, it also does not fully take into account that Americans overseas bear additional expenses due to the limited availability of adequate schools, quality health care, and other services often taken for granted in the United States.

The Tax Increase Prevention and Reconciliation Act of 2005

The *Tax Increase Prevention and Reconciliation Act of 2005* (TIPRA) reduced the preexisting partial tax exclusion. As a result, Americans working overseas now pay even higher taxes – by some estimates as much as $25,000 more than they did on their 2005 returns (see attached example). In many cases Americans working overseas were often pushed into the highest tax bracket as a direct effect of the TIPRA changes, although their salaries and benefits remained the same. Additionally, higher marginal rates were levied on employer-provided payments reflecting the higher cost of living overseas, and the housing cost limitation was capped at a lower level. The U.S. Treasury Department has worked to address some of the disparity in housing costs in new regulations, but this effort does not fully offset the tax hike imposed by TIPRA on Americans working overseas.

U.S. Competitiveness and Export Growth in Jeopardy

If these harmful changes are not reversed, U.S. workers and companies will continue to play on an uneven playing field. The United States is the only industrialized country in the world that taxes its citizens on their worldwide income. This system places employees and employers in a severe economic disadvantage to competitors in Europe, Australia, and Asia. Not only will American companies be unable to locate employees abroad, U.S. citizens will also be less willing to work outside the United States to the detriment of U.S. competitiveness in the global economy. At a time when the United States is dependent on continued growth in the export market, Americans are going home and being replaced with local or non-American workers.

In fact, it is estimated in a 2005 study by PriceWaterhouseCoopers that repeal of Section 911 would reduce the number of Americans working abroad, and cause an $8.1 billion loss in U.S. manufactured exports that support 77,115 U.S. domestic jobs. In contrast, the report concluded, removing the cap on the foreign earned income exclusion would increase U.S. manufactured exports by $14.4 billion and support an additional 137,319 domestic jobs.

According to the Commerce Department, U.S. exports of goods and services in 2007 totaled more than $1.6 trillion – the highest recorded level for the United States. In fact, the National Association of Manufacturers (NAM) reports that exports are expected to grow by 7.6 percent in 2008, which would double the projected rate of import growth and would result in the fourth-consecutive year that export growth outpaced increases in imports – a first in 17 years. NAM also estimates that continued growth in exports will generate nearly a quarter of total U.S. economic expansion in 2008. As the United States economy tries to recover from the current slow down, exports are an indispensable engine of growth.

To be sure, many factors contribute to America's export strength. Having articulate and able representatives in foreign markets is an important aspect of this strength. Experience has demonstrated that Americans often are the best "salespeople" for American products. American families living overseas are involved in and make positive contributions to the communities in which they live. They support the proliferation of American teachers and educational standards, while spreading important American values of volunteerism, ethical business practices, social responsibility, democratic government, and environmental protection. Moreover, American business people abroad tend to source goods and services from the United States to support their sales activities in foreign markets. With this in mind, one would assume that U.S. tax policy would support Americans working overseas; unfortunately, the opposite is true.

To be sure, this is not just a problem faced by large corporations. If the TIPRA changes to Section 911 are not reversed, Americans who are employees or owners of small- and medium-sized businesses or who work in other professions (such as education) will continue to face unfair tax bills. In particular, small- and medium-sized businesses rely on foreign export markets for continued growth and viability. They oftentimes employ just one or two U.S. citizens abroad, but even that has become increasingly unsustainable with the cuts to the Section 911 benefits.

Conclusion

There are an estimated 4 million Americans working and living abroad. These Americans are on the sales teams and the front lines of the competitive world marketplace. They deserve fair tax treatment. For the sake of Americans working abroad, and for America's strength in the increasingly global marketplace, we urge Congress to repeal the changes made in the *Tax Increase Prevention and Reconciliation Act of 2005* and refrain from further increasing the tax burden on American citizens working overseas.

ATTACHMENT

Example of Section 911 TIPRA Changes

Section 911(f) forces taxpayers who have income that would otherwise be excluded by Section 911 to calculate which tax bracket they are in by looking at both their taxable and excluded income.

For example, if an unmarried taxpayer has $80,000 in foreign income that may be excluded under Section 911, and $100,000 of regular, taxable income, Section 911(f) forces the taxpayer to pay taxes on his $75,000 of taxable income as if he were in the $160,851-$349,700 tax bracket instead of calculating them as he would as belonging to the $77,100-$160,850 tax bracket. Before this provision was added, our taxpayer would have paid only $22,110.75 in taxes. Under this provision, our taxpayer must pay $28,957.50 in taxes. (See next page for calculations.) It will cost an American business an additional $684,675 to employ 100 such American employees overseas during just one year.

CALCULATIONS IN EXAMPLE

Tax Rates for Single Persons in 2007

Income Level	*Base Tax Amount Due*	*Tax Rate on Excess*
$77,100 – 160,850	$15,698.75	28%
$160,850.01 - $349,700	$39,148.75	33%

Tax Due Before Enactment of Section 911(f)

Taxes Due = Base Amount + (tax rate)(excess)

= $15,698.75 + (28%)($100,000 – $77,100)

= $15,698.75 + (28%)($22,900)

= $15,698.75 + $6,412

= $22,110.75

Taxes Due Under Section 911(f)

Taxes Due = [Taxes on ALL Income] – [Taxes on Excluded Income)]

= [Taxes on $180,000] – [Taxes on $80,000]

= [$39,148.75+ (33%)($180,000 - $160,850)] –

[$15,698.75 + (28%)($80,000 - $77,100)]

= [$39,148.75 + (33%)($19,150)] – [$15,698.75 +(28%)($2,900)

= [$39,148.75 + $6,319.50] – [$15,698.75 +$812]

= [$45,468.25] – [$16,510.75]

= $28,957.50