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Statement of

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A Blueprint for Tax Reform and Health Reform*

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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 earn-

ings 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 ghoul-ish 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 in 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 (Birnbau 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.

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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
Other 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.

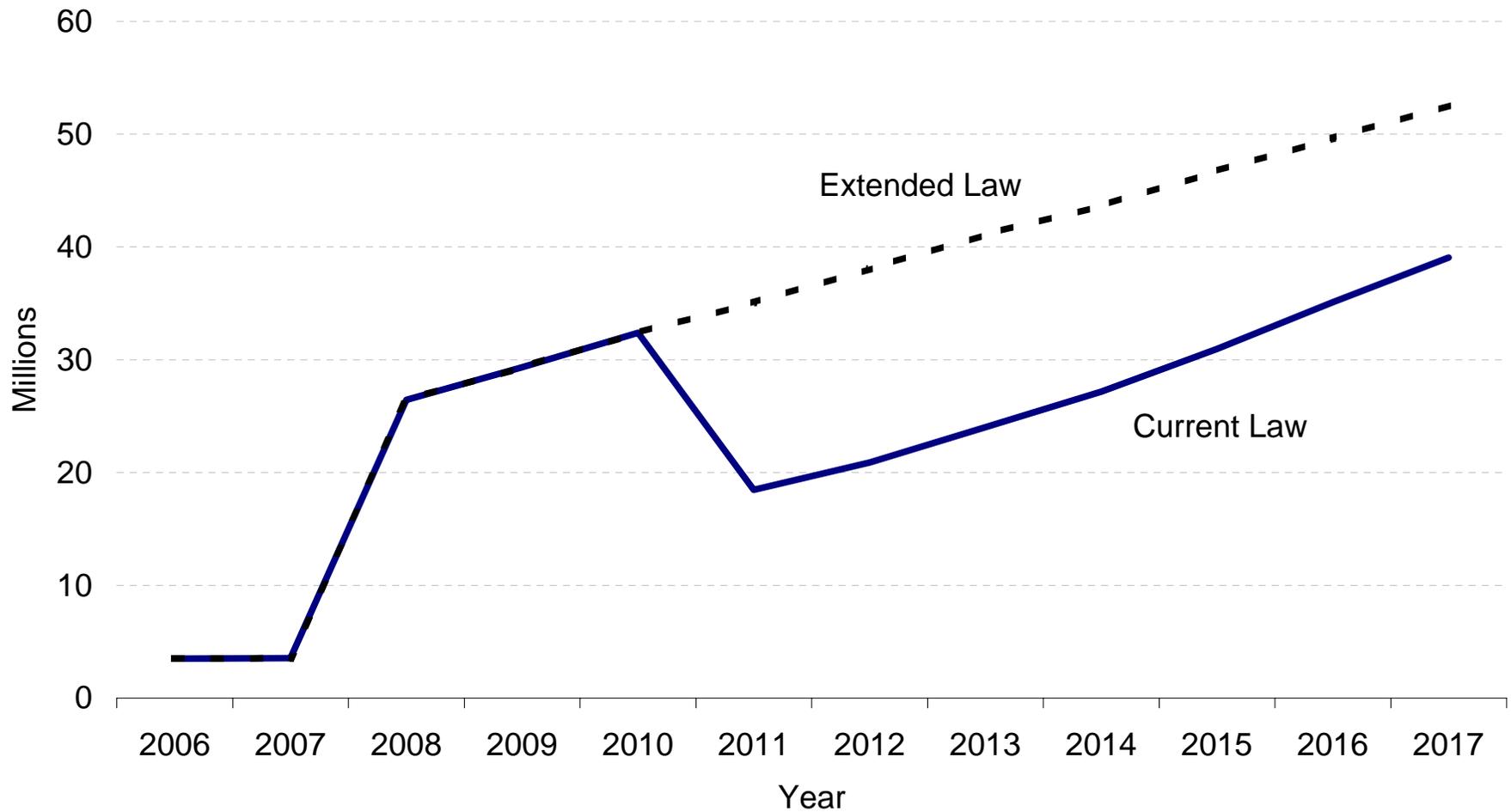
Notes: (1) Calendar year. Baseline is pre-EGTRRA law. Tax cuts include individual income and estate tax provisions in EGTRRA, JCWA, JGTRRA, WFTRA, AJCA, TIPRA, and PPA.

(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.

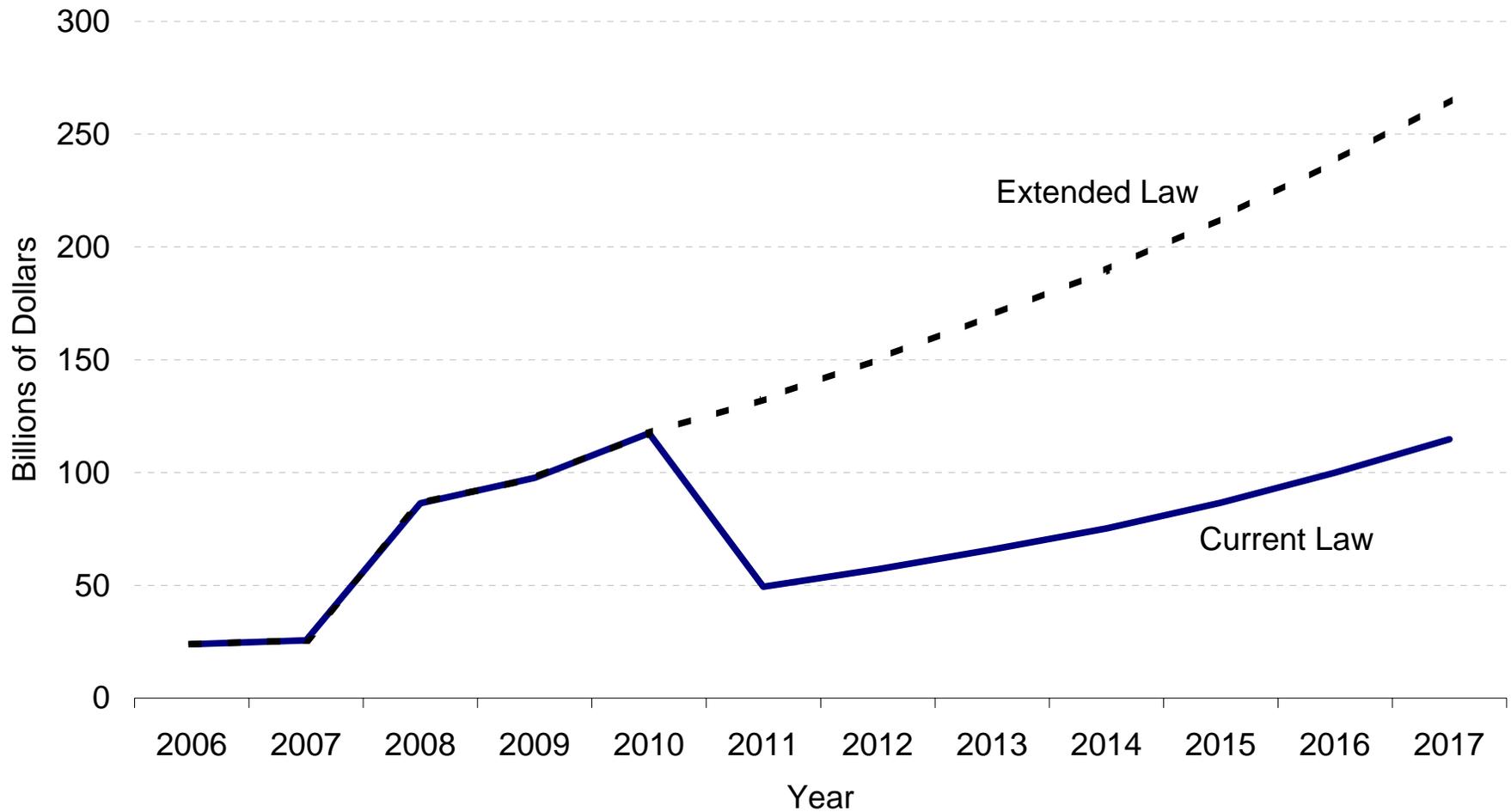
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

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



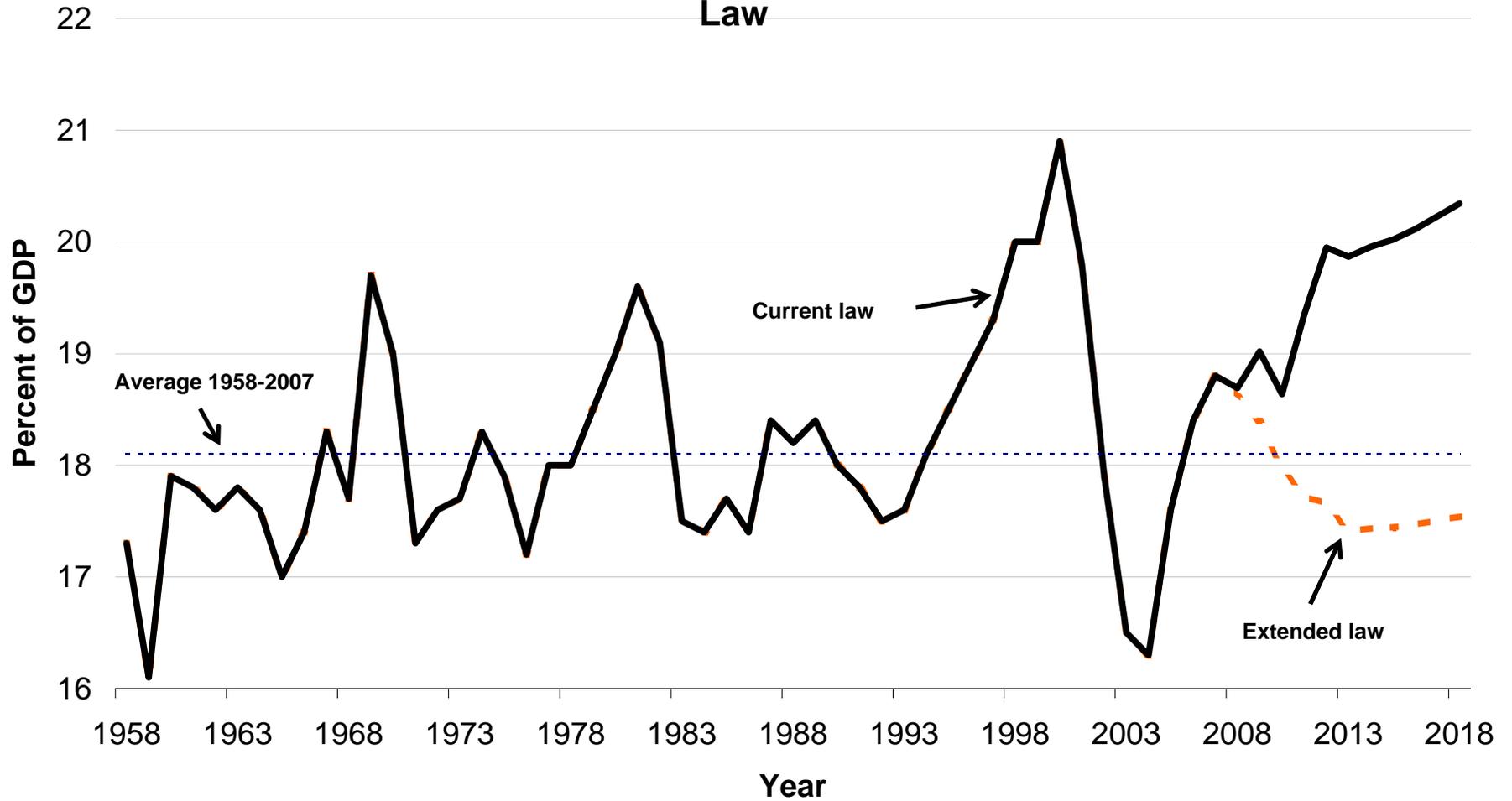
Source: Tax Policy Center, www.taxpolicycenter.org/T08-0043

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



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

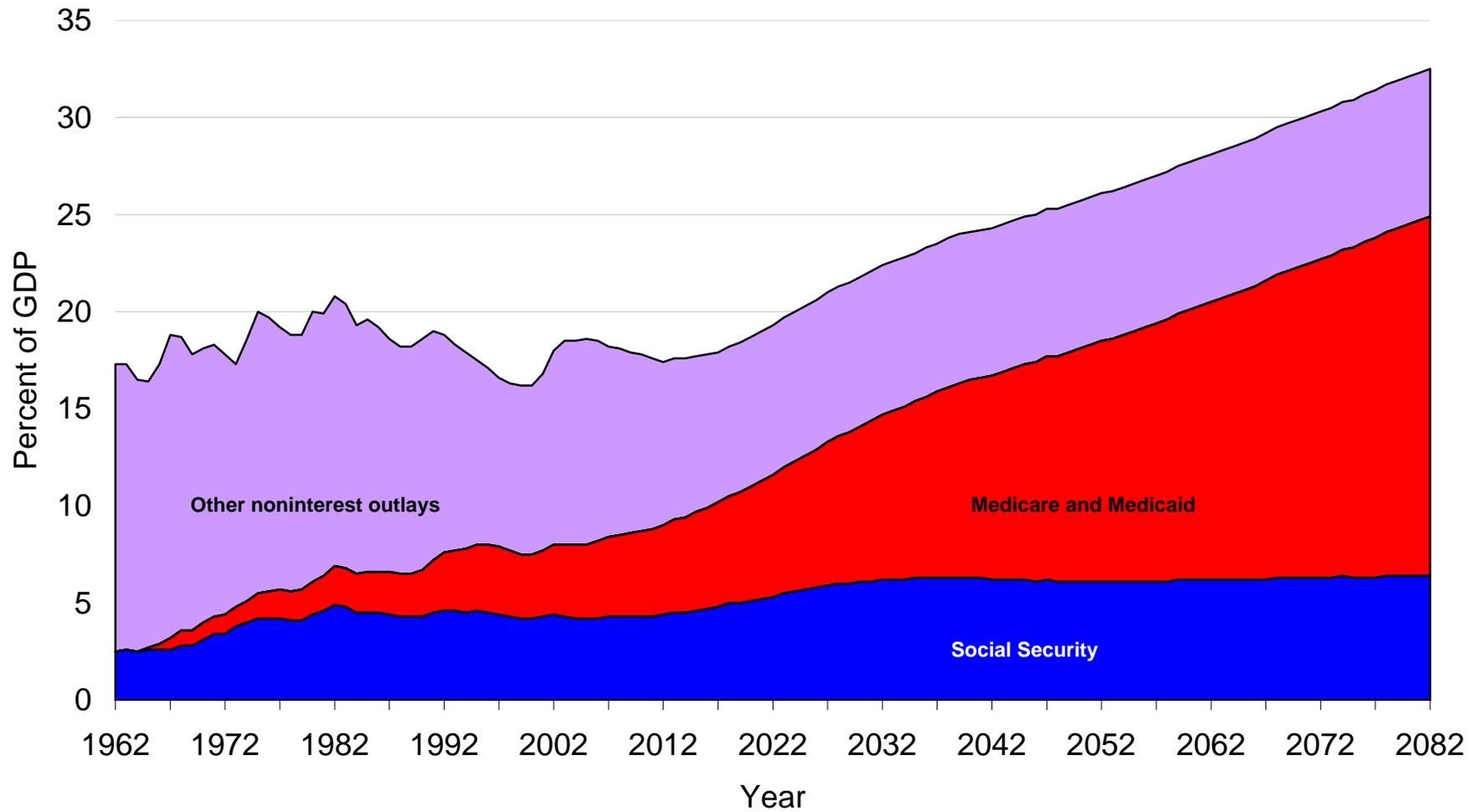
Figure 3. Historical and Projected Receipts: Current vs. Extended Law



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

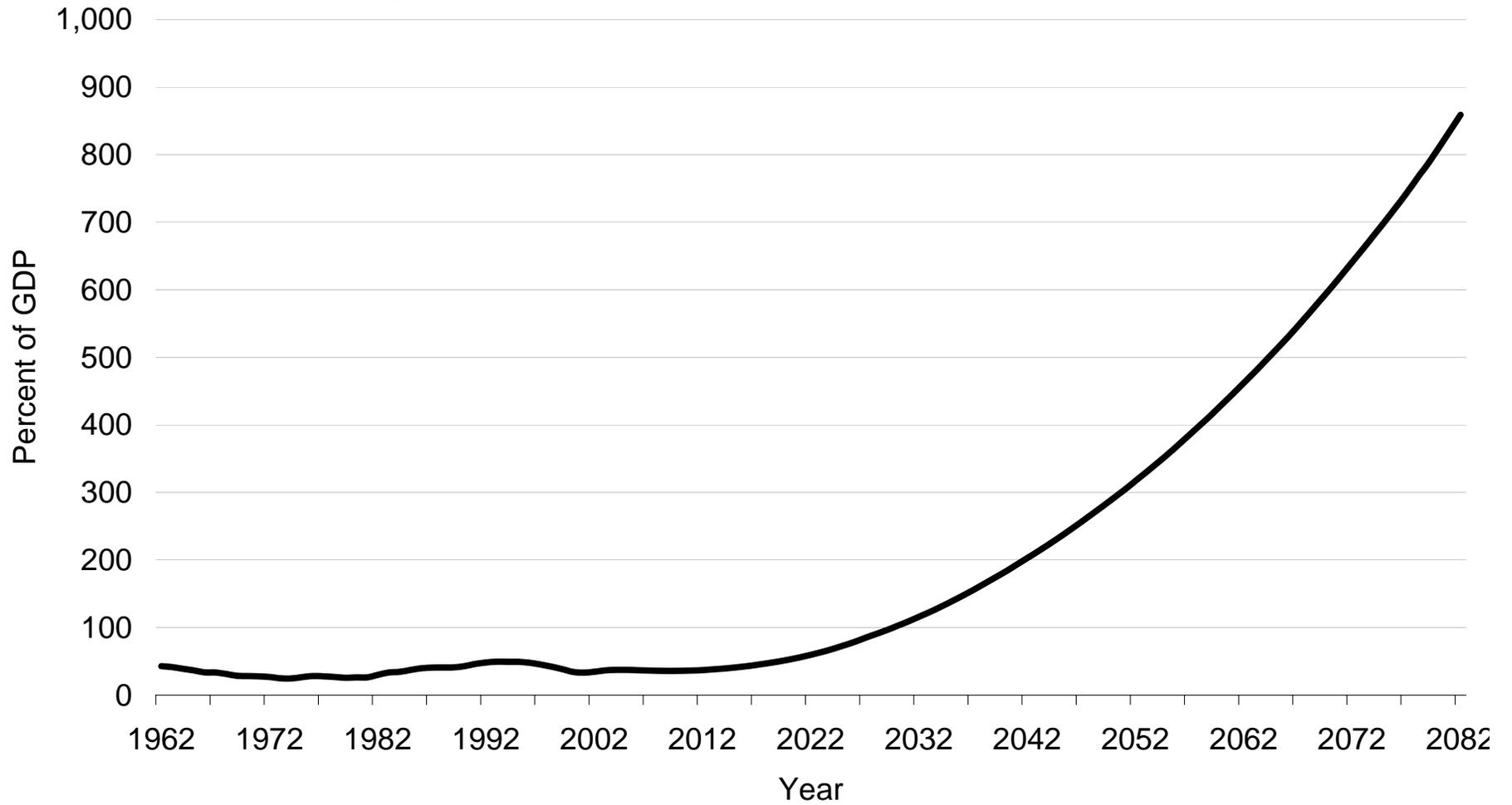
Note: extended law assumes extension of Bush tax cuts, AMT indexing, and other expiring provisions.

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).