IRET
Institute For Research On
The Economics Of Taxation

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to the

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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.

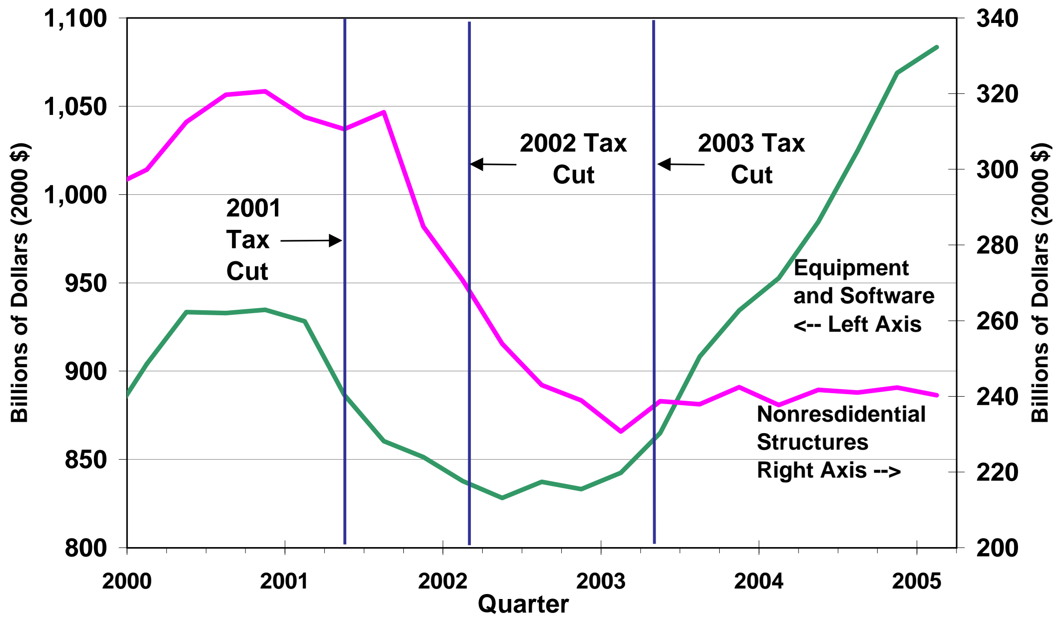
Chart 4
Inflow-Outflow Tax

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

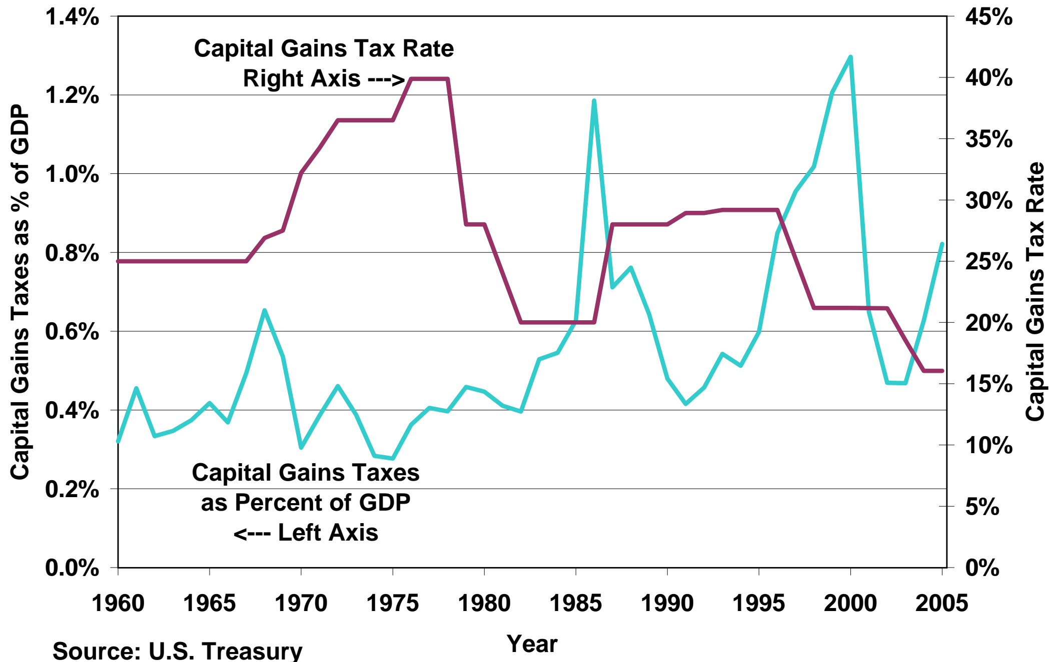
Schedule B, Saving	
List net saving (+) or withdrawals (-) from financial institutions reported on 1099 forms.	
First National Bank	-$ 1,000
Merrill Paine Schwab	$ 4,000
Total (if greater than zero, this is net saving; if less than zero, this is a net withdrawal). Enter on Form 1040, line 2.	$ 3,000

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

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