United States Senate
Committee on Finance

Sen. Chuck Grassley · Iowa
Ranking Member

http://finance.senate.gov
Press_Office@finance-rep.senate.gov

Contact: Jill Kozeny, 202/224-1308
Jill Gerber, 202/224-6522

Opening Statement of U.S. Senator Chuck Grassley
Ranking Member, Senate Committee on Finance
Tax Reform: Historical Trends in Income and Revenue
Thursday, December 1, 2010

Mr. Chairman, thank you for having this hearing today. With so many extremely important tax matters before Congress, it is good to take a step back, and think about tax policy broadly. When I use the term "tax reform," I mean that term to be revenue neutral. Tax reform to me means a restructuring of the tax Code so as to decrease inefficiencies and decrease complexity – it does not mean a grab of more revenue by the Federal government. So, revenue neutrality means setting a target of revenue that ties to current tax policy.

Why do we not like high taxes?

One is that the economy is growing globally outward. The Fortune 500 is no longer almost completely comprised of US companies. US companies now must compete with foreign companies. Thus, if average tax rates that US-headquartered companies are subject to are higher than the average tax rates of foreign-headquartered companies, we shouldn't be surprised to find that fewer and fewer global businesses are headquartered in the US. Furthermore, if the marginal tax rate that a US business has is higher than that of a foreign business, we would find that the cost-of-capital for US businesses would be higher than for foreign businesses, putting the US businesses at a competitive disadvantage.

From those conclusions regarding America's position in the global economy, it follows that efforts to reduce complexity and tax burdens on flow-through businesses need to be enhanced not reversed. Most of the business growth since the 1986 ACT has been in the flow-through sector. Raising marginal rates and applying complex business tax rules to this sector will retard that growth.

Not only can high taxes fund a too large Federal government, but also that they harm the private sector and make the free market not so free. Income taxes create a disincentive from earning taxable income, thus distorting decision-making and stifling the economy. I believe this to be true no matter what level of taxation there is.

Yes, some minimum level of revenue is necessary for the Federal Government. And, so, some minimum level of taxation is necessary. But to raise a given amount of revenue, there are

very harmful ways to raise it, and, on the other hand, there are ways that only cause minimal harm to the free market.

Statistics showing what the average tax rate is for a given set of taxpayers are important. Even more important are the marginal tax rates. Marginal tax rates show what a taxpayer will pay on the next dollar of income. Most decisions are made "on the margin." That is, generally taxpayers will not decide, in response to high taxes, to simply not work. (Admittedly, that does happen some – especially in the case of a spouse rejoining the workforce.) Most people need income, and thus most people need to work.

But, what is common, is making the decision whether to do an extra, or marginal, amount more of work, to make marginally more income. Too high a marginal tax rate can disincentivize work.

It's fundamental to understand this. But yet, back in July of this year, this Committee had before it a witness who was OK with the idea of a 90 percent marginal tax rate. He was of the opinion that since such a taxpayer could keep 10 percent of the return on his effort, it was still worth his while to make the effort. But that's nonsense – if one can only keep 10 cents for every dollar of income, a person will probably decide that he doesn't need the additional income after all, and maybe it's just a good time to take vacation. Or, instead of earning additional taxable income to, say, hire contractors to build a garage next to your house, high marginal rates can lead you to instead build the garage yourself.

Let's hypothetically suppose that a flat income tax with a 20 percent tax rate raised sufficient revenue for the government. Of course, such a flat rate structure could be made progressive by getting rid of the flat 20 percent rate and instead having a 10 percent tax rate for taxable income below some given amount, and a 30 percent tax rate for taxable income above such amount. Note that for people making a low-enough income, their marginal tax rate would be 10 percent, rather than 20 percent. This would increase such persons' incentives to make additional income. However, for higher income people, they would find their incentive to earn more money has gone down. That is, their marginal tax rate would no longer be 20 percent, but would be 30 percent.

So, it may seem that the two sets of rate structure net out. That is, under the progressive rate structure with tax rates of 30 percent and 10 percent, some taxpayers have more incentive, as compared with the 20 percent flat tax, to make additional income, but others would have less incentive. As far as the incentive effects to earn additional income, the two rate structures may "net out."

But that's not telling the full picture.

The full picture is this: Many taxpayers who would be in the 30 percent tax bracket have income that they don't need to have. That is optional. They have their needs met without additional income, so may easily decide to not earn more. Of course, for lower-income workers, they often need the additional money, and so a lower marginal rate (10 percent instead of 20

percent) does not as much encourage additional work, because they likely already wanted and needed additional income.

On a related point, on July 14, this Committee held a “kick-off” tax-reform. At that hearing, I spoke about a taxpayer named John, a real-world case, where John had a high marginal rate of 30 percent, but actually paid no tax at all, and even received a small check from the government. That is, John had a high disincentive from making additional income, but the government got no money from John – the worst of both worlds.

One final word, Mr. Chairman. When it comes to the topic of tax reform, we will inevitably hear a lot of statistics. That’s good and proper, given the subject matter. However, it is also worth keeping in mind what the great Conservative leader, Benjamin Disraeli, had to say on this topic. He said: “There are three kinds of lies: Lies, Damned Lies, and Statistics.” That’s worth keeping in mind with a lot of statistics we will undoubtedly hear re tax reform.

In particular, the United States has changed demographically. There are fewer joint filer households and many more singles and head of households. That demographic change has tended to make joint filers look “richer” than they otherwise would simply because of the mechanics of the measurement. As a result, we get a lot of studies showing a growing income gap with no accounting for this demographic shift.

Thank you, Mr. Chairman.