S. HRG. 112–437

HOW DO COMPLEXITY, UNCERTAINTY, AND OTHER FACTORS IMPACT RESPONSES TO TAX INCENTIVES?

HEARING

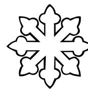
BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

MARCH 30, 2011



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

74–611—PDF WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
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HOW DO COMPLEXITY, UNCERTAINTY, AND OTHER FACTORS IMPACT RESPONSES TO TAX INCENTIVES?

WEDNESDAY, MARCH 30, 2011

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

The hearing was convened, pursuant to notice, at 10:06 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Wyden, Carper, Cardin, Hatch, and Snowe.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; Tiffany Smith, Tax Counsel; Holly Porter, Tax Counsel; and Joseph Scovitch, Detailee. Republican Staff: Chris Campbell, Staff Director; Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; Jim Lyons, Tax Counsel; and Preston Rutledge, Tax Counsel.

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

The CHAIRMAN. The hearing will come to order.

Albert Einstein once said, "Make everything as simple as possible, but not simpler."

There is a limit to how simple certain things can be, but today's tax code can certainly be simplified. And the complexity of the code has significant consequences.

At the last hearing we held, we looked at unintended consequences of the complications in our tax code. Our witnesses laid out undesirable distortions that may prevent growth and job creation. For example, they discussed how the tax bias toward debt in the tax code may have contributed to the financial crisis.

But some of the tax code's complexity is a result of incentives inserted in the code. That intentional complexity is what we are discussing today.

Today we will ask our expert witnesses how to measure the effectiveness of a tax incentive, including our current incentives. We will ask how to best structure incentives so people respond as we intended.

We will ask how we can get the most bang for our buck. In the words of Dr. Einstein, "How do we keep it simple, but not too simple?"

Today we have all sorts of incentives in the code. Many are meant to encourage or discourage certain behavior. The research

and development credit is meant to encourage innovation and create jobs. Higher education incentives are meant to help students pay for college. The retirement savings incentives are meant to encourage savings for those later years.

In 2010, we used $109 billion for more than a dozen different incentives to help Americans save for retirement. We used $91 billion to promote homeownership through the mortgage interest deduction. All in all, incentives in the income tax code cost more than $1 trillion each year. That is about the same as the total amount raised by the income tax code.

Studies show that the way tax incentives are presented and structured affects the way individuals respond to them. Take retirement savings tax incentives, for example. Studies have found that taxpayers save more of their money for retirement when they receive a contribution that matches their own rather than receiving a tax refund at the end of the year.

Tax incentives are also more effective when they are offered immediately. Programs like Cash for Clunkers showed that on-the-spot incentives are more effective than a tax credit individuals received when they filed their tax returns. More people purchased energy-efficient cars more quickly through that program because the money was in their hands right away.

Today we will ask our witnesses what makes a well-designed tax incentive. Do taxpayers respond less to complex incentives? What about the responses to temporary tax incentives?

There are certainly many complex and overlapping tax incentives. For example, there are more than 15 provisions to assist with the rising costs of higher education. The sheer number of options, and choosing between them, often overwhelms taxpayers.

Does this complexity discourage young people from enrolling in college?

There are also a huge number of temporary tax incentives, and the prevalence of these temporary provisions has risen dramatically over the past decade. There are now 141 temporary provisions that expire nearly every year. These temporary tax incentives hinder taxpayers' ability to plan. As a result, they may only benefit those people who would have acted anyway.

Ultimately, the desirability of any tax incentive will depend on whether we want to encourage that activity in the first place. If Congress is going to encourage certain activities through the code, we need to know how to most effectively achieve the intended policy goals.

We need to know how to structure tax incentives that are simple enough to generate a response, but not so simple that they are not well-targeted.

I look forward to the discussions today.

[The prepared statement of Chairman Baucus appears in the appendix.]

Senator Hatch?

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Well, thank you, Mr. Chairman. As we continue our march through the potentials and pitfalls of tax reform, this hearing stood out.

The tax code should send clear signals to taxpayers. This way, individuals and corporations can make rational decisions about what they do with their money. Unfortunately, as several of our witnesses will explain today, the Internal Revenue Code has become so complex that it is colliding with human nature.

On balance, taxpayers are inclined to behave according to the political economic theory of Rod Tidwell, the star wide receiver in the film "Jerry Maguire." Tidwell operated by a simple philosophy—"show me the money."

In some ways, that is the philosophy of the American taxpayer. Families and businesses, when considered in the aggregate, would prefer to allocate their capital based on the tax treatment of various activities.

If the code taxes capital, capital formation will become more difficult. If the code taxes consumption, savings will go up.

What this hearing addresses is how inefficiencies in the Internal Revenue Code impact the otherwise rational responses of taxpayers.

In short, the code has become so complex that even when lawmakers attempt to extend preferences for certain activities, businesses and families do not respond. It is critical then that we restructure the code to provide a more rational and less complex system for American taxpayers.

I would like to reiterate a few key principles for this reform. First, I believe that our entire tax system, not just the corporate tax system, needs to be reformed. We cannot simply raise taxes on flow-through businesses, a large portion of which are small businesses, by taking tax incentives away without lowering tax rates in return.

Now, this is both just and politically necessary. Can you imagine if someone told you, "I am going to reform the law in a way that directly impacts your life and livelihood? Now here is what I am going to do. I am going to take something away from you and you are not going to get anything in return." You will not find many people willing to accept a terrible deal like that one. Yet, that is the offer that some would like to extend to these businesses.

Second, tax reformers need to take into account the shrinking of the base on the individual side. Considering that even the liberal Tax Policy Center found that 47 percent of households in 2009 did not pay any income taxes, we cannot ignore the individual income tax system when we look at tax reform.

And we need to keep in mind that this 47-percent figure will grow significantly higher in 2014 when the health insurance premium refundable income tax credit goes into effect. It makes you wonder. And we know that 47 percent is just the beginning, because that does not include all of the people on welfare nor does it include a raft of others.

Again, it is a matter of fairness. And I might add that many in the 47 percent get money back from the government with no real skin in the gain.

So, as a matter of fairness, would it not make more sense if all citizens paid at least something in income taxes? We hear a lot about sharing responsibilities from the other side. Well, this would be a start. And I am convinced that it would help us in our fight against excessive Federal spending. You get a lot of takers if they want more of something and you tell them it is free.

Third, we cannot ignore the pending tax increases at the individual level that will go into effect if Congress does not act. The bottom line is that, if Congress does not intervene, taxes are scheduled to go up significantly on January 1, 2013. If President Obama and the congressional Democratic leadership have their way, the top two tax rates would already be at 36 percent and 39.6 percent.

It might be a convenient talking point to suggest that these are cost-free tax increases on the rich. But in reality, the nonpartisan Joint Committee on Taxation tells us that 50 percent of all flow-through income is subject to these proposed tax rate hikes.

Now, these tax rate increases would be especially harmful to small businesses, because most small businesses are organized as flow-through business entities, such as partnerships, S corporations, or limited liability companies.

And, since we all seem to agree that we need to provide certainty to businesses and other taxpayers so that they can go ahead and plan their affairs, including hiring new workers, it would make a lot more sense to go ahead and prevent these tax rate hikes now rather than waiting until 2012, a presidential year, to act.

Finally, we need to be careful about what we are identifying as tax incentives. Are we talking about a true tax incentive or are we really talking about spending being done through the Internal Revenue Code?

If a provision resulted in an outlay by the Federal Government, the amount of the outlay is actually spending under the Congressional Budget Act. It is not a tax cut.

For example, almost three-fourths of the refundable income tax credit from the health spending bill is not a tax cut, but is actually spending done through the tax code, according to the nonpartisan Joint Committee on Taxation.

As we continue down the road of tax reform, these principles will continue to inform my analysis of the challenges that we face. With respect to tax incentives and whether they introduce inefficiencies into the tax code and counterproductively distort economic behavior, it is important that we not lose sight of what should be our ultimate goal—the need for comprehensive reform that lowers the burden of taxation on individuals and businesses.

I want to thank you, Mr. Chairman, and I look forward to hearing the testimony of our witnesses.

The CHAIRMAN. Thank you, Senator.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. I will look forward to the witnesses. This is where it gets fun.

First is Dr. Raj Chetty, professor of economics at Harvard. Welcome, Dr. Chetty. I appreciate your coming here.

Dr. Robert Carroll, who is a principal of quantitative economics and statistics at Ernst and Young, served previously as Deputy Assistant Secretary for Tax Analysis at the Treasury Department. Thank you, Dr. Carroll, very much for your perspective.

And Dr. Eric Toder is a fellow at the Urban Institute, and co-director at the Urban-Brookings Tax Policy Center. Thank you very much, Dr. Toder.

Each of you will have your statement included in the record automatically, and I ask each of you to speak 5 or 6 minutes, whatever seems appropriate.

Why don't you begin, Dr. Chetty?

STATEMENT OF DR. RAJ CHETTY, PROFESSOR, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. CHETTY. Thank you, Chairman Baucus, Ranking Member Hatch, and members of the committee. Thank you for asking me to appear before your committee today. It is a pleasure to share my views on the complexity of the tax code and its implications for taxpayer behavior and tax policy.

Economists and policymakers have traditionally focused on the financial incentives created by the tax code when predicting its effects on the economy. However, recent research shows that the salience and transparency of tax incentives matters as much or more than the financial incentives themselves.

In this testimony, I will review some examples of this recent evidence and then discuss their implications for tax policy. I will focus primarily on the taxation of individuals and households, but many of the lessons that I am going to discuss also apply to the taxation of corporations and small businesses.

So let me start. I am going to do this with the aid of some charts. With the first chart, the point I want to make is that the tax code in the U.S. is highly complex and is becoming increasingly so as reforms are implemented piece by piece.

So figure 1 here depicts the Federal income tax schedule faced by a single earner with two children in the U.S. in 2006. The figure plots the marginal tax rate, that is, the tax rate on a family's last dollar of earnings, which is relevant for a broad range of economic choices ranging from work decisions to IRA contributions to home mortgage decisions.

So what this figure shows you is that marginal tax rates vary considerably with income. And moreover, the figure does not account for transfer programs that further affect incentives, or provisions such as the Alternative Minimum Tax.

In addition, families also pay many other taxes beyond the income tax, such as sales taxes, property taxes, excise taxes, all of which further complicate decisions.

So the complexity of the tax system today raises the possibility that many families may not fully account for the tax implications of their economic decisions, and there is now quite a bit of evidence suggesting that the lack of transparency does, in fact, affect behavior.

So let me give you a few examples, if I can move to the next chart. So I will start with a very simple example, one that—in some sense, the simplest taxes we have——

The CHAIRMAN. But in the last chart, what you show is just the variations of the marginal rates.

Dr. CHETTY. The variation of marginal rates by income.

The CHAIRMAN. By income and how people—they probably do not even know what their marginal rates are.

Dr. CHETTY. That would be my guess, for many people, yes.

The CHAIRMAN. Thank you.

Dr. CHETTY. So to illustrate how even relatively simple taxes may not be fully perceived by consumers, let me give you the following very simple example. So States levy sales taxes on the purchase of many goods. My colleagues and I ran a very simple experiment where—normally, when you go, say, to a grocery store and buy something, you pay sales tax at the register, but the price that you see on the shelf does not include the sales tax that you would pay at the register. It is added later on. Right?

So we did a simple experiment where, for 1,000 products in half an aisle of a major grocery store, we posted the tags that you see here, a very simple tag that tells you what the tax-inclusive price is. It just tells you information that, in a sense, you might already have known if you were paying attention to this tax.

So, for example, you can see on this chart we tell you that the total price of that hairbrush in the upper right is $5.79, plus California sales tax, is $6.22. And so we then tracked the amount of demand for these products before and after this experiment to see if just telling people what the tax-inclusive price of the good is affects their consumption behavior.

What you find is that sales of these products fall by about 8 percent when you simply post this information, showing that taxpayers were not fully taking into account the fact that the sales tax was affecting the price of the good, when it was not explicitly posted.

So even a very simple tax does not seem to be fully perceived by consumers, suggesting that the much more complicated income tax code—it is unlikely that people fully recognize the incentives that it creates.

Now, you see this kind of effect even for larger purchases. So, for instance, a recent study has shown that tax credits for buying hybrid cars that are given at the time of purchase of the car—so like a sales tax reduction—have 7 times as large an effect as a reduction in income taxes that is given later on for buying the same car.

So you have exactly the same financial expenditure by the government, but you have 7 times as large an effect if the consumer sees the money that they are getting at the time of purchase as opposed to getting it later on as part of their income tax refund.

Let me turn now to another example in the context of the income tax, if I can move to the next chart. So this chart here shows you how the earned income tax credit in the U.S. varies—the size of the earned income tax refund varies with earnings. And you can see this pyramid shape where, as you earn more, the size of the refund gets bigger. That is the incentive to encourage low-income families

to work more, to make work pay, in some sense, and then the credit is phased out at higher levels of income.

Now, when you do surveys of families who received the earned income tax credit, what you find is that, while many people have heard of the EITC, most people have very little idea about how the size of their refund varies with the amount that they earn, which is a necessary condition for them to start earning more because of this program.

So, if you survey people, less than 5 percent of people know that, if you are earning less than $10,000, the more you earn, the bigger the refund you get. And I think that is partly owing to its complexity, where the parameters of this refund vary substantially depending upon your family structure, the number of kids you have, whether you are married or not, and so forth.

Now, in another experiment, we provided simple information to families about the incentives created by the EITC, and we found that just giving 5 minutes of information, saying something like, "the EITC creates an incentive to work; for every $10 you earn, the government gives you $4, so effectively, your wage rate becomes $14 an hour instead of $10 an hour," that simple information induced substantial changes in earnings behavior by households, showing that you can make the program much more effective just by increasing its transparency.

We can move on now to the next chart. Now, because information about the EITC is so limited, the responses to the program vary substantially across the U.S., even though it is a Federal program. So the incentives are basically uniform across States in the U.S.

But what this chart shows you is that responsiveness is much greater in some parts of the U.S. So the dark shaded areas here are areas where people are responding much more to the credit by changing their earnings, increasing their earnings in response to the credit. And you see that in certain States, such as Texas, there is a substantial response; but in other States, like North Dakota, it is almost like people are not aware of the program at all.

The evidence seems to be consistent with diffusion of information, where, in some places, people seem to be informed about this program and are responding to it; in other places, the government is spending substantial money on this program, but is having relatively little impact on behavior.

The CHAIRMAN. It means up in our State, Montana——

Dr. CHETTY. Yes.

The CHAIRMAN [continuing.] That people just do not know about it.

Dr. CHETTY. This chart does not directly tell you that people do not know about it, but what we can see in the data is that people do not seem to be responding to it in the sense that their earnings are not increasing to reach the point where they would maximize their EITC refund.

The CHAIRMAN. Theoretically, the EITC is as available in Montana as it is in Texas.

Dr. CHETTY. Exactly. Exactly. That is right.

I am actually going to skip to the last chart, if that is all right.

So I have shown you a few examples of how transparency and salience affect the impacts of the tax code. Let me sum up by just

talking about a few policy implications, and I am happy to go into more detail on each of these.

So I think one simple lesson from this evidence is that we want to minimize non-transparent tax incentives. So, when we have a program that is intended to incentivize some behavior, but essentially the people who would have already done that behavior would take advantage of the program and we do not end up changing other people's behavior, we are spending money, but not really having any impact on the economy.

So I think it makes sense to minimize non-transparent incentives. And, second, invest to some extent in marketing so that we really reach out and explain to people in very simple terms what the key provisions are of the tax code and how that should affect their behavior.

One way to do that is to build tax incentives into prices so people pay attention to prices. You know how much you are spending on something. You know how much you get paid when you work. So you can make tax incentives much more powerful if people do not even have to think about the tax incentive, they can directly look at the price and the tax has already been built in there.

Another tool one can use is defaults with an opt-out clause. So, have a default where people automatically are saving some money for retirement. They can opt out of that, but you are more likely to influence behavior in that way.

Skipping to number 5, I think these tax complexity issues can potentially have substantial effects on the income distribution. So there is evidence that lower-income individuals might be less likely to take up or figure out a complex tax provision than higher-income individuals. And so complexity creates distributional effects.

By changing transparency, we change the extent to which tax burdens are shared between consumers and businesses. That is another important factor to take into account.

Lastly, tax policy, because of these issues, may often have smaller effects in the short run than in the long run, as people start to understand these incentives, and that is very important to keep in mind when evaluating the effectiveness of various tax policy incentives.

So I will stop there.

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

The CHAIRMAN. Thank you very much, Dr. Chetty.

Dr. Carroll, you are next.

STATEMENT OF DR. ROBERT CARROLL, PRINCIPAL, QUANTITATIVE ECONOMICS AND STATISTICS, ERNST AND YOUNG, LLP, WASHINGTON, DC

Dr. CARROLL. Chairman Baucus, Ranking Member Hatch, and distinguished Senators on the committee, I thank you for the opportunity to testify today regarding complexity, uncertainty, and the evaluation of tax incentives.

I have had the opportunity to consider tax expenditures and other special tax provisions included in the Internal Revenue Code from a number of different perspectives, inside and outside the government, in the context of broad reform of the code, how the provi-

sions affect household and business decisions, and who receives their benefits.

Tax expenditures, of course, represent a broad array of provisions and priorities of the Congress in the development and evolution of the code since the inception of the income tax a century ago.

The code includes nearly 200 tax expenditures that total roughly $1.1 trillion annually. These provisions affect large segments of the U.S. economy, touch upon many aspects of household and business decisions, and significantly narrow the tax base, thereby requiring higher tax rates to raise a given amount of revenue.

Many of these provisions are longstanding provisions that have been part of the code for many years, but others reflect more recent priorities. These provisions were carefully considered and debated at the time of their enactment and added to the code to meet specific objectives.

Tax expenditures are, in part, receiving closer scrutiny due to the growing imbalance between what the Federal Government spends and collects in revenue, projected over the next several decades. With these increasing fiscal pressures, they are seen by some as a potential source of revenue to help stem the fiscal gap and reform the tax system.

In addition, there is also a growing recognition that reevaluation of spending priorities ought to also take into account related spending that occurs through the tax code.

Two of the most important factors that may influence the effectiveness of special tax provisions is their complexity and their uncertainty. The design and delivery of a special tax provision can have profound effects on its effectiveness. Provisions that have complex eligibility requirements and other rules can impose substantial compliance costs that detract from their benefits.

In some areas, duplicative provisions require taxpayers to understand and consider the tax benefits from several related provisions and choose the one that best meets their needs. For example, there are a number of provisions to encourage saving, but these provisions have different income thresholds, different spousal participation rules, different effective contribution limits, different withdrawal rules, and different minimum distribution rules.

There are other similar examples in the areas of health care, education, family provisions, work incentives, and so on. The reliance on tax advisors to navigate these provisions and their rules increases compliance costs and further detracts from the benefits they are intended to provide.

There are also a large number of provisions, expiring provisions, often extended a year or two at a time. In principle, the periodic extension of expiring provisions provides Congress an opportunity to reconsider and reevaluate their effectiveness, but the lack of their permanence makes it difficult for taxpayers to rely upon and base decisions on the benefits they provide.

Moreover, expiring provisions are no longer limited to the several dozen primarily business tax provisions, but now also include the Alternative Minimum Tax patch and the 2001 and 2003 tax cuts. The result is a tax system where large portions of the code are, in effect, temporary.

Special provisions narrow the tax base and require higher tax rates to raise a given amount of revenue. These higher tax rates impose additional economic costs themselves that also need to be understood and weighed against the special provisions included in the code.

This committee should be commended for focusing on these issues as part of their dialogue and deliberations on tax reform. A better understanding of the effect of these provisions and who they benefit would be valuable inputs into the policy debate as the Congress reevaluates various priorities on both the spending and tax sides of the budget to meet the Nation's challenges.

I thank you, and would be pleased to address any questions you may have.

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

The CHAIRMAN. Thank you, Dr. Carroll.

Dr. Toder?

STATEMENT OF DR. ERIC J. TODER, INSTITUTE FELLOW, URBAN INSTITUTE, AND CO-DIRECTOR, URBAN-BROOKINGS TAX POLICY CENTER, WASHINGTON, DC

Dr. TODER. Chairman Baucus, Ranking Member Hatch, and members of the committee, thank you for inviting me to testify today on taxpayer responses to incentives in the individual and corporate income taxes.

The views I express are my own and should not be attributed to the Tax Policy Center or the Urban Institute, its board, or funders.

My written testimony addresses the following questions: what traditional economic theory tells us about the effects of tax incentives on behavior, what we have learned from statistical studies of major tax incentives, how new research in the field of behavioral economics by Dr. Chetty and others has affected our views on how to influence the behavior of individuals, and how the complexity of the current income tax alters the effectiveness of tax incentives.

Senator Baucus mentioned Dr. Einstein. So I would offer another quote. He said, "The hardest thing to understand is the income tax," and, of course, it has gotten more complicated since he made that statement.

I will discuss three aspects of complexity. First, some tax incentives are so complex that even well-advised and sophisticated taxpayers find it hard to figure out how best to use them. Some examples are the multiple tax incentives for higher education, multiple forms of savings incentives and the need to choose between Roth and deductible, phase-outs and limitations on tax incentives that reduce their benefits over various income ranges, interactions of tax incentives with the Alternative Minimum Tax, and complex eligibility requirements for some incentives, such as the earned income credit.

Second, the overall complexity of the entire tax system makes even simple tax incentives less transparent. Today, in response to this complexity, about 90 percent of taxpayers use either preparers or software to calculate their tax liability. Assisted methods reduce the cost of complying with the tax law and help taxpayers use available tax benefits, given their economic behavior.

But, because taxpayers now have less understanding about how their taxes are calculated, they may be less likely to change their economic behavior in response to incentives. They just claim the benefit after the fact. And, because of how various incentives interact, taxpayers are also likely to be less aware of the marginal tax rates they face, as was discussed before.

Third, most of our tax law has become temporary. So people facing economic choices may have no good way to predict the tax consequences of their actions. Provisions that will expire in the next 2 years include the entire individual tax rate structure, relief for capital gains and dividends, marriage penalty relief, the payroll tax holiday, the temporary patch that keeps millions of taxpayers off the AMT, and numerous tax incentives for businesses, including the research and experimentation credit.

We can now say that the individual income payroll tax and corporate tax are all temporary taxes today.

In addition to this, as long as we continue to face a prospective explosion of the national debt, taxpayers will wonder whether higher future taxes might be part of the solution and, if so, which tax provisions will be affected.

So it is hard to respond to a tax law when you do not know what it is going to be.

Despite very important and exciting new research in the field of behavioral economics, there are still vast gaps in our knowledge of how people respond to tax incentives. And the increased complexity of the tax code and the temporary nature further reduces the extent to which we can rely on targeted incentives to influence behavior.

I conclude, therefore, that we should, when possible, resist temptations to use the tax code for complex social engineering schemes and instead move to promote tax reforms that treat taxpayers with the same incomes in an equal and evenhanded way.

I thank you, and I look forward to your questions.

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

The CHAIRMAN. Thank you, Dr. Toder; very provocative, which prompts a question.

In your experience or in your study and analysis, was there sort of the same kind of lead-up to 1986? That is, was there an accelerated number of new provisions in the code which created complexity and uncertainty leading up to the 1986 tax reform or not? Because it is my understanding, and I have forgotten the number, but since 1986, I think we have had—do you remember the number, how many thousands of new additions to the code—close to 15,000 changes to the code since 1986. And I saw a chart recently of the number of expiring provisions, and it has accelerated quite significantly in the later years.

I am just wondering, for my own information, if today is in any way comparable to the lead-up to 1986.

Dr. TODER. Thank you. I do remember 1986. I am old enough to know that. I think, certainly, complexity was a factor. And in the Treasury report, the word “simplicity” had a prominent place in a description and the purpose of their reforms.

However, I think other factors were also very important, one of which was we still had a top marginal rate of 50 percent on indi-

viduals and 46 percent on corporations—and we had come down a bit from the World War II rates, but people wanted to come down further. And we had this proliferation of tax shelters, particularly in the early 1980s, which led to great concerns about the fairness of the tax system, and that was largely driven by various incentive provisions that had been put into the tax law.

So I think those were more motivating factors—to produce more fairness and to get the top rates down—than simplicity, but simplicity was certainly a component of it.

The CHAIRMAN. You made a point, it was kind of interesting, or one of you did—actually, it might have been you, Dr. Chetty—that incentives tend to have the greatest bang for the buck in the short term and, after a while, may not have quite the same effect, if I understood your points, which raises just one example that we are faced with often here in the committee, and that is the research and development tax credit.

Some businesses claim they have to have it. If they do not have it, we are going to lose our American competitive edge. Well, we are losing it anyway in research. Then I hear others say, we would do the research anyway, we do not have to have the credit.

Of course, they like the credit; it helps. But do any of you have any thoughts on the utility of the R&D tax credit? I guess it raises the deeper question. What about research? Many people think the more there is research in America as opposed to other countries, the more that is good on the margin and tends to help American competitiveness and helps create jobs, et cetera.

Do any of you want to take a shot at that?

Dr. CARROLL. I think that the research and development credit kind of points to one of the problems with expiring provisions. Having expiring provisions does give the opportunity to the Congress to reevaluate their effectiveness, but at the same time, particularly with the research and development credit—where it occasionally has been allowed to lapse, occasionally it is extended retroactively—it is very hard, I think, for companies to use provisions that are very highly uncertain. Oftentimes, the people in companies making the investment decisions are not the people who have a very well-developed understanding of the tax treatment or how things work in Congress.

So, even though the R&D credit is pretty routinely extended, it still may be very difficult for companies to reflect the likely extension of the R&D credit year after year after year into their decision-making.

It also plays into how these provisions are reflected in the financial statements. It affects earnings per share. It affects the market's perspective on a company. Uncertain provisions, provisions that are extended retroactively—it is very difficult for those provisions to be incorporated into financial statements.

The CHAIRMAN. You are probably not well-qualified to answer my next question, which is, basically: let us say we do, magically, with transition rules—because it is going to be difficult to change—move to a regime that is much more simple, maybe to a few tax expenditures, much more permanency, less complexity.

The Congress always meets, and there are lots of groups in this country that want—they say, "Well, I understand the general rule,

but, in my case, I need a little different treatment," and Congress tends to respond to those entreaties.

How in the world—and, again, you are probably not well-qualified to answer this—how do we stop that or how do we minimize that? I suppose if there is some standard that people could agree to as to when something should be changed or not changed, that might help a little bit.

I am asking probably the unanswerable question when it comes down to discipline around here, but just any thoughts you might have on any kind of system or any kind of something to set up so that we are less likely to keep changing it all the time?

Dr. Chetty?

Dr. CHETTY. Thanks. That is a very interesting idea. So, while it is very hard to figure out how you would deal with that systematically, I think one thing that could help is if we have in mind an explicit cost to adding a new provision that creates complexity in the same way that one would consider the financial costs of a change in tax incentives.

If we have in mind essentially a dollar cost to saying, "I am willing to consider this provision, but it is going to have a certain cost in terms of increasing complexity," I think that would create a clearer way to assess which types of changes in the code have benefits that outweigh the added complexity costs.

Now, that is something one can try to do systematically, measure the costs of complexity. There is research that is ongoing on that. But I think having something numerical in mind so that it is not just something that is disregarded qualitatively could potentially——

The CHAIRMAN. Well, my time has expired. But you do make a good point. It is very important to quantify these standards. Otherwise, it is just—the impression is in the eyes of the beholder. But if it is quantified, it makes it a little bit easier.

My time has expired.

Senator Hatch?

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

Dr. Carroll, tax rates are high, and they are set to go up further unless Congress acts. Today, the top tax rate is 35 percent, but this rate will rise to 39.6 percent in 2013 unless Congress acts to prevent this particular listed tax increase.

Now, the health spending law will increase the Medicare hospital insurance tax effective January 1, 2013. And most States also impose their own income taxes, which raises marginal tax rates even further.

Now, how high can tax rates really go before we need to be concerned about how they will interfere with household and business decisions and the drag that they might place on the economy?

Dr. CARROLL. Thank you for the question. I think that is a very interesting question. When you look back after the 1986 act, the top rate was set at 28 percent; and then, a few years later, in 1990, it went up to 31; in 1993, it went up to 39.6; and, in 2001, it came back down to 35, where it is today.

But it is, of course, beholden to the periodic extension of the 2001/2003 tax cuts. And the rate does not just stop there. You have

to add in State tax rates, as you point out. In 2013, the Medicare tax increase plays into the effective rate.

So, when you add all the rates together, we could well face an effective rate of over 50 percent, depending on what State you live in. It looks like rates that we have not seen in quite a while.

One thing that I think is clear from the economic research is that very high tax rates do affect decision-making. They affect them in important ways, affect decisions to work, to save, to invest, and that is a significant concern.

Another effect of those high tax rates is they do cause the tax base to contract, to shrink, which has an effect on revenues. My recollection from when I was at Treasury is, when Treasury estimates the revenue effect of changes to the top two rates, they incorporate a revenue feedback of about 25 percent. So, for every dollar in revenue that Treasury would collect on the top two rates, they would assume that about 25 cents on the dollar is lost due to behavioral responses.

I am not sure exactly what the Joint Committee assumes, but that is kind of another way to think about kind of the economic cost to the government fisc.

It is not just the ordinary rates. The dividend tax rate will also go up, and, here, I think you have to think a little bit more broadly. You have to look at both the corporate and individual income taxes together. And the effective tax rate on dividends in 2013 will be upwards of 68 percent.

When you think about it from the perspective of a dollar invested in the corporate sector and paid out as dividends, what rate would that be? When you take into account the corporate tax, the investor-level taxes on dividends, then tax to 39.6 percent, the Medicare tax, and the State tax, a 68-percent tax rate on dividends, I would think, is very high.

One would expect it to have a pronounced effect on companies' dividend payment policies, which could have impacts on corporate governance.

The other thing I would mention is, it is not just the individual side, but you also have to think of this very globally. It makes it very, very hard when thinking about reform, but we also have a very high corporate tax rate, as you know, relative to other nations, currently the second-highest among OECD nations. Japan may or may not be lowering its corporate tax rate.

That is another consideration: how we compare to other countries, which is particularly important in the business area.

Senator HATCH. This is for Dr. Carroll and Dr. Chetty, and it is about the research and development tax credit. If Congress wanted to focus on one aspect of it or change one aspect of it that would really improve its incentive effect—if we could improve this effect, what would that be? What aspect would you change?

Allow me to give you just a few possible choices on how to improve the incentive effect of the credit: making it permanent—I would like to make it permanent so they can rely on it year after year after year; increasing the Alternative Simplified Credit, or the ASC, percentage from 14 percent to 20 percent; clarifying the definition of "qualified research" so that there is more of a bright line between what is qualified research and what is not qualified re-

search or, more precisely, targeting the credit on qualified research. That would not happen but for the credit's availability.

Which one of those things is perhaps most important in improving the incentive effect of the R&D tax credit, or would it perhaps be something else that I just have not mentioned?

Dr. CHETTY. I think all of these are great ideas that you suggested, Senator. If I were to pick one of them, I would probably pick making it permanent, because evidence shows that changes in the rates, like, from 14 to 20 percent, probably has some impact, but has less impact than something like stability or knowing that you will definitely have access to this credit and be able to count on it, understand it well.

I think the kind of provision that really does not make sense that was mentioned earlier is retroactive R&D credits, because, there, you are basically giving money to companies that chose to do something and not really changing behavior on the margin.

So, if I were to pick one, I would pick making the credit permanent and perhaps making it, also, clearer. What exactly counts as research and development and what does not?

Senator HATCH. Do you agree, Dr. Carroll?

Dr. CARROLL. I think, as Dr. Chetty suggests, an uncertain tax code undermines the effectiveness of tax provisions. I think the R&D credit is probably an excellent example of—the temporary nature of that provision in particular undermines its effectiveness.

Senator HATCH. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Carper, you are next.

Senator CARPER. Thanks, Mr. Chairman. Welcome, one and all. Senator Wyden and I were at a meeting earlier this morning with some folks from some—I guess they were the business media—and they were asking questions of a number of us. We had a good conversation.

One of the questions that we got into was the right balance of revenues as part of the deficit reduction plan, and we talked a bit about the need for businesses that are sitting on a lot of cash to have certainty with respect to a broad range of policy issues—tax reduction, energy policy, transportation policy, tax policy, and the list goes on.

So we talked a fair amount about how helpful some certainty on the tax side would be to businesses that are looking for certainty in a lot of ways, and I think I have heard that repeatedly from businesses: give us some predictability, give us some certainty, get out of the way, and we will do the rest.

Hopefully, we will do that. Hopefully, we will do that. And maybe the triumph of man is hope over experience, but I am encouraged we just might.

I would like to ask you, within that context of providing certainty with respect to taxes, would each of you pick one or two provisions of the tax code, in addition to all that might be part of that certainty message, that would be especially helpful to bolster economic growth?

I would like to say, as much as I believe we need to reign in spending on domestic discretionary, defense discretionary, entitlement program spending, I do not know that we can just cut our

way out of this deficit. We have to grow our way out of the deficit. We need some additional revenues, and we need to grow the economy.

So would each of you pick one or two provisions of the tax code that you think, as we go through this deficit reduction debate and tax reform debate, that we change, preserve, amend in some way just to promote economic growth?

Dr. TODER. I will start then. I think one of the big mistakes that was made 2 years ago was not starting with addressing the question of what tax cuts would and would not be extended really very early on in the session.

I think what is going to happen, if you do not deal with the expiring tax cuts and the AMT very quickly, you are going to end up waiting until 2012, and then you will have yet another temporary extension of various provisions.

So I think the fact that we have this expiring tax code, which is really a new phenomenon—we had not had it before 2001 and, of course, in 2001, it was 10 years in the future, so people were not worrying about it.

I think without saying whether you should extend all of the cuts, some of the cuts or none of the cuts, I think a decision on that early would be very desirable.

Senator CARPER. All right. Thank you.

Dr. CARROLL. I would agree with Dr. Toder that having a more certain tax code, obviously, is going to be extraordinarily helpful.

As Dr. Toder said, we pretty much now have a tax code where a large fraction of it is extended every few years. It is in flux. It makes it extraordinarily difficult for businesses and households to make decisions. And starting the process as early as possible so that households and businesses can have a certain tax code that they can incorporate into their decision-making, their planning, is, I think, critical.

Senator CARPER. That is not really my question, though. I think we agree we need some certainty, some predictability. But within that, are there a couple of provisions of the tax code that you would especially ask us to take a look at——

Dr. CARROLL. I think it is very important to——

Senator CARPER [continuing]. Either preserving or changing?

Dr. CARROLL. I think it is very hard to pick a couple provisions out, because such a large fraction of the tax code is changing. We have the rates changing on ordinary rates, on dividends, on capital gains.

We have the estate taxes in flux, as well. We have all the expiring provisions on the business side and some on the individual side, more traditional expiring provisions.

So I think it is really hard to—I think you have to evaluate each one.

Senator CARPER. That is why we have you guys here.

Dr. CARROLL. That may not be helpful, but——

Dr. TODER. I really do not think that picking one of those elements of the tax code is really going to do very much good if you do not address the whole rate structure.

I might say the AMT, if you push me to the wall and ask me to talk about one thing, but that is——

The CHAIRMAN. We just pushed you. You were just pushed.

Dr. TODER. And I just said it.

The CHAIRMAN. On AMT, which is?

Dr. TODER. To make the patch permanent.

Senator CARPER. Dr. Chetty?

Dr. CHETTY. So I am now going to try to give you an example on the business side.

Senator CARPER. Please.

Dr. CHETTY. I think it is one of many examples, as has been suggested.

So I think the variation in dividend tax rates over time induces firms to do things that they would not otherwise do if they had a stable system. So, for instance, lots of companies try to pay special dividends right before they know that a dividend tax increase is going to occur or right after a cut occurs.

You saw this right after the 2003 dividend tax cut that was enacted, when there was uncertainty about how long it would last.

That kind of behavior is perfectly rational on the business side, but it induces sort of wasted effort and re-timing the point at which you distribute cash to shareholders. It distorts investment decisions.

As another example related to that, when you have, say, tax holidays to repatriate profits to the United States, that, again, basically creates uncertainty about how should I time things, when should I bring money back.

So I think, especially on the business side, having stability in specific things like the dividend tax rate, or the tax rate on repatriation of profits, would be quite valuable. I think that is what the evidence suggests.

Senator CARPER. Thank you all.

The CHAIRMAN. Thank you, Senator.

Senator Wyden, you are next.

Senator WYDEN. Thank you. Thank you, Mr. Chairman. I think it is very appropriate, Mr. Chairman, that you are having this hearing on the complexity of the tax code right now.

I saw something from the Internal Revenue Service just recently that indicates that Americans spend 6 billion hours a year complying with the tax law, and it costs us $160 billion a year. So the chairman's scheduling of a hearing on complexity when what we ought to be trying to do is give the American people their springtime back, I think this is very appropriate, Mr. Chairman. I am really glad you are holding this today.

The question I have for you, Dr. Toder and Dr. Chetty, in particular: is there any reason, on the individual side of the tax law, why our country should not have a 1-page 1040 form?

This has been recommended by Democrats and Republicans for just ages, and I would be interested to get your thoughts on why there should not be a 1-page 1040 form.

Dr. TODER. I guess my thoughts on that are maybe not what you are looking for. I actually do not think——

Senator WYDEN. We can just move on. [Laughter.]

Dr. TODER. I actually do not think——

Senator WYDEN. Seriously, I want to hear what you think.

Dr. TODER. I actually do not think the form matters that much anymore. Most people are using assisted methods, and the biggest source of cost in complying with the tax law for individuals is recordkeeping, actually figuring out what all these numbers are.

So the structure of the form when you do it in an automated way, which is what the people with complicated returns are doing—the people with simple returns are already using 1040–EZ, so they already have a 1-page form.

But the people with complicated returns are having their form automatically populated. So it is not really a matter of what is on the form so much as what are the numbers of things you need to do in order to get at your tax liability; what are the kinds of records you have to keep; what are the kinds of data requirements.

Senator WYDEN. Just on that point, and then we will go to you, Dr. Chetty, I was really struck, and you have said that the 1040–EZ form—folks are using it.

In the "oops" list that the Internal Revenue Service puts out, they said that many of the people who worked in 2009 could not figure out how to claim the Making Work Pay Credit on their form 1040–EZ.

So, in effect, here the Congress passes tax legislation with hundreds of billions of dollars worth of tax breaks, the system is so complicated, people cannot even claim the breaks that Congress authorizes. And you cited the 1040–EZ form, and the IRS puts out on their "oops" list that people thought it was too complicated to take the Making Work Pay Credit.

Dr. TODER. Well, absolutely, but that is a 1-page form. So I guess that is my point. It is not the length of the form. It is what you are asking people to do.

Senator WYDEN. Let us ask your colleague. Dr. Chetty?

Dr. CHETTY. Thank you, Senator Wyden. So let me make three points. I think the observation you made about the very large compliance costs, the number of hours that the taxpayers spend filling out these forms, in a way, actually, understates the cost of complexity, because of what you said, for instance, about the Making Work Pay Credit.

The compliance cost just measures how long it takes people to fill out these forms, but I think the bigger cost is that we are spending a lot of money on these programs without actually having incentive effects and changing the amount people work when we have the Making Work Pay Credit.

I think, in order to make those programs more effective, it is not necessarily the length of the form, per se, which is what Dr. Toder was, I think, getting at. It is more about making these credits, when we enact them, very transparent to people.

So I think, to some extent, separating, say, even from the 1040, having direct information given to people about how the Making Work Pay Credit works and how you can go about claiming it, can greatly increase the effectiveness of such programs independent of the length of the forms required to be filled out.

Third, coming back to a point that Senator Baucus made earlier in terms of why we cannot end up having just a 1-page form, there are always going to be various contingencies where some people

want to promote saving for retirement or promote work, and you are going to want to target those programs in certain ways.

It is hard to get all of that to fit into a 1-page form. So I think the focus should be more on, how do we make the relevant group that we are targeting understand exactly what we are trying to accomplish with these incentives, rather than minimizing the length of the form.

Senator WYDEN. Mr. Chairman, is my time up? I cannot tell.

The CHAIRMAN. Your time is up, but you can go ahead and ask another question.

Senator WYDEN. Well, just staying with this complexity issue. I guess you all have reservations about this 1-page 1040 form, or at least you do, Dr. Toder.

The commission that was set up by the Bush administration, they recommended it. It has been recommended in the past by Democrats. What would you like to see in terms of making the system simpler?

I guess maybe for you, Dr. Toder. I think Dr. Chetty is perhaps more sympathetic to this. But what would you like to see to make the system simpler for people?

Dr. TODER. I think there is a huge number of proposals that have been recommended by the taxpayer advocates and others. There were some that were in the President's Economic Recovery Board report. There were some that were in the tax reform panel in the Bush administration.

But a lot of things that would eliminate phase-outs of benefits, reduce the number of alternative incentives people have to use for saving or education, eliminate the AMT or reduce the scope of that; in other words, provisions that just simply make the determination of your tax liability simpler, and there is a very, very long list of those things that are possible to do without really changing the distribution of tax burdens or the overall broad incentive structure.

Senator WYDEN. Whatever the clock says, Mr. Chairman, I must be over my time, and I thank you.

The CHAIRMAN. You are welcome, Senator.

Senator Cardin, you are next.

Senator CARDIN. Thank you, Mr. Chairman. Let me thank our panel of witnesses.

As I listened to your exchange with Senator Wyden, it just reinforces my concern as to whether we really can save this tax code that we have today. In 1986, we tried to simplify it. We tried to make it fairer, and it lasted less than a year before changes came about.

You mentioned the efficiency of the tax provisions that we have enacted, as to the purpose for which we put those provisions in the code, and I think that is a very good point as to whether we are getting the efficiency factor for the revenues that are being expended as tax expenditures.

But let me try to give a different angle to it which really troubles me, and get your view on it. Our overall tax code is so complicated that two families living next door to each other in the exact same financial circumstances do not believe they are being treated equally under our tax code.

Therefore, when we pass a tax provision which, in many respects, depends upon voluntary compliance as far as the rules are concerned, the taxpayer believes that he or she can go beyond the edge because their neighbor has gone beyond the edge.

So I guess my question to you—is there any way of solving that under our current income tax code; that is, the public perception that there is a lack of fairness in the code? And, therefore, where we depend upon voluntary compliance for much of the information we receive, will we ever get that level of voluntary compliance that gives us reason to believe that what we are doing is right?

Dr. TODER. That is a very complicated question. Certainly, the perception of fairness does hurt compliance. I do not have an estimate of how much it hurts compliance, but it is certainly a negative factor.

I think if you look at voluntary compliance, you might be surprised at how low it really is. The compliance rates that the IRS estimates are about 85 percent, but, when you break that down, it is more like 99 percent for wages and salaries and 95 percent for interest and dividends; that is, for items of income for which there is withholding or information reporting or matching, it is extremely high.

For other items where there is not such information reporting, such as business income, it is quite a bit lower.

Senator CARDIN. That is my point.

Dr. TODER. That is a very difficult issue to deal with.

Senator CARDIN. And my point is exactly that. For a lot of the provisions we are talking about on efficiencies, it requires voluntary compliance in order to receive that particular tax provision.

Historically, we have had a very high percentage of voluntary compliance with our tax code. As we become more complicated, I believe that the voluntary compliance, other than where we have reporting, has gotten worse.

The question is, can you save it under this tax code that the public perceives as being basically so complicated that they do not know whether they are being treated fairly?

Dr. TODER. Well, I mean, I guess that is an interesting question because, in some sense, the fairness is coming—the perception of unfairness is coming about because of programs that the Congress wants to enact, and they want to use the tax code to enact those programs.

So, if they are giving a farm subsidy payment to somebody, somebody is getting money from the government, but it is not reducing their tax liability. So people do not see it as unfair that somebody is getting this payment from the government and someone is not.

But, if they are getting an earned income tax credit or they are getting a mortgage interest deduction, then it is coming through on their tax form and they are paying less taxes than somebody else.

So substantively, when you do things through the tax code, you are creating this perception, but part of the reason is you actually do want to have these programs.

So it is a conundrum.

Senator CARDIN. And I appreciate the frankness of your answer, and you are absolutely correct.

I guess one of the points that I have been bringing up is whether it is time to fundamentally change the way we bring in the revenue in this country.

Dr. TODER. And I am very sympathetic to your point of view. I think we would have to do something on the order that Senators Wyden and Gregg have proposed, or something even more radical, to move to a system where taxes are just, more simply, based on people's income and there are fewer tax benefits, and we keep rates lower as a consequence.

Senator CARDIN. And, of course, we also have to come to the conclusion that the tax code's purpose is to raise revenue.

Dr. TODER. Correct.

Senator CARDIN. Which is not exactly where we are today.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Before I turn to Senator Snowe, there was one interesting observation here that was mentioned, Dr. Toder, which was 99 percent compliance on, what, dividends?

Dr. TODER. Wages.

The CHAIRMAN. Wages, and 97 percent compliance——

Dr. TODER. Ninety-five on dividends and interest.

The CHAIRMAN. On dividends, and that is because of reporting requirements. Going to Senator Cardin's point, there is a lot of income not collected that has nothing to do with the perception of fairness. It is just that people cheat. They know they are cheating.

I am talking about under-reported income. Some people know they are under-reporting income that maybe goes to—I am talking about—I do not want to get myself in too much trouble here—and, also, over-expensing, and that is the largest part of the tax gap. And I do not know how much that is based upon people's belief that the tax code is unfair. I think it is, some people are just trying to figure a way, because there are no reporting requirements, that they can figure out a way to not pay their fair share.

Senator CARDIN. Would you just yield for one moment? My understanding is, if you go back in time on collection of revenues under the tax code, when we did not have as much of the information reports that were made available, there was much higher voluntary compliance, including reporting income where there were no reports to the government, that there was a higher percentage of compliance than there is today.

The CHAIRMAN. I am talking about different income groups, not the income that Dr. Toder is mentioning. The last—I think it was Treasury, with the tax gap assessment—it was back quite some years ago, and that was $300-and-some-billion annually. That was back then.

Anyway, clearly, we have work to do.

Senator Snowe, you are next.

Senator SNOWE. Thank you, Mr. Chairman.

In the health care law, there is a new section that added a small business tax credit to help small businesses pay for health care coverage for their employees, and this credit can mean as much as 35 percent of the insurance premiums small businesses pay for medical coverage for their employees. And it also took effect in the taxable year of 2010.

I heard about this through many of my constituents, but one example really stood out, and that was the case of an accountant who was determining whether or not he himself would be eligible for this tax credit, and it took him 9 hours to figure out whether or not he was eligible for that tax credit, and discovered at the end of that calculation that he was not.

In fact, accountants are recommending to their clients not even to bother to hire professional help to determine whether or not they are eligible for this tax credit, because the cost of that professional advice would be greater than the value of the tax credit itself.

We changed that tax credit from what it was originally to what occurred on the floor, where they changed the number of employees, for example, from 50 or fewer employees where a small business would be eligible to 25, and then the employer had to pay at least 50 percent of the employees' health insurance.

We have a chart here just to show and demonstrate how complicated this tax credit is. This is not my chart. It was one that was used in the Ways and Means Committee on the House side.

But I think it makes the point about the complexity of this tax credit that is probably virtually useless for many small businesses who clearly do not have that kind of wherewithal within their small entities to make those determinations.

If an accountant cannot do it in 9 hours, then clearly there is something wrong in the way we are crafting these initiatives.

So, Dr. Carroll, would you care to comment on what we ought to be doing differently? I am certainly mindful here that we should be conscious of how complex—every time we are making revisions in provisions, that it results in this kind of complicated calculation and computation.

Dr. CARROLL. One of the things you see is, when you look at compliance costs by size of business, when you are looking at—there are a certain amount of fixed compliance costs associated with businesses, and when you are relating those compliance costs to assets or receipts, as a percentage of assets or receipts, they are much higher for smaller businesses.

It is just kind of the way it works. It has to do with the fixed nature of complying with the business tax system. And so the code has kind of dealt with that or the Congress has dealt with that in some respects by having some special provisions that make things a bit easier for some small businesses.

Section 179 expensing, for example, would be kind of a perfect example, where smaller businesses can write off 100 percent of their—most of their—purchases of equipment immediately and do not have to worry about keeping track of the depreciation over a period of time. And there are some other provisions.

But this particular provision, looking at your chart, goes in the opposite direction.

Senator SNOWE. Well, it certainly does, and maybe what we ought to be doing differently in Congress, that is for sure, is to show these types of charts and exactly what the tax credit looks like before it is enacted, because, clearly, if that had presented itself on the floor of the Senate, I think that there would have been a general reluctance to vote for a tax credit that would look like this in the final analysis.

Dr. Chetty or Dr. Toder, do you have any comments on that, any advice for Congress?

Dr. CHETTY. Senator Snowe, precisely as you suggested, I think one thing that would be useful is to, when enacting a law like this, do sort of a pilot study and try to anticipate how many hours would it take an accountant to figure this credit out for a representative business, and if you find that, in many cases, it is 9 hours and the costs are going to exceed the benefits, I think quantifying those costs, as we were discussing earlier with Senator Baucus, would be a valuable input to the legislative process and might make such legislation less likely to happen.

Senator SNOWE. I appreciate that.

Dr. Carroll, you mentioned several weeks ago in a hearing before a Ways and Means subcommittee one of the issues that I have expressed, as well, and that is on the issue of tax reform exclusively on the question of corporate tax rates.

I know that Secretary Geithner was before the committee a month or so ago and talking about having corporate tax reform, without recognizing what the impact will also be on flow-through entities. And one of the suggestions that he was making is somehow to revoke the longstanding practice of subchapter S to pay individual tax rates on their business income, which, obviously, would have a great effect on 27 million small businesses, not to mention that more than $3 trillion in additional capital would be subject to higher tax rates.

Could you give us some comments on that whole issue, because that clearly is a problem, requiring flow-throughs to be, obviously, double-taxed, both at the entity level and the individual level, rather than just simply paying one tax rate.

Dr. CARROLL. I guess I would start out with the observation that the corporate income tax is in need of reform. The corporate tax rate is certainly high from a global perspective. It is increasingly high as other countries lower their tax rates.

So that is an issue that I think is appropriately getting a lot of focus. But I think it is very difficult, given the way the business sector is arranged in the United States, to do corporate tax reform by itself. It is very difficult.

The flow-through sector is simply very large. It is not just S corporations. It is partnerships, it is sole proprietorships, it is LLCs and LLPs. They employ about 54 percent of the private sector workforce. They report about 35–36 percent of business receipts. About 44 or 45 percent of all business taxes are paid on flow-through income by the owners of those flow-throughs when they file their individual tax returns.

So it is a large sector. If one were to finance or pay for a corporate rate reduction by repealing all business tax expenditures, that would have a substantial increase on the tax paid on that flow-through income. It would go up by about 8 percent.

About 22 percent of business tax expenditures are claimed by flow-through entities. So I think it is very hard to deal with one without dealing with the other, dealing with the corporate tax without dealing with other business taxes at the same time.

If one were to have special treatment—if one were to try to just repeal the corporate tax expenditures alone, then it would be a

very complicated system to try to apply one set of depreciation rules to C corporations and other depreciation rules to the other types of flow-through entities.

Another, I think, very large consideration is the role of the corporate tax and the role of flow-throughs. One of the advantages of the flow-through form is it affords businesses and business investment one single layer of tax.

For businesses that are operating in the flow-through form, they are not subject to the double tax, and the double tax carries with it a lot of important tax biases. It affects business decisions in important ways. It discourages the incentive for companies to pay out profits as dividends, which affects corporate governance. It affects the debt-equity choice. It raises the overall cost of capital in the economy. And those are all considerations that I think need to play into that discussion.

Senator SNOWE. I appreciate that. Either one of you, any comment, Dr. Chetty or Dr. Toder?

Dr. TODER. I would certainly agree with most of what Dr. Carroll said, and really note that the ideal way to tax business income is the way we tax S corporations. We would like to attribute the income to the owners, and the only reason we have a corporate tax is, for large and frequently traded companies, it is very hard to do that and identify the owners who would pay the tax.

But where you can do that, we should do that. And so that is the right treatment. I also believe that we cannot look at corporate tax reform in isolation without looking at the effect on the flow-throughs and, also, the effect on the taxation of corporate income at both the individual and the corporate level.

Part of the reason we have given tax breaks to individuals—very low capital gains and dividends rates—is to adjust for the double taxation of corporate income. And so, if we are going to reduce the corporate rate, we might think about how we tax individuals, and maybe we do not need to give them as much preferential treatment.

But I think putting things in a box, corporate tax here and individual tax there, is not the right way to go.

Senator SNOWE. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator, very much.

It is interesting. The flow-through is a problem, clearly. What about the reporting requirements of C corps, which do provide a certain benefit to the public, 10(k)s and reports, et cetera? Those are large corporations, have a certain number of shareholders.

I do not know this. I am asking the question. How many flow-throughs are as large in size as, say, a reporting company, a reporting C corporation? Because, if I am a C corp, I have to file, but I do have certain liability protections if I am a C corp, whereas, if I am a flow-through, I do not have to file. I do not have to tell anybody what I am doing, except pay my taxes, and I do not have the same liability protection that a C corp has.

So I just wanted to try to figure out—I do not know the answer to this question—what are the size—are there large flow-throughs, whether they are hedge funds, they are private equity firms, partnerships, really, that are as large as many C corps? Are there or are there not? I just do not know.

Dr. CARROLL. Again, I guess I would approach that issue from the perspective of broadly looking at our business tax system. We kind of have a line that is drawn between the corporate sector and the non-corporate sector, and where you draw that line really depends on how much business activity do you want the double tax to apply to.

As Dr. Toder indicated, there are different approaches of dealing with the double tax. One could relieve the double tax at the investor level by having larger reductions in capital gains and dividends taxes. But I think the way to think about it is, how much of the activity do you want the double tax to apply to?

So, if you were to bring some of the—there are large S corporations, there are large flow-through entities, clearly. They employ a lot—a fair number of people. I do not know the statistic off the top of my head, but I can get that to you.

If you were to extend the corporate tax to them, it would raise the cost of capital, raise taxes on them.

The CHAIRMAN. I understand. I understand. You made that point very clearly. That gets into the complication of the question.

Dr. CARROLL. Right.

The CHAIRMAN. What about—well, let us take education. We may be getting ahead of ourselves a little bit, because what I want to do is take the major tax expenditures, not today, but at a future date, and drill down more on the effectiveness of them or a cluster.

Let us take education, for example. I think there are 15 credits and deductions, incentives for higher education. They are very confusing.

A group of educators was in my office just a couple, 3 weeks ago, and I asked them which of these makes most sense and helps students the most and helps families the most. They had no idea. They had no idea what they were. That is a bit of exaggeration, but I was, frankly, surprised at the degree to which they did not know what the various provisions were. Even they did not. These are officials, administrators at colleges and universities in our country.

But off the top, I suppose you would say make it simple, upfront, transparent. But your thoughts? And when we do get into, for example, education, how do you think we should change incentives for higher education?

Dr. CHETTY. I think there is actually quite a bit of evidence showing that, in particular, programs that require you to fill out the Free Application for Federal Student Aid (FAFSA) to qualify—that is such a complicated form. People are talking about the complexity of the income tax code. It is even more complicated.

The CHAIRMAN. It is very complicated.

Dr. CHETTY. Yes.

The CHAIRMAN. I have firsthand experience with that.

Dr. CHETTY. So there is evidence that State-level programs that are much more streamlined, they are sort of contingent on a smaller set of things, have a much greater bang for the buck. So a dollar spent through those State-level programs increases college attendance rates much more than equivalent Pell grants or Stafford loans.

So I think restructuring programs so that—the State programs, such as the ones enacted in Georgia, for example, provide good examples of the types of structures that one might consider using at a Federal level.

The CHAIRMAN. Why are they more efficient?

Dr. CHETTY. I think they are more efficient simply because there is a simpler set of eligibility requirements. So one might argue that they are less targeted, in a way, because they are less contingent on the assets that you have.

The reason for the complexity in the FAFSA is that it depends—qualifying for a Pell grant depends upon a whole host of things, and, basically, the Georgia program reduces the number of things that matter to a much smaller set of variables.

Now, that might make the program a little bit less well-targeted, if it is not going to low-income folks that you want to target the program at, but it comes, I think, at the benefit of tremendously increasing awareness of the program and impacts on college attendance rates.

The CHAIRMAN. Well, that is interesting, because it gets a bit to the question Senator Snowe was asking about the small business health care credit. This committee worked on that, and it gets to the two, opposing goals in tax policy. One is simplicity, and the other is equity. And in this case, we are trying to also make it equitable; that is, help smaller businesses—try to help the business with employees whose salary is a little lower, and so forth.

That was the goal. Now, perhaps this committee went and made it too complex, but at least that was the goal of that provision.

Senator SNOWE. Mr. Chairman, may I add a comment to that? Actually, the committee did have much the simpler approach to the tax code. It was changed on the floor.

The CHAIRMAN. Was it really?

Senator SNOWE. Yes.

The CHAIRMAN. But the main point is, we struggled in the committee to try to figure out how to address the opposing goals of equity and simplicity.

Dr. CHETTY. If I could add? I think one point related to that, Senator Baucus, is that complexity may directly affect equity in the sense that complex programs are less likely to be taken up by lower-income individuals, thus affecting the equity of the program itself.

So I think rather than thinking that—what the new research shows is, rather than thinking of it as a pure tradeoff between simplicity and equity, there might actually be a direct connection between those.

The CHAIRMAN. That is probably true. Yes. I think there is something to that. And, also, we want to be efficient, and that gets to the same point.

Senator Thune?

Senator THUNE. Thank you, Mr. Chairman and Senator Snowe, for holding this important hearing, and to all of you for being with us and sharing your insights.

I think buying a home, giving to charity, producing renewable fuels, purchasing health care are just a few of the many things that our current tax code is designed to incentivize. And, while working

through tax reform, it is essential that we think about not only which activities we want to continue to incentivize but, also, how effective are those incentives.

So I appreciate your testimony and responses today. And I wanted to focus, if I might, and I guess I would direct this to Dr. Carroll, and if others would care to comment as well.

But, Dr. Carroll, in your testimony, you discussed why certain tax incentives are efficient as judged by the fact that positive external effects are not reflected in market decisions or prices absent the tax incentive.

You mentioned the R&D tax credit is a good example of this. I would note another compelling example of this situation, which is the charitable giving deduction. Increased charitable giving has enormous benefits to our society. For example, taxpayers bear less of a burden as fewer Americans are forced to rely on government assistance.

So I guess my question is, would you agree that the tax deduction for charitable giving is a good example of tax policy that promotes economic efficiency by more effectively taking into account the societal benefits of an activity?

Dr. CARROLL. I guess the way I would answer that is, I think Congress has kind of determined over the evolution of the Internal Revenue Code and the income tax system over 100 years, there are a whole host of provisions like the charitable deduction, like the home mortgage deduction, a number of other provisions, where there is a perception out there of benefits that warrant the presence of those provisions in the code.

If one were to reconsider any of them, one, I think, would need to carefully evaluate the effects of any reengineering or changes to the provisions, how they would affect various groups and how they would affect, in your question, the level of giving.

That is also an issue in the estate tax, where the estate tax is another lever that drives charitable giving. It is something that did come up in discussions of the estate tax, changes in the estate tax over the last decade.

Senator THUNE. And to follow up on that, as you may know, the President's budget proposes to limit the value of itemized deductions by limiting the tax value of these deductions to 28 percent for high-income taxpayers.

Assuming that the societal benefits of charitable giving are substantial, would limiting the value of this tax incentive be expected to make our tax code more or less efficient?

Dr. CARROLL. I think you would have—I think it is clear that if you lowered the tax benefit of charitable giving or limited it to 28 percent or some lower amount, it would in all likelihood reduce the amount of giving.

I think Dr. Toder has some mention of the tax treatment of charitable giving and its incentive effects in his written testimony. So, yes, I think it would certainly have an effect.

Senator THUNE. And what about capping the charitable deduction and maybe discussing a little bit how that might decrease the marginal incentive to give, if you want to elaborate on that.

Dr. Toder, if you want to add to that discussion, too, that would be—I would welcome your input on that.

Dr. TODER. So, just a few comments. Certainly, capping deductions to 28 percent for high-income taxpayers is one of those types of proposals that makes the tax law a lot more complicated in terms of how you have to calculate your tax liability, and it is the kind of fine-tuning I am generally not too happy with.

On the other hand, one of the issues that has been raised with the charitable deduction is, it is giving a match of 35 cents on the dollar to high-income people who give, and it is giving a match of 15 percent to middle-income people who give, and nothing to people who do not itemize.

So you are encouraging the kinds of charities that a certain set of the population prefers relative to other charities. Maybe that is a policy choice you may choose to make, but I think you should understand that that is a consequence of the way the charitable deduction is structured.

So you might have more contributions to the arts, more contribution to higher education, less contribution to charities that help low-income folks or to religious organizations, by having it structured in that manner.

So alternative designs—you could have a flat credit which gave the same incentive to everybody, and maybe you had some floor so you did not have to worry about people who gave $100 and are trying to claim small amounts which you could never monitor.

So there are ways of reforming that that are certainly worth consideration and would not make the tax law more complicated.

Senator THUNE. But do you think that for, let us say, people of the high-income categories, the volume of giving, at least, obviously, is going to be the higher-income people generally? I think the statistics bear this out, and I do not have it in front of me.

But the incentive to give for somebody who is able to get today a 35-percent deduction against their taxes, if you lower that, do you——

I guess the point I am making, I do not think people give simply because there is a tax advantage to giving. But I do believe that it affects the amount that they give.

So I guess the question is, if you were to cap that deduction that people can take, does that decrease the marginal incentive for people to give, and particularly——

Dr. TODER. No question it does. The question is, how much of an effect that would have, and I think that is uncertain.

Dr. CARROLL. Clearly, to give a dollar to charity, somebody is facing a 35-percent rate; it only costs 65 cents to give that dollar because of the tax benefit. Yet, for somebody of a lower-income, where they are in, let us say, the 15-percent bracket, it would cost 85 cents to give that dollar.

I think that was the point that Dr. Toder was making.

Senator THUNE. Right.

Dr. CARROLL. There might be equity considerations. There are also complexity considerations with the administration's proposal. It may be complex to try to engineer or limit, in their design, to 28 percent.

Senator THUNE. And I understand that. And I understand that if you have a—obviously, if you paid a higher tax rate, you get a

larger deduction against the charitable giving. So there is an equity argument, which you pointed out.

I guess my question gets at, to what degree would we see a reduction in the amount of giving to charitable organizations if, in fact, we were to lower the cap to 28 percent? And, again, clearly, that would impact those people on the higher-income levels, but it would strike me, at least—and there are some studies that have been done on this and I think at this point, it is somewhat—you have to—there is a certain amount of maybe guesswork that is involved with it.

Dr. TODER. Yes. I mean, there are many, many, many studies that have been done, and some of them might say you lose more than a dollar's worth of giving for each dollar of revenue you gain from restricting the deduction, but others come to the opposite conclusion.

Senator THUNE. To my chairman, my time has expired. So, thank you. Thank you all very much.

The CHAIRMAN. Thanks a lot.

I am going to list various incentives, and I would like you to tell me which ones, all things being equal, you think make most sense or have the most effect: deductions, itemized deductions, exclusions, nonrefundable credits, refundable credits, deferral—maybe some others.

Dr. CHETTY. Let me make one simple comment on that. So just take deductions versus credits. What is the fundamental difference? Since we were talking about the charitable deduction, in order to figure out the value of that deduction to an individual, you need to know what your marginal income tax rate is, and you need to have a good sense of that in order to figure out the value of that deduction.

A credit is different in the sense that, if I tell you you get a 20-percent credit if you spend a certain amount on college, and especially if it is a refundable credit, then I do not need to worry about what my tax liability is at all, and so it is, I think, likely to be much more transparent. And I think especially a credit that is given at the time that you make the decision as opposed to when you are filing income taxes up to, say, a year later——

The CHAIRMAN. You have to have income, though. You have to have income.

Dr. CHETTY. That is right. But a refundable credit.

The CHAIRMAN. You have to have income tax.

Dr. CHETTY. Yes. Yes. I think credits that are very directly linked to people's behavior at the time they are making those choices are likely to have the most impact.

So on the list you had suggested, I would pick a refundable credit.

The CHAIRMAN. Dr. Carroll?

Dr. CARROLL. I think it is a hard question to answer. The comments that Dr. Chetty has made on salience and transparency, I think make a big difference here. If you look at the difference between, let us say, an exclusion and a deduction and a credit, yes, I think if you look at the exclusion for employer-provided health insurance, it has been my experience that that is not something that

is well-known, particularly when you travel beyond Washington, DC.

I think a lot of people are unaware of exactly how that operates and the notion that a significant portion of their compensation is not included in their taxable income. It is not the way they think about it.

The difference between a deduction and credit—I think there are very different equity considerations that come into play, which really require a lot of judgment on the part of—different individuals will approach equity and progressivity in very different ways.

If you had 100 people in a room, you would probably have more than 100 different perspectives on that issue. So that is, I think, another consideration.

The CHAIRMAN. Dr. Toder?

Dr. TODER. Well, I would largely agree with Dr. Chetty's comments. I think, in general, refundable credits are best, and to the extent they can be given at the time people are making the decision in real time.

Just a couple of qualifications. I think, since deductions benefit high-income people more or incentivize them more, there might be circumstances—and charities have been mentioned as an example—where the responsiveness of high-income givers might be bigger than other givers. So you might actually want a deduction and have an uneven incentive, but that is something you would have to feel that you actually have some evidence that that is true.

Also, I think one of the problems with credits that we have is a lot of them phase out as your income goes above a certain amount, which means something like that earned income credit—we tried in the Clinton administration to encourage people to use the advanced income tax earned income credit, and the take-up rate was about 1 percent on that. And that would have gotten the money into people's hands right away, but I think they were afraid that they might get to the end of the year and find out that the credit was phased out and they would have to pay some income tax, and they were a little worried about that.

So, to the extent that the credit is not going to be affected by your tax liability, it is helpful.

The CHAIRMAN. In your experience—we have all talked about the American system. Do any other countries do it better with respect to complexity, uncertainty, all the things we are talking about today?

Dr. TODER. There are certainly aspects of the British tax system, for example, which are significantly simpler. For example, I believe the way they handle mortgage interest is, they do it through the banks rather than through the individuals.

Actually, that is the way they handle charities, as well—the money goes to the charity. That may not be feasible here for constitutional reasons, but you give money to charity and the government tops up the charity rather than giving you—so you do not have to—if you are in the basic tax bracket, you do not have to deal with it on your tax return.

Dr. CARROLL. Just to add to that. The British have something more along the lines of a return-free system for a large segment of the taxpaying population, and that is actually driven—in some re-

spects, it has probably driven them to simplify some of the provisions and move kind of the nexus, where you get the deduction from the individual to the charity. Same thing with the home mortgage or the housing preference.

So the way they have structured—how they structured the way the tax system interacts with taxpayers has kind of affected how they have structured some of the preferences.

In order to operate a return-free system, we would have to organize our—we would have to provide preferences in a much different way than we do.

The CHAIRMAN. What about other countries? I knew the percentage was high. I did not know it was that high, when Dr. Toder mentioned 90 percent of Americans have preparers or use software to fill out their income taxes.

Is it that high in other countries?

Dr. TODER. I do not know.

Dr. CARROLL. I am not familiar with those statistics. But I would agree with Dr. Toder's earlier comments that the use of technology has really changed the way one needs to think about compliance burdens because, if you go out and buy tax software for a fairly nominal price, and that allows you to comply with and fill out a complicated tax form, you do not really need to have as great an understanding of how the education provisions work, because the software will be doing it for you.

Dr. CHETTY. I think another key difference in other countries is that there are a lot more prefilled returns. So there are many Scandinavian countries, for example, Denmark, where many taxpayers, except those with fairly complicated situations, would basically just have to sign a form when it arrived in the mail, saying this is how we calculated your tax liability.

The reason for that is they have much better information reporting. So we talked about how information reporting is crucial to the high compliance rate in the U.S. And other countries go beyond—I think they have a U.S.-type system, but, on top of that, capital gains and various other things are directly reported and aggregated with modern technology and you basically get a form which you sign that tells you your tax liability, greatly reducing the compliance burden.

The CHAIRMAN. Right. So in Denmark, the government sends you a form and tells you, "Here is your tax liability."

Dr. CHETTY. Yes. I think in various Scandinavian countries that is true, yes.

The CHAIRMAN. Do you think that has potential? Do you think that is an approach we should pursue?

Dr. CHETTY. I think that would simplify the compliance aspect. So the comment that was made before that it takes taxpayers many hours to actually fill out the tax forms, it would significantly reduce that time spent. But it would not solve the problem we have been talking about more broadly about getting people to respond to incentives. In some ways, it might even make that worse, because you just sign this form, and you have no idea of what determined your tax liability.

So this issue of, if we want to get people to go to college, and we want to use the tax system to encourage that, that is not going to be solved by a prefilled form.

The CHAIRMAN. We are working way out in right or left field here. But does Denmark provide incentives for higher education?

Dr. CHETTY. Now you are really stretching my knowledge of the Danish tax system.

The CHAIRMAN. We can go to any other country you want.

Dr. CHETTY. Well, I think a number of countries provide incentives for higher education in the sense that there are basically state-subsidized schools. So it is not necessarily through the tax system.

The CHAIRMAN. That is very true. It is true in other countries. It is very true.

Dr. CHETTY. Yes.

The CHAIRMAN. Well, this has been very interesting, because we clearly have to—we clearly have a lot of work ahead of us, and you have provided a lot of guidelines and notes and stuff to us to keep plowing ahead, keep moving ahead.

Thank you very, very much for the time you have taken.

The hearing is adjourned.

[Whereupon, at 11:47 a.m., the hearing was adjourned.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Opening Statement of Senator Max Baucus (D-Mont.)
Regarding the Effectiveness of Tax Incentives
As prepared for delivery

Albert Einstein once said: "Make everything as simple as possible, but not simpler."

There is a limit to how simple certain things can be. But today's tax code can certainly be simplified. And the complexity of the code has significant consequences.

At our last hearing we looked at unintended consequences of the complications in our tax code.

Our witnesses laid out undesirable distortions that may prevent growth and job creation. For example, we discussed how the tax bias towards debt in the tax code may have contributed to the financial crisis.

But some of the tax code's complexity is a result of incentives inserted in the code. That intentional complexity is what we are discussing today.

Today we will ask our expert witnesses how to measure the effectiveness of a tax incentive, including our current incentives.

And we will ask how to best structure incentives so people respond as we intended.

We will ask how we get the most bang for the buck. Or, in the words of Dr. Einstein, how do we keep it simple, but not too simple?

Today, we have all sorts of incentives in the code. Many incentives are meant to encourage or discourage certain behavior.

The research and development credit is meant to encourage innovation and create jobs.

The higher education incentives are meant to help students pay for college.

The retirement savings incentives are meant to encourage saving for those later years.

In 2010, we used 109 billion dollars for more than a dozen different incentives to help Americans save for retirement. We used 91 billion dollars to promote homeownership through the mortgage interest deduction.

All in all, incentives in the income tax code cost more than one trillion dollars each year. That's about the same as the total amount raised by the income tax code.

Studies show that the way tax incentives are presented and structured affects the way individuals respond to them.

Take retirement savings tax incentives, for example. Studies have found that taxpayers save more of their money for retirement when they receive a contribution that matches their own rather than receiving a tax refund at the end of the year.

Tax incentives are also more effective when they are offered immediately.

Programs like "Cash for Clunkers" show that on-the-spot incentives are more effective than a tax credit individuals receive when they file their tax returns.

More people purchased energy-efficient cars more quickly through that program because the money was in their hand right away.

Today we will ask our witnesses what makes a well-designed tax incentive.

Do taxpayers respond less to complex incentives? What about the response to temporary tax incentives? There are certainly many complex and overlapping tax incentives.

For example, there are more than 15 provisions to assist with the rising costs of higher education. The sheer number of options, and choosing between them, often overwhelms taxpayers.

Does this complexity discourage young people from enrolling in college?

There are also a huge number of temporary tax incentives. And the prevalence of these temporary provisions has risen dramatically over the past decade.

There are now 141 temporary provisions that expire nearly every year. These temporary tax incentives hinder taxpayers' ability to plan. As a result, they may only benefit those people who would have acted anyway.

Ultimately, the desirability of any tax incentive will depend on whether we want to encourage the activity in the first place.

If Congress is going to encourage certain activities through the tax code, we need to know how to most effectively achieve the intended policy goals.

We need to know how to structure tax incentives that are simple enough to generate a response, but not so simple that they are not well targeted.

I look forward to the discussion today from these experts.

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How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?

Testimony before the

Senate Finance Committee

United States Senate

Robert Carroll[1]

March 30, 2011

Chairman Baucus, Ranking Member Hatch, and distinguished members on the Committee, thank you for the opportunity to testify today regarding the evaluation of special tax incentives and tax expenditures.

Tax expenditures represent a broad array of provisions and priorities of the Congress in the development and evolution of the Internal Revenue Code (the "Code") since the inception of the income tax a century ago. These provisions affect large segments of the U.S. economy, touch upon many aspects of household and business decisions, and significantly narrow the tax base, thereby requiring higher tax rates to raise a given amount of revenue. Many of these provisions are long-standing provisions that have been part of the Code for many years, but others reflect more recent priorities. These provisions were carefully considered and debated at the time of their enactment and added to the Code to meet specific objectives.

There are also a large number of provisions – expiring provisions – often extended a year at a time. In principle, the periodic extension of expiring provisions provides Congress an opportunity to reconsider and reevaluate their effectiveness, but the lack of their permanence may undermine the ability of taxpayers to rely upon and base decisions on the benefits they provide. Moreover, expiring provisions are no longer limited to several dozen business tax provisions, but now also include the alternative minimum tax (AMT) patch and the 2001 and 2003 tax cuts. The result is a tax system where large portions of the Code are in effect temporary.

Tax expenditures are in part receiving closer scrutiny due to the growing imbalance between what the federal government spends and collects in revenue over the next several decades. With growing federal deficits, the federal government debt held by the public is projected by the Congressional Budget Office to rise to 87 percent by 2021 and continue to grow to unsustainable levels. With these increasing fiscal pressures, there is a growing recognition that reevaluation of spending priorities ought to also take into account related spending that occurs

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[1] Principal, Ernst & Young LLP. Formerly, Deputy Assistant Secretary for Tax Analysis, U.S. Department of the Treasury, November 2003 through January 2008. The views expressed do not necessarily reflect those of Ernst & Young LLP.

through the tax code. Tax expenditures are also seen by some as a potential source of additional revenue that can help stem the fiscal gap and/or be used to lower tax rates.

An evaluation of the effectiveness of tax expenditures can be particularly helpful to the Congress as various policy priorities are reconsidered in light of the nation's long-term fiscal imbalance and need for tax reform.

I have had the opportunity to consider tax expenditures and other special tax provisions included in the Code from a number of perspectives, inside and outside of government, in the context of broad reform of the Code, how the provisions affect household and business decisions, and who receives their benefits.

Today I will discuss issues relevant to the evaluation of tax expenditures and other special tax provisions. First, I will focus on tax expenditures and their limitations. Next, I will focus on the rationale for special tax provisions. Then I will discuss how complexity and uncertainty affect their effectiveness and provide some considerations important to their evaluation.

The tax expenditure concept and its limitations

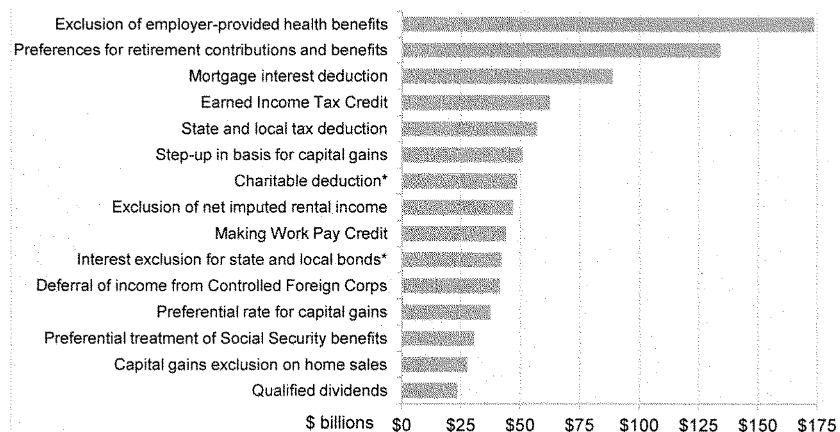
More often than not, the tax system has been used to encourage certain activities or provide benefits to particular groups of taxpayers through various special tax provisions often referred to as "tax expenditures." These provisions often take the form of exclusions, deductions, credits, or special tax rates that confer special benefits to activities and groups. The term "tax expenditures" reflects the notion that many of these provisions can be viewed similar to government spending programs, but that are included as part of the tax system.[2]

Tax expenditures have recently gained attention in part due to the large federal deficits over the past several years and the growing imbalance between what the federal government is projected to spend and receive in revenue over the next several decades. The 173 tax expenditures listed in the Budget of the United States total roughly $1.1 trillion annually.[3] These provisions result in a more narrow tax base that requires higher tax rates to raise a given amount of revenue. The higher tax rates themselves have adverse effects on work effort, saving and investment. The idea that tax expenditures reflect spending through the Code also suggests that their effectiveness and distributional effect ought to be considered together with reevaluation of direct spending priorities.

One important consideration is that many tax expenditures have been part of the Code for a long time. As shown in Chart 1 below, these provisions represent a broad range of priorities and are among the most politically popular provisions in the Code. Many provisions have been reconsidered and studied extensively since their enactment.

[2] See Stanley S. Surrey, 1970, "Federal Income Tax Reform," *Harvard Law Review* 84, pp. 352-408; and Stanley S. Surrey and Paul R. McDaniel, 1985, *Tax Expenditures* Harvard University Press, Cambridge, MA.
[3] Office of Management and Budget, Budget of the United States, Fiscal Year 2012, February 14, 2011.

Chart 1. Largest 15 tax expenditures, annual average, 2012 - 2016



* Denotes that tax expenditure includes both corporate and individual tax expenditure components.
Note: Estimates were based on current law prior to enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.
Source: Budget of the United States for FY 2012, Analytical Perspectives, Tax Expenditures (Chapter 17), February 14, 2011.

Nevertheless, it is useful to consider the conceptual framework underlying tax expenditures and some of its limitations. Tax expenditures are, in some respects and in some cases, subjective departures from a more general and theoretical notion of an "ideal" income tax system. Their measurement takes certain key aspects of the income tax system as given and adheres to a set of rules that simplifies their estimation, but limits their usefulness. Also, in practice, the Congress has looked well beyond tax expenditures in past efforts for reform. Thus, tax expenditures only provide a limited guide for what would likely be considered in an actual reform.

Tax expenditures and the baseline tax system

The process of identifying and quantifying tax expenditures became formalized in 1974 with the enactment of the Congressional Budget and Impoundment Control Act of 1974, which mandated the annual publication of tax expenditure estimates in the Budget of the United States Government. This Act defined tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[4]

Despite this requirement, identifying and quantifying tax expenditures is not straightforward and involves judgment. Identifying tax expenditures requires defining a baseline tax system against

[4] Congressional Budget and Impoundment Control Act of 1974 (PL 93-344), sec. 3(3).

which special provisions can be measured.[5] Tax expenditures can only be understood as deviations from a hypothetical baseline tax system that serves as a point of comparison.[6] This is because tax expenditures are a *negative* concept defined by reference to what is *not* done, i.e., taxes that are not collected on a particular activity or group of taxpayers.

The baseline tax system underlying the identification and measurement of tax expenditures used by both the U.S. Department of the Treasury and the Joint Committee on Taxation (JCT) is a comprehensive income tax. Under such a system, all household income would be taxed. In practice, however, a number of important departures from a comprehensive income tax are embedded into the baseline used by the Treasury Department and the JCT. First, the individual and corporate income taxes are viewed in isolation of each other. The fact that some income has been previously taxed under the corporate income tax, for example, is not considered when evaluating tax expenditures under the individual income tax. Thus, the lower tax rate on dividends and capital gains resulting from corporate equity investments is viewed as a tax expenditure even though this income has already been subject to the corporate income tax.[7] This, in effect, embedded the double tax on corporate profits into the baseline tax system for tax expenditures. Rather than the investor level taxes on this income being viewed as surtaxes, the lower rate on this income is instead viewed as a tax expenditure.

The baseline used for official tax expenditures also assumes that income is only taxed when realized even though a comprehensive income tax would tax income as it accrues. Thus, the deferral of tax on unrealized capital gains is not considered a tax expenditure.[8] Tax rates are allowed to vary by income, thus building the graduated tax rate existing in any particular year into the baseline tax system. In addition, tax rates, the standard deduction, personal exemptions and various other provisions are allowed to vary with marital status and the value of assets and debt are not adjusted for inflation.

The very choice of a comprehensive income tax as the underlying baseline system also has a considerable effect on the provisions included as tax expenditures. Under the alternative of a consumption tax baseline, the return to saving and investment would be free of tax. Roughly one-third of household financial assets and two-fifths of the return to investment receive consumption tax treatment under the current income tax system; that is, the current so-called income tax is very much a hybrid income-consumption tax.[9] Those provisions currently listed as tax expenditures because they relieve some of the return to saving and investment from tax

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[5] For a more detailed discussion of these issues, see Robert Carroll, David Joulfaian, and James Mackie, "Income Versus Consumption Tax Baselines for Tax Expenditures," *National Tax Journal* 64(2), 2011, forthcoming.
[6] Bradford, David F., 1989, "Tax Expenditures and the Problem of Accounting for Government," In Bruce, Neil (ed.), *Tax Expenditures and Government Policy* John Deutsch Institute for the Study of Economic Policy, Kingston, Ontario, pp. 427-434.
[7] The U.S. Budget released in February 2004 through February 2009 had accounted for the fact that the return from equity-financed investment in the corporate sector had been previously taxed under the corporate income tax when evaluating the tax expenditures related to dividends and capital gains. The U.S. Budget released in February 2010 no longer takes this interaction between the individual income and corporate income taxes into account.
[8] While tax upon realization is integrated into the "reference law" baseline tax system used by the Treasury Department and the "normal tax" baseline used by the Joint Committee, the lower tax rate applied to capital gains realizations is included as a tax expenditure.
[9] Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System,* November 2005, p. 23 and 71.

would not be counted as tax expenditures under a consumption tax baseline. Provisions such as individual retirement accounts, section 401(k) accounts, education savings accounts, health saving accounts, accelerated depreciation, and expensing would all be excluded as tax expenditures under a consumption tax baseline. To the extent some tax is imposed on the return to saving and investment, these items would instead be surtaxes under a consumption tax baseline. Of course, those special tax provisions unrelated to the return to saving and investment would remain tax expenditures under either an income or consumption tax baseline.

Other limitations of tax expenditures

Other well-known limitations apply when considering tax expenditure estimates.[10] The estimates do not, for example, include incentive or behavioral effects. For example, taxing dividends at ordinary rates would affect corporate dividend policy, but these effects are not incorporated into tax expenditure estimates. They also do not include interactions with other provisions. A higher tax rate on dividends could affect capital gains because companies would be more likely to retain corporate earnings rather than pay such profits out as dividends. Retaining corporate earnings would increase firm value and future capital gains realizations.

Interactions unrelated to behavioral effects are also not reflected in tax expenditure estimates. Repeal of an itemized deduction, for example, is estimated in isolation of other itemized deductions. If two or more provisions were repealed simultaneously, they would have interactive effects that are not reflected in tax expenditure estimates.

Another major limitation of official estimates of tax expenditures is that they focus solely on the income tax. Tax expenditures arise under other revenue sources, such as the payroll tax, excise taxes, and the estate tax.[11] Any departure from the theoretical baseline underlying these alternative revenue sources could be viewed as tax expenditures. For example, the largest income tax expenditure, the exclusion for employer-sponsored health insurance (Chart 1), would also be viewed as a tax expenditure under the payroll tax.

The rationale for special tax provisions

Economists have long focused on the role taxes play in the decisions of households and businesses. Resources transferred from the private economy to the government through taxes reduce disposable income, and the manner in which revenues are raised can have important consequences for the economy.

Virtually every tax creates what economists call an excess burden or deadweight loss, which represents the loss in welfare over and above what people transfer to the government as taxes. Taxes can distort choices and steer resources away from their best and highest use based

[10] For a more detailed discussion of these limitations, see Office of Management and Budget, *Budget of the United States, Fiscal Year 2012, Analytical Perspectives*, Chapter 17 (Tax Expenditures), February 14, 2011, pp. 240-255.
[11] For a discussion of tax expenditures under the excise tax, see Bruce F. Davie, "Tax Expenditures in the Federal Excise Tax System," *National Tax Journal* 47(1), March 1994, pp. 39-62.

purely on economic merit. Generally, when decisions are made in part for tax reasons, economic resources are wasted.[12]

Special tax provisions, however, can address deficiencies in the private market – the failure to take into account information or spillover effects of one activity to others. These provisions may attempt to achieve their objectives by encouraging (or discouraging) a particular economic activity. Invariably, this type of special tax provision also transfers economic resources. In other cases, special tax provisions are instead intended to solely achieve distributional objectives by transferring economic resources to a particular group.

Influencing taxpayer behavior through the tax code

One common rationale for special tax provisions intended to encourage a particular economic activity is the notion that some external effect is not reflected in market decisions or prices. In this case, private market participants acting on their own would base decisions without fully taking into account the societal benefits of an activity. In this case, it might be appropriate for the government to intercede in the market place, in effect, to nudge the private market towards a more economically efficient outcome; that is, an outcome that takes into account the societal benefits of the activity.

For example, research and development can provide benefits that are external to the benefits a private market participant may consider when making its decision on how much to spend on research and development or in what manner to spend on research. Such spillover effects of the research may benefit other market participants or broadly benefit the economy as a whole as new and innovative ideas are developed and incorporated into production processes. The same reasoning could apply to a broad range of provisions, including those that encourage additional education or health care spending, or the use and development of renewable and alternative energy sources, or charitable giving.

The size of the tax incentive embodied in the special tax provision, in principle, should be related in some way to the external benefits of the economic activity. In economic terms, the special tax provision should provide a subsidy that equals the difference between the total value to society and the value the private market places on the activity at the margin. That is, the incentive should be just large enough to nudge the private market to the economically efficient level of, for example, research and development, if the private markets fully understood and could reflect the social benefits of this activity.

While this serves as a useful theoretical framework for considering one role of some tax incentives, in practice, there are a number of difficulties that arise. First, it may be difficult to measure or know the social benefit of an activity. In some cases, there may be economic research that indicates or that could be conducted to indicate the social value of an activity to

[12] The consumer suffers a loss in economic welfare because the tax causes him to make a less desirable consumption choice as compared to a world without taxes. Virtually all taxes generate some type of excess burden because they create a wedge between the actual price and the underlying economic value of the product or services.

serve as a guidepost for the size of a subsidy. In other cases, judgment may need to be exercised as to the societal value of an activity.

Another difficulty might be how best to deliver a tax incentive. Providing a tax incentive to all of the underlying activity to align the societal and private benefits at the margin will generally be significantly more expensive as compared to a policy that was able to realign these benefits at the margin. Incremental credits, for example, have sometimes been used to attempt to focus more of the incentive on decisions at the margin. The drawback with focusing the incentive on marginal decisions, however, is that the incentive design is invariably substantially more complex and this complexity can undermine the effectiveness of the incentive and impose additional compliance and enforcement costs.

There may also be unintended consequences associated with a tax incentive due to unanticipated effects in other markets or industries or on other economically important decisions. For example, the home mortgage deduction is intended, in part, to promote homeownership. Homeownership has been linked to stronger and more cohesive neighborhoods, which has been associated with greater civic participation and lower rates of crime. It has also been observed that this deduction may affect household financing decisions and leverage. That is, the channel through which an incentive whose main purpose is to promote homeownership is delivered may have the unintended consequence of also promoting greater leverage.

Transfers of resources through special tax provisions

All tax subsidies also involve transfers of resources to the economic agents – the households and/or businesses – involved in the economic activity that is being encouraged. These distributional effects are an important aspect of the tax subsidy and play into notions of fairness.

It may seem relatively straightforward how tax subsidies that flow directly to households affect the distribution of the tax burden across income or demographic groupings. However, subsidies can be reflected in the price of the encouraged activity and the effects can flow beyond those directly claiming the tax benefits on their tax forms. For example, there is some evidence that the special tax provisions that provide subsidies for higher education have been passed forward into higher tuition costs.[13] Thus, taxpayers who claim the benefits of these provisions when filing their tax returns may also bear higher tuition costs, thereby reducing the benefits that flow to them from these provisions. Moreover, other consumers may pay higher tuition costs without the benefit of the tax subsidy.

Similar issues arise with special tax provisions for businesses. Workers may, for example, earn higher wages as their productivity is increased from faster integration of more innovative technologies or investors may earn higher returns due to such innovation. Similarly, consumers

[13] For example, see Bridget T. Long, "The Impact of Federal Tax Credits for Higher Education Expenses," In *College Choices: The Economics of Where to Go, When to Go, and How to Pay For It*, edited by Caroline M. Hoxby, University of Chicago Press, September 2004, pp. 101-165.

may broadly benefit as new technologies lower production costs and prices or new products are introduced that improve their general welfare.

In addition, the overall distributional effects of special tax provisions for businesses is confounded by the fact that businesses themselves cannot bear the burden of taxes. Only individuals, in their role as consumers, workers and investors can bear the burden of taxes through changes in prices, wages and returns to capital investments. Thus, while it is valuable, for example, to understand to which industries the benefits of the research and development credit flow,[14] this by itself does not tell us the entire story of how this provision affects the distribution of the tax burden.

Some special tax provisions are not necessarily designed to influence decision making, but instead to transfer resources to a particular group of taxpayers. For example, the child tax credit and the dependent exemption are intended to lighten the tax burden of families with children. In contrast, another family orientated tax provision, the child and dependent care tax credit, is designed to reduce the cost of child care for working parents. The benefits of many of these types of provisions are targeted to low-income and moderate-income taxpayers in various ways.

Evaluating special tax provisions

Two of the most important factors that may influence the effectiveness of special tax provisions may be their complexity and uncertainty. The design and delivery of a special tax provision can have profound effects on its effectiveness. Provisions that have complex eligibility requirements and other rules can impose substantial compliance costs that detract from their benefits. In some areas, duplicative provisions require taxpayers to understand and consider the tax benefits from several related provisions and choose the one that best meets their needs.

Examples of duplicative provisions include the numerous provisions in the Code to encourage savings or promote education spending. For the savings provisions, different income thresholds, different spousal participation rules, different effective contribution limits (e.g., pre-tax versus after-tax dollars), different withdrawal rules and different minimum distribution rules apply.[15] There are a dozen different provisions for education with different eligibility criteria, different benefits and different rules for what constitutes a qualified expense or expenditure.[16] The reliance on tax advisors to navigate the rules increases compliance costs and further detracts from the benefits of the provisions.

Uncertainty over tax provisions also undermines their effectiveness. A large number of tax provisions are now extended a year or two at a time. These provisions include many business and individual provisions such as the research and development credit and the state and local sales tax deduction. This results in significant uncertainty for taxpayers who rely on these provisions, including uncertainty in financial reporting for businesses. The uncertainty of these provisions makes it difficult for businesses to incorporate them into planning and investment

[14] For a recent analysis of the industry effects of business tax expenditures, see Gerald Prante, Robert Carroll and Tom Neubig, "Lowering Business Tax Rates by Repealing Tax Expenditures: An Industry Analysis," *Daily Tax Report* vol. 2011, no. 34, February 18, 2011.
[15] National Taxpayer Advocate's 2008 Annual Report to Congress, December 31, 2008.
[16] Congressional Research Service, *An Overview of Tax Benefits for Higher Education Expenses,* January 3, 2005.

decisions, thereby undermining their effectiveness. Some of these provisions have been allowed to lapse altogether or have been, on occasion, been extended retroactively. The 2001 and 2003 tax relief and the AMT patch are also temporary provisions leaving a significant portion of the Code in flux. The temporary nature of large portions of the Code adds complexity and uncertainty.

Evaluating special tax provisions requires examining the full range of their potential effects. Last year two bills introduced to extend expiring provisions (H.R. 4213 and S. 3793) included a provision that would have required the Joint Committee on Taxation (JCT) to prepare a study on the effectiveness of tax expenditures to help inform the Congress in its future consideration of these provisions.

Although ultimately not included in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 enacted in December 2010, the provision suggests the type of additional analysis of tax expenditures that Congress might benefit from in the current environment of large deficits and a growing national debt. The ten points included in the provision (see Appendix) provide a useful approach for evaluating special tax provisions. The Committee should be commended for also focusing on the complexity and uncertainty of special tax provisions and these issues might also be explicitly included on the list.

One item included on the list and of primary interest is whether a special tax provision has achieved its original purpose; that is, did the provision encourage the activity for which it was initially enacted? This would appear to be the key question in evaluating any special tax provision initially enacted to encourage (or discourage) a particular economic activity. Does, for example, the research and development credit actually result in additional research? Have the credits for solar and wind turbines actually resulted in the development and integration of these technologies into the energy grid?

It may be relatively straightforward to track the economic activity targeted by a specific provision. One can then glean from the data whether the enactment of the provision had a discernable effect on the activity. Isolating and quantifying the effect of the tax provision on the level of activity, however, may be significantly more difficult. A variety of other factors may also influence the activity and obscure the effects of the special provision. Statistical approaches to account and control for other factors unrelated to the tax provision, but that also affect the target activity, can be used but often require detailed data and are complex.

One aspect of evaluating the effectiveness of a special tax provision is ascertaining whether the benefits of the provision lower the after-tax cost of an item or are reflected in prices or possibly asset values. If the special tax provision ultimately inflates prices, it is less likely that the provision would have the desired effects of encouraging the economic activity. The benefits of the special tax provision are, in effect, taken away by the rise in prices.

Capitalization can also affect who benefits from a tax provision. Current owners of assets might benefit from special tax provisions that are capitalized into asset values and prices even though future owners may claim the direct benefits when filing their tax returns. Changes in asset

values and prices can also shift the benefits of a provisions to economic actors other than those who claim the benefits when filing their tax returns.

One area of concern is whether a special tax provision has had collateral consequences. Considering the impact of the provision on other economic decisions would generally be worthwhile so that the benefits of the provision can be weighed against potential costs due to collateral consequences. For example, in the case of the exclusion for employer-provided health insurance, it might be important to weigh the benefit of additional pooling of risk through employer provision of health insurance with the effect of the likely increased use of low-deductible plans and prepayment of routine health care through insurance that also accompanies employer-provision of health insurance. The pooling of risk may help lower overall costs, while low-deductible and prepayment may increase overall costs. Other provisions are also likely to have collateral consequences that should be carefully considered when evaluating their overall effectiveness.

Summary

Tax expenditures and other special tax provisions are receiving additional scrutiny by the Congress and others in the policy arena in the current environment of large deficits and a national debt projected to grow to unsustainable levels. The 173 tax expenditures identified by the Treasury Department total roughly $1.1 trillion annually and affect household and business decisions in fundamental ways. Many of these provisions are longstanding provisions of the Code, while others are relatively new additions.

This committee should be commended for focusing on these issues as part of their dialogue and deliberations on tax reform. A better understanding of the effect of these provisions and who they benefit would be valuable inputs into the policy debate as the Congress reevaluates various priorities on both the spending and tax sides of the budget to meet the nation's fiscal challenges.

Thank you and I would be pleased to address any questions you may have.

Appendix: Extenders Bill Requirement for JCT Cost-Benefit Analyses of Tax Expenditures

The extenders bills considered last year by both the House (H.R. 4213) and the Senate (S. 3793) included a provision that would have required the Joint Committee on Taxation (JCT) to prepare a study on the effectiveness of each tax expenditure to help inform the Congress in its future consideration of the provisions. Initially, the Joint Committee would have been instructed to first focus on the business and energy tax expenditures included in the extenders legislation.

Although ultimately not included in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 enacted in December 2010, the provision is a clear indication of the additional scrutiny tax expenditures are receiving by the Congress in the current environment of large deficits and a growing national debt.

Each Joint Committee tax expenditure report would cover ten issues:

1. An explanation of the tax expenditure and any relevant economic, social or other context under which it was first enacted.
2. A description of the intended purpose of the tax expenditure.
3. An analysis of the overall success of the tax expenditure in achieving its intended purpose and supporting evidence.
4. An analysis of whether further extension of the tax expenditure, or making it permanent, would contribute to its intended purpose.
5. A description of the direct and indirect beneficiaries of the tax expenditure, including identifying any unintended beneficiaries.
6. An analysis of whether the tax expenditure is the most cost-effective method for achieving its intended purpose, a description of more cost-effective approaches, and modifications to make it more effective.
7. A description of any unintended consequences of the tax expenditure useful to understanding the tax expenditure's overall value.
8. An analysis of how the tax expenditure could be modified to better achieve its original purpose.
9. A brief description of any interactions (actual or potential) with other tax expenditures or direct spending programs in the same or related budget function worthy of further study.
10. A description of any unavailable information the Joint Committee on Taxation might need to complete a more thorough examination and analysis of the tax expenditure and what must be done to make such information available.

The Joint Committee reports were to be prioritized with reports completed in order of their costs (from the least cost to the greatest cost).

Salience and Taxation: Evidence and Policy Implications

Testimony for the

Committee of Finance
United States Senate

Hearing on "How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?"
Dirksen Senate Office Building, Room 215
March 30, 2011

by

Raj Chetty
Professor of Economics, Harvard University

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

Thank you for asking me to appear before your Committee today. It is a pleasure to share my views on the complexity of the tax code and its implications for taxpayer behavior and tax policy.

Economists and policy makers have traditionally focused on the financial incentives created by the tax code when predicting its effects on the economy. However, recent research shows that the salience and transparency of tax incentives matters as much or more than the financial incentives themselves. This testimony reviews some examples of such evidence and then discuss their implications for tax policy. I will focus on taxation of households, but many of the lessons discussed below also apply to the taxation of corporations and small businesses.

1 Evidence

The tax code in the United States is highly complex and is becoming increasingly so as reforms are implemented piece-by-piece. Figure 1 depicts the federal income tax schedule faced by a single earner with two children in the United States in 2006. The figure plots the marginal tax rate – that is, the tax rate on a family's last dollar of earnings. This marginal income tax rate is relevant for making economic choices ranging from work decisions to IRA contributions to home mortgages. The figure shows that marginal income tax rates vary considerably with income. Moreover, Figure 1 does not account for transfer programs such as Supplemental Nutritional Assistance Program (SNAP) or Temporary Assistance for Needy Families (TANF) that further change incentives. Nor does it account for provisions such as the Alternative Minimum Tax (AMT). Families also pay many taxes beyond the income tax: sales taxes, property taxes, excise taxes, all of which further complicate decisions. The complexity of the tax system raises the possibility that many families may not fully account for the tax implications of their economic decisions.

Recent research has demonstrated that tax complexity affects a broad range of economic choices, ranging from commodity purchases to college enrollment decisions. The following are five illustrative examples of the findings of these studies.

1. Sales taxes. Even relatively simple taxes, such as the sales tax levied by states, are not fully salient to consumers. Posted prices in the United States typically do not include the sales tax. To test if people under-react to the sales tax, an experiment posted tags showing the tax inclusive

price below the original pretax price tags (Chetty, Looney, and Kroft 2009). Figure 2 shows the original tags as well as the new tax inclusive price tags. The demand for the goods that had the new tax inclusive price tags decreased by 8% when the new tags were posted. If consumers had been taking the sales tax into account to begin with, there would have been no change in demand. Chetty, Looney, and Kroft (2009) also show that changes in excise taxes that are included in posted prices have larger effects on consumer behavior than equivalent changes in sales taxes that are not included in posted prices. Hence, the lack of transparency of the sales tax mitigates its impact on consumer decisions.

2. Green taxes. Gallagher and Muehlegger (2008) compare the impact of sales and income tax rebates on hybrid vehicle purchases. Sales tax rebates are received at the time of the purchase and are thus highly salient and visible. Income tax rebates are received later, as a credit when income taxes are filed, and are thus less transparent at the time of purchase. The sales tax rebate had seven times as large an effect on the number of hybrid cars sold as an equivalent-sized income tax rebate. Thus, two policies that cost the government exactly the same amount had very different impacts on encouraging environmentally friendly choices purely because of how they were perceived by consumers.

3. Earned Income Tax Credit. The Earned Income Tax Credit (EITC) is a major cash transfer program whose goal is to increase work among low-income families by providing a subsidy for working. Unfortunately, knowledge about the incentives created by the EITC is limited. 50-90% of low-income families have heard about the EITC and know that it is a tax refund for working (Maag 2005, Romich and Weisner 2002). However, less than 5% of these families know how the amount they earn affects the size of their EITC refund. This may be because the EITC refund depends in a somewhat complex manner on earnings levels, number of dependents, marital status, and other characteristics, as shown in Figure 3. A recent experiment directly tested whether providing simple information about the work incentives created by the EITC would amplify its effects on earnings (Chetty and Saez 2009). The experiment involved 43,000 EITC claimants in Chicago, half of whom received simple information about the marginal tax incentives created by the EITC tailored to their situation when filing their tax returns. For instance, those in the phase-in region of the program were told, "Suppose you earn $10 an hour, then you are really making $14 an hour [because of the EITC program]." The experiment tracked earnings over time for the

treated and control groups. The provision of information had significant impacts on earnings for many households, although the effects varied substantially based on how tax preparers explained the program.

The most recent evidence shows that responsiveness to the EITC also varies considerably across communities (Chetty, Friedman, and Saez 2011). One simple way to analyze the extent that households respond to EITC incentives is to consider how many of them bunch at the portion of the EITC schedule where they receive maximum benefits. Figure 4a shows the amount of bunching at the peak of the EITC schedule in each state in 2008. There is substantial geographic heterogeneity in response to the EITC across the United States despite the fact that it is a federal program.* The variation in responsiveness is prevalent even at the local level. Figure 4b depicts bunching in 2008 by 3-digit zip code in Kansas, Louisiana, Oklahoma, and Texas. For example, Austin and San Antonio, cities within 80 miles of each other, have substantially different levels of response to the EITC. This differential responsiveness to the EITC across regions of the country is consistent with spatial diffusion of knowledge about the tax code, and may also reflect the impact of local cultural and mores or heterogeneity across tax preparers.

4. Retirement savings. The tax code includes several provisions intended to increase the incentive to save, such as tax-deferred savings accounts (e.g. IRAs and 401(k)s) and the Saver's Credit for low-income households. The Saver's Credit provides a 100% match on savings in tax-deferred accounts of up to $2000 for eligible households in certain income ranges. Despite the large incentive to save, a 100% match created by the Saver's Credit raises participation in IRAs by less than 2.5 percentage points (Duflo et al. 2006). In contrast, an experiment conducted by Duflo et al. (2006) that offered 50% matches in a transparent and salient manner at the time of tax filing increased participation in IRAs by 11 percentage points. The incentive effects of the Saver's Credit may be dulled because the rules associated with the credit are very complex, and it is hard for filers to predict their effective matching rate.

The impacts of tax-deferred accounts are also relatively modest in comparison to other tools that aim to change savings behavior. Defaults that automatically enroll workers in tax-deferred savings plans are a far more powerful determinant of behavior than changes in incentives to save.

*Some states have add-on state EITC's, but the differences shown in Figure 4a are not correlated with these state EITC programs.

Figure 5 compares participation rates in a company's 401(k) program across cohorts (Madrian and Shea 2001). New hires were automatically enrolled in the 401(k) plan (and could choose to opt out), while previously hired employees were required to elect participation by filling out a form. The figure shows that new hires have a participation rate of 86%, which is nearly twice the participation rate of workers hired just before automatic enrollment was implemented. This doubling in 401(k) participation dwarfs the impacts of changes in 401(k) tax incentives on savings rates.

5. College tax credits and subsidies. A broad range of federal policies are intended to increase higher education by reducing the cost of attending colleges via either tax credits (e.g. the Hope and Lifetime learning credits) or interest-free loans (e.g. Pell grants). Dynarski and Scott-Clayton (2008) argue that the complexity of filling out the FAFSA form needed to obtain Pell grants and Stafford loans explains why these programs have little impact on increasing college attendance rates in the U.S. They show that simpler state-level programs increase college attendance much more than complex federal programs that offer similar financial incentives to attend college. An experiment conducted by Bettinger et al. (2009) found that dependent children whose families received assistance from tax professionals in filling out the FAFSA were more likely to submit an aid application and enroll in college. These findings suggest that the lack of transparency of existing incentives to stimulate college attendance may substantially dull their intended impacts, particularly for low-income families.

2 Policy Implications

The evidence reviewed above shows that policy makers have a powerful lever at their disposal in deciding how to frame and advertise tax policies. While the appropriate method of optimizing tax salience will vary across policies, economic theory offers several general principles that are relevant for many policies (Chetty, Looney, Kroft 2009, Congdon, Kling, and Mullainathan 2009).

1. Minimize non-transparent credits. There is little justification for tax credits and expenditures whose intended incentives are not understood by families. Such tax expenditures cost the government money but have little impact in changing economic behavior as intended. For instance, a non-transparent Saver's Credit program essentially gives money to families who were already saving but does not encourage other families to start saving. The government would be better off

either scaling back the size of such programs or devoting resources to increase their transparency.

2. Invest in marketing. While the private sector devotes extensive resources to marketing and information dissemination, such expenditures are much smaller for government programs. For example, the official IRS publication on the EITC intended for the public (Internal Revenue Service, 2007, Publication 596) is 57 pages long and never explicitly mentions the incentive parameters of the credit. The publication simply states the EITC amounts in the form of a 7 page table that has 4,770 entries. Low-cost efforts to explain the incentives created by the EITC more transparently to the public would be valuable. As another example, tax credits to reduce electricity usage are likely to be more effective if coupled with smart meters that allow consumers to directly monitor their electricity usage in real time.

3. Build tax incentives into prices and use defaults. Mechanisms that do not require consumers to pay special attention to the tax code may be even more effective than information provision. Including tax credits directly in advertised prices and salaries could substantially increase their impact. For example, the widely advertised Cash for Clunkers program in which consumers received discounts directly from dealers likely had a much larger impact in increasing automobile purchases than the much less well known sales tax deduction in the American Recovery & Reinvestment Act of 2009 (ARRA). Setting defaults (with opt-out provisions) that encourage choices such as saving for retirement can be more effective than simply providing financial incentives to do so.

4. Minimize the salience of negative incentives. Some taxes are needed purely for revenue collection. For instance, income taxation raises revenue but may reduce labor supply or the growth of small businesses. While the government should never hide taxes, increasing the salience of such negative incentives is less desirable from the perspective of maximizing economic efficiency and growth.

5. Salience can affect the income distribution. Lower-income households may not have the resources to obtain information about all aspects of the tax code. As a result, tax complexity may amplify inequality by making it harder for low-income families to take advantage of advantageous provisions.

6. Salience affects how tax burdens are shared between consumers and businesses. Policies regulating tax salience also affect how tax burdens are shared between businesses and consumers. If companies are allowed to post pre-tax prices (rather than tax-inclusive prices), consumers are

likely to bear more of the economic burden of the tax. For example, the prices of many widely-used services are commonly advertised excluding fees and taxes. If companies were forced to advertise tax-inclusive prices, they would have an incentive to reduce the prices they charge (i.e., bear more of the burden of the tax themselves) in order to compete and attract customers.

7. *Tax policy may have smaller impacts in the short run.* Since information takes time to diffuse, the impacts of tax changes may be much smaller in the short run than the long run (Chetty 2009). Thus one cannot directly predict the long-term impacts of tax policies from their immediate impacts on economic behavior. The costs and benefits of tax policies must therefore be assessed either over long horizons or using pilot studies where the policies are made highly salient.

To summarize, policy makers should consider the transparency of proposed tax policies to the same extent that they consider the financial implications of proposed reforms. Reforms targeted at improving tax salience offer a rare opportunity to increase the benefits of tax incentives and expenditures with little budgetary cost.

1. Bettinger, Eric P., Bridget Terry Long, Philip Oreopoulos, and Lisa Sanbonmatsu (2009). "The Role of Simplification and Information in College Decisions: Results from the H&R Block FAFSA Experiment," NBER Working Paper No. 15361.

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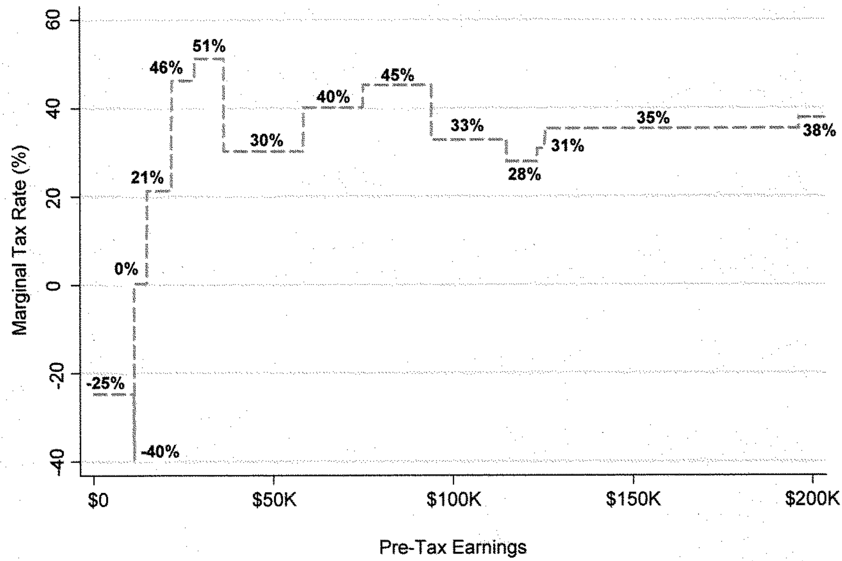
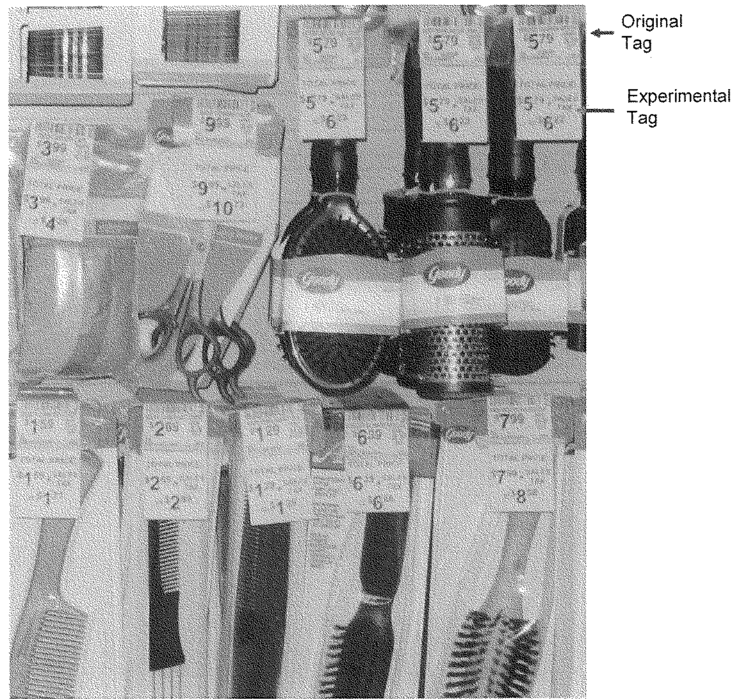
FIGURE 1
Marginal Federal Income Tax Rates in 2006



Source: Chetty (2009, Figure 9)

Notes: This figure plots marginal federal income tax rates for a single tax filer with two children and no other exemptions or deductions in 2006. Tax rates were calculated using NBER TAXSIM. See Chetty (2009) for details.

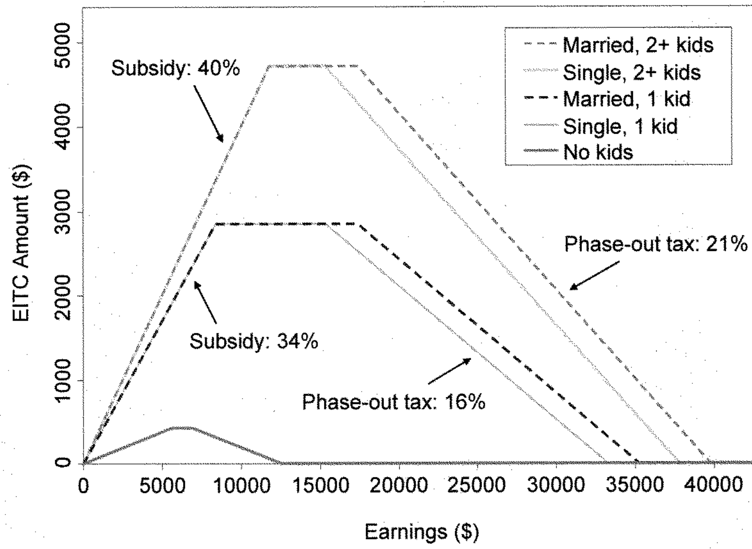
FIGURE 2
Sales Tax Inclusive Price Tags



Source: Chetty, Looney, and Kroft (2009, Exhibit 1)

Notes: This figure shows the price tags that were added to products in a grocery store in the experiment conducted by Chetty, Looney, and Kroft (2009). Tax-inclusive price tags were added for roughly 1,000 products in one aisle of the store.

FIGURE 3
EITC Refund Amount as a Function of Earnings in 2007

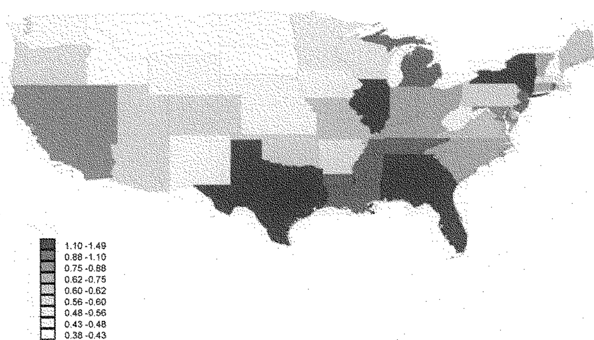


Source: Chetty and Saez (2009, Figure 1a).

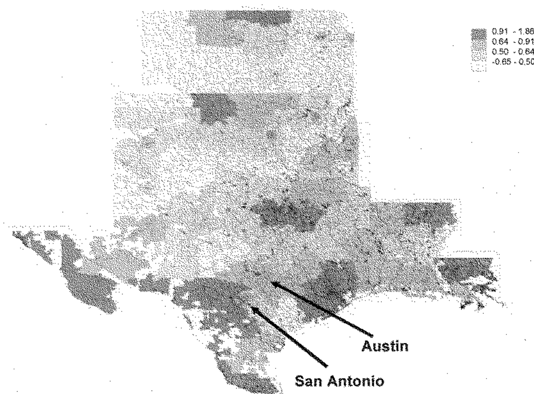
Notes: This figure plots the size of the EITC refund amount vs. earnings for various family structures. See Chetty and Saez (2009) for more details.

FIGURE 4
Geographic Variation in Responses to the Earned Income Tax Credit

a) EITC Bunching by State in 2008



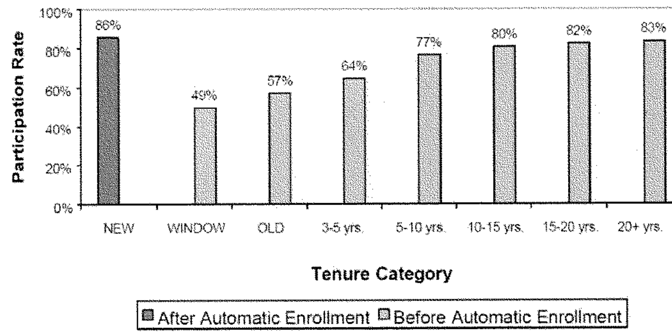
b) EITC Bunching by 3-Digit Zip Code in Kansas, Louisiana Oklahoma, and Texas in 2008



Source: Chetty, Friedman, and Saez (2011, Figure 2)

Notes: This figure plots a measure of the impacts of the EITC on reported taxable income across geographic regions in the United States. Responsiveness is measured by the fraction of individuals who "bunch" at the first kink point of the EITC schedule shown in Figure 3, which is the point at which the refund amount is maximized. Darker shaded areas have more tax filers whose reported taxable income maximizes their EITC refund, indicating greater responsiveness to the EITC. See Chetty, Friedman, and Saez (2011) for details.

FIGURE 5
Effects of Defaults on Retirement Savings



Source: Madrian and Shea (2001, Figure 3)

Notes: This figure compares the 401(k) participation rates at a private corporation for individuals who were automatically enrolled into 401(k) plans (the first bar) with participation rates for earlier cohorts who were eligible for the same program but were not automatically enrolled. See Madrian and Shea (2001) for details.

Senate Finance Committee Hearing
"How Do Complexity, Uncertainty, and Other Factors Impact Responses to Tax Incentives?"
March 30, 2011
Responses to Questions for Dr. Raj Chetty

Questions from Senator Orrin Hatch

1. There is a multi-layer of uncertainty surrounding the temporary nature of the estate tax. Many family-owned businesses and farmers are uncertain whether the estate tax rate will come roaring back in 2013 at a 55 percent rate with a $1 million exemption amount. In order to pay the estate tax, many family-owned businesses take out insurance policies, which if structured correctly, are used to pay the estate tax.

   Because of the uncertainty of the rates and exemption amount in 2013, many family-owned businesses are withholding capital that could be used to invest in jobs and equipment in order to pay for anticipated increases in insurance policies.

   This uncertainty is coupled with the uncertainty of whether estates will have to pay taxes on gifts they made prior to 2013 and whether portability will continue.

   Would you agree that the uncertainty of the fate of the estate tax is stifling economic growth?

   I think the uncertainty of the estate tax is undesirable, but I do not believe that it plays a major role in stifling aggregate economic growth. The estate tax, even if brought back with a lower exemption level, affects a relatively modest fraction of individuals. While the estate tax is likely to lead to income shifting and more tax planning activity, its impacts on actual investment and entrepreneurship are likely to be modest because individuals would have to be highly foresighted to take estate taxes into account when making investment decisions at the peak of their working career (e.g. age 40 or 50). Nevertheless, there is no good reason to maintain uncertainty about the estate tax, and eliminating such uncertainty would surely be valuable.

Questions from Senator Robert Menendez

1. **Increasing Middle Class Response from Tax Incentives**

   There seems to be a general consensus today that one of the critical issues with tax incentives is complexity. When forced to choose between a wide range of complex and often overlapping incentives, most Americans, myself included, would find it difficult to select the most valuable incentive for a range of activities without professional help. This is perhaps most evident with education as there are currently 18 different tax provisions

aimed to help with the cost of higher education. In fact a recent Treasury report found that less than 40% of eligible American families claimed the American Opportunity Tax Credit, even though it's generally the most valuable tuition tax incentive. This includes 420 thousand New Jersey families who might have missed out on a more valuable tuition incentive. This is just one example of many where complexity in the tax code can effectively hide tax benefits from American families.

Could each of you identify one or two areas where complexity creates the most difficulty for middle class families to understand the value of tax incentives available to them and where you believe Congress should make it a priority to simplify?

Two of the highest priorities should be simplifying education tax credits and tax credits to increasing saving, particularly among low income families.

2. **Complication**

Simply put, as our tax code has become more complex, tax incentives have become more the domain of those who can afford professional assistance navigating their intricacies. In fact, Dr. Chetty, you remarked in your testimony: "tax complexity may amplify inequality by making it harder for low-income families to take advantage of advantageous provisions."

Could you briefly give your thoughts on whether you think our complicated tax system gives rise to such predatory tactics like high interest refund anticipation loans?

The complexity of the tax system naturally creates many market opportunities for businesses to fill. However, I would not attribute the demand for RAL's solely to the tax system. The market for payday loans – another form of high interest lending – has little to do with the tax system but is rapidly growing. Designing the tax system to promote saving and more prudent financial decisions may reduce the demand for such high interest loans in the long run.

3. **Simplification and the Low U.S. Savings Rate**

One of the major issues confronting families today is finding ways to save as middle class wages have stagnated while the costs of raising a family continue increasing. We have included a host of new tax incentives to encourage saving over the last 30 years, all while watching American savings rates plummet. And even though they've ticked up recently after the economic crisis, savings rates still stand at less than half what they were thirty years ago.

So while I believe the tax responses to this increasing problem did not cause the low savings rate, my question is could we reform the savings incentives to boost savings rates? That is, do you think that by reforming and simplifying savings incentives, we could affect savings rates for middle class families?

Yes, I believe the savings rate for middle class families could be dramatically increased by simplifying tax incentives for saving, in two ways. First, the Saver's Credit, which is currently taken up by less than 5% of eligible families despite the generous matches it provides, should be made much more transparent and visible to families. One way to do this would be to make it a refundable credit with much simpler eligibility roles along with wide advertising. Second, the tax code could include a default contribution to an IRA, which could optionally be removed by families.

4. **Increasing Effectiveness of Education Tax Incentives**

   Dr. Chetty and Dr. Toder, your testimonies identified many of the problems found with incentives in the tax code and also offered several solutions to fix them. In particular you found that with retirement incentives, creating a "default" choice with the ability to "opt-out" actually encouraged saving more than simply providing a financial incentive to do so.

   Can this type of "default" rule be used in other areas, such as with education incentives where creating a default education credit would encourage more families to invest in education, or are there other reforms that can make tax incentives for education easier to use and more valuable for the average family?

   Yes, having a default option with a simplified system of education credits is likely to make the take-up of these credits higher. However, in the case of education (unlike saving) it is important to remember that the behavior that one is attempting to influence is college going, not simply participating in the credit. Creating default education credits may not increasing college attendance rates unless they are widely advertised to targeted populations.

Questions from Senator Snowe

1. In our first hearing on tax reform in September 2010, we discussed the problems that are part of our current tax code – problems of both real and perceived unfairness, problems of complexity, problems that flow from the fact that more than 15,000 changes have been made to the tax code since 1986. Randy Weiss of the Conference Board and formerly of JCT put it well in his testimony:

   "In the fairness arena, the biggest problem today appears to be not so much a systematic ability of high-income people and companies to avoid paying tax, but rather a kind of randomness in the computation of tax liability. There are so many overlapping incentives that, along with the alternative minimum tax and people's increasing delegation of tax preparation to tax professionals and computers, it is very difficult for many people to understand how their tax liability is determined and to make decisions accordingly. A perception of fairness requires that people see that their tax liability is determined

according to some logical principles. A tax reform package that responded to this concern would be popular."

If the 2011 version of tax reform were to take several tax incentives and combine them into functional categories – such as development tax incentives, energy incentives, retirement incentives, and family incentives, etcetera – would that address the complexity and fairness issues that are key problems with current tax law? How might you propose such combination be accomplished?

Yes, consolidating the incentives into broad categories would go a long way toward simplifying the system. I would recommend grouping the incentives by type as suggested: retirement, education, energy, etc. There is no need to have 18 different education credits and multiple distinct vehicles for retirement saving, each with their own rules and regulations.

2. In our initial tax reform hearing in September 2010, we discussed the issue of "distributional neutrality" – that is, making sure that at the end of the process the code is rationalized without changing the relative burden of tax liability on different income groups. Former Congressman Dick Gephardt said, "We were not trying to raise taxes on the rich, nor cut them either. And, we didn't want to add to the budget deficit that was already careening out of control."

   If Congress were to extend permanently all tax rates before they rise after 2012, then Congress would achieve "distributional neutrality" but clearly have a negative impact upon the deficit.

   If Congress were to extend permanently only some of the rates that would then set the budget baseline at a point of higher taxes for some people in perpetuity thus freezing a decision being made today as a building block for tax reform next year.

   So by permanently extending some tax relief and allowing others to rise today, wouldn't that permanently stack the deck against those for whom the rates are allowed to rise?

   Yes, it is true that the existing tax system is used as a point of reference, and thus any reform has lasting impacts. This is why any policy decision about tax rates – even if intended to be temporary – must be analyzed from a long-run perspective. If one's goal is to reduce tax burdens on certain groups only temporarily, then extending tax relief to those groups even for a few years may have permanent effects.

STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER
U.S. SENATE COMMITTEE ON FINANCE HEARING OF MARCH 30, 2011
HOW DO COMPLEXITY, UNCERTAINTY, AND OTHER FACTORS
IMPACT RESPONSES TO TAX INCENTIVES?

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing examining the effectiveness of tax incentives:

As we continue our march through the potentials and pitfalls of tax reform, this hearing stood out. The tax code should send clear signals to taxpayers. This way individuals and corporations can make rational decisions about what they do with their money.

Unfortunately, as several of our witnesses will explain today, the Internal Revenue Code has become so complex that it is colliding with human nature. On balance, taxpayers are inclined to behave according to the political economic theory of Rod Tidwell, the star wide receiver in the film *Jerry Maguire*.

Tidwell operated by a simple philosophy — *Show...Me...the...Money.*

In some ways, that is the philosophy of the American taxpayer. Families and businesses, when considered in the aggregate, would prefer to allocate their capital based on the tax treatment of various activities.

If the code taxes capital, capital formation will become more difficult.

If the code taxes consumption, saving will go up.

What this hearing addresses is how inefficiencies in the Internal Revenue Code impact the otherwise rational responses of taxpayers.

In short, the code has become so complex that even when lawmakers attempt to extend preferences for certain activities, businesses and families do not respond.

It is critical then that we restructure the code to provide a more rational and less complex system for American taxpayers. I would like to reiterate a few key principles for this reform.

First, I believe that our entire tax system, not just the corporate tax system, needs to be reformed. We can't simply raise taxes on flow-through businesses, a large proportion of which are small businesses, by taking tax incentives away without lowering tax rates in return.

This is both just and politically necessary. Can you imagine if someone told you:

I am going to reform the law in a way that directly impacts your life and livelihood. Now here's what I am going to do. I'm going to take something away from you, and you're not going to get anything in return.

You won't find many people willing to accept a terrible deal like that one. Yet that is the offer that some would like to extend to these businesses.

Second, tax reformers need to take into account the shrinking of the base on the individual side. Considering that even the liberal Tax Policy Center found that 47 percent of households in 2009 did not pay any income taxes, we can't ignore the individual income tax system when we look at tax reform.

And we need to keep in mind that this 47 percent figure will go significantly higher in 2014 when the health insurance premium refundable income tax credit goes into effect.

Again, as a matter of fairness, wouldn't it make more sense if all citizens paid at least something in income taxes? We hear a lot about shared responsibility from the other side. Well, this would be a start.

And I am convinced that it would help us in our fight against excessive federal spending. You get a lot of takers when you ask people if they want more of something and you tell them it's free.

Third, we cannot ignore the pending tax increases at the individual level that will go into effect if Congress does not act. The bottom line is that if Congress does not intervene, taxes are scheduled to go up significantly on January 1, 2013. If President Obama and the Congressional Democratic Leadership had their way, the top two tax rates would already be at 36 percent and 39.6 percent.

It might be a convenient talking point to suggest that these are cost free tax increases on the rich. But in reality, the nonpartisan Joint Committee on Taxation tells us that 50 percent of all flow-through income is subject to these proposed tax rate hikes. These tax rate increases would be especially harmful to small businesses, because most small businesses are organized as flow-through business entities, such as partnerships, S corporations or limited liability companies.

Since we all seem to agree that we need to provide certainty to businesses and other taxpayers so that they can go ahead and plan their affairs, including hiring new workers, it would make a lot more sense to go ahead and prevent these tax rate hikes now, rather than waiting until 2012 — a presidential election year — to act.

Finally, we need to be careful about what we are identifying as tax incentives. Are we talking about a true tax incentive or are we really talking about spending being done through the Internal Revenue Code?

If a provision results in an outlay by the federal government, the amount of the outlay is actually spending under the Congressional Budget Act. It is not a tax cut.

For example, almost three-fourths of the refundable income tax credit from the health spending bill is not a tax cut, but is actually spending done through the tax code, according to the nonpartisan Joint Committee on Taxation.

As we continue down the road of tax reform, these principles will continue to inform my analysis of the challenges that we face. With respect to tax incentives, and whether they introduce inefficiencies into the tax code and counterproductively distort economic behavior, it is important that we not lose sight of what should be our ultimate goal — the need for comprehensive reform that lowers the burden of taxation on individuals and businesses.

Thank you Mr. Chairman.

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Statement of

Eric J. Toder

Institute Fellow, the Urban Institute and

Co-director, Urban-Brookings Tax Policy Center

Before the

Senate Committee on Finance

Responses to Tax Incentives in a Complex and Uncertain Tax Law

March 23, 2011

The views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders

Chairman Baucus, Ranking Member Hatch, and members of the Committee

Thank you for inviting me to testify today on taxpayer responses to incentives in the individual and corporate income taxes. I will limit my comments to a discussion of how tax incentives might affect behavior, what the available evidence does and does not tell us, and how the increased complexity of the tax code affects responses to these incentives. I will not address the important questions of whether the behaviors that tax incentives encourage add to or subtract from economic efficiency or how tax incentives alter the distribution of income.

The tax code can be viewed conceptually as consisting of two types of provisions – 1) general rules and 2) exceptions to those rules. The general rules define what is to be taxed (the tax "base" or bases), the rates at which taxes should be applied (flat or graduated), the taxpaying unit (single individuals, couples, corporations), and rules for adjusting the tax base to account for family size. The exceptions consist of provisions that allow special exemptions, deductions, tax credits, preferential tax rates, or deferrals of recognition of income for selected activities or categories of taxpayer.

There is considerable dispute about which provisions should be viewed as part of the normative or baseline tax system and which provisions are exceptions, or "tax expenditures". For example, the baseline tax system is a broad-based income tax, while some economists would prefer a consumption-based system that allows deferral of liability until income is consumed. Under such an alternative baseline, deferral of tax on income accrued within qualified retirement plans would no longer be a tax expenditure. Nonetheless, the Congressional Budget Act of 1974 required both the Office of Management Budget (OMB) and the Congressional Budget Office to prepare annual lists of these tax expenditures and estimates of their revenue losses. The Joint Committee on Taxation (JCT) has assumed responsibility for preparing these estimates on the Congressional side. Every year, both OMB and JCT release updated estimates of tax expenditure provisions.[1]

Tax expenditures often intend to reward selected groups of taxpayers, encourage certain forms of behavior, or do both. For example, child credits, special deductions for the elderly and blind, and exemption of Social Security benefits for low-income taxpayers intend to help certain groups Congress views as meriting assistance and are substitutes for cash transfer programs. Other provisions, such as tax credits for renewable energy, or deferral of tax liability for income accrued within qualified retirement plans, intend to promote policy goals, such as reduced use of

[1] The OMB estimates are included in the Analytical Perspectives section of the federal budget. The Treasury Department's Office of Tax Analysis prepares the estimates for OMB.

fossil fuels or adequacy of retirement saving. Still other provisions, such as the earned income credit, intend both to help low-earners with families and to encourage workforce participation.

The use of the term tax expenditures reflects the insight that many of these benefits in the tax law could alternatively be structured as spending programs. Renewable energy tax credits could be structured, for example, as grants for qualifying energy investments provided by the Department of Energy. The child credit could be paid out as an annual check to qualifying families from the Department of Health and Human Services. In some cases, the tax code may be a convenient way to provide benefits because it does not require recipients already reporting to the IRS to interact with a different government agency or the government to create a new agency and because some characteristics for qualifying, such as annual income, may already be reported on tax forms. Nonetheless, often the tax system is used to provide incentives simply because tax incentives with exactly the same structure as benefit programs can be marketed as tax cuts instead of new spending.

Tax expenditures cost the government substantial revenues. My colleague Donald Marron has recently calculated that losses in individual and corporate revenues from tax expenditures reported in the fiscal 2012 budget, including the refundable portion of credits, add up to almost $1.2 trillion in fiscal year 2011, about the same as projected total individual and corporate income tax receipts. [2] Total tax expenditures do not lose the same amount of revenue as the sum of the individual provisions because each provision is estimated as if all other provisions in the tax law remain in effect.[3] But the $1.2 trillion figure is probably a very good approximation and may be an understatement. In a recent paper, Len Burman, Chris Geissler, and I estimated the simultaneous effect of eliminating virtually all individual income tax expenditures, other than those affecting the reporting of business income, in 2007. [4] We found that taking account of interactions among provisions raised the estimate of total revenue losses by between 5 and 8 percent, compared with simply adding up each item separately.

Many of these tax incentives intend to encourage certain forms of behavior. But it is not always clear what Congress intended when it created particular tax incentives. For example, when the

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[2] Donald B. Marron, "How Large are Tax Expenditures," *Tax Notes*, March 28, 2011.

[3] Eliminating any separate tax expenditure or group of tax expenditures would also not necessarily raise the same amount of revenue as the tax expenditure estimate shows because the tax expenditure estimates ignore behavioral responses. For example, eliminating the preference for capital gains would induce lower capital gains realizations, so would not raise as much revenue as the static loss from the preference at existing levels of realizations.

[4] Leonard Burman, Eric Toder, and Christopher Geissler, "How Big are Total individual Income Tax Expenditures and Who Benefits from Them?" Tax Policy Center. Discussion Paper No. 31. December 2008. At http://www.taxpolicycenter.org/UploadedPDF/1001234_tax_expenditures.pdf

modern federal income tax was introduced in 1913, all interest was deductible as a cost of producing income. But the resulting deductibility of home mortgage interest originally had very little effect on economic behavior; many fewer people owned homes than today, only the very highest income Americans were subject to any income tax, and the fixed rate 30 year mortgage had not become widely prevalent. Subsequent changes, including the conversion of the income tax from a "class" tax to a "mass tax" during World War II, the post-war expansion of homeownership, and the increased available of mortgage financing, turned the deduction into an important incentive, encouraging investment in larger homes. The deduction then became even more of an anomaly in the tax code after 1986 when deductibility of other forms of interest not associated with the production of income were curtailed and over time as opportunities to accrue interest tax-free in qualified retirement plans increased.[5] Today, we can retrospectively construct reasons why Congress might have wanted to subsidize home mortgage borrowing, but this provides a possible rationale for the policy and not an explanation of how it came about.

Regardless of the actual goals of provisions, we can identify provisions that subsidize certain investments by businesses and consumption choices by households. And we may want to know whether these incentives actually increase the subsidized behaviors.

In my comments today, I will address the following questions:

- What does traditional economic theory tell us about the effects of tax incentives?
- What have we learned from statistical studies of the major tax incentives?
- What is "behavioral economics" and how has this relatively new approach to economic research affected our views of how tax policies affect behavior?
- Based on the insights of this research, in what ways does the complexity of the current income tax alter the effectiveness of tax incentives?

Traditional Economic Analysis of Tax Incentives

Traditional economic theory starts with the premise that businesses and households behave rationally. Businesses seek to maximize profits, subject to restraints imposed on them by markets for goods, labor, and capital and laws, regulations and social customs. Households try

[5] See discussion of the mortgage interest deduction in Eric Toder, Margery Austin Turner, Katherine Lim, and Liza Getsinger, "Reforming the Mortgage Interest Deduction," Urban Institute and Tax Policy Center, April 2010, at http://www.urban.org//UploadedPDF/412099-mortgage-deduction-reform.pdf

to maximize their economic well-being, broadly defined to include availability of leisure time and amenities in the work place as well as consumption of goods and services purchased with money income.

In maximizing their economic well-being, households must make the following basic choices:

- Households choose how to allocate their time between working for pay and engaging in non-market activities. These two categories are often called "work" and "leisure" in the economic literature, but leisure broadly defined includes many forms of uncompensated work performed in the home, such as child care, cooking meals, and self-performed household repairs.
- Households choose to allocate their income between consumption today and saving, so that they can consume more in the future or, for some, leave a larger bequest.
- In any year, households choose how to allocate their current consumption among different goods and services such as food, clothing, housing, and recreation.
- Households choose how to invest their saving among choices of real and financial assets with different expected returns and risks. They may also invest in their future earning power through schooling and on-the-job training.

All these choices are influenced by relative prices for different activities – the relative price between an extra hour of "work" and "leisure" (the wage rate), the relative price of current and future consumption (the interest rate or return to saving), the relative prices of different consumer goods, and the relative returns (and risks) among different investment opportunities. Taxes, in turn, affect the relative prices consumers pay for goods and services, the relative incomes they receive from different activities, and the costs that businesses face in supplying the goods and services households demand. They do this by reducing the price sellers receive (net of tax) below the price paid by buyers (including tax). Income taxes reduce the after-tax wage, relative to the firm's cost of employing workers, and the net return to saving, relative to the price businesses pay for capital services. Selective sales and excise taxes raise the prices of taxed goods and services relative to those not taxed or taxed at lower rates. Broad-based consumption taxes reduce the value of earnings workers receive, relative to the prices they pay for goods and services, but do not affect the return to saving. The corporate income tax increases the cost of capital services to corporate firms, but also contains numerous complex incentives affecting choices between debt and equity, dividend payout rates, the international location of investment, amounts of income reported to different tax jurisdictions, and decisions on whether to be structured as a taxpaying corporate entity or a flow-through business with income taxed directly to owners.

Tax incentives affect behavior by changing relative prices faced by households and firms, compared with those they would face in the baseline tax system. For example:

- The home mortgage interest deduction reduces the cost of capital in owner-occupied housing by lowering interest net of taxes paid by borrowers. It favors owning over renting and encourages homeowners to invest more in their homes, thereby diverting capital from financial assets and businesses to the household sector. The subsidy is larger for those in higher tax brackets than for those in lower income tax brackets and there is no subsidy at all for taxpayers who claim the standard deduction instead of itemizing.

- The charitable deduction reduces the "price" of giving so that, for example, a taxpayer in the 35 percent bracket spends only 65 cents per dollar she donates to a qualified charity. As with the home mortgage deduction, the subsidy to giving is larger for those in higher than in lower tax brackets and there is no subsidy for non-itemizers.

- Tax credits for renewable energy reduce the cost of generating electricity from renewable energy sources such as hydropower or geothermal energy, relative to the cost of burning fossil fuels.

Economic theory generally implies that tax incentives that affect decisions at the margin by reducing the cost of additional activities a taxpayer may undertake are more effective than those that provide fixed dollar benefits that do not increase as output rises. For example, IRAs with a fixed dollar contribution limit may provide little incentive to save for those who typically save more than the limit. An incentive to save more would only occur if the dollar limit was higher than what the households would have otherwise saved and if the household was unable to contribute up to the limit either by transferring other assets or by borrowing. Tax benefits for new investment, such as expensing or investment credits, may increase investment more per dollar of revenue cost than tax rate cuts that benefit existing as well as new investment.[6]

Because tax incentives work by changing prices that households and businesses face for subsidized activities, standard economic theory implies that it does not matter whether the subsidy is claimed by the seller or the buyer. What matters instead is how responsive sellers and buyers are to price changes. According to this view, for example, a 20 percent interest credit

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[6] Some subsidies may have opposite effects on the incentive to undertake an activity at all and the incentive to undertake more of the activity for those participating. For example, the earned income credit (EIC) raises the reward for working in the market, but may discourage working more than a certain number of hours if the taxpayer's income is in the range at which the earned income credit phases out with additional earnings. Research shows that the EIC raises hours worked overall because the increase in hours from higher labor force participation outweighs any decrease in hours among those otherwise working.

paid to mortgage borrowers should have the same effect on borrowing as a 25 percent interest subsidy paid to lenders.[7]

Joel Slemrod has provided a useful classification of the hierarchy of responses to targeted incentives.[8] Incentives that affect the *timing* of behavior by providing a tax benefit, for example, in December 2011 than is not available in January 2012, can induce a very large shift in economic activity to qualify for the benefit, even while total activity over several years is unchanged. For example, the tax holiday for repatriation of foreign profits enacted in December 2004 induced a huge volume of dividends paid to U.S. parent companies from foreign subsidiaries while the benefit was in effect. Incentives that affect *financial arrangements*, such as whether a particular investment is financed with equity or debt or where income is reported, can also generate fairly large, but not as large responses as timing differences. For example, the growing gap between the U.S. corporate income tax rate and tax rates in other countries has induced companies to find ways to report more income in lower-taxed offshore jurisdictions. Incentives that affect *real* activities, such as the level of investment or labor supply, generate the smaller responses. The same growing corporate rate gap that induces income shifting encourages some additional investment overseas compared with investing in the United States, but the likely shift in real investment is much more modest than the shift in reported profits.[9]

Among subsidies for real activities, more narrowly targeted subsidies that favor assets or consumer goods that are close substitutes for others generate larger behavioral responses. Thus, a favorable tax concession for capital employed in one industry or type of firm is likely to generate a much larger response for the subsidized asset than would a tax benefit that affects all assets equally and relies on inducing households in general to save more. This is not to say that narrowly targeted incentives necessarily represent good policy. If one believes that private market signals provide a better guide to investment choices than government decisions, then the targeted incentives could generate a large efficiency loss by misallocating scarce capital resources to investments with lower pretax returns.

[7] To see that these two subsidies are equivalent, suppose the borrower is charged a 10 percent interest rate and claims a 20 percent credit. The net cost of borrowing is 8 percent and the bank receives 10 percent. Suppose, instead that a 25 percent credit is paid to the bank. The bank charges the borrowers 8 percent interest and then receives a payment from the government equal to 25 percent of the interest charged, leaving the bank with a total return from the borrower plus government of 10 percent.

[8] Joel Slemrod, "Do Taxes Matter? Lesson From the 1980s," National Bureau of Economic Research, Working Paper 4008, March 1992.

[9] For example, Martin Sullivan cites IRS data showing that the ratio of reported profits to assets for U.S. multinational companies is much higher in low-tax than in high-tax countries. See Martin A. Sullivan, "Economic Analysis: Extraordinary Profitability in Low-Tax Countries." *Tax Notes*, August 25, 2008.

Research on Tax Incentives and Behavior

There have been numerous studies of how price changes induced by tax incentives affect economic behavior. These results of these studies are difficult to interpret because economists typically cannot perform the type of controlled experiments that are possible in other scientific fields. Instead, economists search for "natural experiments" in which it may be possible to isolate the effects of price variations on economic behavior. Cross-section studies compare the behavior of taxpayers in the same year, who are faced with different tax incentives, either because they live in different jurisdictions or because the incentive depends on other aspects of their economic or tax position. Time-series studies compare changes in taxpayer behavior over time when there have been changes in tax incentives. If they are available, panel studies that follow the same taxpayers over time provide a useful way of capturing changes in behavior of the same taxpayers when the incentives they face change relative to others.

All of these studies confront serious problems of statistical interpretation. Correlation between two variables does not imply that one change causes the other and there are usually many aspects of a taxpayers' situation that are changing at the same time, confounding attempts to identify the separate effect of the incentive being studied. Statistical studies provide broad confirmation that tax incentives affect behavior, but the size of estimated behavioral responses often varies greatly among studies.

It is not my purpose to summarize the vast amount of research on tax incentives and economic behavior, but I cite a few examples:

- Numerous studies find that charitable contributions are affected by the "tax price" of giving; the lower the price net of tax, the larger amounts given, holding other variables constant. But the size of estimated responses varies greatly; some studies find that taxpayers give more *net* of the tax benefit in response to a larger benefit[10], suggesting that it is more "cost-efficient" for government to support charities through a tax incentive than

[10] Technically, this happens when the response of charitable giving has a price elasticity that is great than 1, meaning that, for example, a 10 percent reduction in the tax price increases giving by more than 10 percent. If for example, a 10 percent tax credit causes giving to rise by 20 percent, someone previously giving $100 would now give $120. Charities would receive an additional $20 in contributions at a cost to the government of only $12 (10 percent of $120). In contrast, if the price elasticity of giving is less than one, the revenue loss to the government will exceed the increased gifts received by charities.

through direct grants. Other studies find a much smaller response of giving to the tax price.[11]

- Many studies show that capital gains realizations increase when the tax rate on realized capital gains falls, although this does not necessarily imply that investment also increases. Some studies suggest that, within certain ranges, a lower capital gains rate could raise revenue from capital gains taxes. The short run response and timing effects, however, have been shown to be much larger than the long-run effects.[12]
- There have been diverse results from studies of the effects of saving incentives for IRAs and 401k plans on saving.[13] Some studies find large effects on household saving, but others find that most contributions come from other saving accounts or from borrowing. Some research finds much larger positive saving effects, per dollar of participation in plans, for low-income households who do not have the ability to shift assets from other accounts.[14] But these households represent a minority of plan participants and hold a very small share of total assets in qualified plans.

New Lessons from Behavioral Economics

"Behavioral economics" departs from traditional economic theory by assuming "non-rational" behavior among households. Thus, it seeks to explain better how people do behave instead of how they would behave if they were making rational and consistent choices to maximize their well-being.

Assuming households are non-rational does not mean that their tastes and preferences differ from ours. It is perfectly consistent with a rational economic model for an individual to consume all her income every year and not worry about being impoverished in retirement, although we might

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[11] Many of these studies are summarized in John Peloza and Piers Steel, "The Price Elasticities of Charitable Contributions: A Meta-Analysis," *Journal of Public Policy and Marketing* 24(2), 2005.

[12] For a discussion of much of this research, see Leonard E. Burman, *The Labyrinth of Capital Gains Tax Policy – A Guide for the Perplexed,* Brookings Institution Press, Washington, DC, 1999.

[13] See, for example, Eric M. Engen, William G. Gale, and John Karl Scholz, "The Illusory Effects of Saving Incentives on Saving," *Journal of Economic Perspectives* 10(4), 1996, R. Glenn Hubbard and Jonathan S. Skinner, "Assessing the Effectiveness of Saving Incentives," *Journal of Economic Perspectives* 10 (4), 1996, and James M. Poterba, Steven F. Venti, and David A Wise, "How Retirement Saving Programs Increase Saving," *Journal of Economic Perspectives* 10(4), 1996.

[14] Eric M. Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth Differences Across Earnings Groups," National Bureau of Economic Research, Working Paper 8032, 2000.

think such behavior is unwise. Instead, non-rational behavior means that households do not act according to a consistent set of preferences. Behavior is affected by how incentives are framed, by default rules, and by other attributes that do not alter real economic choices.

If household behavior were viewed as purely random, then behavioral economics would be no help in understanding the economy. But behavioral economics can make an important contribution to our understanding of how incentives affect economic choices to the extent it can reveal systematic patterns of inconsistent behavior.

Some of the findings of research by behavioral economics contradict the assumption of rationality and improve our understanding of household behavior. A few examples:

1. Participation in retirement saving plans and choices among investments within plans are heavily influenced by default rules. Participation rises dramatically when workers are automatically put into retirement plans and given the chance to "opt out" than when they have to take an active decision to participate. When enrollment is automatic, most participants retain the investment portfolio that the plan defaults them into. And, although standard economic theory suggests that more choices make people better off, households are more likely to sign up for participation in plans that offer fewer investment options, perhaps because the inability to decide which fund to select deters them from doing anything. [15] Sometimes people fail to sign up for plans offering an employer match even when the match can be converted directly into cash and therefore could leave them with increased wealth at no sacrifice in current consumption.[16]

2. The visibility of incentives (referred to as "salience") affects behavior substantially. People reduce demand for taxed goods more when sales and excise taxes are stated separately than when they are simply incorporated in the price of goods.[17] Use of an EZ-

[15] Over the past decade, a large volume of articles by James Choi, David Laibson, Brigitte Madrian, and others have explored the effects of default rules on retirement saving choices. For a summary, see John Beshears, James Choi, David Laibson, and Brigitte C. Madrian, "The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States." In Jeffrey R. Brown, Jeffrey Liebman, and David A. Wise, editors, *Social Security in a Changing Environment*, Chicago, University of Chicago Press, 2009.

[16] James Choi, David Laibson, and Brigitte C. Madrian, "$100 Bills on the Sidewalk: Suboptimal Investment in 401(k) Plans," *Review of Economics and Statistics*, forthcoming.

[17] Raj Chetty, Adam Looney, and Kory Kraft, "Salience and Taxation: Theory and Evidence," National Bureau of Economic Research, Working Paper 13330, 2009.

pass to pay tolls increases the volume of traffic on toll highways by more than can be explained by time saved by not waiting at a toll booth.[18]

3. How subsidies are framed affects behavior. Matching grants to charities appear to induce more giving than subsidies in the form of rebates.[19] While matching grants do induce additional charitable giving, the size of the match ratio appears to have no additional effect.[20] Evidence from a controlled experiment suggests that matching grants increase contributions by low-income households to retirement plans more than refundable tax credits.[21]

These research results challenge conclusions of traditional economics about how best to design incentives to influence behavior. It turns out it does matter whether an incentive is provided to the buyer or seller, even if the real incentive effect is the same. Lump sum subsidies or fixed grants can affect behavior, even if they are easily substitutable for cash so don't really provide an economic incentive for the desired activity (the so-called "flypaper" effect). People will respond differently if offered a fixed-dollar subsidy for an activity instead of cash even if the subsidy is immediately and easily convertible to cash and therefore, in theory, equivalent. People are heavily influenced by default positions and have a strong bias to loss relative to their starting point. So they will be influenced much more by potential losses from changing behavior than by potential losses from not changing it.

The emphasis of behavioral economics on salience and framing of policies has particular relevance to how tax complexity affects responses to incentives. Even with fairly simple incentives, people may fail to perceive the benefits to them from particular choices. The problems become multiplied in our increasingly complex income tax. I turn now to some general observations about complexity and its effects.

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[18] Amy N. Finkelstein, "E-Z Tax: Tax Salience and Tax Rates," National Bureau of Economic Research Working Paper 12924, 2007.

[19] Catherine Eckel and Philip Grossman, "Subsidizing Charitable Contributions: A Natural Field Experiment Comparing Matching and Rebate Subsidies," Working Paper, 2007.

[20] Dean Karlan and John A. List, "Does Price Matter in Charitable Giving? Evidence from a Large-Scale Natural Field Experiment," *American Economic Review*, December 2007.

[21] Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," National Bureau of Economic Research, Working Paper 11680, 2005.

Tax Complexity and Responses to Incentives

I identify three ways in which tax complexity can affect responses to tax incentives. First, and most directly, some tax incentives are so complex that even well-advised and sophisticated taxpayers find it hard to figure out how to respond optimally. Second, the overall complexity of the entire tax system makes even simple tax incentives less salient. Third, most of our tax law has become temporary, so people facing economic choices may have no good way to predict the tax consequences.

Some Tax Incentives are Horrendously Complex

Some tax incentives may themselves be so complex that taxpayers have a hard time figuring out how best to respond in their own interest. Examples include:

- The multiple tax incentives for higher education and their interactions with spending programs, such as Pell grants.
- Multiple forms of saving incentives, including the choice between pre-paid (Roth) and deductible accounts, that make choice of the optimal response challenging even for highly educated tax professionals and their financial advisors. The relative benefits from saving in a Roth or deductible accounts depend on numerous factors, such as the taxpayer's expected future income, expectations of how Congress may change tax rates in the future, and expectations of the timing of future consumption needs.
- Various phase-outs and limitations on tax incentives that reduce their benefits and alter incentives to work and save in certain income ranges, including the limitation on itemized deductions, the personal exemption phaseout, and phase-outs of the child credit, education credits, IRA participation limits, and the earned income credit.
- Interaction of tax incentives with the alternative minimum tax
- Complicated eligibility provisions for certain tax benefits, such as the earned income credit.

The report of the President's Economic Recovery Board included a number of options to rationalize and simplify tax incentives.[22] To date, however, this and similar proposals in

[22] The President's Economic Recovery Advisory Board, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," August 2010.

previous years advanced by the IRS Taxpayer Advocate and others have had little impact on legislation.[23]

The Overall Complexity of the Tax System Makes Even Simple Tax Provisions Less Salient

The tax system has become increasingly complex over time. Surprisingly, however, IRS researchers find that the cost for individual taxpayers to comply with the tax system has declined slightly in the past decade.[24] A plausible explanation for this is that the increased productivity of automated tax preparation methods has offset the rise in complexity of the tax code.

Currently, about 90 percent of taxpayers use either preparers or software to calculate their tax liability. The use of automated methods reduces time spent in preparing returns and helps taxpayers maximize their use of the benefits available to them in the tax code, given their economic behavior.

But this time saving comes with a cost. Taxpayers need to know less about the tax system in order to complete their returns and, unless they have a very proactive tax advisor, are less likely to respond to incentives in the tax code in a manner consistent with their personal economic interests. Because they know less about how their tax bottom line is calculated, they are less likely to be sensitive to the types of incentives that are placed in the tax law to change their behavior.

Further, various provisions have very complicated interactions with each other. In particular, although marginal tax rates are supposed to measure tax incentives and disincentives, it is very hard for taxpayers to know what their marginal tax rate will be when making decisions.

Here's a simple example. The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) reduced the top marginal rate on capital gains to 15 percent in 2003. But for some taxpayers, the marginal rate on realized gains is much higher than that. Suppose, for example a taxpayer in the state of Maryland who is in the phase out range of the alternative minimum tax (AMT) exemption realizes an additional $100 of capital gains. The $100 of additional income reduces the AMT exemption by $25. At the 26 percent rate (the first rate bracket of the AMT), the

[23] Annual reports of the National Taxpayer Advocate list the most serious problems faced by taxpayers in complying with the tax law. The latest report has a section on tax reform that discusses options for simplifying the tax code. See National Taxpayer Advocate. *2010 Annual Report to Congress.* At http://www.irs.gov/advocate/article/0,,id=233846,00.html

[24] George Contos, John Guyton, Patrick Langetieg, and Melissa Vigil, "Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increased Complexity," Presentation at IRS Research Conference, June 2010. At http://www.irs.gov/pub/irs-soi/10rpresconindtax.pdf

individual liability increases by $21.50 -- $15 from the $100 of capital gains and another $6.50 (26 percent of $250) from the reduction in the AMT exemption.[25] Adding on the 8 percent rate on capital gains in Maryland, which is not deductible for taxpayers on the AMT, makes the total rate on capital gains 29.6 percent – double the 15 percent rate. Without the AMT, the taxpayers would still pay state income tax on her capital gain, but the state tax would be deductible and the federal tax would be only 15 percent, so the total state-federal rate would be 21.8 percent (.08+(.15*.92)).

Not knowing one's marginal tax rate means one can't gauge the incentive effect of tax benefits that are in the form of deductions, exclusions, exemptions, and deferrals of income. And it also means that preferential tax rates may be not as preferential as you might think for some taxpayers.

An Expiring Tax Code

Even if people understood the detailed working of all these incentives, they would still face great uncertainty assessing future tax burdens. The tax cuts enacted in 2001 and 2003 all expire at the end of 2012. It is possible they will be extended again, but one can't rule out a political stalemate that leads to their partial or complete expiration. The AMT patch also expires at the end of 2011; it has been extended several times in the past, although sometimes only just before the tax year has ended. The one-year payroll tax holiday also expires at the end of 2011. This provision was meant to be temporary, but allowing people's withholding to rise in January of an election year might give some legislators pause. Numerous business tax incentives expire annually or every two years. Some expiring incentives, such as the one-year expensing provisions enacted at the end of 2010, are meant to be temporary, but others have been extended numerous times in the past. For example, the R&E credit was initially enacted in 1981 and modified and extended many times since then. Although it has been effect now for 30 years, it has never been a permanent feature of the tax law.

Congress could greatly improve the transparency of the tax system by limiting temporary provisions to those that really are meant to be temporary, for example a few selected short-term anti-recession measures. Temporary tax cuts could be allowed to lapse or made permanent or some provisions could be made permanent while others are allowed to end. Whatever the shape of a future tax system, taxpayers would be much better served by tax laws that are reasonably stable and predictable.

[25] See Greg Leiserson, "The 15 Percent Rate on Capital Gains: A Casualty of the Alternative Minimum Tax," Tax Policy Center article, at http://www.urban.org//UploadedPDF/901052_Capital_Gains.pdf

Sunset dates in the tax code are, not, however, the only major of source of uncertainty about future tax policy. As long as long-term fiscal policy continues to feature unsustainable deficits, taxpayers will wonder whether higher taxes might be part of the budget solution. And they will have no way to predict whether those higher taxes will take the form of increased tax rates, reduced tax incentives, new tax sources, or some combination of all of these.

The complexity of the tax law has several implications for the effectiveness of tax incentives. First, research findings on behavioral responses that come from studies performed when the tax law was more stable and transparent may not be relevant to today's environment. Second, there is a presumption that lack of transparency may make people even less responsive to tax incentives than they may otherwise have been. We cannot be sure of this, however, because lack of awareness of how various benefits are phased out may make people over-respond instead of under-responding to what they perceive as the benefit from certain tax incentives. What we can conclude is only that people are less likely to make the best choices for themselves when it becomes much harder to figure out the consequences of these choices.

Conclusions

Standard economic theory yields robust predictions of the direction of response to various tax incentives and insights on how to design effective incentives. A large body of statistical research finds that people do respond to incentives in the expected direction, undertaking more of an activity when its tax price falls. But while these studies are useful, there is a large uncertainty about the size of responses.

Insights from the new field of behavioral economics cast doubt on some of the prior beliefs of economists. Individuals do not necessarily behave in a rational and consistent way and are affected by how incentives are framed, default rules, and transparency of provisions. While this new body of research provides important insights about ways to design policies to affect behavior, they also suggest that we know a lot less about how well current incentives work than previously believed. And research applying behavioral insights in still in its infancy.

The increased complexity of the tax code and its temporary nature further reduces the extent to which we can rely on targeted incentives to influence behavior. Increased use of software and tax preparers and improved efficiency in the tax preparation industry may have kept compliance costs from rising in spite of a more complex tax code and helps taxpayers make use of available tax benefits, based on their economic behavior. But the increased reliance on preparers and software also reduces taxpayers' awareness of how the tax law works and makes them less likely to change their behavior to optimize their net benefit from tax incentives.

This may all sound depressing, but I would like to close on an upbeat note. The good news is that if we take this all to heart, we may be less tempted to use the tax code for complex social engineering schemes and more inclined to promote tax reforms that treat taxpayers with the same incomes in an equal and even-handed way.

Senate Finance Committee Hearing
"How Do Complexity, Uncertainty, and Other Factors Impact Responses to Tax Incentives?"
March 30, 2011
Responses to Questions for Dr. Eric Toder

Questions from Senator Orrin Hatch

1. There is a multi-layer of uncertainty surrounding the temporary nature of the estate tax. Many family-owned businesses and farmers are uncertain whether the estate tax rate will come roaring back in 2013 at a 55 percent rate with a $1 million exemption amount. In order to pay the estate tax, many family-owned businesses take out insurance policies, which if structured correctly, are used to pay the estate tax.

   Because of the uncertainty of the rates and exemption amount in 2013, many family-owned businesses are withholding capital that could be used to invest in jobs and equipment in order to pay for anticipated increases in insurance policies.

   This uncertainty is coupled with the uncertainty of whether estates will have to pay taxes on gifts they made prior to 2013 and whether portability will continue.

   Would you agree that the uncertainty of the fate of the estate tax is stifling economic growth?

   I agree that we would be much better served with more certainly in the tax code. And people could make better decisions if they knew what tax rules they would face in the future. While tax rules may always be changed by future Congresses, provisions that expire automatically create additional uncertainty. I agree that Congress should enact a permanent exemption amount (indexed to changes in the price level) and a permanent maximum rate for the estate tax. As you may recall, in 2009, the House of Representatives voted to make the 2009 estate and gift tax law provisions permanent, but that provision was not enacted in the U.S. Senate.

   I believe it is an exaggeration to suggest, however, that uncertainty about the estate tax is stifling economic growth. This uncertainty has existed ever since the 2001 tax cuts, which provided for a gradual reduction in estate taxes over the decade, elimination of the estate tax in 2010, and restoration of the 55 percent rate and $1 million exemption in 2011. During that decade, we experienced two recessions, but also a period of several years of strong economic growth. Also, given that both parties have supported measures which would extend rates at the 2009 level or below, it seems unlikely that many people expect a return to pre-2001 law.

2. In your written testimony at page 8, you acknowledge that research has established that 401(k) plans have larger positive savings effects on low-income households than on higher earnings groups. But then you go on to say that these households represent only a

minority of plan participants and hold a very small share of total assets in retirement plans. However, according to the attached chart, 38% of all private company 401(k) participants earn less than $50,000, and this income group represents the largest single block of participants across all income groups. The chart was prepared by ASPPA, the American Society of Pension Plan Actuaries, and is based on Statistics of Income from the IRS. In light of the significant participation in 401(k) plans by lower paid employees at companies that sponsor 401(k) plans, and in light of the larger positive savings effects these plans have on low-income households, do you agree that Congress should encourage the formation and maintenance of 401(k) plans rather than discourage their use?

I have a chart that demonstrates my point about 401(k) participation which is attached. The chart was prepared by ASPPA, the American Society of Pension Plan Actuaries, and is based on Statistics of Income from the IRS.

Retirement account balances grow with increasing age and tenure, regardless of income level. So isn't the key to retirement saving to first get business owners to set up plans, and then get workers to join the plans and start saving at the beginning of their careers and encourage them to continue saving throughout their working lives?

I do not have access to the IRS data on which the referenced chart is based. But I can put these figures in their proper perspective. The chart reports that 38 percent of 401(k) participants have adjusted gross income of less than $50,000 in 2008. In comparison, publicly available IRS data (at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96981,00.html) reveal that 64 percent of tax filers reported adjusted gross income of $50,000 or less in 2008. So these taxpayers are underrepresented among 401(k) participants. At the other end of the income scale, the chart reports that 26% of participants have income over $100,000. But the same IRS data show that less than 15% of returns report income over $100,000 or more.

While these figures confirm that people in the bottom 2/3rds of the income distribution account for much less than two-thirds of 401(k) participants, the concentration of asset holdings (as opposed to participation rates) among high-income households is even greater. In 2007, according to data from the Federal System's Survey of Consumer Finances, only 1.9 percent of participants in 401(k), 403(b) and similar retirement plans were in the bottom quintile of the distribution, 12 percent in the bottom two quintiles, and 33 percent in the bottom three quintiles. (The latter figure is roughly consistent with the cited IRS data showing the bottom 64 percent of tax return filers including 38 percent of participants.) But the distribution of assets in plans is much more skewed to the high end of the income distribution than the distribution of participants. Families in the bottom quintile of the income distribution held only $5 billion (0.1 percent) of the $4.1 trillion of assets in these retirement plans. Families in the bottom two quintiles held $63 billion (1.5 percent) of the assets in these plans and families in the bottom three quintiles $324 billion (8.1 percent). In contrast, those in the top 10 percent held over half the assets in employer-sponsored retirement plans.

Distribution of Families with Assets in 401(k) or 403(b) or Other Account Type Plans, 2007 (Percent)

Income Percentiles	Distribution of Families with Assets	Distribution of Assets
Bottom quintile	1.9%	0.1%
Second quintile	10.1%	1.4%
Third quintile	20.6%	6.4%
Fourth quintile	30.6%	20.5%
80-90th percentiles	19.2%	19.6%
Top 10 percent	17.6%	52.0%
Total	100.0%	100.0%

Source: Tabulations from Board of Governors of the Federal Reserve System, *Survey of Consumer Finances*, 2007.

With regard to the second part of the question, I totally agree that a key to retirement preparation is for workers to start saving early in their careers and that employer-sponsored 401(k) plans can facilitate that effort. For tax incentives to be effective in encouraging younger workers, who are often in low tax brackets, to save, it is important that they be designed to help these workers. And low and middle-income workers receive a much larger incentive from a refundable saving credit, combined with auto-enrollment provisions, than they receive from tax incentives as currently designed.

Questions from Senator Robert Menendez

1. **Increasing Middle Class Response from Tax Incentives**

   There seems to be a general consensus today that one of the critical issues with tax incentives is complexity. When forced to choose between a wide range of complex and often overlapping incentives, most Americans, myself included, would find it difficult to select the most valuable incentive for a range of activities without professional help. This is perhaps most evident with education as there are currently 18 different tax provisions aimed to help with the cost of higher education. In fact a recent Treasury report found that less than 40% of eligible American families claimed the American Opportunity Tax Credit, even though it's generally the most valuable tuition tax incentive. This includes 420 thousand New Jersey families who might have missed out on a more valuable tuition incentive. This is just one example of many where complexity in the tax code can effectively hide tax benefits from American families.

   Could each of you identify one or two areas where complexity creates the most difficulty for middle class families to understand the value of tax incentives available to them and where you believe Congress should make it a priority to simplify?

I would certainly identify incentives for higher education, as the question describes, as one of the most complex areas of the tax code that middle-income families must confront. Another area of considerable complexity is the bewildering array of saving incentives for retirement and other purposes. Any individual without a pension plan at work may contribute to an IRA, but for people who are covered (or whose spouse is covered), amounts they may contribute to a deductible or Roth IRA phase out as incomes increase. And those who are eligible to contribute to a Roth or deductible IRA face a complex decision on which type of plan to select. Roth IRAs have the advantage of allowing larger net after-tax contributions (although the statutory limits are the same) and not requiring withdrawals after age 70, but deductible IRAs may be the better choice if one expect to be facing lower tax rates in retirement than when working. Tax-qualified plans also include a variety of rules what qualifies for a penalty-free pre-retirement withdrawal. Finally, there are a variety of other saving plans for education and health, which are subject to their own special rules and limitations.

Another provision that creates considerable complexity and uncertainty is flexible spending accounts available at the workplace. For examples, individuals may choose at the beginning of the year to set aside part of their salary to pay for non-covered health expenses with pretax dollars, but will lose any unspent amounts at the end of the year. This often leads people who have incurred lower than expected health costs during a year to run out and schedule routine check-ups near the end of the year or to purchase new eyeglasses and other devices to use up their unspent funds.

All of these provisions could be vastly simplified, assuming they are retained in the tax code at all. The variety of tuition benefits could be replaced with one credit, with a single and simplified definition of qualified expenses and one set of income limits and phase-outs (if one must phase them out at all). The complex incentives for retirement saving outside could be replaced with a single type of retirement plan, with a combined employer-employee contribution limit and no income limits on participation. A supplemental refundable saving credit could be made available as an alternative to families who cannot benefit from a deduction. The choice between deductible and Roth options could be eliminated (my preference would be to retain the deductible option.) Flexible spending accounts for health care could be replaced with a limited deduction (below the 10 percent floor) for non-covered health care expenses or scrapped entirely.

2. **Increasing Effectiveness of Education Tax Incentives**

Dr. Chetty and Dr. Toder, your testimonies identified many of the problems found with incentives in the tax code and also offered several solutions to fix them. In particular you found that with retirement incentives, creating a "default" choice with the ability to "opt-out" actually encouraged saving more than simply providing a financial incentive to do so.

Can this type of "default" rule be used in other areas, such as with education incentives where creating a default education credit would encourage more families to invest in

education, or are there other reforms that can make tax incentives for education easier to use and more valuable for the average family?

I can't see how default rules for higher education might work or that they are analogous to default rules for saving in the work place. Employers know how much they are paying their workers and can default them into a plan that withholds a fixed share of their earnings for retirement saving. But the IRS does not know in advance whether a family has an eligible college student. And while any employee can enroll in a workplace saving plan, not everyone gets admitted to a college. So I am unclear who would receive the default credit; it would certainly not be cost-effective to provide an "education credit" to all families and then require those without an eligible student to return it. And one can't default students into college attendance.

There have been a number of proposals to simplify tuition credits. For example, the report on tax reform options of The President's Economic Advisory Board (August 2010) presented an option that would replace the multiple subsidies for higher education with one or two incentives, limit qualified expenses to easily documented items such as tuition (but not expenses for books and rent), and retain only a credit, while allowing the tuition and fees deduction to expire. The 2005 Report of the President's Advisory Panel on Federal Tax Reform recommended replacing all the tax incentives for higher education with a family credit allowance of $1,500 for all families with full-time students age 20 and under and allowing families to save tax-free for future education expenses.

Questions from Senator Snowe

1. In our first hearing on tax reform in September 2010, we discussed the problems that are part of our current tax code – problems of both real and perceived unfairness, problems of complexity, problems that flow from the fact that more than 15,000 changes have been made to the tax code since 1986. Randy Weiss of the Conference Board and formerly of JCT put it well in his testimony:

   "In the fairness arena, the biggest problem today appears to be not so much a systematic ability of high-income people and companies to avoid paying tax, but rather a kind of randomness in the computation of tax liability. There are so many overlapping incentives that, along with the alternative minimum tax and people's increasing delegation of tax preparation to tax professionals and computers, it is very difficult for many people to understand how their tax liability is determined and to make decisions accordingly. A perception of fairness requires that people see that their tax liability is determined according to some logical principles. A tax reform package that responded to this concern would be popular."

   If the 2011 version of tax reform were to take several tax incentives and combine them into functional categories – such as development tax incentives, energy incentives, retirement incentives, and family incentives, etcetera – would that address the complexity

and fairness issues that are key problems with current tax law? How might you propose such combination be accomplished?

There are number of models that have been suggested in various tax reform proposals Many of these have in common several features – 1) reduce available options, 2) eliminate income phase-outs, 3) convert provisions intended to incentivize behavior from deductions to credits (while retaining deductions necessary to measure income properly instead), 4) make credits refundable, and 5) introduce common definitions and requirements (for example, enacting a common definition of a qualifying child for various child-related provisions or making rules for any income-phase outs uniform among proposals with similar objectives).

For example, the tax reform proposal of the debt reduction task force of the Bipartisan Policy Center would vastly simplify family incentives. It would eliminate the standard deduction, personal exemptions, the current child credit and the current earned income tax credit. It would replace all these provisions with two simple provisions – a uniform fully refundable child credit and a refundable per-worker earnings credit at a fixed rate, up to a maximum eligible level of earnings. Neither of these benefits would phase out with income. I have calculated that a child credit of about $1,660 in 2012 would on average provide the same benefit for an additional child as all the child related-benefits in the current income tax, although the distribution of the benefit would change both among and within income groups, compared with current law. Under this option, taxpayers could simply register once for eligibility for the child credit and then receive it automatically and workers with one employer could receive the earnings credit through an advanced payment mechanism that provides the credit as a share of each paycheck until the maximum annual amount is reached. These credits could be combined with changes in the rate structure to keep the distribution of tax burdens among income groups roughly the same as it is under current law.

Alternatively, the 2005 Report of the President's Advisory Panel on Federal Tax Reform would replace the personal exemption, standard deduction, and child credit, with a simplified family credit and replace the earned income credit with a work credit that is coordinated with the family credit.

Retirement incentives can also be consolidated and simplified. In place of the numerous types of plans in current law, the tax code could allow all taxpayers to place a fixed share of earnings, up to a maximum amount, into a deferred retirement saving account. The contribution limit would apply to all employer and employee plans combined in which the worker participates. To encourage low-income families to save, I would allow them to claim a refundable credit for contributions instead of a deduction, so effectively the government would be matching their saving. With a direct subsidy to saving by low-wage workers, it would be possible to eliminate the complex set of non-discrimination rules based on employee participation that are meant to induce employers to match their employees' contribution to 401(k) and other tax-deferred retirement accounts to get them to join the plans. If one wants to encourage more saving, this could be combined with an "automatic" IRA feature, as the current Administration has proposed. I would eliminate

income phase-outs for participation, on the grounds that income phase-outs are complicated, currently only apply to IRAs and not to other retirement incentives, and are not really necessary because with aggregate contribution limits, the allowable contribution as a share of income falls sharply at the top end of the income distribution.

I would also eliminate the choice between traditional deductible plans and pre-paid (Roth) plans. My preference would be to retain the deductible plans, based on the concern that the Roth plans mask the long-run budgetary costs of saving incentives and will create a massive problem of perceived unfairness in the future when many affluent retirees will be receiving substantial amounts of tax-free investment income. (In contrast, the 2005 President's Advisory Panel favored keeping only the Roth plans.)

I agree, however, with the 2005 Panel's recommendation to combine all non-retirement saving incentives into a single additional plan, that would allow tax-deferred saving for other uses, such as purchasing a home, paying for a medical emergency, of financing college tuition.

There are many other possible simplifications, but I would reiterate the recommendation many have made to eliminate the individual alternative minimum tax, which introduces needless gratuitous complexity into the tax law. If the goal is to reduce the use of tax preferences, Congress could either eliminate selected preferences or impose simple limitations on separate provisions or groups of provisions (such as uniform percentage reductions, caps, or floors) that reduce their costs.

2. In our initial tax reform hearing in September 2010, we discussed the issue of "distributional neutrality" – that is, making sure that at the end of the process the code is rationalized without changing the relative burden of tax liability on different income groups. Former Congressman Dick Gephardt said, "We were not trying to raise taxes on the rich, nor cut them either. And, we didn't want to add to the budget deficit that was already careening out of control."

   If Congress were to extend permanently all tax rates before they rise after 2012, then Congress would achieve "distributional neutrality" but clearly have a negative impact upon the deficit.

   If Congress were to extend permanently only some of the rates that would then set the budget baseline at a point of higher taxes for some people in perpetuity thus freezing a decision being made today as a building block for tax reform next year.

   So by permanently extending some tax relief and allowing others to rise today, wouldn't that permanently stack the deck against those for whom the rates are allowed to rise?

   This is a really interesting problem created by the temporary nature of our tax laws. In the reform effort leading up to the 1986 Act, the meaning of keeping the distribution of the tax burden constant was clear because we were starting with a relatively stable (though highly distortionary) tax law. But today, there are alternative ways to define the

starting point. Is it the tax provisions taxpayers currently face in tax year 2011 (and, with some small modifications, have faced for most of the past decade.)? Or is it the tax provisions that will apply to them under current law in 2013?

The choice of how the tax burden should be distributed among income groups is ultimately a political decision, not one that analysts can decide. The Tax Policy Center has frequented displayed its distributional analysis of tax proposals in two ways – relative to our current policy baseline, which assumes all tax rules in effect in 2011 (except for the temporary one-year payroll tax holiday) are permanent) and relative to current law (the CBO baseline), which assumes tax laws remain unchanged, so that the 2001, 2003, and 2010 tax cuts expire at the end of 2012 and the AMT patch expires at the end of 2011. The estimated revenue and distributional effects of tax proposals differ substantially, depending on which baseline is used. The Obama Administration in characterizing its' fiscal year 2012 budget proposals, uses yet other baseline, which assumes some but not all of the 2001 and 2003 tax cuts are extended. Ultimately, in designing a tax reform, the Congress will have to decide which baseline to use as the standard for achieving overall revenue and distributional objectives. Put another way, Congress will need to decide how much revenue the tax system should raise and how the tax burden should be distributed among income groups, without reference to any clear standard that can be used as the starting point.

COMMUNICATIONS

STATEMENT FOR THE RECORD

UNITED STATES SENATE
COMMITTEE ON FINANCE

PUBLIC HEARING
March 30, 2011

How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?

SUBMITTED BY

AMERICAN BENEFITS COUNCIL

AMERICAN COUNCIL OF LIFE INSURERS

AMERICAN SOCIETY OF PENSION PROFESSIONALS & ACTUARIES

THE ERISA INDUSTRY COMMITTEE

FINANCIAL EXECUTIVES INTERNATIONAL

FINANCIAL PLANNING ASSOCIATION

THE FINANCIAL SERVICES INSTITUTE

FINANCIAL SERVICES ROUNDTABLE

INSURED RETIREMENT INSTITUTE

INVESTMENT COMPANY INSTITUTE

NATIONAL ASSOCIATION OF INSURANCE AND FINANCIAL ADVISORS

PROFIT SHARING / 401k COUNCIL OF AMERICA

RETIREMENT INDUSTRY TRUST ASSOCIATION

SMALL BUSINESS COUNCIL OF AMERICA

SOCIETY FOR HUMAN RESOURCE MANAGEMENT

U.S. WOMEN'S CHAMBER OF COMMERCE

PRESERVE THE EMPLOYER PROVIDED RETIREMENT SYSTEM

The undersigned organizations are committed to preserving and enhancing the voluntary employer provided retirement system and the tax incentives that support it. These plans are helping millions of American families achieve a secure retirement. **As Congress and the Administration consider comprehensive tax reform and deficit reduction, we urge them to preserve these provisions that both encourage employers to offer and workers to contribute to retirement plans.**

- **Employer-provided plans are a key component of our nation's retirement system.** Together with Social Security and individual savings, employer-provided retirement plans produce significant retirement benefits for America's working families. There are approximately 670,000 defined contribution plans covering 82 million participants and over 29,000 defined benefit plans covering 44 million participants (including active and retired workers). Recently enacted enhancements to the defined contribution system including automatic enrollment and automatic escalation are expanding participation and improving retirement preparedness. The Bureau of Labor Statistics reports that in March 2010 employer-provided retirement plans were available to 74 percent of full time and 65 percent of all (i.e. both full-time and part-time) private-sector workers. This success extends to low- to moderate-income workers, the focus of efforts to expand coverage. Changing the tax treatment and/or lowering contribution levels may result in fewer workers being offered retirement plans by their employers.

- **Employer-provided retirement plans offer key advantages to workers.** Employers voluntarily establish these plans and add immeasurable value by acting as fiduciary and investment management overseers, monitoring plan fees, selecting quality investment alternatives, making significant contributions, providing financial education, and encouraging and facilitating savings through payroll deductions. These plans must be operated for the exclusive benefit of and "solely in the interest of" the participants. They must meet broad coverage and nondiscrimination tests that ensure that the eligibility and operation of the plan are fair. Low and moderate income workers are much more likely to have retirement savings if they are offered a retirement plan at work. The Saver's Credit benefits lower-income workers who save through these plans.

- **Retirement plans play an important role in the capital markets.** As of 9/30/10, tax qualified retirement plans held $16.6 trillion in assets, of which approximately $13 trillion is attributable to employer provided plans. This pool of capital helps to finance productivity enhancing investments and business expansion. Contributions by employees and employers to defined contribution plans continued even through the recent years of financial stress. Changes to the tax treatment of retirement plans that would reduce contributions or discourage the establishment and maintenance of plans could negatively impact the role of these pivotal players in the capital markets.

- **Taxes on retirement savings are deferred, not excluded. Deferral treatment is not equivalent to the exclusion associated with other tax expenditures, such as the mortgage interest deduction.** As individuals begin to retire, distributions from retirement savings are taxed and revenue will flow to the U.S. Treasury.

Conclusion

The employer-sponsored retirement plan system has introduced tens of millions of American workers to retirement saving. Employers voluntarily establish and promote these plans to help their workers build assets for a secure retirement. Eliminating or diminishing the current tax treatment of employer provided retirement plans will jeopardize the retirement security of tens of millions of American workers, impact the role of retirement assets in the capital markets, and create challenges in maintaining the quality of life for future generations of retirees. While we work to enhance the current system and reduce the deficit we must not eliminate one of the central foundations – the tax treatment of retirement savings – upon which today's successful system is built. The effects of such a change for individuals, employers and the system as a whole are simply too harmful and must be avoided.

Senate Committee on Finance

Hearing on:

"How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?"

Wednesday, March 30, 2011

10:00 a.m.

215 Dirksen Senate Office Building

Submitted Testimony by

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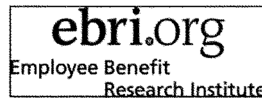

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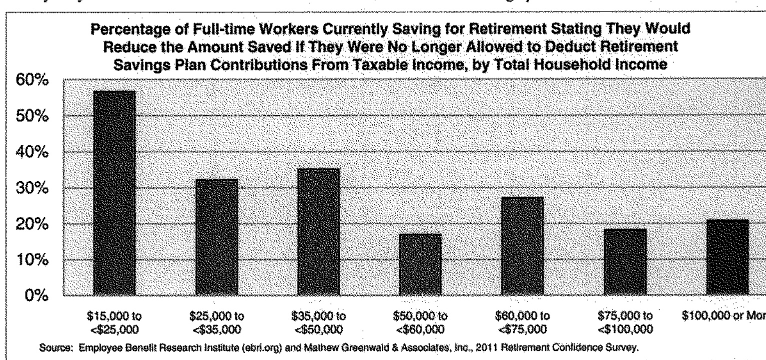
SUMMARY

If Congress were to modify the exclusion of employee contributions to retirement savings plans from taxable income, who would most likely cut back on their savings: lower-income workers, or those with higher income? This is examined in detail in the March 2011 *EBRI Notes,* a copy of which follows this summary and is available online at http://bit.ly/ebrimarch2011notes

Although conventional wisdom is that upper-income workers would be most affected, new findings by the nonpartisan Employee Benefit Research Institute (EBRI) suggest that lower-income workers are far more likely to say they would reduce their contributions if the tax exclusion for employee contributions to retirement savings plans were lowered or eliminated.

Results from EBRI's just-released 2011 Retirement Confidence Survey (RCS) show that more than half (56 percent) of full-time workers with household income of $15,000 to $25,000 currently saving for retirement say they would reduce the amount they save if they were no longer able to deduct retirement savings plan contributions from taxable income. By comparison, only 22 percent of full-time workers currently saving for retirement with household incomes of $100,000 or more say they would save less if the tax treatment of their retirement savings plan were reduced or eliminated.



Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence Survey.

The reactions become even starker as savings amounts grow, EBRI found: 71 percent of those with less than $1,000 in savings said they would reduce the amount saved if they were no longer allowed to deduct their contributions, compared with about 13 percent of those with $500,000 or more.

Additional groups found to be most likely to reduce their contributions to retirement savings plans include individuals who work for small private organizations as well as those with relatively low educational levels.

Background: In recent years, proposals have surfaced to reform the 401(k) system based on the assumption that higher-income individuals receive more tax-related benefits from these programs than do individuals in lower marginal tax brackets (as well as those who may pay no federal income taxes in a particular year). Some of these proposals have included modifications of the current federal income taxation treatment that excludes some or all of the contributions employees make to tax-qualified defined contribution plans.

From a strictly financial perspective, it is logical to assume that lower-income individuals (those most likely to pay no or low marginal tax rates and therefore have a smaller financial incentive to deduct retirement savings contributions from taxable income) would be least likely to rate the exclusion of employee contributions for retirement savings plans from taxable income as "very important."

However, the RCS data show that those in the household income category of $15,000 to $25,000 actually have the largest percentage of respondents classifying the tax deductibility of contributions as "very important." While higher-income workers would be the most likely to be negatively affected by a proposal to cut or eliminate the exclusion of employee contributions to retirement savings plans from taxable income, EBRI notes that behavioral economics has shown that workers' reaction in similar situations are often at odds with what would have been logically predicted.

The Impact of Modifying the Exclusion of Employee Contributions for Retirement Savings Plans From Taxable Income: Results From the 2011 Retirement Confidence Survey

By Jack VanDerhei, Employee Benefit Research Institute

Introduction

In recent years proposals have surfaced to reform the 401(k) system based on the assumption that higher-income individuals receive more tax-related benefits from these programs than do individuals in lower marginal tax brackets (as well as those who may pay no federal income taxes in a particular year). Some of these proposals have included modifications of the current federal income taxation treatment that excludes some or all[1] of the contributions employees make to tax-qualified defined contribution plans. This article provides some stylized examples of how the total tax advantage of some defined contribution plans varies by marginal tax rate and contrasts these values with the potential reduction in defined contribution balances if contributions were no longer "deductible."[2] This is followed by an analysis of two new questions from the 21st wave of the Retirement Confidence Survey (RCS)[3] showing how workers[4] would likely react if they were no longer allowed to deduct retirement savings plan contributions from taxable income.

Current Tax Treatment and Potential Impact of Modifications

One of the most common types of retirement savings plan contributions today involves employee contributions to 401(k) plans. Although after-tax contributions to these plans have been utilized for several years (primarily in response to Sec. 402(g) limits and/or the need to comply with ADP/ACP nondiscrimination requirements)[5] and in Roth 401(k) plans that have recently been introduced for many employees, the majority of employee contributions to 401(k) plans are still so-called "before-tax" contributions.

Determining the overall tax advantage of making before-tax contributions to a 401(k) plan involves the prediction of several factors, including amounts and timing of contributions, marginal tax rates during the accumulation and decumulation periods, rates of return, and withdrawal behavior during the decumulation period. Figure 1 shows results for a highly stylized example in which an individual currently age 55 makes annual (end-of-year) contributions of a constant amount to a 401(k) plan for 10 years and then immediately takes the account balance out as a lump sum, paying taxes on the entire amount. In contrast, a second scenario is analyzed in which an individual currently age 55 makes annual (end of year) contributions of the after-tax value of the same amount (viz., (1-marginal tax rate) times the amount contributed in the first scenario) to a non-tax-advantaged vehicle for 10 years and then takes the account balance out as a lump sum paying no additional taxes at that time. Because the investment in the second scenario is made in a non tax-advantaged vehicle, it is assumed that federal income taxes on the investment income are paid at the end of each year.[6] The total tax savings are computed as the difference between the net accumulation after taxes from Scenario 1 and the net accumulations after taxes from Scenario 2. This savings is then divided by the net accumulation after taxes from Scenario 1 to show the advantage as a percentage of the amount that would be accumulated after 10 years.

Each of these scenarios is calculated at investment rates of return of 2.5, 5.0, and 7.5 percent, and marginal tax rates of 15, 28, and 35 percent. Rates of return and marginal tax rates are assumed to remain constant over the 10-year period. Figure 1 shows that within each assumed rate of return scenario, the total tax advantage (as measured by the percentage increase in retirement income available after 10 years of contributions) increases with higher tax brackets. However the absolute difference between the total tax advantage of the highest vs. the lowest tax bracket varies with the assumed rate of return. At a 7.5 percent rate of return assumption, the absolute difference is 6.4 percent; however, this decreases to 2.2 percent at a 2.5 percent rate of return assumption.

Some proposals have focused on this disparity by suggesting that the deductibility of 401(k) contributions be either reduced or eliminated. Presumably, those who continued to make contributions under these proposals on an after-tax basis would be able to recover those contributions free of federal income tax when withdrawn and pay taxes only on the investment income similar to what is available under the current tax code for non-Roth after-tax contributions.

Assuming that marginal tax rates will be constant over the accumulation and decumulation periods and that investment income continues to be tax-deferred under these proposals, one may expect that there would be little change in overall tax advantages accruing under the proposed 401(k) system, unless the participants are constrained in the amount of funds they have to contribute each year.

Assuming that the participants need to reduce their contributions to the point that they are only able to contribute (1-marginal tax rate) times the previous amount because of their financial constraints, and that 401(k) contributions are no longer deductible (in any amount), Figure 2 shows the percentage reduction in 401(k) balances from eliminating deductions of contributions as a function of marginal tax rates and assumed rate of return. Similar to Figure 1, within each rate of return scenario, the impact is greater for those in the larger tax brackets: a 5.9 percent difference between the highest and lowest tax brackets at a 7.5 percent rate of return but reducing to a 2.1 percent difference at a 2.5 percent rate of return.

Results From the 2011 Retirement Confidence Survey

Although this highly stylized analysis suggests that higher-income employees would be the most likely to be negatively affected by a proposal to cut or eliminate the deductibility of 401(k) contributions (at least to the point they are constrained with respect to the annual funds available to contribute to a 401(k) plan),[7] behavioral economics[8] has shown that the reaction of employees in situations similar to this are often at odds with what would have been predicted by an objective concerned simply with optimizing a financial strategy. In an attempt to better understand potential employee behavior with respect to a proposed elimination of deductions for 401(k) contributions, this year's RCS included two new questions. The first asked respondents how important is being able to deduct their retirement savings plan contributions from their taxable income in encouraging them to save for retirement. When confined to full-time workers (n=591), the weighted results were as follows:[9]

Not at all important	4.3%
Not too important	5.0%
Somewhat important	27.8%
Very important	61.5%

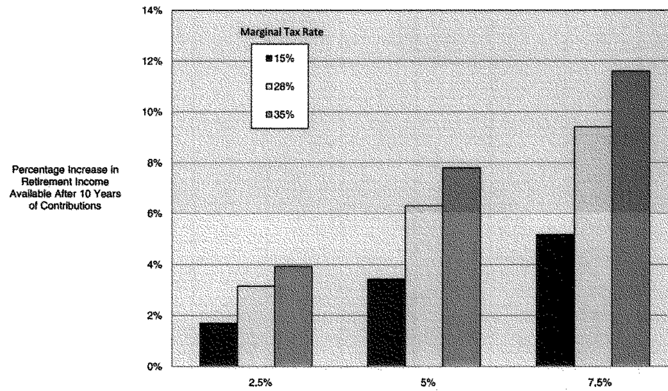
If one were to look at this from a strictly financial perspective, one would assume that the lower-income individuals (those most likely to pay no or low marginal tax rates and therefore have a smaller financial incentive to deduct retirement savings contributions from taxable income) would be least likely to rate this as "very important." However, Figure 3 shows that those in the lowest household income category ($15,000 to less than $25,000) actually have the largest percentage of respondents classifying the tax deductibility of contributions as very important (76.2 percent).

The second question asked of those currently saving for retirement was "Suppose you were no longer allowed to deduct retirement savings plan contributions from your taxable income. What do you think you (and your spouse) would be most likely to do?" When confined to full-time workers (n=460), the weighted results were as follows:[10]

Stop saving for retirement altogether	4.7%
Reduce the amount you save	20.5%
Continue to save what you do now	56.2%
Increase the amount you save for retirement	17.1%

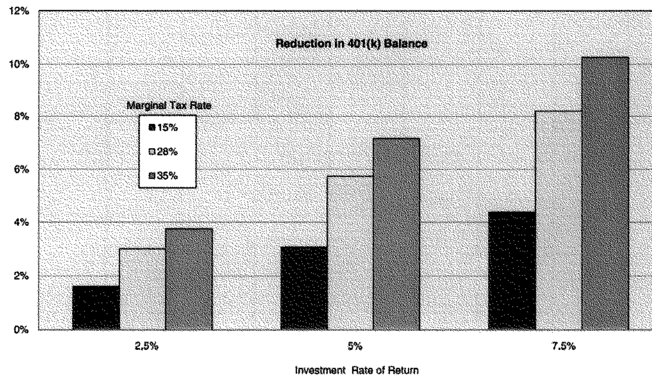
Combining the first two categories above (and eliminating those who refused to answer or responded that they did not know) results in approximately 1 in 4 full-time workers (25.6 percent) who indicated that they would reduce (in some cases completely) their contributions if the ability to deduct them was eliminated. Figure 4 shows the distribution of the percentage of full-time workers currently saving for retirement who state that they would either stop saving for retirement altogether or reduce the amount they save as a function of household income. Similar to Figure 3, the lowest-income category ($15,000 to less than $25,000) has the largest negative reaction to this proposal, with 56.7 percent indicating a savings reduction.

Figure 1
Stylized Examples of the Total Tax Advantage of a 401(k) Plan, as a Function of Marginal Tax Rate and Assumed Rate of Return



Source: Employee Benefit Research Institute (ebri.org) calculations. See text for explanation of scenarios and assumptions.

Figure 2
Stylized Examples of the Reduction in 401(k) Plan Balances From Eliminating Deductions of Contributions, as a Function of Marginal Tax Rate and Assumed Rate of Return



Source: Employee Benefit Research Institute (ebri.org) calculations. See text for explanation of scenarios and assumptions.

retirement altogether or reduce the amount they save as a function of household income. Similar to Figure 3, the lowest-income category ($15,000 to less than $25,000) has the largest negative reaction to this proposal, with 56.7 percent indicating a savings reduction.

A similar occurrence takes place when the percentage of those stating they would reduce the amount they are saving or stop saving altogether is displayed by the amount they currently have in savings and investments, not including the value of their primary residence or the value of defined benefit plans. Figure 5 shows that there is a significant increase in the self-reported propensity to reduce savings for those in the lowest savings categories. For example, of the full-time workers who are currently saving for retirement who report that they currently have less than $1,000, 71.3 percent indicate they would reduce the amount saved. This value declines to 38.8 percent for those with savings of $1,000 to less than $10,000.

Given these results, it is not surprising that the higher propensity to indicate a reduction in savings as a response to eliminating the deduction for contributions is also observed for those with lower educational levels. Figure 6 shows that 32.2 percent of high school graduates indicate they would reduce savings, whereas only 22.1 percent of those with a graduate or professional degree have a similar response.

Marital status also appears to have a very significant impact on the likelihood that a full-time worker currently saving for retirement would reduce the amount saved. Figure 7 shows that more than 2 in 5 respondents that are single, never married (44 percent) as well as those not married, living with a partner (47 percent) would reduce their savings. However, only 22 percent of married respondents, 16 percent of divorced or separated, and 14 percent of widowed respondents indicated they would reduce their savings.

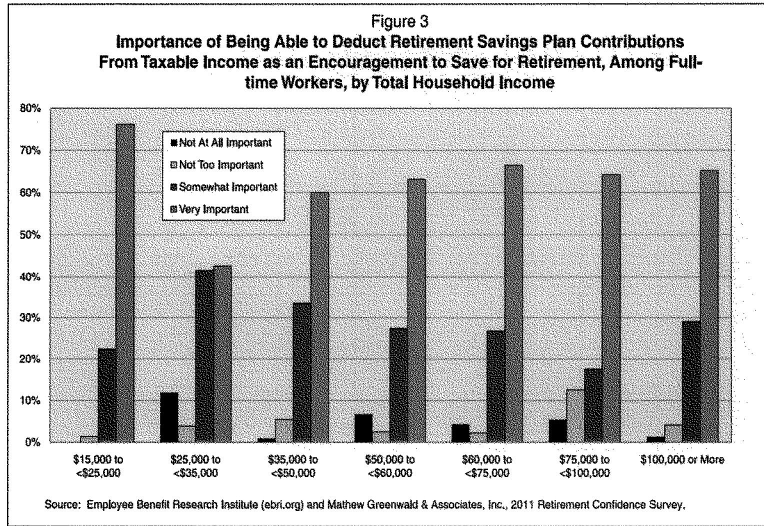


Figure 3
Importance of Being Able to Deduct Retirement Savings Plan Contributions From Taxable Income as an Encouragement to Save for Retirement, Among Full-time Workers, by Total Household Income

Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence Survey.

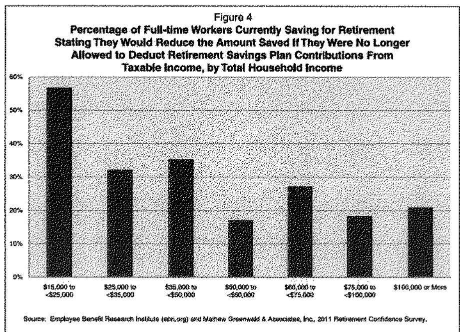


Figure 4
Percentage of Full-time Workers Currently Saving for Retirement Stating They Would Reduce the Amount Saved If They Were No Longer Allowed to Deduct Retirement Savings Plan Contributions From Taxable Income, by Total Household Income
60%
50%
40%
30%
20%
10%
0%
$15,000 to <$25,000
$25,000 to <$35,000
$35,000 to <$50,000
$50,000 to <$60,000
$60,000 to <$75,000
$75,000 to <$100,000
$100,000 or More
Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence Survey.

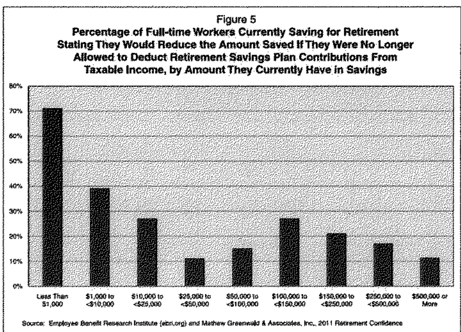


Figure 5
Percentage of Full-time Workers Currently Saving for Retirement Stating They Would Reduce the Amount Saved If They Were No Longer Allowed to Deduct Retirement Savings Plan Contributions From Taxable Income, by Amount They Currently Have in Savings
80%
70%
60%
50%
40%
30%
20%
10%
0%
Less Than $1,000
$1,000 to <$10,000
$10,000 to <$25,000
$25,000 to <$50,000
$50,000 to <$100,000
$100,000 to <$150,000
$150,000 to <$250,000
$250,000 to <$500,000
$500,000 or More
Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence

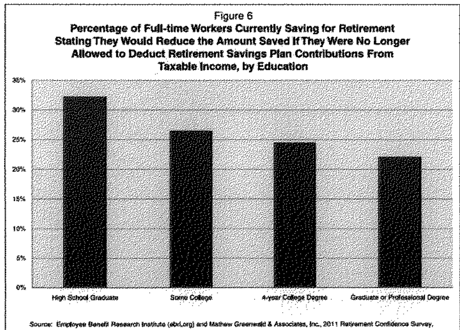


Figure 6
Percentage of Full-time Workers Currently Saving for Retirement Stating They Would Reduce the Amount Saved If They Were No Longer Allowed to Deduct Retirement Savings Plan Contributions From Taxable Income, by Education
35%
30%
25%
20%
15%
10%
5%
0%
High School Graduate
Some College
4-year College Degree
Graduate or Professional Degree
Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence Survey.

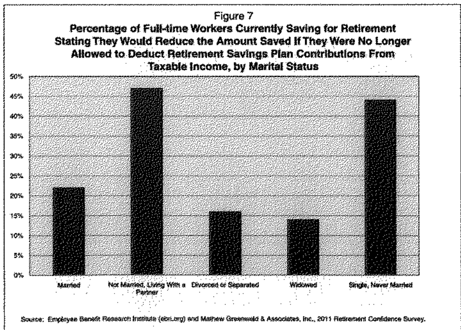


Figure 7
Percentage of Full-time Workers Currently Saving for Retirement Stating They Would Reduce the Amount Saved If They Were No Longer Allowed to Deduct Retirement Savings Plan Contributions From Taxable Income, by Marital Status
50%
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
Married
Not Married, Living With a Partner
Divorced or Separated
Widowed
Single, Never Married
Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence Survey.

The type of entity that the respondent works for also appears to have a significant impact on their likelihood to reduce savings. Figure 8 shows that within private organizations, only 22 percent of the employees working for corporations with more than 1,000 employees indicate that they would reduce savings. This percentage increases to 30 percent for employees working for businesses with 100–1,000 employees, and 35 percent for businesses with less than 100 employees. Public employees have a lower-than-average propensity to decrease contributions (20 percent for federal employees and 16 percent for state and local employees).

Many workers may have two financial advantages to participate in an employer-sponsored retirement plan: An employer match, as well as the tax deductibility of contributions. Everything else equal, it would be logical to assume those employees who do not have an employer match available would be more sensitive to the potential loss of the tax deductibility. This is indeed what is observed in Figure 9, where the percentage of those without an employer match indicating that they would reduce the amount saved is much larger (31.2 percent) than those whose employer matches all or part of their contributions (22.5 percent).

Conclusion

Proposals to modify the exclusion of employee contributions for retirement savings plans from taxable income may have unintended consequences according to results from the 2011 RCS. Instead of reducing the contribution levels of those who might be thought to be most impacted (i.e., those with larger taxable incomes and hence higher marginal tax rates), the RCS results suggest that the categories of full-time workers most likely to reduce (in some cases completely) their contributions are those:

- With the lowest household income.
- With the lowest current amounts in savings and investments, not including the value of their primary residence or the value of defined benefit plans.
- With the lowest educational levels.
- Who are single, never married or not married, living with a partner.
- Who work for small private organizations.

VanDerhei and Copeland (July 2010) document a significant reduction in the percentage "at risk" for inadequate retirement income between 2003 and 2010, based in large part on the advent of auto-enrollment in 401(k) plans; however, for the one-third of the households with the lowest indexed[11] pre-retirement income, the at-risk percentages, while much smaller (they were 80 percent in 2003) are still extremely high (70 percent in 2010). Of course, when one limits the analysis to those who are already saving, the numbers improve substantially: among Gen Xers without any future eligibility for participation in a defined contribution plan, the at-risk percentage is 60 percent, but it drops all the way to 20 percent for those with 20 or more years of future eligibility.[12]

However, the potential increase of at-risk percentages resulting from a substantial portion of low-income households decreasing or eliminating future contributions to savings plans as a reaction to the exclusion of employee contributions for retirement savings plans from taxable income needs to be analyzed carefully when considering the overall usefulness of such proposals.

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- VanDerhei, Jack, and Craig Copeland. "The EBRI Retirement Readiness Rating:™ Retirement Income Preparation and Future Prospects." *EBRI Issue Brief,* no. 344 (Employee Benefit Research Institute, July 2010).

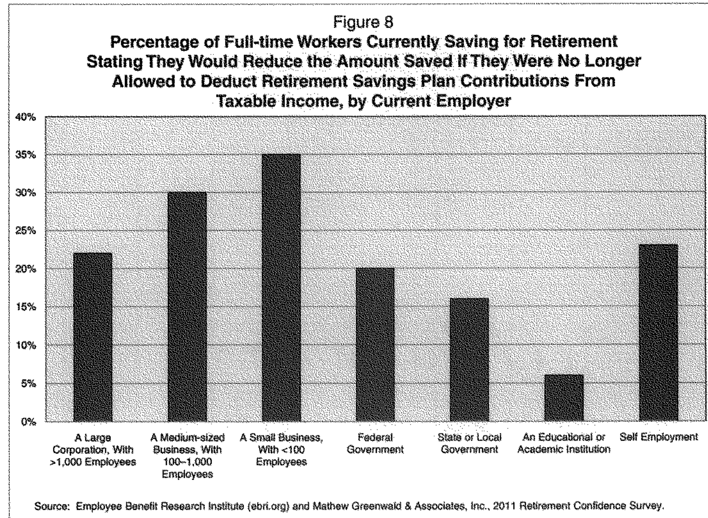


Figure 8
Percentage of Full-time Workers Currently Saving for Retirement Stating They Would Reduce the Amount Saved If They Were No Longer Allowed to Deduct Retirement Savings Plan Contributions From Taxable Income, by Current Employer
40%
35%
30%
25%
20%
15%
10%
5%
0%
A Large Corporation, With >1,000 Employees
A Medium-sized Business, With 100–1,000 Employees
A Small Business, With <100 Employees
Federal Government
State or Local Government
An Educational or Academic Institution
Self Employment
Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence Survey.

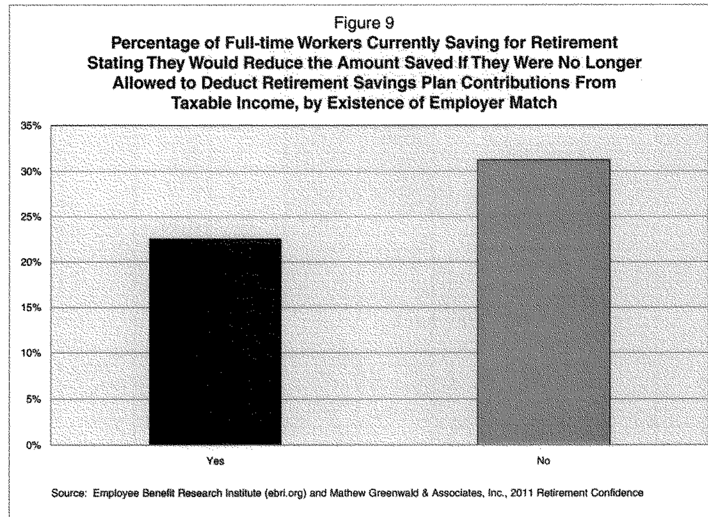


Figure 9
Percentage of Full-time Workers Currently Saving for Retirement Stating They Would Reduce the Amount Saved If They Were No Longer Allowed to Deduct Retirement Savings Plan Contributions From Taxable Income, by Existence of Employer Match
35%
30%
25%
20%
15%
10%
5%
0%
Yes
No
Source: Employee Benefit Research Institute (ebri.org) and Mathew Greenwald & Associates, Inc., 2011 Retirement Confidence

Endnotes

[1] Elective Deferrals are limited to $16,500 in 2011 by Internal Revenue Code Sec. 402(g)(1). A plan may permit participants who are age 50 or over at the end of the calendar year to make additional elective deferral contributions. The elective deferral limit increases by $5,500 for those over age 50 in 2011. Effective for years beginning on or after January 1, 2006, if a plan adopts a Roth feature, employees can designate some or all of their elective contributions as designated Roth contributions (which are included in gross income), rather than traditional, pre-tax elective contributions.

[2] Under a 401(k) plan, an employee can elect to have the employer contribute a portion of the employee's cash wages to the plan on a pre-tax basis. These deferred wages (elective deferrals) are not subject to federal income tax withholding at the time of deferral, and they are not reflected as taxable income on the employee's Form 1040, U.S. Individual Income Tax Return.

Although this is does not technically mean that the employee contributions are "deductible," it was easier to specify that treatment to Retirement Confidence Survey respondents using the common parlance.

[3] These findings are part of the 21st annual Retirement Confidence Survey (RCS), a survey that gauges the views and attitudes of working-age and retired Americans regarding retirement, their preparations for retirement, their confidence with regard to various aspects of retirement, and related issues. The survey was conducted in January 2011 through 20-minute telephone interviews with 1,258 individuals (1,004 workers and 254 retirees) age 25 and older in the United States. Random digit dialing was used to obtain a representative cross section of the U.S. population. To further increase representation, a cell phone supplement was added to the sample. Starting with the 2001 wave of the RCS, all data are weighted by age, sex, and education to reflect the actual proportions in the adult population. Data for waves of the RCS conducted before 2001 have been weighted to allow for consistent comparisons; consequently, some data in the 2011 RCS may differ slightly with data published in previous waves of the RCS. Data presented in tables in this report may not total to 100 due to rounding and/or missing categories. In theory, the weighted sample of 1,258 yields a statistical precision of plus or minus 3 percentage points (with 95 percent certainty) of what the results would be if all Americans age 25 and older were surveyed with complete accuracy. There are other possible sources of error in all surveys, however, that may be more serious than theoretical calculations of sampling error. These include refusals to be interviewed and other forms of nonresponse, the effects of question wording and question order, and screening. While attempts are made to minimize these factors, it is impossible to quantify the errors that may result from them. The RCS was co-sponsored by the Employee Benefit Research Institute (EBRI), a private, nonprofit, nonpartisan public policy research organization, and Mathew Greenwald & Associates, Inc., a Washington, DC, based market research firm. The 2011 RCS data collection was funded by grants from more than two dozen public and private organizations, with staff time donated by EBRI and Greenwald. RCS materials and a list of underwriters may be accessed at the EBRI Web site: www.ebri.org/rcs.

For more detail, see Helman, Copeland and VanDerhei (March 2011, online at www.ebri.org/surveys/rcs/2011/).

[4] In the RCS, retiree refers to individuals who are retired or who are age 65 or older and not employed full time.

Worker refers to all individuals who are not defined as retirees, regardless of employment status.

[5] In order to ensure that a traditional 401(k) plan satisfies nondiscrimination requirements, the employer must perform annual tests, known as the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests, to verify that deferred wages and employer matching contributions do not discriminate in favor of highly compensated employees. Other types of 401(k) plans (e.g., safe harbor 401(k) plans) are subject to less complex rules.

[6] All investment income is assumed to be taxed as ordinary income in this example.

[7] Actually, the constraints would need to be compared to the 402(g) limit as well as any plan-specific constraints on tax contributions (primarily for the Highly Compensated Employees).

[8] DiCenzo (January 2007).

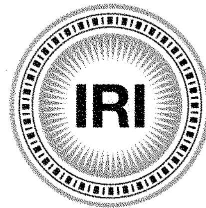
[9] 1.4 percent responded that they did not know.

[10] 18 percent responded that they did not know and 0.35 percent refused to answer.

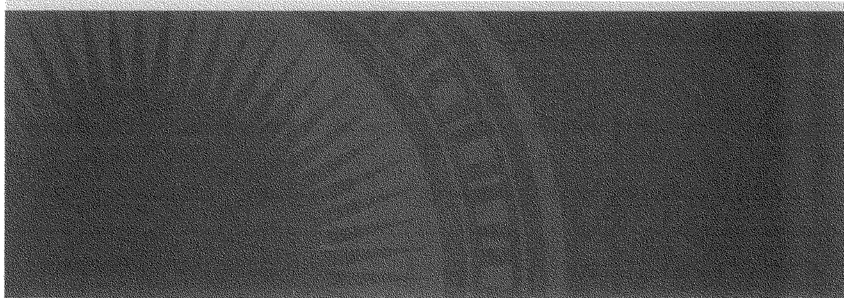
[11] See endnote 17 of VanDerhei and Copeland (July 2010) for more detail.

[12] VanDerhei (September 2010) also demonstrates that eligibility for a defined contribution retirement plan has a significant positive impact on reducing the additional compensation most families need to achieve the desired level of retirement income adequacy.

STATEMENT FOR THE RECORD
U.S. SENATE COMMITTEE ON FINANCE
PUBLIC HEARING MARCH 30,2011
"HOW DO COMPLEXITY, UNCERTAINTY
AND OTHER FACTORS IMPACT
RESPONSES TO TAX INCENTIVES?
SUBMITTED BY
THE INSURED RETIREMENT INSTITUTE



Insured Retirement Institute



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March 30, 2011

The Honorable Max Baucus
Chairman
Senate Finance Committee
219 Hart Senate Office Building
Washington, D.C. 20510

Re: March 30, 2011, Finance Committee Hearing: "How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?"

Dear Chairman Baucus:

I am writing to request that the attached report: "The Tax Advantages of Annuities: How Tax Deferral and Guaranteed Lifetime Income Strategies Can Benefit All Consumers" be included in the record for the March 30th hearing in the Committee.

The Insured Retirement Institute (IRI) is a not-for-profit organization and is the authoritative source of all things pertaining to annuities, insured retirement strategies and retirement planning. IRI exists to vigorously promote consumer confidence in the value and viability of insured retirement strategies, bringing together the interests of the industry, financial advisors and consumers under one umbrella. IRI's mission is to: encourage industry adherence to highest ethical principles; promote better understanding of the insured retirement value proposition; develop and promote best practice standards to improve value delivery; and to advocate before public policy makers on critical issues affecting insured retirement strategies.

IRI released its exclusive report on February 28th of this year. The report found that the tax deferral of annuity earnings is of greatest benefit to middle income Americans, who comprise the largest segment of annuity owners. With eight in 10 (80%) annuity buyers having incomes less than $100,000 and two-thirds (64%) earning less than $75,000, insured retirement strategies clearly play a significant role in the retirement income planning of middle class Americans. In addition, in the absence of tax deferral, hard-working middle income Americans would be faced with potentially burdensome restrictions to access insured retirement solutions.

Insured retirement strategies are designed with the goal to help provide guaranteed retirement income for all consumers who seek to ensure a stable and secure financial future. IRI's report proves these products are indeed serving those whom need them most – hard working middle class Americans.

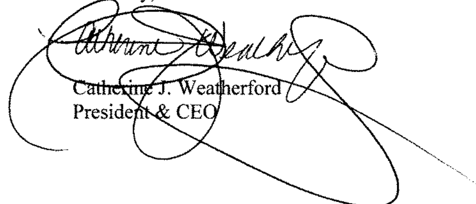
Today, the personal responsibility attached to retirement income is at an all-time high. Millions of Americans are looking for ways to provide themselves with the 'mailbox money' that will give them a guaranteed paycheck for life. Annuities, and their tax deferred status, are uniquely poised to provide middle class Americans with the retirement peace of mind they seek.

IRI's The Tax Advantages of Annuities report also found that:

- The deferral of taxes on the inside buildup of annuity contracts is a key selling point for advisors and investors, as noted by 37% of advisors and 56% of annuity owners.
- The removal of the tax deferred status of annuities would not necessarily increase the tax revenue generated by the products. Yet it might result in the reduced use of annuities among the population that has come to rely on them most, the middle class.
- There is a strong tie-in between tax deferral and retirement income, as the removal of tax deferral would require investors to tap other personal assets to pay for taxes on the annual build-up within the annuity, resulting in a lower level of funds available for retirement.
- The tax-deferred treatment of the inside build-up within an annuity can amount to a significant sum over a period of many years, often resulting in a higher level of savings available at retirement compared to a similar investment that incurs income taxation every year.

We would welcome the opportunity to work with you and your staff as the legislative process continues to move forward. Please feel free to contact me or John Little, our Chief Operating Officer (202 469-3003), if we can provide additional assistance or to further discuss these issues.

Sincerely,



Catherine J. Weatherford
President & CEO

Insured Retirement Institute

The Tax Advantages of Annuities

How Tax Deferral and Guaranteed Lifetime Income Strategies Can Benefit All Consumers

February 2011

Overview

It has been well established that there are three key attributes that contribute strongly to sales of retail annuities: retirement income, principal protection, and tax deferral of earnings. The tax deferral component, intrinsic to most insurance products, has often been the source of debate, mainly as it is misinterpreted as a tax incentive for the wealthy. As we will demonstrate in this report, the tax deferral of annuity earnings is of greater benefit to middle income Americans, who comprise the largest segment of annuity owners, and plays a large role in their retirement income planning. The Insured Retirement Institute (IRI) contends that in the absence of tax deferral, middle income Americans would be faced with potentially burdensome restrictions to access insured retirement solutions.

Key Findings and Analysis

- The deferral of taxes on the inside buildup of annuity contracts is a key selling point for advisors and investors, as noted by 37% of advisors and 56% of annuity owners.
- The present tax status of annuities encourages long-term savings in the products due to a longer horizon needed to counteract the ordinary income tax due on earnings when funds are withdrawn, and to account for the fact that earnings are deemed to be withdrawn before principal.
- There is a strong tie-in between tax deferral and retirement income, as the removal of tax deferral would require investors to tap other personal assets to pay taxes on the annual build-up within the annuity, resulting in a lower level of funds available for retirement.
- The additional funds needed to pay these taxes could amount to significant dollars over the years, potentially adding the equivalent of at least 40 basis points to the effective cost of a variable annuity with a guaranteed lifetime withdrawal benefit and 45 basis points to one with the guaranteed minimum income benefit, and diminishing the annuity's appeal.
- As two-thirds of annuity owners have annual household incomes under $75,000, and (per EBRI) approximately half of earners in the second-to-lowest income quartile will be unable to cover their basic expenditures and uninsured health costs in retirement, additional taxation of annuities would negatively impact the group that is in the greatest need of supplemental retirement income.

Background

In December 2010, the National Commission on Fiscal Responsibility and Reform (the Fiscal Commission) published a report detailing its proposals to the fiscal challenges facing the United States. The report, *The Moment of Truth*, cited several ideas to address tax reform, including the elimination of more than 150 "tax expenditures," generally understood to include the protections afforded to insurance products. In Section 2.1.3, the Fiscal Commission wrote that "Congress and the President must decide which tax expenditures to include in the tax code in smaller and more targeted form than under current law, recognizing that any add-backs will raise rates." Later in this section, however, it was recommended that there must be provisions for several programs, including retirement savings and pensions.

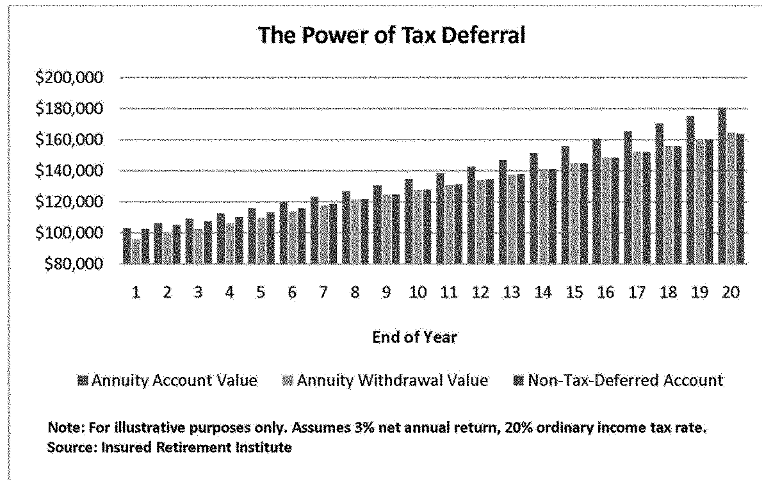
Although the President's proposed budget, released February 14, 2011, did not address any changes to the current tax treatment of annuities, this is only the beginning of the tax reform debate. *The Moment of Truth* document brought the tax treatment of annuity products into the limelight. Several leading economists and tax attorneys have opined that a complete overhaul to the U.S. tax system would put the tax benefits of annuities—particularly the deferral of taxes on the investment earnings (often referred to as inside build-up)—in jeopardy. This is key, as numerous studies show that tax deferral plays an important role in the decision to invest in an annuity, and that middle class investors would face significant tax impacts should this come to fruition.

According to the Insured Retirement Institute's (IRI) 2010 Annuity Fact Book, 80% of annuity buyers in 2009 had household incomes of less than $100,000, and 64% earned less than $75,000.. In a statement released on January 25, IRI President and CEO Cathy Weatherford affirmed that "we must continue to identify ways to incentivize retirement savings for all Americans. Now is not the time to consider potentially burdensome restrictions on the ability of those lacking financial security to access insured retirement solutions."

The Power of Tax Deferral

Before delving into the impact of potential changes to annuity contract holders, we should first examine the reasons tax deferral is a valued benefit. The Internal Revenue Code (IRC) provides numerous incentives for individuals to save for retirement using annuities. When an annuity is purchased by individuals using after-tax dollars (known as a non-qualified annuity), investment returns in the annuity accumulate on a tax-deferred basis until funds are withdrawn. Additionally, transfers between investment options within a variable annuity do not trigger taxation, nor do certain instances of replacing one annuity with another. The tax-deferred treatment of the inside build-up within an annuity can amount to a significant sum over a period of many years, often resulting in a higher level of savings available at retirement compared to a similar investment that incurs income taxation every year.

By way of example, albeit simplistic, we compared the hypothetical growth of an annuity with that of an investment that is subject to ordinary income taxation on its earnings. (The latter may be thought of as an annuity without the benefit of tax deferral, although it was designed to be product-agnostic and, therefore, does not impose surrender charges.) Using a single, after-tax deposit of $100,000, an annual net return of 3%, and an ordinary income tax rate of 20% (the net amount, per Internal Revenue Service tables, associated with the average household income of non-qualified annuity holders in 2009), we calculated three balances: accumulated value of the annuity, surrender value of the annuity (incorporating income taxation and surrender fees), and net value of the non-tax-deferred investment. While there is no withholding on the latter, the net value reflects the taxes that are paid from another source, reducing the overall savings of the investor. Early withdrawal, or surrender, charges on the annuity are assumed to be a 7-year declining scale (7%, 6%, 5%, 4%, 3%, 2%, 1%, 0%). We will return to these calculations throughout this report.



As seen above, the accumulated value of the annuity is consistently the largest, and the gap widens with each year. The accumulated value is of importance as this is often the minimum amount payable as a guaranteed death benefit from the annuity. The gap between the annuity and the non-tax-deferred vehicle ranges is 5.1% after ten years and 10.4% after twenty, representing a significant advantage. Note that this assumes a 3% annual rate of return—the difference is magnified at higher investment returns.

As annuity earnings are taxed upon withdrawal, we also examined the case in which the annuity contract was fully surrendered. In the first seven years of the contract, when early withdrawal charges are assessed, the surrender value of the annuity was, not surprisingly, less than that of the non-tax-deferred investment. Yet, once the surrender charge period on the annuity ends, the balances of the two are running fairly even, with the surrender value of the annuity overtaking that of the non-tax-deferred investment after 15 years. As with the above, the crossover point gets earlier as the underlying investment return rises, yet is realistically in the range of 8 to 15 years. This may have a considerable impact on the retirement dollars annuities provide.

Annuities and Retirement Income

The tax-deferred nature of annuities is of great significance to both investors and their advisors. More than half (56%) of annuity owners surveyed for The Allianz *Reclaiming the Future* Study cited "an effective way to get tax-deferred growth potential" among the reasons they are satisfied with the product. And, according to Cerulli Associates, 37% of all advisors consider tax deferral a key

criterion when recommending an annuity to their clients—and this is most prominent (43%) in the independent channels, where most annuity sales occur.

Nonetheless, the key purpose of an annuity is to provide guaranteed retirement income, a function that is held in very high regard by advisors. Among the advisors surveyed by Cerulli Associates, 67% cited retirement income as a very important criterion when recommending an annuity. Yet, these two factors are not independent. An IRI survey conducted by Cogent Research in late 2010 showed that 60% of advisors believed that the guaranteed lifetime income provided by annuities should be promoted and further incentivized. Whether this is accomplished through guaranteed lifetime withdrawal benefits or lifetime annuity income benefits, tax deferral plays a significant role in maximizing guaranteed income.

By the Numbers: Tax Deferral and Retirement Income		
Tax Deferral	Annuity owners citing tax deferral as a reason for satisfaction with the product they purchased	56%
"	Advisors who consider tax deferral a key criterion when recommending an annuity	37%
Retirement Income	Annuity owners citing supplemental retirement income as a reason for satisfaction with the product they purchased	56%
"	Advisors who consider retirement income as a key criterion when recommending an annuity	67%
"	Advisors advocating further incentives for lifetime income via annuities	60%

Sources: Insured Retirement Institute, Allianz Life Insurance Company of North America, Cerulli Associates, Cogent Research

Although the removal of tax deferral would not necessarily result in a smaller accumulated value (unless withholding is implemented), the owner would need to tap other sources for the funds to pay the tax, reducing long-term savings in the process. Using the example at the beginning of this chapter, the taxes payable on the non-tax-deferred $100,000 investment would amount to nearly $7,000 in the first ten years combined assuming a 3% annual return and 20% income tax rate. This jumps to nearly $13,000 with a 5% annual return. Therefore, removing the tax deferral incentive from annuities would effectively raise the cost of the product, diminishing its appeal.

We examine this effect for two key retirement benefit riders offered through annuities—the guaranteed lifetime withdrawal benefit and the guaranteed minimum income benefit. In both examples, the additional tax was converted into basis points to illustrate how the required cash reserve effectively impacts the cost of the riders.

Guaranteed Lifetime Withdrawal Benefits

Guaranteed lifetime withdrawal benefits (GLWB) provide a specified percentage of a guaranteed benefit base that can be withdrawn each year for the life of the contract holder, regardless of market performance or the actual account balance. The percentage is typically related to the age of the contract holder (and is often in the range of 4%-5%). The benefit base is usually the level of

premiums, although many have provisions that step up the benefit base to the account balance, periodically, if higher. Therefore, the GLWB provides both lifetime income and principal protection, two features in strong demand by investors and advisors.

The GLWB is an optional rider on a variable annuity contract, and was elected by nearly two-thirds (64%) of contract holders in the fourth quarter of 2009. Its cost ranges from 0.25% to 1.70% of the benefit base annually, with a weighted average of 1.03% (103 basis points), per Morningstar, Inc. Yet, if tax deferral were removed, contract holders would be responsible for paying taxes every year on the contract's earnings. This would require that contract holders create, and fund regularly, an account from which the taxes would be paid. Assuming an interest rate of 3%, and no withdrawals, this would equate to an increase in the effective cost of a VA with a GLWB by 40 basis points, to 1.43%. This figure increases further for higher rates of return.

Effective Cost of Annuity Retirement Riders, No Tax Deferral

Benefit type	Current weighted average rider cost	Effective cost with no tax deferral, 3% base return	Effective cost with no tax deferral, 5% base return
Guaranteed lifetime withdrawal benefit	1.03%	1.43%	1.83%
Guaranteed minimum income benefit	0.74%	1.19%	1.59%

Sources: Insured Retirement Institute, Morningstar, Inc.

Annuitization and Guaranteed Minimum Income Benefits

IRI defines annuitization as the conversion of the annuity accumulation value to a fixed or variable income stream for the life of the annuitant(s) or for a specific period. (The annuitant is the person, frequently the contract owner to whom an annuity is payable, and whose life expectancy is used to calculate the income payment.)

Traditional annuitization calls for the conversion of the accumulated value of the annuity contract, an amount that is not guaranteed for variable annuities. In other words, market declines just prior to annuitization The guaranteed minimum income benefit (GMIB) is also a popular variable annuity rider, selected by 26% of contract holders in the fourth quarter of 2009. The GMIB is designed to provide a base amount of income at retirement regardless of how the underlying investments performed. It guarantees that if the owner decides to annuitize the contract, payments are based on the greater of the amount invested, credited with a pre-stated interest rate, or the accumulated value of the contract.

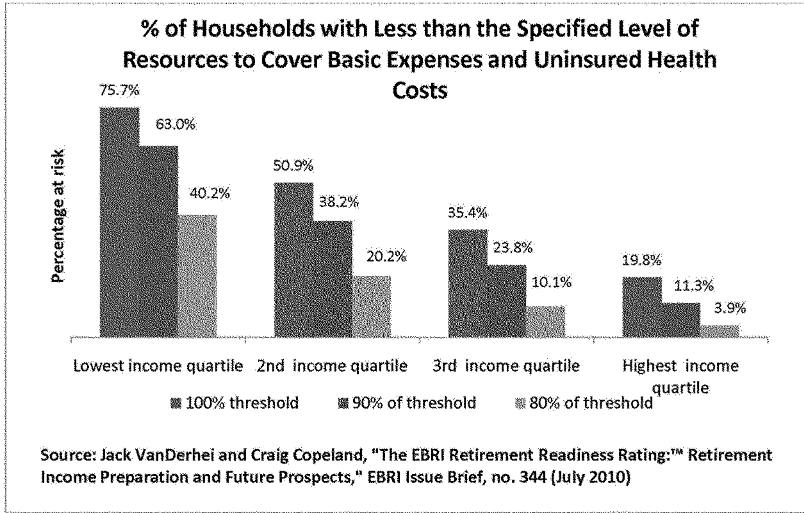
The cost of a GMIB rider ranges from 0.20% to 1.15% of the benefit base annually, with a weighted average of 0.74% (74 basis points). Without tax deferral, the amount of cash reserves the contract holder would need to maintain to pay taxes would equate to 45 basis points annually assuming a 3% annual return, bringing the effective cost to nearly 1.20%.

Traditional annuitization, which does not guarantee a minimum base amount, would be impacted as well, by the need for an additional account from which to pay taxes. While there is no separate charge for this benefit, as it is built into every annuity sold in the retail market, the basis point equivalent of the cost of the cash reserve would be 60 basis points assuming a 3% rate of return.

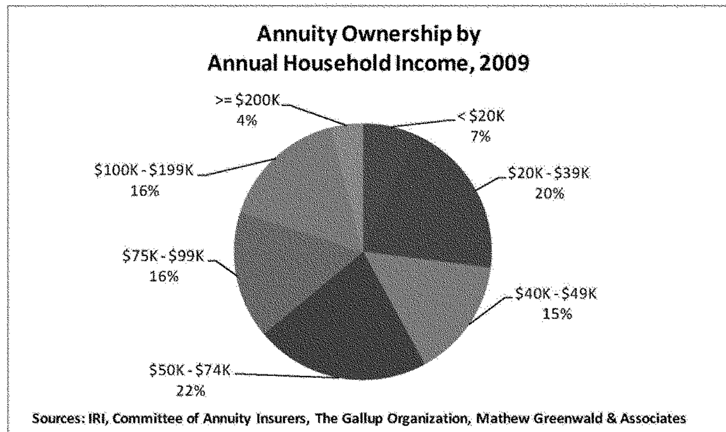
Demographic Impact

The additional reserves required to sustain an annuity in the absence of tax deferral would be a significant burden on the population who presently owns the product—middle income earners. First, households in the middle class are far more likely to need supplemental income in retirement than their affluent counterparts. Second, contrary to the widely held belief that annuities are products for the wealthy, data shows us that middle income earners comprise the majority of annuity owners.

Research from the Employment Benefit Research Institute (EBRI) shows an inverse relationship between pre-retirement income level and their ability to pay for "basic retirement expenditures and uninsured health care costs." Since 2003, EBRI has calculated a proprietary Retirement Readiness Rating™ for various segments of the population, indicating the percentages of individuals "at risk" of not having sufficient funds for retirement. The results by pre-retirement income level, as reported in its 2010 report, are shown below. Just more than half of earners in the second-to-lowest income quartile are expected to be unable to cover 100% of their anticipated basic retirement expenses, and one-fifth will be unable to cover 80% of these expenses. This is in contrast to the highest income quartile, in which only one-fifth cannot fully cover these expenses, and less than 5% will experience a shortfall in covering 80% of their anticipated expenses.



Fortunately, middle income Americans comprise the majority of annuity owners, showing some personal responsibility to closing this shortfall. Data from the IRI Annuity Fact Book shows that the majority of owners of non-annuity contracts (57%) had household incomes between $20,000 and $74,999. Eight of 10 annuity owners have annual household incomes under $100,000, and two-thirds have incomes under $75,000. The underlying data tells us that the average annual household income is just over $75,000.



Finally, let's revisit the mathematical impact of tax deferral discussed earlier in this report, focusing on three different income bands. From the calculations, it is clear that annuities, with current tax treatment, are advantageous over longer periods, higher interest rates, and for those in lower tax brackets. All calculations assume that the annuity is assessed surrender charges in the first seven years, and the effective tax rate applicable to the specified income levels.

The exhibits that follow examine the average annual internal rates of return realized on an annuity that is surrendered after a stated number of years, at varying base levels of return on the underlying product. For example, for an investor at the $50,000 income level, an annuity that accrues at an annual rate of 3% would have a post-surrender rate of return of 2.54% after ten years, compared to 3.41% for a product on which investment returns are taxed annually. Extend the holding period to 15 years, and the internal rate of returns are roughly equal. At a 5% interest rate, the annuity return is advantageous by 10 years.

Internal Rate of Return, Tax-Deferred Annuity versus Non-Tax-Deferred Investment, $50K Income Level

	Time Horizon									
	3 years		5 years		10 years		15 years		20 years	
Annual interest rate of product	Tax deferred	Not tax deferred	Tax deferred	Not tax deferred	Tax deferred	Not tax deferred	Tax deferred	Not tax deferred	Tax deferred	Not tax deferred
2%	0.09%	1.69%	1.10%	1.70%	1.68%	1.70%	1.70%	1.71%	1.71%	1.71%
3%	0.90%	2.54%	1.97%	2.55%	2.54%	2.56%	2.57%	2.56%	2.59%	2.56%
4%	1.76%	3.39%	2.83%	3.40%	3.41%	3.41%	3.46%	3.41%	3.50%	3.41%
5%	2.62%	4.23%	3.70%	4.25%	4.29%	4.26%	4.36%	4.26%	4.41%	4.26%
6%	3.49%	5.08%	4.58%	5.10%	5.18%	5.11%	5.27%	5.11%	5.34%	5.12%
7%	4.37%	5.93%	5.45%	5.95%	6.07%	5.96%	6.18%	5.97%	6.28%	5.97%
8%	5.24%	6.77%	6.34%	6.79%	6.97%	6.81%	7.11%	6.82%	7.23%	6.82%

Note: Assumes 17% ordinary income tax rate, single earner.
Source: Insured Retirement Institute

Moving up the income ladder, we see that the cross-over point—that is, the time at which the post-surrender annuity with tax deferral overtakes the product that is not tax deferred, is lengthened. While differences at the $75,000 income level are minimal compared to the $50,000 earner, the cross-over point for a $200,000 earner is between 10 and 15 years. In theory, the cross-over point may be extended for the highest earners as they are more likely to invest in products that offer returns in the form of capital gains.

Therefore, while middle income earners must still hold an annuity for a long period to realize the benefits of tax deferral, the length of time may be more palatable than that required for higher income earners. As nearly 60% of annuity buyers are over age 50, according to the IRI Annuity Fact Book (based on research done by the Gallup Association and Mathew Greenwald Associates), a ten-year holding period is reasonable—and the presence of tax deferral increases encourages long-term savings strategies at this critical age.

Internal Rate of Return, Tax-Deferred Annuity versus Non-Tax-Deferred Investment, $75K Income Level

	Time Horizon									
	3 years		5 years		10 years		15 years		20 years	
Annual interest rate of product	Tax deferred	Not tax deferred	Tax deferred	Not tax deferred	Tax deferred	Not tax deferred	Tax deferred	Not tax deferred	Tax deferred	Not tax deferred
2%	0.03%	1.65%	1.04%	1.65%	1.63%	1.66%	1.64%	1.66%	1.66%	1.66%
3%	0.81%	2.47%	1.88%	2.48%	2.46%	2.49%	2.49%	2.49%	2.52%	2.49%
4%	1.64%	3.29%	2.71%	3.31%	3.30%	3.32%	3.36%	3.32%	3.40%	3.32%
5%	2.47%	4.12%	3.56%	4.13%	4.16%	4.15%	4.24%	4.15%	4.30%	4.15%
6%	3.32%	4.94%	4.41%	4.96%	5.02%	4.98%	5.13%	4.98%	5.22%	4.98%
7%	4.16%	5.76%	5.26%	5.79%	5.90%	5.80%	6.03%	5.81%	6.14%	5.81%
8%	5.00%	6.58%	6.11%	6.61%	6.78%	6.63%	6.94%	6.64%	7.08%	6.64%

Note: Assumes 20% ordinary income tax rate, single earner.
Source: Insured Retirement Institute

Internal Rate of Return, Tax-Deferred Annuity versus Non-Tax-Deferred Investment, $200K Income Level

	Time Horizon									
	3 years		5 years		10 years		15 years		20 years	
Annual interest rate of product	Tax deferred	Not tax deferred	Tax deferred	Not tax deferred	Tax deferred	Not tax deferred	Tax deferred	Not tax deferred	Tax deferred	Not tax deferred
2%	-0.09%	1.56%	0.92%	1.57%	1.51%	1.58%	1.53%	1.58%	1.55%	1.58%
3%	0.63%	2.34%	1.70%	2.35%	2.29%	2.37%	2.33%	2.37%	2.37%	2.37%
4%	1.39%	3.11%	2.48%	3.14%	3.09%	3.15%	3.15%	3.16%	3.21%	3.16%
5%	2.17%	3.89%	3.27%	3.92%	3.90%	3.94%	3.99%	3.95%	4.08%	3.95%
6%	2.96%	4.67%	4.06%	4.70%	4.72%	4.73%	4.85%	4.73%	4.96%	4.74%
7%	3.74%	5.44%	4.86%	5.48%	5.55%	5.51%	5.71%	5.52%	5.86%	5.53%
8%	4.53%	6.22%	5.67%	6.26%	6.39%	6.30%	6.60%	6.31%	6.77%	6.31%

Note: Assumes 26% ordinary income tax rate, single earner.
Source: Insured Retirement Institute

Looking at this data in tandem enables us to draw several key conclusions about the importance of annuity tax deferral:

- Additional taxation on annuities would negatively impact the group that is in the greatest need of retirement income.
- The effective increase in costs of income and principal protection benefits is onerous and would likely drive middle income investors away from annuities.
- Tax deferral benefits become more pronounced at holding periods of ten or more years, encouraging long-term investing while not deterring buyers at the point of sale.

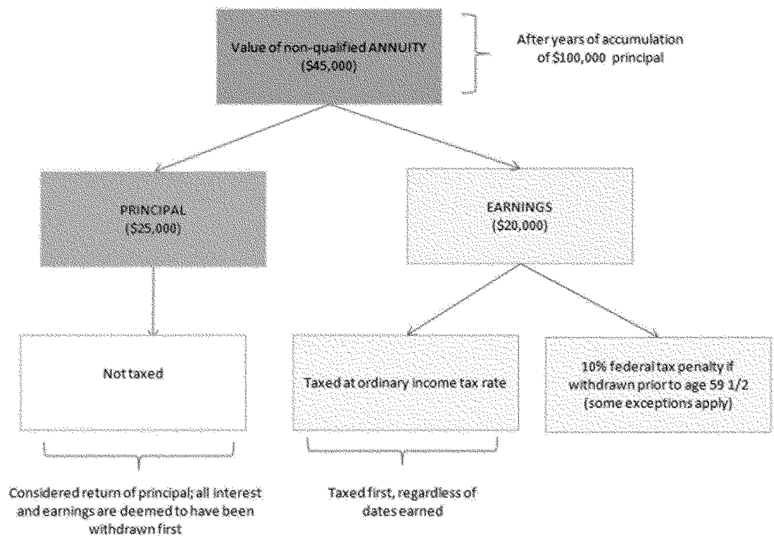
Tax Deferred, Not Tax-Free

It is imperative to note that "tax deferred" does not equate to "tax-free." The taxation of annuity income is governed by Section 72 of the IRC and generally applies to contracts issued after August 1982. As shown in the earlier example, when a contract holder begins to receive money from an annuity, distributions taken in excess of the amount invested are subject to taxation at the owner's ordinary income tax rate.

The methods of taxation differ by the way money is withdrawn from the annuity. The most common scenarios are for contract holders to make withdrawals from the accumulated value while the contract is in force, or to surrender the entire contract altogether. For most annuity contracts, the tax rule on withdrawals is "interest and earnings first," meaning that interest and earnings are considered withdrawn first for federal income tax purposes. For example, if someone invested $25,000 in a fixed or variable annuity and the contract is now worth $45,000, the first $20,000 withdrawn is taxable. The remaining $25,000 is not taxed as it is considered a return of principal. Withdrawals are taxed until all interest and earnings are withdrawn; the principal then can be withdrawn without tax.

The "interest and earnings first" rule is intended to encourage the use of annuities for long-term savings and retirement planning. Congress decided that the advantage of tax deferral should not be accompanied by the ability to withdraw principal first, with no tax payable until all principal is withdrawn.

Tax Treatment of Annuity Withdrawals and Full Surrenders
Illustrated: $25,000 principal, full surrender



Note: For illustrative purposes only. Above excludes the impact of any early withdrawal charges imposed on the value of the annuity by the terms of the contract.

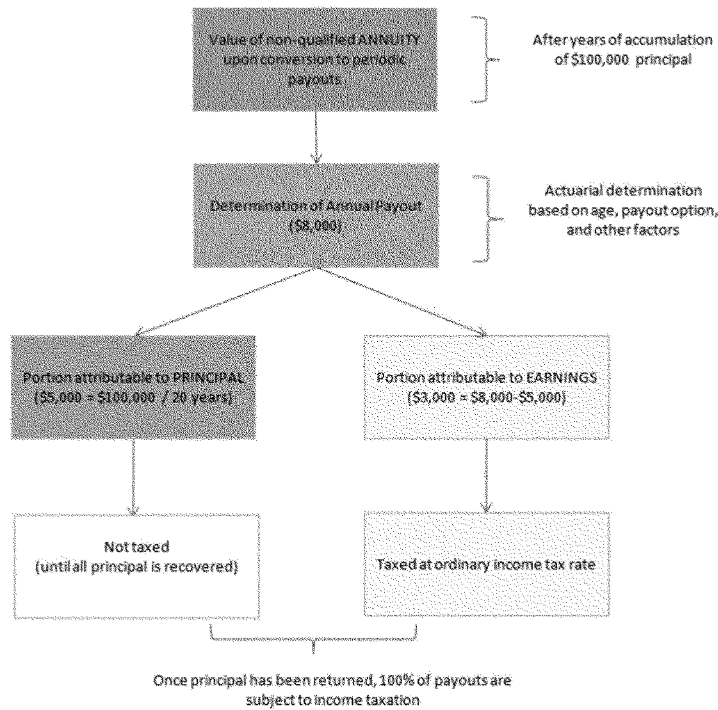
Source: IRI 2010 Annuity Fact Book

Less common is for contract holders to annuitize—meaning that the accumulated value of the annuity is converted to an income stream for the life of the payee or for a specified period. (Note that this differs from withdrawals made via living benefit guarantees—these are considered withdrawals, not annuity payouts, as the contract is not converted under this circumstance.) The rules for the taxation of annuity payouts are complex, and are outlined in detail in Section 72 of the IRC. We present them in this report for completeness, as well as to illustrate the role of the accumulated value that has been building on a tax deferred basis.

The basic rule for annuity payouts (as distinguished from withdrawals or other non-periodic payments) is that the money a contract owner invests in the contract is returned in equal non-taxable installments over the payment period. This quantity, called the exclusion amount, is determined by using actuarial factors including life expectancies and total expected payouts from the annuity. The remainder of the amount received each year is treated as the earnings on the owner's premiums and is included in income. The total amount that is received without taxes can never exceed the premiums the owner paid for the contract.

Therefore, owners of annuitized contracts realize two tax benefits—tax deferral of gains during the accumulation period, and exclusion of tax on a portion of payments during the payout period.

Tax Treatment of Annuity Payouts (scheduled, periodic payments)
Illustrated: $100,000 principal, 20 years of annuitized payouts



Note: For illustrative purposes only. Does not apply to withdrawals or living benefit payments.

Source: IRI 2010 Annuity Fact Book

Conclusion

It is clear that tax deferral of annuity earnings is critical to the retirement income ultimately realized by the contract owner. Although the removal of tax deferral would not necessarily result in a smaller accumulated value, the owner would need to tap other sources for the funds to pay the tax, reducing long-term savings in the process. This would be cumbersome for the majority of annuity contract holders, who are primarily middle class.

The Moment of Truth document was not the first time the topic of annuity tax deferral was presented for debate. In 1992, for example, the President's budget proposal included a narrowing of

the definition of annuities for which tax deferral would be permitted. While the 1992 proposal did not pass—and the current budget will likely leave the annuity rules unchanged, as well—the insurance industry must still remain prepared to demonstrate the impact that such a change would have on retirement savings in the U.S.

Tax deferral is a powerful motivator to save, particularly among the middle class. It prevents the need for the creation of a distinct account for the sole purpose of paying taxes on the annuity—which can amount to tens of thousands of dollars over a lifetime, an amount that is out of reach for most middle income earners. Additionally, the cost of the key annuity benefits of guaranteed lifetime withdrawals, guaranteed income, and guaranteed annuity payout levels, would add to this tax burden, further driving middle income investors—the ones who need supplemental retirement income guarantees the most—away from annuities.

Further, it must be emphasized that annuities are presently tax-deferred—not tax-free. Taxes on annuity income are generated at the time that funds are withdrawn, and are assessed at income tax rates, not capital gains rates. Therefore, the removal of the tax deferred status of annuities would not necessarily increase the tax revenue generated by the products, especially among middle income investors. Yet, it might very well result in reduced use of annuities, and most likely among the population that has come to rely on them the most.

REPRESENTING THE RESTAURANT INDUSTRY

The Cornerstone of the Economy, Career Opportunities and Community Involvement

Statement for the Record

Of

Dave Koenig, Director, Tax and Profitability, National Restaurant Association

For The Hearing On

"How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?"

Before

The U.S. Senate Committee On Finance

On Behalf Of

The National Restaurant Association

Wednesday, March 30, 2011

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Chairman Baucus, Ranking Member Hatch, and members of the Senate Committee on Finance, thank you for the opportunity to submit this statement for the record on behalf of the National Restaurant Association. We applaud the Chairman and the Committee's leadership on tax reform.

The restaurant industry plays a significant role in this nation's economy. There are 960,000 restaurant and foodservice outlets in this country. Seven out of ten restaurants are single-unit operators, which means the restaurant industry is an industry of small businesses. Most eating and drinking establishments, 93 percent of the industry, have fewer than 50 employees. Restaurants also serve as the conference rooms for many of the self-employed and other small businesses.

This year alone, the restaurant industry is estimated to generate $604 billion in sales, with an overall economic impact of more than $1.7 trillion. Every dollar spent in restaurants generates an additional $2.05 spent in our nation's economy. The restaurant industry is one of the nation's largest private employers, employing nearly 13 million people, representing nearly 10 percent of the U.S. workforce.

Currently, the tax law presents taxpayers with a great deal of complexity and uncertainty, impacting responses to tax incentives. Tax reform provides an opportunity to address these issues. Done properly, a comprehensive and nuanced review of the tax system could result in predictability, simplicity, and fairness, while encouraging economic growth and job creation.

In this regard, we wanted to bring to your attention a few tax policies that are important to the restaurant industry and could benefit from reform efforts. The tax policies are: the 15-year depreciation schedule for leasehold improvements, restaurant improvements and new construction, and retail improvements; the Work Opportunity Tax Credit ("WOTC"); the deduction for donations of food inventory; and the deduction for business meals.

15-year Depreciation Schedule for Leasehold Improvements, Restaurant Improvements and New Construction, Retail Improvements

The Internal Revenue Code ("Code) contains a temporary provision under which leasehold improvements, restaurant improvements, new restaurant construction, and retail improvements can be depreciated over 15 years rather than a 39-year recovery period that would otherwise apply to nonresidential real property. By way of background, Congress permanently provided for the 15-year depreciation schedule for retail motor fuels outlet stores in the Small Business Job Protection Act of 1996. In recognition of their shorter expected lives, Congress subsequently expanded property subject to the 15-year depreciation schedule to include leasehold improvements (American Jobs Creation Act of 2004), restaurant improvements (American Jobs Creation Act of 2004) and new construction (Emergency Economic Stabilization Act of 2008), and retail improvements (Emergency Economic Stabilization Act of 2008).

The 15-year depreciation schedule for leasehold improvements, restaurant improvements, new restaurant construction, and retail improvements reflects the tax policy principle that costs of assets are allocated over the period in which they are used. Assets with longer expected lives are

depreciated over a longer period of time, while assets with shorter lives are depreciated over a shorter period of time. With more than 130 million Americans patronizing restaurants each day, restaurant building structures experience a daily human assault. Restaurateurs must constantly make changes to keep up with the structural and cosmetic wear and tear caused by customers and employees. The heavy use accelerates deterioration of a restaurant building's entrance, lobbies, flooring, restrooms, and interior walls. National Restaurant Association research shows that most restaurants remodel and update their building structures every six to eight years. As a result, 15 years is a much more accurate timeframe for writing off restaurant buildings and improvements.

Moreover, a 15-year recovery period reduces the cost of capital expenditures and increases cash flow. In turn, this provides needed capital for American restaurants – which, in turn, translates into American jobs. As demonstrated in Figure 1 below, the annual tax savings and corresponding additional cash flow realized by restaurateurs from a 15-year, rather than a 39-year, depreciation schedule are considerable. For example, a restaurateur's annual tax liability would increase by nearly $10,000 if the recovery period for a $1 million investment were increased from 15 years to 39 years. In an industry with median profit margins of 3 to 5 percent, every penny counts. A more accurate recovery period frees resources to expand business either through new hires or further capital expenditures. Both contribute directly and indirectly to job creation as benefits are multiplied through the economy.

Figure 1.

Sample Calculations for 15-Year versus 39-Year Depreciation

Total Capital Expenditure on Eligible Property	Annual Depreciation Based on 39-year Schedule	Annual Tax Savings from Depreciation	Annual Depreciation Based on 15-year Schedule	Annual Tax Savings from Depreciation	Annual Difference in Tax Savings Between 15- & 39-Year Schedules
$100,000	$2,532	$608	$6,667	$1,600	$992
$250,000	$6,329	$1,519	$16,667	$4,000	$2,481
$500,000	$12,658	$3,038	$33,333	$8,000	$4,962
$700,000	$17,722	$4,253	$46,667	$11,200	$6,947
$1,000,000	$25,316	$6,076	$66,667	$16,000	$9,924
$1,500,000	$37,975	$9,114	$100,000	$24,000	$14,886
$2,000,000	$50,633	$12,152	$133,333	$32,000	$19,848

Expenditure Scenarios

Rebuild Costs:	Renovate Costs:
Quickservice - $700,000	Quickservice - $250,000
Fullservice - $1,500,000	Fullservice - $500,000

Note: Figures are based on a 24% effective marginal tax rate

However, the 15-year depreciation schedule for these properties is temporary and must be extended annually. The piecemeal and temporary approach to the 15-year depreciation schedule, requiring extension every couple of years, presents taxpayers with unnecessary uncertainty and complexity. Moreover, in some cases, the provision has been allowed to lapse. This situation occurred recently, when the provision expired at the end of 2009. The provision was later

retroactively extended for 2010 and prospectively extended for 2011 by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("2010 Act"), enacted in December 2010. The provision's lapse resulted in some restaurants waiting to undertake capital improvements.

Making permanent the 15-year depreciation schedule for leasehold improvements, restaurant improvements and new construction, and retail improvements would address this issue, providing taxpayers with predictability, simplicity, and fairness. Our nation's businesses are looking forward, planning capital expenditures to improve and expand their businesses. For example, according to the National Restaurant Association December 2010 Tracking Survey, 47 percent of restaurant operators plan to make a capital expenditure for equipment, expansion, or remodeling in the next six months. The ability to plan for these expenditures and know what the tax treatment will be in the future is important to those who are making those decisions right now.

Moreover, the 15-year recovery period is an important driver of economic activity, fueling investment and job growth. When restaurants invest in construction and renovations, the impact spreads through the economy. Before the economic downturn, the restaurant industry spent more than $10 billion in 2007 on construction of restaurant buildings. According to the Bureau of Economic Analysis, every dollar spent in the construction industry generates an additional $2.39 in spending in the rest of the economy and every $1 million spent in the construction industry creates more than 28 jobs in the overall economy. That means that restaurant industry construction spending created 214,000 jobs in 2008, at a time when the overall economy was contracting (see figure 2 below).

Figure 2.
Restaurant Spending on Construction

Year	Billions ($)	Jobs Created In Overall Economy
2004	5.2	145,000
2005	7.4	208,000
2006	6.6	185,000
2007	10.4	292,000
2008	7.6	214,000

Source: U.S. Census Bureau and National Restaurant Association

Work Opportunity Tax Credit

Another important – but temporary – aspect of the Code is the WOTC, a tax credit provided to employers who hire individuals from twelve target groups who face significant barriers to employment. Examples of WOTC-targeted employee groups include veterans who either are food stamp recipients or are unemployed and suffering a service-connected disability, former felons, disconnected youth, and members of families receiving benefits under the Temporary Assistance for Needy Families Program ("TANF").

The restaurant industry employs close to 13 million people, many of whom may not have been hired had WOTC not been in place. WOTC enables these workers to move from economic dependency into self-sufficiency as they earn a steady income and become contributing taxpayers. A 2003 study by the Urban Institute shows just 51 percent of TANF recipients were employed at the time of a 2002 survey. Each additional barrier to work further reduces the likelihood of employment to 30 percent for adults with one additional barrier to work and 14 percent for adults with two or more barriers to work.

Moreover, WOTC works. According to the Department of Labor, during fiscal year 2008, over 691,000 WOTC certificates were issued.

Congress should consider making permanent this successful program, which has proven to be an efficient incentive for business to provide jobs for workers who might otherwise fall through the cracks. Doing so would further the objectives of providing taxpayers with predictability and certainty in the Code.

Deduction for Charitable Donation of Food Inventory for Small Businesses

Each day, 35 million Americans are at risk of hunger. At the same time, billions of pounds of food are wasted each year. America's restaurants give back to their communities in major ways, the most significant of which is through food donation. According to National Restaurant Association research, 73 percent of restaurants donate food to individuals or charities.

The National Restaurant Association strongly encourages its members to donate more food, and we have partnered with Food Donation Connection (FDC) to do just that. Founded by a former restaurant executive, FDC serves as the liaison between the restaurants interested in donating food and the social service agencies adept at getting that food to people in need. FDC helps restaurants develop and implement programs designed to provide an alternative to discarding surplus food, while capitalizing on the economic benefits of those donations through the tax savings. Since 1992, FDC has helped facilitate the donation of over 140 million pounds of food to non-profit, hunger-relief agencies.

The deduction for charitable donation of food inventory is a critical tool in alleviating hunger. Without the provision, taxpayers get the same tax treatment for throwing out surplus food as they do for giving it to charity. The enhanced deduction encourages donating the food to charity instead, by helping to offset the costs associated with storing and transporting the extra food. Absent the enhanced deduction for the charitable donation of food inventory, these charities would be hard-pressed to meet critical demands, putting our nation's most vulnerable families at risk for hunger.

However, the impact of the deduction could be improved. For nearly 30 years since its inception in 1976, the tax deduction for contributions of food inventory was limited to C corporations. In 2005, the provision was temporarily expanded to include pass-through entities (i.e. Subchapter S corporations, limited liability companies) and has subsequently been extended on subsequent occasions. Making permanent the now-temporary component of the deduction would make it

more effective, while advancing the objectives of providing taxpayers with simplicity and predictability.

Increase The Business Meal Deduction to Stimulate the Economy

It is a general principal of the Code that "(o)rdinary and necessary business expenses, as well as expenses incurred for the production of income, are generally deductible."[1] However, under current law, the business meal deduction is limited to only 50 percent of costs incurred. By way of background, business meals previously were fully deductible. In 1986, the deduction was reduced to 80 percent and, in 1993, the deduction was further reduced to its current level of 50 percent, adding to the Code's complexity and unpredictability.

The business meal deduction should be reformed to better reflect the basic principle that business expenses should be fully deductible. Full deductibility would appropriately bring the business meal deduction in line with other ordinary and necessary business expenses, but even increasing the limitation to 80 percent would better align the provision with these objectives. Such reform efforts would also increase the Code's simplicity and predictability.

According to National Restaurant Association research, increasing the business meal deduction to 80 percent would increase business meal sales by over $7 billion and increase the number of jobs by over 200,000. Moreover, the impact of the restaurant industry on the nation's economy is considerable and felt in every state (Figure 3 p. 7 provides the state-level economic and jobs data for an increase in the deduction limitation from 50 percent to 80 percent; Figure 4 p. 8 provides the same information for full deductibility). We service more than 130 million guests every day. Every dollar spent dining out generates $2.05 in business to other industries, totaling more than $1.7 trillion in overall economic impact.

While officially the recession may be over, the restaurant industry is still reeling from the effects of decreased consumer spending and increased unemployment. Increasing the business meal deduction to appropriately reflect that it is an ordinary and necessary business expense would encourage consumers to dine out and also benefit small businesses. America's restaurants are small business' conference rooms and the restaurant table is where much business is conducted. Increasing the deduction is a benefit not only to restaurateurs and their employees, but to their guests, the many small business owners across the country. For many small companies, the ability to conduct business over a meal is their only means of advertising and marketing their business.

Conclusion

We greatly appreciate this opportunity to submit this testimony on behalf of the restaurant industry today. Tax reform presents an opportunity to provide taxpayers with predictability and fairness, while encouraging economic growth and job creation. As Congress considers the important issue of tax reform, we are happy to be a resource to Congress and the Committee and we look forward to our continued work together on these issues.

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[1] Office of Mgmt & Budget, Exec. Office of the President, Budget of the United States Government (Fiscal Year 2011) 2010.

Figure 3.

Estimated Impact of Increasing Business Meal Deductibility from 50% to 80%

State	Increase in Business Meal Spending 50% to 80% Deductibility (in millions)	Total Economic Impact In the State (in millions)	Total Employment Impact In the State (number of jobs created)
Alabama	$92	$186	2,952
Alaska	$19	$33	452
Arizona	$151	$300	3,984
Arkansas	$50	$101	1,689
California	$967	$2,267	26,315
Colorado	$136	$313	3,943
Connecticut	$88	$165	2,019
Delaware	$24	$43	499
District of Columbia	$39	$53	313
Florida	$472	$957	12,522
Georgia	$230	$532	6,732
Hawaii	$54	$104	1,402
Idaho	$28	$55	933
Illinois	$313	$744	8,786
Indiana	$135	$278	4,272
Iowa	$51	$102	1,669
Kansas	$56	$112	1,606
Kentucky	$90	$183	2,618
Louisiana	$98	$193	2,888
Maine	$29	$55	848
Maryland	$148	$307	3,594
Massachusetts	$193	$388	4,649
Michigan	$191	$380	5,872
Minnesota	$119	$272	3,714
Mississippi	$50	$95	1,630
Missouri	$134	$298	4,084
Montana	$21	$40	710
Nebraska	$35	$73	1,190
Nevada	$83	$147	1,974
New Hampshire	$34	$63	784
New Jersey	$205	$442	4,993
New Mexico	$45	$82	1,331
New York	$482	$954	11,251
North Carolina	$222	$467	6,849
North Dakota	$12	$22	373
Ohio	$252	$540	8,081
Oklahoma	$74	$157	2,491
Oregon	$94	$194	2,611
Pennsylvania	$258	$582	7,688
Rhode Island	$29	$53	706
South Carolina	$108	$221	3,329
South Dakota	$15	$30	509
Tennessee	$143	$322	4,191
Texas	$576	$1,405	17,036
Utah	$50	$113	1,682
Vermont	$13	$22	335
Virginia	$200	$423	5,312
Washington	$157	$340	4,160
West Virginia	$32	$54	950
Wisconsin	$107	$224	3,629
Wyoming	$12	$19	346

Source: National Restaurant Association estimates, 2011

Figure 4.

Estimated Impact of Increasing Business Meal Deductibility from 50% to 100%

State	Increase in Business Meal Spending 50% to 100% Deductibility (in millions)	Total Economic Impact In the State (in millions)	Total Employment Impact In the State (number of jobs created)
Alabama	$167	$336	5,334
Alaska	$34	$59	817
Arizona	$273	$542	7,198
Arkansas	$91	$182	3,052
California	$1,748	$4,095	47,543
Colorado	$245	$565	7,124
Connecticut	$160	$298	3,648
Delaware	$43	$77	901
District of Columbia	$70	$96	565
Florida	$854	$1,729	22,623
Georgia	$416	$961	12,162
Hawaii	$97	$188	2,533
Idaho	$50	$99	1,685
Illinois	$565	$1,344	15,874
Indiana	$243	$501	7,718
Iowa	$92	$185	3,015
Kansas	$101	$202	2,902
Kentucky	$163	$331	4,730
Louisiana	$177	$348	5,219
Maine	$53	$100	1,533
Maryland	$267	$554	6,493
Massachusetts	$348	$701	8,399
Michigan	$345	$686	10,610
Minnesota	$216	$492	6,710
Mississippi	$90	$171	2,944
Missouri	$241	$539	7,379
Montana	$38	$72	1,282
Nebraska	$64	$132	2,149
Nevada	$150	$266	3,566
New Hampshire	$62	$114	1,416
New Jersey	$370	$799	9,022
New Mexico	$81	$148	2,405
New York	$871	$1,724	20,328
North Carolina	$401	$844	12,374
North Dakota	$22	$40	673
Ohio	$455	$976	14,601
Oklahoma	$133	$284	4,500
Oregon	$170	$350	4,717
Pennsylvania	$467	$1,052	13,890
Rhode Island	$52	$95	1,276
South Carolina	$195	$400	6,014
South Dakota	$28	$54	920
Tennessee	$258	$582	7,571
Texas	$1,041	$2,539	30,778
Utah	$91	$204	3,039
Vermont	$23	$40	606
Virginia	$362	$764	9,598
Washington	$284	$614	7,516
West Virginia	$57	$98	1,717
Wisconsin	$193	$405	6,556
Wyoming	$22	$35	626

Source: National Restaurant Association estimates, 2011

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March 30, 2011

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate
215 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Orrin Hatch
Ranking Member
Committee on Finance
United States Senate
215 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Statement for the Record for March 30, 2011 Full Committee hearing titled "How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?"

Dear Chairman Baucus and Ranking Member Hatch:

The National Roofing Contractors Association (NRCA) commends you for holding a hearing of the Committee on Finance to discuss how complexity, uncertainty and other factors impact responses to tax incentives. Like many members of the committee, we at NRCA believe Congress needs to take steps to ensure the government is not impeding the ability of businesses to create jobs and grow the economy, while minimizing uncertainty for the taxpayer. As the Committee moves forward with tax reform proposals that will seek to address concerns arising from today's hearing, we urge you to consider legislation that provides for pro-growth tax policies that minimize uncertainty and enable entrepreneurs to grow their businesses and create jobs within our industry.

Established in 1886, NRCA is one of the nation's oldest trade associations and the voice of professional roofing contractors worldwide. NRCA's approximately 4,000 members are located in all 50 states and typically are small, privately held companies, with the average member employing 45 people in peak season and attaining sales of about $4.5 million per year.

Unemployment in the construction industry remains alarmingly high at 20.0%, according to recent data from the Bureau of Labor Statistics. Clearly, the construction industry has been one of the hardest hit sectors of the economy over the past two years and our members continue to struggle in very difficult economic conditions. As such, pro-growth tax policies are needed now more than ever, and NRCA urges Congress to pursue the following initiatives in tax reform legislation going forward.

Commercial Roofing Depreciation Reform

Small businesses within the roofing industry are uniquely positioned to play an important role in creating high-quality jobs for American workers. Congress should facilitate the creation of an estimated 40,000 jobs annually within our industry by passing legislation to reduce the depreciation schedule on commercial roofs from 39 years to 20 years. In addition to creating 40,000 jobs among contractors and manufacturers, such legislation would also enhance the energy efficiency of our nation's commercial buildings and simplify taxes for small businesses in many industries.

Passage of depreciation reform legislation is necessary because between 1981 and 1993 the depreciation schedule for nonresidential property was increased from 15 years to 39 years. However, the current 39-year depreciation schedule is not a realistic measure of the average life span of a commercial roof. A study by Ducker Worldwide, a leading industrial research firm, determined the average life expectancy of a commercial roof to be 17 years.

The large disparity between the 39-year depreciation schedule and average life span of a commercial roof is a major incentive for building owners to delay the replacement of failing roofs. This is slowing economic activity and the adoption of more advanced energy-efficient roofs, because an owner who replaces a roof before 39 years have elapsed must continue to depreciate that roof for tax purposes even though it no longer exists. A Treasury Department Report to Congress on Depreciation Recovery Periods and Methods corroborated this problem by finding "...a 'cascading' effect, where several roofs are being depreciated at the same time, even though only one is physically present." Given this situation, many building owners choose to do only piecemeal repairs, most often with older technology, rather than replace a failing roof in its entirety with new, more energy-efficient materials.

In the 111th Congress, several bills (H.R. 426 and H.R. 5396) were introduced with bipartisan support to rectify this situation. This legislation would reduce the depreciation schedule from 39 to 20 years for commercial roofs that meet a benchmark energy efficiency standard. This would facilitate job creation in our industry by accelerating demand for energy-efficient commercial roofs by eliminating the disincentive in the tax code for building owners to engage in such economic activity. Enactment of this legislation would also benefit small businesses of all types by mitigating the "cascading effect" of having to depreciate more than one roof in instances where a roof must be replaced before the 39-year depreciation schedule has been completed.

According to the Ducker Worldwide study, this legislation would produce the following benefits by accelerating demand for energy-efficient commercial roofs:

- Create 40,000 new jobs within the roofing industry;
- Add $1 billion of taxable annual revenue to the economy;
- Provide savings to small businesses of all types through a simpler and more equitable system of taxation and lower energy costs; and,
- Reduce U.S. energy consumption by 13.3 million kilowatt hours annually and cut carbon emissions by 20 million lbs. per year.

Given the unique combination of job creation and energy efficiency benefits, this legislation enjoys support of a diverse array of businesses, manufacturers, labor and energy efficiency groups. The bill will create jobs not through a special tax incentive, but by the removal of an obstacle in the tax code which restricts economic growth and impedes the movement towards more energy efficient buildings.

Extension of Bush-Era Lower Tax Rates

NRCA supports the *permanent* extension of pro-growth tax rates on individual income, capital gains and dividends originally enacted by Congress in 2001 and 2003 and recently extended for two years, through the end of 2012. These lower tax rates were instrumental to our emergence from the 2001 recession with strong economic growth. The extension of pro-growth tax rates is particularly critical during a time of prolonged weak economic growth which our economy, and the construction sector most acutely, is currently experiencing.

With the lower individual tax rates set to expire on Jan. 1, 2013, NRCA urges Congress to pass legislation to permanently extend the rates in order to provide long-term certainty for "main street" small businesses, many of which are S-corporations and other flow-through organizations that are taxed through the individual rates. Currently, the vast majority of the tax code is temporary, with taxes set to increase dramatically without further congressional action. The prospect of future tax increases hangs like a dark cloud over many small businesses, our nation's primary job creators.

The prospect of future higher taxes on small businesses and the entrepreneurial sector of the economy is particularly troubling to NRCA. The growth of small businesses is absolutely vital to creating the millions of jobs needed for economic recovery, and failure to move forward in the future with pro-growth tax policies will surely impede the recovery.

Three Percent Withholding Tax on Government Contracts

NRCA urges the immediate repeal of the three percent withholding on government contracts mandated in Section 511 of the *Tax Increase Prevention and Reconciliation Act of 2005* (TIPRA) through the prompt consideration of the Withholding Tax Relief Act of 2011 (H.R. 674). Repeal of the withholding law is vital to job creation and economic growth in the roofing industry. If the tax withholding law is not repealed, roofing contractors performing government work are due to face serious repercussions:

- The three percent of the payment that is withheld is taken off the total value of the contract, not the profit earned on the project;
- Given that three percent or less of the total contract is the average profit margin in our industry, withholding could eliminate contractors' profits on many projects, thus severely limiting the ability of contractors to grow their business and create jobs;
- While the contractor may collect the remaining three percent at the end of the year, cash-flow and operating capital disruptions caused by withholding will be a tremendous burden, particularly for small businesses;
- This disruption in operating capital will also negatively impact a company's ability to become bonded, which is required for bidding on many government projects;

- Bookkeeping systems are not set up to account for amounts withheld from invoices. Withholdings will also complicate tax filings and the need to accurately determine tax liability. This new complexity will create added compliance costs on businesses and thus will further impair efforts to create jobs;
- Many roofing contractors will be forced to stop bidding on government contracts. Also, contractors continuing to perform government work may be forced to pass additional costs created by withholding along to the government and taxpayers;
- Without immediate action by Congress, withholding will begin impacting contractors soon, as the provision takes effect at the beginning of next year.

Completed Contract Method Reform

NRCA supports bipartisan legislation (H.R. 6097) introduced last year by Reps. Herger and Berkley to modify the tax code to expand the number of construction contractors who may utilize the completed contract method (CCM) of accounting when dealing with long-term construction contracts. Under current law, construction contractors cannot use the CCM if average annual gross receipts exceed $10 million, a threshold that has not been adjusted for inflation since 1986. Contractors who cannot utilize CCM must use the percentage of completion method (PCM) of accounting, which often does not accurately reflect results due to the required use of cost estimates.

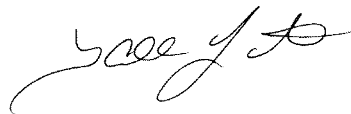
H.R. 6097 would increase the threshold for using the CCM to $40 million, index it for inflation, and also provide relief from the Alternative Minimum Tax and "look-back" provisions in the tax code. NRCA commends Representatives Herger and Berkley for their leadership on this legislation and looks forward to working with Congress on this issue of importance to the construction industry.

Conclusion

Again, NRCA believes that any tax reform legislation considered by Congress must provide for pro-growth tax policies that enable entrepreneurs to grow their businesses and create jobs within our industry. NRCA looks forward to working with members of the in support of such policies during the 112th Congress.

Thank you for your consideration of NRCA's views on tax reform as it relates to small businesses. Please contact NRCA's Duane Musser or Brandon Audap at 202-546-7584 if you have questions or need more information about NRCA's position on these important issues.

Sincerely,



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President, NRCA

STATEMENT FOR THE RECORD

UNITED STATES SENATE
COMMITTEE ON FINANCE

PUBLIC HEARING
March 30, 2011

How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?

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UNDERSTANDING THE ROLE OF TAX TREATMENT IN THE EMPLOYER PROVIDED RETIREMENT SYSTEM

The recent report of the National Commission on Fiscal Responsibility and Reform recommends a significant reduction in the limits of the special tax treatment of employer provided defined contribution plans that permits deferral of income recognition by participants until benefits are distributed, while permitting a current deduction for employer contributions. Under the "Illustrative Tax Plan" proposed by the Commission, the combined annual contributions from employers and employee salary deferrals in a defined contribution plan can not exceed the lesser of $20,000 or 20 percent of a participant's income. Under current law, the section 415(c) annual defined contribution combined limit for employee and employer contributions is $49,000, not including catch-up contributions. The report also includes an alternative recommendation in which the special tax treatment is entirely eliminated. While it is absolutely appropriate for policymakers to examine this and all tax expenditures as part of a comprehensive deficit reduction effort, it is critical that the treatment of employer provided employer plans and its role in creating retirement income for American workers be fully understood.

Simply put, any erosion of the current tax treatment of employer provided retirement plans will result in fewer Americans saving for retirement. Low and moderate income workers' retirement savings will drop disastrously without the employer provided system. To the extent that they save, it likely will be in general purpose accounts where access to use savings for current needs will reduce amounts available for retirement.

Absent an attractive tax incentive, a significant majority of employers will not offer a retirement plan to their workers. Contrary to popular belief, employers gain no tax benefit from offering a retirement plan as opposed to merely providing additional deductible cash compensation. In fact, they incur significant additional administrative and compliance costs, and fiduciary exposure, as the result of offering a retirement plan. Management and higher paid employees will be indifferent to whether or not their employer offers an after-tax savings program. In fact, highly paid employees may find more attractive investment alternatives outside their employer's plan.

According to the Investment Company Institute, total retirement assets were $16.6 trillion as of September 30, 2010.[1] Thirteen trillion dollars of that amount is attributable to employer provided retirement plans. The Bureau of Labor Statistics reports that in March 2010 employer provided retirement plans were available to 74 percent of full time and 65 percent of all private sector workers.[2] The Department of Labor Form 5500 analysis for 2007 (latest available data) reports 707,787 private sector retirement plans covering 123 million participants with assets in excess of six trillion dollars.[3]

It is widely recognized that practically no retirement savings occurs outside employer plans or IRAs. In recent Congressional testimony, Jack VanDerhei, Research Director at EBRI, while discussing retirement income adequacy, noted "If you eliminated the expected retirement income generated by defined benefit pensions, defined contribution plans, and IRAs, the at-risk percentages would be even larger than without Social Security benefits."[4]

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[1] *The U.S. Retirement Market, Third Quarter 2010*, Investment Company Institute, January 2011

[2] *Employee Benefits in the United States,* Bureau of Labor Statistics News Release, July 27, 2010.

[3] *Private Pension Plan Bulletin, Abstract of 2007 Form 5500 Annual Reports,* U.S. Department of Labor Employee Benefits Security Administration, January 2010.

[4] Testimony by Jack VanDerhei, EBRI research director, before the Senate Health, Education, Labor and Pensions Committee, on "The Wobbly Stool: Retirement (In)security in America" (T-166), October 7, 2010.

The tax treatment of employer provided retirement plans, particularly the treatment of salary deferrals under 401(k) and similar plans, is often misunderstood. Critics complain that the tax benefit applies inordinately to those in higher income brackets. Given our progressive income tax regime, that should surprise no one. What most critics do not understand, or sometimes fail to mention, is the significant nondiscrimination and coverage requirements that ensure that tax qualified employer provided plans provide meaningful and substantial benefit to workers at all income levels. Critics also complain that tax qualified retirement savings merely replace other savings that would be made regardless of any special tax treatment. They are partially correct – a small but not insignificant number of participants will save for retirement without qualified employer provided plans. They overwhelmingly will be high income individuals.

The maximum deferral percentage rate for highly compensated participants, composed of those earning $110,000 or more in 2011, the "top-paid" group, or business owners, is mathematically tied to the average deferrals of nonhighly compensated employees. This often results in the inability of high income workers and owners to defer the maximum amount permitted under law. To address this problem, plan sponsors undertake significant measures to induce participation in the employer's plan through educational campaigns, offering matching contributions, or providing safe harbor plans that are deemed to meet the nondiscrimination tests if certain vesting and matching or nonelective contribution requirements are satisfied. In PSCA's annual survey of the 2009 plan year, 31 percent of plans reported limiting the deferral rates of highly compensated participants below the statutory limits and 36.9 percent used a safe harbor plan to meet the average deferral percentage test.[5] Vanguard's analysis of 2009 activity of 600 plans and 1.3 million workers reveals that participants earning between $30,000 and $50,000 deferred an average 5.7 percent of salary into a 401(k) type plan, compared to 6.8 percent for all participants.[6]

All tax qualified private sector employer provided retirement plans, including 401(k), profit sharing, and defined benefit pension plans, must meet broad coverage and nondiscrimination rules that guarantee that the plans are offered to rank and file workers and that benefits are fairly provided. The top heavy rules that impact small businesses add a second layer of onerous vesting and contribution requirements if 60 percent of plan assets are held by key employees – a very common occurrence in small employer plans. As an additional incentive for lower-paid workers, the Saver's Credit provides a nonrefundable matching income tax credit based on retirement plan contributions.

The tax treatment of employer provided retirement plans should not be judged by an income distribution analysis but on its effectiveness in providing retirement benefits to working families. In that regard, the evidence is overwhelming that the existence of an employer provided retirement plan is the preeminent criteria in determining the retirement security of American workers. The Congress Research Service recently reported that in 2007 only 2.6 percent of taxpayers with adjusted gross incomes between $25,000 and $50,000 contributed to a traditional IRA.[7] In comparison, my analysis of the Employee Benefit Research Institute's study of the March 2010 Current Population Survey (for 2009) reveals that 53.4 percent of private sector wage and salary workers age 21-64 earning between $20,000 and $50,000 worked for an employer or union that sponsors a retirement plan and 43.5 percent participated. For all workers (private sector and public) in the same category, 59.4 percent are covered and 50.6 percent

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[5] *53rd Annual Survey Reflecting 2009 Plan Experience,* Profit Sharing / 401k Council of America.
[6] *How America Saves 2010 – A Report on Vanguard Defined Contribution Plan Data,* Vanguard, July 2010.
[7] *Ownership of Individual Retirement Accounts (IRAs) and Policy Options for Congress,* Congressional Research Service, November 5, 2010.

participate.[8] While this in not an apples-to-apples comparison, in this analysis low and moderately paid workers are 19.5 times more likely to participate in an employer provided retirement plan than contribute to a traditional IRA.

The implications for policymakers are clear. The current tax treatment, with its strict coverage and discrimination requirements, has resulted in broad-based employer provided plans for low and moderate income workers. Low and moderate income workers are exceedingly more likely to accumulate and retain retirement assets if they are offered a retirement plan at work. Employers add immeasurable value to these plans by acting as fiduciary and investment management overseers, monitoring plan fees, selecting quality investment alternatives, making very significant employer contributions, providing financial education, and encouraging and facilitating savings through payroll deductions. Eliminating or diminishing the current tax treatment of employer provided retirement plans will jeopardize the retirement security of tens of millions of American workers, dramatically reduce retirement assets in capital markets, and create new and ominous government challenges in maintaining the quality of life for future generations of retirees.

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[8] *Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2009,* Employee Benefit Research Institute Issue Brief 348, October 2010.

Why the US Employee Tax Credit is the Best Tax Incentive

By Tom Pallow of Third Way Progressives, ThirdWayProgressives.org, 202-903-1133

Economist may disagree as to the value that tax incentives bring to generating economic efficiencies and prosperity. Some see great value in tax incentives and others do not. Regardless of these disagreements, there are some tax incentives that virtually all economists and policy makers like. Regarding tax incentives for businesses that bring private sector job growth to the US, in recent years the two most popular of these tax incentives seems to have been the R&D tax credit and the early depreciation of certain capital expenses. Given the popularity of these two tax incentives, if the superiority of the US Employee Tax Credit were to be demonstrated when compared to these two more known tax incentives, it would be safe to say that the US Employee Tax Credit should join these two more popular tax incentives as part of our country's collection of tax tools that our federal and state governments use. This paper will demonstrate the superiority of the US Employee Tax Credit to these two effective tax incentives. Our US ETCs would affect C Corporations and businesses that are taxed as personal income.

Regarding businesses that are taxed as personal income, our US ETC would be awarded for all US W-2'd employee expenses up to the FICA tax cap. This credit would be worth $.15 for every dollar expensed. Our personal income tax plan would raise taxes on the top two brackets up to the same rates and income brackets as President Obama has proposed, or above that. However, businesses that hire employees in the US will be able to use these tax credits to lower their effective tax rate to no lower than if today's rates stayed the same and the bottom three rates were dropped even further. Such a policy would create an effective tax cut for the employers of 98% of Americans who work for a non-C Corporation business. Yet statically scored, these tax credits would only cost about 21% of all the federal revenues that would be raised otherwise.

Very importantly, studies propose that President Obama's tax plan would cause the loss of over 6 million private sector jobs between 2013 and 2020. While using some of these same assumptions, our personal income tax plan would create or save over 7 million private sector jobs during the same period. Such a difference, if dynamically scored, would mean that our personal income tax plan would raise as much as 4 to 5 times the federal revenues as the President's plan.

What our US ETCs would do is institutionalize in our tax code a reality that exists in our society but that is not yet institutionalized in our tax code. That reality is: All things being equal, someone who employs people in the US is more important to society than is someone who

does not. Therefore, we should reward and incentivize private sector employment in our tax code in order to create more of it.

The beauty of this policy is that the math always works for us. That is, even within the highest income stratums, those who employ people are always a relatively small percentage of each stratum. For example, within all of the income that is produced by all those within the top 2% of US income earners, the point where the President wants to raise personal income tax rates, only 19% of all that income is the profits of any business that is taxed as personal income that has one or more employees in the US. For the top 1% of US income earners this number is about 21%. For the top 5% this number is about 16%, and for the top 10% it is about 12%. Therefore, the math always works for us. The greater we make the effective tax rate difference between wealthy people who do not employ in the US, versus all entrepreneurs who do, the more private sector jobs and/or government tax revenues will be raised! If there is only one thing that all economists across the spectrum agree on, it is that incentives matter.

Our C Corporation tax plan would also use the same US ETCs, but use them in a slightly different way that is revenue neutral and that also provides more of an award for C Corporations that hire in more socially responsible ways. This is done by making the US ETCs worth only $.04 on the dollar, but allowing C Corps to exercise these tax credits to an even lowered effective tax rate than within our personal income tax plan. Plus, C Corps who have a higher mean wage than the prevailing wage of the geographic areas where they employ would be awarded a tax credit tax that is worth more than $.04 on the dollar.

While our C Corporation tax plan would appear to be revenue neutral if statically scored, the plan would incentivize enough new private sector jobs that significant new tax revenues would be raised. To read all about our personal income and C Corporation tax plans, along with our capital gains, FICA, and environmental tax plans, visit ThirdWayProgressives.org.

Now that our US ETCs have been explained, let us see why they would be even more efficient and would develop even more prosperity than would the rightfully popular R&D tax credits and early write offs of capital expenses. There are two primary questions to ask when it comes to comparing tax incentives and credits. The first is: In relation to the cost of the incentive, how well does the incentive achieve what it was enacted to achieve? The second is: How easy is it for the IRS to police the tax incentive?

Starting with policing, it is obvious that our US ETCs would be one of the easiest tax incentives of all incentives to police. This is true primarily because nothing is more comprehensively documented in the area of tax policy than are W-2'd employee expenses. They are

comprehensively documented, using multiple forms of documentation, from both the employer and employee, and on both the state and federal government levels.

Sure it is all too common for undocumented workers to use phony forms of documentation to work in the US. However, if an employer were to exercise a US ETC for employee expenses given to an undocumented worker in the US, at least these employee expenses would be going to someone working in the US and therefore most of this wage would be spent in the US. This is not true for many tax incentives that can be taken for expenses that are actually spent in a foreign nation. Further, it would be very easy to require, as a prerequisite for exercising a US ETC, that employers use the IRS's E-Verify System. Also, in a very important way the US ETC would actually create an incentive for employers to pay higher taxes. That is, those employers in the US who are currently paying employees under the table and not paying FICA taxes would have an incentive to claim all of their employee expenses and pay FICA taxes in order to exercise the US ETC. This is because a US ETC could not be exercised without an almost equivalent FICA tax being paid; the US ETC being worth more to the employer than the existing FICA tax expense. Avoidance of FICA taxes by employers has been a growing problem, and it will become even more so the higher we raise the FICA tax rates.

Secondly, R&D and capital expenses are much harder to pin down and define, and are therefore much harder to police when it comes to tax incentives. It is much harder to determine whether a business expense is an R&D expense or simply a general businesses expense. This is both true for employee expenses that are said to be used for R&D and the capital expenses that are said to be used for R&D. Capital expenses can also be problematic in this regard. With every capital expense the IRS must ask, are these expenses actually legitimate business expenses or personal expenses used by those running or owning a business? Further, many hands on investigations are needed by the IRS to determine whether a capital expense is being used in the US or in a foreign country. Whereas again, nothing in tax policy is more clearly cut than W-2'd employee expenses up to the FICA tax cap.

Regarding the effectiveness of US ETCs, R&D tax credits, and early capital expense write offs, all three have the primary goal of increasing private sector jobs in the US, yet once again it can be shown that the US ETC is superior. For one, because as is shown above that it is easier to make certain that more of the US ETC is spent in the US, more of the federal expense of the US ETC will be spent in the US than would the federal expenses for the other two tax incentives. This will mean that the US economy will grow more with US ETCs. Also, and very importantly, there is nothing to mandate in law that R&D expenses that are spent in the US will mean that whatever new technologies and ideas that are generated by this R&D will lead to jobs in the US rather than jobs in a foreign nation. The same is true for capital expenses that are used in a

foreign country but written off as though they were spent in the US. The US ETC does not have this problem.

One of the great aspects of R&D tax credits and early capital expense write offs is that they primarily help manufacturing businesses, and manufacturing businesses typically pay on average a higher wage than do most other business sectors in the economy. Yet our US ETCs also accomplish the same thing. For one, within our current C Corporation tax plan, a tax credit could be worth more than $.04 on the dollar if the mean wage of a C Corporation is above the prevailing wage of the geographic area where they are employing in the US. The same could be true with our personal income tax plan. Secondly, more and more evidence shows that manufacturers find it more efficient and productive to conduct their R&D and make their capital expenses where they do their manufacturing. Therefore, if we were to enact US ETCs and therefore create more of an incentive to manufacture in the US, more R&D and capital expenses would follow this manufacturing into the US, even without an R&D tax credit and early capital expense write offs!

Our overall tax plan also contains a capital gains and FICA tax plan, together raising $558 billion in new federal revenues in the first 10 years. Our capital gains tax plan alone, and statically scored, would raise over 63% more federal revenues than President Obama's capital gains tax plan. Our overall tax plan would raise $1.25 trillion over 10 years versus the President's tax plan and the Deficit Commission's tax plan that would raise $700 billion and $925 billion over 10 years respectively. Our overall tax plan would create or save over 11,553,000 private sector jobs between 2013 and 2020, while studies propose that the President's overall tax plan would create the loss of over 6,243,000 jobs through that same period. It is safe to say that the Deficit Commission's tax plan would create the loss of even more jobs. If this jobs data were then dynamically scored into these federal revenue projections, our tax plan would raise as much as four to five times the federal revenues as the other two tax plans! For much more information on all components of our tax plan, visit ThirdWayProgressives.org.

The last reason why the US Employee Tax Credit is the best tax incentive is that it is one of the few, if not the only, tax incentive that could set the political stage for a grand compromise between Republicans and Democrats. The US ETC, along with our overall tax plan, would lead to the best case scenario for income taxes going up after the 2012 election! For more information on why this is so, read our paper, "A Compromise Where America Wins", that can be found at the Weekly Blog section of our website, ThirdWayProgressives.org.