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EXAMINING WHETHER THERE IS A ROLE FOR TAX REFORM IN COMPREHENSIVE DEFICIT REDUCTION AND U.S. FISCAL POLICY

HEARING

BEFORE THE

SUBCOMMITTEE ON FISCAL RESPONSIBILITY AND ECONOMIC GROWTH

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

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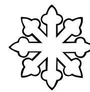

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EXAMINING WHETHER THERE IS A ROLE FOR TAX REFORM IN COMPREHENSIVE DEFICIT REDUCTION AND U.S. FISCAL POLICY

TUESDAY, SEPTEMBER 13, 2011

U.S. SENATE,
SUBCOMMITTEE ON FISCAL RESPONSIBILITY
AND ECONOMIC GROWTH,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:16 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Bill Nelson presiding.

Present: Senators Bingaman, Wyden, Nelson, Crapo, and Coburn.

Also present: Democratic Staff: Ryan McCormick, Staff Director, Subcommittee on Fiscal Responsibility and Economic Growth. Republican Staff: Mike Quickel.

OPENING STATEMENT OF HON. BILL NELSON, A U.S. SENATOR FROM FLORIDA, CHAIRMAN, SUBCOMMITTEE ON FISCAL RESPONSIBILITY AND ECONOMIC GROWTH, COMMITTEE ON FINANCE

Senator NELSON. Good afternoon and thank you. We are looking forward to today's star-spangled panel.

This week marks the 3-year anniversary of the collapse of Lehman Brothers, and we have yet to recover. If this Congress does not get serious, then the structural budget imbalances facing the economy could permanently reduce labor productivity and economic growth for years to come.

A launching point for getting our fiscal house in order should be the overhaul of the Federal income tax code. And if that means lowering tax rates, eliminating tax expenditures and other loopholes, and simplifying the tax code, then so be it.

We hear a lot about entitlement programs, Social Security and Medicare, in particular. What we do not hear a lot about are the 250 entitlement programs cooked into the tax code.

Tax expenditures, the various tax credits, deductions, and exclusions grafted onto the tax code are entitlement programs, pure and simple. And, if you are eligible, you can claim the benefit. They are expenditures, and there is no application process in order to claim the benefit. And there is no annual or even periodic review of tax expenditures' efficiency by the Congress.

So tax expenditures are entitlement spending without accountability. Some of these tax expenditures, particularly those relating to oil and gas, date back to the early 1900s and might have outlived their justification.

The last time Congress tackled the tax expenditures in a systematic way was 25 years ago in the Tax Reform Act of 1986. I voted for that. That legislation took a hatchet to special interests and lowered the top individual tax rate from 50 to 28 percent, but the special interests then came back stronger than ever. And since 1986, according to the Joint Committee on Taxation, Congress has enacted 158 new tax expenditures.

Is it right that an oil company could reap an $11 billion tax windfall from the worst environmental disaster in our history in the Gulf oil spill? I think that is questionable. And I do not think oil spill cleanup costs due to the negligence of the parties that were drilling should be treated as an ordinary and necessary business expense. And that is just one tax break.

Is it right that large multinational corporations can report billions in profits, yet still pay no Federal income tax? And, of course, the example that has been out in the news quite a bit is General Electric, which had worldwide profits of over $14 billion and they paid zero in Federal income tax in 2010.

Well, this does not seem to be right; it does not seem to be fair. We need a tax system that is embraced by the population as being fair, but these are examples that strike the everyday American as a system that is very unfair.

Well, is it right that Wall Street executives can avoid millions in taxes using complex deferred compensation schemes, while the average taxpayer can put no more than $5,000 a year into their Roth IRA? Or is it right that a special tax rule allows oil and other commodity speculators to treat a portion of their short-term trading profits as long-term capital gains in order to have a lower tax rate?

In fiscal year 2008, tax expenditures such as these totaled $1.2 trillion in lost revenue. That is in one year. That sum is greater than the entire amount raised by the individual income tax in that same tax year. It is also greater than all Federal discretionary spending in that same year of 2008, and it is twice as much as all non-defense discretionary spending.

Between 1972 and 2008, the number of tax expenditures more than quadrupled from 60 to 247. And, over a 25-year period from 1974 to 2008, tax expenditures climbed from 5.7 percent to 8.6 percent of GDP.

If we simply reverted to the 1974 level of tax expenditures, we could wipe out more than $400 billion of our annual deficit this year and more than $4 trillion over 10 years.

So, tax expenditures can be characterized more accurately as tax earmarks, because they represent favors for a particular interest. That is revenue that is not coming into the system that has to be made up someplace else by the average American taxpayer. And so tackling tax expenditures is not just about deficit reduction and increasing revenue. It is also about getting rid of distortions that act as a drag on investment and economic growth.

And, over the last 2 decades, our foreign trading partners have moved rapidly to modernize their tax systems to make them more

relevant in a global economy where capital moves at the touch of a button, the click of a mouse; where intellectual property is easily transferred; and goods are manufactured in global production chains that transcend borders.

Here at home, the United States plods along with an antiquated tax system in which the rules for taxing international trade and investment were developed in the 1920s. The time for tinkering has now past, and we need to overhaul the way that we tax U.S. companies that operate around the world.

So, we are going to focus today on whether there is a role for tax reform in comprehensive deficit reductions and U.S. fiscal policy.

One of the things is tackling tax expenditures to make the tax code simple, fair, and equitable. The code is so complex that so many taxpayers just simply throw up their hands. They spend an estimated 7.6 billion hours each year complying with filing requirements. Tax compliance cost taxpayers roughly $140 billion in 2008. Sixty percent of taxpayers pay tax preparers to fill out their forms.

I could go on and on. But I will submit for the record the rest of the testimony here.

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

Senator NELSON. Let me just, before I turn to my colleague, Senator Crapo—I want to say that we do have an extraordinary panel to speak on this subject.

The first witness, Alan Greenspan, managed U.S. monetary policy under four presidents during his five terms he served as Chairman of the Federal Reserve. And during that time, the United States grew from a $5-trillion to a $13-trillion economy.

John Taylor served as a member of the Council of Economic Advisors in the George H.W. Bush administration and was Under Secretary of Treasury for International Affairs in the George W. Bush administration. And he is a professor of economics at Stanford.

Martin Feldstein served as Chairman of the White House Council of Economic Advisors in the Reagan administration, and Dr. Feldstein has written more than 300 research articles in the field of economics, founded the National Bureau of Economic Research, and is currently a professor at Harvard.

John Engler, president of the Business Roundtable, was a 3-term Governor of Michigan. Mr. Engler, Governor Engler, was president and CEO of the National Association of Manufacturers before his current position.

Edward Kleinbard served as Chief of Staff of the Joint Committee on Taxation from 2007 to 2009. He has 20 years of experience practicing tax law in New York and is currently a professor of law at the University of Southern California.

It is an extraordinary panel. Thank you for honoring us with your presence.

Senator Crapo?

OPENING STATEMENT OF HON. MIKE CRAPO, A U.S. SENATOR FROM IDAHO

Senator CRAPO. Thank you, Mr. Chairman. I appreciate your holding this hearing, as well.

And I want to focus right at the outset on one of your early comments, that, as any part of the important needed changes that we need to be making in America today with regard to our economic and fiscal policy, tax reform is one of the key pieces that we must not allow to be ignored.

As you know, I have been working with a group of six—it has been called a gang. I know that you have been working in other contexts, and Senator Wyden, as well, who has a proposal of his own. But the one area of agreement that I think we have among us and among many others is that, in addition to controlling the excessive spending appetite of Washington and getting our spending under control—which is undoubtedly an important and necessary piece of the reform of our fiscal policy—we also need a pro-growth element of our fiscal policy and of our economic policy.

And, if we are going to deal with the issues that America faces properly, we will focus not only on the austerity and the proper fiscal policy relating to expenditures—to spending—but also with regard to those kinds of reforms that I think are started at the foundation, with fundamental reform of our tax code that will generate a pro-growth opportunity for America and help us to build and strengthen our economy.

Today's hearing focuses on the issue of tax reform, and, as you have said, we have an outstanding panel here to discuss this with us. And the notion that tax reform is needed is hardly in dispute, I think, in the United States today, but there are a tremendous number of ideas about how we should do it.

You have identified a number of pieces of the complexity of the tax code where I think I got the feeling you felt we could simplify. As you know, the group that I have worked with has proposed dramatic reduction of the complexity in our tax code. And I know that Senator Wyden's proposals are similar in that regard.

Undoubtedly, we will have to engage in the discussion and the debate over these various specific aspects of our tax code, and there will be disagreement about individual pieces and their policy justifications. But we must engage in that debate.

I have said many times that if we were to go about creating a tax code that is more unfair, more complex, more expensive to comply with, and more anticompetitive to U.S. business interests, we would be hard-pressed to do it worse than I think we have done it with our code.

Now, some may argue with me on that, but I do not think that they would argue that we dramatically need to flatten our code, improve it, make it much less complex, much more friendly to growth and to business development in America.

Some have called for a combination of raising tax rates and modifying and eliminating tax expenditures as a way to raise revenue that would be dedicated to deficit reduction. Others, like myself, have disagreed with the notion that we should stay in what I consider to be the age-old box of battling over whether we should raise taxes on those who are particularly identified as the wrong people in America to receive tax benefits, raising taxes on the wealthy or lowering taxes on this category or whatever, and we need to move out of that box into a debate in this country over how to reform the tax code.

The proposal that I have supported, the proposals that many others have proposed of their own all have similar elements, and that is they look at simplifying and reducing the complexity in the code. Most focus on reducing tax rates in accordance with that and building the economy. And that is definitely the approach that I think would be music to the ears of those seeking to engage in capital formation and business development in the United States.

A by-product of the economic growth that I would hope that would come from tax reform would be the additional kind of revenue that we do not now currently see in our economy, not because current tax rates are too low, but because our economy is not growing.

History has shown that our annual total revenue as a percentage of GDP is about 18.2 percent. This has been the case whether the top tax rate was 70 percent or 28 percent or 35 percent.

In booming times, we have seen temporary revenue spikes, and in times of slow growth and high unemployment, as we have in recent years seen, we have seen dips in the total revenue. But over time, we have always seen revenues return to their historic average, regardless of what Congress has done to the tax code.

In fact, annual revenues have only exceeded 20 percent of GDP three times in the last 70 years, and two of those times were at the end of World War II, when our Nation was still running high deficits.

The other time was in 2000, when the annual revenue of 20.6 percent of GDP took place at the height of the stock market bubble. And this temporary spike in revenue was bound to come down as soon as the bubble popped, and it did, which also coincided with the post-9/11 recession that occurred.

In fact, other than one year, 2000, of the other 11 times since 1940 when our budget has been in surplus, revenues were less than 20 percent of GDP; and, in 7 of those 11 years, revenues were below 19 percent of GDP.

It is also important to note that our budget has never been in balance when the Federal spending exceeded 19.4 percent of GDP.

Along those lines, I appreciate that many of our witnesses today note in their prepared testimony that, while tax reform is an important goal for Congress, fundamental entitlement reform must also be a primary and immediate goal for Congress, as it is the largest driver, by far, of our long-term fiscal shortfall.

Nevertheless, even if we do cut trillions of dollars of spending, which we must do, so long as our economy remains in the tank and unemployment remains persistently high, policies that will generate the kind of robust economic growth that is currently nowhere to be found must also be a priority.

It is for this reason that I support the inclusion of pro-growth tax reform as part of a comprehensive fiscal reform plan that also includes fundamental entitlement reform and strict enforcement mechanisms that will keep Congress from violating those guidelines and those requirements.

I am very pleased, Mr. Chairman, that you and I have been working so closely together on these kinds of issues. As I have noted, the other Senators here on the panel, we all have, to some extent, different ideas about exactly how to achieve it, but there is

a huge overlap in our commitment to achieving this kind of fundamental tax reform, and the hearing that we are holding today is evidence of that.

So, again, Mr. Chairman, I look forward to what our witnesses here have to tell us and look forward to working with you and our other colleagues in Congress in developing a pro-growth agenda for our economy as we also move forward to deal with our spending excess.

Thank you.

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

Senator NELSON. Thank you, Senator Crapo.

Chairman Greenspan?

STATEMENT OF HON. ALAN C. GREENSPAN, PRESIDENT, GREENSPAN ASSOCIATES, LLC, WASHINGTON, DC

Mr. GREENSPAN. Thank you, Mr. Chairman. Mr. Chairman, Senators, I very much appreciate the opportunity to testify before this committee.

It is an extraordinarily important subject, and I am glad that the Congress is taking a very pronounced effort to come to grips with it.

Tax reform is a major part of any program of fiscal reform. It will contribute to a restoration of American competitiveness and the vibrant economy that goes with it. The fiscal success we achieved in the early 1990s was essential to containing budgets that seemed inherently prone to excess. But the great irony of those years was that the surpluses that emerged from 1998 through 2001 as a consequence of that success thoroughly undermined fiscal prudence.

We have now come full circle to a point where, as much as I wish it were otherwise, there is no credible scenario of addressing our current fiscal problems without inflicting economic pain.

We have been procrastinating far too long in coming to grips with the retirement of the baby-boomer generation, a fiscal problem that has been visible for decades.

By 2006, with chronic surpluses already a distant memory, the Medicare trustees indicated, according to calculations by the Council of Economic Advisors, that the Medicare program does not have enough projected revenue to cover projected future spending. A reduction in Medicare Part A expenditures by 51 percent would be necessary to make the Medicare trust fund solvent.

But, rather than repairing that huge shortfall and a lesser one in Social Security, we expanded entitlements still further, without a matching source of revenue.

Our major problem is not only that spending has been rising rapidly, but that it has been mainly in the form of entitlements rather than of discretionary outlays, such as war spending or bridge building, that cease when the activity comes to an end. The entitlements, however, once bestowed, are very difficult to rescind.

The growth of our economy in the years ahead is bound to slow. Our civilian labor force, short of a major change in immigration, should parallel a slowing in the growth of the working-age population, most of whom are already born.

Professor Gordon of Northwestern University has concluded that his most recent 20-year forecast of the growth rate of per capita real GDP, as he put it, represents the slowest growth of the measured American standard of living over any 2-decade interval recorded since the inauguration of George Washington.

In the years ahead, increasing entitlements will be pressing against shrinking economic growth.

My preference going forward, as I have noted often, is something akin to the budget recommendations of Paul Ryan, the chairman of the House Budget Committee. I regret, however, that for now at least, that Ryan's budget lacks the votes for passage. And as European current experience underscores, delays in implementing policy reform can be destabilizing.

Of the politically feasible budget proposals on the table, that proffered by the Bowles-Simpson National Commission on Fiscal Responsibility and Reform appears the most substantive. What impressed me most about Bowles-Simpson is that it addresses tax expenditures. Cuts in tax expenditures, mostly subsidies, can be alternatively structured and viewed as cuts in outlays rather than a reduction in revenues.

Subsidies of whatever stripe distort the optimum functioning of markets and ultimately the standard of living of society as a whole. I do not know whether a U.S. budget crisis is immediately on the horizon or is years off. What I do know is that if we presume that we have a year or two before starting serious long-term restraint and we turn out to be wrong in that optimism, the impact on financial markets could be devastating.

If we are wrong in being overly fiscally cautious in the year ahead, that is a problem that is readily solvable.

Thank you, Mr. Chairman.

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

Senator NELSON. Thank you, Chairman Greenspan.

Dr. Taylor?

STATEMENT OF DR. JOHN B. TAYLOR, MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY, AND GEORGE P. SCHULTZ SENIOR FELLOW IN ECONOMICS, HOOVER INSTITUTION, STANFORD UNIVERSITY, STANFORD, CA

Dr. TAYLOR. Thank you, Mr. Chairman, other members of the committee, for holding this hearing on the role of tax reform in U.S. fiscal policy.

The most important thing for our economy right now is to have higher growth and, therefore, lower unemployment, and comprehensive reform of fiscal policy is a big part of that.

I think for the past several years, we have focused more on more temporary targeted types of interventions, and, in my assessment, they have not been effective. And so that is why it is so important, I think, to move towards a more comprehensive strategy.

There are two elements of that strategy. One is the budget strategy, and second is the tax reform strategy, and they are intimately linked together.

I would like to refer to a graph that I have distributed from my testimony, which is in front of you. This graph that I will come to in a minute illustrates, I think, the way to go about this in a sensible way.

You would start with the Budget Control Act of this summer, the Budget Control Act of 2011. While criticized by many, it has accomplished a reduction in spending growth compared to the original budget submission of the President.

If the Joint Select Committee comes up with the additional spending reductions, it will take the spending levels by 2021 from 24.2 percent to 22 percent—24.2 percent was in the President's budget; it will come to 22 if that action is taken.

But I think we need to go further and would suggest that we take spending levels back to where they were in 2007. As a share of GDP, levels will be higher, of course. That level is 19.5 percent of GDP.

There are two big advantages of that strategy as I will show in the graph in a minute. One is, it allows tax increases to be taken off the table, which is a stimulus to economic growth; two, it will allow for revenue-neutral tax reform, meaning lowering marginal rates and broadening the base, the classic definition of tax reform.

Those advantages are, I think, essential for raising economic growth. The tax reform strategy, of course, should just do that—reduce marginal rates as the base is broadened, and you have indicated many ways, Mr. Chairman, how to do that.

It can be done both on the corporate side and on the personal side. I think both should be part of this.

I would like to just, in the last couple of minutes, try to work through my graph to illustrate this, because the numbers are very important here. But, if you look at page 5 of my testimony, you will see a graph that shows Federal spending, Federal outlays as a share of GDP from 2000 to 2021.

The history is most remarkable because it shows really a gigantic increase in spending as a share of GDP from 18.2 percent in 2000 to over 24 percent now. The President's original budget did not deal with that spending problem, as we all know, and it is shown in the graph. It would have had spending at 24.2 percent of GDP by the end of the budget window.

With the Budget Control Act, plus the continuing resolution of 2011, and with the extra work the Joint Select Committee must do, you can see that has been—the picture has changed dramatically, assuming you did not go ahead with these. It takes spending to 22 percent of GDP.

But, as you can see, if you really want to have a budget strategy that does not entail tax increases, you have a little ways to go. And what I would suggest is, with the tax reform proposals and entitlement reform proposals and other reform, it is quite feasible to get to just where we were in 2007. That was 19.6 percent of GDP.

I have drawn in my graph a way to do that. There are other ways to do that. Chairman Greenspan referred to another one. But this would be the way to have a comprehensive budget strategy, a comprehensive tax reform strategy, and one which will do a great deal of good for the American economy, with higher growth and lower unemployment.

Thank you.

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

Senator NELSON. Thank you, Dr. Taylor.

Dr. Feldstein?

STATEMENT OF DR. MARTIN S. FELDSTEIN, GEORGE F. BAKER PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. FELDSTEIN. Thank you very much, Mr. Chairman. I am very pleased to have this opportunity to testify.

I have been talking about tax expenditures and about pro-growth tax reform for many years, indeed, even before I served as chairman of the Council of Economic Advisors for President Reagan. So I was really very pleased to hear your opening comments and those of Senator Crapo.

I wrote the testimony that I submitted before I heard President Obama's speech to the Congress the other day and his plan to finance his new stimulus package. If you have looked at my testimony, you know that I, like yourselves, favor reducing tax expenditures. But I must say I do not favor the way President Obama proposes to limit tax expenditures.

I think there are two reasons why his proposals are bad ideas. First, they use the revenue to finance his new collection of government spending programs, when we need that revenue from reduced tax expenditures to reduce future budget deficits and to lower marginal tax rates.

Second, as you know, the President would limit the tax expenditure reductions just to higher-income taxpayers, those with more than $200,000 in income. But long-term deficit reduction requires that everyone share in that burden.

If Congress were to pass the President's proposal to reduce tax expenditures just for high-income individuals, I think it would be very difficult to revisit that at a later time and to extend it to the entire population of taxpayers.

With that said, let me return to the testimony that I submitted. And, again, I said, as both of you said, and as the two previous speakers have said, tax reform, although it is the focus of this hearing, is not a substitute for the fundamental reform of Social Security, of Medicare, and of Medicaid, the primary sources of the future growth of government spending.

I think the key to those reforms is to reduce gradually the growth of the projected government benefits and to supplement those benefits with universal investment-based annuities and private health spending. Doing that would protect the future incomes and health care of older Americans without requiring higher future tax rates.

But let me turn to tax reform, where I, in the prepared testimony, emphasize what you have both spoken about, and that is the role of tax expenditures; tax expenditures which, as you said, are substitutes for direct government spending.

I think that the key to favorable tax reform is to limit the revenue lost because of these tax rules and to use the resulting extra revenue to reduce current and future marginal tax rates.

Today's marginal tax rates are typically close to 50 percent for a middle-income family because of the combined impact of the income tax, the payroll tax, and State taxes. These high marginal tax rates reduce the incentive to work, to acquire more skills, to start or expand a small business, to save, and to invest. They induce individuals to seek their compensation in non-taxable forms and fringe benefits, and to spend money in wasteful ways that generate tax reductions.

So, limiting tax expenditures and using the resulting revenue to lower marginal tax rates would produce a double win. It would reduce wasteful behavior directly and would strengthen incentives for increased economic growth. And, of course, that can be made a triple win by using some of the resulting revenue to reduce budget deficits.

Although limiting tax expenditures produces additional revenue, it is, as the chairman indicated, really a way of cutting government spending, government entitlements. The effect shows up in the revenue side of the budget, but it is really a cut in spending. The accounting rules make it look like a tax increase, but the economic effect is the same as any other reduction in government outlays.

Let me be more specific about how I think the cutting or the limiting of tax expenditures might be approached, because I think it can be done without actually eliminating any of the tax expenditures or even putting limits on specific tax expenditures, like the size of the mortgage deduction.

I think a better and fairer way to reduce the revenue loss caused by tax expenditures is to allow individuals to use all currently available tax expenditures, but to limit the total tax benefit that each individual can get from those tax expenditures, to limit that total tax benefit to a percentage of that individual's adjusted gross income.

For example, limiting the revenue loss from the itemized deductions and from the exclusion of employer payments for health insurance to 2 percent of each individual's adjusted gross income would raise more than $275 billion a year at current income levels and more than $3 trillion over the next decade.

The size of the tax cap could, of course, be started with a higher rate and gradually reduced to a 2-percent cap. Even a 5-percent cap would generate more than $100 billion of additional annual revenue at current income levels.

A key point to stress about this idea is that the 2-percent cap is applied to the tax expenditure benefit and not to the total amount deducted or excluded. For example, someone with a 30 percent marginal tax rate who pays an annual mortgage interest of $5,000 would receive a tax expenditure benefit now of $1,500, and that 2-percent, 5-percent cap would apply to that.

It also would generate tremendous simplification. A 2-percent cap on tax expenditure benefits would cause nearly 75 percent of individuals who now itemize their deductions to shift to the standard deduction, which would, indeed, be an enormous simplification.

I have said a little bit about corporate tax reform; basically, lowering tax rates and shifting to the territorial system that is used by virtually every other industrial country.

But I will stop there and look forward to questions after the other speakers.

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

Senator NELSON. Thank you, Dr. Feldstein.

Governor Engler?

STATEMENT OF HON. JOHN M. ENGLER, PRESIDENT, BUSINESS ROUNDTABLE, WASHINGTON, DC

Mr. ENGLER. Thank you, Mr. Chairman.

I will pick right up on the corporate tax reform where Dr. Feldstein left off.

Thank you to the committee for holding this meeting today. And I might mention in my credentials, I guess, as a 3-term Governor, after 25 years, we were able to get Michigan back to a AAA-rated State. So I appreciate the challenge in front of the committee.

My testimony today focuses on the critical relationship among business tax reform, economic growth, and deficit reduction. Business tax reform should be designed to maximize economic growth over time, while creating permanent jobs with good wages.

We believe that congressional action can improve the ability of American workers to compete in the hyper-competitive world economy. Such action to sustain economic growth would have the additional benefit of reducing the burden the Nation's current debt imposes on our economy.

If sound corporate tax reform, along with other reforms, including broad regulatory reforms, improves economic growth by even half a percentage point, we can generate millions of new jobs for Americans.

Mr. Chairman, you and the committee could not be holding a more timely hearing than today's session. Our companies are disadvantaged today by a U.S. corporate tax system that is an outlier at a time when capital is more mobile and the world's economies are more interconnected than at any time in history.

Your opening statement focused on that and recognized that our current tax system impairs the ability of U.S. companies to compete abroad, and it discourages capital investment in the United States.

The U.S. corporate tax system is quite possibly the least competitive tax system in the entire OECD family. And I put a little chart up just to show what has happened over a period of time, because I thought it important that we do that. And, again, you noted that we have an antiquated tax code developed for a different era.

This chart 25 years ago shows where we made changes, and we are in a more competitive posture. Today, we need a simpler, flatter, lower-rate system that allows American businesses and your constituents, America's workers, to compete and win.

The two primary reforms Business Roundtable endorses are a competitive territorial tax system and a significant reduction in the U.S. statutory corporate tax rate.

First, territorial tax systems, under which foreign earnings are exempted from domestic tax, are the predominant practice, again, within the OECD. Territorial tax systems allow domestically headquartered companies to compete on a level playing field in foreign

markets where they do business. I have a table here that kind of shows just how predominant the practice is.

And then, second, as the other chart was showing, we had a once statutory—competitive statutory tax rate, we no longer do. Rate reductions over the past 20 years have resulted in the U.S. corporate rate now being 50 percent greater than, again, the average of the OECD countries.

I believe that the proposals we bring today would boost the worldwide competitiveness of American companies, increase jobs for American workers, increase wages, promote long-term economic growth for the United States, and help pay down our debt.

In evaluating the cost of adopting these reforms, it is important to consider their cost relative to the revenue stream the government would have otherwise collected.

In doing so, I urge Congress to recognize that many provisions in the tax code, although they may have statutory expirations, have routinely been extended year after year. Again, you sort of mentioned that in your opening comments. The R&D tax credit, to choose one, for example, has been a temporary provision now for 30 years.

Provisions that have been repeatedly extended are realistically part of the baseline against which the revenue from a reformed tax system must be measured.

Some will argue that instead of tax reform, business tax increases should be used for deficit reduction now. Still others will argue that business tax increases should be used for new spending.

But the Business Roundtable will argue that any business tax changes should be used to, as the President said to the Congress the other night, on Thursday, lower one of the highest corporate tax rates in the world.

Clearly, given the deficit and everyone's desire to be fiscally responsible, coupled with everyone's desire to see the U.S. unemployment rate come down, we must guard against any diversion of corporate tax revenues, lowering the rate, and eliminating the unfair worldwide tax system.

Comprehensive tax reform is a challenge. It will not get any easier by settling for piecemeal changes in the tax base or succumbing to the targeting that you spoke of for a specific industry. Success will come when we address the fundamental tax reforms that can help achieve a higher U.S. standard of living.

On behalf of the Business Roundtable, I look forward to working directly with Congress on passing tax reform to provide sustained economic growth and sustained job creation.

And we did bring one other chart. I will close with that. Leave that up, because it kind of is important, and it shows where the payrolls are today. This one has gotten a little bit of attention, but that is what we need to change, tax reform, and help move those numbers on the employment side in a positive direction.

Thank you, Mr. Chairman.

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

Senator NELSON. Thank you, Governor.

Mr. Kleinbard?

STATEMENT OF EDWARD D. KLEINBARD, PROFESSOR OF LAW, U.S.C. GOULD SCHOOL OF LAW, LOS ANGELES, CA

Mr. KLEINBARD. Thank you, Mr. Chairman and distinguished members, for inviting me to testify.

The U.S. today is an extraordinarily low-tax country by world norms, the fourth lowest in the OECD. And even by our own standards, we are collecting historically low levels of tax, below 15 percent of GDP for the last 3 years.

At the same time, we are spending outliers in two large respects. And since spending determines the level of tax revenues that we require, I need to say one quick word about that.

First, we spend much more on health care per capita than does any other country, and our per capita government share of this spending is the second highest in the world. If the U.S. were to spend per capita what Norway does on health care, our aggregate health care spending would immediately decline by $800 billion a year.

Second, the U.S. spends as much on its military as do the next 14 countries combined, 42 percent of the entire world's military expenditures. Our current revenue base cannot be reconciled with our outsized spending on health care and defense.

Moreover, whatever the long-term set of government entitlement spending policies we transition to, we will need to finance the costs of getting there, and that, in turn, means higher tax revenues than those we currently collect.

The U.S. can afford to increase its total tax collections as a fraction of GDP. Just a decade ago, the country ran budget surpluses and enjoyed both a robust economy and job growth, while tax collections exceeded 20 percent of GDP.

The CBO budget baseline assumes that the so-called Bush tax cuts will all expire at the end of 2012. Extending those temporary tax discounts would add some $4.6 trillion to our cumulative deficit over the next 10 years.

We, therefore, have no practical choice but to treat the CBO baseline as the tax reform base case. Our tax reform goals should be to raise about the same revenues as the CBO baseline, but to do so in a smarter way.

This, in turn, means that we must abandon our nostalgia for the Tax Reform Act of 1986. That tax reform effort was revenue-neutral because it could afford to be. It also was preceded and followed by major tax increases.

The fact that we have to raise revenue today means that this tax reform effort will look different, not that it is impossible. In particular, this tax reform will need to tackle some of the deliberate congressional subsidy programs baked into the tax code, which is to say tax expenditures.

Of all of these, the most important to address are the personal itemized deductions, such as deductions for home mortgage interest, charitable contributions, and State and local taxes. They are extraordinarily costly, about $220 billion a year in foregone tax revenues.

They are inefficient in that they lead to major misallocations of economic resources, particularly in the housing sector. They are poorly targeted in that the government subsidies go to individuals

who would have behaved the same without them, and they are unfair in that they are upside-down subsidies. They subsidize high-income Americans more than low-income ones.

The Tax Policy Center has estimated that eliminating these subsidies for personal itemized deductions would increase tax revenues in the neighborhood of 1.5 percent of GDP over and above the lapse of the temporary tax discounts.

This is an enormous revenue pickup. Their elimination also would simplify the code and increase its progressivity.

Now, I fully recognize that the personal itemized deductions invariably are described as political sacred cows, but they are sacred cows that we can no longer afford to maintain. Either we eliminate these sacred cows or we allow them to stampede over us.

Tax reform also must address the corporate income tax. I agree with Governor Engler that its 35-percent rate is too high by current world norms. But at the same time, U.S. multinationals are adept at gaming the current U.S. tax system and those of other high-tax countries through the production of what I call stateless income, income that is taxed essentially nowhere.

The U.S. corporate base is being systematically eroded through these stateless income tax planning strategies. And a territorial system along the lines advocated by the Business Roundtable would make these problems worse in every dimension.

A revenue-neutral corporate tax reform package could be fashioned along the following lines. First, eliminate business tax expenditures; second, reduce the corporate tax rate to something in the range of 25 to 27 percent; and, finally, tax multinationals currently on their worldwide income.

The resulting corporate system would represent a huge competitive boost for American domestic firms, would attract inward investment into the U.S., and would provide a fair tax environment for U.S.-based multinationals.

Thank you, Mr. Chairman.

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

Senator NELSON. Thank you, Mr. Kleinbard.

Senators, I am going to ask one question. I am then going to turn to you for your questions.

Gentlemen, how much revenue could Congress expect realistically to be generated by broadening the tax base, eliminating tax expenditures, and closing the loopholes? Let us just go right down the list.

Mr. GREENSPAN. It is a very extraordinarily large number, but I would not put the issue that way, because what we are dealing with is a major problem in this country in which what we have promised in the way of entitlements is, in physical volume terms, more than I think the size of the American economy can produce.

And so it is not an issue of raising revenue, per se. It is a question of our spending being already committed to more than we have the capacity of achieving. So I would say that the focus has to be fundamentally on the issue as to why, for example, as I mentioned in my earlier remarks, the trustees of the Medicare Fund several years ago found that we are very significantly underfunding Medi-

care. And unless and until we understand that our problem is spending and not taxes, I think we will lead ourselves astray.

Finally, let me just say, Mr. Chairman, that there is no question that the level of taxation is a very major factor in determining the level of economic activity, and the issue that I think we ought to focus on is that we are in a period of very sluggish economic activity. There seems to be no real potential for changing that materially, and the revenues we are going to engender, irrespective of the tax code, are going to be much less than I think is currently being projected either by CBO, OMB, or a number of private economists.

If that is the case, we have to recognize that we have a major problem on the expenditure side and that the way I would define it is that this is not discretionary spending, which is very easy to end. It is very difficult to cut entitlement spending, and I think unless and until we put our focus on that issue and then determine what it is we need to raise in revenues—after we determine what we are going to spend is, to my view, the appropriate way to focus on tax policy.

Taxes are there to fund spending, and the lower the level of spending, the less the problem of funding.

Dr. TAYLOR. If it is just a matter of——

Senator NELSON. Hold on, Dr. Taylor. I want to follow-up with Chairman Greenspan.

But just focusing on tax expenditures, it is an item worth $14 trillion over 10 years. What do you think is realistic for the Congress to squeeze out of that $14 trillion of tax expenditures?

Mr. GREENSPAN. Well, Mr. Chairman, I am one of those, and I suspect you may be, as well, who thinks tax expenditures should not exist in our fiscal system and that, as far as I am concerned, what the Bowles-Simpson Commission essentially did is started off with the presumption that tax expenditures would be zero and then work back from there.

I like that premise. In fact, I realize that it is going to be very difficult to avoid having to keep some of that in place, but as far as I am concerned, the sooner we can get rid of the whole concept of tax expenditures, the better we would be.

I would like to see all expenditures go through the appropriation process rather than go through tax credits or other things, which I find is merely a mechanism to get around the ultimate choosing process which the Congress, to my judgment, has to do.

Senator NELSON. So get rid of $14 trillion and then build from there.

Mr. GREENSPAN. I would say, if you start with the assumption that tax expenditures are an inappropriate means of raising revenue and then work back from there, I think we are in the right direction, as the Bowles-Simpson Commission recommends.

Senator NELSON. Dr. Taylor?

Dr. TAYLOR. I think if you want to just eliminate the tax expenditures and not consider it along with tax reform, which is really adjusting the marginal rates, then you are going to be disappointed about how much extra revenue you raise.

If we have a strongly growing economy, say, like we had after the recession in the early 1980s, 6 percent a year, 6.5 percent a

year rather than 2 or 2.5, with the same share of taxes, we get a lot more revenue. We can do a lot more things.

So it is the growth that is most important. So I would say when you are thinking about zero in terms of tax expenditures, you better be simultaneously thinking about the marginal rate reductions that are going to go along with that.

Senator NELSON. Which is precisely what we have said up here.

Now, Dr. Feldstein, you proposed a 2-percent cap on any individual and, I assume, corporate amount of tax expenditure. And if I recall your testimony, that was about $3 trillion over 10 years. And that way you do not have to pick and choose which ones you want and do not want.

Dr. FELDSTEIN. That is right. But let me be clear. That was just on the personal side. It is hard to think about what the equivalent of a percentage of AGI is for the corporate side, but I have not looked at that.

I do know that if you look at the tax expenditure analysis by the joint committee, much, much more of the tax expenditures are on the personal side than on the corporate side, although the things you mentioned are important and on the corporate side.

There is also a question of how one ought to treat incentives for saving and investment. Under a broad income tax measure, you would say contributions to individual retirement accounts or the interest earned within 401(k) accounts are tax expenditures and should not be allowed.

But I would disagree with that. I would say—and the numbers that I mentioned assume that pro-saving items in the tax code, pro-saving features of the tax code like IRA deductions and the non-taxation of the inside buildup in IRAs, would continue to be allowed.

So that $3 trillion over 10 years comes just from the personal deductions and the exclusion of employer payments for health insurance, putting a 2-percent cap on that.

Senator NELSON. Governor?

Mr. ENGLER. Well, being only a very mediocre agricultural economist, not an esteemed economist like my colleagues here, I am not able to put a number on this. But let me just remind the committee of something that virtually every member of this committee was part of back in 1995 and 1996 when we were doing welfare reform. And I think that still stands as one of the singular accomplishments in the last part of the last century.

But we saw in that, when the incentives changed, we had people going back to work whom people said would never work. We had entire counties where everybody on public assistance was working somewhat, and that was as simple as changing the way we handled income disregards.

I would simply argue that to restore sort of the animal instincts of our entrepreneurs and to get the incentives lined up, the kind of changes that are being talked about here are going to yield additional revenue beyond what, say, a static analysis over in some CBO corner of the room would come up with and that the dynamism of this tax code is not to be underestimated, if we get it right.

And what we, I think, have to be focused on and what manufacturers and Business Roundtable members deplore is the lack of

economic growth in this country. We need to be a jobs engine again as a Nation, and our policies should be coordinated to get there, and your topic today can help.

Senator NELSON. Mr. Kleinbard?

Mr. KLEINBARD. Well, as the former Chief of Staff of the Joint Committee on Taxation, it is, I guess, incumbent on me to do what you have always suspected my old group did and pull a number off the top of my head.

I come up with about—I am rounding here—about $4.5 trillion, and the way I get there is, first, the itemized deductions—it is somewhere in the neighborhood of $2.5 trillion over 10. Second, the employer-sponsored health insurance, I would not put a cap on that the way Marty has proposed. We can talk about that in more detail. But what we tend to forget is that this is one tax expenditure which also has a tax expenditure effect on our Social Security tax payments, our payroll taxes, and that is about $1 trillion over 10 years.

So regardless of what we do on the income tax, if we included employer-sponsored insurance as part of our FICA tax base for payroll purposes, we would be talking about another trillion. So I could see about $3.5 trillion.

And then there is over $1 trillion, $1.2 or $1.3 trillion in business tax expenditures. Those need to be reversed. Every country that has lowered its rate has also broadened its corporate base, in particular, by getting rid of accelerated depreciation. That is a fair trade, and that would put in over $1 trillion, which, in my view, should be employed to reduce the corporate tax rate.

Having said that, when we are talking about fundamental changes like this, like eliminating the personal itemized deductions, it is important to remember a maxim that Chairman Baucus taught me, which is that you have to boil the frog slowly, that we cannot simply wake up tomorrow with no home mortgage interest deduction, and I confess that my numbers do not reflect any transition rules.

Mr. ENGLER. The frog is still dead, though, I would point out, which is one of the problems. [Laughter.]

Senator NELSON. So your proposal is $4.8 billion a year or multiplied by 10 years——

Mr. KLEINBARD. Well, it is about $4.8 trillion, aggregate, over 10, yes.

Senator NELSON. So 4.8——

Mr. KLEINBARD. Trillion over 10, yes.

Senator NELSON. Over 10.

Senator Crapo?

Senator CRAPO. Thank you very much, Mr. Chairman.

And I assume, by the way, that that number, Mr. Kleinbard, would be $4.8 trillion out of the 14 or so trillion dollars that there is now in the tax code.

Mr. KLEINBARD. By way of tax expenditures, yes.

Senator CRAPO. It would mean there would be about $9 trillion left in the tax code as part of the tax expenditure system.

Mr. KLEINBARD. Yes. And most of those would be on the capital income side that Marty referred to, retirement plans and things like that.

Senator CRAPO. Thank you. And I would just like to ask the entire panel, very quickly: in the Bowles-Simpson approach and I think in the administration's approach and others, at least the proposals that are out there with regard to the corporate income tax rate, are being proposed on a revenue-neutral basis.

Is there any disagreement that on the corporate side, the reforms should be revenue-neutral? Does anyone disagree with that?

Mr. Kleinbard?

Mr. KLEINBARD. I do not disagree with that, except to note that some business tax expenditures are, to some extent, claimed by non-corporate businesses. The bulk, though, are claimed by corporations. About 80 percent are claimed by corporations.

Senator CRAPO. All right. Thank you very much. Getting back to the question of whatever the level of adjustments that can be made in the Internal Revenue Code is in terms of flattening the code and reducing the tax expenditures—and I think there is no disagreement among any element here with regard to the fact that, in some way, we should do that—the bottom line is, it seems to me, that there is a big debate over how that revenue savings to the Federal Government should be utilized.

As I see it, it can be used in three ways. It can be used to reduce rates, it can be used to justify more spending, and it can be used to reduce the deficit or to pay off debt. And there may be other ways to use it that I have not thought about yet, but in a broad sense, it seems to me that those are the three options.

In my mind, reducing rates would be the most effective utilization of those kinds of savings. But I would like to have, just from each member of the panel, your observation as to how we should approach that.

Mr. GREENSPAN. Senator, ordinarily I would agree with you, but we are in such precarious shape fiscally at this stage that I think it is essential that we get the level of the deficit down as quickly as possible because, remember, every day that deficit sits out there at a $1 trillion-plus annual rate, we are adding to the debt. And in order to reduce that debt, we have to run a surplus.

And leaving aside the issue of stabilizing the fiscal system by making sure that the level of debt relative to the GDP is some stable number, that is an economist's fiction, because what can happen very readily in that context is interest rates can go up and that whole thing breaks apart.

I think the combination of, one, a slower rate of growth and, therefore, of fundamental revenue creation coupled with the issue of the very considerable difficulty we are having in cutting spending, leads me to conclude that the very first thing we ought to address is get the deficit down.

Once the deficit is down, then I think we approach the issue of cutting spending, and, having cut spending, then cut taxes. I do not believe it makes sense, except in very extraordinary circumstances, to cut taxes funded by borrowed money. I do not think, at the end of the day, that works.

So I think we underestimate in all the calculations we are making how severe this problem is. And the mere fact that everybody seems to agree on the baseline of this and the total revenues on that, which, in fact, tends to be the case—OMB and CBO tend to

come out reasonably even in all areas—they make the same fundamental assumptions about the long-term economic outlook, and, as a consequence, that is the major driver of revenues. And so my judgment is, let us get our house in order, let us remember that taxes are there for the purpose of funding spending, and decide what level of spending this country can afford, not what it would like, but what it can afford.

Senator CRAPO. Dr. Taylor?

Dr. TAYLOR. I am in strong favor, without any qualifications, of your first approach, which is to use it to reduce rates, which, to me, is the classic definition of tax reform, expanding the base and lowering the rates in a revenue-neutral way.

The strategy or the plan for the budget I outlined orally at the beginning and in my written testimony has that built into it, and I think it is one of the real advantages of a credible gradual reduction in this very high level of spending we have recently just achieved.

So it seems to me, number one is the way to do this.

Senator CRAPO. Thank you.

Dr. Feldstein?

Dr. FELDSTEIN. I would split the revenue between the two uses, and I thought that the Bowles-Simpson proposal, which does do that, probably puts too much into rate reduction and not enough into deficit reduction.

I think we do have to get back to annually balanced budgets, not every year, but over the business cycle, as quickly as possible.

Here is the good news. After World War II, we had a debt-to-GDP ratio of 110 percent, and 15 years later it was down under 50 percent, and that happened because over those 15 years, on average, there was no deficit. Some years plus, some years minus, but the fact that the economy grow 2.5, 3 percent and we had inflation 2.5, 3 percent, meant that nominal GDP kept growing while the total debt remained unchanged.

And so we got back from this very high debt-to-GDP ratio to something that we then lived with for several decades until recently.

Senator CRAPO. Thank you.

Governor Engler?

Mr. ENGLER. I was going to mention Simpson-Bowles, as well, in terms of the structure. But from the corporate, the business side, I think it is very important, the image, the concept of revenue neutrality, that it would be the right baseline. That is why I wanted to put that in my spoken testimony today, because that can alter things a lot depending on how you play that.

But I would see, in the business side, a rate reduction, which I think has a positive effect in terms of economic growth and deficit reduction. I think the only thing you clearly have to be very clear on is no increased spending, because that needs to go in the other direction.

Senator CRAPO. Thank you.

Mr. Kleinbard?

Mr. KLEINBARD. Well, I thought Chairman Greenspan was quite persuasive. Milton Friedman famously once said that to spend is to tax. So it is really spending that drives the question of how

much revenue we need. And here I think we are all perhaps not keeping on the table this inescapable demographic fact that the country is getting older.

Just look at this panel here in front of you as proof. And the result of that is that our health care expenditures are rapidly growing at a rate that greatly exceeds our growth in GDP.

So we need to rethink our spending patterns, our long-term entitlement patterns. Those have to be phased in slowly. We have to boil the frog slowly in terms of changing those entitlement rules to more sustainable ones, and, in turn, whatever is left we have to finance, and we finance that through taxes.

So, in the medium term, I do not see any prospect other than higher taxes being used to help reduce the deficit or, at a minimum, not increase it as we make a transition to a different spending path.

Senator CRAPO. Thank you.

Senator NELSON. Senator Bingaman?

Senator BINGAMAN. Thank you very much. And thank all of you for being here to talk with us today.

I guess a question I would just still like a little more clarification on is whether or not, as Congress approaches this whole idea of tax reform, we need to raise additional revenue.

And I gather Mr. Kleinbard says we do need to raise additional revenue. I understand Chairman Greenspan to be saying we do. I believe that is my interpretation. And I believe the rest of you have said we do not or maybe we do. I do not know.

Dr. Feldstein, maybe you could clarify your—you are nodding your head.

Dr. FELDSTEIN. My view is that, if we eliminate or cap, which is my preference, tax expenditures, we should use—you all should use some of that money to reduce deficits and some of it to reduce marginal tax rates.

Senator BINGAMAN. So we should raise additional revenue, and it is just a question of how we use the additional revenue.

Dr. FELDSTEIN. Well, if you eliminate tax expenditures, you automatically raise revenue.

Senator BINGAMAN. Right.

Dr. FELDSTEIN. The question is, do you give it all back——

Senator BINGAMAN. Right.

Dr. FELDSTEIN [continuing]. In the form of lower rates, or do you use some of it——

Senator BINGAMAN. And your view is we should give some of it back in the form of lower rates, but not all of it, by any means.

Dr. FELDSTEIN. Exactly.

Senator BINGAMAN. Dr. Taylor, your view is we should do the reforms, but we should use the revenue that we achieve from those reforms to cut rates, as I understand it.

Dr. TAYLOR. Yes. It would be analogous to what we did in the 1980s, the 1986 reform.

Senator BINGAMAN. So you would not want us to do an increase.

Dr. TAYLOR. The reason is because I think growth is so important, economic growth, and that is where you think the revenues will come from. Classic tax reform is what I would suggest.

Senator BINGAMAN. But am I correct, Chairman Greenspan, that your view is, as I think you put it, deficits are so important, we first need to bring down deficits, which means that we are going to have raise revenue until we get back toward a balanced budget. Is that your position?

Mr. GREENSPAN. It is, Senator. But very specifically, what I would recommend is a recognition that the Bush tax cuts of the years 2001 and 2003 essentially rested on a concept of looking at, for a large period, surpluses, an unbelievable amount of surplus, as some of the analysts put it back at that time, as far as the eye could see.

And I always envisaged the Bush tax cuts as essentially being one means by which we could take advantage of that, meaning: get the tax cuts and reduce the surplus.

I would think, at this particular stage, that what we ought to do is go back to the tax structure that existed prior to 2001 and then start again, meaning that we want to get the level of taxes down, but you can only do it if you bring expenditures down.

And so I think the primary objective of policy ought to be, one, get ourselves to a stable position and allow the Bush tax cuts, all of the Bush tax cuts, to be rescinded. We will start to get to a point where we can begin to get balance in the system.

And remember that, as I pointed out in my prepared remarks, this is not like the end of World War II with 110-percent ratio of debt to GDP. That was very easy to cure. You just stopped World War II, and all of a sudden spending went down.

And if you have a lot of discretionary spending, that is easy to cut, but we are locked in with entitlements, and everyone who receives them believes the government says, this is your right. And as a consequence, rescinding them is something very difficult politically to do.

My view has always been that we are in the process of promising more to people who are maybe 55 years of age, a level of Medicare benefits, in real terms, for, say, the year 2030, which I do not think our economy is going to be able to deliver. And basically, not delivering what is promised by government is the worst thing that government itself can do, because that person who is 55 years of age can—if they knew what an actual benefit size was going to be in Medicare, for example, they could perhaps work a year or two longer than they ordinarily would have expected because they had retired on the assumption that those benefits were real.

And I think they are not, and I think that unless and until we recognize that we have a very serious problem, this is going to be a very tough row to hoe to get us back to fiscal stability.

Senator BINGAMAN. Thank you very much, Mr. Chairman.

Senator NELSON. Thank you, Senator Bingaman.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. And thank you for your leadership on this. This is a particularly important topic, in my view, and I commend you and Senator Crapo for the work that you are doing.

I want to zero in on the jobs issue with respect to this topic, and start with you, if I could, Dr. Feldstein.

As you know, I am very sympathetic to the basic kind of proposals and ideas you are advancing in this area. When we looked at the Bureau of Labor Statistics' figures, in the 2 years after the 1986 reform bill, the country created 6.3 million new jobs, and I keep zeroing in on that almost like the old record player that just never stops—6.3 million new jobs.

And it seems to me the study that you did on the 1986 bill, which, to a great extent, has affected my thinking over these years, the bipartisan bill I had with Senator Gregg and now with Senator Coats is really based on that, which is look to lower marginal rates while keeping progressivity, and you are on a path to stimulating the economy and creating family-wage jobs.

Do you continue to feel that those principles are sound?

Dr. FELDSTEIN. Absolutely, yes.

Senator WYDEN. The second question—and maybe we can get Mr. Kleinbard and any of you who would like to participate in this—is on the question of the corporate rate.

Senator Coats and I, in our proposal, have it at 24 percent, which is actually the lowest on offer right now. Most of them are between 25 and 27. But the point is, everyone is moving in the tax reform debate towards the same kind of figure.

The question is, how do we make sure that in corporate tax reform, we get as many jobs as possible here in the United States? Because what the typical citizen is saying is, "Look at these tax breaks." You have tax breaks for shipping jobs overseas. We need jobs here.

Well, a lot of companies would like to put their focus here. So the question then becomes, where do we need to go to get that done?

It seems to me what you are saying in your testimony, Mr. Kleinbard, is that, if you cut corporate rates to the mid-20s, and I am certainly open to whether it ought to be 22 or this or that percentage amount, your theory is that that could create jobs here in the United States for companies that are already here, number one, companies that are looking around the world to invest here, and for multinationals.

In other words, it would allow us to run the table and do everything as far as tax policy that is needed for pro-growth tax reform. Is that essentially true?

Mr. KLEINBARD. Senator Wyden, that is an excellent summary. I believe quite strongly that the corporate rate is too high. I also believe, frankly, that too much attention has been paid to the plea of multinational firms for a territorial system which would, in fact, work for technical reasons to erode the domestic corporate base even further.

Domestic firms have been sort of left out in this discussion. The right approach is to lower the rate on domestic business operations to attract jobs, to attract inbound capital, more jobs as a result of that, and then to offer multinational firms a fair system in respect of their international operations.

But when you look at the tax rates in OECD countries where they actually operate, where the large economies are, those rates are still in the high 20s at the moment. And so, if we were to offer U.S. firms a worldwide rate in the mid-20s, we will be smack-dab

in the middle of where the OECD, the G–7 major economies, are today in respect of their domestic income tax.

One last little footnote. When we make these comparisons, we have this tendency to throw in State and local taxes. The fact is that multinational firms do not pay State and local tax on their foreign income. And so we are not talking about a 39-percent rate. We are starting with 35. We need to get it down to 25, and at that point it is a win-win domestically and a fair environment internationally.

Senator WYDEN. Dr. Feldstein, on this question of where you get that sweet spot in order to increase growth to the greatest degree possible, get as many American workers employed as we can, I want to get your thoughts on the territorial issue.

Senator Gregg and I spent a gazillion, quadrillion hours on this, and that is barely an exaggeration, and I kept coming back to all the issues with respect to territorial systems that involve gaming, where somebody generates a profit over here and books it over there, and the like. And I came to the conclusion that competitive rates solve a whole lot of problems.

Our goal is 24. Maybe it should be something else, and I am open to all that, and I am open to continuing to look at a territorial system.

But is it fair to say—and this seems to be in line with your study of the 1986 bill, the effect of marginal rates while keeping progressivity and the like—that competitive rates will solve a lot of problems here?

Dr. FELDSTEIN. Of course, my work on the 1986 tax cut was about the personal cuts rather than corporate.

Senator WYDEN. Right.

Dr. FELDSTEIN. I was coordinator of the President's Economic Recovery Advisory Board for President Obama's tax study, and we spent a fair amount of time looking at the—and listening to witnesses and talking to Treasury officials and others on this question, and I refer to the sections of that report in my written testimony.

I am struck every time, though, by the fact that the United States, I think with one exception, is the only OECD country that does not have a territorial system. And when I think how easy it is for a French company or a German company to do cross-border investing—after all, they have all their neighbors there—and yet they do it, and they find it favorable, and they create manufacturing jobs in their own economy.

So I can see the pros and cons. I can see the complexity of it, and yet I am struck by the fact that all of these other countries have chosen to go the territorial route.

Senator WYDEN. Let me ask one other question, if I might, and this one is for you, Mr. Engler.

This summer I was just struck by how many businesses said that what they really want for growth and investing is some certainty and some predictability and some measure of permanence.

The *Wall Street Journal* said the other day the only thing permanent about the tax system is it is impermanent, and you keep lurching from one fix, one band-aid, one temporary proposal or another.

Isn't there an urgent need, if we are going to have significant economic growth, to get some certainty and some predictability that you can only get if you have real tax reform?

Mr. ENGLER. I think so, and I think that many of our companies think that, as well.

I believe that that certainty, certainly—and I mentioned regulatory reform in a number of other areas. It is across everything today. But you are completely correct in terms of the tax code. Let us, whatever we do, make it permanent and be done.

The complexities of scoring things, of how long this is in effect or not, and, in fact, what we have done with AMT, I mean, all of that needs to go away. We need to make some decisions. That is the job of the Congress. And direction is important. Transition rules are important.

We can go to a very good place over a period of time, and that is another permutation on our discussion today. If I know where we are going and it is permanent that I am going there, the path has some options at least that exist.

But I think from the competitive standpoint, it just makes no sense for me, if I might just finish this thought, to have a system—a German-headquartered company, a U.S.-headquartered company, we both sell in China. The German company pays whatever the tax rate is in China and takes some money home. The U.S. company pays the China tax, leaves the money over there because, if they bring it home, they pay another tax.

Why would we not want the money to come home, just on the off chance we might spend it here once it gets here versus leaving it out there?

Senator WYDEN. My time is up. I think you make an important point with respect to the example. I made the judgment, with Senator Coats, that, if we are going to a permanent tax reform change, it does make sense to have some sort of one-time repatriation so that you make it attractive for people to bring that amount home.

I just think that, as we get into this, as was done in 1986—and that was what I was alluding to with respect to your analysis—is that Democrats, who are plenty liberal, and Ronald Reagan made a judgment that competitive rates plus progressivity solved a lot of problems.

And Dr. Feldstein today confirmed my thinking that that still makes sense. And beyond that, I am very open to working with your organization and others with respect to what those rates ought to be. At 24 percent, Senator Coats and I have what is the only bill, the only bill that has been scored, with the lowest rate on offer.

It may not be the right one, and we are prepared to work with you to get the right one. But what we need to do, picking up on what Dr. Feldstein found after 1986, is accept these principles that have been proven to create jobs and proven to create jobs in the United States, which is what Mr. Kleinbard has so eloquently said.

Mr. ENGLER. I know I am out of time, as well, but if I can just finish the thought on—to take my example and stretch it a little bit further.

We used to have an investment tax credit in this country, a 10-percent credit. We now, in effect, with the way territorial works—

in my little example, the German company and the U.S. company, with the China money, the German company has that income and buys something here. If we bring our money home and buy something here, we first take a hit, a tax hit on that before we can make a purchase. Thus, that is why the Clydesdales get bought by ImBev, not the Clydesdales owning ImBev.

Senator WYDEN. Mr. Kleinbard, do you want to respond to that?

Mr. KLEINBARD. Yes. This is a very difficult issue, and I have spent the last 2 years working on this very issue. I agree with Governor Engler. We want the money to come home. We do not want a system that has $1.4 trillion of money trapped overseas, as is the case today.

That is silly. The current system is silly in that respect. But there are two solutions. One is a territorial system. The other is worldwide tax consolidation, because then you have already been taxed and you bring the money home. There is no extra cost.

So, for example, if you were to reduce tax rates to 24 percent, well, from memory, and I may be wrong here, but from memory, China's tax rate is 25 percent. So the worldwide tax consolidation would add no burden to a United States firm doing business in China.

The trouble with a territorial system is not the theory, but the practice. And, in fact, when you start looking at what sophisticated territorial countries like Germany have done, they have imposed all sorts of limitations, for example, on the deductibility of interest all over the world, including the parent company in Germany, that the member firms of the Business Roundtable would find extremely distressing.

So a well-designed territorial system that is robust to gaming, in fact, would raise revenue compared to current law in ways that would be viewed as troublesome to multinational firms.

Senator WYDEN. Mr. Chairman, my time is up. And I just want it understood that my goal is to reconcile these two viewpoints, because I think it is going to be necessary to pass a bill.

I can recall a conversation I recently had with a CEO who said, "I really like your bill. I love the fact you and Coats are doing it. If you get the corporate rate run down to 21 percent, we are on board."

I said, "Well, gosh, I'm kind of not in charge of this. Chairman Baucus is in charge. The President of the United States is in charge."

And we are going to have to have a lot of negotiations with respect to trying to find that sweet spot where we can be competitive and create family-wage jobs in this country.

I mean, maybe you know this off the top of your head, Mr. Kleinbard, but I think Singapore has a rate of like 10 percent or something like that.

Mr. KLEINBARD. It is something in that neighborhood, yes, sir.

Senator WYDEN. So businesses come to me and say, "We are not going to get the rate down to 10 percent." But we can walk out of this debate with a competitive rate and then get to where you just described, Mr. Engler, which is some semblance of certainty and predictability so your businesses around the country can plan, be-

cause that is what I found this summer: all they said is, just get away from this 1-year or another kind of thing.

And, colleagues, I think if we do not get the kind of cooperation Chairman Nelson and Senator Crapo are talking about, we will have a debate in the lame duck session of 2012 that is just along the lines of the lame duck session of 2010. We will be right back talking about extending a dysfunctional, broken system rather than getting the kind of family-wage jobs that these outstanding witnesses would have.

So I really encourage the work of you, Chairman Nelson and Senator Crapo, and look forward to working with you all in a bipartisan way.

Senator NELSON. This is clearly a moment in time in which we could get something done with the Super Committee.

Senator Crapo?

Senator CRAPO. Thank you, Mr. Chairman. I appreciate you letting me go next and out of order, because I have to run to another engagement. But with this group of experts present, I cannot resist asking this one last question.

There has been a lot of discussion by every member of the panel today about the fact that we have to get our deficit under control and that we may have some differences among us as to what portion of that problem relates to overspending versus the tax code or what-have-you.

But we now have a special committee operating, and it is working to get about $1.2 trillion, minimum, of additional deficit reduction from where we have already gone in this Congress.

I am one of those who believes that that is not enough, and the reason I believe that is, as you know, I served on the Bowles-Simpson Commission. Its proposal would have reduced the deficit over 10 years by about $4.7 trillion, leaving aside how you get there, the spending and the other policies.

The broader picture of, how far do we need to get is the question I am asking. If you took the $4.7 trillion figure and played it out for 10 years, assuming Congress did not get around it somehow and that it worked, even after that was all done, we have barely just kept our head above water, as I understand the facts, meaning that our debt-to-GDP ratio would be about the same as it is today, although it would not have skyrocketed like it will with no action. Our national debt would still be $12 trillion or more.

And the point I am making is that it seems to me that our Nation, in terms of setting a target, needs to be looking at somewhere at least in the $4 trillion to $5 trillion neighborhood of deficit reduction now in terms of our plan for the next decade.

And I would just like to ask each member of the panel if you could quickly react to that in terms of what you think our target ought to be or how bold do we need to get in terms of our deficit reduction as we try to work on some of these proposals.

Mr. GREENSPAN. Senator, I think the $4 trillion is a minimum, and one of the reasons I believe that is I think that the current services budget projections are not—the current services projections of the deficit are too low and that what we do know, when you look at history, is that there is a tendency on the part of any-

body who does budget analysis in government to be optimistic, and the problem is it does not work out that way all the time.

And just taking a second to comment on this issue of uncertainty. One of the measures that I find very riveting is the fact that currently, if you look at non-financial corporations in the United States, usually, they will spend approximately what their cash flow is.

Today, they are at the lowest level of investment in long-term illiquid assets of any time relative to cash flow since 1940.

The whole level of uncertainty is also reflected in equity prices in the sense that the equity premium, which is a measure of the extent of what those who issue stock require in order to sell an issue, that equity premium, according to JP Morgan, is at the highest level in 50 years.

So the level of uncertainty is deep. It is partly related to the tax issue and especially the permanence issue, because you can almost argue that it is the impermanence of the tax code which creates degrees of uncertainty, which makes investment in 20-year assets very difficult to do.

Before I was in government, I served on innumerable corporate boards in which I was involved in making projections of long-term capital investment procedures, and I will tell you that the degree of stability of long-term tax expectations played a very important role, not in the average expected rate of return on a particular investment, but its variants. And once you start putting variants on a number of these investments, the risk premiums become prohibitive.

So I think that a focus of this committee and, indeed, the whole process has got to be, for once and for all, let us get a structure of taxation which is not constantly subject to change and is not constantly subject to things such as tax expenditures which are funding every single thing you can think of, because it is more difficult to get it through the appropriations process.

Senator CRAPO. Thank you.

Dr. Taylor, what should our target be?

Dr. TAYLOR. I originally estimated it would be $6.2 trillion relative to the President's first budget.

I think if the Joint Select Committee gets its 1.2, there will still be about $3 trillion left to do. And what I mean by that, the amount that—if it is on the spending side, it takes spending to 19.5 percent of GDP.

In fact, I would suggest that some of this dialogue be transformed back into discussions, because these trillions over 10 years are a little much for people out there to really fathom.

But the idea of holding our spending, Federal spending to the same level it was in 2007, 19.5 percent, is something most people can understand, and it does add to the certainty. I would recommend that. But there is a long way to go.

On this uncertainty, predictability, permanence, I mean, 2 years ago, over 2 years ago, when the case was being made for temporary, targeted, timely tax cuts, I testified in the Budget Committee and said, "No, we need permanent, predictable, pervasive tax cuts," and created a little joking about alliteration, but that is where we had come to.

And you articulated very well, Senator, I think, the other position here is very important to remember.

Senator CRAPO. Thank you. I know I am out of time, but if the other three of you could quickly respond, I would appreciate it.

Dr. FELDSTEIN. If I remember correctly, the CBO number is that we are on a course now which would take us to about a 90-percent debt-to-GDP ratio. I think a reasonable goal would be to get it down to 60 percent and stabilize it there—it would be better to have it lower—but doing that requires taking out 30 percent of GDP over this period of time, and that means, roughly, $6 trillion less debt than is currently projected.

And then you have to, in order to stabilize it at 6 percent, you would need to get the budget deficit down to about 3 percent on an annual basis.

Senator CRAPO. Thank you.

Mr. ENGLER. And I would just say the employers are ready to do their part to try to get the growth rate up a little bit; that, if we are going to have a 9.2-percent unemployment rate, a GDP that can hardly get to 2 percent, we cannot cut enough for tax, and we will probably get ourselves out of the hole over the horizon.

Senator CRAPO. Thank you.

Mr. Kleinbard, you get the last word on this question.

Mr. KLEINBARD. CBO estimates that deficits at 2021 would run in the neighborhood of 1.5 percent of GDP, and that is, I think, in the ballpark of where we need to be.

The trouble is that, in doing that, CBO assumes the expiration not just of the individual tax cuts, but also all the business extenders. And when you add all that up, CBO is assuming $5.5 trillion more in tax revenue than we are collecting today.

What is more, and this is a point that I take Chairman Greenspan to have been emphasizing, the CBO also assumes constant growth. There are no hiccups in the CBO baseline.

So, if you want to build in a rainy-day fund on top of that, you are, unfortunately, talking about some number, compared to current policy, in excess of $6 trillion.

Senator CRAPO. Thank you.

Senator NELSON. Dr. Feldstein, what do you recommend that we do with the Bush tax cuts?

Dr. FELDSTEIN. Tell me what the economy is going to be like. I am afraid the economy is going to be very weak and, therefore, when I think about deficit reduction and reform, I think that we have to do the timing such that we do not take a weak economy and push it down even more.

I think there is, unfortunately, contrary to a lot of the both private and public official forecasts, I think that there is a 50-percent or better chance that we are going to go into a new recession.

I think consumers and businesses are not, under current circumstances, inclined to spend. And so I am afraid that, if that is where we are, it would be a mistake to let those tax cuts lapse.

Senator NELSON. Anybody on the panel, I would like you to opine on this. Do you have any favorites among the tax expenditures that you would like to get rid of that you particularly think are a drag on the economy, and where we can get the most effect in helping

not only the deficit situation, but the overall economy by eliminating that particular tax expenditure?

Mr. GREENSPAN. If you want me to just list one, the obvious one is ethanol, which, to an agricultural economist, would make a good deal of sense getting rid of that.

It strikes me that we have an impossible problem of a sluggish economy and the need to get more revenues. I do think we ought to keep in mind the studies that have been made with respect to reducing the problems of excess of, say, fiscal problems over the years.

Most who study this issue, including the IMF and a lot of academics, have come to the conclusion that, yes, an increase in taxes as a possible solution does contract economic activity, and, also, a cut in spending does, but nowhere near as much.

In fact, I think the actual verbiage that the IMF used was that the decline in GDP as a consequence of a reduction in spending was not significant in a statistical sense.

So I think we have to recognize that raising taxes is a problem. If somebody could say to me that we will cut spending by the amount of the Bush tax cuts, I would say that is great, because remember that the issue with the Bush tax cuts is not that they are sacrosanct in any respect, but that, if we go back to where we were before they were enacted—and, in fact, their enactment, in my judgment, was mistaken because there was a judgment there that the surpluses were going to continue indefinitely, and, in fact, they stopped in the third quarter of 2001.

And dealing with that sort of thing, you realize that you have a very tough decision to make. If we could find a way to cut spending enough to allow the tax cuts to go up—rather, to prevent the tax cuts from going up, that is the best of all possible solutions.

But in my judgment, as bad as the problems are, I think they would be worse if we find, as a consequence of this very sluggish period, we are going to end up with 110 percent of debt to GDP or something like that, which is going to be very difficult to pare, because paring is not simple when you are dealing with entitlements.

You cannot cut them in the way you can cut other spending, and it is going to be a very tough row to hoe. So my judgment is, let us—I grant you that enabling all of the tax cuts to lapse overnight is probably more than I would wish to see the economy taking, but at least put in place a phased-in program.

At the same time, try to really understand that the purpose of taxation, as I said before, is to fund spending, and unless and until we get spending down, all the discussion of the appropriate level of taxation is irrelevant.

Senator NELSON. Anybody else with a favorite tax expenditure?

Dr. FELDSTEIN. I would just make a point that follows on what Alan was saying. The studies that show that cutting spending is less contractionary or not contractionary at all relative to raising taxes, generally, those tax increases are increases in marginal tax rates or increases in business taxes, very different from reducing tax expenditures.

So I have asked the authors of these studies, do they have an answer? Does a tax expenditure reduction have the macroeconomic ef-

fects of a spending cut or the macroeconomic effects of a tax increase of a traditional sort, raising tax rates? And they say, "Well, we just don't have the experience to answer that."

But my hunch is that eliminating tax expenditures does not have the same kind of adverse effects, because it does not hurt incentives.

Mr. ENGLER. The only thing I could fall back on a little bit is some of the experience I had as a Governor where we, at the time I became Governor in Michigan, had some taxes that other States did not, and we had had a study done, and one of the things that it showed pretty clearly is that people were mobile and we were losing people.

And I think there has been some evidence lately in other States that tax increases have resulted in the relocation—the taxes on certain classes of people or income levels or whatever resulted actually in less revenue as they relocated residences to other States.

In fact, a good Oregon constituent is now a Las Vegas resident. Apparently, the legislature did some tax changes up in Senator Wyden's home State.

I think on the tax expenditure side, we are kind of presenting unprecedented testimony maybe today to say, look, let's put them all on the table, but let's then use them to achieve what, again, Senator Wyden mentioned: get that rate low.

If you start losing these—and I think the Finance Committee has—we are counting on you to champion to fight the poaching of these by other spenders or other interests around the Congress who have not studied the issue the way you have.

But you have to protect them in order, I think, to drive the rate down. If you lose them, you cannot go as low with the rate, and then you get a lot of different distortion and I think unequal effects.

None of these tax expenditures got here by themselves. They were voted in because somebody was persuaded they were a good policy decision at the time. But now we are saying, let us all come to the table, put everything on the table, and see if we can just flat out get a permanent, more competitive structure, and I think that is an interesting conversation, and I applaud you for holding the hearing.

Dr. TAYLOR. It seems to me there is a lot of agreement, uniform, that the focus on reducing spending growth should be the highest priority.

Chairman Greenspan indicated you should not worry too much about going too far with that. But even the proposal I laid out, which takes spending to 19.5 percent of GDP, spending keeps growing. There are no cuts in the sense that the Federal budget keeps growing.

And so I do not think it is a problem to—it is not draconian. It is not austerity. It is just something I think the American people want to have happen.

So the highest priority, it seems to me, is to do what Chairman Greenspan would like to do—he seems skeptical about the possibility that we will get there—go as far as you can on that and then worry about the extra revenues.

But in the meantime, the 1986 tax reform, revenue-neutral, lowering rates to stimulate growth is really what the aim should be.

Senator NELSON. At the same time, you have to have a tax code that people consider to be fair.

Any other comment about tax expenditures here?

Dr. FELDSTEIN. I would not eliminate the so-called tax expenditures for savings and investment. We talked about that. And, similarly, I would not eliminate it for charitable contributions.

The President's proposal to limit the charitable deduction to a 28-percent marginal tax rate—I did a calculation based on the extensive research that has been done on how charitable giving responds to the cost of giving to the taxpayer and, yes, the government would get additional revenue by putting that cap on. But, basically, every dollar that the government got came from the charities; the taxpayers would not have any less money available to spend on other things, because they would cut back their charitable giving by an equal amount.

That strikes me as a bad one to change because, unlike a lot of other tax expenditures which distort spending in a bad way, I put the charitable contribution, along with saving and investment, as something that we as a country ought to be in favor of.

Mr. KLEINBARD. Thank you, Senator. I just want to reiterate the point that Dr. Feldstein made in his earlier comments that not all tax increases are the same, and, in fact, some tax increases are spending cuts. That is the whole point of this tax expenditure discussion.

So, yes, we need to cut spending, but the way to cut spending is through eliminating tax expenditures. And, as Dr. Feldstein said, it is just an accident of accounting that we call that a tax increase.

The personal itemized deductions are not going to change the behavior. Eliminating those will not change behavior in the same way that raising marginal rates will, which is why I keep coming back to the idea that they, for better or worse—and I am sympathetic to the charitable contribution deduction—but for better or worse, they need to be eliminated as a way of doing the least amount of damage to economic incentives, to raise the revenue sufficient to support the spending path that we are already embarked on.

Senator NELSON. Chairman Greenspan?

Mr. GREENSPAN. There is one issue that I think needs to be addressed on this whole question of tax expenditures.

The experience following the 1986 tax legislation was very dispiriting, because I recall elaborate discussions with respect to bringing the marginal—expand the base, bring marginal tax rates down, and that was achieved in the 1986 bill.

The problem is, almost immediately we began to erode that process. And so, there is something inherent in our political process, which means that we need two things—one, get rid of a lot of issues of tax expenditures and other such things and broaden the base, but find a legislative vehicle which prevents it from eroding thereafter, because, if you have the same processes going today that existed post-1986, we may solve the problem now and find out we are back in 10–15 years having another cut at this problem.

Senator NELSON. You recall, at the outset, I mentioned how many new tax expenditures had been enacted since 1986.

Mr. GREENSPAN. As I recall, Mr. Chairman, it did not take very many days for a number of those things to come back in place merely because it was so easy to get them through, because they were relatively small and no one recognized what they really were.

Senator NELSON. Senator Wyden?

Senator WYDEN. I had nothing else, although I just wanted to say I very much share your views on that last point, Dr. Greenspan. No current Congress can ever totally bind a future Congress, but we sure can find some hoops that anybody who wants to unravel tax reform would have to go through once you get it passed, and there has been a lot of work done looking at some of those possibilities. And any ideas that you or panel members have would be very much appreciated.

I mean, literally, when you look at what has happened since 1986, there have been some studies that have shown there has been almost one change for every working day, year in, year out, which gets to the question that I asked Governor Engler and that you touched on very thoughtfully, which is the impermanence of it all.

But I think this has been an excellent hearing, Mr. Chairman. I have probably gone to about as many tax reform hearings as anybody around, and yours is really one of the best, and I appreciate it. And I appreciate all of the excellent testimony from our witnesses.

Senator NELSON. Well, Senator, we are at a moment in time that the body politic is poised to allow us to get out of our individual selfish interests, and I do not use that word derogatorily, because we have to, to look at the common weal, the common good.

And, if this hearing in any way serves to advance that possibility this year, then it has been a worthwhile 2 hours.

And to all of our panelists, we are deeply grateful to you for lending your expertise.

Thank you, and the hearing is adjourned.

[Whereupon, at 4 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Opening Statement of Hon. Mike Crapo
Subcommittee on Fiscal Responsibility and Economic Growth Hearing
"Examining Whether There Is a Role for Tax Reform in
Comprehensive Deficit Reduction and U.S. Fiscal Policy"

Thank you, Mr. Chairman, for holding this important hearing.

Deficit reduction, and fiscal reform more generally, is clearly the issue of the day here in Congress, and across the country, as it should be.

Today's hearing focuses on the issue of tax reform, and we have an outstanding panel of witnesses here to discuss this important issue.

The notion that comprehensive tax reform is greatly needed is not in dispute.

We would be hard pressed to create a tax code that is more complex, unfair, burdensome, inefficient and anti-competitive than the one we have now.

But there are many different positions out there as to when tax reform should take place, what should be the primary goals of tax reform, and what should be the key elements of tax reform.

Some have called for a combination of raising tax rates and modifying or eliminating tax expenditures as a way to raise revenue that would be dedicated to deficit reduction.

Other proposals, such as the Gang of Six proposal I was involved with, have called for pro-growth tax reform that lowers all tax rates, simplifies the tax code by eliminating many tax expenditures and reforms our corporate tax code to make U.S. businesses more competitive in the global marketplace, with the goal of this tax reform being a significant increase in economic growth. A byproduct of this increased economic growth would be the kind of additional revenue that we are not seeing in our current economy, not because current tax rates are too low, but because our economy is not growing.

History has shown that our annual total revenue as a percentage of GDP is about 18.2%.

This has been the case whether the top tax rate was 70% or 28% or 35%.

In booming times, we have seen temporary revenue spikes, and in times of low growth and high unemployment, as we have seen in recent years, we have seen dips in total revenue.

But, over time, we have always seen revenues return to their historic average, regardless of what Congress has done to the tax code.

In fact, annual revenues have only exceeded 20% of GDP three times in the last 70 years. Two of those years were at the end of World War II, when our nation was still running high deficits. The other time was in 2000, when annual revenue of 20.6% of GDP took place at the height of the stock market bubble. This temporary spike in revenue was bound to come down as soon as the bubble burst, which it did, at a time that coincided with the post-9/11 recession.

In fact, other than in the year 2000, of the 11 other times since 1940 when our budget has been in surplus, revenues were less than 20% of GDP, and in 7 of those 11 years, revenues were below 19% of GDP.

It is also important to note that our budget has NEVER been in balance when federal spending exceeded 19.4% of GDP.

Along those lines, I appreciate that many of our witnesses today note in their prepared testimony that, while tax reform is an important goal for Congress, fundamental entitlement reform must be a primary and immediate goal for Congress, as it is by far the primary driver of our long-term fiscal shortfall.

Nevertheless, even if we do cut trillions of dollars of spending, which we must do, so long as our economy remains in the tank and unemployment remains persistently high, policies that will generate the kind of robust economic growth that is currently nowhere to be found must also be a priority.

It is for this reason that I support the inclusion of pro-growth tax reform as part of a comprehensive fiscal reform plan that also includes fundamental entitlement reform and strict enforcement mechanisms that will not only get our nation on a more stable budgetary path, but will keep future congresses from diverting from that path.

I look forward to hearing the testimony of our witnesses today about how best to accomplish these goals.

Thank you, Mr. Chairman.

Written Statement of
The Honorable John M. Engler,
President, Business Roundtable

Before the
United States Senate Committee on Finance
Subcommittee on Fiscal Responsibility and Economic Growth
Hearing Examining Whether There is a Role for Tax Reform in
Comprehensive Deficit Reduction and U.S. Fiscal Policy

September 13, 2011

Overview

Chairman Nelson, Ranking Member Crapo, and distinguished members of the Committee. The topic of today's hearing is one of the most important issues that Congress will tackle over the coming months. I appreciate the opportunity to share the views of the Business Roundtable on this very important topic.

Business Roundtable (BRT) is an association of chief executive officers of leading U.S. companies with over $6 trillion in annual revenues and more than 14 million employees. BRT member companies comprise nearly a third of the total value of the U.S. stock market and invest more than $150 billion annually in research and development -- nearly half of all private U.S. R&D spending. Our companies pay $163 billion in dividends to shareholders. BRT companies give nearly $9 billion a year in combined charitable contributions.

Deficit reduction is a national imperative. Except for World War II, the federal debt of this country has never been larger as a share of income than today -- and under many projections the United States is on an unsustainable path of continuing increases in debt burdens relative to our country's ability to service it. At the same time, the U.S. economy suffers from stagnating economic growth and insufficient job creation. Not since the Great Depression has the need for job creation been greater.

There are no easy solutions to these two issues, and some will argue that anything you do to improve one will only worsen the other. While not a magic bullet, strategies designed around maximizing economic growth do provide a win-win solution. Economic growth strategies create jobs, increase wages, and improve the standard of living of Americans. Economic growth also reduces the burden of any amount of outstanding debt relative to national income. Economic growth results in more revenue for the government and makes any given level of government spending more affordable as a share of national income.

The desire for economic growth is bipartisan. To improve economic growth, we need to reexamine a host of existing laws and regulations, and impose strict cost-benefit rules on new ones. This is true across the board, in every government agency and every sector of the economy.

My testimony today focuses on one such area -- the topic of your hearing -- the important role of tax policy toward business to promote economic growth and improve the ability of American workers to compete in the fast changing world economy. Corporate tax reform done right can grow the economy by enhancing the ability of every company operating in the United States, whether domestically headquartered or foreign, to better compete in the world economy.

There are no secrets as to the elements that U.S. corporate tax reform must encompass. The U.S. corporate tax system has failed to keep pace with the changing global economy. Today the U.S. corporate tax system is an outlier at a time when capital is more mobile and the world's economies are more interconnected than at any time in history. Our current tax system discourages U.S. companies from competing abroad and it discourages capital investment in the United States. It is quite possibly the least competitive tax system in the entire OECD. The end result of this tax system is a more slowly growing capital stock of both physical capital and intellectual property, reducing the productive capacity of the U.S. economy and resulting in fewer jobs and lower wages than under the tax systems of our trading partners.

Tax reform that makes our corporate tax system more competitive should follow the tax systems of our trading partners. American corporations should be taxed on their active business operations only on the income generated from their U.S. activities, as under the territorial tax systems of our trading partners. And the statutory rate of tax should be brought down substantially for all corporations. Many have talked about a 25 percent tax rate. Indeed, when combined, a 20 percent federal rate and 5 percent state rate would create a U.S. statutory tax rate equal to the average of our trading partners. These recommendations are largely those of the President's Fiscal Commission, chaired by former Senator Alan Simpson and Erskine Bowles, on which four members of this subcommittee served with distinction.

And like the recommendations of the President's Fiscal Commission, Business Roundtable believes that these reforms can be undertaken in a fiscally responsible manner, with the cost of these reforms to be offset as much as possible through aggressive base broadening in ways similar to the practices of our trading partners.

In evaluating the cost of adopting such reforms, it is important to measure revenue neutrality against the revenue stream that the government would otherwise have collected. In doing so, I urge you to consider that many provisions in the tax code, although they may have statutory expirations, have been routinely extended year after year. In the case of the R&D tax credit, it has been part of the tax code for the past 30 years, extended on 14 separate occasions. Provisions that have been repeatedly extended are realistically part of the baseline against which the revenue from a reformed tax system should be measured.

This simpler, flatter, lower rate tax system would boost long-term economic growth by attracting investment to the United States, increasing the growth of U.S. companies and their

domestic employment, and making the United States an attractive location for multinational businesses.

Some will argue that instead of tax reform, business tax increases should be used for deficit reduction now, with tax reform to be delayed to another time. I strongly urge you to reject such a path. Corporate tax reform is essential to increase U.S. competitiveness, jobs, and economic growth. Not only will business tax increases set us in the exact opposite direction -- less competitive American businesses, fewer jobs, and reduced growth -- it will make the eventual task of tax reform even harder as any remaining base broadening will look far less attractive and the ability to make positive changes to the tax code all the more challenging. Comprehensive tax reform is a challenge, but it will not get easier by making piecemeal changes in the tax base to raise revenue in legislation that fails to address the fundamental reforms that can help achieve a higher U.S. standard of living.

A Troubled Economic Landscape

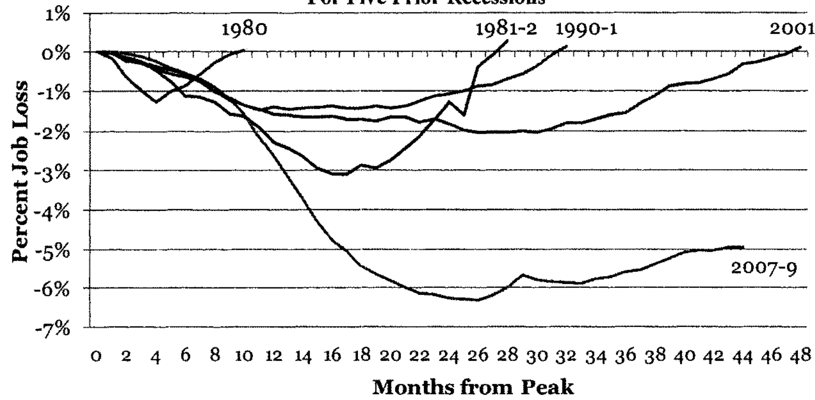
While the official scorekeepers declared the 2007 recession ended more than two years ago, the U.S. economy remains very weak, unemployment is unacceptably high, and the economic news of the past few months suggest these conditions are likely to persist without better economic policies.

The official unemployment rate is 9.1 percent with 14 million workers unemployed. Others note the rise in the large number of people who are omitted from these figures, either because they have stopped looking for work as they wait for better prospects or they are working part-time while desiring full-time employment. Using this broader concept of unemployment, more than 25 million Americans need a job -- or 1-in-6 of the American workforce.

With ongoing growth of the working age population exceeding the new jobs created each month, the "job gap" confronting us gets worse. Brookings economists calculate that it would take almost 12 and a half years -- not until 2024 -- to return employment to the same percentage of the working age population as before the recession under the optimistic assumption that we continuously add 208,000 jobs per month (representing average monthly job growth in the best year of the past 10 years) for the next 12 and a half years. Clearly, this is too long for the unemployed and those entering the labor force to wait. Yet some might argue, our current policies are insufficient to even generate employment gains this rapidly.

As Figure 1 on the next page shows, now 44 months since the start of the recession, payroll employment remains 5 percent below its 2007 level. This recession is far deeper and its effects far more lasting than any of the prior recessions we have faced in modern history.

Figure 1.--Percent Change in Payroll Employment from Peak Employment For Five Prior Recessions



Source: Bureau of Labor Statistics, U.S. Department of Labor, September 2011.

Employment follows economic growth. Over the past six months, gross domestic product has grown at less than one percent and over the past four quarters by only 1.5 percent. In contrast, following the deep 1981-1982 recession, GDP growth was 7.7 percent in the first year of the recovery and 5.6 percent in the second year.

According to the latest *Blue Chip* economic forecast, economic growth in 2012 is forecast at just 2.2 percent, after only 1.6 percent growth this year. We have a growth deficit where we are failing to grow sufficiently to add new jobs and bring down unemployment.

Tax policy must focus on growth. One doesn't have to be a supply-sider to understand that some taxes are more destructive to job creation and economic growth than other taxes. Economists generally agree that the corporate income tax is one of the most harmful taxes to job creation and wage growth. Tax reform that makes American companies more internationally competitive in foreign markets and that brings down the corporate rate to attract investment will grow the economy, providing the steady long-term growth that makes a real difference.

If sound corporate tax reform and other reforms to our laws and regulatory systems resulted in the economy growing just a half percentage point faster year after year, this economy would provide millions more jobs for Americans and faster growing wages for this generation and future generations of American workers. We can grow the economy and we must.

America's Companies and America's Workers Face a Hyper-Competitive World

As New York Times columnist Thomas Friedman wrote in his 2005 book of the same name: "the world is flat." American companies and American workers have never faced such strong competition from around the globe, both in competing for consumers in our domestic market and abroad.

Reductions in the cost of communication and transportation, falling trade and investment barriers, and increasing incomes of consumers around the world have opened the door to competition on a truly global scale. With 95 percent of the world's consumers outside the United States, competition for these markets is fierce for American companies.

Cross-border investment has become an increasingly important way in which modern business activities are conducted. U.S.-headquartered companies today account for less than one-fourth of all cross-border investment in the world, down from about 40 percent in the early 1980s.[1] In other words, cross-border investment of foreign-headquartered companies is now three times greater than that of U.S.-headquartered companies.

This intense competition means that American-headquartered companies are no longer the dominant companies in most foreign markets. Measured by total sales, just eight of the largest 20 companies in the world were American companies in 2011, down from 13 in 1985 and 17 in 1960. A decline in America's competitiveness in world markets results in fewer American jobs, lower wage growth, and a more slowly growing economy.

Research confirms that there is a significant connection between the success of American companies and the growth of jobs and wages of American workers. When American companies succeed in world markets, they also add jobs at home and expand the U.S. economy.

American-headquartered multinational companies support 63 million American jobs: they directly employ 22 million Americans in their U.S. operations and they support an additional 41 million jobs through their U.S. supply chains. In 2008 American multinationals purchased $1.52 trillion in supplies from American small businesses.

American multinational companies are responsible for significant growth of productivity in the United States. Higher worker productivity in turn is the key determinant of higher wages and a higher standard of living for American workers. A Federal Reserve Board study finds that American companies with international operations are responsible for more than three-fourths of the increase in labor productivity in the U.S. corporate sector between 1977 and 2000 and all of the labor productivity growth in the U.S. corporate sector in the late 1990s. Higher productivity results from greater use of advanced technology, organizational efficiency, and innovation spurred by R&D.

Further, according to analysis of the Bureau of Economic Analysis, this productivity advantage increases with the global scope of a company's operations. In 2008, American companies

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[1] See Business Roundtable, *Taxation of American Companies in the Global Marketplace: A Primer* (April 2011) for complete sources and references to material in this section.

operating in 10 or more countries had 54 percent greater value added per employee than those companies operating in just one foreign country and 21 percent greater value added per employee than companies that operated in two to nine foreign countries.

America's businesses have the capability to expand into world markets and deliver the highest quality and most innovative products to consumers. But we are currently competing on a tilted playing field with an antiquated tax code developed for a different era. Tax reform can level the playing field and allow American businesses and their American workers to compete at home and abroad against the best foreign businesses in the world.

U.S. Corporate Tax Reform: Worldwide vs. Territorial Tax Systems

Current U.S. tax policy fails to recognize the value contributed to our economy by successful American companies with worldwide operations.

We would never think to tax a foreign-headquartered company on their earnings outside the United States, but our current law imposes tax on the worldwide income of U.S.-headquartered companies by virtue of their being incorporated in the United States. In effect, we treat U.S.-headquartered companies less favorably than foreign companies by this disparate tax treatment.

The trend over the past 15 years among OECD countries has increasingly been away from worldwide systems of this type toward "territorial" systems under which the country of incorporation exempts active foreign business income from domestic taxation. Today, 26 of the 34 OECD countries employ territorial tax systems, with Japan and the United Kingdom the most recent to adopt this system in 2009. Of the 26 territorial countries in the OECD, 18 fully exempt foreign earnings while eight exempt 95 percent to 97 percent of foreign earnings (see Table 1, next page).

Table 1.--OECD Home Country Method of Tax of Foreign-Source Dividends

Method of Taxation	Countries		Dividend Exemption Percentage
Territorial Tax Systems	**OECD Countries with Territorial Tax Systems**		
Exempt foreign-source dividends from domestic income taxation through territorial tax system[1]	Australia, Austria, Canada, Czech Republic, Denmark, Estonia, Finland, Hungary, Iceland, Luxembourg, Netherlands, New Zealand, Portugal, Slovak Republic, Spain, Sweden, Turkey, United Kingdom		100% exemption
	Norway		97% exemption
	Belgium, France, Germany, Italy, Japan, Slovenia, Switzerland		95% exemption
Worldwide Tax Systems	**OECD Countries with Worldwide Tax Systems**		
	Country	**2011 Tax Rate**[2]	
Worldwide system of income taxation with deferral and foreign tax credit	Chile	17.0%	0% exemption
	Greece	20.0%	0% exemption
	Ireland	12.5%	0% exemption
	Israel	24.0%	0% exemption
	Korea	24.2%	0% exemption
	Mexico	30.0%	0% exemption
	Poland	19.0%	0% exemption
	United States	**39.2%**	0% exemption

[1] In general, territorial tax treatment providing exemption of foreign-source dividends depends on qualifying criteria (e.g., minimum ownership level, minimum holding period the source country, income tax treaty status, and/or the source country tax rate).
[2] Refers to generally applicable tax rate, including surcharges, of combined central and sub-central government taxes.

The seven OECD countries other than the United States that employ worldwide tax systems have tax rates significantly below the United States (an average rate of 21 percent), and, excluding Ireland (which has a 12.5 percent tax rate), undertake little foreign investment (together accounting for less than 2 percent of the world's outward foreign direct investment).

A territorial tax system would allow American companies to compete on a level playing field in foreign markets. Under current law when a U.S.-headquartered company is competing abroad against a foreign-headquartered company, it must factor in the higher rate of tax it will pay on its foreign earnings when it brings these earnings home. This higher rate of tax makes the U.S.-headquartered company less competitive relative to its competition -- it can only successfully compete if it is sufficiently more productive to overcome this tax disadvantage and still earn a competitive rate of return on its investments.

The unfortunate outcome is that the United States is giving away markets to foreign-headquartered companies that may be less efficient than our American companies because American companies cannot overcome this extra tax hurdle imposed by our worldwide tax system. By reducing the market potential of our American companies, their U.S. operations are smaller than they would otherwise be, their U.S. employment is reduced, and their purchases from U.S. suppliers are reduced. Each of these factors results in a contraction of the U.S. economy and fewer jobs and lower wages for American workers.

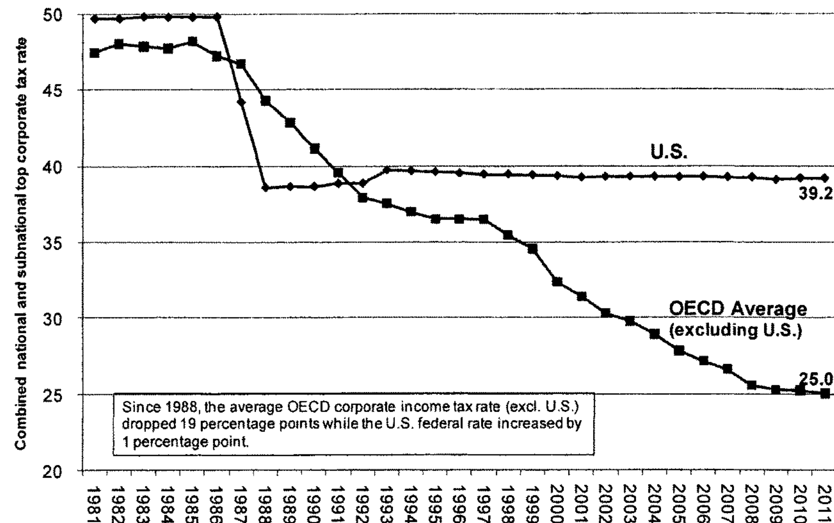
U.S. Corporate Tax Reform: Statutory Corporate Tax Rate

Another essential change to our tax system to promote economic growth is a significant reduction in the statutory corporate tax rate. The U.S. rate is out of step with our trading partners to the detriment of investment in the United States. The loss in investment and economic activity reduces economic growth and job creation.

According to the OECD, the U.S. statutory corporate tax rate (including deductible subnational taxes) was 39.2% in 2011, more than 50 percent higher than the 25.0 percent average tax rate for the rest of the OECD. The U.S. rate is the second highest among the 34 countries in the OECD, only fractionally below Japan's.

Since 1988, the average OECD corporate income tax rate (excluding the United States) has dropped 19 percentage points while the U.S. federal rate increased by one percentage point over the same period (see Figure 2, next page).

Figure 2.--Average OECD and U.S. Corporate Tax Rates, 1981-2011



Source: OECD Tax Database, 2011.
U.S. rate for 2011 is based on the 35-percent federal tax rate and average state taxes of 6.44 percent, which are deductible from federal taxes.

And reductions in the corporate rate continue as countries know this reform plays a significant role in attracting investment and boosting growth in their economies. For example:

- The United Kingdom reduced its rate in stages from 28% in 2010, to 26% in 2011, with announced budget plans to lower it to 25% in 2012 and 23% by 2014.

- Canada reduced its federal rate from 22% in 2007 to 18% in 2010, to 16.5% in 2011, and 15% in 2012. In 2012 the combined federal and provincial rate will be about 25%.

A substantially lower corporate tax rate would result in more investment in the United States by both domestic and foreign multinational companies.

An increase in capital investment translates into to an increase in jobs, wages, living standards and higher worker productivity.

Because of the effect of the corporate income tax on capital investment and wages, economic research suggests that a significant part of the corporate income tax is more appropriately

viewed as a tax on labor through a reduction of employment opportunities and wages—and not primarily a tax on the owners of capital, including shareholders.

A study by the Congressional Budget Office, for example, estimates that 70 percent of the burden of the U.S. corporate income tax is borne by American workers in the form of lower wages, with the remaining 30 percent borne by Americans through a reduced rate of return on their savings.

Recent research by the OECD concludes that the corporate income tax has the most adverse impact of economic growth of any tax.

In a 2005 study, the Congressional Joint Committee on Taxation compared individual income tax reductions and corporate income tax reductions and concluded that a reduction in the corporate income tax had the greatest impact on increasing long-term economic growth, due to increased capital investment and increased labor productivity

Our competitors have reduced corporate tax rates as a way to attract investment, create jobs, and increase wages. We need to do the same, especially at this time of stagnating wages and insufficient job creation.

Proposals

The U.S. should adopt a competitive territorial tax system comparable to those of our trading partners and reduce the federal corporate tax rate to a level that when combined with state income tax burdens results in a combined statutory tax rate no higher than the average of our major trading partners.

Together these proposals would boost the worldwide competitiveness of American companies, increase jobs for American workers, increase wages, and promote long-term economic growth for the United States.

Conclusion

It is clear that our economy suffers from many deficits -- the fiscal deficit, a jobs deficit, and a growth deficit. Policies directed at improving the long-run growth of the economy can help us bring down all three of these deficits.

Corporate tax reform is one of the most straightforward policies this Congress can undertake to promote economic growth. A simpler, flatter, lower rate corporate tax system that incorporates a competitive territorial tax system like our trading partners can provide the foundation for a U.S. corporate tax system designed to promote economic growth and job creation.

These are not abstract ideas. Nearly every one of our trading partners has a corporate tax system that resembles this proposal. The design elements of this reform are very close to those put forward by the co-chairmen of the President's Fiscal Commission.

Growth enhancing tax reform is an important element of a comprehensive deficit reduction program, but its benefits are even greater. It should be fully pursued.

On behalf of Business Roundtable, I look forward to working closely with this Committee toward this important goal, reducing the deficit, increasing economic growth, and putting the economy on a path of sustained job creation.

The Role of Tax Reform in Comprehensive Deficit Reduction and Fiscal Policy

Martin Feldstein*

Thank you, Mr. Chairman. I am very pleased to have this opportunity to testify on this important subject.

Our nation faces an enormous fiscal problem, with budget deficits that are projected, on overly optimistic assumptions, to be heading toward 100 percent of GDP. Preventing this explosion of our national debt is critical for our country's economic health.

Putting the deficits and debt on a declining path would create the confidence among households and businesses that is now needed to increase spending and jobs. Reducing the future government debt would also lower future tax rates and would contribute directly to capital formation and growth. I have discussed this subject extensively in a recent paper that I will submit for the record.[1]

Although this hearing focuses on tax reform, I must emphasize that tax reform is not a substitute for the fundamental reform of Social Security, Medicare and Medicaid, the main sources of the future growth of government spending. Unless those programs are changed, they will eventually force a doubling of our tax rates, with very adverse effects on economic activity and growth.

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* Testimony of Martin Feldstein to the Senate Subcommittee on Fiscal Responsibility and Economic Growth, September 13, 2011. Martin Feldstein is Professor of Economics at Harvard University.

[1] "Preventing a National Debt Explosion," NBER Working Paper 16451 (2010). forthcoming in NBER Tax Policy and the Economy, volume 25, 2011. Available as http://www.nber.org/papers/w16451.pdf

The key to those reforms is to reduce gradually the growth of the projected government benefits and to supplement those government benefits with universal investment-based annuities and health spending. Doing that would protect the future incomes and health care of older Americans without requiring higher future tax rates.[2]

Fundamental tax reform can strengthen the economy and improve the incentives that affect the behavior of households and businesses. I will focus this testimony on improving the individual income tax but will conclude with some remarks on corporate tax reform.

The Individual Income Tax

The tax code is full of special features that reduce tax revenue and that hurt the economy by distorting the way that individuals spend their time and their income. These tax rules lead to excessive household debt, overspending on housing, the high cost of health care, and other economic problems.

Many of these features of the tax code are substitutes for direct government spending. The law provides special tax breaks instead of government checks to encourage certain forms of household behavior. That's why they are called "tax expenditures" or "government spending through the tax code." They are wasteful in the same way that direct government spending would be.

The key to favorable tax reform is to limit the revenue lost because of these tax rules and to use the resulting extra revenue to reduce current and future marginal tax rates. Today's marginal tax rates are typically close to 50 percent for a middle income family because of the combined impact of the income tax, the payroll tax, and state taxes. Those high marginal tax rates reduce the incentive to work, to acquire more skills, to start or expand small businesses, to save, and to invest. They also induce individuals to seek compensation in nontaxable forms and to spend money in wasteful ways that generate tax deductions.

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[2] See section 3 of "Preventing a National Debt Explosion."

Limiting tax expenditures and using the resulting revenue to lower marginal tax rates would produce a double win: it would reduce wasteful behavior directly and it would strengthen incentives for increased economic growth. And that can be made a triple win by using some of the resulting revenue to reduce budget deficits.

Although limiting tax expenditures produces additional revenue, it is really a way of cutting government spending. The effect shows up in the revenue side of the budget but it is really a cut in spending. The accounting rules make it look like a tax increase but the economic effect is the same as any other reduction in government outlays.

I know that limiting tax expenditures is politically difficult. Every form of tax expenditure has some justification – just as every form of direct government spending has its justification. But reducing spending through the tax code is the key to better incentives and lower budget deficits.

Tax reform can reduce the revenue loss from tax expenditures without actually eliminating any of the tax expenditures or even putting limits on specific tax expenditures (like the size of the deductible mortgage). A better and fairer way to reduce the revenue loss caused by tax expenditures is to allow individuals to use all currently available tax expenditures but to limit the total tax benefit that each individual can get from those tax expenditures to a percentage of that individual's adjusted gross income.

Limiting the revenue loss from the itemized deductions and the exclusion of employer payments for health insurance to two percent of each individual's adjusted gross income would raise more than $275 billion at current income levels and more than $3 trillion over the next decade.[3]

This tax expenditure limit does not apply to the tax rules that encourage saving and investment, like the deduction for IRA contributions, the exclusion of the earnings in IRA and 401k accounts, and the lower tax

[3] For more details, see Martin Feldstein, Daniel Feenberg and Maya Macguineas, "Capping Individual Tax Expenditure Benefits," Tax Notes, May 2, 2011. Available at http://www.nber.org/feldstein/TAXNOTES-may2011.pdf

rate on capital gains. Although these features are counted as "tax expenditures" in the official government analyses, they have favorable effects on saving and investment and should therefore be preserved without limits.

The size of the cap could of course be started with a higher rate and gradually reduced to a two percent cap. Even a five percent cap would generate more than $100 billion of additional annual revenue at the current income levels.

Using the revenue from a two percent cap to reduce marginal tax rates would allow a 25 percent across the board reduction in rates - the current 35 percent rate could be cut to 27 percent and the 25 percent rate could be cut to 19 percent. Or some of that extra revenue could be used to strengthen saving and investment incentives by greater rate reductions on interest, dividends, and capital gains. And of course some of it should be used to reduce budget deficits, as the Bowles-Simpson commission proposed, thus reducing the national debt and the future tax burdens of paying interest on that debt.

A key point to stress is that the two percent cap in this proposal is applied to the tax expenditure benefit and not to the total amount deducted or excluded. For example, for someone with a 30 percent marginal tax rate who pays annual mortgage interest of $5,000, the related tax expenditure benefit would be $1,500.

There is a further benefit of capping tax expenditures - simplification. A two percent cap on tax expenditure benefits would cause nearly 75 percent of individuals who now itemize their deductions to shift to the standard deduction, an enormous tax simplification for tens of millions of taxpayers.

Corporate Tax Reform

Although I have focused this testimony on reforming the individual income tax, current corporate tax rules should also be reformed to strengthen the economy, increasing employment and growth. The two key features of desirable corporate tax reform are to lower the existing tax rate (now higher than that in every other country but Japan) and to

shift the form of taxation of foreign source income to the "territorial" system used in virtually every other industrial country.

I have discussed these reforms in a recent Wall Street Journal article[4] and in the report on tax reform options prepared for President Obama's Economic Recovery Advisory Board.[5]

I look forward to your questions.

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[4] "Want to Boost the Economy? Lower Corporate Tax Rates." WSJ February 15, 2011 available at http://www.nber.org/feldstein/wsj02152011.pdf)

[5] The Report on Tax Reform Options, President's Economic Reform Advisory Board, 2011, Parts IV and V

Dr. Alan Greenspan
Testimony before the Senate Subcommittee on Fiscal Responsibility and Economic Growth
September 13, 2011

A decade ago, the Federal Reserve embarked upon a serious effort to identify how the Fed's Open Market Operations, the core of monetary policy, could be implemented in an economy with projected surpluses that would eventually eliminate the availability of outstanding federal debt for Federal Reserve operations.

Those surpluses, regrettably, thoroughly undermined the fiscal prudence that had emerged in the 1990s. Chronic deficits back then fostered a fiscal regime of paygo and increasingly prudential fiscal policies. We viewed paygo as essential to stem budgets that were inherently prone to excess.

We have now come full circle to a point where, as much as I wish it were otherwise, there is no credible scenario of addressing our fiscal problems without inflicting economic pain. We have been procrastinating far too long in coming to grips with the retirement of the baby-boomer generation, a fiscal problem that has been visible for decades. By 2006, with chronic surpluses already a distant memory, the Trustees of Medicare Part A indicated, according to calculations by the Council of Economic Advisors, that:

> The Medicare program does not have enough projected revenue to cover projected future spending . . . A reduction in Medicare Part A expenditures by 51 percent would be necessary to make the Medicare Trust Fund solvent.[1]

But rather than repairing that huge shortfall, and a lesser one in Social Security, we expanded entitlements still further, without a matching source of revenue.

Our major problem is not only that spending has been rising rapidly, but that it has been in the form of entitlements, rather than of discretionary outlays such as war spending or bridge

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[1] *Economic Report of the President*; February 2007; pg. 93.

building that cease when the activity comes to an end. Entitlements, however, once bestowed, are very difficult to rescind.

The growth of our economy in the years ahead is bound to slow. The retiring baby-boom generation is the most skilled and productive of the current cohorts of our labor force. They are being replaced by the younger people who, as students, did so poorly in 1995 and since, in international test score comparisons in math and science.[2] As a consequence, their incomes, a proxy for their relative productivity, have trailed the relative incomes of previous new labor market entrants, enough to subtract as much as a tenth of a percentage point in annual productivity growth – a number which cumulates to significance over time.

Moreover, the growth of our civilian labor force, short of a major change in immigration, should parallel a slowing in the growth of the working age population, most of whom are already born. Professor Robert J. Gordon of Northwestern University has concluded that his most recent twenty year forecast of the growth rate of per capita real GDP "represents the slowest growth of the measured American standard of living over any two-decade interval recorded since the inauguration of George Washington."[3]

In the years ahead, increasing entitlements will be pressing against shrinking economic growth. The Congressional Budget Office's August forecast was based on data published prior to the Bureau of Economic Analysis' major downward revision of GDP for recent years.

My preference going forward, as I have noted on previous occasions, is something akin to the budget recommendations of Paul Ryan, the Chairman of the House Budget Committee. I regret, however, for now at least, that Ryan's budget lacks the votes for passage. And, as

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[2] TIMSS.

[3] Gordon, Robert J. *Revisiting U.S. Productivity Growth over the Past Century with a View of the Future,* NBER Working paper No. 15834, March 2010.

European current experience underscores, delays in implementing policy reform can be destabilizing.

Of the politically feasible budget proposals on the table, that proffered by the Bowles-Simpson National Commission on Fiscal Responsibility and Reform, appears most substantive.

What impressed me most of Bowles-Simpson is that it addresses tax expenditures. Cuts in tax expenditures can be alternatively structured, and viewed, as cuts in outlays rather than a reduction in revenues. The deduction for interest on home mortgages, for example, could just as easily have been reconstituted as a subsidy payment to homeowners. Similarly, oil and gas depletion allowances could be restructured as subsidies to producers. Subsidies, I might add, of whatever stripe, distort the optimum functioning of markets, and ultimately, the standard of living of society as whole.

I do not know whether a budget crisis is immediately on the horizon or is years off. What I do know is that if we presume that we have a year or two before starting long-term restraint, and we turn out to be wrong, the consequences could be devastating. If currently we are wrong in being overly fiscally cautious, that is a problem that is readily solvable.

TESTIMONY OF PROF. EDWARD D. KLEINBARD

HEARING TITLED

"THE ROLE OF TAX REFORM IN COMPREHENSIVE DEFICIT REDUCTION AND U.S. TAX POLICY"

U.S. Senate Committee on Finance

Subcommittee on Fiscal Responsibility and Economic Growth

September 13, 2011

Chairman Nelson, Ranking Member Crapo, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Edward Kleinbard and I am a Professor of Law at the University of Southern California's Gould School of Law. From 2007-2009 I was privileged to serve as Chief of Staff of the Congress's Joint Committee on Taxation.

I. SUMMARY OF TESTIMONY.

- There is a broad bipartisan consensus that the long-term fiscal policies of the United States are unsustainable.
- In grappling with the enormity of our adverse budget deficit trends, it is extremely helpful to divide our economic and fiscal problems into three time buckets: the short-term (perhaps the next two years), the medium-term (Years 2-10) and the long-term (the next several decades).
- The short-term crisis is about jobs; tax reform can do little to help here.
- The long-term problem is entitlements spending, particularly spending on healthcare. The United States today spends much more on healthcare per capita than does any other developed economy in the world. *If the United States were to expend per capita what Norway (the second place country) does on healthcare, our aggregate healthcare spending (public and private) would immediately*

decline by some $800 billion/year. Our per capita government share of our total healthcare spending is the second highest in the world.

- While long-term entitlement spending reform is critical, we must "boil the frog slowly," to borrow a phrase from Chairman Baucus. Both our citizens' expectations and our healthcare delivery institutions are built around current policies. Change must follow a predictable path that starts in the near future, phases in slowly, and comes to rest with new institutions that will serve the needs of Americans for decades to come. The requirement that we boil the frog slowly in turn has important implications for tax revenues.
- Tax reform and tax policy are most relevant to the medium-term horizon. This period must serve as the bridge from where we are to the more sustainable package of government spending and taxing that we need to reach.
- Current levels of nondefense discretionary spending are modest by world norms. This "spending" includes some items, like infrastructure, that are bona fide investments with long-term economic benefits.
- Defense discretionary spending, by contrast, is the other great outlier in U.S. government spending policies. *By one estimate, the United States spends as much on its military as do the next 14 countries combined – 42 percent of the entire world's military expenditures.*
- This implies that, unless we completely rethink our defense policies, spending cuts cannot by themselves fund all of our deficit reduction requirements in the medium term. Whatever the long-term world we transition to, we will need to finance the costs of getting there, and that in turns means higher tax revenues than those we currently collect.
- The United States is an extraordinarily low-taxed country by world norms – the fourth lowest in the OECD. And even by our own standards we are collecting historically low levels of tax – below 15 percent of GDP for 2009-2011. This level of revenues cannot be reconciled with our outsized spending on healthcare and defense.

- By all measures, the United States can afford to increase the total taxes it collects as a fraction of GDP. Just a decade ago, the country ran budget surpluses and enjoyed both a robust economy and job growth, while tax collections exceeded 20 percent of GDP.

- CBO budget projections show us running deficits (albeit relatively small ones) 10 years from now, even with the assumptions that (i) we enjoy uninterrupted growth over those 10 years and (ii) the "Bush tax cuts" (more neutrally, the "2001-03 temporary individual tax discounts") will all expire at the end of 2012. *By contrast, extending these tax discounts indefinitely will add some $4.6 trillion to our cumulative deficit.*

- We therefore have no practical choice but to raise the level of tax collections in the medium term to the range of 20 percent of GDP, as implied by the CBO baseline, to finance our gradual transition to more sustainable long-term entitlement policies. Discretionary spending cuts also will be useful, but cannot handle the entire burden if we are to maintain even minimum levels of developed country government services.

- *The CBO baseline effectively must also serve as the tax reform base case.* We should assume the lapse of the 2001-03 temporary tax discounts, and ask, how can we raise about the same amount of revenue, or maybe a little more, but in a smarter way?

- This in turn means that we have to abandon our nostalgia for the Tax Reform Act of 1986. That tax reform effort was revenue neutral, because it could afford to be. (It also was preceded and followed by major tax increases.) The fact that we have to raise revenue today means that this tax reform effort will look different, not that it is impossible. We should not hold ourselves prisoners to tax nostalgia.

- Specifically, I propose the following as the tax reform "Base Case" – the stalking horse that we can seek to improve, while maintaining the same level of revenues, or a little more:

- In general, allow the 2001-03 individual tax discounts to lapse at the end of 2012.
- Restore the estate and gift taxes to their 2009 levels, preferably as of January 1, 2012. (This actually has a roughly $260 billion cost relative to the CBO baseline.)
- Maintain current policy's prescription that corporate dividends should be taxed at the same rates as long-term capital gain. (This proposal loses revenue relative to the CBO baseline but has strong policy justification.)
- Add a new top marginal tax rate of, say, 42 - 44 percent for incomes above $2 million. (The idea would be to find the income level that would raise revenues sufficient to fund the dividend tax reduction.)

- We can do better than this Base Case. The straightforward goals of an incremental reform of the personal income tax (which includes the 1986 Tax Reform Act) should be (1) to raise the targeted level of revenues with (2) the desired distributional consequences while (3) keeping *marginal* tax rates – the tax imposed on your last dollar of income – as low as possible.
- Raising average tax rates without raising marginal rates (beyond the expiration of the 2001-03 tax discounts) requires broadening the tax base. Unlike in1986, when the tax system overflowed with unintended tax shelters that could be cleaned up and traded off against lower rates, this means directly tackling some of the deliberate Congressional subsidy programs baked into the tax code, which is to say, tax expenditures.
- Of all current law's tax expenditures, the most important to address in tax reform are the personal itemized deductions, such as the deductions for home mortgage interest, charitable contributions and state and local taxes. They are extraordinarily costly subsidies – about $250 billion/year in forgone tax revenues. They are inefficient, in that they lead to major misallocations of economic resources, particularly with respect to housing. They are poorly targeted, in that the government subsidies go to individuals who would have behaved the same

without the subsidies. And they are unfair, in that they are "upside down" subsidies – they subsidize high-income Americans more than low-income ones.

- *Tax Policy Center has estimated that eliminating the subsidies for personal itemized deductions would increase tax revenues in the neighborhood of 1.5 percent of GDP, over and above the lapse of the 2001-03 temporary tax discounts.* This is an enormous revenue pickup; it could be used for deficit reduction or to mitigate the tax rates implicit in the Base Case. The elimination of these subsidies also would simplify the tax code greatly and increase its progressivity. Moreover, their elimination would large remove the need for an AMT "patch," because it is these deductions that drive most taxpayers into the AMT in the first place.

- I fully recognize that the home mortgage interest deduction and other personal itemized deductions invariably are described as "sacred cows." *But they are sacred cows that we can no longer afford to maintain.* Either we eliminate these sacred cows, or we allow them to stampede over us.

- The elimination of personal itemized deductions must be phased in. For example, the deductions could be removed ratably over the 5-year period 2013-17, ideally by turning them into tax credits where the credit amount declines to zero over that time.

- Tax reform also should address the corporate income tax. Its 35 percent rate is much too high by current world norms. At the same time, U.S. multinationals have become extremely adept at gaming the current U.S. system, and those of other high-tax countries around the world, through the production of what I call "*stateless income*" – income that is taxed essentially nowhere. The U.S. corporate tax base is being systematically eroded through these stateless income tax planning strategies.

- A revenue-neutral tax reform package should be fashioned along the following lines:

    - Eliminate business tax expenditures, all of which represent Congressional meddling in matters best left to the markets.

- o Reduce the corporate tax rate to something in the range of 25-27 percent.
- o Tax multinationals on their worldwide income.

- The resulting corporate tax system would represent a huge competitive boost for American domestic firms, would attract inward investment, and would provide a fair tax environment for U.S.-based multinationals.

II. <u>THINKING ABOUT THE DEFICIT.</u>

There is a broad bipartisan consensus that the long-term fiscal policies of the United States are unsustainable. I therefore wish to make only a few brief observations about our overall deficit trends.

First, the passions of our fractious political dialogues often make it difficult for us to think objectively about our problems. Like a couple with marital difficulties, we might sometimes benefit from considering the perspective and advice of dispassionate outside professionals. In this regard the Organization of Economic Cooperation and Development (OECD) – a supranational organization of over 30 member countries, most of which have developed economies with at least some similarities to that of the United States – adnd other international organizations such as the IMF have done a great deal of useful work showing how the United States is doing in comparison to other countries, and drawing from that some straightforward advice. By concentrating on cross-country comparisons, this work supplements the nonpartisan and enormously valuable analysis provided by the Congressional Budget Office, the Congressional Research Service, and the Staff of the Joint Committee on Taxation.

Second, in grappling with the enormity of our adverse budget deficit trends, it is extremely helpful to divide our problems into three time buckets: the short-term (perhaps the next two years), the medium-term (Years 2-10) and the long-term (the next several decades). The issues in each time horizon are different, and so too are the best tools to apply to each.

1. *<u>Short-Term</u>*. The short-term fiscal crisis is not a crisis in financing the national debt; Treasury borrowing rates are at near-record lows. Nor is there a crisis in the

availability or cost of capital for the private sector, except perhaps in some continued difficulty in access to bank borrowings by small or less creditworthy firms.[1] Instead, we face an immediate jobs crisis. This topic, however, is far afield from my understanding of the purpose of today's hearing, and tax reform would have little immediate impact on this problem.

2. *Long-Term*. The long-term fiscal crisis confronting our country is in large measure a spending problem, driven to a surprisingly large degree by one paramount issue: healthcare spending, and to a much lesser extent by Social Security. The Congressional Budget Office has projected that government spending on Social Security and healthcare will amount to 12 percent of GDP in 2021. In 2007 that figure was 8.2 percent, and in 1970 3.8 percent.

These adverse spending trends reflect to a significant extent the inescapable demographic fact that our population is growing older.[2] That fact in turn has direct implications for the level of tax revenues required to provide basic services to an aging population, and also to the design of these entitlements programs.

OECD data are extremely useful in helping us to see just what an outlier the United States is *today* in respect of healthcare costs. The United States today spends much more on healthcare than does any other developed economy in the world. This is true when measured as a percentage of GDP:

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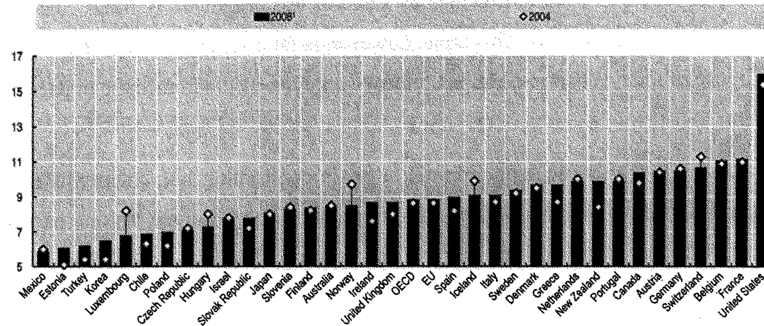
[1] See, e.g., Richard Bravo, *Bank Loans to Companies Defying U.S. Slowdown*, Bloomberg News, Sept. 7, 2011.

[2] This of course is a universal phenomenon in developed countries. See, e.g., OECD, *OECD in Figures 2009*, at 6-7.

Figure 3.23. **Health expenditure**
Percentage of GDP



Note: Users of the data must be aware that they may no longer fully reflect the current situation in fast reforming countries.
1. 2007 for Australia, Denmark, Greece and Japan; 2006 for Portugal.
Source: OECD (2010), *Health Database.*

StatLink http://dx.doi.org/10.1787/888932373514

(Source: OECD, *Economic Policy Reforms: Going for Growth 2011* at 174.)

It also is true when measured as dollars spent per capita. In 2009, the United States spent $7,960 per capita on healthcare, by far the highest in the world; the next most profligate country, Norway, spent $5,352 per capita.[3] *If the United States were to expend per capita what Norway does on healthcare, our aggregate healthcare spending (public and private) would immediately decline by some $800 billion/year.*

More remarkably, the United States today is second in the world (only to Norway) in *government* spending per capita on healthcare.[4] Our federal, state and local governments today spend more per capita on healthcare than do the governments of Germany, Denmark, Switzerland or Canada. Our extraordinary profligacy in government spending on healthcare has nothing whatsoever to do with the Patient Protection and Affordable Care Act, which was not even enacted in the 2009 (the year covered by the data), and which in fact is projected by the CBO to mitigate somewhat the accelerating path of government healthcare spending.

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[3] OECD Health Database 2011, Table: *Total expenditure on health, /capita, US$ purchasing power parity.*

[4] Id, Table: *Public expenditure on health, /capita, US$ purchasing power parity.*

And of course, in return for this profligate spending on healthcare, the United States enjoys poor health outcomes; our life expectancy, for example, is at the bottom end of the OECD, well below that of the countries mentioned above.

In short, the government's long-term *fiscal* health depends directly on grappling much more fundamentally than we have to date on how we provide *physical* healthcare services to our citizens.[5] But change in this area will be challenging, and as Chairman Baucus has pointed out, in such situations it is important that you "boil the frog slowly,"[6] by relying on long transition periods to move from where we are to where we need to be without unfairly upsetting settled expectations and modes of healthcare delivery systems. *In the meantime, however, the resulting costs must be financed.*

3. *Medium-Term.* Tax policy and tax reform are most directly relevant in the medium term (Years 2-10, for example), as we begin the transition from unsustainable long-term government entitlement program spending patterns to more efficient ones. The medium-term is the critical budget reform timeframe, because it can function as the bridge from where we are to a fundamentally different package of government services and revenues. By developing and implementing sensible long-term policies today with appropriate transition periods, we can reorient public thinking to accept this different long-term environment, demonstrate Congressional commitment to making hard choices, and address the concerns of the financial markets.

Government discretionary spending has been on a decades-long downward trend, interrupted only by the emergency spending to deal with the Great Recession.[7] Regardless of what one thinks about the efficacy of those programs, they were in fact temporary and will not contribute further to the deficit in future years.

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[5] CBO, 2011 Long-Term Budget Outlook at 45-47 (June 2011).

[6] Cf. http://en.wikipedia.org/wiki/Boiling_frog.

[7] See, e.g., CBO, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021*, Fig. 3-3 at 79 (Jan. 2011).

In general, our nondefense discretionary spending today is modest by world standards.[8] Moreover, our standard budget presentation of discretionary "spending" is a hopeless muddle, because it mixes what in a private business would be treated as current expenses (salary for government employees, for example) with items that a private firm would properly characterize, not as an expense, but as the purchase of an asset. In effect, we confuse income statement and balance sheet items. In doing so, we overstate government nondefense discretionary spending.

By contrast, the U.S. military budget is a discretionary spending outlier. We all are proud of our Armed Forces and are grateful for their work in keeping our country secure, but I nonetheless suspect that it would come as a surprise to many Americans to learn that, by at least one third-party estimate, we spend more on our military services than do the next 14 largest militaries *combined* (in fact, 42 percent of the world's total military expenditures), and more per capita than does Israel, for which existential threats are arguably much more immediate.[9]

This suggests to me that, with the possible exception of our defense spending, discretionary spending cuts can make at most only a modest impact on the federal budget deficit in the medium term. And if one further accepts the maxim that one must boil the entitlements spending frog slowly, that leaves larger tax revenues as the only means of financing the policies to which we largely are committed.

In this connection, an OECD Economics Department Working Paper from a year ago that reviewed the U.S. federal budget trajectory offered a useful suggestion for our medium-term fiscal goals. That study suggested that our medium term goals should be a budget deficit of 3 percent by 2015 and zero by 2020; to do so, the report concluded, will require some "modest" increases in tax revenues.[10]

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[8] This is particularly the case if veterans' benefits and services are properly recharacterized as a component of defense spending, rather than as nondefense discretionary spending (the current budget presentation).

[9] Stockholm International Peace Research Institutue, *Yearbook 2011*, at 183.

[10] Patrick Lenain, Robert Hagemann and David Carey, *Restoring Fiscal Sustainability in the United States*, OECD Economics Department Working Paper No. 806 (Oct. 25, 2010), at 12-14.

To be clear, both the American people and the financial markets want to see that the United States has reoriented itself to long-term fiscal sustainability, but that does not mean that we have to reach budget surplus in three years, or that we have to rip out our healthcare system overnight. What we do need in the medium-term is to establish a coherent long-term plan, demonstrate a commitment to stick with the plan, and be willing to finance our transition to that plan.

III. TAX COLLECTIONS AND DEFICIT REDUCTION.

Bipartisan majorities on the recent deficit reduction panels (for example, the Bowles-Simpson and Rivlin-Domenici commissions), major nonpartisan studies (for example, the Peterson-Pew Commission on Budget Reform's report), the OECD, thoughtful budget experts like Robert Greenstein at the Center for Budget and Policy Priorities and fellow panelists at this hearing Alan Greenspan and Martin Feldstein have all agreed that tax revenues must rise from their current levels in order to finance our government. Bluntly, there is no other alternative.

The most recent CBO "baseline" projections show the United States continuing to run federal budget deficits over the next 10 years, albeit at levels that decline substantially, especially after 2012, so that by the end of the period deficits will be in the neighborhood of 1.2 percent of GDP per annum (assuming the effectiveness of the deficit reductions to come from the Joint Select Committee on Deficit Reduction) – a level at which federal debt held by the public (in effect, the cumulative tally of past deficits) will start to decline.[11] Given the uncertainty associated with all budget projections, and in particular their great sensitivity to unpredictable economic developments, these baseline projections can be understood as at best sounding a note of cautious optimism. Many observers no doubt would argue, to the contrary, that projections of any deficits at all 10 years in the future are wholly unsatisfactory, given that the projections assume continuous economic growth for the next 10 years.

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[11] CBO, *The Budget and Economic Outlook: an Update* Summary Table 1-2 at 4-5. (August 2011).

These baseline projections assume the expiration of the Bush tax cuts (or, perhaps more accurately, the "2001-03 temporary tax discounts"). As a result, the baseline projections predict that federal tax revenues will rise to just below 21 percent of GDP by 2021. This level of tax revenues is significantly higher than the historic average of the last several decades up to the Great Recession, of about 18.4 percent.

The prospect of tax revenues running at the rate of about 21 percent of GDP is plainly unpalatable to many. But to put matters starkly, extending the 2001-03 individual tax discounts indefinitely by themselves would add an additional *$4.6 trillion* to CBO's baseline deficits over the next 10 years.[12] And if the 2001-03 temporary tax discounts and other associated current policies were all extended indefinitely, then deficits at the end of the 10-year period would basically revert to levels approaching 5 percent of GDP per annum, and federal debt held by the public would spiral upwards.[13] No one would recommend that the country set out to follow this budget trajectory.

Put another way, CBO projections demonstrate that the continuation of current revenue and entitlements policies would mean that the federal government would run a deficit in the coming decade even if it were to spend *zero* on all nondefense discretionary spending programs:

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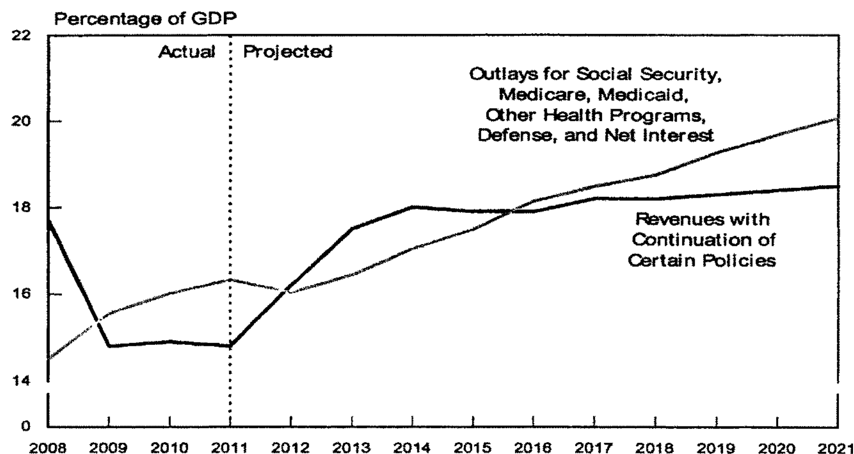
[12] CBO, *The Budget and Economic Outlook: an Update* at 26 (August 2011).

[13] Id, Summary Figure 1 at xii.



(Source: Congressional Budget Office; does not reflect August 2011 update)

All this means that, whatever the long-term world we transition to, we will need to finance the costs of getting there, and that in turns means higher tax revenues than those we currently collect.

This conclusion sits badly with some. They like to point out that high taxes impede economic growth and job creation. These sorts of nostrums have as much policy utility as the old adage that, all other things being equal, it is better to be rich and healthy than poor and sick. Tax revenues need to increase not because higher taxes are desirable as an independent goal, but because there is no other choice as part of a transition from current policies, which in turn have been shaped by both political parties over many decades.

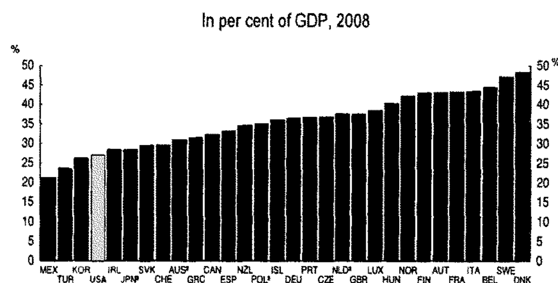
Fortunately, we begin with such an extraordinarily low level of federal tax collections in the United States that it is feasible to raise tax collections over the next several years without unduly disrupting the U.S. economy. CBO and the Staff of the Joint Committee on Taxation predict that for Fiscal Year 2011 revenues will equal only 14.8 percent of GDP; Fiscal Years 2009 and 2010 were also below 15 percent. Over several decades leading up to the collapse in revenue collections during the Great Recession,

revenue collections averaged about 18.4 percent of GDP; in 2000, when the United States last produced a budget surplus, revenues were well over 20 percent of GDP, yet the economy was robust and job creation was strong. If in fact we collected tax revenues for this year at the historic rate of 18.4 percent of GDP, then this year's budget deficit would be some $538 billion smaller than we currently expect.[14]

More generally, and without regard to the current collapse in tax revenues, the United States is an extraordinarily low-tax country by world norms. Here OECD comparative data (which combine national and subnational taxes) are extremely helpful:

Figure 4. The US tax-GDP ratio is low by OECD standards[1]

In per cent of GDP, 2008



1. The Revenue Statistics database contains data provided by the national tax authorities, which are generally based on standard national accounts definitions and methodologies. However, divergences with the national accounts exist in some areas. The differences are small for most countries and in most years, but are substantial in some cases. The most frequently used measure of the tax burden is shown in the figure (total taxes plus social security contributions as a percentage of GDP).
2. 2007 final data, provisional 2008 data not available.

Source: Revenue Statistics database.

(Source: Lenain, Hagemann and Carey, *Restoring Fiscal Sustainability in the United States*, OECD Economics Department Working Paper No. 806 (Oct. 25, 2010), at 15.)

As described earlier, at the same time that the United States imposes tax burdens close to those of Turkey or Mexico, we finance a military bigger than the next 14 countries combined, and the most expensive healthcare system in the world. Why are we then surprised that we are running budget deficits?

Another way of getting a sense of our current levels of tax burdens is to look at the "tax wedge" on labor – the difference between what an employer pays (including

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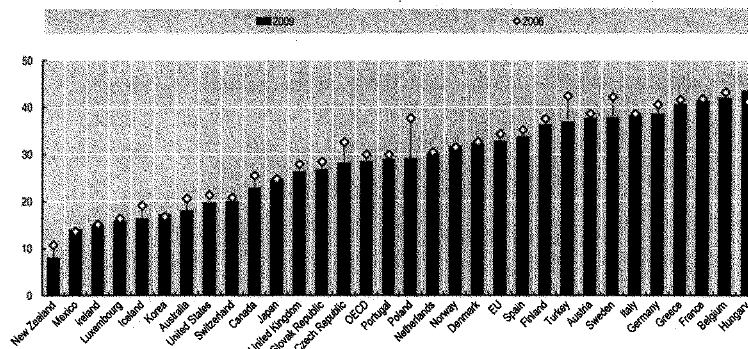
[14] Obviously the text assumes that GDP would be unaffected.

social security contributions) and what an employee takes home as after-tax wages. Here again OECD data demonstrate that the United States is at the low end of developed country norms:

Average Tax Wedge on Labor (As Percentage of Compensation)
(Couple with 100% of Average Earnings and 2 Children)



Note: Users of the data must be aware that they may no longer fully reflect the current situation in fast reforming countries.
1. Measured as the difference between total labour compensation paid by the employer and the net take-home pay of employees, as a ratio of total labour compensation. It therefore includes both employer and employee social security contributions.
2. Average of three situations regarding the wage of the second earner.

Source: OECD (2010), *Taxing Wages Database*.

StatLink http://dx.doi.org/10.1787/888932373134

(Source: OECD: *Economic Policy Reforms: Going for Growth 2011* at 156.)

For these reasons, the recent OECD "report card" on the United States concluded that: "Given that the tax-to-GDP ratio in the United States is among the lowest in the OECD area, even including taxes at the levels of state and municipalities, modest tax increases could be made while keeping the overall tax burden at a relatively moderate level."[15]

Finally, and realizing that any mention of one Administration can be perceived as politically charged, the undeniable facts are that in the 1992-2000 period the economy grew much faster than it has since that time, and that the economy did so notwithstanding

[15] Lenain, Hagemann and Carey, supra n. 10, at 14.

the burdens of tax rates that did not reflect the application of the 2001-03 tax discounts. All other things being equal, lower taxes are better than higher taxes (just as being rich and healthy beats being poor and sick), but whether viewed from the perspective of world norms or our own recent history it is simply not credible to argue that the U.S. economy cannot sustain higher levels of tax collections than the historically low levels of the last two years. Given that our "baseline" budget projections already have baked into them the lapse of the 2001-03 tax discounts, and that those baseline projections restore us only to deficits in the range of 1.2 percent at the end of the estimating horizon, the only reasonable question to debate is what form those tax increases should take.

IV. IMMEDIATE STRUCTURAL TAX REFORM.

A. The Tax Nostalgia Industry.

In recent years, a number of participants in the Tax Reform Act of 1986 have published essays recounting their roles in the legislative process and drawing from that one piece of legislation lessons that purportedly should govern current tax reform efforts. Chief among these is the observation that, since the 1986 Act was designed to be revenue neutral, so too must contemporary tax reform legislation. Other corollaries include the assertion that tax expenditures that survived the 1986 reform have by that fact alone become impregnable to future reform efforts.

These exercises in tax nostalgia are unhelpful and lead in general to bad advice. The 1986 Act was fashioned at one moment in time, now a full generation in the past, through a complex process that reflected economic, political and demographic factors that no longer are relevant.

In contrast to the environment surrounding the 1986 Act (itself preceded and followed by major revenue-raising legislation), tax revenues need to rise from their current depressed levels. Moreover, the economy is very different from what it was in 1986 (for example, in the rise of cross-border business activity and the creation of whole new industries). At the same time, tax policy analysis has advanced substantially in the last 25 years, and we have a better understanding of the tradeoffs between different

policies than we did in 1986. We therefore should put to one side our nostalgic impulses and focus instead on the problems we face today.

B. The Baseline As the Base Case.

As previously noted, CBO "baseline" budget projections assume that the 2001-03 individual tax discounts will lapse. Some observers think that the budget deficits reflected in those baseline projections (in the range of 1.2 percent of GDP by the end of the 10 year horizon, assuming the effectiveness of the new provisions relating to the Joint Select Committee on Deficit Reduction) are still too high. Extending the 2001-03 individual tax discounts indefinitely would add an additional *$4.6 trillion* to those baseline deficits over the next 10 years.[16]

For all the reasons developed earlier, I believe that we need to accept the CBO baseline as the tax reform base case: tax revenues will need to rise to levels in the neighborhood of 20 percent of GDP, or even a bit more, over the medium-term horizon. Our current entitlements and defense programs, particularly the trajectory of healthcare spending, require this level of funding, and it will take years of substantial revenues both to pay down the debt hangover from the Great Recession and to fund the transition to some as yet unspecified package of less expensive entitlements programs and/or reduced defense spending.

I further submit that the most pragmatic way of reaching tax revenues in line with the CBO baseline is in fact to follow the baseline, more or less! Specifically, I recommend that tax reform begin by postulating the following individual revenue package:

1. In general, allow the 2001-03 individual tax discounts to lapse at the end of 2012.

[16] CBO, *The Budget and Economic Outlook: an Update* at 26 (August 2011).

2. Restore the estate and gift taxes to their 2009 levels, preferably as of January 1, 2012. (This actually has a roughly $260 billion cost relative to the CBO baseline.[17])

Tax reform should build on this tax revenue "Base Case." That is, we can appropriately talk about "revenue neutral" tax reform, so long as revenue neutrality is measured against this revenue base. The goal should be to see whether through other reforms we can improve the distributional fairness or economic efficiency of the individual tax system while preserving revenue neutrality, *all relative to this Base Case.*

For example, I would propose two modifications to this base case, designed to be a revenue neutral pairing:

3. Maintain current policy's prescription that corporate dividends should be taxed at the same rates as long-term capital gain. (This proposal is discussed below; it loses revenue relative to the CBO baseline but has strong policy justification.)

4. Add a new top marginal tax rate of, say, 42 - 44 percent for incomes above $2 million. (The idea would be to find the income level that would raise revenues sufficient to fund the dividend tax proposal).

Others might have their own pet reform ideas, but again the rule should be that they must be revenue neutral relative to the Base Case described above.

C. The Central Importance of Tax Expenditures.[18]

The straightforward goals of an incremental reform of the personal income tax (and I put the 1986 Tax Reform Act into this category) should be (1) to raise the targeted level of revenues with (2) the desired distributional consequences while (3) keeping marginal tax rates – the tax imposed on your last dollar of income – as low as possible. The intuition here is simple: people are more sensitive to the tax rate imposed on their last dollar of income than to their average tax burden. The deadweight loss of taxation

[17] CBO, *Reducing the Deficit: Spending and Revenue Options* at 216 ("Alternative 2") (March 2011).

[18] Some of this subsection is abstracted from Edward Kleinbard, *The Hidden Hand of Government Spending*, Regulation (Cato Inst., pub.), Fall 2010, at 18.

can be minimized by keeping marginal tax rates as low as possible, consistent with the other two goals.

Raising average tax rates without raising marginal rates (beyond the expiration of the 2001-03 tax discounts) requires broadening the tax base. Unlike 1986, the individual income tax today has not been eroded through suspect tax shelters or other schemes to avoid the tax system that Congress anticipated when drafting the tax code. (There are of course exceptions, but they are not significant to the overall revenue picture.) This means that the only way to raise significant revenues (perhaps enough to "buy back" some of the tax increases contemplated by the base case summarized earlier) without raising marginal tax rates is to tackle directly some of the deliberate Congressional subsidy programs baked into the tax code, which is to say, tax expenditures.

As you know, tax expenditures, particularly those that can be phrased as "tax subsidies," are a form of government spending, not tax reductions.[19] Tax expenditures dissolve the boundaries between government revenues and government spending. They reduce both the coherence of the tax law and our ability to conceptualize the very size and activities of our government.

Tax expenditures serve many different purposes. Some (the earned income tax credit, the special tax rates on long-term capital gains) really function as adjustments to the tax rate tables; others (the child credit, the refundable portion of the EITC) serve important social and distributional goals; still others (pension plan contributions) can be explained as moves towards a consumption rather than an income tax.[20] But many fall into the category of well-intentioned but ultimately inadvisable instances of

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[19] The history and theory of tax expenditure analysis is developed at length in the Staff of the Joint Committee on Taxation's publication, *A Reconsideration of Tax Expenditure Analysis*, JCX-37-08 (May 12, 2008). Since that date the Staff of the Joint Committee on Taxation has retreated from some of the modes of analysis proposed therein to its traditional presentations of tax expenditure analysis. I think that this is a mistake, because reverting to an excessive reliance on a "normal tax" as the analytical starting point weakens the case for bipartisan agreement on the central importance of tax expenditure reform.

[20] One of the principal contributions of *A Reconsideration of Tax Expenditure Analysis*, supra n. 19, was to urge that tax expenditures be grouped into different conceptual buckets, so that each could fairly be analyzed in accordance with its overall purpose. The current JCT Staff's retreat from this mode of analysis unfortunately weakens the utility of tax expenditure analysis in general.

Congressional meddling, by subsidizing different forms of personal consumption or business activity. These latter sorts of tax expenditures typically introduce economic inefficiencies, miss the target of their intended beneficiaries, and waste a great deal of money.

The magnitude of tax expenditures is staggering: the federal government spends today almost twice as much through tax expenditures as we do through old-fashioned explicit non-defense discretionary spending programs. In fact, we spend more in tax expenditures than we collect in cash through the personal income tax. It's as if our tax base were twice as large as it appears, and then we gave half or so of those revenues back through various ersatz subsidies that in many cases are poorly targeted and result in misallocations of economic activity.

Tax expenditures dissolve the boundaries between government revenues and government spending. As a result, they reduce both the coherence of the tax law and our ability to conceptualize the very size and activities of our government. To see how, consider a little example involving the small but self-reliant country of Freedonia. Its economy is comprised of 10 fruit and vegetable growers, each earning $1,000 pre-tax, for a total gross domestic product of $10,000. Each grower pays income tax to support the Freedonian army at a flat rate of 15 percent, for total tax revenues of $1,500.

Freedonia's sole kumquat producer is particularly resourceful. Armed with scientific reports showing the many health benefits of kumquat consumption, he convinces the Freedonian legislature that kumquat production deserves tax incentives, to bring kumquats within the reach of every Freedonian family. The legislature responds by effectively exempting kumquat production from its income tax through an innovative kumquat production tax credit.

But Freedonia is not a profligate state, and it believes in fiscal discipline in the form of pay-as-you-go budget rules. Therefore, to keep the kumquat credit revenue-neutral, the legislature pairs the new preference with an 11.1 percent tax hike on the other producers, to maintain tax revenues at $1,500. (Freedonian tax policy allows for rounding error.) That means that the other fruit and vegetable farmers will each pay $167 (instead of $150) in tax on their $1,000 of income.

In a world without tax expenditure analysis, Freedonian legislators can argue that nothing has changed: government revenues are constant, and there is no increase in government spending or borrowing. But this is plainly wrong; things have changed, in both the private and public sectors.

First, the tax incentive increases kumquat production and consumption. The equilibrium price and quantities sold of kumquats will be different relative to other fruits and vegetables after the tax incentive. Economists believe that, in the absence of some identifiable market failure, markets set prices better than legislatures do, but the kumquat credit alters the quantity of kumquats sold relative to the case in which the tax burden of all fruit and vegetable growers was equal. Unless the health of Freedonians really is improved by the kumquat credit (perhaps due to prior rampant borderline scurvy among the population), the result will be a less efficient allocation of our collective resources.

Second, the introduction of the kumquat credit in an apparently virtuous "revenue neutral" fashion has another profound economic effect: tax rate increases on the incomes of all the fruit and vegetable producers who do not receive targeted tax relief. All taxes, no matter how beautifully implemented, impose "deadweight losses." That is, some transactions that are rational in a world without taxes become too expensive in a world with those taxes and do not take place. And deadweight loss increases faster than the tax rate — in standard presentations, in fact, at the square of the tax rate.

What all this means is that, by virtue of granting "revenue neutral targeted tax relief," the Freedonian government may raise the same aggregate revenues as it did previously, but impose more deadweight loss on the remaining taxable Freedonian private sector. This result is one of the great ironies of many tax expenditures, particularly those that fall into the category of business incentives — once the incentive's impact on tax burdens *for others* is considered, it impoverishes the country even more than it enriches the beneficiaries of the legislative largesse. (Deadweight loss of course cannot be avoided for long by electing "targeted tax relief" without revenue offsets. Unfortunately, recent U.S. tax history has some of this flavor.)

Third, by virtue of its new kumquat credit, the Freedonian government just got bigger, even though aggregate nominal tax revenues remain constant. The best way to

analogize the new kumquat credit to a uniform 11.1 percent tax hike on all of Freedonia's fruit and vegetable producers, followed by a $167 kumquat crop farm subsidy payment to the kumquat producer. By recasting the tax expenditure in this way, as a constant tax burden and a separate transfer payment, the two different functions of government are restored to their customary formal presentation, and the words "revenue" and "spending" can be applied consistently to economically identical (but formally different) modes of implementation. As so recast, it is easy to see that Freedonia's economic handprint on the private sector is no longer $1,500 in tax revenues, but rather $1,667 in economic terms. The government is bigger in every meaningful sense of the word.

D. Healthcare Tax Expenditures.

The two largest clusters of tax expenditures are those for healthcare and those for owner-occupied housing. Each has had a large and profoundly negative allocative effect on the economy – that is, each has distorted what goods and services we all purchase, by changing relative prices through hidden government subsidies. Each also is poorly targeted, in the sense that the subsidy often goes to taxpayers who would have purchased those goods or services without the help of the subsidy.

The most important healthcare tax subsidy is the treatment of wages paid by an employer in the form of healthcare benefits (whether called insurance or out of pocket reimbursements) as tax-exempt in the hands of an employee. This "exclusion" from employees' incomes of wages paid in the form employer-provided healthcare will cost some $117 billion in forgone income taxes in 2011 alone (and $161 billion in 2014, when the economy is projected to be more robust),[21] but even these enormous costs understate the true picture, because they do not include the payroll tax revenues forgone by the exclusion. In 2008, the JCT Staff estimated these payroll tax costs at some $100 billion for one year alone.[22]

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[21] Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014*, JCS-3-10 (December 2010).

[22] Staff of the Joint Committee on Taxation, *Tax Expenditures for Healthcare*, JCX-66-08 (July 2008).

In short, the total value of this government subsidy for one mode of healthcare delivery is on the order of $250/billion year. Yet precisely because this subsidy is delivered as an income "exclusion," its recipients are largely unaware that they are the beneficiaries of a hidden government handout. The result is a terrible distortion in public discourse, as seen in the debate surrounding the Patient Protection and Affordable Care Act. Many Americans believed that the Act represented an unprecedented government intrusion into the private sector, but were unaware that the government had long been subsidizing their healthcare (but not necessarily those of other Americans with different employers). This is why in my academic writing I have emphasized the corrosive effects of tax expenditures on our ability to conceptualize the role of government in our lives.[23]

Substantively, the subsidy for employer-sponsored distorts our spending patterns, by encouraging us to take compensation in the form of generous healthcare programs (its allocative consequences), does so inefficiently (by subsidizing higher-income Americans more, since tax-exemption is more valuable to them – the classic "upside down" subsidy pattern of many tax expenditures), and does so unfairly (because its availability depends on the programs offered by your employer, not consistent national standards available to everyone).

For these reasons, every health economist of whom I am aware believes that the tax subsidy for employer-sponsored health insurance is both unaffordable and bad policy. Many I believe were acutely disappointed that the Patient Protection and Affordable Care Act left the subsidy largely intact (except for certain "Cadillac" plans).

The difficulty is not with this ultimate conclusion, but rather with the frog boiling procedure. The tax subsidy for employer-provided healthcare is so deeply engrained in the healthcare delivery system that it cannot be removed except through a carefully thought-out transition to a different system. Whether the Patient Protection and Affordable Care Act is that system, or only a steppingstone to a more comprehensive rewriting of how healthcare is delivered in the United States, is a complex question, but the unwinding of the tax subsidy for employer-sponsored healthcare should take place in

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[23] E.g., Edward Kleinbard, *The Congress Within a Congress: How Tax Expenditures Distort Our Budget and Our Political Process*, 36 Ohio Northern L. Rev. 1 (2010).

the context of a plan that assures Americans that healthcare will not become less available or wholly unaffordable.

E. The Sacred Tax Cows of Personal Itemized Deductions – It's Them or Us

Employer-provided healthcare is the largest single government subsidy program delivered through the tax system. As a group, though, the personal itemized deductions – in particular, the deductions we claim that subsidize our homes (the home mortgage interest deduction, the deduction for property taxes, etc.), our charitable contributions, our state and local income taxes, and so on – are even larger. These three tax subsidies alone are projected to cost at least $240 billion in forgone revenues for just the current fiscal year, and that cost will climb as the economy recovers.

I propose that we phase out the tax subsidies for these activities over the five years from 2013-2017. The most elegant way to do so would be to convert the deductions into tax credits, and then phase down the credit rate to zero ratably over that five-year period.

I recognize that all of these items are frequently described as political "sacred cows," but they are simply unaffordable luxuries in the current environment. Either we eliminate these sacred cows, or they will stampede us.

The elimination of the personal itemized deductions, together with the lapse of the 2001-03 tax discounts, will by themselves yield enough revenue to address our deficit concerns for the medium-term, and thereby buy us the time we need to develop and gradually implement long-term entitlement spending reforms. Moreover, their elimination would large remove the need for an AMT "patch," because it is these deductions that drive most taxpayers into the AMT in the first place.

In December 2010 the Tax Policy Center was kind enough to produce some estimates for me of the revenue impact of repealing the personal itemized deductions. The data speak for themselves:

Revenue Consequences of Eliminating Personal Itemized Deductions
Assuming Lapse of 2001-03 Tax Discounts and No Transition Relief

	2013	2014	2015	2016	2017
GDP*	16,705	17,760	18,630	19,508	20,398
Total Deficit*	-525	-438	-507	-585	-579
Eliminate All Itemized Deductions Eff. 1/1/2013**	253	268	283	297	311
Revised Deficit	**-272**	**-170**	**-224**	**-288**	**-268**
Memorandum					
Baseline Deficit as Percentage of GDP	-3.10%	-2.50%	-2.70%	-3.00%	-2.80%
Revised Deficit as Percentage of GDP	-1.60%	-1.00%	-1.20%	-1.50%	-1.30%

* CBO August 2101 Projections. Reflects expiration of all 2001 + 2003 tax cuts

** Tax Policy Center Dec. 30, 2010. Estimates are static; they do not include a behavioral response

Source: Tax Policy Center

These figures admittedly are imperfect. They are a year old, and they are "static," in the sense that they do not account for any behavioral responses. Moreover, the figures do not incorporate any transition relief along the lines I propose. They do, however, reflect "tax form behavior," which is to say they reflect the fact that affected taxpayers will switch from itemizing their deductions to the standard deduction. Nonetheless, the data do capture the order of magnitude of these public subsidies for personal consumption decisions.

The fact that we are today forgoing revenue on the order of magnitude of *1.5 percent of GDP per annum* for these government subsidies of personal expenses suggests to me that, whatever their political appeal, they are simply luxuries we cannot afford.

And as I noted already, their repeal largely resolves the current crisis over what to do with the individual AMT, because it is these deductions that drive most taxpayers into the AMT in the first place.

By phasing out the deductibility of personal itemized deductions, we not only raise a very large amount of revenue, but we do so efficiently. We raise this incremental revenue *without* raising marginal tax rates. The elimination of the tax preferences for these items also will add to the progressivity of the tax system, because itemizers generally have higher pretax incomes than do taxpayers claiming the standard deduction.[24] (Only about one-third of tax filers are eligible to claim itemized deductions today.)

Moreover, by eliminating these sacred tax cows we directly address a fundamental misallocation of capital in the private sector, which is our overinvestment in single-family homes compared to other forms of capital investment.[25] We also will eliminate the inefficiencies by which we provide these subsidies to those who would have bought their homes (or made charitable contributions, or chosen to live in high-tax states) regardless of the tax incentives.[26]

At bottom, the personal itemized deductions, as the name implies, are all *personal* expenses. Their elimination would make the tax system more progressive, more efficient, less distortive and simpler. Doing so also would raise a heck of a lot of money without adding unduly to the deadweight loss from taxation, and raising a heck of lot of tax revenue in general is something that we have no choice but to embrace.

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[24] See, e.g., Testimony of Robert Greenstein Before the Senate Committee on Budget, March 9, 2011, Table 1 (listing distributional consequences of itemized deductions by income quintiles).

[25] Robert Carroll, John F. O'Hare and Phillip L. Swagel, *Costs and Benefits of Housing Tax Subsidies*, Pew Charitable Trusts (June 2011); Evridiki Tsounta, *Home Sweet Home: Government's Role in Reaching the American Dream*, International Monetary Fund Working Paper Wp/11/191 (August 2011).

[26] For example, Tsounta, supra n. 24, finds (Table 8 at 28) that Canada's tax subsidies for home ownership are perhaps 1/5 as large as a percentage of GDP as those of the United States, yet Canada has a higher rate of home ownership.

The reason to eliminate *all* of the personal itemized deductions is that it is impossible to choose among them. Each can be defended as an incentive for one desirable goal or another. Our only practical hope is to round up and eliminate all these tax sacred cows at once.

The incremental revenues that would result from eliminating personal itemized deductions can be used to speed the transition to a different set of long-term government spending and tax policies, or to pay down the federal debt, or to "buy back" some of the tax increases contemplated by the Base Case I posited earlier. Regardless, closing down these inefficient, poorly targeted and unfairly top-weighted government subsidy programs would constitute a major achievement in tax reform.

Martin Feldstein, who is on the panel with me today, has an even more ambitious proposal, which he describes as a 2 percent cap on the tax benefits that an individual taxpayer can claim from tax expenditures.[27] Marty and I share a common emphasis on the importance of addressing tax expenditures as the right way to raise revenue, but I do not agree with his recommendation.

First, the Feldstein proposal would be extremely complex to implement, much more so than suggested by the NBER paper I reference in a note. Second, whether by design or not, the Feldstein proposal would impose very large tax burdens on many lower income working Americans.

The reason is that he effectively would reverse the current tax subsidy for employer-provided healthcare and the child credit, except to the very limited extent of his 2 percent floor. By his own calculations (in a Washington Post op-ed, not in the NBER paper), *54 percent of all taxpayers who today claim the standard deduction would pay higher taxes under his proposal.* A single mother of two working full time at the minimum wage would lose more than $1,400 of her $2,000 child tax credit under the Feldstein proposal— more than 80 percent of her current credit. Meanwhile, a family of

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[27] Martin Feldstein, Daniel Feenberg and Maya MacGuineas, *Capping Individual Tax Expenditure Benefits*, NBER Working Paper 16921 (April 2011).

four earning $60,000 would lose about $800 of their $2,000 child tax credit, or 40 percent of it.[28]

By contrast, the elimination of personal itemized deductions by definition would affect only taxpayers who today itemize their deductions, not those who claim the standard deduction. That is why the elimination of personal itemized deductions is not only an efficient reform from an economic perspective, but increases the progressivity of the tax code.

I understand completely the impulse to dismantle the tax subsidy for employer-provided healthcare, but as I emphasized earlier in my testimony, we should do so only in the context of a completely secure path to a superior healthcare delivery system that is still affordable. I also am concerned that any tax reform legislation not burden the poorest Americans. For both reasons I think that the Feldstein proposal goes too far.

F. Business Tax Reform.

As noted earlier, one important exception that I would make to my general base case of allowing the 2001-03 individual tax discounts to lapse relates to the tax burden on dividend income. Keeping that tax at the same rate as the rate on long-term capital gains, rather than allowing to revert to the tax rate on ordinary income, is highly desirable for the simple reason that it will not distort corporate dividend policy (because otherwise investors would insist on taking their returns through stock sales). A great deal of corporate tax planning in the past was devoted to converting dividend income into long-term capital gain; failing to maintain tax rate parity will simply invite tax lawyers to dust off those old planning stratagems. Moreover, dividend income and long-term capital gains on corporate stock can plausibly be linked as the only two cases of genuine double taxation in the tax code; there is merit in mitigating that phenomenon in both cases.

The U.S. statutory corporate tax rate today is too high, and should be lowered. Here is an area where roughly *revenue-neutral* tax reform makes sense: broaden the business tax base and lower the rate. The business sector also is riddled with government

[28] Tax calculations kindly provided by Center for Budget and Policy Priorities, based on 2011 tax law.

subsidies in the form of tax expenditures. In the income tax area, those subsidies amount to roughly $100 billion/year, of which about 80 percent are captured by corporations and the remainder by noncorporate businesses. In addition, there are numerous excise tax subsidies that are not even scored in the annual tax expenditure roundups. These subsidies, with all their poor targeting and allocative distortions, should be traded in for lower corporate tax rates.

Implicit in this suggestion is the idea that, to some extent, noncorporate businesses will pay more in tax so that corporations will pay less. I believe that this is appropriate, for a number of reasons. First, as noted, most business tax expenditure benefits are claimed by corporations, not pass-through entities. Second, noncorporate businesses today generally enjoy lower rates on capital income than do corporations.[29] For example, gain on sale of a noncorporate business generally is taxed as long-term capital gain, even though there is no double taxation of the firm's earnings, the purchaser can obtain a step-up in tax basis without further cost, and those long-term capital gains in fact often relate to the labor contributions of the owner-operator. Third, small noncorporate businesses in general have had a long and troubled tax compliance history, including mingling of personal and business expenses and nonreporting of cash income.

I have written extensively recently about our international corporate tax regime.[30] The long and the short of it is that I believe that U.S.-based multinational firms have vastly overstated the "uncompetitiveness" of the U.S. system for taxing foreign direct investment. To the contrary, sophisticated U.S. multinationals have succeeded in effectively gaming both the U.S. tax system and those of other high-tax jurisdictions through their adroit production of income taxed nowhere – what I call "stateless income." At the same time, the real competitiveness story, which is the tax burden imposed on U.S. *domestic* corporations, has largely escaped attention.

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[29] CBO, *Taxing Capital Income: Effective Rates and Approaches to Reform*, Table 1 at 8 (Oct. 2005).

[30] See, e.g. Edward Kleinbard, *Stateless Income's Challenge to Tax Policy*, 132 Tax Notes 1021 (Sept. 5, 2011), and the longer papers cited therein.

For all the reasons developed in my papers on the subject, the right answer here is to tax U.S. firms on their worldwide income, but at much lower tax rates. I believe that tax rates in the neighborhood of 25 to 27 percent are easily achievable. Rates at this level would provide U.S. multinational firms with a "competitive" tax environment while substantially improving the tax environment for domestic firms, and encouraging inbound cross-border investment. These arguments are developed at much greater length in the papers cited in note 30.

There is understandable concern that at some point, if individual marginal rates go up and corporate rates go down, the corporation will become a "tax shelter," in that individuals will prefer to earn income through a corporation, to take advantage of its lower tax brackets. There are awkward technical solutions to this problem already in the tax code; the better answer, though, lies as part of a more ambitious long-term tax overhaul, as quickly outlined below.

V. LONG-TERM STRUCTURAL TAX REFORM.

If Congress were to allow the 2001-03 temporary tax discounts to lapse, phase out personal itemized deductions, and engage in revenue-neutral business tax reform along the lines outlined above, it would have done enough. It could then turn its attention to the difficult issues of long-term entitlements spending reform, in particular the structure of our healthcare delivery system.

Nonetheless, it is possible to imagine even more fundamental tax reforms. One direction, of course, would be to reorient the tax system more in the direction of consumption taxes. There are economic efficiency arguments that support a preference for consumption over income taxes, but of course there also are difficult transition and design issues.

In my research I focus instead on the income tax, which I believe is much spryer than do many of its critics. I believe that it is possible to imagine a much more economically efficient income tax than our current system, in the sense of one that would impose more consistent tax burdens on economically similar items of income, regardless

of their legal labels, and one that would tailor those burdens to the different kinds of income in question.

Policy discussions about fundamental income tax reform usually are highly fragmented. We debate capital gains policy, or the corporate tax rate, or "small business" taxation, or "carried interest," as independent concepts, but this ultimately is silly. Notwithstanding the generations of law students who have been taught to the contrary in Tax 1 courses around the country, as a practical matter income really is derived from labor, from capital, or from the two combined.[31] Very roughly, 2/3 of our GDP is contributed by (a "return to") labor, and 1/3 by capital.[32] "Capital" income includes interest and rental income, dividend income and capital gains, and also corporate income, because a corporation (at least a large publicly-held one) compensates its labor factor of production directly in the form of tax-deductible wages.

The corporate income tax in the first instance is thus a tax on capital income. It is a different (but of course important) question whether the incidence of that tax (the ultimate economic burden) is shifted to labor, in the way that the excise tax on gasoline actually is borne by consumers.

Our policy debates, overinfluenced by the tax ideologies reflected in the Tax Reform Act of 1986, tend to see an ideal income tax as one that taxes returns to labor and returns to capital on a single progressive tax rate schedule, but there is no reason why this should be so. To the contrary, the economic evidence suggests that labor and capital have different sensitivities, or if you prefer, aversions, to taxation. The only reason to insist on a common tax rate schedule as the ideal is because it is difficult to distinguish between returns to capital and returns to labor. For example, the local restaurant owner who invests her life savings and all of her working hours into her restaurant obtains economic

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[31] Treasure trove, the lucky fan who catches the record-setting home run baseball, and the purchase of an old piano that turns out to be stuffed with cash are important only for law school exams, not for tax revenues.

[32] Recent CBO data would put the split at 60/40. CBO, *The Budget and Economic Outlook: an Update* Figure 2-13 at 56 (August 2011).

returns in the form of business profits from the combination of her labor and her capital, but all that we see is a single bottom line profit.

It turns out, however, that good research and even real-world experiments have been done on this question of distinguishing labor income from capital income, which in turn opens up the question of what the tax burden should look like on each. I group this work under the general rubric of "dual income taxes."[33] (They are "dual" in that they have two rate schedules, one for labor income and one for capital income.)

At the same time, we also have learned a great deal about how to think conceptually about capital income. We now understand that it can usefully be broken down into three categories: "normal" returns (the bread and butter risk free returns from waiting, or, if you prefer, the return on marginal investments in competitive markets), "risky" returns (the compensation we demand for taking on uncertain projects) and "economic rents" (the supersized returns from owning some especially valuable asset that cannot simply be reproduced, like a valuable patent).[34]

In a nutshell, it is possible to use these new insights and techniques to design an income tax system that first separates income into two buckets – capital income and labor income (which latter category would include treasure trove and all the other marginalia that animate tax law professors), and then applies coherent but separate rules to each. I call the core component of this reimagining of our income tax the "business enterprise income tax."[35]

The capital income side is the more difficult one. But one can imagine a feasible and administrable capital income tax system that is much superior to our current approach, including along the following margins:

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[33] See, e.g., Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 Nw. J.L. & Soc. Pol'y 41 (2010).

[34] See, e.g., Edward Kleinbard, *Designing an Income Tax on Capital*, in Taxing Capital Income, The Urban Institute Press (2007).

[35] For early iterations of the idea, see Kleinbard, supra n. 32; Edward Kleinbard, *Rehabilitating the Business Income Tax* (The Hamilton Project, May 2007).

1. It would eliminate the tax preference for debt over equity financing.[36] It is an interesting insight into the limitations of traditional tax expenditure analysis that this enormously distortive tax subsidy is not even scored as a tax expenditure, because it is thought to be inherent in any income tax. But that is not correct.

2. It would achieve tax integration – that is, the elimination of double taxation on business earnings.

3. It would tax all business entities identically, rather than having different rules for different legal forms, and similarly would tax all forms of capital investment identically.

4. It would move the taxation of much business income (more specifically, "normal" returns) to the level of the individual rather than that of the firm. This has very important technical benefits both for the measurement of capital income and for practical international tax "competitveness" concerns.

5. It would ground the taxation of capital gains on some principled basis, rather than our current instinct either to overtax or to undertax such instances of capital income, and apply a single consistent tax rate to all forms of capital income, whether earned over time or as a lump sum through a sale.

6. By providing a single tax schedule for all instances of capital income, it would greatly reduce the distortions arising from the collision of current tax law's fixation with out of date legal constructs and commercial realities.

I find all of this to be an exciting prospect for my academic research, and hope one day to see it implemented into law. But none of this should detract from what should be the immediate focus, which is raising sufficient revenues as painlessly as possible to enable the country to buy the time required to revise its entitlement spending programs in a way that is fair to settled expectations and to our shared vision of what it means to be Americans.

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[36]Ruud A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, International Monetary Fund Staff Discussion Note SDN/11/11 (May 2011).

U.S. Senator Bill Nelson
Opening Statement
September 13, 2011

This week marks the third anniversary of the collapse of Lehman Brothers, an event that triggered our Nation's worst financial crisis since the Great Depression. Three years later, we've yet to fully recover.

Simply put, if Congress does not get serious, the structural budget imbalances facing the U.S. economy could permanently reduce labor productivity and economic growth for years to come.

A launching point for getting our fiscal house in order should be an overhaul of the federal income tax. And that means lowering tax rates, eliminating tax expenditures and loopholes, and simplifying the tax code.

We hear a lot about two entitlement programs – Social Security and Medicare. What we don't hear about are the 250 entitlement programs cooked into the tax code. Tax expenditures – the various tax credits, deductions, and exclusions grafted onto the tax code – are entitlement programs, pure and simple. If you are eligible, you can claim the benefit. There is no application process. And there is no annual or even periodic review of their efficacy by Congress. In short, tax expenditures are entitlement spending run amok.

Some of these tax expenditures, particularly those related to drilling for oil and gas, date back to the early 1900s and have little if any justification today.

The last time Congress tackled tax expenditures and other tax loopholes in a systematic way was 25 years ago, in the Tax Reform Act of 1986. That legislation took a hatchet to the special interests and lowered the top individual tax rate from 50 to 28 percent. But the special interests came back stronger than ever. Since 1986, according to the Joint Committee on Taxation, Congress has enacted 158 new tax expenditures.

Is it right that an oil company could reap a $11 billion tax windfall from the worst environmental disaster in our history? I don't think so; I don't think oil spill clean-up costs should be treated as an ordinary and necessary business expense. And that's one tax break I've already introduced legislation to change.

Is it right that large multinational corporations can report record profits yet still pay no federal income taxes? Last year, for example, General Electric reported worldwide profits of $14.2 billion. And how much was the federal corporate tax bill for America's largest firm? Zero. Nothing. Nada.

I don't think it's right.

Or, is it right that Wall Street executives can avoid millions in taxes using complex deferred compensation schemes while the average taxpayer can put no more than $5,000 a year into their Roth IRA?

Or, is it right that a special tax rule allows oil and other commodities speculators to treat a portion of their short-term trading profits as long-term capital gains subject to a lower tax rate?

In fiscal year 2008, tax expenditures like these totaled $1.2 trillion in lost revenue. That sum is greater than the entire amount raised by the individual income tax in 2008. It is also greater than all federal discretionary spending in 2008 and twice as much as all nondefense discretionary spending.

Between 1972 and 2008, the number of tax expenditures more than quadrupled from 60 to 247. And over a 25-year period from 1974 until 2008, tax expenditures climbed from 5.7 percent to 8.6 percent of GDP. If we simply reverted to the 1974 level of tax expenditures, we could wipe more than $400 billion off our annual deficit this year and more than $4 trillion over 10 years.

Tax expenditures can be characterized more accurately as "tax earmarks" because they represent favors for special interests at the expense of average taxpayers.

Tackling tax expenditures is not just about deficit reduction and increasing revenue. It is also about getting rid of distortions that act as a drag on investment and economic growth.

Over the last two decades, our foreign trading partners have moved rapidly to modernize their tax systems to make them more relevant in a global economy where capital moves at the touch of a button, intellectual property is easily transferred, and goods are manufactured in global production chains that transcend borders.

The United States, on the other hand, plods along with an antiquated tax system in which the rules for taxing international trade and investment were developed in the 1920s. The time for tinkering has passed, we need to overhaul the way we tax U.S. companies that operate around the world.

Tackling tax expenditures is also about ensuring the tax code is simple, fair, and equitable. Today's code is so complex many taxpayers simply throw up their hands and give up on trying to figure out their taxes on their own. Taxpayers and businesses spend an estimated 7.6 billion hours each year complying with filing requirements. In monetary terms, these costs were roughly $140 billion in 2008. 60 percent of taxpayers pay tax preparers to fill out their returns.

Between 1987 and 2009, the instruction booklets sent to taxpayers for the Form 1040 increased in length from 14 pages to 44 pages of text. And, more than 15,000 changes to the tax code have been made since 1986.

Thus, comprehensive deficit reduction should include well-designed fundamental tax reform that lowers tax rates, simplifies the tax code, brings our system of business taxation into the 21st century, promotes job creation, and repeals or limits unnecessary tax expenditures and loopholes. This was the recommendation of the bipartisan Bowles-Simpson Commission and the bipartisan "Gang of Six."

With fundamental income tax reform and spending reductions, we can turn this ship around and generate the revenue necessary to protect our bedrock commitments to seniors and working Americans.

Today, we are fortunate to have several of the country's greatest economic minds with us to share their views on whether tax reform should have a role in comprehensive deficit reduction. The first witness, Alan Greenspan, managed U.S. monetary policy under four presidents during his five terms as Chairman of the Federal Reserve Board of Governors from 1987 until 2006. During that time, the United States grew from a $5 trillion to a $13 trillion economy.

Our second witness, John Taylor served as a member of the Council of Economic Advisors in the George H.W. Bush Administration and as Undersecretary of Treasury for International Affairs in the George W. Bush Administration. He is currently a professor of economics at Stanford University.

The third witness, Martin Feldstein, served as chairman of the White House Council of Economic Advisors in the Reagan Administration, from 1982 until 1984. Dr. Feldstein has written more than 300 research articles in the field of economics, founded the National Bureau of Economic Research, and is currently a professor of economics at Harvard University.

Our fourth witness is John Engler, President of the Business Roundtable and a former three-term governor of Michigan. Prior to the Business Roundtable, Mr. Engler was president and CEO of the National Association of Manufacturers.

The fifth and final witness is Edward Kleinbard, who served as Chief of Staff of the Joint Committee of Taxation from 2007 to 2009. Mr. Kleinbard has 20 years of experience practicing tax law in New York and is currently a professor of law at the University of Southern California.

Welcome to all of you. Senator Crapo?

The Need for a Comprehensive Economic Strategy

John B. Taylor*

Testimony before the Committee on Finance
Subcommittee on Fiscal Responsibility and Economic Growth
United States Senate

September 13, 2011

Chairman Nelson, Ranking Member Crapo and other members of the Subcommittee on Fiscal Responsibility and Economic Growth, thank you for the opportunity to testify at this hearing on "The Role of Tax Reform in Comprehensive Deficit Reduction and U.S. Fiscal Policy."

The economic recovery from the deep recession is now over two years old. However, the recovery is so weak that it is really a recovery in name only. Real GDP growth has averaged only 2.4 percent per year in this recovery compared with 6.5 percent in the 1983-84 recovery from the most recent very deep U.S. recession. As a result unemployment is still over 9 percent. Fewer people as a percentage of the working age population are working now than when the recovery began.

Some blame the weak recovery on the depth of the previous recession and the need for people to cut back consumption and pay back debt. But during the much stronger 1983-84 recovery, people consumed a smaller fraction of their income. And while housing is weak, it is a much smaller drag than declining net exports were in 1983-84. The economic weakness now is broader than any one sector.

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* Mary and Robert Raymond Professor of Economics at Stanford University and George P. Shultz Senior Fellow in Economics at Stanford University's Hoover Institution

Temporary and Targeted Fiscal Policy Has Not Worked

So far the U.S. fiscal policy responses to the recession and the weak recovery have largely been in the form of temporary and targeted actions and interventions. This approach has not worked very well and, in my view, is a reason why the economic recovery is weak and unemployment is high.

In the 2009 stimulus package (the American Recovery and Reinvestment Act of 2009), the federal government borrowed money and gave it to people in the form of one-time payments or temporary refundable tax credits. I examined where the money went and found that most of it stayed in people's pockets. The temporary transfers created little or no boost to aggregate consumption or thus to jobs. I found the same thing in the temporary stimulus packages of 2001 and 2008.

In another component of the 2009 stimulus package, the federal government borrowed money and gave it to the states in the hope that they would start new construction projects and hire people. But when my colleague John Cogan and I examined where the money went, we found that state and local governments put most of it in their coffers. These governments started few if any construction projects that they would not have started without the stimulus. The federal government also undertook its own construction programs as part of the stimulus; but, with few shovel-ready projects, it could only increase infrastructure spending by an immaterial .05 percent of GDP.

In my estimation, these interventions and most others—cash-for-clunkers, first-time homebuyers credit, quantitative easing by the Fed, and the sharp increase in federal outlays from 19.6 percent in 2007 to 23.8 percent of GDP today—have not only been ineffective, they have

lowered investment and consumption demand by increasing concerns about the federal debt, another financial crisis, threats of inflation or deflation, higher taxes, or simply more interventions. Most businesses have plenty of cash to invest and create jobs. They're sitting on it because of these concerns.

Some argue that the economy would have been even weaker without the 2009 stimulus act, but the only evidence they site are simulations of models which provide no new information. The actual money flows reveal little or no effect.

For these reason, rather than more of these temporary interventions, we need a comprehensive economic strategy that will create strong economic growth and job growth. Permanent and predictable tax reform should be an essential part of that strategy rather than temporary and targeted tax changes.

Embedding the Budget Control Act in a Larger Reform Strategy

A natural starting place for such a strategy is the debt-limit cum spending-control agreement reached this summer. Signed into law by President Obama on August 2, the Budget Control Act of 2011 reduces projected increases in spending over ten years by between $2.1 trillion and $2.4 trillion—depending on the recommendations of the Select Joint Committee—and thus reduces the cumulative budget deficit and debt by the same amount.

According to the August 2001 baseline projections of the Congressional Budget Office (CBO), with the Budget Control Act, federal outlays as a share of GDP will decline to 22.0 percent of GDP in 2021 compared with 24.2 percent in President Obama's original budget. That would cut 2.2 percentage points off the 4.9 percent deficit as a share of GDP that had been

projected by the Congressional Budget Office when it estimated the Administration's budget earlier this year.

The Budget Control Act reduces spending growth in a very gradual way, which is appropriate in a weak economy. The agreement thus has the benefit of reducing some of the uncertainty hanging over private investment decisions without incurring the cost of sudden unanticipated short-term spending cuts.

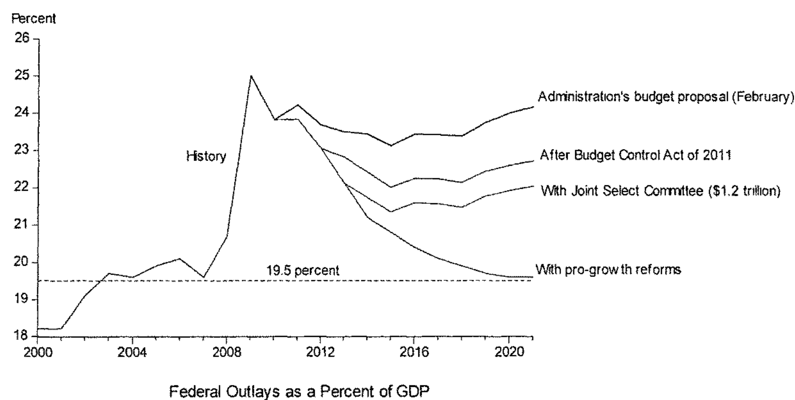
However, while representing substantial progress, the agreement does not fully deal with the debt and the deficit problem, which is why it needs to be embedded in a broader economic strategy with the goal of closing the rest of the budget gap through pro-growth reforms.

A Strategy with Revenue Neutral Tax Reform

There are of course differences of opinion about the reforms needed to achieve this goal. Given that spending was 19.6 percent of GDP as recently as 2007, a strategy which brings spending back to that percentage is sensible and doable. This approach has the important advantage of taking tax increases off the table, in the sense that by 2021 tax revenues as a share of GDP would be close to this percentage if the tax system in place in 2007 remained in place. In other words, the budget would be brought into balance with that tax system.

Hence, a comprehensive economic strategy which includes holding outlays to around this 2007 percentage could also include a fully revenue neutral tax reform and still balance the budget. By reducing marginal tax rates while broadening the base, such a tax reform will be beneficial to economic growth. And of course with higher economic growth, tax revenue growth will also be higher.

The following graph explains this strategy. It shows federal outlays as a percent of GDP from 2000 to 2021. The history of the years from 2000 to the present—but especially from 2008 to the present—is a history of increasing federal spending as a share of GDP.



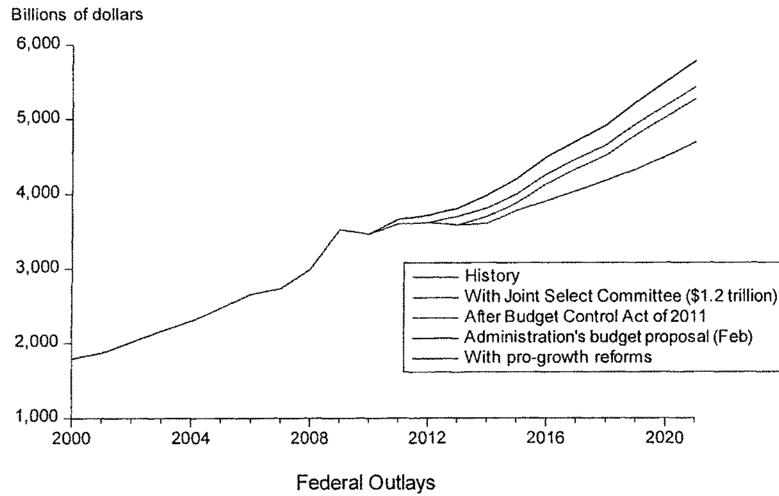
Federal Outlays as a Percent of GDP

The impact of the Budget Control Act is seen by comparing the path of outlays in the top line, which shows the original February budget submission of the Administration, as scored by CBO, with the next two lower lines. The line labeled "After the Budget Control Act of 2011" is simply the new CBO baseline estimated in August. It thus incorporates the Budget Control Act as well as other changes since the CBO scored the Administration's budget, including the 2011 Continuing Resolution. The next line labeled "With Joint Select Committee" shows the additional spending reductions as a share of GDP that will occur if the Joint Select Committee reduces outlays by $1.2 trillion over 10 years. The year-by-year distribution of outlays over those years is based on CBO assumptions published in "Budget and Economic Outlook: An Update," of August 2011

Clearly the Budget Control Act has substantially changed the budget picture since the start of this year, but there is still a long way to go. The lower line in the graph illustrates the comprehensive budget strategy proposed here. Nothing changes relative to the Budget Control Act until 2014 when outlays of a share of GDP start moving down further, until they gradually reach the 2007 percentage level and thereby allow for fully revenue-neutral pro-growth tax reform.

While the Select Joint Committee might expand its mandate to consider such a reform, the obvious differences of opinion may have to be hammered out in the 2012 election with all Americans participating. Tax reform, as well as entitlement reform, regulatory reform, monetary reform—indeed the fundamental role of government in the economy—should be part of that debate, but with a clear commitment to the strategy of America living within its means as in the strategy illustrated here.

The gradual nature of the strategy avoids abrupt and unanticipated changes in spending. Compared with current law from 2013 forward it does not involve actual reductions in federal outlays as shown in the next graph of total federal outlays. The more credible the strategy is, the greater will be its benefits and the smaller any adjustment costs.



Federal Outlays

Such comprehensive budget strategy will take us toward a more stable and predictable economic policy with less uncertainty about the future. It will thereby increase both demand and supply and get the economy growing and creating jobs again.

Thank you very much. I would be pleased to answer any questions.

COMMUNICATION

Comments for the Record

United States Senate Committee on Finance
Subcommittee on Fiscal Responsibility and Economic Growth

Examining whether there is a Role for Tax Reform in
Comprehensive Deficit Reduction and U.S. Fiscal Policy
Tuesday, September 13, 2011, 2:00 PM
215 Dirksen Senate Office Building

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Chairman Nelson and Ranking Member Crapo, thank you for the opportunity to address this topic. The Center for Fiscal Equity believes that tax reform will play a key role in comprehensive deficit reduction. Our comments will address the context of the debate, the role of health care expenses for the long term, our standard tax reform plan, how tax policy can address long term health costs and how to retain some form of vertical equity.

The Context of the Debate

The key fact of the deficit reduction debate is that the entire exercise is only necessary to fund the extension of the 2001, 2003 and 2010 tax cuts. If these tax cuts were allowed to expire automatically, no further deficit reduction would be required. For the efforts of the Joint Select Committee to succeed, they must not only link cuts to permanent tax reforms, but they must also enact enough cuts and reforms to make extending the Bush cuts a non-issue.

Cutting only $1.5 trillion on top of the previous $900 billion in cuts is inadequate for a master compromise, because no agreement is likely possible on which tax provisions to offset. If cuts are proposed to offset tax savings to preserve the 10%, 25% and 28% rates and the $1000 child tax cut, Republican members will never agree – as this would allow the President to veto any additional tax cut extensions. Democrats will never allow tax cuts at the high end to come to the floor unless low end cuts are enacted first. In order to enact any tax plan, some type of tax simplification is necessary, else gridlock will solve the deficit problem, provided the President refuses to compromise on temporary tax cut extensions.

The Role of Health Costs

Over the long term, rising health care expenses require either budget cuts or increased revenue. Making such revenue increases politically acceptable requires that they be broad based, rather than targeted only to wealthy taxpayers and they should have offsets so that private delivery of health care now funded by the government reduces such targeted taxes.

Health care reform complicates the entire picture more than is generally known or acknowledged. If reform collapses the private insurance market or a subsidized public option is needed to replace the recent reforms and preserve private insurance, fixes to Medicare and Medicaid will seem like an afterthought.

The key issue for the future of health care reform is the impact of pre-existing condition reforms on the market for health insurance. Mandates under the Affordable Care Act (ACA) may be inadequate to keep people from dropping insurance - and will certainly not work if the mandate is rejected altogether for constitutional reasons.

If people start dropping insurance until they get sick – which is rational given the weakness of mandates – then private health insurance will require a bailout into an effective single payer system. The only way to stop this from happening is to enact a subsidized public option for those with pre-existing conditions while repealing mandates and pre-existing condition reforms.

In the event that Congress does nothing and private sector health insurance is lost, the prospects for premium support to replace the current Medicare program is lost as well. Premium support also will not work if the ACA is repealed, since without the ACA, pre-existing condition protections and insurance exchanges eliminate the guarantee to seniors necessary for reform to succeed. Meanwhile, under a public option without pre-existing condition reforms, because seniors would be in the group of those who could not normally get insurance in the private market, the premium support solution would ultimately do nothing to fix Medicare's funding problem.

Resorting to single-payer catastrophic insurance with health savings accounts would not work as advertised, as health care is not a normal good. People will obtain health care upon doctor recommendations, regardless of their ability to pay. Providers will then shoulder the burden of waiting for health savings account balances to accumulate – further encouraging provider consolidation. Existing trends toward provider consolidation will exacerbate these problems, because patients will lack options once they are in a network, giving funders little option other than paying up as demanded.

Shifting to more public funding of health care in response to future events is neither good nor bad. Rather, the success of such funding depends upon its adequacy and its impact on the quality of care – with inadequate funding and quality being related. For example, Medicare provider cuts under current law have been suspended for over a decade, the consequence of which is adequate care. By way of comparison, Medicaid provider cuts have been strictly enforced, which has caused most providers to no longer see Medicaid patients, driving them to hospital emergency rooms and free clinics with long waiting periods to get care.

Ultimately, fixing health care reform will require more funding, probably some kind of employer payroll or net business receipts tax – which would also fund the shortfall in Medicare and Medicaid (and take over most of their public revenue funding).

Tax Reform Plan

The Center for Fiscal Equity's Tax Reform plan, which has four major parts:

- Value Added Taxes (VAT) to fund domestic military and civil discretionary spending (in addition to other excises, such as the gasoline tax);

- VAT-like Net Business Receipts Taxes (NBRT) on labor and capital to fund non-pension entitlement spending which replace some payroll and most income taxation at both the individual and corporate levels;

- Old Age and Survivors Insurance (OASI) payroll taxes on employers and employees to fund old age and survivors insurance (retirees only) – with survivors insurance to non-retirees and disability insurance funded by the NBRT (and decoupled from income); and

- Income surtaxes on cash disbursements from all sources, including inheritance to fund overseas military and naval deployments, retirement of debt to the Social Security system and other trust funds, and net interest on the debt and any additional debt retirement.

Funding Health Care

Unlike a VAT, an NBRT would not be visible on receipts and should not be zero rated at the border – nor should it be applied to imports. While both collect from consumers, the unit of analysis for the NBRT should be the business rather than the transaction. As such, its application should be universal – covering both public companies who currently file business income taxes and private companies who currently file their business expenses on individual returns.

The key difference between the two taxes is that the NBRT should be the vehicle for distributing tax benefits for families, particularly the Child Tax Credit, the Dependent Care Credit and the Health Insurance Exclusion, as well as any recently enacted credits or subsidies under the ACA. In the event the ACA is reformed, any additional subsidies or taxes should be taken against this tax (to pay for a public option or provide for catastrophic care and Health Savings Accounts and/or Flexible Spending Accounts).

To incentivize cost savings under an NBRT, allow companies to offer services privately to both employees and retirees in exchange for a substantial tax benefit. Employers who fund catastrophic care would get an even higher benefit, with the proviso that any care so provided be superior to the care available through Medicaid. Making employers responsible for most costs and for all cost savings allows them to use some market power to get lower rates, but no so much that the free market is destroyed. The ability to exercise market power, with a requirement that services provided in lieu of public services be superior, will improve the quality of patient care.

This proposal is probably the most promising way to decrease health care costs from their current upward spiral – as employers who would be financially responsible for this care through taxes would have a real incentive to limit spending in a way that individual taxpayers simply do not have the means or incentive to exercise. While not all employers would participate, those who do would dramatically alter the market. In addition, a kind of beneficiary exchange could be established so that participating employers might trade credits for the funding of former employees who retired elsewhere, so that no one must pay unduly for the medical costs of workers who spent the majority of their careers in the service of other employers.

Employer provided health care will also reverse the trend toward market consolidation among providers. The extent to which firms hire doctors as staff and seek provider relationships with providers of hospital and specialty care is the extent to which the forces of consolidation are overcome by buyers with enough market power to insist on alternatives, with better care among the criteria for provider selection.

The NBRT would replace disability insurance, hospital insurance, the corporate income tax, business income taxation through the personal income tax and the mid range of personal income tax collection, effectively lowering personal income taxes by 25% in most brackets. Note that collection of this tax would lead to a reduction of gross wages, but not necessarily net wages – although larger families would receive a large wage bump, while wealthier families and childless families would likely receive a somewhat lower net wage due to loss of some tax subsidies and because reductions in income to make up for an increased tax benefit for families will likely be skewed to higher incomes. For this reason, a higher minimum wage is necessary so that lower wage workers are compensated with more than just their child tax benefits.

The Center calculates an NBRT rate of 27% before offsets for the Child Tax Credit and Health Insurance Exclusion, or 33% after the exclusions are included. This is a "balanced budget" rate. It could be set lower if the spending categories funded receive a supplement from income taxes.

Conceivably, NBRT offsets could exceed revenue. In this case, employers would receive a VAT credit.

Retaining Vertical Equity

In order to preserve vertical equity in a given tax year in a consumption tax environment, some form of progressive income and inheritance taxation is essential, otherwise the debt crisis cannot be avoided as consumption taxes will never be adequate to replace the lost revenue. The Center suggests retaining surtaxes on high income earners and heirs. These would replace the Inheritance or Death Tax by instead taxing only cash or in-kind distributions from inheritances but not asset transfers, with distributions remaining tax free they are the result of a sale to a qualified Employee Stock Ownership Plan.

In testimony before the Senate Budget Committee, Lawrence B. Lindsey explored the possibility of including high income taxation as a component of a Net Business Receipts Tax. The tax form could have a line on it to report income to highly paid employees and investors and pay a surtax on that income. We considered and rejected a similar option in a plan submitted to President Bush's Tax Reform Task Force, largely because you could not guarantee that the right people pay taxes. If only large dividend payments are reported, then diversified investment income might be under-taxed, as would employment income from individuals with high investment income. Under collection could, of course, be overcome by forcing high income individuals to disclose their income to their employers and investment sources – however this may make some inheritors unemployable if the employer is in charge of paying a higher tax rate. For the sake of privacy, it is preferable to leave filing responsibilities with high income individuals.

Identifying deficit reduction with this tax recognizes that attempting to reduce the debt through either higher taxes on or lower benefits to lower income individuals will have a contracting effect on consumer spending, but no such effect when progressive income taxes are used. Indeed, if progressive income taxes lead to debt reduction and lower interest costs, economic growth will occur as a consequence.

Using this tax to fund deficit reduction explicitly shows which economic strata owe the national debt. Only income taxes have the ability to back the national debt with any efficiency. Payroll taxes are designed to create obligation rather than being useful for discharging them. Other taxes are transaction based or obligations to fictitious individuals. Only the personal income tax burden is potentially allocable and only taxes on dividends, capital gains and inheritance are unavoidable in the long run because the income is unavoidable, unlike income from wages.

Even without progressive rate structures, using an income tax to pay the national debt firmly shows that attempts to cut income taxes on the wealthiest taxpayers do not burden the next generation at large. Instead, they burden only those children who will have the ability to pay high income taxes. In an increasingly stratified society, this means that those who demand tax cuts for the wealthy are burdening the children of the top 20% of earners, as well as their children, with the obligation to repay these cuts. That realization should have a healthy impact on the debate on raising income taxes.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.