Testimony of

Stephen J. Entin
President and Executive Director
Institute for Research on the Economics of Taxation

before the

Senate Committee on Finance
hearing on
Tax Reform Options: Marginal Rates on
High-Income Taxpayers,Capital Gains, and Dividends

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Chairman Baucus, Senator Hatch, and Members of the Committee, my name is Stephen J. Entin. I am President of the Institute for Research on the Economics of Taxation. Thank you for the opportunity to testify today on the subject of marginal tax rates on upper income individuals, the tax treatment of capital gains and dividends, and their relationship to tax reform.

I hope to address two issues in the hearing title. First, what would raising tax rates on the upper income taxpayers' ordinary income, capital gains, and dividends do to the economy and the budget? Second, what is genuine tax reform, and does it include such policies? My conclusions, briefly, are:

- Higher marginal tax rates on any group, especially those already paying the highest rates, would reduce GDP and income across the board, not just for the people paying the initial tax bill. The burden of higher taxes on capital formation falls largely on labor in the form of lower wages and hours worked.[1]

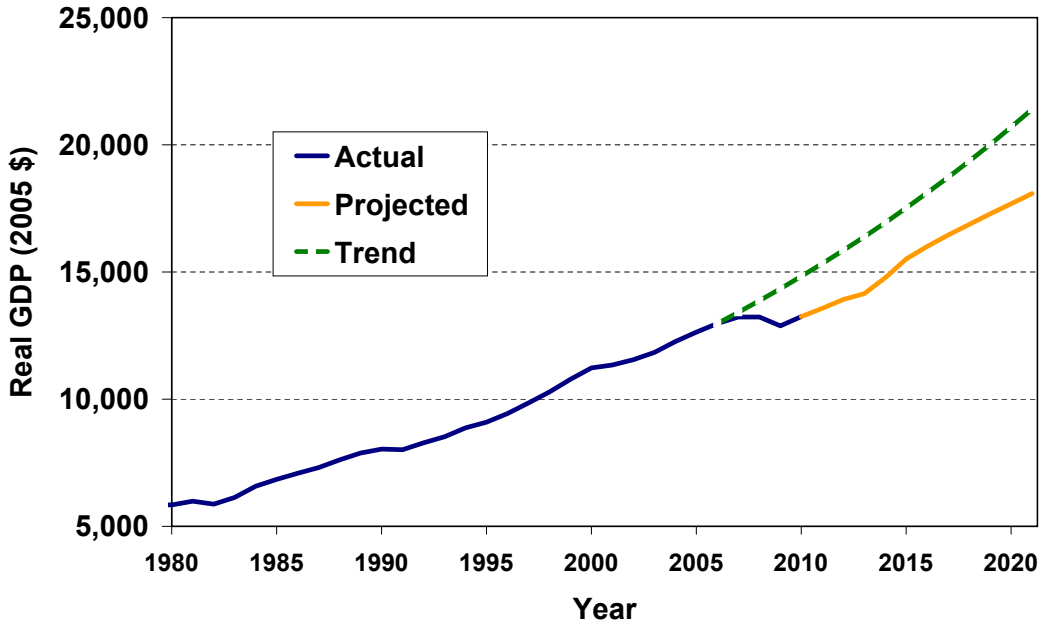
- Increasing the double taxation of corporate income by raising tax rates on capital gains and dividends would dramatically reduce capital formation and wages, and would not raise the expected revenue.

Institute for Research on the Economics of Taxation
1710 Rhode Island Avenue, NW • 11th floor • Washington, D.C. 20036
Phone: (202) 463-1400 • Fax: (202) 463-6199 • Internet: www.iret.org

- Neither tax change has any place in a real tax reform. We should not repeat the Tax Reform Act of 1986, which tried to perfect the "broad-based income tax"; rather, we should adopt a different tax base that is more neutral in its treatment of saving and investment relative to consumption.

Please note that it is important that any tax reform promote economic growth, because lack of growth is the source of lower incomes, higher unemployment, and much of the current deficit. Chart 1 projects the GDP as if it had continued beyond 2006 at the trend rate of real growth since 1950. We are now some 12 percent below that level, due to the recession and the financial industry debacle. CBO does not envision a recovery to that trend line in its forecast under current policy. That is a shame, because the lower levels of GDP mean lower levels of income and employment for all. CBO assumes reductions in unemployment largely by assuming workers become discouraged and leave the labor force. There is more at stake than the federal budget. As for the budget, the growth shortfall is responsible for about 40 percent of the deficit. The jump in spending as a share of GDP since the recession adds about 13 percent more. With those two issues resolved, the deficit would be a more manageable 4 percent of GDP instead of nearer 8.5 percent.

Chart 1 Projected Real Gross Domestic Product (Real GDP) Falls — And Stays — Below Its Trend



Data: Congressional Budget Office for Actual and Projected Real GDP. Trend Line computed by author based on Real GDP growth over period 1950-2006.

It is tempting to tax the rich because they have only a few votes and "they can afford it." It is also important to note that the top income earners already pay a very high proportion of the income tax. The top 0.1% of taxpayers had 11.93% of adjusted gross income (AGI) in 2007 (before the stock market crash) and paid 20.19% of the income tax. The top 2% of taxpayers had 27.95% of AGI and paid 48.68% of the income tax. The bottom 50% of tax filers had 12.26% of AGI and paid 2.89% of the income tax. Half of tax filers now owe no income tax or receive a refundable credit. Many individuals do not have to file because of low income or types of income not subject to tax. But the real concern about the tax system is not who sends the checks to the Treasury but what is being taxed and how that affects growth, employment, wages, and income from saving.

Simulating tax increases on the upper income taxpayers.

Under current law, the two top tax rates of 33% and 35% will revert to 36% and 39.6% in 2013. The top 15% tax rate on capital gains will revert to 20%. The top tax rate on dividends, now linked to the capital gains rate, will revert to ordinary income tax rates. The health reform act will impose a 3.8% tax on capital income on upper income individuals, effectively extending a Medicare-related payroll tax to capital income for the first time. The two top brackets begin fairly close to the often-mentioned thresholds of $250,000 for joint filers and $200,000 for single filers who are to be subjected to higher taxes as a deficit reduction measure. The President has recommended extending the 2001 and 2003 tax cuts for lower income brackets. It seems likely that the link between the dividend and capital gains rates may also be extended.

I have run five potential variations of the pending tax increases on upper income taxpayers through a simple model of the economy and a tax calculator geared to 2008 income levels.[2] The results are displayed in Tables 1 and 2. The model is driven by the effect of the tax changes on the marginal tax rates on labor income, and on the effect of the tax rate changes on the service price of capital (the threshold rate of return an investment in equipment or buildings or other capital must earn to cover its cost, pay its taxes, and yield a normal after-tax return of a bit under 3% for the investor.) Tax increases that raise the service price reduce the capital stock, lower productivity and the demand for labor, and reduce wages and employment. Capital is especially sensitive to tax rate increases, more so than the supply of labor. People may respond to a drop in the after-tax return on capital in the United States by saving less, such that the capital that cannot meet the higher required pre-tax return is not formed, or it may be formed abroad instead of in the United States.

• Case 1: Raise the top tax rates on ordinary income to 36% and 39.6%. Leave the top tax rates on capital gains and dividends at 15%.

This tax increase on wages, interest, and non-corporate business income would knock half a percent off private sector output and labor income across the board (not just in the upper tax brackets), and cut a percent off the capital stock. The service price rises primarily for non-corporate businesses. (See Table 1). The reduced income and economic activity would reduce federal revenue from all types of taxes by about 40% of the expected static revenue gain. The loss of GDP and the tax payment to the government would cost the public $4 for each $1

collected in tax. A dollar of government spending funded in this manner must be worth a great deal more than its apparent budget cost of $1 to justify the outlay. The marginal tax rate increase on non-corporate business income is particularly high. (See Table 2.)

• Case 2: Leave the top tax rates on ordinary income at 33% and 35%. Raise the top tax rates on capital gains and dividends to 20%.

TABLE 1
EFFECT OF RAISING TWO TOP TAX RATES ON GDP, CAPITAL STOCK, LABOR INCOME, SERVICE PRICE, AND FEDERAL REVENUE
(Effects and revenue estimates are modeled at 2008 income levels.)

Tax options for two top brackets	1*	2*	3*	4*	5*
GDP	-0.47%	-1.19%	-1.63%	-6.09%	-2.10%
Private sector GDP	-0.50%	-1.23%	-1.71%	-6.33%	-2.18%
Capital stock	-1.05%	-3.24%	-4.20%	-15.68%	-5.68%
Wages	-0.26%	-1.01%	-1.25%	-5.04%	-1.79%
Hours worked	-0.25%	-0.22%	-0.47%	-1.36%	-0.40%
Service price					
Corporate	-0.02%	3.00%	2.95%	15.12%	5.36%
Non-corporate	1.90%	-0.09%	1.79%	1.54%	-0.16%
Total	0.55%	2.08%	2.60%	11.09%	3.72%
Static revenue ($ billions)	$37.7	$38.0	$75.9	$100.1	$66.3
Dynamic revenue ($ billions)	$22.5	$0.4	$22.8	-$98.7	-$1.1
% revenue loss to economic change	-40.2%	-98.9%	-69.9%	-198.6%	-101.6%
GDP loss per $ of revenue gain	$3.01	$418.66	$10.33	N/A**	N/A**
Cost of $1 of govt. spending	$4.01	$419.66	$11.33	$880.67	304.05

* Tax options:
1: Raise top tax rates on ordinary income to 36% and 39.6%.
Leave top tax rates on capital gains and dividends at 15%.
2: Leave top tax rates on ordinary income at 33% and 35%.
Raise top tax rates on capital gains and dividends to 20%.
3: Raise top tax rates on ordinary income to 36% and 39.6%.
Raise top tax rates on capital gains and dividends to 20%.
4: Raise top tax rates on ordinary income to 36% and 39.6%.
Raise top rates on capital gains to 20%; tax dividends as ordinary income.
5: Leave top tax rates on ordinary income at 33% and 35%.
Raise top tax rates on capital gains and dividends to 23.8%.

** Tax rate increase depresses GDP to the point of losing revenue.

TABLE 2
EFFECT OF INCREASES IN TOP TWO TAX RATES ON MARGINAL TAX RATES BY TYPES OF INCOME (2011 tax rates at 2008 income levels)

Case 1*

Federal Marginal Tax Rates on:	2011 rate	Alternative	Point Incr.	% Increase
AGI	22.76%	23.43%	0.66%	2.92%
Wages	21.71%	22.10%	0.39%	1.78%
Dividends	12.28%	12.28%	-0.01%	-0.05%
Interest Income	23.41%	24.42%	1.01%	4.31%
Business Income	27.44%	29.41%	1.97%	7.17%
Long-term Capital Gains	13.48%	13.46%	-0.02%	-0.16%

Case 2*

Federal Marginal Tax Rates on:	2011 rate	Alternative	Point Incr.	% Increase
AGI	22.76%	22.64%	-0.12%	-0.51%
Wages	21.71%	21.56%	-0.16%	-0.72%
Dividends	12.28%	14.90%	2.61%	21.28%
Interest Income	23.41%	23.40%	-0.01%	-0.04%
Business Income	27.44%	27.37%	-0.08%	-0.28%
Long-term Capital Gains	13.48%	16.72%	3.23%	23.98%

Case 3*

Federal Marginal Tax Rates on:	2011 rate	Alternative	Point Incr.	% Increase
AGI	22.76%	23.30%	0.54%	2.37%
Wages	21.71%	21.96%	0.24%	1.12%
Dividends	12.28%	14.87%	2.58%	21.02%
Interest Income	23.41%	24.38%	0.97%	4.14%
Business Income	27.44%	29.32%	1.88%	6.84%
Long-term Capital Gains	13.48%	16.66%	3.17%	23.54%

Case 4*

Federal Marginal Tax Rates on:	2011 rate	Alternative	Point Incr.	% Increase
AGI	22.76%	23.10%	0.34%	1.50%
Wages	21.71%	21.46%	-0.26%	-1.18%
Dividends	12.28%	27.06%	14.78%	120.29%
Interest Income	23.41%	25.01%	1.60%	6.83%
Business Income	27.44%	29.14%	1.69%	6.17%
Long-term Capital Gains	13.48%	16.73%	3.25%	24.09%

* Tax options:
1: Raise top tax rates on ordinary income to 36% and 39.6%.
Leave top tax rates on capital gains and dividends at 15%.
2: Leave top tax rates on ordinary income at 33% and 35%.
Raise top tax rates on capital gains and dividends to 20%.
3: Raise top tax rates on ordinary income to 36% and 39.6%.
Raise top tax rates on capital gains and dividends to 20%.
4: Raise top tax rates on ordinary income to 36% and 39.6%.
Raise top rates on capital gains to 20%; tax dividends as ordinary income.

This is a tax increase that falls very hard on capital, and on the sector where the tax is doubled up at the business and shareholder level. It is particularly hard on growth and employment. The tax increase on capital gains and dividends would lower private sector output by 1.23%, and trim labor income across the board (not just in the upper tax brackets) by the same amount. It would reduce the capital stock by 3.24%, mainly by increasing the service price in the corporate sector. (See Table 1). The reduced income and economic activity would reduce federal revenue from all types of taxes by almost 99% of the expected static revenue gain; that is, it would raise virtually no revenue while costing income and jobs. The loss of GDP and the tax payment to the government would cost the public $420 for each $1 collected in tax. Nothing the government buys is worth that much. The marginal tax rate increase on dividends and capital gains is very large. (See Table 2.)

• Case 3: Raise the top tax rates on ordinary income to 36% and 39.6%. Raise the top tax rates on capital gains and dividends to 20%.

Combining the first two cases makes the GDP and job destruction worse. Output and income are down 1.7% in the private sector. About 70% of the expected revenue is lost. A dollar of government spending costs the country about $11 in lost income and tax payments.

• Case 4: Raise the top tax rates on ordinary income to 36% and 39.6%. Raise the top rates on capital gains to 20%; tax dividends as ordinary income.

Allowing the tax rate on dividends to revert to ordinary income tax rates raises their marginal tax rate by 120%. (See Table 2.) It greatly increases the service price and the damage to the economy compared to keeping the dividend tax in line with the tax rate on capital gains at 20% as other rates rise (Case 3). The drop in GDP and labor income would be about 6%. The capital stock would fall more than 15%. This economic damage would offset nearly 200% of the expected static revenue; that is, revenue would fall instead of rise, and by a large amount.

• Case 5: Leave the top tax rates on ordinary income at 33% and 35%. Raise the top tax rates on capital gains and dividends to 23.8%, including the health reform tax on capital gains and dividends. (The tax increase on interest income from the health reform tax was not modeled.)

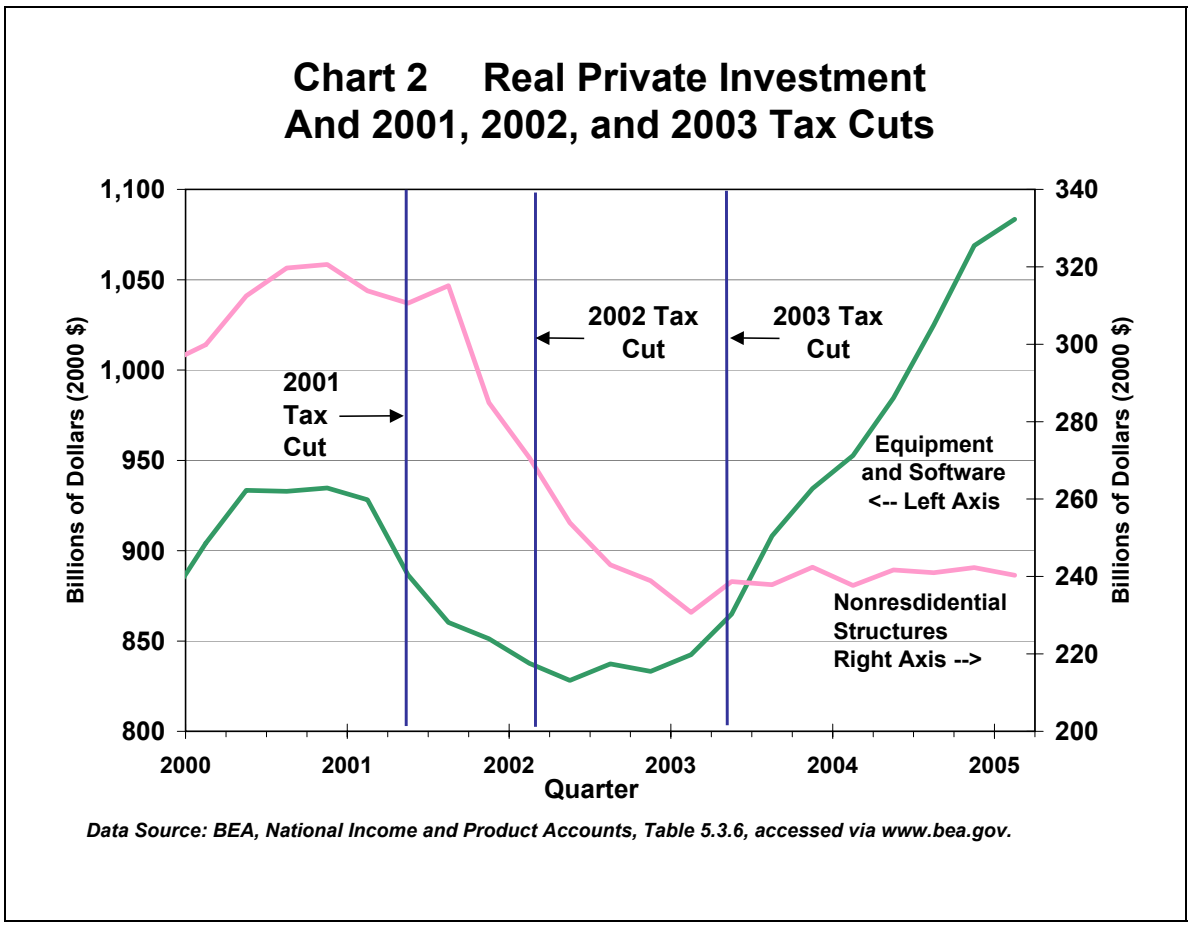
This case goes beyond the increase in the capital gains and dividends tax rate in case 2 by adding the 3.8% tax imposed by the health care reform act. It would further reduce GDP and labor income by about 0.9% compared to case 2. The added economic damage would fully eliminate the projected revenue gain from the two capital tax increases.

Other tax increases on upper-income earners are possible. One could add another tax bracket beginning at higher incomes than where the current top rate begins, perhaps a million dollars for a true "millionaire's surtax" or some lower figure. That would require a decision as to whether that number should be $1 million for single filers and $2 million for couples, or the same for both, continuing the marriage penalty that still exists in the upper brackets. In any case, narrowing the income range subject to higher tax rates would require raising the tax rate even more to make up for the reduced amount of income subject to the higher tax. That would make the economic damage more intense, destroy more jobs, lower wages further, and cause even more of the expected static revenue gains to be lost.

Response of the economy to changes in the service price.

Tax changes that lower the service price of capital have a major impact on investment, employment, and output. Taxes that have little or no effect on investment incentives do far less. Marginal tax rates on labor and other income matter as well, but are less powerful due to the relatively low labor supply elasticity. Taxes that are not at the margin, or not much at the margin, such as the 1975 Ford tax rebate, the 2001 rebate-like refund reflecting the 10% tax bracket, and the more recent stimulus rebates, make little difference to production and employment.

Chart 2 tracks the effect of the 2001 and 2003 tax cuts on investment. There was a very slow "jobless recovery" from the 2000-2001 recession in the first two years after the 2001 tax reduction. The marginal rate cuts were phased in so slowly that there was little initial incentive effect. It was not until the 2003 tax cut that there were significant incentives for saving and investment. In that year, the capital gains and dividend tax rates were reduced to 15%; expensing, introduced in 2002 at 30% of equipment spending, was boosted to 50% of equipment outlays; and the rest of the marginal tax rate cuts were brought forward. Estate tax relief helped too. After 2003, investment in equipment rose rapidly, and job growth accelerated.



Data Source: BEA, National Income and Product Accounts, Table 5.3.6, accessed via www.bea.gov.

Response of capital gains realizations to higher tax rates.

The revenue estimates tied to changes in the capital gains or dividend tax rates described above are based on the effect of the tax changes on economic performance. The following table and chart deals with a different issue: how do changes in the capital gains tax affect the rate at which people choose to take gains. It offers additional support to the warning that raising these tax rates may lose revenue rather than gain revenue.

The table is from the Department of the Treasury, Office of Tax Analysis. It displays the amount of capital gains realized and the tax paid in dollars, the average effective tax rate, realized gains as a percent of GDP, and the maximum tax rate on long-term gains from 1954 to 2007. The numbers cover all types of capital gains, including those on real estate, corporate stock, non-corporate businesses, bonds, and other assets. The maximum rate includes adjustments for exclusions, surcharges, the minimum tax and alternative minimum tax, and the phase-out of itemized deductions as income rises. These are features of the tax code that have been in place at various times.

There have been four major reductions and two major increases in the capital gains tax rate since 1978. The Steiger Amendment lowered the top tax rate most commonly found on long term capital gains in mid-1978, from just under 40% to 28%. It eliminated capital gains as a preference item under the minimum tax and created a 60% exclusion of long term gains from taxable income. Realizations were 2.20% of GDP in 1978, and rose by about a fourth to between 2.58% and 2.86% of GDP in 1979-1981. The Economic Recovery Tax Act of 1981 reduced the top rate to 20% in the spring of that year. Realizations were 2.77% of GDP in 1982, rising to 3.47% in 1983 and 4.08% in 1985.

The longest and most interesting change occurred following the Tax Reform Act of 1986, which raised the top capital gains tax rate from 20% back to 28%. The rate hike was effective January 1, 1987. To beat the 1987 rate hike, asset holders realized a large amount of capital gains in the last months of 1986. Realizations surged from 4.08% of GDP in 1985 to 7.36% in 1986. There was a subsequent drop in realizations in 1987, to 3.13% of GDP.

This two-year rise and fall could have been due to a simple timing shift, moving gains from 1987 to 1986. However, gains remained depressed as a share of GDP for a decade. Realizations continued falling to 1.86% of GDP in 1991 (a recession year), and struggled back only to 3.34% of GDP in 1996, still below the 1985 share. Gains did not recover their 1985 share of GDP until 1997, when the capital gains tax rate was again reduced to 20% by the Taxpayer Relief Act of 1997, effective as of May 8th of that year. This episode of a decade-long depression in realizations and tax revenue simply cannot be dismissed as either short-term timing or a fluke.

Following the 1997 rate cut to 20%, realizations remained elevated until the dot-com stock market crash and economic recession in 2001. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the top rate from 20% to 15%. Realizations rose from 2.95% of GDP to 4.27% in 2004 and to 6.56% in 2007. In each of these years, government revenue estimators under-estimated the rise in the gains and the duration of the increase, and had to revise their projected gains and revenues up in each new year's budget work. Gains have undoubtedly swung widely since the latest recession and stock market crash in 2008.

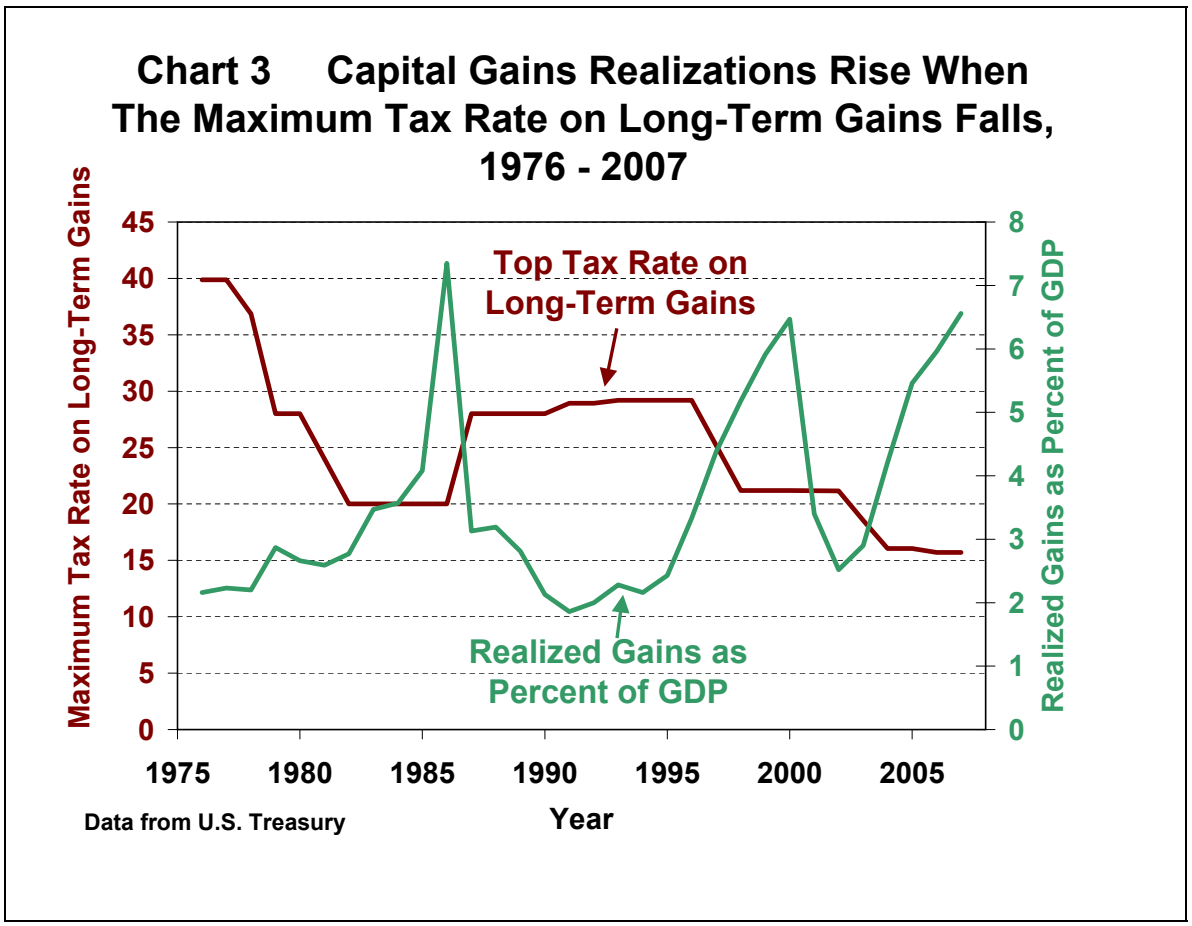
Capital Gains and Taxes Paid on Capital Gains for Returns with Positive Net Capital Gains, 1954-2005 (dollar amounts in millions)

Year	Total Realized Capital Gains	Taxes Paid on Capital Gains	Average Effective Tax Rate (percent)	Realized Gains as a Percent of GDP	Maximum Tax Rate on Long-Term Gains
1954	7,157	1,010	14.1	1.88	25.00
1955	9,881	1,465	14.8	2.38	25.00
1956	9,683	1,402	14.5	2.21	25.00
1957	8,110	1,115	13.7	1.76	25.00
1958	9,440	1,309	13.9	2.02	25.00
1959	13,137	1,920	14.6	2.59	25.00
1960	11,747	1,687	14.4	2.23	25.00
1961	16,001	2,481	15.5	2.93	25.00
1962	13,451	1,954	14.5	2.29	25.00
1963	14,579	2,143	14.7	2.36	25.00
1964	17,431	2,482	14.2	2.62	25.00
1965	21,484	3,003	14.0	2.98	25.00
1966	21,348	2,905	13.6	2.70	25.00
1967	27,535	4,112	14.9	3.30	25.00
1968	35,607	5,943	16.7	3.91	26.90
1969	31,439	5,275	16.8	3.19	27.50
1970	20,848	3,161	15.2	2.01	32.21
1971	28,341	4,350	15.3	2.51	34.25
1972	35,869	5,708	15.9	2.89	36.50
1973	35,757	5,366	15.0	2.58	36.50
1974	30,217	4,253	14.1	2.01	36.50
1975	30,903	4,534	14.7	1.89	36.50
1976	39,492	6,621	16.8	2.17	39.875
1977	45,338	8,232	18.2	2.23	39.875
1978	50,526	9,104	18.0	2.20	39.875/33.85
1979	73,443	11,753	16.0	2.86	28.00
1980	74,132	12,459	16.8	2.65	28.00
1981	80,938	12,852	15.9	2.58	28.00/20.00
1982	90,153	12,900	14.3	2.77	20.00
1983	122,773	18,700	15.2	3.47	20.00
1984	140,500	21,453	15.3	3.57	20.00
1985	171,985	26,460	15.4	4.08	20.00
1986	327,725	52,914	16.1	7.36	20.00
1987	148,449	33,714	22.7	3.13	28.00
1988	162,592	38,866	23.9	3.18	28.00
1989	154,040	35,258	22.9	2.81	28.00
1990	123,783	27,829	22.5	2.13	28.00
1991	111,592	24,903	22.3	1.86	28.93
1992	126,692	28,983	22.9	2.00	28.93
1993	152,259	36,112	23.7	2.29	29.19
1994	152,727	36,243	23.7	2.17	29.19
1995	180,130	44,254	24.6	2.43	29.19
1996	260,696	66,396	25.5	3.34	29.19
1997	364,829	79,305	21.7	4.39	29.19/21.19
1998	455,223	89,069	19.6	5.18	21.19
1999	552,608	111,821	20.2	5.96	21.19
2000	644,285	127,297	19.8	6.56	21.19
2001	349,441	65,668	18.8	3.45	21.17
2002	268,615	49,122	18.3	2.57	21.16
2003	323,306	51,340	15.9	2.95	21.05/16.05
2004	499,154	73,213	14.7	4.27	16.05
2005	690,152	102,174	14.8	5.46	16.05
2006	798,214	117,793	14.8	5.96	15.70
2007 1/	924,164	137,042	14.8	6.56	15.70

Department of the Treasury
Office of Tax Analysis

January 14, 2010

1/ Preliminary estimate, subject to revision.



Treasury, CBO, and Joint Tax Committee revenue estimators acknowledge and try to take account of short run timing effects of tax rate changes in their capital gains revenue estimates. In all these historical cases, however, there appears to have been a longer term response to the lower rates, in addition to a short-run unlocking event after a rate cut or a timing shift in anticipation of a rate hike. This thirty year period indicates that people hold assets longer, and take fewer gains over time, at higher capital gains tax rates than they do at lower rates. This is a permanent realizations effect that government revenue estimators should take into account.

Tax reform, the tax base, and tax expenditures

Fighting the deficit while improving the economy is not a simple task. Tax reform must be done right if it is to help the situation. It is important to understand two things. First, government spending does not increase employment and output; it crowds out private sector output, usually with a decrease in value to the public, and creates dead-weight losses from the taxes imposed to fund the spending. Second, "perfecting" the income tax by "broadening the base and lowering the rate" would hurt, not help, the economy; we need a more fundamental shift to a different tax base.

The current income tax system is heavily biased against saving and investment, and is seriously depressing output and income. There are several less-biased, more growth-friendly tax alternatives, such as the cash flow tax in the Report of the President's Panel on Tax Reform — the Bush panel — or the Flat Tax, various versions of the USA Tax, or the Bradford "X" tax, or the straightforward inflow-outflow tax developed by Norman Ture (on our web site at www.iret.org). Real tax reform would move toward one of these systems.[3]

The "broad-based" income tax hits income used for saving and investment repeatedly and more harshly than income used for consumption. Pay tax on your income (tax layer one) and consume the remainder, and there are few added federal taxes (other than alcohol, tobacco, and gasoline). But save your after-tax income (outside of limited pension and IRA options), and the profit, interest, dividends, or capital gains are taxed (tax layer two). Dividends and stock-related capital gains also face the corporate tax (tax layer three). For all businesses, corporate and non-corporate, investment expenses must be deducted over many years instead of when they are made (when expensing is not in force), overstating income, and creating a back-door increase in effective tax rates. Save too much, and you become subject to the estate tax (tax layer four).

Real tax reform would end these biases and over-statements or double counting of capital income by taking a few key steps. They would fundamentally shift the tax base from "broad-based income" to "consumed income" or "cash flow".

• Step 1: Give all saving the same treatment received by pensions; either defer tax on saving and its returns until the money is withdrawn for consumption, or tax the saving up front and do not tax the earnings.

• Step 2: Adopt expensing instead of depreciation; alternatively, adjust the depreciation allowances for the time value of money (index unused portions by an appropriate discount rate) to preserve their present value.

• Step 3: Tax income in the corporate sector either at the level of the firm or at the level of the shareholder, but not both; that is, integrate the corporate and personal income taxes.

• Step 4: Eliminate the estate tax.

• Step 5: Move to a territorial tax system.

The broad-based income tax was designed by its intellectual godfathers, Professors Robert Haig and Henry Simons, to redistribute income at the expense of thrift and production, not to foster economic growth. (Although even Haig and Simons thought the corporate tax on top of the personal tax was going too far.) Simons acknowledged that his tax proposals would dampen saving and reduce GDP. We do not need more of that. Perfecting the income tax by broadening the base by double or triple taxing the same income is not the answer to our tax problems.

If one is content with superficial solutions, it is very easy to lower tax rates. Here is the new IRS Form 1040:

Line 1. Enter your income.
Line 2. Multiply line 1 by three.
Line 3. Pay tax at half the old tax rate.

Presto! The tax rate is cut in half and the revenue jumps by half! Of course, it is too good to be true. The tax rates on the actual income have gone up by half due to the mismeasurement of the tax base. The economy will shrink due to the larger tax wedge on productive activity. Revenue will fall short of the hoped for gains.

The Bowles-Simpson Deficit Reduction Commission's preferred tax plan claims to maintain progressivity, reduce tax rates, raise revenue, and promote growth by closing tax expenditures and broadening the tax base. Merely playing "close the loophole" with the tax expenditure tables of the Treasury and the Joint Tax Committee will not do the job. These tables accept the anti-saving biases in the income tax as the norm, and do not distinguish between loopholes and genuine costs of production that must be allowed as a deduction from revenue to correctly determine income. They fail to distinguish provisions that avoid double-tax situations that would otherwise destroy jobs and income from blatant subsidies of money-losing activities that reduce jobs and GDP.

Taxes would be higher under the Commission Plan than under current levels. That cannot promote growth unless the revenue raisers are restricted to those items which are wasteful and non-growth related, while incentives for additional investment and employment are enhanced, a very tall order. The Deficit Commission did not make such distinctions, nor did it ask for or receive the quantitative analysis needed to determine whether the balance of its proposals would move the economy forward or drag it down.

The Commission advocated 28% top rates for individuals and corporations. To get there, it explicitly called for taxing capital gains and dividends at the same rate as other individual income. That would increase the double taxation of income produced by labor and capital in the corporate sector. The dividend tax is on top of the corporate tax, and the capital gains tax is largely a tax on after-tax retained earnings that raise the value of the company.

With a 35% corporate tax rate and a 15% tax rate on capital gains and dividends, shareholders keep 55.25 cents on a dollar of income in the corporate sector after taxes (57.93 cents with the manufacturers' credit). With two 28% top tax rates, shareholders would keep only 51.84 cents, a 6% (or 10.6%) drop in the rate of return. The tax rate at either the corporate level or the shareholder level would have to be much lower than in the Commission proposal for shareholders to break even (very low 20s, less for manufacturing). Otherwise, the tax hurdle for corporate capital would be raised. According to a macroeconomic analysis by IRET, the resulting reduction in capital formation would slash GDP by almost 3%, and the capital stock by $2.5 trillion, relative to levels they would otherwise reach. The dynamic damage would cancel out $70 billion of the $80 billion the Bowles-Simpson panel wanted to raise.

The Deficit Commission seems to have modelled its system on the Tax Reform Act of 1986 (TRA86), the last time we treated cap gains as ordinary income. But this is not 1986. The starting point is very different.

The Tax Reform Act of 1986 (TRA86) raised the net tax at the margin on capital and reduced it for labor. On balance, it slightly reduced potential output. It would have been a modest positive for the economy if Congress had followed the Treasury reform plan as submitted, but it did not. Treasury had recommended indexation of depreciation allowances for inflation. That would have helped to reduce slightly the required service price or "hurdle rate of return" that capital must earn in order to be a feasible investment, in spite of longer assets lives and repeal of the investment tax credit under the bill. Congress dropped the indexing provision, and the hurdle rate went up, discouraging investment.

Nonetheless, TRA86 cut the corporate rate 12 points from 46% to 34%; Bowles-Simpson would cut it from 35% or 31.85% (with the manufacturing credit) to 28%, only a 4 to 7 point cut. TRA86 raised the top rate on capital gains from 20% to 28%, but lowered the top rate on dividends from 50% to 28%, reducing the double tax on corporate income. Under Bowles-Simpson, both would rise from 15% to 28%, increasing the double tax from current levels. TRA86 eliminated the investment tax credit. Bowles-Simpson would eliminate the current expensing provision, equally bad.

TRA86 fixed some excesses within the framework of the income tax, but it did not change the character of the tax much. It was not the sweeping pro-growth reform of a shift to the neutral base of the Flat Tax, Bradford X tax, or the cash flow tax of the Bush panel. That type of fundamental reform has the potential to add ten percent to national output and income. The Bowles-Simpson Commission also rejected a major shift in the tax base, and its changes within the confines of the income tax would be far more damaging to tax neutrality between saving and investment than those of TRA86.

When TRA86 raised the capital gains tax rate, CBO and Treasury estimated it would cause a reduction in the taking of gains (realizations) only briefly. In fact, as discussed above, capital gains realizations crashed (after soaring in the year before the effective date to avoid the rate hike) and they remained depressed below their 1985 share of GDP for a decade until the rate was reduced again to 20% in 1997. The effect of the higher tax rates on realizations was permanent, not temporary. If Congress makes that mistake again, the Treasury will not gain a nickel.

The tax expenditure lists made up by Treasury and the Joint Tax Committee are based on deviations from the broad-based income tax. They assume the added tax layers and biases in the income tax against saving and investment are part of the ideal norm. Many of the items on the list of tax expenditures are partial offsets to the biases in the income tax. These offsets include all the pension and retirement and education saving arrangements, accelerated depreciation and expensing provisions, lower tax rates on capital gains and dividends, and most offsets to the corporate income tax. The credit against the estate and gift tax and exempt amounts for annual giving are also offsets to an extra tax layer of tax on capital. Perfecting the

income taxes or estate levies by eliminating offsets to these added tax layers would increase the tax bias against saving and investment.

The anti-saving bias is more important, and more damaging to the economy, than many of the differences in tax preferences among industries. Eliminating the preferences by raising the tax on the partially protected sectors, rather than extending the tax relief to the sectors not now favored, would depress economic activity, not improve it.

During the last five years of President G. W. Bush's administration, U.S. Budget documents showed an alternative list of tax expenditures under a "saving-consumption neutral" tax. Most of the big ticket expenditures (other than health insurance) fell out, including all retirement plans, expensing or rapid depreciation, and lower tax rates on dividends and capital gains. Under a consumed-income or neutral tax system, the corporate tax is a "negative" tax expenditure, as is the ordinary tax treatment of saving outside of retirement plans. President Obama's budget document dropped that expanded coverage of the alternative view of tax expenditures. Now all we see is the broad-based income tax (and a closer-to-Haig-Simons variant) as the ideal tax base, and the tax expenditures associated with that base.

Real tax reform alternatives, which would treat saving and consumption evenly, such as a cash flow tax, Flat Tax, or national sales tax, are not on the table. Those taxes do not punish investment versus consumption. They regard pensions and immediate expensing of investment costs as the norm and not deviations from the "ideal." All saving would be taxed only once, with no double-taxation of corporate income and estates.

The Bowles Simpson Commission did not examine the economic benefits of a real tax reform, one example of which they briefly considered and dismissed. No estimates were provided by Treasury or the Joint Committee on Taxation of the effect of their proposals on the cost of capital. The economic damage from their net tax hikes on capital was not factored into the revenue estimates. No money would be raised, and the public would suffer a drop in income.

Competitiveness

The United States is part of the global economy. To be competitive, it needs to be a good place in which to produce goods and services. One of the requirements is a tax system that is not anti-investment and anti-growth. Tax differentials matter. Consider two cases.

In 1988 and 1990, Japan mimicked the U.S 1986 tax reform. It had been exempting interest on most savings from tax, and did not tax capital gains. In the reform, it ended the tax exempt interest for people below retirement age, and implemented a capital gains tax. Rate cuts were not sufficient to offset the raise in the service price. Japan also raised a national property tax on real estate. The tax increases pricked the stock and real estate "bubbles" and rendered the banking system insolvent. To this day, Japan regards its troubles as a banking problem, not realizing that it was triggered by a misguided move toward a more comprehensive income tax. The result has been a twenty year depression. Japan continues to have the highest corporate tax rate in the developed world.

The People's Republic of China has taken the opposite approach. It has a 25% corporate tax rate, and relies on a VAT for the remainder of its national government income. The VAT incorporates expensing. The income tax is reserved for the provinces. Capital gains on Chinese shares are not taxed, nor is bank interest. There is no estate tax. The Chinese tax system is closer to a consumed-income or saving-consumption-neutral tax base than to a broad-based income tax. China is lifting hundreds of millions of people out of poverty. The Chinese tax system has some other drawbacks, its state-supported industries absorb too much of its investment, and lack of secure property rights and personal freedoms are troubling. But the growth of the Chinese economy in recent years has been remarkable, especially compared to the stagnation in Japan.

Conclusion

The nation needs a change to a better tax system with a better tax base more neutral in its treatment of saving and investment. If the Congress is not able to provide that, it should extend the current tax cuts and stick entirely to spending cuts for deficit reduction.

Endnotes

1. See Stephen J. Entin, "Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax?" *IRET Policy Bulletin*, No. 88, September 10, 2004, available at http://iret.org/pub/BLTN-88.PDF.

2. The tax calculator was provided courtesy of Gary Robbins of the Heritage Foundation Center for Data Analysis, who also assisted with modeling advice.

3. A national retail sales tax or a VAT are equally "neutral" between consumption and investment. Both incorporate expensing and avoid multiple taxation of capital income. Their major drawback is that they tend to mask the cost of government from the taxpayer/voter, which is a bad policy in a democracy. It is also difficult to exclude the poorest citizens from these tax except by exempting large amounts of "necessities", which drives up the rate on other items.