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Statement of

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

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Chairman Baucus, Ranking Member Hatch, Members of the Committee. Thank you for inviting me to testify on tax reform options affecting high-income taxpayers. I applaud the committee for devoting much of the past year to examining ways to make the tax code simpler, fairer, and more conducive to economic growth, and I'm honored to be asked to contribute to those deliberations.

In summary, here are my main points:

- Economic theory suggests that the degree of progressivity should balance the gains from mitigating economic inequality and risk-sharing against the costs in terms of disincentives created by higher tax rates. The optimal top tax rate depends on social norms and the government's revenue needs.
- Experience and a range of empirical evidence suggests that the rates in effect in the 1990s would not unduly diminish economic growth. However, a more efficient option would be to broaden the base (reform or eliminate tax expenditures and eliminate loopholes) to achieve distributional goals while keeping top rates relatively low.

- The biggest loophole is the lower tax rate on capital gains. Several bipartisan tax reform plans, including the Bipartisan Policy Center plan that I contributed to, would tax capital gains at the same rate as other income. Combined with a substantial reduction in tax expenditures, this allows for a cut in top income rates while maintaining the progressivity of the tax system. That was also the approach taken by Ronald Reagan in 1986.
- Different economists reach diametrically opposite conclusions about the taxation of dividends. I find most compelling a recent analysis that suggested that concerns about tax avoidance activities of multinationals (e.g., moving headquarters and jobs overseas) would argue for fully taxing dividends and using the revenue raised to cut corporate tax rates.
- Finally, there has been much hand-wringing about lower-income families that don't pay income tax or even receive net subsidies. Some of these families are retired and I can't imagine that taxing them is feasible or desirable. The lower-income working families receive tax subsidies that encourage work, which is consistent with the prescriptions of optimal tax and transfer literature. To clarify the distinction between tax obligations and benefits, I suggest that the IRS produce a tax and subsidy report for all filers showing what their true tax liability is—before tax expenditures—as well as the value of their tax subsidies.
- Bottom line: allowing the top tax rates to return to their pre-2001 levels after the economy has recovered would not be economically disastrous and might help build support for tax reform that would broaden the base and lower rates while maintaining the progressivity of the tax system (and hopefully contribute to reducing the debt).

1. Top Income Tax Rates

Next year, if not sooner, Congress will again have to address the question of whether to allow the "Bush tax cuts" to expire for some or all households. The president has proposed to allow the top two income tax brackets to return to their Clinton-era levels. The top rate would increase from 35 to 39.6 percent and the second bracket would increase from 33 to 36 percent. Doing nothing would allow all the rates to return to Clinton levels.

Three questions must be answered to determine the top income tax rates. First, how much revenue does the government need? It seems obvious to me that when the economy is doing well, revenues should be close to the level of spending. That certainly does not imply a balanced budget every year or even necessarily over the business cycle, but it does rule out large persistent deficits as we have experienced over the past decade. That said, there is a strong argument for running deficits while the economy remains weak, because raising taxes or cutting spending reduces aggregate demand and could plunge the economy back into recession. That argument holds with special force now when monetary policy appears to be tapped out. And, even when the economy is at full employment, there might be an argument for a modest deficit if much of government spending is in the form of investments that pay returns over many years. On the other hand, if the government is accumulating obligations without adequately funding them, there might be an argument for running surpluses.

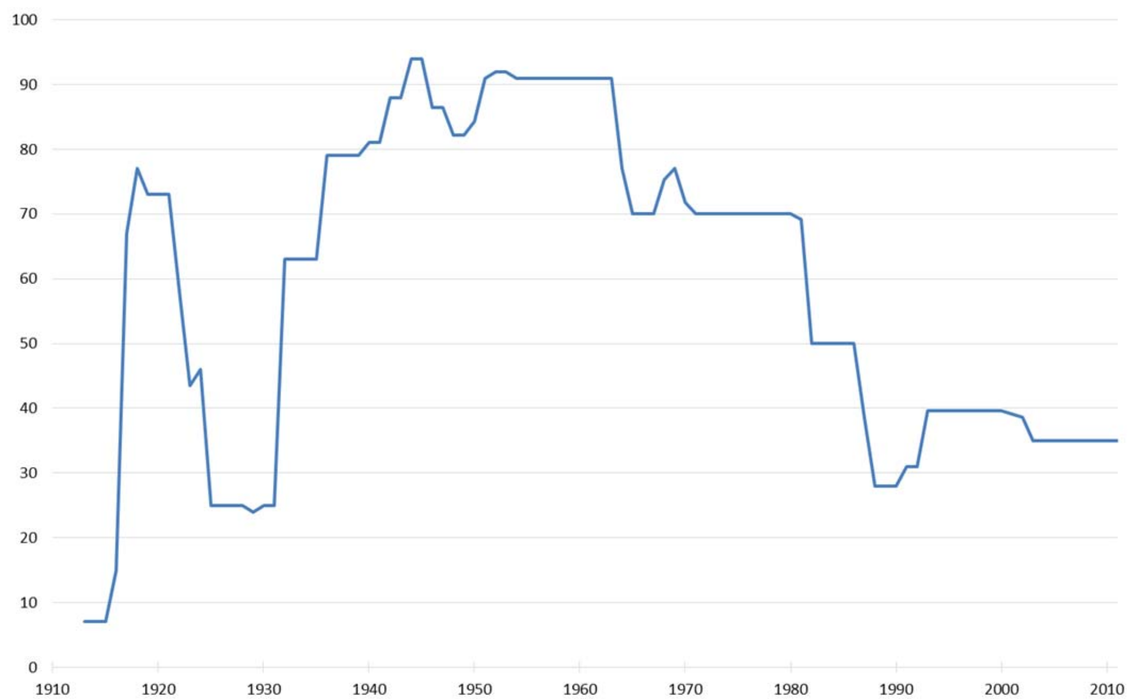
Second, how broad or narrow will the tax base be? Currently, the income tax code includes around a trillion dollars of tax subsidies or tax expenditures. The exact number could be larger or smaller depending on what is considered a tax expenditure, but my point is that they are quantitatively quite significant. Most economists' preference would be to eliminate or reform many tax expenditures so that rates can be kept as low as possible while still meeting distributional and revenue objectives. Every recent tax reform, dating back at least to the proposals made by President Bush's tax reform commission, would significantly scale back tax expenditures and use at least some of the savings to cut income tax rates.

Third, how should the tax burden be distributed? The answer to this question balances normative considerations reflecting social values against the economic incentive effects of higher tax rates. Less well understood is the fact that taxes provide a kind of insurance whose value offsets to some extent the negative incentive effects.

It is certainly not my role to opine on social values, but I can provide some data that might be relevant to you in your considerations.

Top tax rates are low by historical standards. Although higher than they were in the immediate aftermath of the Tax Reform Act of 1986, top tax rates are now (and were during the Clinton Administration) lower than at any time between 1932 and 1986. (See Figure 1.) While it is possible that the economic costs of taxation have grown since 1986—for example, because the technology of tax avoidance has improved—it is unlikely that returning tax rates to their levels in 2000 would entail a huge economic cost. Despite predictions that the economy would collapse in 1993 when tax rates increased, economic growth was quite robust until 2000. And notwithstanding forecasts that the Bush tax cuts would turbocharge the economy, growth was anemic throughout the last decade (even before the Great Recession). This certainly does not prove that economic growth is independent of tax rates, but it does suggest that, at least at current tax levels, other factors are more important.

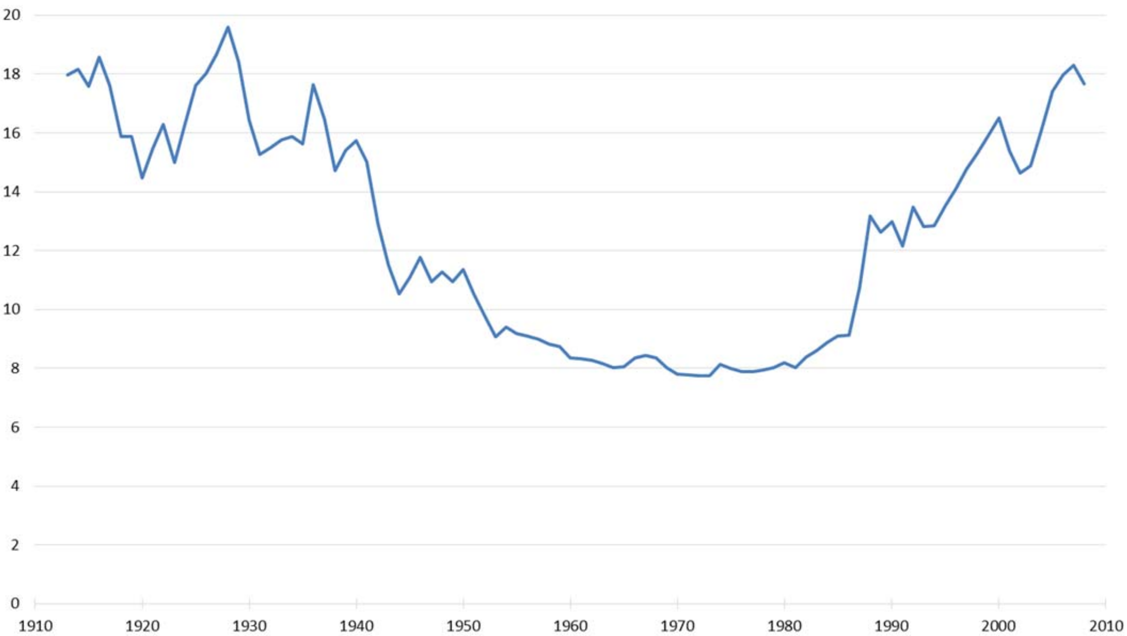
Figure 1. Highest Individual Income Tax Bracket, in percent, 1913-2011



Source: Tax Policy Center, http://taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=543

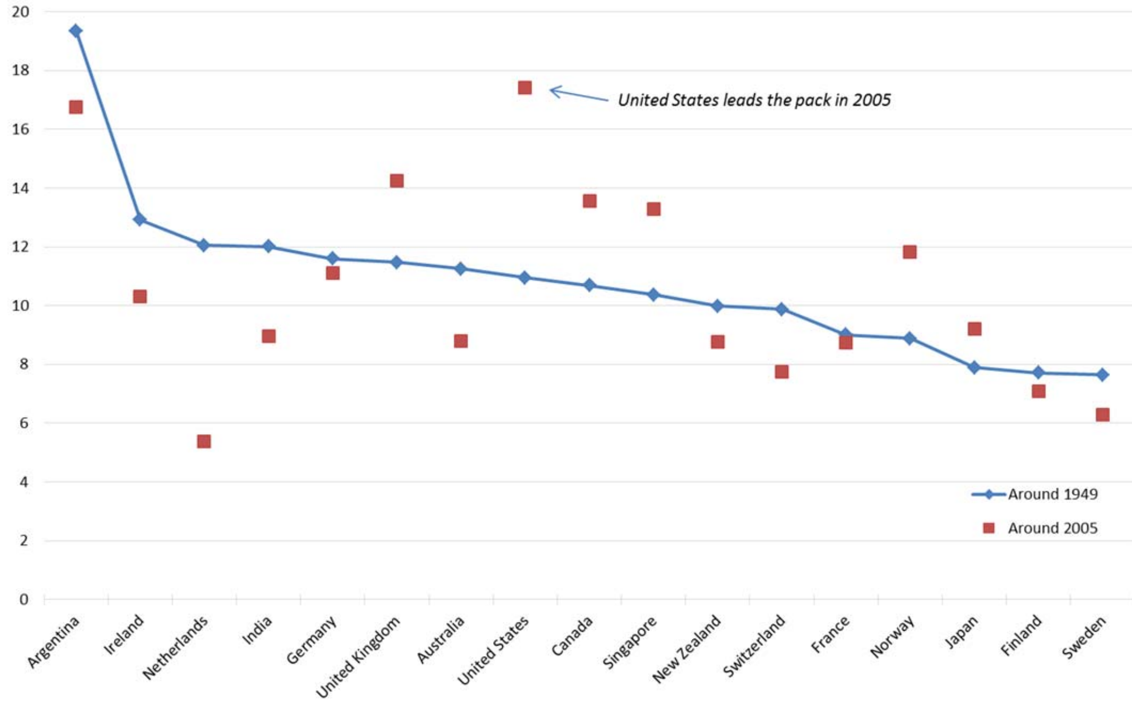
Inequality in 2007 was at its highest level since the great depression. Before the Great Recession, both income and wealth inequality had reached the highest levels in almost 80 years. For example, data collected by economists Thomas Picketty and Emmanuel Saez (see figure 2) show that, in 2007, the top 1 percent of households earned over 18 percent of all income (excluding volatile capital gains) for the first time since 1929. The income share of the top earners plummeted during the great depression falling below 10 percent from the 1950s through the 1970s before rising steadily starting in the 1980s. Income inequality in the United States is now among the highest in the developed world. (See figure 3.)

Figure 2. Income Share of Top 1 Percent, Excluding Capital Gains, in Percent, 1913-2008



Source: Thomas Picketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," Quarterly Journal of Economics, 118(1), 2003, 1-39. Updated data at http://elsa.berkeley.edu/~saez/TabFig2008.xls.

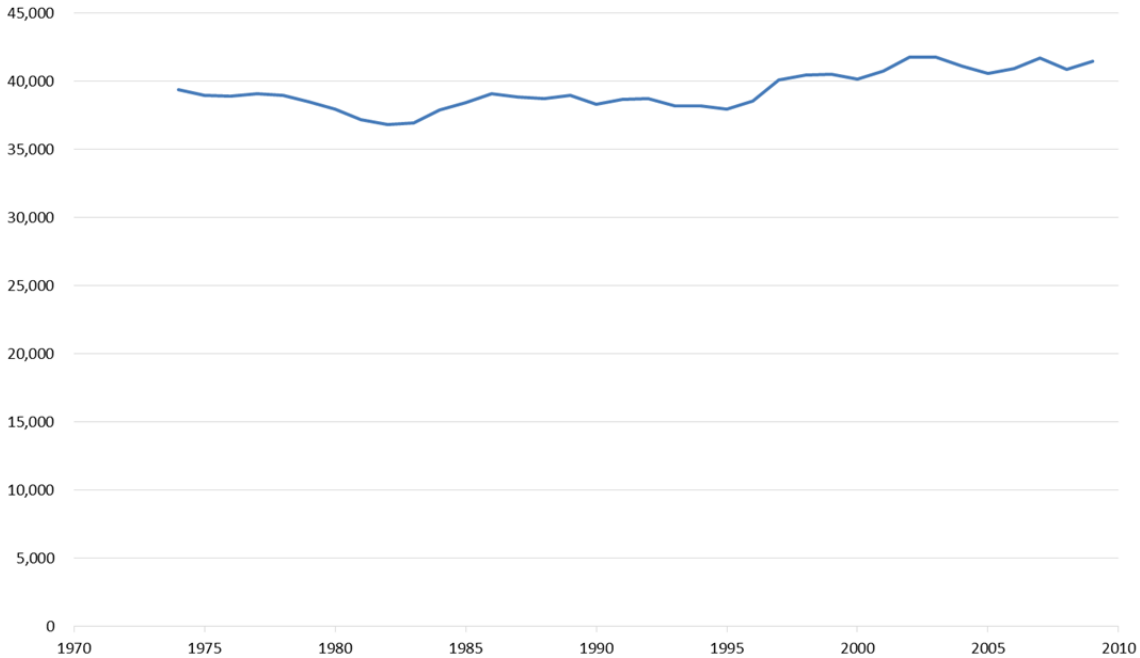
Figure 3. Top Income Shares in Selected Countries, in Percent, 1949 vs. 2005



Tony Atkinson, Thomas Piketty, and Emmanuel Saez, "Top Incomes in the Long Run of History" , Journal of Economic Literature, 49(1), 2011, 3-71.

<u>The middle class has been in a 30-year recession.</u> There is great concern about the tremendous harm caused by the financial meltdown and ensuing recession, but the middle class in the United States has experienced almost no income growth for the past 30 years. Incomes by a variety of measures have grown barely faster than inflation. For example, figure 4 shows that median earnings for full-time, full-year workers grew by only 0.15 percent per year from 1974 to 2009 after adjusting for inflation. Some point out that total compensation has grown faster because most workers still get health insurance at work and the cost of health insurance has far outstripped inflation. But I doubt that workers perceive more economic gain when it's explained that almost all of their pay increases have gone to pay for increasingly expensive health insurance.

Figure 4. Median Earnings for Full-Time, Full-Year Workers, in 2009$
1974-2009



Source: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements.

<ins>Extreme inequality may lead to worse economic policy.</ins> As an economist, I'm in awe of the magic of the capitalist system. It is unsurpassed for producing great abundance at low cost, but it doesn't guarantee that the benefits will be widely shared. President Kennedy's famous metaphor is not robust. A rising tide doesn't necessarily lift all boats.

While I view this as undesirable in its own right, I'd argue that even those who do not care about inequality *per se* should be concerned about this trend. If the bottom 60 or 80 percent of the population feels like they're not getting their fair share, that could lead to a populist revolt. Voters might be tempted to support populist calls for trade restrictions, more regulation, or throwback policies like a return to the gold standard. Any of those responses could be extremely detrimental to economic growth. For that reason, those who benefit most from the current system have an incentive—completely beyond any notion of altruism—to try to mitigate extreme inequality in ways that entail less economic cost.

To be sure, the best approach is to provide more economic opportunities, such as better and more affordable education, but not everyone can or should go to college. The income tax plays an important auxiliary role. It's second best because it adjusts outcomes rather than opportunities, but equalizing opportunity is simply impossible. Some people are born smart, rich, good-looking, or with the ability to jump very high or throw a baseball very fast.

The progressive income tax represents a balancing act. A progressive income tax does a number of things. It mitigates inequality, provides a form of insurance, and weakens economic incentives. The first point is obvious. A schedule of rising tax rates means that high-income people pay a much larger share of their income in taxes than lower-income people.

The insurance aspect of progressive taxation is less well understood. With taxes, government becomes a kind of partner—albeit an involuntary one. When taxpayers do well, they pay a lot of tax. When things go badly, they pay less (or even get a net subsidy). Even a flat tax reduces the variance of after-tax returns (since the government takes on a fraction, t, of any gain or loss, where t is the tax rate), but a progressive income tax allows for a higher level of consumption when things go badly than a flat tax system that raised the same amount of revenue. Effectively, it provides insurance in the case of bad luck. (And, just like real insurance, it also provides less incentive to avoid bad outcomes—a cost that I discuss below.) To the extent that the income distribution reflects luck, most of us would prefer a system that smooths after-tax incomes (for the same reason that we buy insurance).

Economist Hal Varian, who developed the theory of taxation as insurance in a seminal paper, argued that this aspect of taxation might argue for especially high tax rates on people with very high incomes—say over $1 million per year. The logic is that incomes that high must have a substantial luck component. It is not plausible that people reach that level of income simply by working especially hard or saving more much than their neighbors. To the extent that very high incomes derive from factors outside taxpayers' control, taxing those incomes at high rates might have little or no effect on their behavior. However, that theory did not account for the possibility of tax shelters that may be especially attractive to those with high incomes.

As noted, the obvious downside of progressive taxation is that it weakens economic incentives. However, most economic evidence suggests that taxpayers' real responses to the individual income tax are small. One might expect high tax rates to deter work and saving, but in fact, the effects are ambiguous. On the one hand, a higher tax rate reduces the reward to both activities. (Economists call this the substitution effect.) On the other hand, by making taxpayers feel poorer, taxes can ironically provide an incentive to work or save more. (This is called the income effect.) For example, a taxpayer whose living expenses are inflexible may need to work harder to make ends meet when take-home pay falls. Someone saving for retirement needs to save more to reach a target level of retirement income if the after-tax rate of return declines. The overall response of both work and saving to taxation is the sum of the substitution and income effects. Empirically, the total response appears to be very small or even zero on average. Surely some people work or save less when taxes go up, but others choose to work or save more.

There are two parts to the labor supply response: participation and hours. Evidence suggests that hours worked is not very responsive to tax rates, but participation (the decision of whether to work or not) is somewhat more sensitive, especially for second earners and those with low incomes. Recent policies tend to encourage participation in both groups. Marriage penalty relief enacted over the past 10 years reduces the marginal tax rates facing many second earners, providing more incentive to enter and stay in the work force. The earned income tax credit and the refundable portion of the child tax credit are contingent on earnings, providing a strong incentive for low-income people to work . Without earnings, they cannot claim the credits.

As for those with very high incomes, their labor supply is unlikely to be very responsive to taxation. Otherwise, people earnings millions of dollars a year would be working hundreds or thousands of times as hard as people with moderate incomes, which is implausible. (One theory of wage inequality at the top is the “winner take all” model, which suggests that the people at the very top echelons earn many times as much as people who are quite talented, but a rung below. This suggests that the penalty to slacking off, even a little bit, would be much more than could be effected by taxation. Compare the salaries of vice presidents with CEOs, triple-A baseball players with major league starters, summer stock actors with Broadway stars. It seems highly unlikely that top performers would slack off in response to higher taxation. And, as noted earlier, luck plays a larger role in the incomes of the super-rich than the rest of us. Overall, evidence suggests that their labor supply is insensitive to tax rates.

However, there are other ways to skirt tax liability, legally and not, and those appear to be more responsive to taxation. Those responses are not typically as economically costly as real responses. If a corporate executive chooses to squirrel away a few hundred thousand dollars in deferred compensation, there may be a loss to the Treasury but there's unlikely to be much of an effect on the real level of economic activity. However, if that executive invests in complex tax shelter arrangements, those might entail a real cost to the economy for several reasons. First, some of the kinds of investments that make good tax shelters would make no sense absent tax considerations. As a result, capital may be allocated to less productive investments than it would without the tax incentives. Second, the kinds of people who invent complex tax shelters could otherwise be doing productive work. Their work on shelters, as creative as it might be, does nothing to make us more competitive or produce goods and services that real people might want to buy. So tax avoidance is wasteful.

In some cases, the avoidance might reflect Congress's priorities. For example, if I decide to save more for retirement to avoid tax, presumably that's exactly what Congress had in mind when it created tax-free retirement accounts. The pay-off for such activities is greater at higher tax rates. And some people might decide to take a chance on starting a business because it is a good way to avoid tax. Businesses can deduct expenses that employees can't, and many of them choose not to report all the income that the IRS thinks should be taxed. Both legal avoidance and shadier evasion activities are more profitable at higher tax rates. If you want to encourage people to go into business for themselves, raising tax rates would provide a boost.

However, to the extent that tax shelters become more prevalent at high incomes, the economic cost of raising top rates will increase at the same time that the revenue yield diminishes. The best ways to address this problem are to eliminate loopholes that enable tax avoidance and raise the likelihood of detection and penalties for illegal tax evasion. And the biggest loophole is the lower tax rate on capital gains, as I discuss in the next section.

There is an upper bound on productive tax rates—in the sense that higher rates could actually reduce revenue (an effect made famous by Arthur Laffer and his napkin). A new survey by economists Peter Diamond and Emmanuel Saez estimated that the revenue-maximizing federal income tax rate was "conservatively" 48 percent assuming the existing tax base and could be as high as 76 percent if the tax base were much broader. Evidence from other studies also suggests that current rates are safely below the unproductive level.

The "right" rate ultimately depends on spending. After the economy recovers, government should be paid for (although small deficits might be justifiable as I explained earlier). If the low marginal tax rates lead to larger deficits, even if the lower rates boost the economy in the short run, the much higher tax rates required to pay back the debt with interest in the future will entail a far bigger economic cost than setting rates at the level required to tame the deficit. Studies by the nonpartisan staffs of the JCT, CBO, and Treasury (all under Republican appointees) reached this conclusion. Policymakers must figure out what government needs to do and, after the economy has recovered from this deep recession, pay for it. That will probably require higher tax rates or significant tax reform.

2. Tax Rates on Capital Gains

Long-term capital gains (those on assets held at least one year) and qualifying dividends are taxed at a top rate of 15 percent. By comparison, the top tax rate on other income is 35 percent. If Congress does nothing, the rates on gains will increase to 20 percent in 2013 and the top rate on dividends will return to 39.6 percent. Moreover, the Affordable Care Act included a surcharge on investment income of 3.8 percent, which would raise the effective rates to 24 and 43 percent.

While long-term capital gains have been taxed at lower rates than other income for most of the history of the income tax, dividends have only been taxed at a lower rate since 2003. The argument for a lower dividend tax rate is that corporation income is already taxed at the company level. Taxing the dividends again corresponds to double taxation. A similar argument is often made to justify lower capital gains tax rates. However, the lower rate is a very imperfect offset. While some corporations pay a lot of tax, some are able to use tax breaks to significantly reduce their effective corporate tax rate.

The ideal adjustment for corporate double taxation — at least from the economist's perspective — would be to "integrate" the individual and corporate taxes. In other words, corporate income would be allocated to shareholders and taxed at individual rates. For technical reasons, however, this is much easier said than done.

While double taxation is a plausible rationale for tax breaks on corporate capital gains and dividends, the lower tax rate also applies to many non-corporate capital gains. This is harder to justify. Proponents support capital gains tax breaks for several reasons: (1) a significant portion of capital gains simply represents inflation and we shouldn't tax that; (2) a lower tax rate on capital gains encourages risk-taking and entrepreneurship; and (3) high capital gains tax rates create an inefficient "lock-in effect."

None of these arguments is compelling. While a significant fraction of capital gains represents inflation, that is also true of other forms of capital income and expense. For example, at a 3 percent inflation rate, the first $3 of interest on a $100 savings account simply offsets inflation, but it is taxable nonetheless. Interest expense is also overstated when there is inflation for the same reason. If capital gains are taxed at lower rates, then interest expense should also be deductible at lower rates. Otherwise, there are large incentives for tax sheltering. (See box.)

The Simplest Tax Shelter

- Borrow $10 million at 5% interest
- Invest $10 million that will pay $10,500,000 in a year
- Borrowing generates $500,000 interest deduction. At a 35% tax rate, that reduces your federal income tax by $175,000. (There may also be state tax benefits.)
- The $500,000 capital gain is taxed at 15%. That adds $75,000 to your tax bill.
- On net, you save $100,000.
- Because of the tax savings, this deal would be worthwhile even if the investment paid less than $500,000 (even though, absent taxes, it would make no sense)

Note: this scheme is so obvious that it is not permitted. However, a whole industry is devoted to finding economically equivalent tax shelters.

"A tax shelter is a deal done by very smart people that, absent tax considerations, would be very stupid."
-- Michael Graetz, Columbia University Law Professor

Capital gains taxes have mixed effects on risk-taking. To the extent that losses are ultimately deductible (and my research with Alan Auerbach and Jonathan Siegel found that they almost always were), the capital gains tax includes the kind of insurance feature discussed earlier. Investors have to share gains with the government, but losses are also shared. Moreover, economist James Poterba has found that much of the capital that finances new investment comes from foreigners and pension funds and is thus not subject to capital gains taxes and unaffected by capital gains tax breaks. Moreover, the reckless behavior that led to the financial meltdown raises the question of whether damping risk-taking would necessarily be a bad thing.

One other area of concern is the effect of the tax on entrepreneurial activity. In fact, the income tax treats investments of “sweat equity" very favorably. Entrepreneurs do not have to pay tax on the value of their labor until it produces income. Effectively, investments in one’s own business are expensed in the sense that tax is avoided altogether on the value of the uncompensated labor invested. Like an IRA or 401(k), this makes entrepreneurial capital tax-free. To the extent that entrepreneurial capital ultimately produces returns in the form of capital gains, entrepreneurs effectively pay a negative tax rate on their own labor input because the contributed labor is expensed while the ultimate return is only partially taxed. And capital gains that are classified “small business” might even be taxed at a zero rate.

There is one special case where this extremely favorable tax treatment seems especially problematic: hedge fund managers and private equity investors who have a “carried interest” in a business deal. These transactions have gotten a lot of attention because the people who engage in them are ultimately taxed at low capital gains tax rates, often on enormous incomes. They argue, with some justification, that their tax treatment is the same as other entrepreneurs (although they should be taxable on the value of the “carried interest” when it is granted them at the outset of the deal). But it offends taxpayers’ sense of fairness that multi-millionaires can often earn giant incomes and pay the same tax rates as lower-income working people.

Treating carried interest like other wage and salary income is one approach to diminishing this inequity, but a better and more consistent one would be to tax all capital gains the same as other income.

Another argument made in favor of lower capital gains tax rates is that taxing capital gains produces a “lock-in effect” because a capital gains tax discourages asset selling. Investors can postpone the tax indefinitely simply by holding. However, my research with William Randolph and the research of other scholars has found that the “lock-in effect" is surprisingly small. This may seem surprising, but one admittedly casual bit of evidence in favor of a small effect may be found on the pages of any financial publication. Not the editorial page, which might rail endlessly against the incentives created by capital gains taxation, but the finance and investing section, which often reports financial strategies that involve much buying and selling with little if any discussion of the tax consequences.

The argument against providing capital gains tax breaks is that removing them could improve both efficiency and equity. Lower capital gains tax rates fuel inefficient tax shelters that entail a significant economic cost. Second, it is unfair to favor people like hedge fund managers and investors who earn a substantial portion of their income from capital gains rather than other more highly taxed forms of income. Third, the vast majority of capital gains are realized by people with very high incomes. Thus, tax breaks on capital gains undermine the progressivity of the tax system. (See Table 1.)

Table 1. Distribution of Net Long-Term Capital Gains and Qualified Dividends, 2010

Cash Income Group	% with Gains	% of Gains	Average ($)	% with Dividends	% of Dividends	Average ($)
Lowest Quintile	1.0	0.3	4,008	5.2	1.2	1,013
Second Quintile	1.9	0.5	4,178	8.5	2.9	1,525
Middle Quintile	3.9	1.3	5,493	13.3	4.9	1,843
Fourth Quintile	7.6	3.0	7,792	23.2	8.8	2,283
Top Quintile	21.3	94.1	100,623	48.7	81.6	11,511
All	5.9	100.0	56,690	17.1	100.0	5,923
Addendum						
80-90	14.5	5.1	15,896	38.1	9.9	3,513
90-95	21.0	3.9	17,392	47.8	7.0	4,165
95-99	32.0	15.6	55,460	67.9	18.8	9,460
Top 1 Percent	47.6	69.5	646,110	82.8	46.0	74,281
Top 0.1 Percent	63.9	46.6	3,225,323	90.0	26.8	397,067

Source: Tax Policy Center, http://www.taxpolicycenter.org/T09-0490

Equating the tax rate on capital gains with the tax rate on other income would allow a high degree of progressivity with lower top income tax rates. Indeed, that was what made the 28 percent tax rate on top income possible in the Tax Reform Act of 1986. The Simpson-Bowles and Bipartisan Policy Center's deficit reduction plans both paired full taxation of capital gains with a substantial cut in top income tax rates, while maintaining progressivity.

Failing such a sweeping reform, if a tax break for capital gains is retained, it would make sense to limit it to corporate stock (to address double taxation).

3. Tax Rates on Dividends

Additional issues surround the taxation of dividends. The economists' ideal solution to the problem of double taxation remains the same: imputation of the corporate tax to individuals. That, however, does not appear to be constructive advice for policymakers in the real world.

A recent paper by economists Raj Chetty and Emmanuel Saez suggested cutting the dividend tax rate in exchange for raising taxes on corporations. The logic was that this would enhance economic efficiency because it would reduce or eliminate the incentive corporate managers currently have to invest retained earnings in unproductive pet projects rather than pay dividends.

Of course, just as under the individual income tax, raising corporate tax rates amplifies the incentive to engage in tax sheltering. This can be especially damaging to our economy when corporations operate in an international environment. For that reason, Rosanne Althshuler, Benjamin Harris, and Eric Toder of the Tax Policy Center suggested almost exactly the opposite approach: Tax gains in full (up to 28%) and dividends as ordinary income and use the revenue gained to lower corporate rates. This would allow for a substantial cut in corporate tax rates and, they argue, would be a progressive change, especially if much of the corporate tax is ultimately borne by workers in the form of lower wages. That strategy could be especially effective if paired with a significant corporate tax reform aimed a closing loopholes and further rate reduction.

4. Tax Treatment of Lower-Income Families

Although not explicitly the subject of this hearing, the tax treatment of low-income families is relevant. The economic discussion of optimal taxation generally concludes that raising the after-tax incomes of low-income families is socially desirable if the costs in terms of incentive effects are not too great. However, some commentators and at least one presidential candidate have expressed alarm about the nearly 50 percent of families that do not pay income tax, so I am uncertain about whether helping low-income working families and retirees is universally accepted as a policy objective.

A couple of observations: First, many of these people are retirees and most of the rest are low-income working families, many of whom receive refundable tax credits. The people who get back more than they pay in taxes all work. It is a requirement for claiming the credits. While they might be exempt from the income tax, they pay payroll taxes. (Payroll taxes are bigger than income taxes for most workers.) As I noted above, encouraging low-income people to work reduces the distortions created by the income tax. In addition, connection to the labor force is important for building job skills (human capital) as well as maintaining personal dignity. And from my perspective making it possible for low-income working families to support themselves despite paltry wages seems only humane.

Moreover, most of us receive more from government than we pay for. That's a consequence of the skewed income distribution and progressive tax rates. How much is a robust national defense, research on life saving medicines and basic science, national highways and parks, food safety, air traffic control, the legal system, etc., worth? The only difference between us and the low-income "lucky duckies" (so called by the Wall Street Journal) is that only some of our benefits are claimed on income tax returns. Many are supplied by traditional government programs.

And then, of course, since we have the option to work in low-wage jobs to avoid tax, but the "lucky duckies" don't have the option to be senators, college professors, or lobbyists, it's clear to me who the real lucky duckies are. It's us.

However, it is potentially problematic if half of Americans think that government is free. One solution might be to clarify the division between tax obligations and government programs, which are currently commingled on income tax returns. Every year, the IRS could send taxpayers a statement letting them know what they paid in income and payroll tax before subsidies (tax expenditures) as well as the value of those tax subsidies. This would make a few things clear. People might discover that they pay much more in tax than they think, although they get a portion of it back after jumping through the hoops required to claim exclusions, deductions, and credits. Some might decide that they'd rather pay less tax and jump through fewer hoops. (That is, tax reform might become a more attractive option.)

Some might be surprised to see how little they benefit from tax breaks. For example, some homeowners are thrilled that they get to deduct their mortgage interest, charity, and taxes, but many have total deductions not much bigger than the standard deduction. Their mortgage interest is only a benefit to the extent that it (plus the other itemized deductions) exceeds the standard deduction. If that excess is only a few hundred dollars and they're in the 10 or 15% bracket, they might not save enough money to pay for a nice dinner out.

And some people might notice that the IRS is not just in the tax collection business, but in the business of administering 200 or so extraneous public programs. A little thought might suggest that some of those programs are not worth the cost and some others might be better run through traditional agencies that can better administer them.

5. Political Economy of Tax Rates

As I noted earlier, most economists think that the best way to meet revenue and distributional targets is with a broad-based income tax with relatively low rates—the kind of thing accomplished in 1986. However, many high-income people would prefer the current system—narrow base and low rates—which creates an impediment to reform. Returning to the Clinton-era tax rates could make high-income people more interested in tax reform. Trading narrow base, high rates, for broad base, low rates, then might become an attractive deal.

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