<u>Tax Reform: The Growth Imperative</u>

Testimony

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Michael J. Boskin

Tully M. Friedman Professor of Economics

and Hoover Institution Senior Fellow,

Stanford University

Chairman Hatch, Ranking Member Wyden, and other distinguished members of the Committee, it is a pleasure to renew my long-standing association with the Senate Finance Committee, which dates back several decades, to the Chairmanship of Senator Long. I've worked with the Committee on issues ranging from the Tax Reform Act of 1986 to improving the nation's measures of inflation and indexing government programs. I recall the pivotal role Senators Packwood and Bradley, and Roth and Moynahan, played in those times. I know that both of you and other members of the Committee have already given much time and effort to tax reform issues. So I will keep my response brief, highlighting a few key issues. I ask that my full written testimony be entered in the record.

I. **Introduction**

Views of what constitutes the “best” tax system date almost from the dawn of political philosophy. The suggested ways to balance concerns with economic efficiency, equity, administrative simplicity and reliability have evolved considerably since the 18th century when Adam Smith enunciated these Four Canons of Taxation and Colbert famously quipped that “the art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing”. But modern research and teaching on taxation issues still emphasizes efficiency and equity and their tradeoffs. How and how much do various taxes affect economic growth, resource allocation, the distribution of well-being and revenue?

Before turning to that subject, let me emphasize the likely large payoff to a better tax system. There is a tremendous opportunity to improve the federal system of corporate and personal income taxation in a manner that will significantly boost economic growth. To be sure, regulation, trade, education, training, immigration and monetary policies can also promote or hinder growth, but tax and spending—and therefore debt—policy reforms are likely to be the most potent.

When the government collects taxes to finance spending, it distorts the allocation of resources. The tax will affect private decisions. Our income taxes doubly (even triply) tax some types of saving and thus distorts the incentive to consume versus save or, alternatively, to consume in the present versus the future, e.g. at retirement. Both income and payroll taxes distort the incentive to work, etc.

The severity of these distortions depends on two things: first, the size of the "tax wedge". How high is the real effective marginal tax rate that drives a wedge between the before and after tax prices paid and received by economic agents? For example, between the before-tax return to investment and the after-tax return to saving; between the wages paid by employers and those received by workers, and so on. Second, how sensitive, or, using economists' jargon, elastic, is the activity to changes in tax rates? Numerous studies, including my own, show that some activities are quite sensitive to tax rates, for example, the realization of capital gains and the labor supply of second earners in families, whereas others, for example tobacco consumption, are much less sensitive. The combination of the size of the wedge and the sensitivity of the activity to it determines the severity of the tax distortion.

The burden that these tax distortions impose on the economy goes up with the *square* of marginal tax rates. Doubling the tax rate quadruples the inefficiency or waste or harm done by the tax distortion. *Thus, high marginal tax rates are very bad for the economy.* This is not a doctrinal issue. It has to do with the area under supply and demand curvdes. When the cost of these distortons is included, the cost to the economy of each additional tax dollar is about $1.30 or $1.40. Thus, a key to the quality of the tax system – how badly it distorts the economy, hinders growth, misallocates resources – is the level of *effective* marginal tax rates*. The lower the effective marginal tax rates, the smaller the distortion of private decisions.*

The tax dollar (which costs the economy $1.30 or so per dollar raised) is put into a bucket. Some of it leaks out in overhead, waste, and so on. (That is also true in the private sector, although competition tends to reduce such inefficiency.) In a well-managed government program, the government may spend $.90 of that dollar on achieving its goals. Inefficient programs would be much lower, e.g. $.40 on the dollar. Thus, another key to an efficient tax system is <u>effective spending</u> that both fulfills important societal needs and keeps the revenue needed to the minimum necessary.

The effective tax rates on private activity can be quite different from statutory rates because they interact with the tax base and can cascade across several taxes and levels of government. For example, state and local income taxes and may add to the distortions caused by the federal income tax. Clearly, the broader the tax base, the lower the rates to raise any given amount of revenue. Hence, most economists agree that *broad bases and low rates are hallmarks of a good tax system*. Narrow bases and high rates do much more harm.

II. Five Big-Picture Tests for Tax Reform

I have five big-picture standards or tests that I apply to tax reform proposals. I will focus primarily on the first, economic performance, particularly economic growth, not only because that is the subject of this hearing, but also because it is growth that makes everythng else possible: rising living standards, revenue to fund government programs, etc.

1. *Will tax reform improve the performance of the economy?*

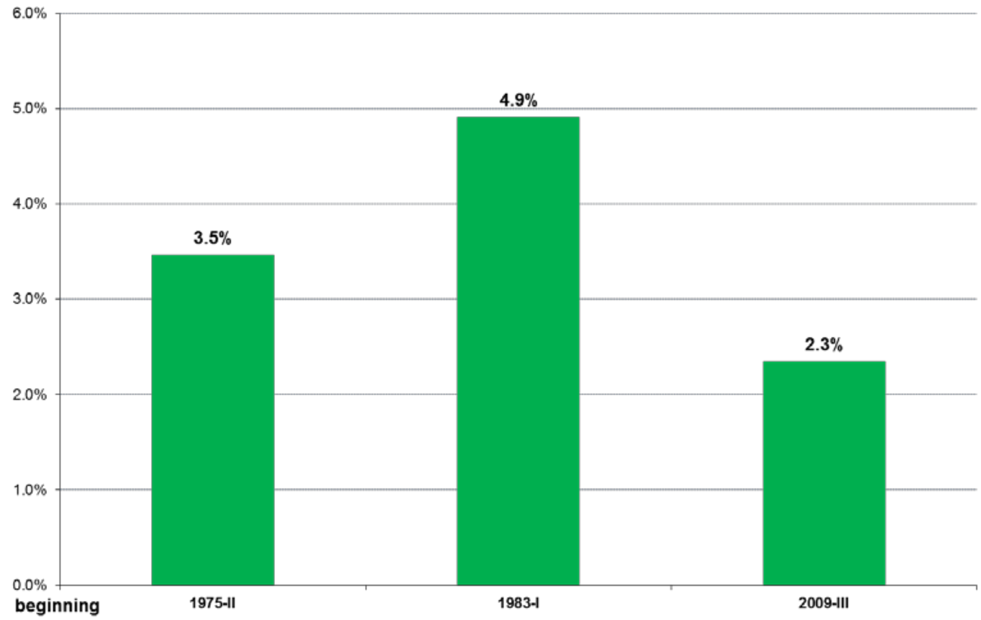
By far the most important aspect of economic performance is the rate of economic growth, because that growth determines future living standards. The economy's potential output grows at roughly the rate of productivity growth plus the rate of labor force growth. It is well known that the current economic recovery has been anemic relative to previous recoveries from deep recessions (Figure 1). We should have been growing at 4%, not the barely over 2% of the past five and a half years. And we should not settle for the anemic growth projections currently being made, e.g 2.1% long-run growth by CBO. The nation's top economic priority must be to strengthen productivity, labor force participation, and skills, and to slow the increase in the ratio of retirees to workers.

The most important way the tax system affects long-run economic growth is through the rates of saving, investment, entrepreneurship, work (see Figure 2) and human capital investment. Business investment has been especially lagging in recent years. These heavily influence productivity, output per worker, the prime determinant of wages on average over time. Productivity has been very weak in recent years (Figure 3), and economists are debating whether this is from a drying up of fundamental productivity-enhancing innovation, just cyclical weakness, or "secular stagnation".

Modern academic public economics concludes that heavy capital income taxation at the corporate and/or personal level substantially harms capital formation and growth.. This is why most prominent academic economists who have studied the issue recommend taxing consumption, or that part of income which is consumed. Such a tax, in its pure form (and all real world taxes are compromises in this regard) is neutral between saving and consumption (intertemporal neutrality) and also among types of investment (atemporal neutrality). Think of intertemporal neutrality as a level playing field goalpost to goalpost and atemporal neutrality as level sideline to sideline. Even a perfect income tax (which would require accurately measuring true economic depreciation and inflation adjustment, among other issues) would only achieve atemporal neutrality, not the far more important intertemporal neutrality. A pure consumption tax, however levied, would guarantee both. A growing body of research suggests that reforming the corporate and personal income taxes into consumption taxes levied at the lowest possible tax rates is the most potent policy reform available to boost growth[1].

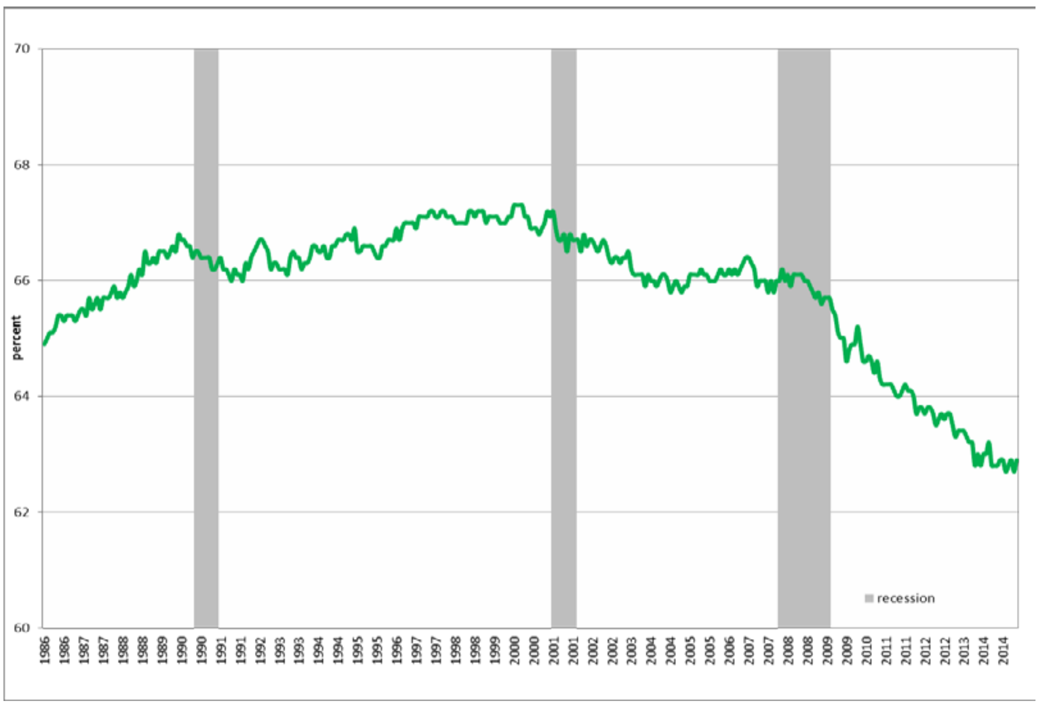
[1] In chronological order to see the development of ideas, see Boskin (1978), Summers (1981), Lucas (1990 and 2003), Prescott (2002).

Figure 1. Average U.S. Real GDP Growth First 22 Full Quarters after Severe Recession Trough



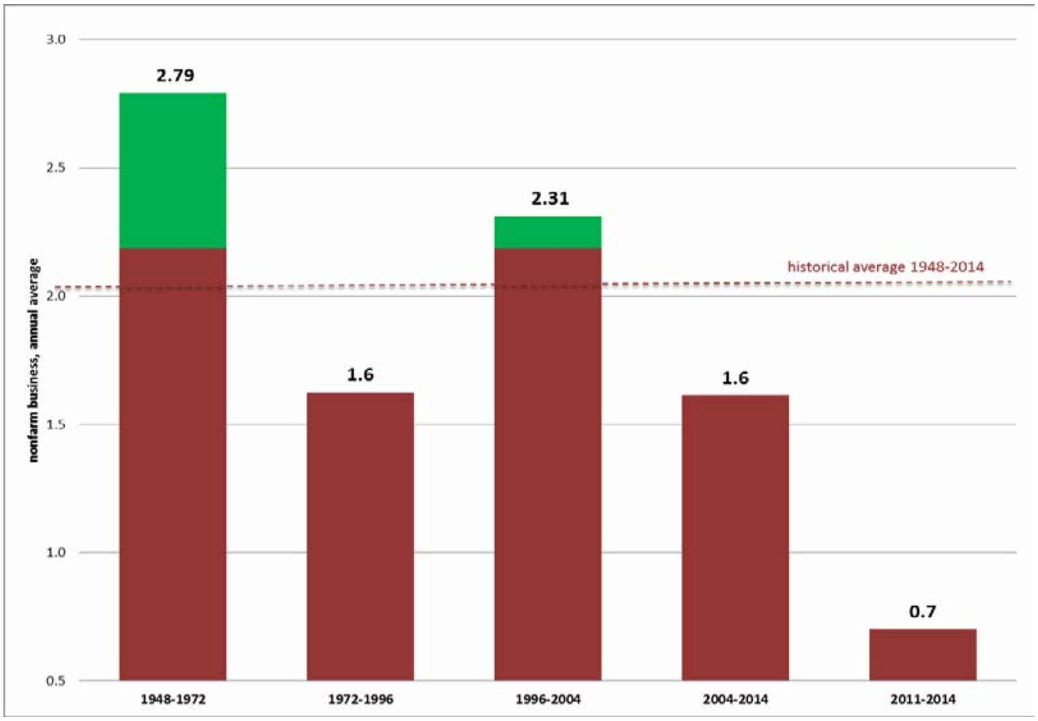
Source: BEA

Figure 2. Civilian Labor Force Participation Rate



Source: BLS

Figure 3. Are Technology-Enhancing Productivity Gains Weakening?



Source: BLS

Nobel laureate Professor Robert Lucas, in his research and 2002 Presidential address to the American Economic Association, concludes that removing the tax distortions to saving and investment and lowering marginal tax rates are by far the most important avenue for improving economic well-being of any potential public policy reform. Indeed, a pure consumption tax at historical tax levels would add 7½%- 15% to income per year, mostly in higher wages. That's the better part of a decade of gains in per capita incomes.

The U.S. national saving and investment rates are low, in part because the current tax system, on balance, is biased against them. Redressing that imbalance is very important and should be a major component of tax reform. That is especially so, given the closely related negative side effects on saving and investment from the growth of the national debt and unfunded social insurance transfers to the elderly. On this test, low-rate consumption taxes work best, high-rate income taxes worst[2].

2. Will tax reform affect the size of government?

Tax reforms that more closely tie the payment of taxes to expenditures will promote a more effective and efficient government for the broadest population. A new tax – a broad-based consumption tax, like a European VAT, for example – may just be piled on top of the existing taxes and used to raise revenue to grow government. This is what has happened in many European countries and is a major detriment to their economic performance.

3. Will a new tax structure affect federalism?

Tax reforms can affect the federal system in many ways. Some types of federal tax reforms would implement taxes heavily relied on by state and local government, e.g. retail sales taxes (or VAT). We should favor those that strengthen federalism and devolve authority and resources to state and local government rather than agglomerate them at the federal level.

4. Will a new tax structure likely endure?

[2] The broader the tax base, the lower the rate or rates. But deductions and/or credits are theoretically desirable under some circumstances in an optimal tax system. See Stiglitz and Boskin (1977) and Feldstein (1980).

We have had over 20 pieces of major tax legislation since I first met with this Committee, more than one every Congress. I have advised on many of them. We should be concerned that we might move to a better tax system only to undo it shortly thereafter. In 1986, the trade-off was lower rates for a broader base. That was slightly undone in 1990, substantially so in 1993; then rates were reduced, then raised and raised again, especially at the top and on capital income. Simultaneously the base, on balance, has eroded. A more stable tax system would reduce uncertainty and complexity and, cet. par., increase investment and growth.

Estimates of the annual compliance burden range into the many billions of dollars, including the (many frustrating) hours devoted to that task. The tax system is clearly too complex. If a new tax, even one deemed administratively simple itself, were added without removing the income taxes, large additional administrative and compliance costs would result. Remarkably, the system of voluntary compliance yields a very high percentage of income tax liabilities actually due, especially when viewed relative to other countries. That speaks well of Americans' basic values. But there is episodic concern, for example in Treasury, that the system of voluntary compliance will be decreasingly effective over time and the nation will be driven to transactions taxes unless a simpler tax system replaces the current complex income tax system.

5. Over time, will tax reform contribute to a prosperous, stable democracy?

Will tax reform alter the number of people on the income tax rolls? Or the number receiving income from government? Or alter the ability of the economy to promote upward economic mobility? We now have a higher ratio of people who are net income recipients to people who are net taxpayers – many are both income taxpayers and benefit recipients -- than at any time in recent history. That reflects several causes. First, the harm to many from the deep recession and the government's response to it; second, changes in the distribution of income, due primarily to technology and globalization in recent decades; third, the growth of traditional transfer payments, and the EITC and other features of the income tax itself. We must deal with this both on the tax side (underground economy, chary of too many off the income tax rolls) and, on the transfer payment side, especially entitlement cost growth which is is increasingly crowding out everything else in the budget.

Equity

Another important criterion of tax policy is equity, horizontal (the equal treatment of equals) and vertical (the distribution of the tax burden, or more generally, the distribution of taxes and transfers). While equity is important, efficiency and growth require that the rate(s) be as low as possible, including the top rate on the most economically productive people and small businesses, but high enough to finance the necessary functions of government. There has been a substantial increase in, and debate about, higher taxes on the "rich". Equity is certainly an important criterion for tax policy. But it is useful to remember that over the period since 1980, when most studies show more rapid gains in higher incomes, taxes became more progressive (CBO). Indeed, the U.S. has the most progressive tax system in the OECD. The top 1% of taxpayers, with 22% of income, pay 38% of income taxes, whereas almost half pay none (some pay payroll taxes and, of course, in most states, sales taxes). Most importantly, most redistribution occurs, and should occur, on the spending side of the budget. The post-tax and transfer distribution of income, is less unequal, as is the distribution of consumption, than the distribution of market income, the focus of most studies. Indeed, for many people, consumption better measures long-run average income than does current income.

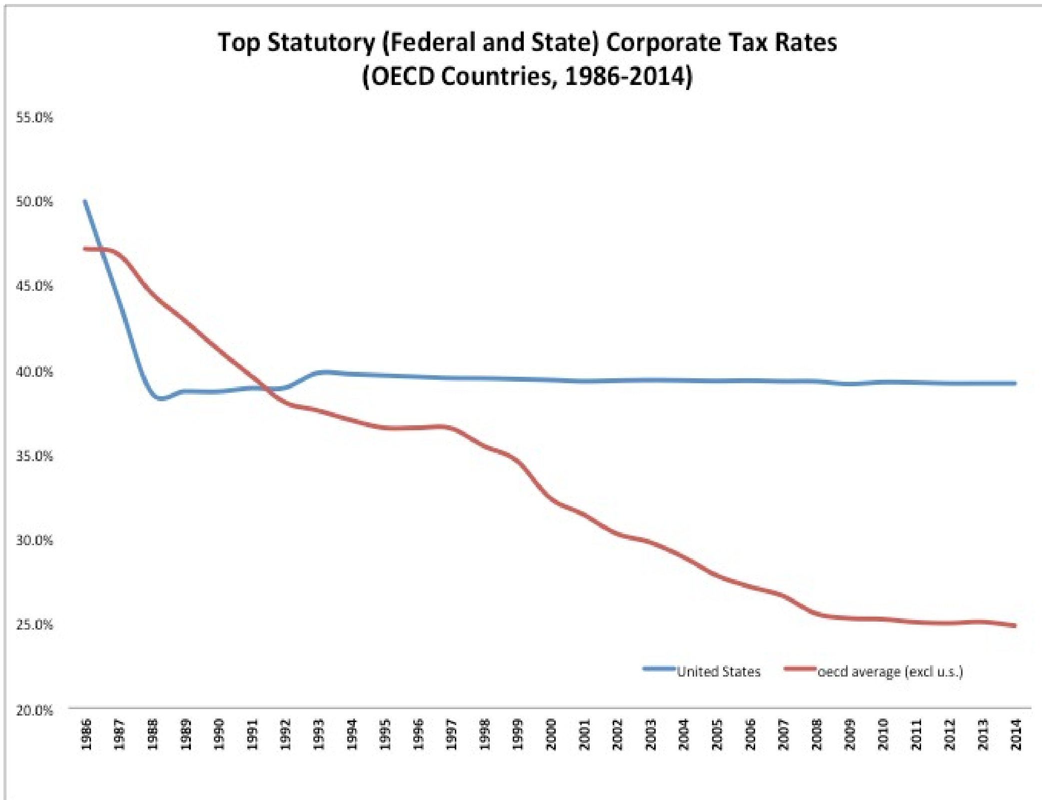
Finally, whatever one's views are about tax rates on higher incomes, it is important to understand that taxes on the rich tend also to be taxes on getting rich. And we must be careful not to create obstacles to getting ahead, which is the most basic force driving the economy.

A progressive consumed income tax can thus be designed to be far less harmful to economic growth than the current individual and corporate income taxes, while allowing subtantial flexibility in treatment of households in different circumstances.

Corporate Tax Reform

The U.S. has the highest corporate income tax rate of any advanced economy (50% higher than the OECD average (Figure 4) and

Figure 4. Top Statutory (Federal and State) Corporate Tax Rates (OECD Countries, 1986-2014)



Source: OECD database

Is one of the few that still taxes worldwide income. At the time of the 1986 reform, we were about at the OECD average. But most countries have since lowered their corporate taxes. Many major competitors, Germany and Canada among them, have reduced their corporate tax rates, rendering American companies less competitive globally, harming our companies and their workers. Of course, various credits and deductions–such as for depreciation and interest—reduce the effective corporate tax rate. Corporate income is taxed a second time at the personal level, as either dividends or capital gains, the taxes on which have been raised recently. Netting everything, including the personal taxes paid on corporate source income, our corporate source income taxation retards and misaligns investment, and these problems will only get worse as more and more capital becomes internationally mobile. We have a corporate tax better tuned to 1965 than 2015.

This complex array of taxes on corporate income produces a series of biases and distortions. The most important is the bias against capital formation, which decreases the overall level of investment and therefore future labor productivity and wages. To repeat, most of the corporate income tax is shifted onto labor, e.g. by decreased capital formation. Also important are the biases among types of investments, depending on the speed of tax vs. true economic depreciation; against corporate (vs. non-corporate) investment; and in favor of highly leveraged assets and industries. These biases assure significant impediments to overall capital formation that vary systematically. There is considerable evidence that high corporate taxes are economically dangerous. An exhaustive study by the OECD concluded that “Corporate taxes are found to be most harmful for growth, followed by personal income taxes and then consumption taxes.”

Thus virtually every major tax reform proposal in recent decades has centered on lowering tax rates and broadening the tax base, Most porposals moving toward taxing broad consumed income, and reducing the double taxation of corporate source income.. This could be accomplished by junking the separate corporate income tax, integrating it with the personal income tax (e.g. attributing corporate income and taxes to shareholders or eliminating personal taxes on corporate distributions), and/or allowing an immediate tax deduction (expensing) for investment, which cancels the tax at the margin on new investment and hence is a priority of most economists. And in the personal tax, by expanding or eliminating the limits on tax-deferred saving. The Hall-Rabushka Flat Tax, the Bradford progressive consumption tax, the Nunnn-Domenici tax, a value-added tax (VAT), the Fair Tax retail sales tax, four decades of Treasury proposals, the 2005 President's Tax Commission proposals, the Simpson-Bowles Commission proposals, Wyden-Gregg and the December 2014 Committee background paper contain in varying degrees elements moving in this direction. The tax changes of the past few years have moved in the opposite direction:higher rates on a narrower base and higher rates on capital income.

Tax reform to strengthen economic growth should therefore move toward lower rates on a broader, more consumed income base. If the reform is designed to be revenue-neutral in static estimates, the actual revenue produced by broadening the base and lowering the rates is likely to be somewhat higher, as taxable income would increase more due to faster growth and less tax avoidance than typically assumed (Feldstein). Any such "revenue dividend" relative to revenue estimates might wisely be devoted to reducing deficits and debt or additional growth promoting fiscal changes.

Reducing the corporate rate would help strengthen what is an historically anemic recovery (Figure 1) from such a deep recession. The late Arthur Okun, CEA Chair under President Johnson, concluded that the corporate tax cut was the most powerful of the Kennedy tax cuts in strengthening slow growth.

Replacing the current tax system with a revenue-neutral equivalent of the reforms mentioned above, phased in over a few years, would also strengthen the economy long-term. American workers would benefit from more jobs in the short run and higher wages in the long run.

However, if tax reform includes a new tax that is used to grow government substantially, it will seriously erode our long-run standard of living. The VAT has served that purpose in Europe and, while better than still-higher income taxes, the larger-sized governments it has enabled there are the prime reason European incomes per capita are 30% or more lower than ours. Trading a good tax reform for a much larger government is beyond foolish. No tax reform can offset losses that large. Hence, a VAT should only be on the table if it replaces other taxes and is accompanied by rigorously enforceable spending control that prevents the need for much higher taxes.

The economies of Western Europe set their taxes and government spending at about half of GDP. In the United States, the figure has averaged about one-third (including state and local government). We have demonstrated we can make that level of government in the economy consistent with solid economic growth and rising standards of living, whereas a substantially higher tax burden is much less likely to be so. The negative correlation between economic growth rates and tax burdens in the OECD countries is suggestive. (Of course, there are any other factors that influence growth rates and per capital income differentials.) Moving from U.S. levels to Western European levels might cut the growth rate by a full percentage point. Over a generation or two, that cumulates to huge differences in standards of living.

So any sensible strategic management of our economic affairs starts with preventing much higher taxes and spending. Projections of entitlement growth imply marginal tax rates on the broad middle class of 60% or more. Simply put, entitlement reform, also the purview of this Committee, is also tax reform.

Conclusion

We have a small window of opportunity to reform our tax system and strengthen economic growth before demographics drive higher entitlement spending financed by higher taxes on a dwindling fraction of the population. Witness how difficult it is for the Europeans to make reforms which we would consider quite modest, even from much higher levels of spending and taxes.

Our collective interest is in keeping the overall hand of government in the economy modest, targeted and effective, and thereby keeping tax rates as low as possible. Reforming the corporate and personal income taxes with broader bases and lower rates less inimical to economic growth should be the Committee's top priority.

If major reform of the corporate and personal income taxes proves politically infeasible and, as some assume, only modest corporate reform is possible, it is important to bear in mind the many linkages between the corporate and personal taxes and the desirability of eventually keeping the top personal rate and the corporate rate roughly equal. Most businesses are not C-corporations and their income is taxed under the individual income tax.

But if the stars align, as they eventually did in 1986, to lower rates on a broader base of both taxes, something like three individual rates with a top rate of 30% or less, as with Simpson-Bowles and some other proposals mentioned above, with simplified saving incentive features and a corporate rate roughly equal to the top personal rate, with simplified but rapid capital cost recovery and territoriality, with a broader base by limiting or capping preferences, would spur economic growth in the short and long run.

Senator Long's famous dictum, that tax reform means "Don't tax you, don't tax me, tax the fellow behind the tree," reflects the trench warfare focused on narrow issues of limiting this deduction or that credit that tax legislation engenders. So much more than that is at stake for our country. The evolution of taxes and spending will be one, perhaps the primary, determinant of whether America rekindles a successful dynamic economy providing rising standards of living, upward economic mobility, and the resources to support the disadvantaged; or whether, like Europe, it slides into complacent economic stagnation.

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